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Why North American banks need RegTech solutions

Q&A with Alex Ford and Jo Ann Barefoot

RegTechs make up a broad category of compliance-related financial technologies. For banking, a highly regulated industry, RegTechs have become a central feature in digital transformation efforts.

Bank compliance teams value the speed, accuracy and control that RegTech digitization provides. Banking executives, meanwhile, enjoy the efficiency and scalability that is delivered as a result. But many believe that RegTechs have yet to reach their full potential.

To discuss why banks need RegTech solutions, Encompass interviewed Jo Ann Barefoot (CEO & co-founder, Alliance for Innovative Regulation) and **Alex Ford** (President, North America, Encompass) to review the state of the RegTech-bank relationship, and the challenges and opportunities that remain ahead.

What is the current state of the RegTech-bank relationship? How do you see it evolving?

Alex Ford

The RegTech-bank relationship has matured over the last five years. Banks are now much more open to adopting RegTech solutions as they have been shown to significantly help in response to evolving regulations and as a way to improve operational efficiency. Banks wanting to move beyond a manual, spreadsheet-based response are now actively leveraging technologies like automation, AI and other RegTech offerings to give them an edge.

Naturally, integrating new RegTech solutions isn't without some hesitation. Banks are wary to introduce technology that is still gaining precedence into an established compliance process. But as banks get more comfortable, RegTechs will be able to better prove their worth — creating case studies and success stories alongside better methods of evaluating their relationship and engagements.

Jo Ann Barefoot

The relationship between RegTechs and banks is reaching an inflection point where the ability for banks to work with RegTechs is accelerating. There's a logical link between RegTechs and banks: banks need better tools and RegTechs are building them.

As more digitally-native RegTech tools have begun to emerge, they've replaced older analogue tools that have proven to be less powerful and more cumbersome. Despite headwinds on adoption, uptake is now accelerating. This will be proven out as banks evolve to the point of using suites of RegTech solutions that will be able to improve a bank's compliance and regulatory performance.

What are the biggest regulatory and operational challenges facing financial institutions? How are RegTech solutions addressing those challenges?

Alex

On the regulatory side, the biggest challenge includes the complexities involved in keeping up with an ever-changing regulatory landscape. This includes adjusting for regulatory changes and differences that exist between jurisdictions in which a global bank might operate. For example, keeping track of regulatory changes internationally, understanding the implications of those changes, and adjusting accordingly can be difficult to execute seamlessly. The macroeconomic climate – from the implications of the Russia-Ukraine conflict, inflation and post-pandemic recovery – have contributed to an increasing number of regulatory changes, making compliance more difficult.

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On the operations side, in light of sanctions and regulatory activity, the challenge remains how do banks respond. For example, For example, how do banks identify new sanction and ensure they adequately review ownership structures and associations of entities across their book of business globally? This becomes particularly challenging when training, hiring, possible restructuring and other updates to the operating model are required to adjust in response.

RegTechs can help address these challenges in a lot of different ways: from monitoring for regulatory changes; verification technology that can adjust a bank's Know Your Customer (KYC) process in light of more stringent regulations; RegTechs that support reporting and data compliance management when auditing is required; to RegTechs that enhance risk and regulatory analysis.

Jo Ann

There are several categories of regulatory challenges facing financial institutions. Anti-money laundering (AML) is one of the biggest in terms of the cost and the risk involved. There are also challenges unique to lending and in the implementation of modernized underwriting tools that use new types of data and AI and analyze risk. In addition, there are tremendous challenges in the area of regulatory reporting. But more broadly, it's the proliferation of regulatory and operational requirements that pose the biggest challenge to financial institutions. What is required of financial institutions is becoming more complex; the products that are required are becoming more complex; and managing all of these challenges from an operational standpoint is full of rising risk and cost.

There are also enormous challenges when converting from systems that are old to systems that are new. Most financial institutions are still using on-premise, centralized IT systems that will eventually be replaced by cloud computing environments. These environments are by nature more efficient, more effective and more secure. But making the shift to cloud will require new technology, different kinds of personnel and an operating system that has the ability to connect through APIs. This transition will require money and new types of skills, and it will introduce risk that will need to be managed extremely well.

RegTech solutions are the answer to many of these challenges. RegTechs help deliver next generation, digitally-native technologies alongside rich and timely datasets that can be brought together and work interoperably. This is a departure from traditional systems that leave data stranded in vertical silos where they're not easy to access. RegTechs help breakdown these silos, turning them 90-degrees to a horizontal platform architecture that stretches across the compliance lifecycle.

