Impact Study | In association with: Fiserv

Can you afford compliance?

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Finextra | fiserv.

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01 | Introduction

Maintaining compliance for both regulatory and industry-driven standards is complex and expensive, yet fundamental to a financial institution's ability to provide payment services.

As the rate and complexity of compliance changes increase, financial institutions are constantly under pressure from regulators that are adopting agile principles designed to protect the evolving financial ecosystem. Financial institutions also have to balance the growth of modern instant payment rails, the need to support mandated overlay services, and the emergence of new and sophisticated forms of risk.

For financial institutions, there is a difficult balance in managing compliance while investing in innovative, customer-centric and competitive capabilities. Further, as the speed of transition to a digital environment increases, so do regulatory and compliance requirements.

While recognising the impact that managing and maintaining compliance has on a financial institution, an upfront assessment of applicable regulatory requirements - and integrating compliance with the overall digital strategy - allows financial institutions to minimise risk while providing a platform for building innovative business propositions. Benefits include protection from financial crime, information analysis and improvements to the customer experience – all driving growth while optimising regulatory obligations.

This impact study explores five core areas of compliance that are challenging financial institutions today, and how combatting these concerns can orient institutions for success.

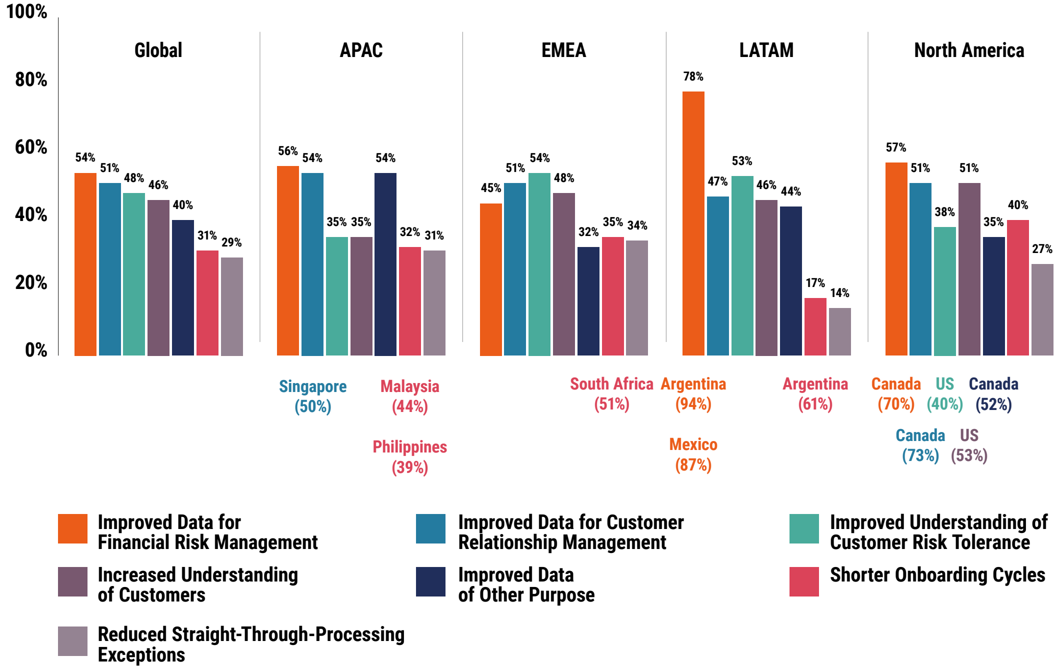
The path to compliance and managing risk varies by the maturity of payments markets, with the approach taken in emerging markets being very different from mature markets in EMEA and APAC.

In LATAM, there is a higher risk of compliance violations in the financial ecosystem, compared to any other region. This is likely a result of the complexity and lack of transparency in the supply chains prevalent in the region.

APAC, on the other hand, has a digitally advanced macroeconomic environment. Regulators focus on digital banking, given its prevalence across the region where a digital-first approach helps enhance economic development, competition, financial inclusion and technological progress. New entrants have the advantage of building compliance into their core strategies and do not have the legacy systems and processes that may hinder traditional banks as they undertake their digital transitions in a rapidly changing environment.

