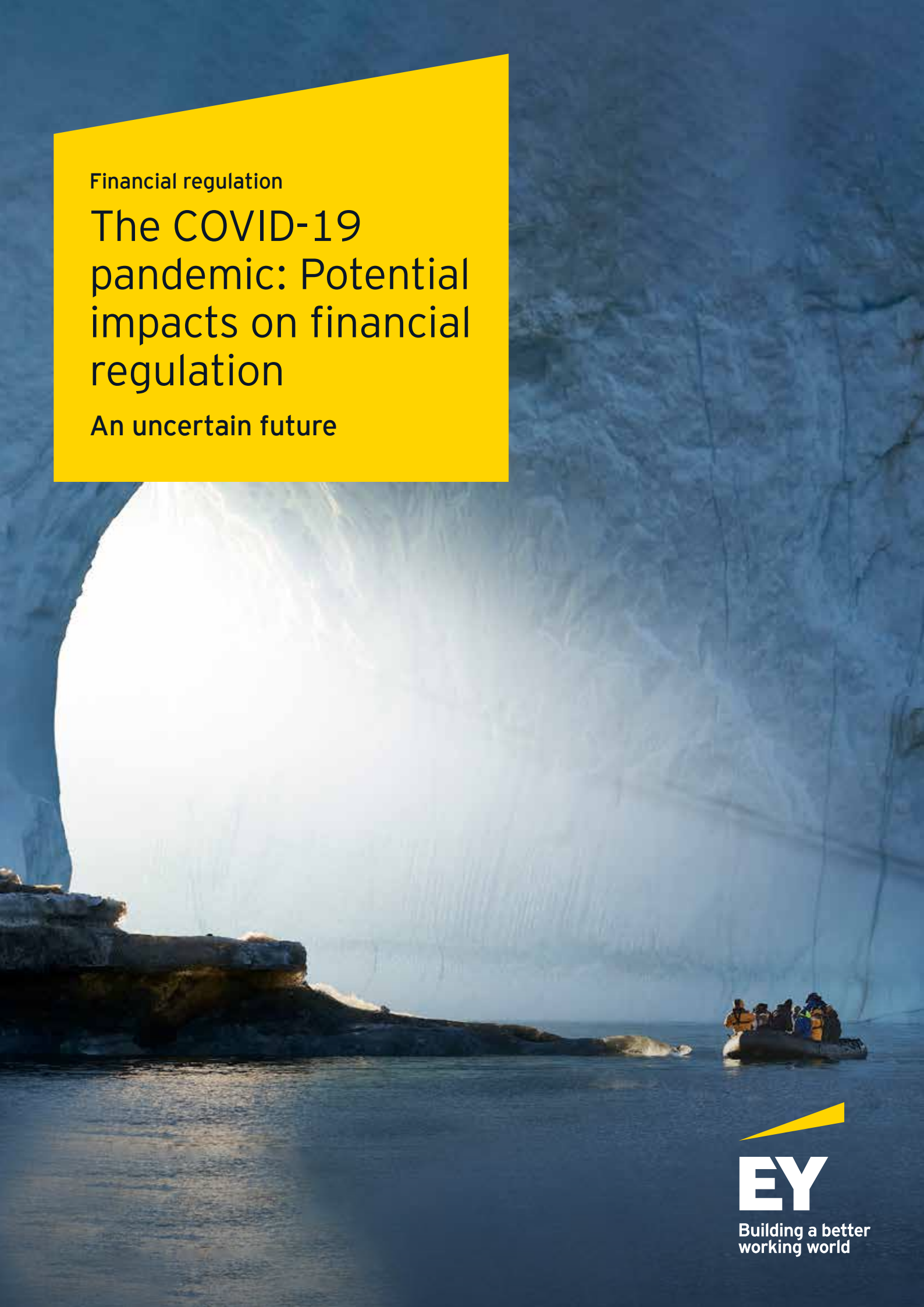
Financial regulation

The COVID-19 pandemic: Potential impacts on financial regulation

An uncertain future



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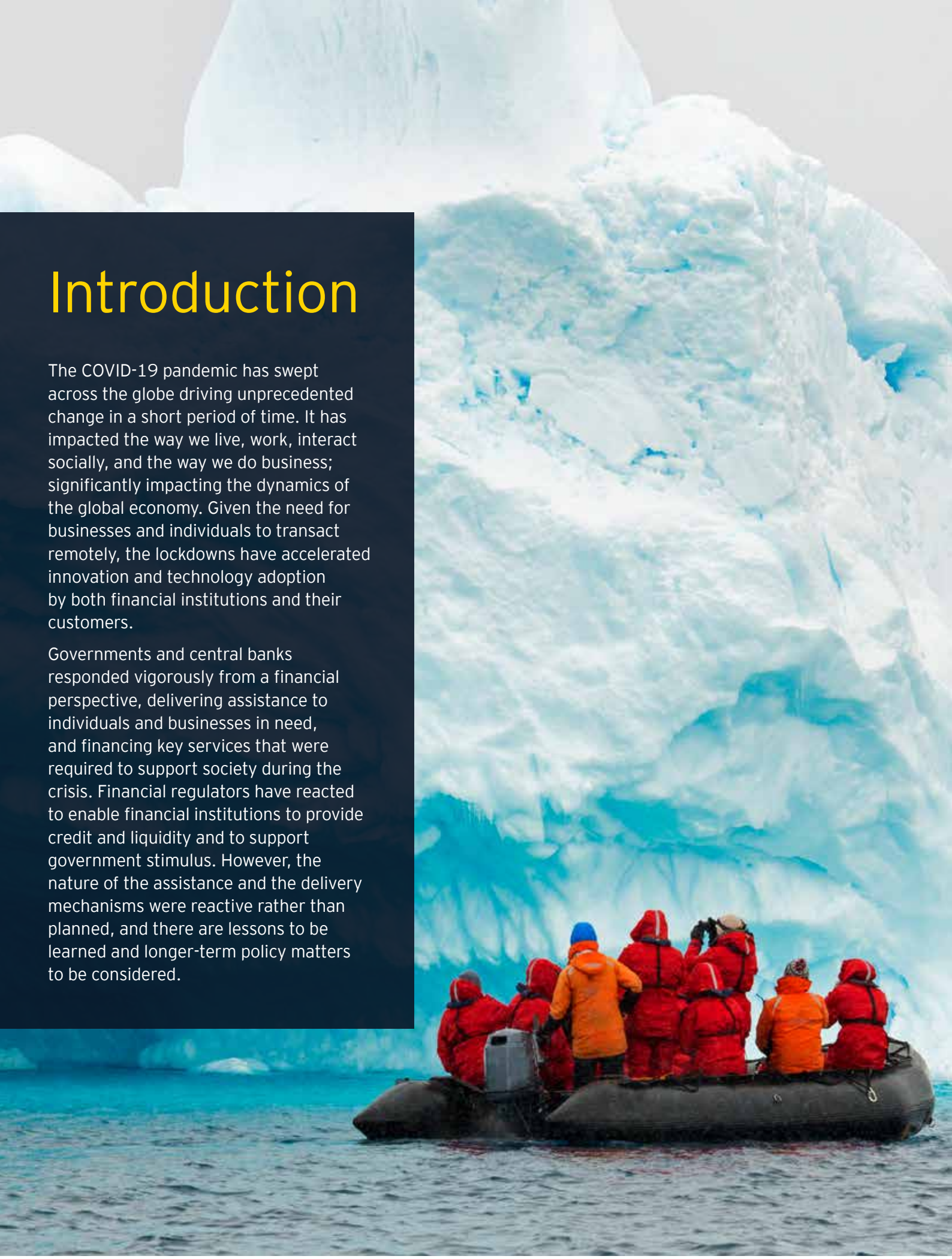
Introduction

The COVID-19 pandemic has swept across the globe driving unprecedented change in a short period of time. It has impacted the way we live, work, interact socially, and the way we do business; significantly impacting the dynamics of the global economy. Given the need for businesses and individuals to transact remotely, the lockdowns have accelerated innovation and technology adoption by both financial institutions and their customers.

Governments and central banks responded vigorously from a financial perspective, delivering assistance to individuals and businesses in need, and financing key services that were required to support society during the crisis. Financial regulators have reacted to enable financial institutions to provide credit and liquidity and to support government stimulus. However, the nature of the assistance and the delivery mechanisms were reactive rather than planned, and there are lessons to be learned and longer-term policy matters to be considered.



Key expected trends and policy development

In this perspective, we examine the impact the COVID-19 pandemic may have on the future of regulation and discuss the related issues financial institutions will need to address going forward. Clearly, future regulation will be influenced by other factors that were already underway prior to the onset of the COVID-19 pandemic, including innovation in financial services and technology. Our focus, however, is on pandemic-related drivers.

In this paper, we will explore current and future implications as they relate to four themes and speculate on how they will impact the regulatory framework.

1 Government, central banks and regulatory policy intervention

2 Operational resilience in the financial sector

3 Environmental, social and governance (ESG) issues

4 Customer expectations and requirements

Government, central banks and regulatory policy Intervention

