

# Road to Compliance

Efficient implementation of regulation leads to competitive advantages



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« Turn compliance into  
business opportunities »»

Regulatory requirements for the financial industry have undergone dramatic change in recent months due to market turbulence, the related losses felt by investors, bail-out measures for banks and large state deficits etc. At the same time, authorities have taken immediate measures for the enforcement of already existing or amended regulations. A weakening or even a reversing of this trend is not currently expected as governments and regulators around the globe have apparently found a common opinion on what the financial market of the future should look like.

Such a market should be marked by transparency and regulations that keep financial institutions within well-defined boundaries and the rights of clients should be strengthened by consumer protection that remains in the foreground. Several laws that follow this paradigm have already been implemented. For example, the Lugano Convention allows clients to file a complaint in his / her place of residency (jurisdiction at the domicile of the consumer); with FATCA, the USA wants advantages to achieve more transparency on assets that are not held in the USA; EMIR should minimize counterparty risks in the area of derivative financial instruments; SLB transactions should only be carried out with qualified clients or with a guarantee of security, etc.

In short, Swiss financial institutions will most likely need to intensively address the following topics over the next five to ten years in order to remain competitive and minimize the legal and reputation risks:

- Transparency guidelines with respect to taxed monies.
- Disclosure of compensation to third parties for the distribution of products.
- Investor protection.
- Cross-border services.
- Product suitability.
- "Client suitability".
- Capital and liquidity planning.

Thus, the service offerings as well as the distribution and management of clients will have to undergo significant changes in order to maintain pace with the increasing requirements.

**For financial institutions, this raises the question of whether they can continue to pursue current company strategies or the existing business model when taking into consideration the changes that have already occurred as well as those changes that are looming, or whether the company will have to make adjustments.**

In the coming years, what must a business strategy look like that must, on the one hand, observe the regulatory guidelines and, on the other hand, not let costs get out of hand? In our view, there are three possibilities:

- Fundamental changes to the business model, i.e. simplification of the distribution structure and the product offering as well as placing focus on certain markets and client groups that can be managed profitably.
- Point-by-point changes to the business model.
- Implementation of the regulatory guidelines while avoiding as much change to the existing business model as possible.

Significant factors for consideration in the decision making process:

- Costs (investments and recurring / ongoing costs).
- Flexibility and sustainability of the target business model with respect to regulatory and market-related changes (achieving cost savings through "synergies" of individual requirements).
- Stabilization of returns by means of new services (for example, tax reporting / forms for offshore clients).

## Practical thoughts on changing a business model

In KPMG's view, what are concrete success factors for changing a business model?

Micha Bitterli, Director Audit Financial Services:

An analysis that serves to illustrate both the weaknesses of the current model as well as potential for action should form the basis for any changes to the business model.

- In which markets is the financial institution active?
- How many clients are managed in this market?
- How many assets do these clients have and what is their potential?
- What are the arising costs in order to adequately manage this market?
- Are there markets with similar regulations ("synergies"), etc.?

If this analysis takes place, the following factors are decisive for further procedures:

- The ability to avoid the complexities of a multitude of interacting / increased regulations and reducing such complexities to the greatest extent possible so that synergies and decisions can be made.
- The ability to assess uncertainties, in particular with respect to the effects of regulations.
- Swift decision on whether to withdraw (if necessary) from certain markets and / or client groups as well as implementation of the decision.
- Swift decision on the reduction, change or increase of service offerings.
- Decision on the desired degree of certainty regarding adherence to the regulations (ensuring adherence solely by means of organizational measures (e.g. establishment of country-specific desks) versus fully automated systems that show client advisors only those products and services that are permitted and suitable for a specific client).

To what extent can the regulatory changes generally be implemented without making significant cuts in the business activities or business model, respectively?

Michael Schneebeli, Partner Audit Financial Services:

If the previous business model is based primarily on the classical off-shore model, the costs for the implementation and the maintenance of the necessary compliance framework are going to be significant. Upcoming regulations such as cross-border banking, suitability, FATCA and withholding taxes alone represent large challenges for the majority of financial institutions. Not only are the related costs of system modification and process change extensive, but there are also costs relating to ongoing changes, monitoring, employee training, etc.. Correspondingly, an implementation of the regulations without simultaneous changes to the business model is not recommended in most cases.