Where can RegTech solutions most impact a bank's compliance operations in the short-term? Where do you see RegTech's long-term impact?

Alex

RegTechs can provide a significant short-term impact to a bank's compliance operations, especially in situations where the incumbent solution(s) requires manual processing. Wherever technology, digitization and automation can effectively supplant human effort, you're going to see a big impact. In a regulatory environment, this takes different forms, from digitizing regulatory monitoring or KYC verification, to reporting, risk analysis, and more.

Long term, RegTechs are likely to have a deeper, more entrenched impact. That is, RegTechs will be able to move the outcomes of bank compliance efforts closer to the intention of the regulator. In the fullness of time, instead of box ticking, bank compliance teams that implement RegTech solutions correctly will be able to more effectively meet regulatory requirements with greater transparency. In the example of financial crime compliance, if technologies like AI can predict risk or automate a risk assessment of a bank's customer, banks will be able respond faster thereby making the regulation more effective. RegTechs will therefore be able to create better outcomes for how banks respond to regulation and improve the overall impact of the regulation itself.

Jo Ann

RegTechs will have the most impact in the short-term in the area of AML. RegTechs help bank compliance teams address every phase of the AML process. On the front-end, they can aid in the KYC work that is required to assess whether or not to allow a person or entity to have a bank account or financial relationship. RegTechs can also make an impact on transaction monitoring. In addition, firms that bring data and analytics together can bring about better case analysis, helping banks determine whether or not money laundering has actually occurred. What is more, by leveraging the power of digital data and AI, RegTech can use intelligence to detect patterns of crime, terrorism or risk. One reason AML is so relevant is that it's an area where there's a lot of consensus that incumbent solutions aren't working. In fact, the UN estimates that we catch less than 1% of money laundering activity. As financial crime remains rampant and continues to represent a significant and growing part of global GDP, there will be appetite for change.

Other areas where RegTechs will have a major impact include credit underwriting and regulatory reporting. RegTechs have the ability to bring in new datasets and analytical tools to fine-tune credit risk. More broadly they will also be able to deploy more data and better analysis to screen for emerging risks, whether it's loan quality, compliance issues, liquidity, or forms of misconduct.

Long term, RegTechs are in position to fundamentally transform how financial institutions manage technology. Much of this will be in the context of cloud computing. Financial institutions will come to realize, if they haven't already, the efficiencies that cloud computing has to offer. For example, upgrading technology today usually requires banks to make a capital investment. It also means converting to a new system which takes time, training and opens the bank up to potential risk. Worse, within a few years, the technology starts to become obsolete, requiring a newer system and, along with it, a new capital project. Cloud computing will change that, allowing financial institutions to make continuous improvement without adding significant cost. RegTechs will be driving much of this transformation.

RegTech as a category is fairly expansive. What are some of the most interesting/ innovative RegTech use cases in banking?

Alex

That's correct – RegTech represents a broad church of different technologies and offerings. I recommend reading an article Encompass co-authored with Ian Loh (Principal at Expand Research, Boston Consulting Group FinTech Control Tower) on the sizing and different categories that make up the RegTech market. It includes a helpful taxonomy for thinking about different RegTech clusters.

Some of the most interesting use cases for RegTech involve addressing today's topical issues such as ESG, consumer data protection, sanctions or bringing greater levels of trust and transparency to crypto. In addressing sanctions, RegTechs will be an effective partner in helping financial institutions tackle regulatory changes, from keeping track of new sanctions on entities, to meeting beneficial ownership requirements. For crypto players, RegTechs will be able to provide the KYC infrastructure and transparency needed in the space. Another much discussed use-case is the potential for RegTechs to help banks achieve an 'always-on' or perpetual KYC model (pKYC) that will make the compliance process significantly faster, more effective and less costly.

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> Alex Ford

Jo Ann

Beside the innovation taking place in AML, we're moving into a period where supervisory technology (SupTech) will flourish and will increasingly be used by the regulators themselves. Expect to see similar types of tools used by risk evaluation entities like auditors, as well. While there will be a need to customize these tools to meet unique regulatory needs of the end-user, the underlying technology that can gather and analyze data is the same. SupTechs that leverage open-source layers of software will also benefit from the network effects that result from interoperability.

Blockers of innovation remain. The biggest among them is a lack of data and technology standardization that make it difficult for systems to work together. This phenomenon is not uncommon. It can occur, for example, when one vendor system is difficult to plug into an API or work with a different vendor. For RegTech to flourish, interoperability will be key.