Nevertheless, **Deloitte** highlights that there are still challenges that these digital-first financial institutions need to address to ensure effective risk management.

Compliance benefits for the business (% ranked among top 3)



02 | Expanding regulatory oversight

The agility-motivated mindset driving the digital transformation of financial institutions is also being replicated by regulators around the globe, responding to threats and risks at a micro level, rather than at the macro level previously seen. Identifying, breaking down and solving specific regulatory concerns is shifting the focus toward ever more frequent updates rather than large, cross-regulatory changes pushed out in the past.

As fintechs expand their play in the financial ecosystem, regulators are increasing their focus on the role of fintechs, and the level of regulation they require - both directly and for financial institutions that incorporate their services. Further, as digitalisation and the extension of a financial institution's ecosystem increases, regulators are taking a two-pronged approach with sector-wide and fintech-focused regulatory measures.

The Cambridge Centre for Alternative Finance and the World Bank Group underscored this shift in a **recent study**, which found that certain challenges are emerging and causing acute difficulty for regulators. Some of these include the performance of core regulatory functions (49% cited this challenge), coordination with other domestic agencies (39% cited this challenge), access to accurate and timely data (29% cited this challenge), or restricted access to essential information (28% cited this challenge), which were naturally intensified in a post Covid-19 and increasingly digital world.

Despite these obstacles, regulators have prioritised innovation and the need to shift towards a more nimble, collaborative regulatory approach. This approach understands that with digitalisation there is a need to ensure interoperability with the wider digital ecosystem, which can bring new risks and threats that need rapid responses once identified.

There is an increasing appreciation of the value of the outreach programmes regulators have in place with the fintech industry, a recognition of how strengthening industry engagement helps to cultivate trust, gain feedback and provide guidance. In jurisdictions where this approach has been adopted, regulators commented on a higher degree of buy-in and compliance across the industry.

The increase in the agility of regulators and their focus on inclusion across the whole ecosystem allows regulations to be focused and finalised quickly, reducing risk and uncertainty. However, it also comes at a cost to financial institutions who will receive an increasing number of small compliance requirements to be implemented in shorter timelines. Where financial institutions once had long notice periods for changes and extended timelines in which to implement them, they now have to adapt to a regulatory environment driven by agile sprint cycles.

03 | Speed and complexity of compliance

Regulators are pulled in multiple directions, which can lead to conflicting priorities. Promoting competitiveness and open access while encouraging innovation can be incompatible with regulators' obligation to preserve financial stability, reduce risk and protect against outside threats.

Anti-money laundering (AML) compliance highlights the complexity that these conflicting priorities present to regulators as they attempt to reduce barriers to entry while ensuring protection and security for the financial ecosystem. This can be overwhelming for financial institutions, with many struggling to manage the complexity of international and overlapping regulations.

This complexity is highlighted by research from **LexisNexis Risk Solutions**, which shows that 87% of AML compliance professionals believe regulators should provide better guidance on how to make AML programmes more effective. It comes at a time when the industry is already showing signs of difficulty in complying with current regulation; the sector is on average 60% of the way through the Fifth Money Laundering Directive (5MLD) that came into force in January 2020.

The Thomson Reuters **2020 Cost of Compliance** survey states that keeping up with regulatory change was a top compliance issue. It also notes that firms, which previously took a simple tick-box approach to culture or conduct-risk, are likely to be vulnerable to risky behaviour and the associated poor customer outcomes as the ramifications of COVID-19 play out.

Global and regional banks with operations that straddle multiple jurisdictions need to have built-in, robust, and comprehensive strategies for external risk, as the pressure to open their systems has the perverse effect of increasing competition while also increasing fraud or cybersecurity regulatory obligations. The rise of fintech and regtech services providing robust solutions for addressing IT failures requires a minimum threshold of digital capability, and not every financial institution's digital transformation is sufficiently developed to take advantage of these services.

