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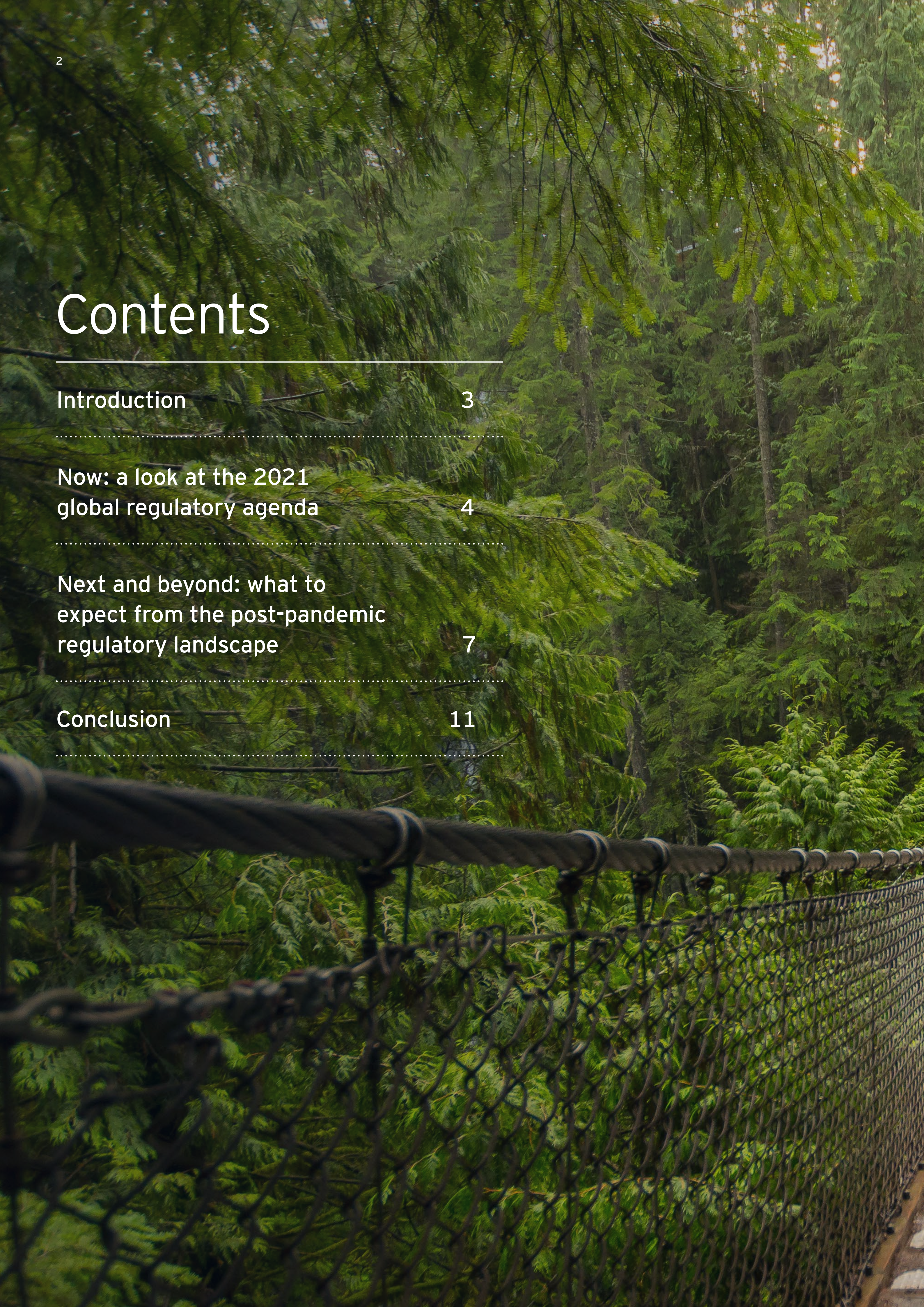
2021 Global bank regulatory outlook

How the COVID-19 pandemic has changed global banking's vision for 2021 and beyond



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Introduction

A year ago, industry outlooks were blissfully ignorant of the pandemic. Twelve months later and it seems that the pandemic will continue to shape current events and have residual impact for some time to come. In 2021, will this external, seismic, global event cause governments and policymakers to overcome divergent tendencies and deliver more joined up solutions in the spirit of common cause, or will it reinforce recent trends of fragmentation and protection of regional and national interests?