- In the near-term, expect keen oversight from regulators on bank provisioning. Stress testing outcomes may result in different capital buffer requirements in various jurisdictions depending on how regulators calibrate these.
- Anticipate amendments for conduct guidelines on resolution or restructuring of non-performing loans (NPL's), with different strategies expected for retail NPL's, and business NPL's with full or partial government guarantees.
- Government will need to work with banks and other lenders on recovery solutions that can be deployed to restructure government guaranteed loans in a sustainable way, benefiting both businesses and government. This may include development of industry utility structures.
- Large numbers of retail or non-guaranteed business loan defaults may lead to banks restructuring balance sheets.
- In the next and beyond timeframe, developing a better understanding of contagion among participants in financial markets may lead to either the imposition or increase in regulatory oversight of participants not currently regulated or lightly regulated.
- The need to ensure orderly markets and protect non-professional investors may lead to new rules, appropriate disclosure, and suitability requirements regarding investment funds promising cash-in availability against potentially volatile or illiquid assets.
- Clearer prescription of the role of insurers in protecting against global disasters or pandemics, and development of a framework that works for the insured, insurers and government.
- The development of a dual stress-testing framework incorporating the existing macro-economic approach, and a separate approach for acute or chronic-impact global events, such as climate change and epidemics.
- Designing a crisis policy framework that identifies the roles of various public bodies and financial institutions, as well as potential tools for dealing with crisis. To the extent that financial institutions are an arm of the policy framework, there will need to be clear understanding of directors' and executives' responsibilities and potential conflicts with their responsibilities to shareholders and creditors.

