As technology moves ahead, are utilities the upgrade you need?

Utilities and shared service models could be the way forward, but they must advance to keep up with the risk and compliance challenges of financial markets in a new digital age.

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Collaborative compliance: the key to more effective and efficient risk management regulation

Our previous article, "How can regulation keep up as technological innovation races ahead?", reviews some of the potential benefits and challenges flowing from the digital transformation of risk management and market regulation and sets out five areas that market stakeholders should re-examine to support a risk and regulatory framework fit for a digital future. In this perspective, EY looks at the potential for more collaborative compliance activities to better monitor the digital marketplace and make better use of technology to do so).

Collaboration on compliance — are industry utilities the way forward?

Technology's potential to transform risk management and regulatory compliance while reducing their costs has galvanized both financial institutions and regulators. Many financial firms are expressing their interest through investments. But most are not investing enough, constrained as they are by a scarcity of the financial and human resources needed to execute major technology implementations and maintain sophisticated new tools. Cutting-edge technology demands specialist skills, which can be hard to find and expensive to keep.

More utility from utilities

Many financial firms are reconsidering shared services models as a way to pool resources; reduce costs; and possibly improve outcomes, both financial and operational, of compliance and technology investments. The concept of utilities is not new; financial institutions have been outsourcing or centralizing core operational activities at an accelerating rate for many years. Such services take a number of different forms: third-party firms may provide services to multiple individual firms; financial institutions themselves may join together in a consortium to sponsor a separate entity that provides services under their direction and funding; and regulators and/or governments may sponsor a utility provider and encourage or require local firms to use it. Whatever form they take, these models can:

- Centralize and scale technology investment
- Concentrate scarce skills to benefit the wider market
- Build standardized, specialized, leading-class processes
- Widen the applicable data pool on which technology tools can operate, encouraging information sharing and increasing the likelihood of detecting risks and issues

Transferring activities to a utility, though, requires much more than simply moving responsibility for a process from one firm to another. At its most mature, a utility model would fundamentally reshape the ecosystem from a siloed, many-to-many patchwork to an integrated, one-to-many infrastructure. This new system will require stakeholders to develop new legal structures, operating models, processes, risk management practices, skills and resources.

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Fit for purpose?

Shared services models are not appropriate for all activities. Current and emerging technologies will amplify the potential benefits for activities that involve large volumes of digital data and processing. As a result, utility models are making inroads where there is:

- **A high volume of activity.** High-volume processes, such as initial screening for breaches of anti-money laundering obligations, regulatory reporting, or automated monitoring and testing of high-volume controls, lend themselves to standardized methods
- **Shared content management.** Examples include central market data repositories, regulatory rules and hosting of commonly used applications (in a cloud platform, for example).
- **Ongoing identification and verification utilities.** These can verify digital identities of potential customers or screen profiles of commonly used vendors.

Utility operations for activities that meet these criteria allow for the standardization and scale that can increase efficiency and improve outcomes from centralization and automation. When combined with collaborative monitoring and information sharing, there are opportunities to benefit honest customers and financial institutions that can operate more seamlessly across borders and hinder dishonest operators that like to hide behind operational and supervisory silos that block financial institutions' and supervisors' sightlines into criminal activity or potential conflicts.

The value of shared utilities is less apparent for activities that rely on judgment or where homogeneity could damage market outcomes or even financial stability. Utilities that enable financial institutions to access third-party-run risk models are one example. In their defense, the operators of such utilities highlight the potential benefits of providing robust models stocked with abundant data to smaller, less-well-heeled firms.

Larger financial institutions, however, have less incentive to participate because their proprietary data stores and risk models are often sources of competitive advantage. But new transparency requirements, such as those stipulated by the Markets in Financial Instruments Directive (MIFID) 2 rules in Europe, have now made pricing and transactional data more widely and readily available to all market participants, eroding that privileged access and providing space for multiple new third-party offerings to emerge.