The UK Treasury Committee **wrote** about this hurdle in 2019, stating that organisations are not doing enough to mitigate the operational risks they face from their own legacy technology, which can often lead to IT incidents. The Committee further reasoned that regulators must therefore ensure that firms cannot use the cost or difficulty of upgrades as excuses to not make vital upgrades to legacy systems: "Given the potential for short-sightedness by management teams, if improvements in firms' management of legacy systems are not forthcoming, the regulators must intervene to ensure that firms are not exposing customers to risks due to legacy IT systems."

Conversely, when financial institutions do embrace new technology, the Committee cautioned that poor management of such change is one of the primary causes of IT failures. As time and cost pressures may cause firms to cut corners when implementing programmes to digitally transform, regulators will adopt a proactive approach to ensure that customers are protected.

The greatest compliance challenge(s) I expect to face in 2020 is/are...

Source: Thomson Reuters Regulatory Intelligence – Cost of Compliance: New decade, new challenges, by Susannah Hammond and Mike Cowan

04 | Mitigating financial crime and fraud

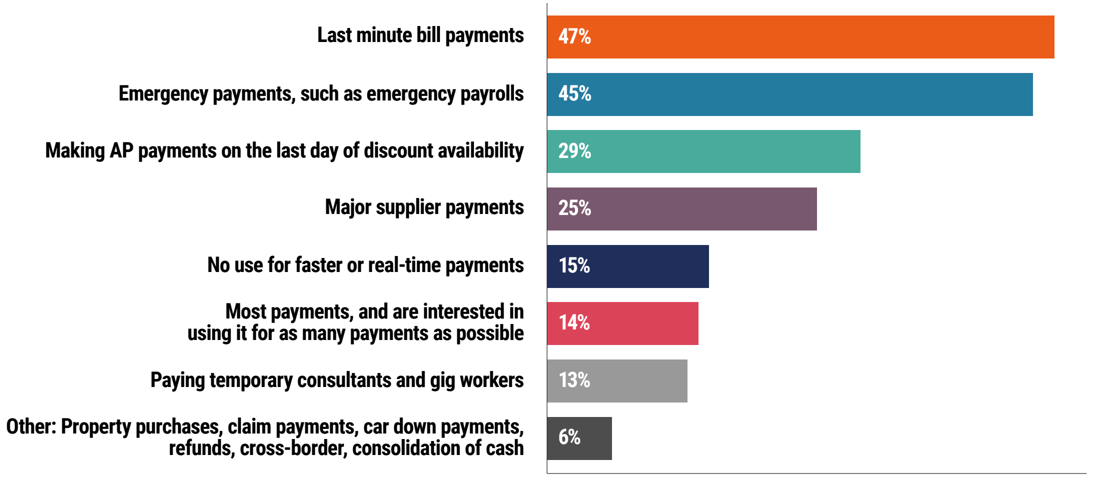
With the transition to modern, instant payment networks, the volume and the amount of data that is transferred is rapidly increasing, and regulators are expanding access to this data outside of financial institutions. Financial institutions are naturally looking at how they can capitalise on the opportunity that the new 'data economy' presents and how to remain compliant as data regulation rapidly evolves.

Instant payment schemes are developing quickly across the globe, driven by the desire to reduce cash payments and the need to implement risk-mitigating payment flows. The underlying benefits of instant payments, combined with open access to accounts and overlay services, is also driving a convergence of payment types, including traditional cards, cheques and ACH onto instant platforms, significantly increasing the volume of transactions whilst reducing the time for compliance checks.

Further, consumer and business adoption is a key driver of instant payments growth. They use solutions provided by financial institutions and leverage payment rails and market infrastructures such as The Clearing House RTP in the U.S., which has access to over 70% of deposit accounts. Consumers and businesses are also more frequently using payment overlay services that sit on top of traditional rails and provide the consumer with an instant experience, despite lacking some key benefits.

Deloitte's recent report highlights this trend, stating that "we are witnessing incumbent payment networks adding incremental features, fintechs launching customer-facing apps, and new real-time payment rails being conceptualised and developed to address the projected volume and demand for real-time payments in the next five to 10 years."

Real-time payments use cases
(based on percentage of organizations surveyed, prepandemic)



Source: 2019 AFP Electronic Payments Survey Report

Basing new instant payment schemes on ISO 20022 does not in and of itself allow interoperability, and will become an ever-increasing concern in cross-border interactions in those countries where there is more than one instant market infrastructure. While it helps build interoperability (seen in the agreement in the US between the Federal Reserve and The Clearing House to collaborate on message standards), there are still major interoperability issues to resolve around process flows, settlement, timing and governance.

