

# FINsights

Technology Insights for the Financial Services Industry

Governance, Risk and Compliance »



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## From the Editors Desk

We are delighted to present the second issue of the Infosys Banking and Capital Markets journal FINsights. The spotlight in this issue is on Governance, Risk and Compliance and the compilation of articles reflect perspectives on risk and its measurement, governance, the compliance conundrum and our take on the priorities in risk and compliance and their technology implications in the coming years.

The increased incidence of failures in the financial services marketplace over the past decade has given visibility to the science (and art) of understanding and measuring risk in running a business, making strategic and tactical decisions and participating in markets and economies that are increasingly linked in a flattening world. A recent such event, covered in one of the articles, has been the sub-prime crisis and the unforeseen ripple effects in markets in distant parts of the world.

As always we have tried to reflect in these articles the unique value that Infosys brings to its clients through a combination of deep domain understanding, technology best practices and global sourcing expertise. The article on sub-prime crisis reflects the current challenges in credit risk measurement and brings a perspective that combines credit risk measurement approaches with a global knowledge process outsourcing (KPO) option.

Risk and compliance is a multi faceted animal and the focus in the past few years has been on giving it a holistic view through a unified Governance, Risk and Compliance (GRC) program. The articles featured on GRC explore integrated controls to implement GRC, use of SaaS in GRC and industry perspectives on GRC and the road ahead. In the area of compliance, the articles look at addressing compliance challenges, an aspect of internal compliance namely employee surveillance and the partial compliance challenge in the wealth management industry. Our articles on risk address credit risk management, the role of master data in risk measurement and risk reporting. Included in this issue is also a case study highlighting the importance of Information Risk Management (IRM).

We would like to thank all the authors from Infosys as well as external contributors - Adam D. Honoré from Aite Group, Tim Leech from Navigant Consulting and Bob Skea of Northstar Systems. As always, we look forward to your queries or comments on Governance, Risk and Compliance or any feedback and suggestions in making FINsights a more relevant and topical journal.

Happy reading and all the best for the new year 2008!

**Balaji Yellavalli and Sudhir Singh**  
*Editors*

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## Addressing the partial compliance trap in the wealth management industry

Banks, broker-dealers and trust companies that compete in the wealth management industry must adhere to very stringent compliance regulations. Yet most firms today cannot keep up with compliance changes and seem to be falling behind when it comes to being fully compliant. This article explains the partial compliance trap, the shortcomings of current efforts and proposes a solution to address the trap.

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## What is the partial compliance trap and why does it happen?

According to International Data Corporation, a US-based research and advisory firm, since compliance is a moving target, no company can really claim 100% compliance all the time. Partial compliance happens when a company cannot respond quickly enough to the changing regulatory environment and is never fully compliant. This normally means the company's systems and process are not flexible enough to adapt to the changing regulatory environment and this results in the company falling into a perpetual partial compliance trap. Although this is true of any industry, wealth management industry is arguably under a closer federal scrutiny than other industries given the profile of clientele and the sums of money involved. And once a wealth firm is put under a federal watch and the auditors arrive, it's too late to protect the firm from negative publicity and regulatory fines – which keep escalating.

As shown in Fig 1, there are three main reasons for this: a changing regulatory environment, the introduction of increasingly complex product offerings and increasing business complexity

in adhering to new and changing regulations. Firms may not have the systems and processes in place to adapt to new rules. Sometimes regulators may even overturn an existing policy. For example, in the US, the recent overturn of the Merrill Lynch rule by the US District court means that broker-dealers, just like any other fee-charging financial advisors, are now required to know and document their customers' investment policy constraints and preferences and adhere to them at all times. Under Regulation 9, financial institutions (particularly banks) that want to be advisory business or compete in the wealth management marketplace should implement more stringent compliance procedures as well as standardize their processes for reporting client information.