Ernst & Young LLP has been selected by TruSight to support the global delivery of TruSight's third-party risk management (TPRM) assessment offering. TruSight, a consortium composed of leading financial services companies, was formed to establish industry leading practices and streamline third-party risk assessments for the collective benefit of financial institutions, their suppliers, partners and other third parties. TruSight is a transformative model designed to simplify the risk assessment process of third parties across the financial services industry.

Running the regulatory rule over collaboration ambitions

Regulators recognize the potential benefits of utility models[1] and welcome any opportunity to monitor noncompliance more comprehensively and effectively. Utilities can also enhance competition, an objective of many supervisors, by making new technologies and complex compliance capabilities available to smaller market participants.

Regulators are nonetheless proceeding with caution. A central service provider, no matter the quality of its technology, is still at the mercy of flawed data, long the bane of better compliance performance. Utilities providing and managing central data pools also create a more complex ecosystem in which multiple financial institutions supply, manage and rely on a central data source — potentially complicating supervision efforts.

Regulators also have limited, if any, direct oversight of many potential utility service providers. Adequate assessment of risk management and financial and operational resilience of these parties is therefore left with financial institutions. Regulators worry that if supervision by financial institutions is inadequate, significant disruption could arise, particularly where there is considerable reliance on a small number of providers for critical functions.

The European Banking Authority has focused on this issue in two recent papers.[2] These suggest specific and comprehensive proposals for how financial institutions manage their third-party relationships generally, and also for cloud service providers specifically. Concern over potential concentrations of critical functions is a clear theme, alongside proposals for financial institutions to carry out more investigation and collect more information on their service providers, potentially for submission to regulators as well as internal risk management. The hope is that by setting clear standards, management and delivery of these services will become more rigorous and transparent, allowing early identification of potential issues and, therefore, quicker actions in response. But a concern would be that too much added bureaucracy and accountability could simply reduce the use of third parties.

Roadblocks to quick adoption

Against this backdrop, progress to accelerate the next wave of compliance-led shared services models has been muted, despite the opportunities that new technology offers to reduce costs and improve operations and outcomes through collaboration. What are some of the roadblocks? Limited cost and efficiency savings is certainly an obvious factor. Utility providers still use a significant proportion of manually driven (although technology-enhanced) processes. Rationalization and automation of these processes could realize significant cost benefits, but would require commitment and resources from both shared services providers and their customers before transformational investments are made.

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[1] "An Opportunity for Community Banks: Working Together Collaboratively," Office of the Comptroller of the Currency, January 2015.

[2] EBA Draft Guidelines on Outsourcing Arrangements, European Banking Authority, June 2018; Final Report: Recommendations on Outsourcing to Cloud Service Providers, December 2017.

With regulators clear that they will hold financial firms to account if there are failures, utility customers have concerns over risk and regulatory uncertainty, so they often retain in-house, parallel processes to mitigate management's and regulators' concerns over the effective operation and risk management of third-party vendors. Regulatory expectations have also led to costly, duplicative efforts by individual firms that each carry out due diligence and ongoing assurance of vendor capabilities and performance. The result is even more reluctance to extend the commitment to shared services on the assumption that the added risk management cost could outweigh any benefits.

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Another factor limiting investment is financial institutions' uncertainty about the reaction of regulators if investments in shared utilities and new technology suffer "teething trouble." Fearing regulatory backlash — and the loss of their considerable investments — financial institutions and service providers alike are imploring regulators to clarify their expectations of and support for shared services models. They are also looking for indications that regulators can be flexible in dealing with unexpected outcomes that arise despite reasonable planning and effort. As they await a response, many are staying on the sidelines.

A challenge also exists regarding quality of both existing processes and critical data sets. The cumbersome, fragmented nature of legacy processes, systems and data in and across many financial firms makes it more difficult for utilities to develop standardized, leading-class approaches, however desirable they might be. Regulators also suffer from inconsistent and unclear data, risk and policy definitions of their own and between jurisdictions, further blocking the development of the automated, standardized rules and processes that could drive exponential benefit.