Finality of transactions, both in terms of user and, increasingly, in terms of inter-bank transactions, is a core benefit of instant payments. This is critical to both the services being built around the payment systems, and the stability of the financial markets as we see ever-increasing volumes and transaction limits.

However, this certainty raises concerns over financial crime, especially when the transaction (and therefore the compliance checks), need to have been completed within hundredths of a second to meet the instant timeframes. Ensuring that a transaction has been initiated and authorised correctly, and is delivered to the intended beneficiary, is driving the development of overlay services, each of which adds a new level of compliance complexity to payment flows.

Instant payments, along with Open Banking and ISO 20022, are seen as the pillars of innovation. However, they present regulators and financial institutions with the challenge of staying ahead, both in terms of understanding risk and protection against threats. Coordination and common understanding across potentially competing parties are key in this fast moving environment, where new compliance requirements need interpretation in terms of both scope and, more importantly, impact.

The approach taken to compliance can be a significant differentiator to those organisations that understand that it is more than a cost; it can provide a platform for value propositions and increased customer satisfaction.

05 | Taking a strategic approach to compliance

To financial institutions, compliance is usually handled as an operational cost, which frequently means that the approach is to perform the necessary changes in a cost-efficient manner. This ensures that there is IT budget available to improve the services, enhance the customer experience and adapt to competition.

However, financial institutions that incorporate compliance into their strategy can take a longer-term view, ensuring it becomes an enabler rather than a cost centre. While the initial costs of this approach may initially be higher than undertaking the minimum changes to remain compliant, the longer-term benefit of the services provided, the enhancement of value propositions and the increase in competitive advantage over those taking the short-term view far outweigh the initial cost differences. Financial institutions having a strategic view that incorporates compliance as an element, usually see a reduction in the on-going compliance costs, complexity and risk.

06 | Looking forward: getting compliance right

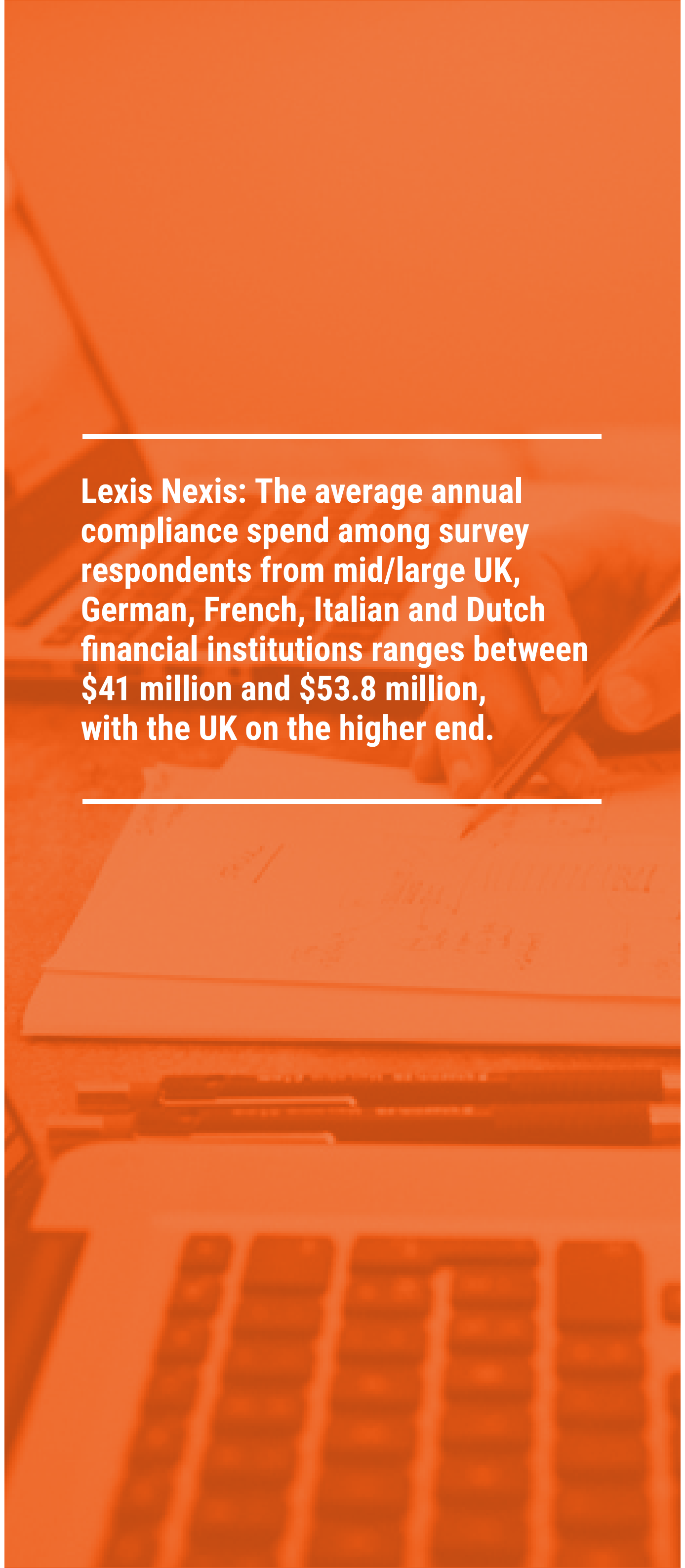
Compliance is complex and open to interpretation, even in Europe where a regulation should be ‘copied and pasted’ into domestic legislation as is. Trying to understand the underlying rationale and risk that the compliance change is tackling requires significant work - from a business, IT and increasingly, a legal perspective.