The immediate prospects are not encouraging. In Europe, although a trade and cooperation agreement with the UK on the terms of its future cooperation with the European Union (EU) has been reached, the consequences for financial services remain a big unknown. In the US, due to the election and its aftermath, the new administration is clarifying its policy and supervisory priorities; and in Asia-Pacific (APAC), geopolitical tensions between China and the US show no signs of abating.

The financial services industry is considerably stronger than during the 2008 crisis, but the change management demands caused by the pandemic have tested risk management capabilities and regulatory responses. We look at the immediate environment (Now) and a little further ahead (Next and Beyond) to identify likely regulatory action. For a more detailed analysis of the future direction of travel, see EY's paper on **the impact of the COVID-19 pandemic on financial regulation.**[1]

[1] 'The COVID-19 Pandemic: Potential impacts on financial regulation', EY January 2021.

Now: a look at the 2021 global regulatory agenda

The pandemic had an immediate impact on several key areas of bank activities. These have required significant changes in business processes and modifications in regulatory and supervisory oversight in the near-term.

The COVID-19 pandemic response

Terms that are now commonplace in regulatory discussions – forbearance, compassionate collection, and business interruption – were hardly top of mind at the start of 2020. Customer protection has taken on added meaning as conduct regulators focus on protecting the vulnerable and ensuring they gain access to payment relief while the pandemic continues and until more normal economic activity resumes. Collection and recovery activities must be reappraised, including those that are outsourced, with revisions to the process and the solutions offered to customers. Banks must now proactively distinguish viable distressed customers from non-viable ones by using borrower-specific debt restructuring and forbearance practices. It will be important for lenders to understand personal circumstances and to reflect them in more flexible arrangements that accommodate what customers can realistically afford.

As firms transition from crisis management they should anticipate and prepare for an increase in complaints, regulatory and political scrutiny and potential legal action. Regulators will be alert to the increased likelihood of mis-selling arising from commercial pressures in a difficult business environment. The conduct authorities are also focused on whether insurers are dealing with claims in a manner that is unfair to vulnerable groups, particularly those related to business continuity. Firms should demonstrate how decisions were made on a fair, equitable, and inclusive basis, and maintain full documentation.

Sustainability

Sustainability will return to center stage in 2021. An immediate boost is the new Biden administration's decision to re-engage in global climate talks, with both Washington and Brussels talking about linking trade and climate agendas. This is accompanied by renewed worldwide regulatory pressure for adoption of sustainable finance frameworks and growing support for the agenda from large international banks, investors and corporates. The foundation of climate risk regulation must now be put in place via a taxonomy that can serve as a list of "green" economic activities and a basis for a series of disclosure requirements for corporates, financial market participants and financial products.

Regional and national efforts are underway, and we expect to see further momentum throughout the year. For example, Singapore and Hong Kong have been driving disclosure and taxonomy initiatives in APAC. The Monetary Authority of Singapore (MAS) is developing standards for insurance, banking and asset management sectors,[2] and the Hong Kong Securities and Futures Commission (HKSFC) has issued proposals for climate risk disclosure by fund managers and with other regulators and is starting on a sector-wide taxonomy to be aligned with the EU and Chinese efforts.[3]

The evolving landscape is explored further in EY's recent paper on **climate change risk.**[4]

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2 "Consultation Paper on Proposed Guidelines on Environmental Risk Management (Banks)," MAS June 2020.