Finally, building volume also relies on data-sharing, which must meet complex, and sometimes conflicting, data privacy requirements. These requirements are set by jurisdiction but often reach outside of those boundaries. An example is the EU's recently activated General Data Protection Regulation, which set strict obligations for the use and protection of EU citizens' data wherever it is held around the globe. And even where data can be centralized in data lakes, concerns over resilience and data security lead some stakeholders (financial institutions, regulators and even the public) to prefer a decentralized model to address fears that a single point of failure will leave a market or system vulnerable to cyber attacks.

As long as these questions remain unaddressed, financial firms will remain reluctant to invest in utility models and enabling technologies as extensively as they might. In turn, shared services providers require the certainty of committed uptake of their services before they will invest in the costly technologies and operational transformation that would convert their services from replication of manual processes to the complete reimagination of a centralized, technology-led service offering.

Taking actions that bolster confidence

Regulators and financial institutions alike have the opportunity to take actions that will give market participants more confidence to move forward.

Clarifying accountabilities. Regulators are adamant that financial institutions that use third-party services retain the obligation to understand and manage their risks. Nonetheless, vendor firms must demonstrate their understanding of and compliance with associated regulatory obligations if they want to expand into services bound by those requirements. Proceeding from this principle, financial institutions can work with third-party providers to document the end-to-end processes moving between them to make sure that the activities, risks and control requirements are well-understood and form a basis for clarifying the respective roles and obligations of the utility and the firm. Risk management frameworks can be improved to deliver a consistent, robust and well-documented process for assessing a potential vendor and the associated risks; clearly articulate risk mitigating actions and strategies; and, finally, provide for comprehensive, ongoing assessment of the performance and outcomes of the vendor's operations.

Regulatory flexibility. Unexpected problems inevitably crop up in the course of complex business change and technology transformation. Many regulators are seeking to address this contingency, in part through "sandbox" initiatives that allow incumbents and new entrants alike to test new technology-led services. For example, a group of regulators convened by the UK's Financial Conduct Authority recently announced plans to cooperate through the Global Financial Innovation Network (GFIN) that would promote the evolution of cross-border standards and approaches to new products and services. This effort could extend beyond specific new services to include broader utility proposals. In turn, financial institutions and service providers can work to improve how they plan, phase, govern and consult on the development and deployment of changes to mitigate the risks inherent in large-scale switchovers.

Fix it, then shift it. Financial institutions should take time to review and reform patchwork processes and clean up data to maximize the return from shared services and technology investments. Phased approaches, as well as leveraging other programs or initiatives where data and processes will in any case be subject to change or review, could facilitate prioritized, controlled change and improve the ability of utilities to harmonize and deliver leading-class processes.

Single version of the truth. Financial institutions and regulators need to align and clarify regulatory taxonomies and requirements. Greater precision and standardization will support the development of the rules that machines must follow to take on more compliance tasks and therefore maximize the development of more standardized processes, technologies and data repositories that can operate at scale. But this benefit may not extend to areas where principles, flexibility and judgment can deliver better outcomes.

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Navigating the course to market confidence

Adoption of the next wave of compliance-led shared services models in financial risk management and compliance has been slow to accelerate, despite the opportunities that new technology offers to reduce costs and improve operations and outcomes through collaboration.