Even from what appears to be simple message format updates, a great deal of investigation and discussion is needed concerning the content required for the new or changed fields. Once understood, how to collect and validate the additional data usually extends the compliance project across multiple departments within a financial institution.

This explains the high cost for compliance. According to **Lexis Nexis**, the cost of remaining compliant with financial crime regulation varies across the world. However, it is highest in the UK and Europe, being on average three times greater than in North America and APAC, and up to seven times higher than in LATAM.

According to LexisNexis, the average annual compliance spend among survey respondents from mid/large UK, German, French, Italian and Dutch financial institutions ranges between $41 million and $53.8 million, with the UK on the higher end.

The cost of compliance, therefore, has a material impact on the budget that a financial institution has available to spend on improvements to its service, expanding its market, reacting to competition, improving customer experience, and growing its revenue.



Lexis Nexis: The average annual compliance spend among survey respondents from mid/large UK, German, French, Italian and Dutch financial institutions ranges between $41 million and $53.8 million, with the UK on the higher end.

With the ever-increasing number and frequency of regulatory and standards compliance updates, it is becoming imperative for financial institutions to incorporate compliance into their strategies. Working with strategic partners who provide regular compliance updates reduces the overall cost of the update as costs are spread across their financial institution clients, and more importantly, can significantly reduce the complexity and risk. Successful solution providers bring together a wide cross section of financial institutions affected by the compliance change and the instigator of the changes, helping to reach an understanding and consensus on the desired outcome and, therefore, the best approach. Extending this to both Banking as a Service (BaaS) and Payment as a Service (PaaS) solutions ensures that compliance updates become just a service change.

Adopting a partnership approach to compliance helps to reduce the risks, complexity and costs, allowing financial institutions to focus on their core business and customers.

07 | Conclusion

Financial institutions across the globe need new ways to manage their compliance regimes to navigate increasingly complex regulatory obligations and improve overall business efficiency.

Understanding the rapidly evolving payments ecosystems, the impact of instant payments and the drive to open the financial market to wider competition is core to financial institutions remaining competitive, ensuring a safe environment for their customers and helping to provide value from their payments operations. Accepting that this cannot be achieved in isolation is critical; working with experienced solution partners ensures that risks, complexity and costs can be shared in a non-competitive environment.

Financial institutions must recognise that compliance has never been more tightly aligned with their fundamental business model, and in order to succeed as a financial institution, compliance should be a key element of their strategy.

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