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FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

Increasing Regulatory Scrutiny of Financial Institutions

Part 7

Renew & Reinvent
Own the Future

INTRODUCTION

Welcome to our seventh briefing on how COVID-19 has affected financial institutions and its impact on current industry trends. In this edition, we focus on the second of our global trends — increasing regulatory scrutiny. This trend has become more evident in the years since the 2008 financial crisis and, as a policy, it appears to be vindicated by the financial sector's resilience in the early stages of the pandemic and is now being shaped by the sustainability and digital transformation megatrends. As always, in addition to sharing our own opinions, we reference the views of external commentators. Please bear in mind that our opinions are based on hypotheses that may change in a rapidly developing situation and there are doubtless other perspectives.

Takeaways

- The expanded regulatory architecture put in place after the 2008 financial crisis is generally seen to have been a success in the face of stressed markets and the financial strain on the economy caused by COVID-19. This approval is likely to see regulators continue with their current regulatory approach.
- The effects of the pandemic have bolstered the trend for regulators to proactively intervene in consumer markets requiring financial institutions to act in their customers' best interests —challenging strict terms and conditions that may be perceived as unfairly disadvantageous to customers.
- The digitization and environment, social and governance (ESG) megatrends are already shaping the future regulatory environment in which financial institutions operate — the former by increasing regulators' expectations around the need for resilient systems and controls in the face of new operational and technological risk; the latter around a whole series of new obligations concerning reporting and disclosure. In both cases, institutions are exposed to significant enforcement and litigation risk.
- As we start to exit the pandemic, there are already signs that its aftermath will lead to increased enforcement and litigation (e.g., for fraudulent behaviors), but to what extent is still unclear. The scale, however, is likely to be far lower than after 2008.

What do we mean by increasing regulatory scrutiny?

Regulatory scrutiny refers not just to the extent of and exigency of regulation but to the expectations of regulators and the likelihood of supervisory and enforcement action. While regulation has been growing in many jurisdictions over the last few decades, the financial crisis of 2008 provided a worldwide push — leading to a greater level of regulation and supervision of financial institutions. Globally agreed reforms through the G20 strengthened the balance sheets of banks and insurers, while measures such as the US Dodd-Frank and EU EMIR legislation sought to improve the risk management and transparency of derivatives markets. The expanding shadow banking sector has avoided outright regulation but has nonetheless been subject to new reporting requirements.

A second element in response to the misconduct identified across various markets following 2008 has seen regulators and the industry seek to improve culture and thereby raise standards of conduct.[1] This encompasses encouraging the development of a sound corporate culture, supporting prudent risk management and incentivizing proper staff behaviors in order to promote positive customer outcomes and high ethical standards. A number of financial centers have seen the creation of explicit individual responsibility regimes to hold, in particular, senior managers to account for failures to take reasonable steps to prevent regulatory failures by their businesses. At the same time, we have seen more enforcement actions brought by regulators against individuals and financial institutions, most notably in jurisdictions other than the US, which has always been enforcement led. In part, this is due to international pressure on countries through the Financial Action Task Force (FATF) to prioritize and better resource enforcement of anti-money laundering and counter terrorism financing (AML & CFT) measures where financial institutions are especially exposed given the critical place they enjoy in the financial system.

What has been the experience from the pandemic?

At the beginning of the COVID-19 crisis, financial institutions faced two main challenges. The first was prudential: a sudden drop in the value of financial assets, or loss of liquidity, whether domestically or elsewhere in the world. The initial dramatic falls on financial markets have long since been reversed, although as economies recover and government intervention measures are withdrawn it remains to be seen what effect defaults will have on balance sheets and asset values. The second was operational: the potential for systems and controls that underpin the financial system to fail in the face of operational stress in the case of inadequate resilience. This is a particular concern for those institutions with legacy IT and in light of the growing adoption of cloud computing.[2] By and large, however, with the reforms enacted since 2008 most financial institutions performed well — in fact in certain respects surpassing regulators' expectations! Regulators and governments have interpreted this apparent success as an endorsement of regulatory and supervisory policies. It will embolden regulators' confidence to continue down this path.