Operational resilience in the financial sector

- In the near-term, regulators will want to ensure that the original manual interventions and amended processes have been upgraded and embedded into a new operating model. The working-from-home operating model will get close attention, in particular the risk governance and controls environment.
- Supervisors will focus on how cybersecurity, fraud and financial crime controls have been implemented. Institutions with market or trading activities will need to concentrate on conduct and operational risk oversight.
- Assessing third-party outsourcing arrangements that have been forced to change or did not function well during the first wave of COVID-19 under a global lock-down. Supervisors will be very focused on operational resilience in the face of continued disruption, and in understanding the longer-term plans for outsourcing and impacts on the supply chain.
- In the next and beyond timeframe, we expect regulators to move toward a more integrated operational resilience framework.
- Building flexibility into the crisis or event response framework will enable more agility and repurposing of resources.
- Rapid build-out of digital technology and data use will drive more attention to the development of a digital operational resilience framework, including more integrated regulations and digital operational resilience testing.
- Increased use of digital technology will drive users to outsourced information and communication technologies (ICT) services, including cloud. Supervisors will expect service-level agreement (SLA) contracts to contain standard contractual clauses and to designate authorities to carry out that oversight.

Environmental, social and governance (ESG) issues

- The commonality of characteristics between pandemic-related and ESG risk has been noted and, given the impacts of COVID-19, will serve to increase the urgency of actions by financial institutions.
- In the next and beyond timeframe, we expect regulators to require ESG-like considerations for financial institutions to reflect lessons learned from the COVID-19 crisis. In particular, institutions will need to consider:
  - How to make firms more resilient to similar future events
  - Future epidemic risk in business strategy and planning
  - The location of macro-economic vulnerabilities, and the effect of further epidemics on economies given societal structures and GDP constraints
  - Exposure to countries based on their social and/or organizational capacity or framework to deal with pandemic-scale events
  - The ESG performance of third parties throughout the supply chain

Customer expectations and requirements

- In the near-term, conduct regulators will focus on the treatment of vulnerable customers that have encountered payment difficulties or suffered losses arising from the COVID-19 pandemic, and will require banks to provide adequate time to allow borrowers to recover.
- In the next and beyond timeframe, the regulatory and supervisory focus will shift to cover the following:
  - Risks to customers caused by more significant shift to digital channels
  - Increased cyber risks and potential theft of data and identity
  - Continued ease of access to banking for customers not digitally competent
  - Focus on the customer journey and the bundling of product and service offerings

Theme 1

Government, central banks and regulatory policy intervention

Theme background

Governments and central banks responded swiftly to the unfolding COVID-19 crisis with aligned fiscal and monetary policy actions.

Critical to the success of the government and central bank policy measures was transmission of these financial support measures to businesses and individuals. The banking sector has been required to play a very significant role in policy delivery and supporting society through business lending, consumer accommodations, providing payment moratoria and foreclosure delays, and executing the Paycheck Protection Program in the US. As a result, banks have substantially increased the risk on their balance sheets, contrary to usual business decision-making imperatives.

Both regulators and supervisors have played an important role. Regulators have adjusted policy and regulation to reduce capital and liquidity buffer requirements and offered policy guidance on provisioning requirements. Supervisors have provided operational relief to banks from many normal supervisory activities. Some regulators have also provided temporary relief for certain documentation requirements. These actions were taken to support the banking system's extension of credit facilities required by businesses and households.

Government, central banks and regulatory policy actions were designed to prevent economies and markets from falling into a severe downward spiral, and to curtail the extent of economic damage from lockdown. In effect, by supporting the economy and the financial markets, these actions were also curtailing the extent of the damage to banks. European Union (EU) banks have been encouraged by the European Central

Bank (ECB) supervision division[1] to utilize regulatory capital buffers to lend into the real economy, making the case that banks' injection of credit is also contributing to economic stimulation and, therefore, is self-serving. This has not played out as designed, as banks are often concerned that markets will perceive utilization of buffers as a sign of weakness or vulnerability. There is significant uncertainty regarding the extent of loan losses, and banks want to be in a position to begin paying dividends again as soon as they are "permitted" to do so. But, in requiring banks to significantly increase their lending exposures, policymakers perhaps have played a part in what is actually the fiduciary duty of boards and the responsibility of senior bank management.

Likely regulatory responses

The current focus of government, central banks and regulators is to manage the economic and social impacts of the present situation until vaccines are made widely available. At the same time, they must plan an exit strategy from the emergency policy framework. However, it could take a couple of years to fully realize the effect as companies fail or reinvent themselves, markets adapt, and labor forces retrain or refocus. Continued support to the real economy and for vulnerable individuals will be unavoidable for some time. The immediate regulatory focus will include:

- Retaining temporary capital and liquidity relief measures. The EU has said they will retain capital relief until the end of 2022 and retain temporary liquidity relief until at least the end 2021. Similarly, in the US, regulators have provided relief for certain capital and liquidity measures that extend into 2021. In Asia, indications are that regulators there will continue to extend temporary capital relief measures. Banks, however, will need to start planning now to ensure that they will achieve these timelines, considering the significant uncertainty in economic forecasting and estimated loan losses.
- Banks are making changes to the provisioning models or, more often, making manual overlays to accrue provision reserves based on assumptions and the best available evidential data. Although regulators will not directly impact accounting provisions, in many jurisdictions they can demand additional capital requirements or drive stress-test capital impacts if they feel provisions are inadequate from a prudential perspective.
- Regulators will expect banks to justify and document all loan loss levels and the judgmental overlays.
- Lenders will require different strategies for retail NPLs, business NPLs with full or partial government guarantees, and corporate NPL or debt. In addition to bank lenders, there are many jurisdictions with non-bank lenders (mostly to the retail sector), and these will need to be brought into the policy framework from a conduct perspective (see customers' expectations and requirements theme).
- Regulators will be focused on supervisory stress testing and institutions' own internal stress testing in 2021, as a means of testing the asset quality of banks and understanding capital vulnerabilities. Asset management firms will focus on liquidity stress testing.
- It is not evident that regulators are changing their stress-testing methodologies significantly, but banks' own methods will likely need to expand to match their evolving credit review processes to include deeper sectoral and supply-chain analysis and focus more on highly