Where do RegTechs fit into a bank's relationship with regulators?

Alex

One of the goals of RegTech should be to bring banks and regulators closer together. In fact, new firms are being incorporated to fulfill this very purpose. For example, SupTech, a category related to RegTech, helps regulators supervise compliance activity. RegTech also assists with supervision because it creates a more transparent and auditable compliance process that can help regulators in their efforts of oversight.

In addition, RegTechs help banks ease the burden of compliance, allowing them to better respond to regulatory changes faster, making the implementation of RegTech solutions a win-win for bank and regulator.

Regulators are also doing more to 'upskill' themselves, working with RegTechs to identify technologies and areas where they can provide the most value. Open hours at the Financial Crimes Enforcement Network (FinCEN), for example, allow RegTechs and regulators to collaborate on the practicalities and possibilities for compliance technology. These efforts should also provide comfort to banks who know that they can accept the use of these technologies in their compliance process. Plus, it gives regulators advanced insight into what capabilities exist, so they can ensure the digital transformation efforts being undertaken at banks leverage appropriate technologies.

Jo Ann

RegTechs are third-party vendors for banks. In the eyes of the regulator, RegTechs fit into a category where the regulator's goal is to hold the vendor to the same standards as they hold the bank. Therefore, RegTechs need the same rigor as a bank would if it was performing the function itself. This is well-known among established RegTechs, where there's a long-standing relationship and reasonable confidence that the RegTech knows what it's doing. But with newer RegTechs, there's very high scrutiny on whether or not the RegTech is able to function as advertised.

In the context of RegTechs and third-party vendors, regulators are now working on how to modernize what they require of banks. For example, the FDIC put out a request for information around what should be required for small banks working with technology partners. Elsewhere, regulators have been revisiting third-party risk issues as well.

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>
> Jo Ann Barefoot

There's still a long way to go in terms of standardization, which means RegTechs face a daunting burden inf getting bank and regulatory approval. However, the trend is towards acceptance.

On the other side of the equation, RegTechs will increasingly be asked to provide solutions to regulators as well. Over time, the relationship between RegTechs, banks and regulators will normalize. And as the level of experience grows, so will the quality of the outcomes.

About Encompass

Encompass enables firms to deliver revenue faster, drive operational efficiency and demonstrate consistent compliance with dynamic KYC process automation.

Our award-winning platform, unrivaled data connections and industry expertise help clients to create and maintain real-time digital risk profiles of everyone they do business with.

Our customers include leading global banks and financial institutions, including Wolfsberg Group members. We have strategic alliances with a range of trusted data, technology and consulting partners, enabling the seamless integration of Encompass into existing workflows and systems.

Find out more at encompasscorporation.com.

About the contributors

Alex Ford

Alex Ford drives business growth in North America, working with customers, partners and the Encompass team to transform KYC with automation in financial institutions and other regulated entities. Joining in 2012, Alex has held Executive responsibility for business functions including Customer Success, Operations, Marketing, Product and Delivery. From 2015 to 2020 Alex was based in Glasgow with the launch and expansion of the UK operation, before taking up leadership of the North America business.

Alex also serves on the board of The RegTech Association and works with the Business Information Industry Association.

In 2022 Alex was named on the InnovateFinance Women in FinTech Powerlist and the NYC FinTech Women 'Influential Fintech Females' list. She is also a co-Founder of the 'Women in RegTech New York' meet-up group.

LinkedIn Twitter

Jo Ann Barefoot

Jo Ann Barefoot is CEO & Co-founder of the Alliance for Innovative Regulation, host of the global podcast show Barefoot Innovation, and Senior Fellow Emerita at the Harvard Kennedy School Center for Business & Government. She has been Deputy Comptroller of the Currency, partner at KPMG, Co-Chairman of Treliant Risk Advisors, and a staff member at the U.S. Senate Banking Committee. She serves on the boards of Oportun and FinRegLab, and on advisory bodies for FINRA, the Milken Institute, and the California Blockchain Working Group. She formerly served on the board of the National Foundation for Credit Counseling. She is Co-founder of Hummingbird RegTech.

In 2021, Jo Ann was named Fintech Woman of the Year by Finovate and selected to the Forbes list of 50 Over 50. She is also in the Fintech Hall of Fame. She previously served on the CFPB's Consumer Advisory Board and chaired the board of the Financial Health Network. She has published nearly 200 articles and speaks each year to thousands of people throughout the world.

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t +1 332-245-4398 | +44 333-772-0002 | +61 300-362-667

e info@encompasscorporation.com

w encompasscorporation.com

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