Which keys will allow companies to prepare themselves for the future and implement regulations on a sustainable and cost-efficient basis?

Alex Geissbühler, Head Regulatory Services:

The initial and most significant step involves carrying out in-depth analysis so that the effects of the regulations on the various processes and the service offerings can be evaluated. As a rule, this includes a revision of the account opening process, client mutations, investment activities/recommendations of the bank, distribution of products, contracts and communication with clients as well as the confidentiality of data.

Finally, the process deals with topics relating to governance structures, data quality and availability, the efficient handling of uncertainties during implementation of the regulations, flexibility of the IT infrastructure and processes as well as an efficient management and coordination of the individual projects in which necessary changes are addressed.

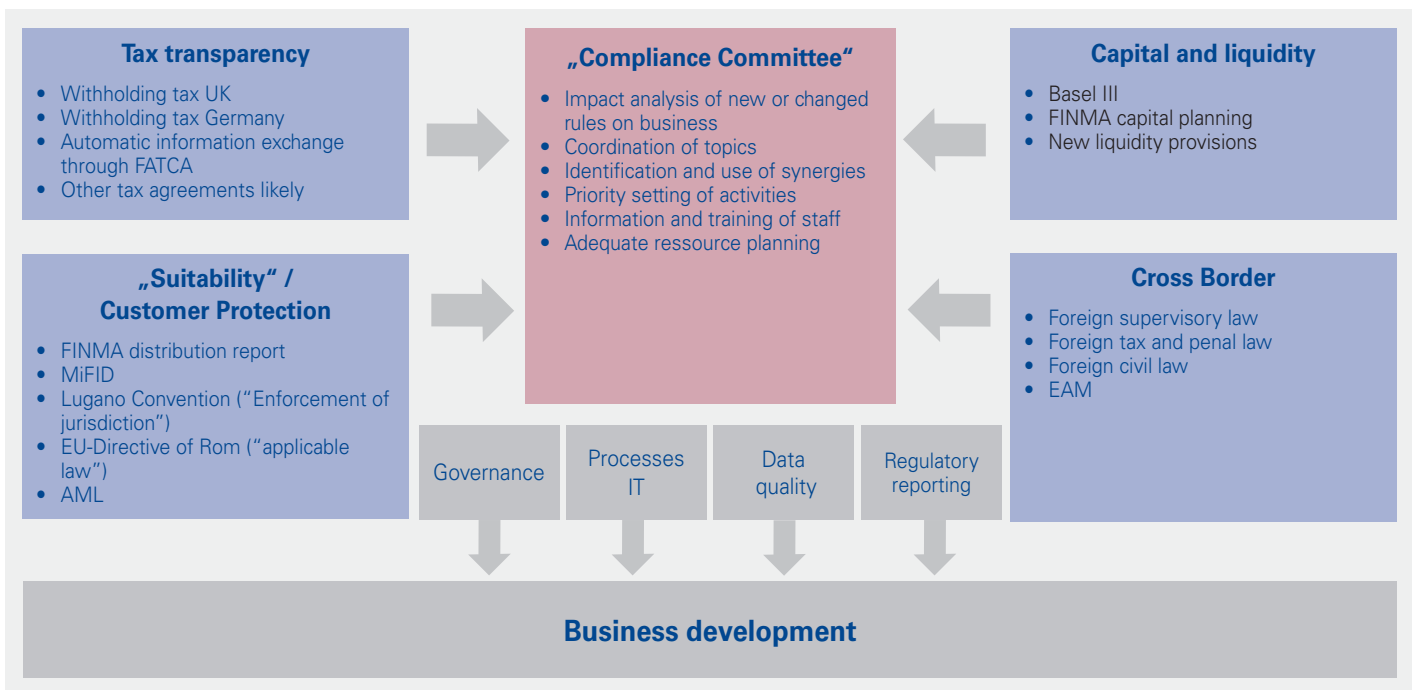


Figure 1: Compliance Committee

### Compliance at the center of cost efficiency

In general, questions arise concerning consolidation of the various regulatory changes (e.g. withholding taxes, FATCA, cross border, suitability etc.) within one project or at the minimum concerning close coordination of the various individual projects. Upon first view, this appears difficult because details of certain regulations remain unclear, the timeframe for implementation has not yet been defined and numerous specialists must be involved during implementation (for example, IT, taxes, law, operations, compliance, but also the front office).