[1] ECB provides temporary capital and operational relief in reaction to coronavirus 12 March 2020. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html Introductory statement by Andrea Enria, at the virtual meeting of the European CFO Network 12 June 2020 https://www.bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp200612~eae5123290.en.html

leveraged borrowers. Given some authorities' pronouncements on the use of buffers,[2] further guidance will likely be needed regarding stress test outcomes, the use and adequacy of buffers, the level of downturn that institutions can withstand, the impact of reverse stress testing and what would trigger recovery actions.

- In the EU, the ECB has stated that it will monitor loan deterioration and management strategies closely and maintain its engagement with banks to devise ways of swiftly disposing of impaired bank assets. This is a clear indication that its policy position during this crisis will be different from the previous crisis, with NPLs still on balance sheets from almost 10 years ago.
- In the UK, the Prudential Regulation Authority (PRA) is being less explicit. However, an independent industry body (TheCityUK) formed a Recapitalisation Group to help consider the post-pandemic COVID-19 recapitalization challenge. They have issued a report[3] proposing various recovery solutions that can be deployed to restructure guaranteed loans in a sustainable way, benefiting both businesses and government and providing banks with a clear roadmap of how to deal with the potentially large number of small- and medium-sized enterprise (SME) loans that will face difficulties. Another independent industry body, UK Finance, is designing a utility structure to operationalize the collections and recovery of government guaranteed loans in a consistent way across the banking sector. These initiatives may well be indicative of the type of integrated approach between banks and government that is required in the development of appropriate exit strategies.
- In the US, regulators have encouraged banks to work with borrowers and provide appropriate accommodations; they will evaluate bank performance in light of current events.
- Establishment of state-owned asset management vehicles or utilities to manage the collection and/or recovery of state guaranteed loans are also a possibility and would support policies that seek to remove NPLs quickly from bank balance sheets. This structure may be the best way for the state to recover value in the long-term.

Beyond loan workout and capital repair, governments, central banks and regulators will need to reflect on lessons learned and consider amendments to the framework going forward. Some of these may include:

- New approaches to understanding the effects of contagion in financial markets
- Regulation of markets and participants
- Approach to stress testing, reflecting the speed, breadth, and depth of the economic impacts
- Changes to the policy framework for responding to similar future events

[2] Media briefing July 28, 2020 Andrea Enria (ECB) confirms buffers can be utilized to at least the end of 2022. Stress testing goes beyond this date. BIS Newsletter on buffer usability (Oct 2019) states supervisors have discretion to impose time limits. https://www.bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp200729~4177c94f5b.en.html and https://www.bis.org/publ/bcbs_nl22.html

[3] Supporting UK economic recovery: recapitalising businesses post Covid-19 — July 2020 https://www.thecityuk.com/research/supporting-uk-economic-recovery-recapitalising-businesses-post-covid-19/

Understanding contagion

To better understand the impact of significant global events, central bank and regulatory policymakers require a better understanding of the contagion effects in markets, particularly for liquidity impacts across the various segments. Understanding contagion will lead to a greater recognition of the roles that various participants play in crisis situations and allow macro- and micro-prudential regulators to re-evaluate systemic risk. It will be important to develop data and models for testing this in a wider stress test and vulnerability assessment framework in order to better determine the vulnerabilities, identify potential systemic changes, and the cause-and-effect relationships.

Regulation of markets and participants

Some of the contagion effects in financial markets impact either non-regulated or significantly less regulated entities. Some of these entities may be driving or amplifying market stress, benefiting from central bank market intervention activities and/or causing stress on more significantly regulated elements of the core funding markets. An example appears to be highly-leveraged hedge funds that hold large arbitrage positions in government bonds which they were forced to sell, causing further price falls in government bonds, and generating significant margin calls on insurance companies and pension funds.[4] If these are coming under pressure from forces outside the regulated entities in the market, then regulators may consider it necessary to extend their oversight and ensure current non-regulated participants have sufficient liquidity to manage their own stresses.

Additionally, the need to ensure the functioning of orderly markets also calls into question again the appropriateness of funds promising deposit-like stability, or cash-in availability against volatile or illiquid assets or, in the case of money market funds, against commercial paper markets that froze under stress. We would expect consideration of changes to fund structures, in particular asset mismatches and price stability promises. In addition, we expect further stress-testing requirements for market volatility. These all will need to be explained to customers and incorporated into product design, suitability and disclosures.

[4] Financial System Resilience: Lessons from a real stress - speech by Jon Cunliffe, Bank of England, June 2020 https://www.bankofengland.co.uk/speech/2020/jon-cunliffe-speech-at-investment-association

Stress testing

During this crisis, it was clear that current scenario-based stress testing was insufficient to estimate the impact on loan books. A more detailed and granular understanding of exposures based on sectors, sub-sectors and information on obligors' exposures to supply chains (production inputs) and demand chains (sales) is critical.

Many of these data points are similar to those for climate change (e.g., understanding supply chains, and client/asset exposures to physical risks). All of this means a big data agenda re: obligors (for financial resilience) and suppliers (for operational resilience), and an amended modeling approach that can accommodate these inputs and estimate the financial impacts on bank and insurance balance sheets.