An international trend toward requiring financial institutions to act in their clients' best interests over and above strict contractual obligations — paying close attention to their regulators' expectations — has received added impetus in light of the flexibility and forbearance toward customers required of the sector in the opening stages of the lockdown and subsequently. Many regulators, for instance, expected insurers to review products to confirm that they continued to offer policyholders value in changed circumstances, where insurance products such as motor, travel or health could not be used as intended or lenders suspended interest and charges on mortgages, loans and overdrafts. Internationally, regulators have been proactive in relation to COVID-19 insurance coverage issues. In the UK, the financial conduct regulator sought declarations in the courts over the meanings of selected terms with a view to quickly resolving ambiguities. It has also required insurers to proactively manage those claims where coverage is in dispute.[3] The Insurance Council of Australia has taken similar steps, while courts in France and Germany have held in favor of policyholders. In the US, hundreds of lawsuits have been filed on this issue with close attention paid to the UK proceedings, as many policies use similar wording or raise factual issues.

Going forward, the UK financial conduct regulator is consulting on whether to introduce a new rule-based "Consumer Duty" on financial institutions to set higher expectations around the standard of care owed to such customers, while the US SEC, in meeting its Dodd-Frank mandate, approved a Best Interest Regulation in 2020. This imposes a new standard of conduct on broker-dealers, requiring that they act in a client's best interest, and mandates the review of conflicts of interest with an eye toward their mitigation, and even elimination, where possible.

Will there be a repeat of the wave of enforcement and litigation seen after 2008?

In the aftermath of a crisis, it is common to expect enforcement and compliance activity to increase. An analogy can be made to the tide going out to reveal wrongdoing that was previously hidden by business-as-usual activity. Additionally, stressed market conditions and laxer controls around home working in the initial stages of the pandemic during 2020 may have resulted in a variety of forms of misconduct. The European Banking Authority has referred to the experience of past crises, suggesting that illicit finance will continue to flow in many cases. It has pointed to evidence of increased levels of cybercrime, COVID-19-related frauds and scams. Banks and other organizations were reminded to take risk-sensitive measures to establish the origin of unexpected financial flows from customers in sectors known to have been affected by the economic downturn in 2020 and COVID-19 mitigation measures (e.g., laxer KYC for emergency loans).[4] Regulators were clear that while some regulatory obligations, such as reporting, might be deprioritized, this did not apply to AML and conduct issues.

In consequence, while activity on regulatory enforcement and compliance investigations was low in 2020 — in part because supervisors were focusing on other priorities (e.g., customer protection, ensuring that markets continued to function well, financial stability and the availability of liquidity) — this is changing as we enter the new normal. Regulators, such as the Monetary Authority of Singapore, warn that, because large-scale remote working is a recent development, the risks may take time to fully emerge.[5] However, when comparing the position to 2008, that crisis originated in part because of the misconduct and excesses of the sector that are not relevant today, so the level of regulatory and compliance action is not likely to reach the same level as in the years after 2009. Future enforcement and compliance activity will be seen in the context of the increasing regulatory scrutiny of the sector, including the holding of individual senior managers to account — as referred to earlier. For the moment, therefore, financial institutions should maintain focus on their control environment. To the extent they have not already been done, risk and compliance audits should be performed in areas of concern most affected by operational adjustments due to COVID-19 to allow prompt self-reporting and appropriate remediation to be put in place to mitigate any potential liabilities.