3 "Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers," HKSFC October 2020.

4 "Climate change and sustainability: global regulators step up the pace," EY January 2021.

Technology and data

Regulators will want to renew efforts to transform supervisory capabilities through expanded use of technology and data. The UK Financial Conduct Authority's (FCA's) digital regulatory reporting (DRR) initiative is already moving ahead via various pilots and proof of concept exercises. More comprehensive and real-time data sets could be within reach of supervisors. However, SupTech and RegTech progress might be offset by other data challenges in the coming months, some of which are compounded by geopolitical issues of the day. In Europe, Brexit will continue to be a major complication, with the European Commission (EC) now faced with deciding if it will adopt any adequacy decisions on data regulation as part of the Brexit process. The US will be trying to achieve some degree of consistency on data privacy within its borders while also pursuing international data access standards that can facilitate enforcement actions. On both sides of the Atlantic a strong sense prevails that Big Tech firms need to be more comprehensively regulated, though the US and the EU have different approaches to privacy. APAC is already caught up with various data localization issues exacerbated by China-US geopolitical tensions.

Algorithmic accountability across artificial intelligence (AI) and machine learning (ML) applications will feature across post-pandemic supervisory reviews, given that there are already concerns about decisions taken on allocation of relief measures, loan decisions and forbearance actions. AI and ML regulatory frameworks are developing fast in APAC and the EU, focusing on fairness and transparency.

Prudential risk

Regulators will be focused on supervisory stress testing and banks' own internal stress testing in late 2020 and 2021 as a means of testing the asset quality of banks and understanding capital vulnerabilities. It is not evident that regulators are changing their stress test methodologies significantly, but COVID-19 exposures and the environmental, social and governance (ESG) agenda are creating new data and stress-testing demands. Banks' own methods will need to expand to match their evolving credit review processes that include deeper sectoral and supply-chain analysis and a focus on borrowers that are more highly leveraged.

The Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, has signaled an end to the post-2008 financial crisis policy agenda.[5] The revised timeline for Basel III implementation has been in place since March 2020, and the GHOS has stated that any further potential adjustments to Basel III will be limited in nature and consistent with ongoing evaluation work. In terms of regional implementation, pandemic recovery measures will take priority ahead of assessments of the remaining elements of Basel III and IV.

The original upbeat assumption by regulators regarding the performance of loan books has evolved into a more uncertain and adverse view of potential outcomes. The European Central Bank (ECB) intends to retain temporary capital relief measures until the end of 2022 and retain temporary liquidity relief until the end of 2021 at least. Similar extensions will apply in APAC and the US. Meanwhile, banks are making changes to provisioning models or, more often, making manual overlays to accrue provision reserves based on assumptions and the best available data.

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5 "Governors and Heads of Supervision commit to ongoing coordinated approach to mitigate Covid-19 risks," press release by Basel Committee on Banking Supervision November 2020.

Regulators will look to understand the impact on capital and liquidity at banks and insurers, and refine policies on resolution of non-performing loans (NPLs), by monitoring loan deterioration and management strategies and maintaining engagement with banks to devise ways of swiftly disposing of impaired bank assets.

Operational risk

The ongoing disruption caused by the pandemic magnifies the importance of operational risk. In August 2020, the Bank for International Settlements (BIS) issued separate consultative documents on "Principles for Operational Risk" and "Principles for Operational Resilience" that references the impacts of the COVID-19 pandemic.[6] In addition to existing operational challenges, extra attention will be paid to:

- Remote working: Institutions will continue to make far greater use of working from home (WFH), but will need to implement enhanced controls and resilience and address training, development, and mentoring needs. Banks will need to demonstrate how they are able to maintain effective controls in a WFH environment. Some supervisors have already expressed concerns that monitoring of staff and controls around trading and customer interaction are showing signs of weakness.
- Digital operational resilience: The rapidly increasing use of digital technology and data across the financial system can aid resilience; for example, to location-based risk events. However, it raises challenges in terms of operational resilience and makes it particularly vulnerable to Information and Communication Technology (ICT) and security risk operational incidents, including cyber-attack, especially when the latter is deployed by state actors during geopolitical tensions. Financial services firms can expect more regulatory 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) oversight of critical third-party providers, including cloud outsourcing.
- Concentration risk in the delegated supply chain: In the case of service or activity outsourcing, 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.