We see a dual stress-testing framework as the norm: (i) a macro-economic scenario-driven framework, similar to current models; and (ii) a broader and far-reaching events-driven framework similar to what the Bank of England (BOE) (UK), the Authorité de Contrôle Prudential et de Résolution (ACPR) (France) and Australian Prudential Regulatory Authority (APRA) are discussing with respect to climate change testing that can be adapted for a wide-range of non-economic derived events.

The need to model contagion in financial markets and in the supply/demand chains of borrowers across sectors, sub-sectors and geographies will drive an even greater need for comprehensive data, data labeling and data management. When coupled with ESG requirements, and the digital agenda being driven by customer demand, this points to more urgent technology re-platforming demands from regulators.

Crisis policy framework

The COVID-19 pandemic has had, among other things, an immense impact on the economy, businesses and individuals' financial welfare. The financial sector has had to play a very significant role in ensuring people, their employment, businesses and production of goods and food were supported from a financial perspective. Although most governments, central banks and financial regulators responded appropriately during this crisis, it would be folly not to review the responses, identify lessons learned, look forward to potential future events, and establish a crisis policy framework now that incorporates a financial markets response. This may be aligned with, or include, elements of climate change or environmental risk framework responses.

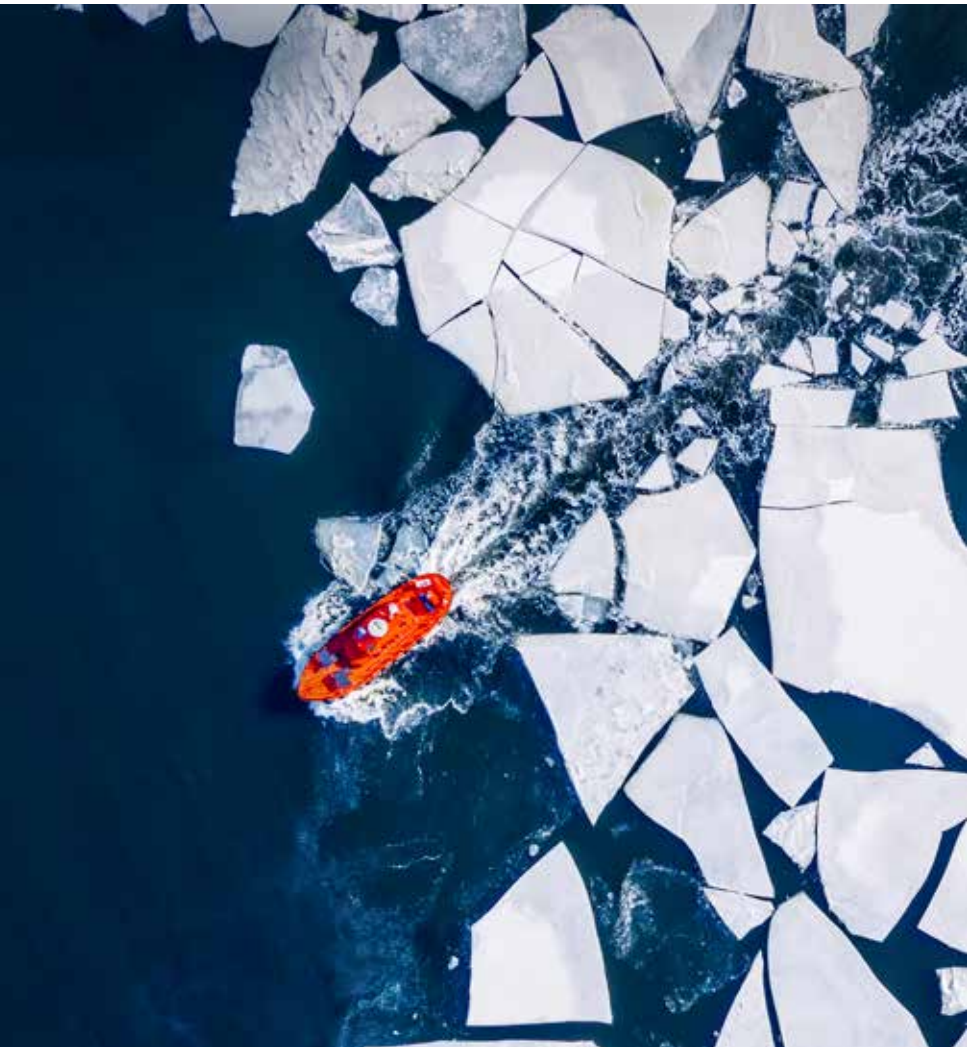
The framework may include:

- Given the reach of policy response in the current crisis and the need to encompass various market participants in the delivery and risk-taking aspects of the various support measures, there is clearly a need to formalize such arrangements for future events. We see the need for a separate crisis policy framework that will be implemented when certain environmental, epidemic or similar events occur that have far-reaching impacts on people's lives, the operation of economies and functioning of the financial system. The playbook would delineate what systemic measures might be taken, the expected role of players in implementing them, and relevant regulatory modifications needed.
- A crisis policy framework will need to include the financial institutions that will be expected to participate as part of the solution. It will provide clarity to boards, senior management and investors in these institutions as to their roles and the responsibilities of the various players in the policy framework vis-a-vis the institutions. It will need to consider the legal obligation of directors and executive management and formally recognize that these will change when they are acting jointly with government and central banks in responding under the crisis framework. There may be "best efforts" and "hold harmless" clauses in the protocol, and expectations that regulators and supervisors will not subsequently seek to hold an institution responsible for unintended consequences of actions taken in good faith (e.g., the extension of credit to entities that in a more normal scenario may not benefit from such decisions; the rapid transmission of economic stimulus with reduced fraud controls to speed up transmission; etc). It should outline the extent or boundary on the level of loss that may occur before backstops or government guarantees kick-in.
- During the current COVID-19 crisis regulators expected banks to support the real economy by utilizing their regulatory capital and liquidity buffers to lend more, dampen the shock and, in theory, protect their balance sheets. In practice this did not happen as banks realized the risks of lending in uncertainty were far greater than the potential macro-economic benefits. The crisis framework, therefore, will have to consider how stimulus will work in practice through the banking system and the infrastructure that can be deployed subsequently to recover and restructure loans in a manner that benefits the economy as a whole.
- Such measures may need to be role-played in system-wide scenario testing with bodies akin to resolution-based crises management groups but with system-wide set up.