**New Investment Products:** In addition, an organization's systems and processes may fail to address compliance across all types of investment products. Since the emergence of new, alternative investment vehicles such as separately-managed accounts, for instance, all types of financial institutions – banks, broker-dealers and trust companies are experiencing a three- to five-fold increase in the number of accounts they need to manage. Yet, most traditional systems only maintain compliance

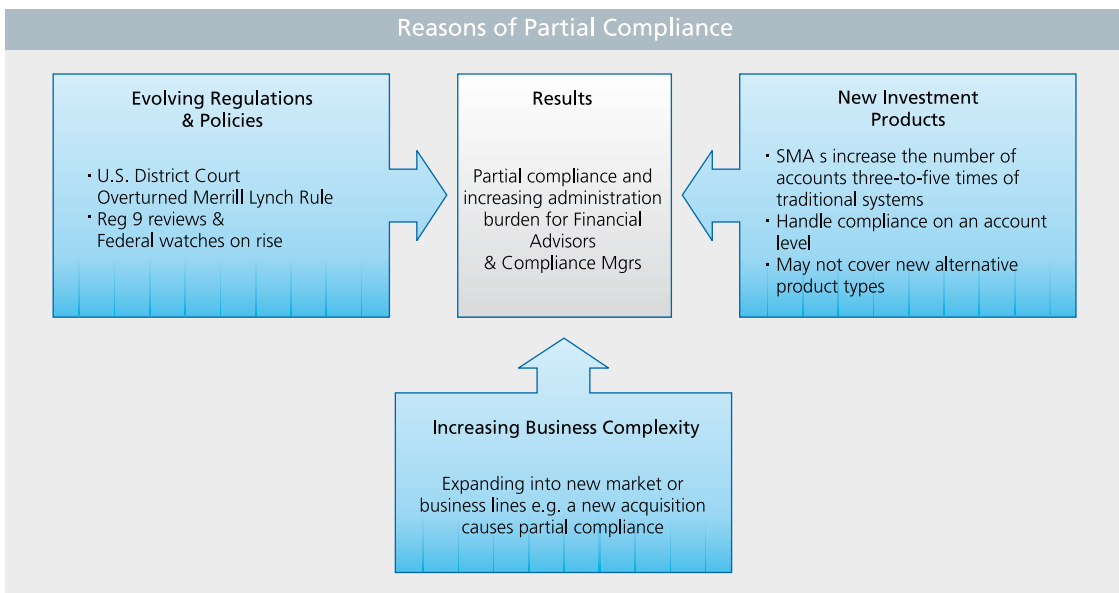


Fig 1: Reasons of Partial Compliance

As shown in Fig 1, there are three main reasons for this: a changing regulatory environment, the introduction of increasingly complex product offerings and increasing business complexity.

**Evolving Regulations and Policies:** Regulators continuously come up with new policies or keep evolving their regulation polices to make them more topical. In this environment, wealth managers may not be proactive

at the account level. As the number of accounts grows, compliance managers as well as financial advisors are increasingly burdened with compliance administration – particularly if a firm is operating traditional systems that handle compliance on an account or product basis. As a result, firms that don't update their compliance systems may experience partial compliance, especially if they offer alternative investments.

**Increasing Business Complexity:** Expanding into new business lines or new markets brings its share of

compliance issues. For instance, following an acquisition, investment policy compliance may not span the newly combined organization. In addition to coverage issues, firms may also experience partial compliance and the risk associated with it due to compliance errors. Errors can occur when policies are applied by some departments but not firm-wide, or if the policies are created manually or on an ad hoc basis. In addition, a wealth management firm that doesn't monitor portfolios over time risks falling through the cracks of rapidly changing regulation, risk client turnover and potential lawsuits.

## The problems with current efforts in addressing partial compliance

The current efforts for addressing partial compliance in the wealth management industry have not been very effective for several reasons:

**Current efforts do not empower the advisor:** On the one hand, when an active investment policy statement is not in place, investors may experience poor portfolio performance stemming from unsuitable investment selections. On the other hand, advisors may lose these clients or not be able to compete effectively for new clients. This is an important trend, since knowledgeable investors are now increasingly seeking out advisors who can offer a higher level of investment policy accountability and service. Given the number of tools wealth managers need and the dynamic nature of the industry, it's easy to see why companies may be partially compliant versus fully compliant.