Inter-bank offered rates (IBOR): Supervisors are communicating explicitly the need to maintain the pace of IBOR transition, but some recognition of pressure points has been seen with the extensions until mid-2023 for the legacy US-dollar London inter-bank offered rate (LIBOR) and until the end of 2023 for use of third-country benchmarks in the EU. In the coming months, we can expect to see further detail on fallback protocols, proposals for alternate rates, and overall timelines. Also, the emergence of the pandemic since the cessation roadmap was outlined has contributed to logistical challenges due to the difficulty of keeping salespeople, other staff and clients trained and updated, and may need to be reflected in the next phase of transition.

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6 "Basel Committee releases consultative documents on principles for operational risk and operational resilience," press release by Basel Committee on Banking Supervision, August 2020.

Next and beyond: what to expect from the post-pandemic regulatory landscape

Banks have been building and enhancing their risk management capabilities for many years. However, the pandemic exposed certain vulnerabilities in governance processes, and regulators have shifted medium-and longer-term priorities.

Policy evolution and strategy

For the second time in just over a decade, governments and regulatory authorities are facing the prospect of balancing a supervisory agenda with the need to ensure that the wider economy is given breathing space to recover from a crisis.

Policy agendas have been revised accordingly. In Europe, the EC has published an updated Capital Markets Union (CMU) action plan, which seeks to bolster market financing, reduce over-reliance on bank financing, and address COVID-19 impacts. The CMU plan contains policy objectives that will resonate globally, such as the search for a greener economy with broader capital markets that deliver more lending across all sectors while addressing conduct issues with a focus on retail customer outcomes.

In the US, the new Biden administration will be reconnecting with a policy agenda that has seen relatively limited recent activity. However, it now looks likely to focus on supervision of systemically important financial institutions, consumer protection and financial inclusion, sustainability, implementation of public support measures and housing finance reform. The International Organization of Securities Commissions (IOSCO), along with several other international bodies, has identified the systemic risks and liquidity mis-matches presented by non-bank financial intermediation (NBFI).[7]

Sustainability

On top of the initial building blocks of taxonomy and disclosure, another milestone will be the integration of climate and sustainability considerations by financial institutions when investing on behalf of or advising clients. However, progress may take longer. During 2020, we have already seen not just regional differences of opinion but new rules and guidance that seem to restrict, rather than expand, the considerations that inform stewardship and investment.[8] Institutions with a global footprint may encounter multiple and varied requirements if the pace of change is not uniform.

Supervisors will also hope to make progress with prudential treatments, stress testing and refinements to the supervisory process. In its November 2020 Financial Stability Review, the ECB said: "The planned ECB climate stress test will … make it possible to assess the impact of potential regulatory and policy measures aimed at mitigating climate risks to the financial sector in a forward-looking way and for different climate scenarios."[9] The Hong Kong Monetary Authority (HKMA) has invited authorized institutions to participate in a pilot exercise on a climate risk stress test to be undertaken in 2021,[10] and the UK Prudential Regulation Authority (PRA) will conduct a climate stress test exercise for the financial services sector in June 2021.

[7] IOSCO Annual Meeting, November 2020.
[8] For example, U.S. DEPARTMENT OF LABOR 2020 https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030.
[9] "Financial Stability Review," ECB November 2020.
[10] Invitation to climate risk stress test, HKMA December 2020.