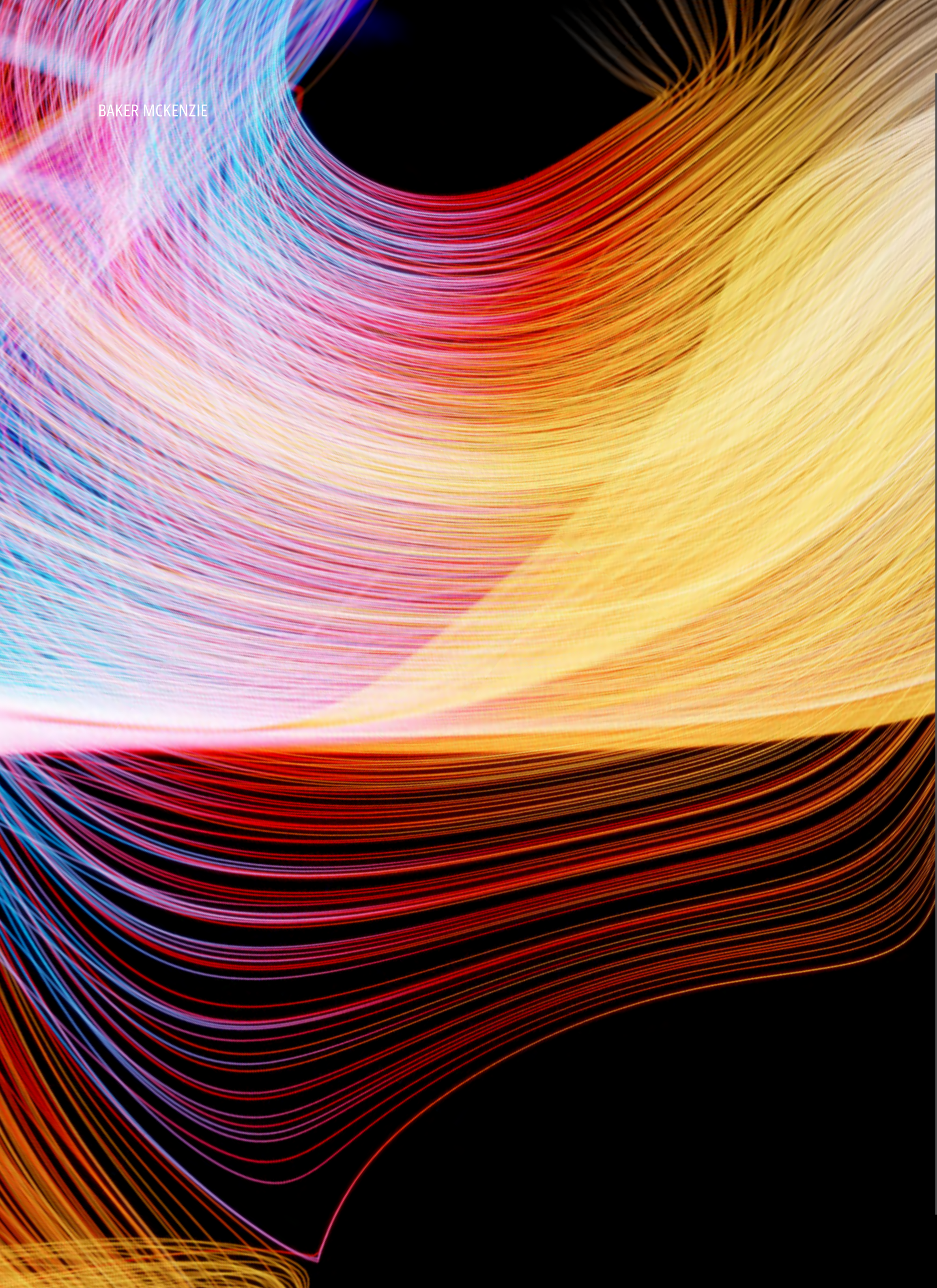
What is the impact of digitization likely to be on regulation?