**Current efforts have been mainly focused on back-end systems:** Key focus on back-end integration requires a lot of time and investment. Companies that invest their entire compliance technology budget in traditional, back office compliance systems that handle compliance on an account basis do not see the benefit of their investment because of

- Rise of alternative investment products like separately managed accounts (SMAs) have resulted in a 3-5 times increase in the number of accounts to manage.
- Systems that manage compliance on an account level are taking too much time and are not offering the best coverage today.

**Integrating "siloed" data does not result in integrating "siloed" functions:** Although considerable effort is being spent on building data warehouses, this is not helping in integrating "siloed" functions. An advisor who is juggling separate tools, such as planning, portfolio construction and customer relationship management software – none

of which is integrated across the enterprise – can't possibly manage the complex administration required to stay in compliance 100% of the time. Spreadsheets, legal pads and data silos are difficult, if not impossible, to monitor.

**Industry lags behind other industries in adoption of technology to automate and centralize Investment Policy process:** The wealth management industry has been slow to adopt technology to automate and centralize the Investment Policy process. Although most wealth managers may attempt to capture client constraints and priorities on an account level, their firms lack the technology to automate and centralize the investment policy process, a primary hurdle to building compliance into the wealth management process. Therefore, documenting the process and validating its implementation are slowly accomplished. The industry in general has been slow to adopting technology. For most wealth management firms, preparing for a compliance audit is still an inefficient and resource-intensive process. For instance, if investment policy statements are manually generated, they may lack audit trails. To prepare for an audit, a firm would need to reconstruct which advisor made each change to a client's investment policy statement.

**New products innovation is broadening the scope all the time:** The industry has been constantly innovating with new products and this has added to the problem. For example, the emergence of account-based investment vehicles, specifically separately-managed accounts, added to an already wide variety of investment products, has occurred as the industry has seen increased frequency of team-based financial advice. This means that, in order to pass the scrutiny of regulator agencies, firms must now proactively monitor not only how advisory teams are managing complex portfolios and client account assets but also financial advisors' internal behavior for out-of-compliance activity.

## Solution for addressing partial compliance using a real time integrated compliance across wealth management advisory process

The solution lies in an integrated compliance approach which tries to address the challenges a little differently from traditional approaches. The solution's approach takes steps to do the following

- Build compliance into front-end
- Build compliance activities across by workflow
- Enable automation of investment policy update.

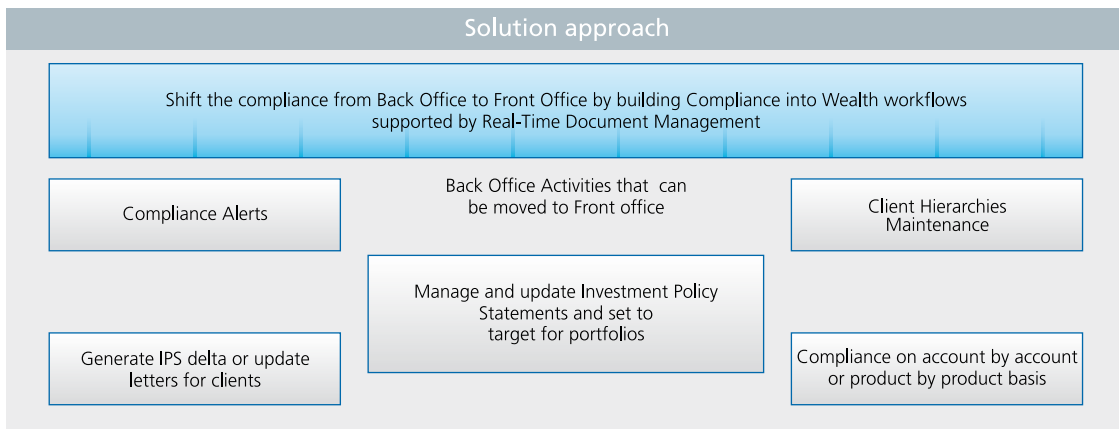


Fig 2: Solution approach

### Build compliance into the front-end

As shown in Fig 2, a lot of back office activities can be moved to the front-end. This will help in the following manner. Provide Single Investment Policy Compliance covering all types of investment products including SMAs, all types of client relationships including legal entities resulting in no need to handle compliance on account by account or product by product basis