The policy response may also address the importance of the insurers' role in the framework and look to engage them more comprehensively. The pandemic has raised questions about contract law and whether insurers are legally required to cover business interruptions caused by pandemics, the breadth of coverage, and their civic responsibilities to be inclusive and good corporate citizens. While insurers will want to protect themselves in the future from liability arising from similar events, this may not be the view of policy-setters. They may need to consider what coverage insurers must offer as part of their licensing conditions and place a cap on both the premium and the liability. This way businesses will be paying for at least part of the cost of protection and recovery and government and insurers acting in concert building off models that currently exist in some countries for flood-damage or terrorism.

Theme 2

Operational resilience in the financial sector



Theme background

The approach to operational resilience differs slightly among global regulators, some taking a more integrated approach and others taking a risk element approach. However, the principles of operational resilience and the risk elements are very similar.

The primary concern of regulators at the start of the crisis was ensuring that institutions were able to stay open for business – delivering products and services to customers. Regulators and supervisors have been satisfied with how financial institutions' operational resilience frameworks managed to transition from business as usual to business continuity operations and then to a remote work-from-home environment. There were delays in getting operational, concerns about controls on trading and other activities, and the effects on outsourced activities in offshore jurisdictions due to local lockdowns. However, institutions managed to operate effectively and recover these services reasonably promptly, in some cases re-onshoring the activities.

Regulatory responses

We expect the immediate regulatory response will be to focus attention on lessons learned in the following areas:

- Identifying bottlenecks and manual intervention challenges during the transition phases, and establishing an understanding of the causes (e.g., legacy systems not properly integrated)
- Understanding material operational risks and ensuring these are being properly identified, recorded and reported to regulators in the standard regulatory returns
- Assessing, monitoring and testing of third-party outsourcing and on-offshore concentrations
- Understanding and addressing cyber, fraud and financial crime risks from adapting processes to support working-from-home, remote client interactions, and the rapid transmission of economic stimulus
- Developing workforce strategies to allow people to return to the workplace as required and in a way that is value-added and for specific purposes

- Planning and implementing enhanced tools for remote operations
- Clarifying requirements for physical versus digital documentation

Post-pandemic, Covid-19 regulators will be sensitive to the many problems that can prevent banks from fulfilling critical roles in the aid transmission framework. As regulators move away from monitoring the immediate responses and vulnerabilities, we expect they will require banks to harness the lessons learned from the response to the COVID-19 pandemic. It is likely that financial institutions will be required to develop a crisis management framework incorporating the lessons learned and that these will become part of a more coordinated and integrated operational resilience framework.

We have already seen in August 2020 the Bank of International Settlements (BIS) issue separate consultative documents on Principles for Operational Risk and Principles for Operational Resilience[5], clearly messaging that Basel sees them as separate concepts.

A more integrated framework will require institutions to develop a service-focused view, map asset interdependencies extensively while noting manual intervention dependencies, identify concentration risks, including single points of failure, and establish impact tolerance metrics. This implies banks establish or enhance the following:

- Service criteria and listing
- Asset identification and mapping
- Risk assessments (e.g., business impact assessments (BIAs and BCPs))
- Concentration risk management, including back-up strategies to diversify exposure and reliance on critical third parties

The COVID-19 events will continue to drive a host of changes to the way institutions work, where they work, how they interact with their clients, the technology they deploy, and how they view the outsourced eco-system. Longer-term policy effects will likely include:

- Institutions will continue to make far greater use working-from-home, but will need to implement enhanced controls and resilience while addressing training, development, and mentoring needs. Banks will need to demonstrate how they are able to maintain effective controls in this environment.
- Current approaches to managing and testing operational resilience focus on prioritization of key business services and ensuring these are defined and protected. However, in an external event-driven crisis these priorities can switch, as in the current COVID-19 pandemic. There will probably be a new emphasis on building flexibility and adaptability into the resilience framework so that people, processes, systems and delivery mechanisms can be swiftly repurposed.
- Regulators will be even more sensitive to the threat of concentration risk in the outsourced supply chain. Firms will need to re-evaluate the resilience of the current ecosystem and apply the lessons learned to enhance resilience and possibly reduce single source or location dependency risk.
- The rapidly increasing use of digital technology and data across the financial system raise challenges in terms of operational resilience and make it particularly vulnerable to ICT and security risk operational incidents and cyber-attack. Financial service firms can expect more attention on a cross-sectoral basis to their digital operational resilience framework, including; (i) development of more integrated, consistent and detailed regulations; (ii) digital operational resilience testing; and (iii) potential oversight of critical third-party providers.
- Given the level of potential risk posed by a digital environment, we expect enhanced regulations across all sectors that will bring stricter enforceability and the need for clear governance, monitoring and testing.
- Consistent with the interconnectivity in the financial system, we expect over time that ICT testing frameworks will require the development of common standards and approaches, including assessments and gap analysis, as well as actual threat-event testing. A common framework would support reliance and mutual acceptance of outcomes across sectors and jurisdictions.
- The increased use of digital technology will drive firms further toward the use of outsourced ICT service providers (including cloud), resulting in greater risk and more concentration residing with these providers. Regulators are already considering the design and development of third-party oversight frameworks, including defining activities and designating the authority that would be responsible for carrying out the oversight. The use of standard contractual clauses, currently being considered for cloud arrangements with financial sector entities, will possibly also be extended to certain other ICT third-party service activities.