Financial inclusion

Post-pandemic priorities may mean that the inclusion agenda may take longer to progress. Ultimately, a key objective is likely to be, via policy development and collaboration between regulators and industry, that markets and institutions deliver financial wellbeing, inclusion and better customer outcomes, rather than just a range of traditional financial services. Broader expectations will be placed on institutions across the spectrum of their operations. When firms are reviewing their outsourcing arrangements, 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. Higher priority must be afforded to diversity and inclusion. We also expect to see a continuation of regulatory protection for vulnerable customers and the development and enforcement of standards that will need to balance customer care, social responsibility and the management of usual business decision imperatives.

Anti-money laundering (AML)

There is no doubt that the fight against financial crime must become more connected across jurisdictions. However, limited cross-border sharing of information, combined with divergent approaches to overseeing AML compliance vis-à-vis financial entities, requires a critical review of strategy. The urgency is compounded by recent events. The pandemic impact has created an environment characterized by business and market upheaval and reduced due diligence of borrowers. This has created new opportunities for internal and external bad actors to exploit business disruption, and has reduced oversight and untested cyber controls, especially in an atmosphere of financial pressure.

Increased cross-border cooperation and proposed regional bodies, such as an independent, stand-alone EU AML agency, will play an important role, but the architecture will be crucial to counter the speed and ingenuity of the criminals. We can expect to see some groundwork being laid on convergence via collection of national standards and intelligence sharing. The US has already passed the first major revision to Bank Secrecy Act (BSA) and AML requirements in two decades, clarifying and streamlining the rules, adding new regulatory requirements, and expanding the scope of a covered entity.

Digital finance

The acceleration of the digital agenda due to the pandemic will require a timely response from regulators. We are now seeing more coherent digital strategies being developed that will aim to pick up all the key elements. One example is the EU Digital Finance package, which prioritizes licensing, AI/ML, retail payments, cryptocurrency/assets, and digital operational resilience. Singapore has launched a coordinated digital program, linking also to green finance.[11] In the next 24 to 36 months, we can expect to see the emergence of a coordinated policy framework for the new digital era of financial services.

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[11] "New Asian Institute of Digital Finance to Spearhead FinTech Education and Research," press release by Monetary Authority of Singapore (MAS), August 2020.

Of course, financial institutions will want to take advantage of the current leap in digital engagement and continue to develop transaction execution and service offering capabilities on the back of the momentum gained during the lockdown, including a significant switch to a non-cash environment. In this context, customer fair treatment and data privacy and protection must be among key policy considerations that accompany the digital acceleration, rather than an afterthought. We can expect to see requirements for greater transparency around how data analytics are used, to determine creditworthiness for example, in order to identify and prevent built-in bias that leads to undesirable outcomes via negative screening, filtering and discrimination.

Supervisors have set down clear markers that regulatory frameworks must be constructed, or adapted, before Big Tech's new wave of payment systems, mobile services, data owners, digital currencies and other FinTech applications generate systemic issues, both domestically and internationally. Predicting what is next has been made easier by events surrounding the suspension of Ant Group's November China and Hong Kong IPO. If one wants to know the likely future of FinTech regulation, the Chinese response is indicative; rules before risk with a strong focus on leveling the playing field between new tech entrants and incumbent financial institutions.

Cryptocurrency: Developments in cryptocurrency will include a heightened response from regulators as they seek to manage the risk posed by cryptocurrencies and payment systems that lie outside the supervisory framework, while at the same time central banks will accelerate efforts to deliver digital currencies (CBDCs) that they hope will form the foundation of national payment systems. The impact of CBDC on the private sector commercial banking system will need to be thoroughly assessed. Developments in this space will make for an interesting dynamic as it is rare for both regulators and market participants to be in the technological vanguard in the same space at the same time. Both will have to address the risk factors that have so far proved to be obstacles to cryptocurrency development, especially financial crime, cybersecurity and data protection.