Fig 3: Illustration of advisor front-end with compliance moved from back-end

- Apply client, regulatory and firm-mandated constraints on client portfolios.
- Ease the process of both internal and external compliance reviews through standard compliance presentations and audit trails.
- Monitor current holdings against investment policy considerations.
- Alert financial advisors and firm supervisors when a violation has occurred unlike traditional system where it is caused during reconciliation post violation

### Build compliance into the work flow

As a result our Solution facilitates the compliance process as firms address their regulatory issues. For example, the Compliance Solution gives firms an early warning system for proactively detecting both internal and external compliance issues before the SEC does. In addition, centralized client-profiling feature helps wealth managers preserve client retention by avoiding mishandled investment guidelines.



Fig 4: Illustration of advisor front-end with compliance integrated with work-flow

### Key Benefits

- By using a wealth management compliance monitoring and alert system, companies can reduce document generation by 50%, providing a more efficient way to create and manage compliance documents as well as prepare for audits. Financial advisors are released from administrative duties associated with compliance. This frees advisors to spend more time with prospects and clients.
- Firms get to see activity they normally would not see without this type of system in place. Firms can detect abnormal behavior proactively. By aggregating all data, firms can now see a single view of the client – where they know everything they need to know about the client so advisors can give them the right advice to move their money for themselves and their

family members. With a single view of the client, advisors can effectively advise people and increase client retention. Another obvious benefit of a best practice-based compliance system is that firms are able to substantially reduce operational and legal costs and expenses.

- This enables advisors to deliver a safer and more secure investment service, identifying compliance issues quickly so they can be addressed. This builds greater client confidence, increases retention levels and can help an advisor increase business.

### Enable automatic update of investment policy

Enables Real-Time Document Management with standardized workflows and templates to design, approve, deliver and store Investment policies. It also does:

- Dynamically maintain and update reference data and IPS
- Generate IPS delta or update letters for clients
- Validate and monitor investment policy adherence: alerts sent when out-of-compliance
- Flag and store compliance artifacts as long as necessary
- Ability to integrate to any JSR-170-compliant content repository

The benefits of this is that firms no longer need to handle investment policy compliance manually or use multiple,

un-integrated systems. Instead, firms can utilize a firm-wide, rules-based compliance platform that automates and builds investment policy compliance directly into the wealth management team's every day workflow

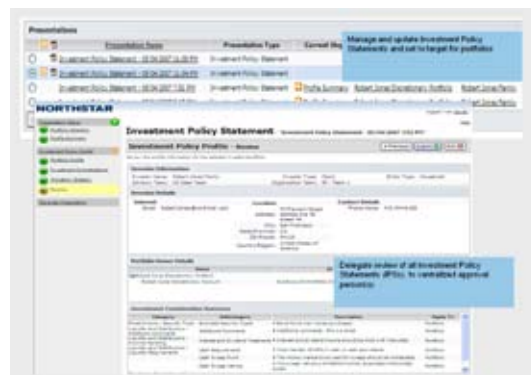


Fig 5: Illustration of advisor front-end with automated documentation and investor policy

### Conclusion

Wealth managers are overwhelmed by compliance regulations and looking for an integrated solution which automatically builds compliance into the wealth management process. The proposed real-time, rules-based solution produces a 360-degree, single view of clients, applying their investment policy statements to all workflows, spanning all types of investment vehicles and client relationships leading to reduced regulatory risk and increased advisor productivity.



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