[5] BIS Consultative documents on principles for operational risk and operational resilience https://www.bis.org/bcbs/publ/d509.html

Theme 3

Environmental, social and governance issues

Theme background

Many of the characteristics of factors common in an ESG framework[6] are present in the impact of and the policy response to the COVID-19 pandemic, namely:

Non-financial impacts: Financial institutions have been required to consider and incorporate into their actions: support of vulnerable customers; additional lending in a high-risk environment to keep businesses operating; insurance claims that may normally be vigorously defended.

Uncertainty: Relating to the timing of events and severity of impacts.

Negative externalities: The wider impacts on society and business sectors will impact the activities of financial institutions long after the event.

Value chain impacts: The effects on clients' supply chains and demand for their products and services is significantly impacting the quality and value of financial institutions' assets and liabilities.

Increased sensitivity to changes in public policy: Significant impact to financial institutions from policy responses of government, central banks, regulators and supervisory bodies.

Thus, the ESG frameworks provide a useful model for considering regulatory responses to the COVID-19 pandemic.

[6] EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms – Oct 2020 https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Discussions/2021/Discussion%20Paper%20on%20management%20and%20supervision%20of%20ESG%20risks%20for%20credit%20institutions%20and%20investment%20firms/935496/2020-11-02%20%20ESG%20Discussion%20Paper.pdf

Regulatory responses

Although the COVID-19 pandemic has halted much of the normal operational supervisory work and redirected much of the policy development work, it has not interrupted the pace of policy development of the climate change and sustainable finance agenda. If anything, it has refocused minds on the importance and urgency of developing a functional policy framework given the effect of an acute event like a pandemic.

A key policy response has been assisting vulnerable customers through financial difficulties. Showing compassion and understanding in executing workout solutions will be critical during the next phase. We expect to see a continuation of conduct regulators' protection of vulnerable customers and the development and enforcement of standards (see customer expectations and requirements). This will require a careful balancing of customer care, social responsibility, and the management of usual business-decision imperatives.

In addition to protection, we expect to see further developments in ensuring access to appropriate services for people who are not technologically savvy or for the financially disadvantaged who cannot easily obtain access to products or services that become a necessity in the increasingly digital and non-cash environment. More needs to be done to improve digital literacy, improve access to digital identities and mobile and internet services, and address biases in data.

The impact of the COVID-19 pandemic has highlighted the exposure of the more vulnerable in society to higher infection rates. This has coincided with international support for the "black lives matter" campaign originating in the US and the general swell of opinion highlighting other areas of social injustice, racism and diversity. As a result, governments will likely be more focused on seriously addressing these issues and their domino effect on regulatory policy.

The expansion of the social agenda into business strategy would require banks, investment firms, securities firms, fund managers and pension funds to consider their balance sheet assets from a social agenda perspective in a similar way to the environmental agenda. Not just "green" investment, but also a socially supportive agenda. Firms that exploit labor at below minimum wage and run "sweat-shop" environments can prompt swift customer reaction when exposed and need to consider the reputational impacts. The sharp fall in revenues that can ensue produce resultant falls in share value, debt downgrades and higher probability of default on loans.

When firms are re-examining their outsourcing arrangements as described in the Operational Resilience theme in this paper, they will need to consider both country and third-party policies toward individuals. This will include the political regime, the treatment and payment of employees, and the conditions under which they operate.

As with the ESG agenda, we expect these matters will require recognition in the following areas of financial institutions planning and management:

- Incorporate future epidemic risk into business models and strategies to determine industries and sectors most impacted by lockdowns and supply chain disruptions.
- Consider vulnerability and the effect of further epidemics on economies given societal structures, the GDP constructs (industrial/service/agricultural), and the impacts on unemployment.
- Reassess investments and loans to businesses or the establishment of outsourcing arrangements in countries based on their social and/or organizational capacity or framework to deal with pandemic-scale events.
- Develop policy and approach for treatment of customers in the event of a future epidemic or other acute health events.

Theme 4

Customer expectations and requirements

Theme background

Dealing with customers' needs and requirements has been at the core of financial institutions' work during the pandemic.

The immediate governmental policy response has been to ensure individuals and households receive income supplements and relief from making debt repayments if their sources of income have ceased or substantially changed. Financial institutions have played a key role in delivering payment holidays to retail clients and lending to many SMEs.

The payment holidays were delivered through different mechanisms. Some were established by legislation, others on a voluntary basis by banks acting through banking federations or acting alone. Irrespective of the basis for establishing payment holidays, conduct authorities have been very active in ensuring that banks deliver this assistance to customers without question and without affecting customer credit scores. In the US, regulators placed a temporary moratorium on foreclosures, and stressed the need for banks to work with customers to the greatest extent possible. However, politicians and the media complained that financial institutions favored certain customers in the distribution of benefits to the detriment of the poor. In Asia, banking regulators have also worked with the industry to provide and extend moratoria on loan payments and other flexibilities to customers in financial difficulties. However, there has been little suggestion of inequality in the distribution of assistance. That may come yet.