Prudential risk

Regulators will want to address some of the contagion effects in financial markets arising from either non-regulated or significantly less-regulated entities, whether via Big Tech or other forms of NBFI. 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.[12]

Regulators may also consider:

- Extension of oversight and ensuring current non-regulated participants have sufficient liquidity to manage their own stresses
- Lower-key liquidity stress testing of funds in the non-bank sector in order to avoid concerns about the potential contagion falling back into the banking system

[12] See "Holistic Review of the March Market Turmoil," Financial Stability Board (FSB), November 2020.

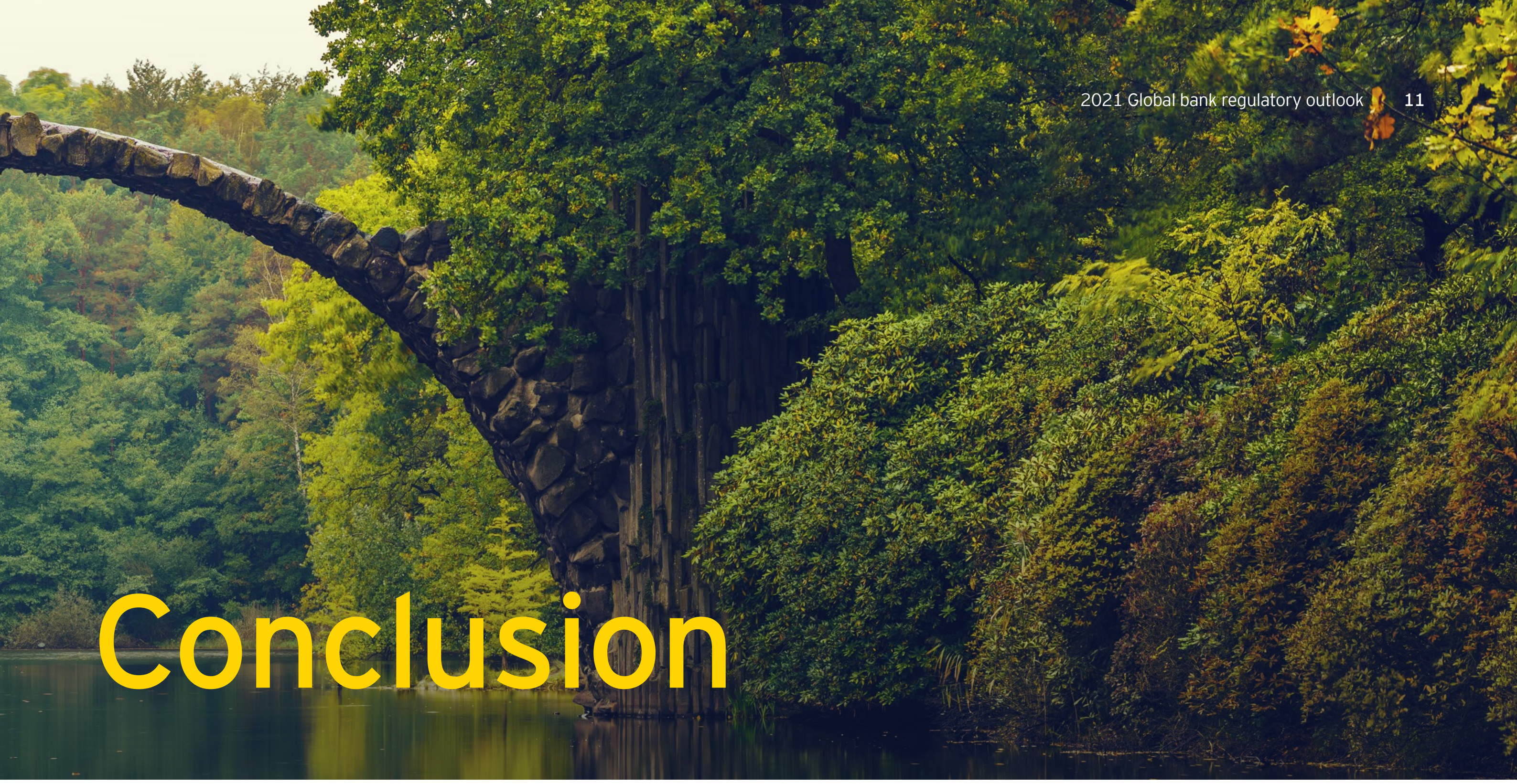
Overall, we see the emergence of a dual stress-testing framework as the norm: (i) a macro-economic scenario-driven framework, similar to current models; and (ii) a broader and far-reaching events-driven framework, similar to what supervisors are discussing with respect to climate change testing, that can be adapted for a range of non-economic derived events. The much longer time-horizons, complexities, uncertainties and unknowns associated with climate change not only require the development of new stress testing and modeling approaches, but will also require the constant review of framework, scenarios, variables, transmission channels, and economic impacts. In other words, a more complex and a more agile capability. A detailed understanding of exposures based on sectors, sub-sectors and information on obligor's exposures to supply chains (production inputs) and demand chains (sales) is critical. All of this means a big data agenda re: obligors (for financial resilience) and suppliers (for operational resilience).