It is fair to say that operational risk and resilience have risen up the list of regulatory priorities in recent years.[6] This can be linked to increasing levels of digitization and outsourcing in financial services. As the way in which services are provided is changing, new vulnerabilities are constantly emerging and, of most concern, incidences of cyberattacks are growing. This requires continual and expensive investment in IT, including systems and processes with informed oversight of outsourced services. In recognition of such risks, countries are imposing tougher obligations on businesses over the collection, use, sharing, storage and disclosure of data. Whereas before, data protection regulators might not have brought enforcement action, now they are just as likely to do so as financial services regulators and can impose substantial fines, some based on turnover.

Therefore, it is vital for financial institutions to strengthen their resilience to such risks. Regulators expect them to identify their most important services and understand the systems and processes that support them, including any critical services that are outsourced,[7] as well as understand the impact of a failure, say an outage, and how quickly a system or process can be recovered or substituted.[8] During the pandemic, payment providers were tested by the collapse of a major European payment processor, and exchange groups have experienced instances of disruption to trading in a number of locations. Where regulators conclude that institutions have insufficiently robust processes, they are at risk not only of enforcement action with the likelihood of sanctions, but their reputation will also take a significant hit. Given the impetus that digitization has received from the pandemic and associated lockdowns, these regulatory and operational concerns have suddenly become much more acute.

Besides the regulatory focus on operational risk and resilience, new digital assets and technology such crypto-assets are attracting the attention of regulators. Wary of them at first, we have seen governments impose AML & CFT obligations on market players to counter the risk of crypto-assets being used for illicit purposes, and the main financial centers are now studying how best to supervise this asset class from a financial regulatory perspective. In general, jurisdictions including the US, Switzerland, Australia, the EU and the UK, are adopting approaches that build on existing securities and payment regulatory frameworks, and while some of these approaches target stablecoin with more bespoke arrangements, all are clear about the need to regulate (if not ban) stablecoin on the grounds that if offered by significant-sized entities with an international footprint there could be risks over systemic financial stability.[9] Various jurisdictions are putting restrictions in place around marketing to retail customers on the grounds that crypto-assets are volatile and inherently high risk. While digitization is an area where the tide of regulation is rising, it is also true that many jurisdictions are largely doing so in thoughtful technology neutral ways and that market players welcome rulemaking because it helps market confidence. The new regulatory frameworks required for open banking, which is disrupting the payments sector, are essential to its operation.

Innovative use of technology and data is facilitating improved scrutiny of markets by regulators, so-called RegTech. Examples include finding the needle of market abuse in the haystack of transaction data through the use of algorithms, mapping access to cash against consumer vulnerability,[10] scraping the web for poor advertising or more quickly identifying red flags around potential wrongdoing.[11] The US Securities and Exchange Commission is using data-driven enforcement actions designed to identify inappropriate activity. It is using quantitative tools, such as risk-based data analytics, to identify potential accounting and disclosure violations, for example, improper reporting of quarterly earnings per share by publicly listed companies.[12] In this way, regulatory scrutiny of financial institutions is greatly enhanced, and regulators are able to leverage technology to identify potential contraventions and bring enforcement action much more quickly and with fewer resources required. In the future, enforcement may apply a similar data-driven approach to root out misleading ESG disclosures.



How will ESG factors affect regulatory scrutiny?

Besides digitization, regulation of ESG matters will undoubtedly increase regulatory scrutiny on financial institutions in the form of enforcement and litigation risk. In some quarters, ESG has been described as the number one enforcement and litigation risk. This derives from a combination of the high priority now placed on ESG by the authorities, reflecting public opinion, which has received a tremendous boost from the COVID-19 pandemic, and secondly, its potentially wide impact across most activities in every organization.