Hurdles	Solutions
Regulatory confusion leads to duplication: the regulatory requirement for accountability prompts many banks that outsource compliance functions to mitigate risks through in-house, shadow processes. The lack of industry standards for assessing and monitoring vendors leads to duplication across many individual firms.	**Clarify accountabilities:** financial institutions can overcome their understandable caution about outsourcing compliance by working with providers to document processes, define regulatory obligations and clarify risks and roles.
Legacy manual processes: many shared service providers are yet to evolve their manually driven processes, which limits the ability to reduce costs and increase efficiencies.	**Comprehensive digitization and automation of processes:** true transformation of compliance processes will be digitally driven, but full automation requires commitment and resources from shared services providers and banks.
Reputational and regulatory impact if it still breaks: some banks are waiting to invest in shared services until regulators clarify their expectations and support in case of "teething issues" with new technologies and utilities.	**Regulatory flexibility and support for innovation:** recognizing the risks of transitions to new models and technology, many regulators are rolling out "sandbox" initiatives to test innovation. Extending these to include broader utility proposals could help smooth transitions to collaborative models.
Inconsistencies in data and regulations: shared services providers struggle to develop standardized, leading-class risk approaches due to fragmented and inconsistent processes, varying data usage and lack of standards. Jurisdictional differences around data privacy requirements and other issues also complicate efforts to centralize information in shared services centers.	**Fix it, shift it and create a single version of the truth:** maximizing the benefits of utilities requires financial institutions to clean up data and align patchwork processes for a phased, controlled shift of data. For regulators, standardized rules allow machines to take on more compliance tasks. Greater scale will accelerate the development of standardized processes, technologies and data repositories.

Summing up

The shared services model can reduce the cost and increase the effectiveness of compliance processes even in its current form. But barriers to comprehensive digitization and collaborative cross-border operation must fall before utilities can realize their full potential. Doing so can finally give compliance operations the reach, scale and sophistication needed to match the operations of both sophisticated financial market participants and malicious actors.

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She has over 20 years' experience working in global professional services firms, advising banking clients on the implications of the regulatory agenda and designing approaches to effectively meet those obligations.

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FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy: Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF.

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Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank.

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He has over 20 years in government and senior regulatory roles. He was previously deputy head of enforcement at the Hong Kong Securities and Futures Commission (SFC). Prior to the SFC, Eugène worked at the Australian Securities and Investments Commission and the Australian Attorney General's Department.

Kentaro Kobayashi
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He spent 37 years as a financial regulator. He held positions in the National Tax Agency and later, Ministry of Finance (MOF), Japan's former financial regulator. After the establishment of the Financial Supervisory Agency (FSA) of Japan in 1998, he served as Chief Inspector and Inspection Administrator and continued to serve in this role after the FSA was reorganized into the Japan Financial Services Agency in 2000.

Christian Lajoie
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As former head of Group Prudential Affairs, BNP Paribas, Christian has broad banking experience and a deep understanding of the regulatory and supervisory impacts on bank management and strategy. In recent years, he played an active role in regulation-making, participating in many international forums and also served as Vice Chair of the EBA Stakeholder Group.

EY Global Regulatory Network executive team previous appointments
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Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and it's predecessors. He is currently EY/UK Financial Conduct Authority relationship lead.

Shane O'Neill
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He has 20 years experience in banking, capital markets, asset finance and prudential regulation in a variety of CFO, COO, strategy and planning, and regulatory roles. Following the financial crisis, Shane was Head of Banking Supervision at a Eurozone Central Bank for four years, during which he influenced significant restructuring, recapitalization and change in the banking sector and in credit institutions, and executed numerous stress tests and asset quality reviews.

Keith Pogson
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Immediate past President of the Hong Kong Institute of Certified Public Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities.

Marc Saidenberg
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Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning.

Scott Waterhouse
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He was capital markets lead expert for large banks at the Office of the Comptroller of the Currency (OCC) and Examiner-in-Charge of the OCC's London Office. He coordinated the supervision of trading, treasury and capital markets activities including Dodd-Frank implementation and Basel Committee requirements.

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Led by John Liver and Marc Saidenberg, the network comprises more than 100 former regulators throughout the Americas, Asia and Europe, many with senior regulatory experience, including membership in the Basel Committee, the Financial Stability Board, the European Banking Authority, the Federal Reserve Bank of New York and the Japanese Financial Services Agency. The network helps our clients to understand and adapt to the impact of the changing regulatory landscape, advising on such topics as:

- Capital and liquidity
- Recovery and resolution
- Governance
- Risk culture and controls
- Structure
- Conduct

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