Post-2008 crisis discussions, which ultimately were of marginal effect around systemic risks in asset management and funds, will also be revisited as already signaled by the Bank of England (BoE) and the FSB. We would therefore expect consideration of changes to fund structures to address asset-liquidity mismatches and price stability promises.

A possible problem-asset strategy may be the establishment of state-owned asset management vehicles or utilities to manage the collection and/or recovery of state guaranteed loans, which would assist in quick removal of NPLs from bank balance sheets.

The case for strategic mergers and acquisitions in an already over-banked European banking sector will grow stronger post-Covid. The ECB has already issued draft guidelines outlining its approach to consolidation,[13] clarifying that acquisition of banks at significantly below book value will create additional eligible capital in the consolidated entity.

[13] "Guide on the supervisory approach to consolidation in the banking sector," ECB July 2020



Conclusion

Most of 2021 is likely to be dominated by supervisory and policy actions designed to address the impact of the COVID-19 pandemic.

After that, we will see regulators returning to several key agendas that were already in motion and in various stages of development: conduct risk, climate risk, digital, operational resilience, data protection, cybersecurity and financial crime.

A recurring theme across the post-pandemic regulatory landscape will be the need for supervisors and standard setters to identify and collect new, standardized data sets that can inform policymaking that allows the new frontiers of technology, sustainability and ESG to expand while maintaining appropriate levels of resilience and risk sensitivity.

Central banks and regulators will need to consider the lessons learned and amendments to the supervisory framework going forward. Some of these may include:

- New approaches to understanding the effects of contagion in financial markets, especially in the non-banking space
- Regulation of markets and participants
- Approaches to stress testing
- A crisis policy framework that incorporates a financial markets response (this may be aligned with or may include elements of climate change and environmental risk framework responses)

For firms, the immediate challenge will be to maintain risk and compliance standards, implement digital transformation and at the same time settle on an efficient set of operations that accommodate more remote and flexible working and can be responsive to similar crises in the future. An additional factor in the coming period, compared with previous post-crisis phases, will be the extra priority that firms must give to sustainability, diversity, inclusion and wider corporate responsibility. The next phase will therefore contain a set of varied challenges.

Related materials

Holistic Review of the March Market Turmoil, FSB November 2020

How COVID-19 will impact M&A in the European Banking Sector, EY October 2020

Effective Practices for Cyber Incident Response and Recovery, FSB October 2020

Implementation of Basel standards, Basel Committee on Banking Supervision November 2020