Regulatory responses

While policymakers are beginning to consider their exit strategies, they will also need to evaluate the implications for retail customers. Conduct regulators will be focused on protecting the vulnerable and ensuring they gain access to payment relief while the pandemic is continuing and until more normal economic activity resumes.

The commencement of rescheduled payments at the end of the payment moratoria will likely reveal a significant cohort of borrowers that are unable to pay immediately or for an indeterminant period due to employment uncertainty. These borrowings will relate to mortgages for family homes, credit cards with high interest rates, and unsecured personal borrowings. From a societal perspective, there is a need to support people who are genuinely vulnerable either directly or indirectly as a result of the virus. Clearly, government policy will seek to protect individuals and financial institutions will most likely be required to participate in this support. These expectations, in most cases, will extend to the not insignificant cohort of non-bank lenders in many countries.

The regulatory and supervisory responses are likely to include:

- Collections and recovery activities potentially will need to change and those that are outsourced will require a revision to the process and the solutions offered to customers. It will be important for lenders to understand customers' personal circumstances arising from the epidemic and demonstrate flexibility to accommodate what customers can actually afford.
- Regulators in some jurisdictions will likely require lenders not to foreclose on mortgages and to devise alternate sustainable restructuring solutions. Some structures can involve the financial institution or a government vehicle taking an equity interest in the property. There is obviously the threat of clients abusing this policy and adopting a "can pay, won't pay" approach and using the extended moratoria to pay-off other debt or make purchases that otherwise may not be feasible.
- Regulators, at the same time, will have to consider the potential cost of trapping mortgage-holders in negative equity due to the potential fall in housing prices.
- In the case of credit card lenders, institutions could be required to reduce interest rates or to settle for reduced repayment of principle.
- As banks transition from crisis management, they should anticipate and prepare for an increase in complaints, potential legal action, regulatory and political questions. Banks should build the case for how decisions were or are made on a fair, equitable, and inclusive basis, and maintain full documentation.
- Fund managers will find a renewed regulatory and customer focus on delivering value for money for investors. At the same time, they will face more scrutiny on how they monitor liquidity and valuation risk within funds, and help this shape their product management and distribution strategies.

The nature of the support will probably differ across jurisdictions as a result of the local legislation and availability of bodies, such as development banks and local political realities. In any event, banks will be forced to take appropriate loan losses upfront.

Not only are retail clients vulnerable, but small business owners are as well, and it is possible that regulators extend retail-like protection to a certain cohort of SME clients. Very often SME borrowers have their homes committed as collateral and foreclosure regulations will also apply to these debts.

The lockdown forced most communications and transactions into digital channels and greatly increased the amount of customer business using these modes. It also increased cyber risk and potential theft of data and identity, and the risk of transactional interference. This is also a heightened risk on the regulators radar and banks need to address the required internal controls and provide documentation. It is important to identify and investigate weakness and potential incidents in data privacy breaches and or data stolen through cyber events, and ensure customers, authorities, and financial supervisors are informed.

Financial institutions will want to take advantage of the current leap in digital engagement and continue to develop transaction execution capabilities on the back of the momentum gained during the lockdown. This includes a significant switch to a non-cash environment. In this context, conduct, customer fair treatment, and data privacy and protection need to be a cornerstone of the developments as they loom as a high priority on the regulatory agenda.

Financial inclusion will also be an important consideration for elements of society. Regulators will be aware of vulnerable customers whose access to cash continues to be important. Lowering use of physical cash is making ATM machines expensive and further pressure on branch closure programs will make cash less available to such customers.

Firms will want to invest in digital architecture and adoption through marketing to build customer awareness of the options open to them, share the successful experiences of new digital customers, and offer support for vulnerable customers or those that do not feel at ease using digital channels.

Accompanying a shift in the technology and digital delivery, institutions may begin to shift the nature of offerings to an expanded offering and a more bundled delivery of service and product with different pricing structures. This will likely bring a suite of other issues for regulators to consider in terms of fair treatment and transparency.

The conduct authorities are also focused on how insurers are dealing with claims, in particular where insurers are interpreting terms and conditions in what regulators see as a manner unfair to vulnerable groups. Small businesses and individuals cannot afford to legally challenge such decisions by insurers. In UK, the Financial Conduct Authority (FCA) has taken a number of insurers to court over their failure to meet business continuity claims. The detailed judgment was substantially in favor of the FCA and the insured, although individual policies will stand on their own merits. The US insurance industry is closely monitoring these developments for the potential longer-term impacts on the sector.

Conclusion

As we move into 2021, marking 12 months since the onset of the COVID-19 pandemic, there is still significant uncertainty regarding the financial effects on individuals, business sectors and financial institutions. The ongoing experience will likely also bring society a step closer to fully acknowledging the risks of climate change and environmental risk and drive more urgent responses, while also accepting the risks of similar epidemics or other health threats, such as antimicrobial resistance. Together with significant concerns regarding societal inequality, social disruption and international geopolitical shifts, these point to further uncertainty and potential disruption.

Against this backdrop, we have explored a number of themes and potential regulatory responses to COVID-19. Some are more obvious than others and some inevitable given the impact of the epidemic and the existing direction of regulatory policy. There are others that require reflection and further analysis in order to develop appropriate responses. One thing is clear, we need to be better prepared and have coordinated societal, government and financial responses.

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