Thus, we feel that it is necessary to form a so-called “Compliance Committee” or “Compliance Board” in which the corresponding functions are represented. The principle duties of these committees are presented as follows:

- Timely registration of all necessary compliance requirements.
- Identification and prioritization of common or similar issues.
- Adoption of a corresponding project plan (see Figure 1).

In the process, there will be certain business relevant decisions that have to be made, such as the continuation or building up of client segments and markets. Management of all regulations in independent projects will lead to inefficiencies and will make the decision making process significantly more difficult because the exact impact on the organization is unclear. In addition, the financial institution will find itself in “project mode” for the next five to ten years, and there is the danger that processes will have to be changed several times through different projects and that clients will have to be continuously contacted as a result.

All of the above-listed activities and topics require permanent changes in the IT systems and processes. Consideration of possible tax consequences for clients is all of central importance. Within the scope of tax transparency, the last points become more important. Among other things, this means the clients will need proper account and deposit statements for handling of taxes. For this reason it is necessary to know the client’s tax status.

Activity / Topic	Cross-Border	Suitability	FATCA	Withholding tax
Investment activity	Can I actively offer the investment to clients?	Does the investment correspond with the client profile? Can the investment be sold to the clients? Is the investment suitable for the domicile of the client (among other things, with respect to tax issues)?	The transaction is disclosed to the IRS. Can I still actually sell the investment to clients?	The client (e.g. US person) is domiciled in Germany. Which deduction do I have to make here?
Account opening	Clarification of residency.	Establishment of client profile (risk profile, residency, etc.) and respective categorization.	Clarification of US person or US company status. (Domicile)	Clarification of nationality / residency.
Change of client information	Change of residency	Change of client profile and investments.	Clarification, e.g., with respect to Green Card or marriage (customs duty).	Change of tax status (e.g. domicile change).
On-going monitoring	Travel activities of the client advisor; distribution of products; amending of the rules due to changes in legislation.	Investments vs. client profile.	Search for so-called US indicators / correctness of delivered taxes.	Correctness of delivered taxes.
Reporting	Management information on adherence to internal rules.	Management information on adherence to the internal rules.	Reporting to the IRS.	Delivery of taxes.

Figure 2: Exemplary illustration (non-exhaustive) of the dependency between present & future regulations

### Dealing with uncertainties and the past

The majority of the above-mentioned regulations are in some areas still not in force and the exact implementation provisions are still missing. The significant outlines and goals of the regulations are nevertheless known. From the current view, there is still time to address the past and establish client relationships on a new basis. In the process, possible sanctions against the financial institution (for example breach of cross-border guidelines) or possible negative effects for clients (e.g. through investments that are not optimized for taxes) can be avoided. The previously mentioned uncertainties or obscurities with respect to the regulations should be identified and evaluated. Those decisions

that can also be delayed until a later point in time without endangering timely implementation of the rules should also be identified.

Thus, the past and the uncertainties must be integrated into the daily business because they cannot be covered within a project that has a definitive timeline. In order to avoid unnecessary inefficiencies, the individual requirements of the regulations must be coordinated with one another. The implemented solutions must also be flexible enough in order to take into account future changes (e.g. new withholding tax agreements) without having to make significant adjustments.

## **Viewing the transformation of financial markets as a chance**

The regulations and the laws confronting financial institutions are of a global nature and should not to be viewed as targeting Switzerland alone. The increased market transparency and regulatory growth leads to harmonization of possible services and identifies improper behavior more quickly. In a market where similar services are offered, those products that are of better quality and function are singled out. Clients of Swiss financial institutions value the quality of the services provided as well as the fact that single providers offer all services.

### **CONCLUSION**

Regulations in the areas of “tax transparency,” “investor protection” and “cross-border services” lead to increased requirements in the management of clients and the disclosure of information to clients and supervisory authorities. Liability or regulatory risks will increase as a result of these regulations should the financial institution not take any risk minimization measures (changes to the organization and processes on the new regulations / processing of “legacies”).

The measures for implementation of the mentioned regulations cannot be viewed individually, but must be linked with one another. In our view, a complete look at the implementation of the regulations helps not only with risk minimization, but also leads to increased cost efficiencies. The key is preparation that facilitates implementation of changing or new regulations on timely basis, at lower costs and with fewer resources. This will inevitably lead to competitive advantages, in particular within a market environment of margin erosion.