Financial institutions may incur liability where ESG statements are misleading or their activities actually contribute to climate change. Potential issues include the following:

- inadequate due diligence around ESG statements contained in public company disclosures or a lack of alignment between aspirational statements and specific measures
- inaccurate disclosure and inappropriate sales practices by asset managers over ESG investments, including deceptive "greenwashing" that exaggerates the ESG qualities of an investment[13]

- financial intermediaries facing claims that ESG-related investments are not suitable, or that they did not conduct appropriate due diligence on the investments they promote and sell
- claims action against financial intermediaries and trustees for breach of fiduciary standards when selecting and monitoring retirement plan investments

While legislators deliberate on draft laws and regulators consult on new disclosure and reporting obligations, enforcement divisions and litigators already have significant remedies to hand. Existing general purpose rules and legal duties allow action to be taken now, for example, in respect of inaccurate disclosure (e.g., greenwashing) and inappropriate sales practices. Besides regulators, and especially in Europe, there is an increasing incidence of legal action brought by non-governmental organizations.

Arguably, wider ESG needs should supersede competition concerns around businesses engaging in coordination and cooperation. However, similar to other businesses, financial institutions risk potential antitrust claims where they come together to collaborate over ESG commitments. Care and advice is required over competition law compliance to avoid unintended consequences, especially as rules may vary from country to country.

Businesses are increasingly publishing information on their policies, for example, regarding diversity and gender equality in the workplace, and on ethical considerations in their supply chains. Unlike financial data, non-financial reporting data has not been subject to audit to date. This is beginning to change, for example, with an EU proposal to subject such disclosure to limited assurance by independent third parties.[14]

To look at the social and governance side of ESG, the diversity and inclusiveness of financial institutions are becoming increasingly important for regulators (e.g., more diverse boards and executive leaderships as well as "safe cultures" that enable employees to bring their whole selves to work). This concerns not only the fitness and propriety of organizations and individuals within them, but their readiness and ability to comply with regulatory expectations. Diversity and inclusiveness are seen as characteristics of healthy cultures that reduce the potential for harm to consumers and markets.[15] Financial institutions should expect their supervisors to ask for more data on these topics and probe them further on their progress in the future.

How will global standards affect financial institutions?

Reflecting the global nature of markets and the inter-connectedness of the world's economies, international standard-setting bodies are becoming ever more important in raising standards and in sharing best practice. They are numerous and include the Bank for International Settlements, the FATF, the International Organisation of Securities Regulators, the Financial Stability Board and the International Association of Insurance Supervisors. All are driving standards up internationally and, while leading to new requirements for financial institutions in some jurisdictions, common standards and shared supervisory practice should help facilitate cross-border business and recognition.

As regards financial crime, the FATF has been especially influential in its recommendations and guidance to supervisors in raising AML/CTF standards, latterly calling for more consistent and effective enforcement — with recent high profile fines in Europe evidence of change. Most recently, the FATF has called for virtual (or digital) assets to be brought within the scope of regulation. AML/CTF regulation is understandably regarded as burdensome by covered entities and the FATF is encouraging supervisors to go beyond a tick-box approach in monitoring the sector's efforts to curb money laundering and terrorist financing.[16] While there are benefits for regulators and the regulated, the adoption of a risk-based approach has been slow and can be challenging when compared to the certainties of the past. Undoubtedly, it will bring greater scrutiny of financial institutions' implementation, requiring clear strategies based on thorough and current risk assessments.

As discussed above, ESG as a regulatory issue has rapidly come to the fore. There are multiple and diverse sustainability standards and, to achieve a system of disclosure that is effective, not unduly burdensome, does not disrupt ESG investment and allows for comparison, it is clear that greater international standardization and convergence is required. A new global Sustainability Standards Board has been proposed to achieve more coordination and standardization.[17] Financial institutions will report on the basis of such standards, but more importantly will be consumers of this data as they fulfil their part in channeling finance toward ESG-friendly economic activities.

Endnotes

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Beyond COVID-19

In the new normal, there are many opportunities for businesses to embrace now-or-never transformation. While there are drivers that can accelerate renewal, there are also potential blind spots that can derail your organization. We can help you adopt an integrated approach to success and renew and reinvent in order to own the future.

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