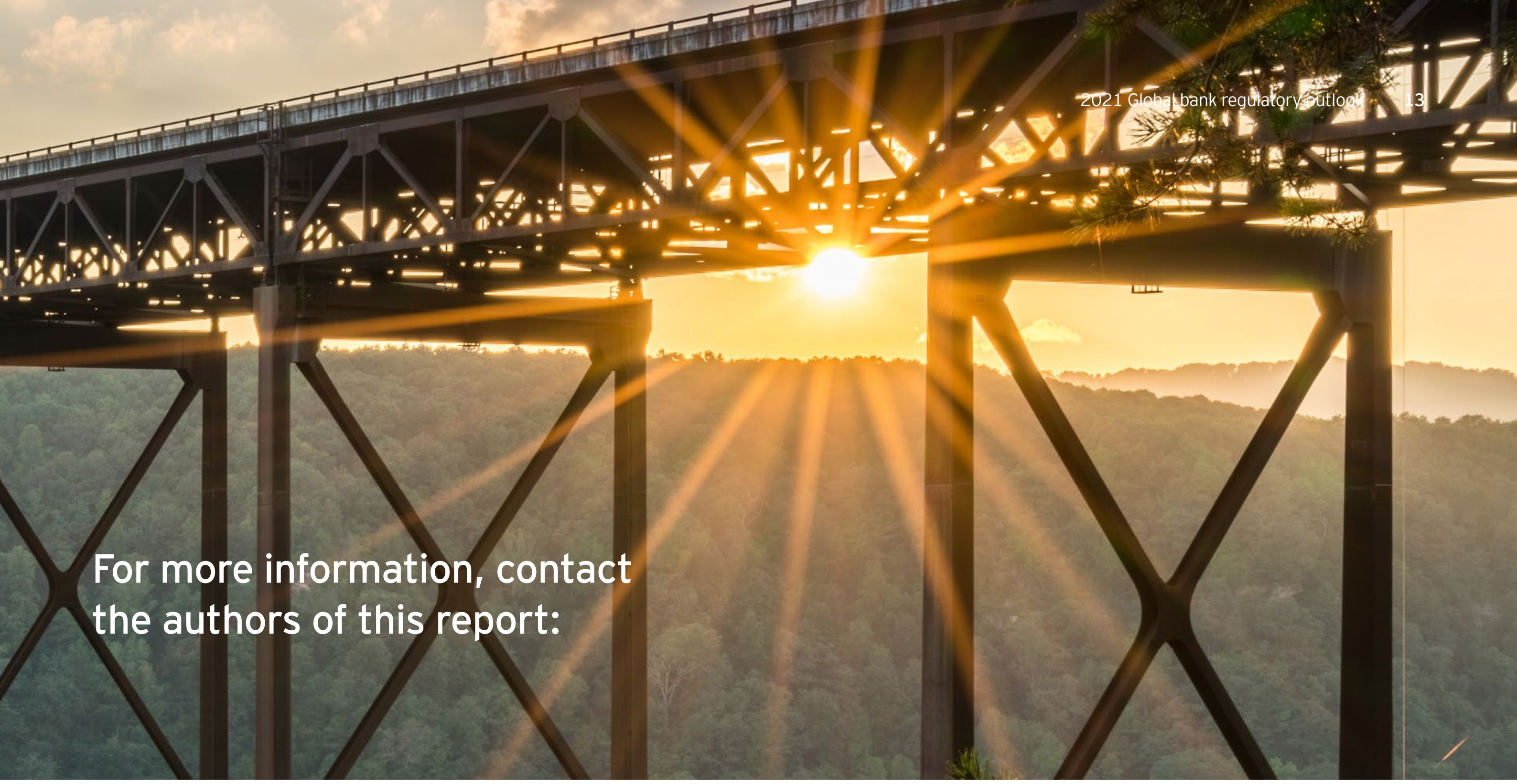
Joint Committee Report on Risks and Vulnerabilities in the EU Financial System, September 2020

2021 Geostrategic Outlook, EY December 2020

Global banking outlook 2021, EY December 2020

Climate change and sustainability: Global regulators step up the pace, EY January 2021

The COVID-19 pandemic: Potential impacts on financial regulation, EY January 2021



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