Financial Services: regulating the new reality

The new reality publication series

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New publication series

The EMA FS Risk and Regulatory Insight Centre (RRIC) is pleased to announce a new thought leadership series ***Financial Services: regulating the new reality***.

As the focus of government and businesses moves from initial response to the COVID-19 pandemic, through resilience concerns, to recovery and the new reality, financial services regulators are also expected to move into a new phase of adjustment and support.

This paper looks at how the financial services industry is being called upon to support recovery. Over the coming months, look out for further articles and papers where we will build on the themes identified in this overview paper.

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Overview

The COVID-19 pandemic has led to substantial shifts on many fronts, including the impact on economic growth and fiscal revenues, large-scale remote working and staff lay-offs, increased use of online services and digital technologies, reduced use of cash and more vulnerable customers. This paper is the first in a series looking at how financial regulators and regulation are changing, to assist with recovery and to reflect the new reality.

The financial services industry is being called upon to support the recovery. Regulators are seeking to encourage growth and innovation but are still focused on resilience and good conduct. And all parties need to embrace the evolving new reality, including accelerated use of technology, longer-term changes in working practices and demands for sustainable finance.

The COVID-19 pandemic has highlighted our global interconnectedness and the need for collective action. As we move towards recovery and beyond, there may be opposing tensions of convergence and divergence in regulatory approaches. Firms will also have to navigate the raising and lowering of national borders, which may present both opportunities and challenges.

One of the big questions for policy makers and regulators is how to unwind concessions and restrictions imposed in response to the pandemic, and reinvigorate economies, businesses and livelihoods, without creating unintended consequences.

Unwinding temporary regulatory measures

In response to the pandemic, regulators have permitted or encouraged firms to make full use of capital and liquidity buffers built up since the last crisis. Concessions have been introduced in the way that some prudential requirements are calibrated and, where possible, high intensity activities such as stress-testing, implementation of new rules and consultation deadlines have been delayed, to provide operational breathing-space. In many areas, reporting requirements have been lifted or leeway given for compliance with reporting deadlines. These concessions relate to periodic reporting to regulators, disclosures to the market (such as annual reports of listed companies) and information provided to clients (such as the notification of 10 percent falls in portfolio values).

There have been new restrictions or requirements, too. Around Europe, national regulators adopted different approaches to short selling, with a handful banning it outright for a period. Most regulators have urged restraint in dividend distribution and remuneration, and require more frequent information in specific areas, such as the liquidity positions of open-ended funds. A small number (such as EIOPA and the UK FCA) have pressed firms to make special concessions for vulnerable or impacted customers, including the provision of interest-free overdrafts or mortgage payment holidays by banks, and claim-handling processes and premium discounts by insurers.

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Regulatory measures are not public or state aid support to financial institutions, but have the same intent of maximising firms' capability to lend and support the real economy. When considering how and when to unwind their various responses to the pandemic, at the very least, regulators will need to be mindful of whether too many deferred deadlines may now be bunched together and whether further easing of some dates is required to ensure that both firms and regulators can reasonably meet the new timelines. There are more substantive questions too, such as the ongoing financial viability of regulated firms and the trade-off between the need to restore capital positions and continue supporting individuals and businesses. Regulators will also need to be cognisant of wider issues impacting firms, including the speed of economic recovery and "lower for longer" interest rates.

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Restoring capital positions

Firms across the financial services industry have benefitted from prudential concessions. In the case of asset managers, a few regulators effectively allowed firms to hold less capital. The rebuilding of reserves will be more difficult for some than others. Revenue for this sector is predominantly based on assets under management. Depending on which markets firms invest in, on behalf of clients, and how long asset values in those markets take to recover, revenue could be depressed for some time.

The picture is also mixed in the insurance sector, as the pandemic has stressed both sides of the balance sheet. Regulators are reflecting on whether they have sufficient tools to supervise firms throughout the cycle and not just during benign market conditions. Some business lines have seen a fall in claims due to reduced economic and human activity, but this may be only short-term as individuals and businesses return to more "normal" activities. Many businesses and their insurers are carefully scrutinising whether policy wordings cover business interruption in the case of a pandemic. Swift settlement of claims for those insured losses will be essential to the recovery of many businesses.

Restoring the financial position of banks could be especially complex and protracted. Post-2008 reforms delivered marked improvement in financial resilience, meaning that banks entered the pandemic with much stronger balance sheets in terms of solvency, liquidity and non-performing loans (NPLs). Regulators have made it clear that buffers are there to be used in times of stress to absorb losses and to enable banks to continue servicing clients. However, it is not yet clear how long banks will have to replenish capital buffers and whether supervisory approaches will differ. Volatility in capital markets, the precarious position of some business sectors and the support provided to individual and corporate clients could result in difficult trading positions and an increase in NPLs, into 2021 and beyond.

Learning operational lessons

The pandemic has been a global stress event that has tested all businesses' financial, operational and commercial resilience. Hypothetical scenarios used in prior stress testing exercises were typically less severe. To a large degree, financial services firms have proved operationally resilient, but in the coming months regulators will want to carry out more detailed analysis, consider weak points and lessons learned, and require firms to demonstrate they have incorporated those lessons into their resilience approach playbook.

Existing operational risks have been heightened by large-scale remote working. Firms that had to acquire and implement new technology quickly may have compromised IT infrastructure and security. Cyber attacks and fraud attempts have increased as criminals attempt to exploit current conditions. Systems, processes and controls were also potential areas of weakness as employees and customers adopted new behaviours. Concerns remain about employees' well-being and connectedness. They may be working with sensitive data in less secure homebased environments or in more stressful/unfamiliar scenarios where increased errors can occur and the potential for market abuse is increased.

Focusing on people

Strong governance and good conduct have long been regulatory imperatives, but regulatory expectations about firms' behaviour towards customers have been re-articulated during the pandemic, and firms' "culture" is being questioned. The challenge is whether pre-pandemic structures and behaviours can and should continue unchanged. Firms will be expected to ask themselves not "Can we?" but "Should we?". Regulators are also focused on access to financial services for all types of customers, with appropriate protections.

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Firms' employment and remuneration policies and their communications with staff are being challenged, both while lockdown measures are in place and as firms contemplate some element of return to office working. The pandemic has brought questions about labour inequality and human rights to the fore. Regulators expect firms to take difficult decisions about ensuring their financial resilience while caring for staff and customers.

As remote working is likely to remain a major factor going forward, there will need to be a wide-ranging review of long-established governance arrangements and controls, many of which are based on the presumption that activities predominantly take place within the office. This will include board meetings, customer and supplier due diligence, sign-off processes and the "three lines of defence" model.

Maintaining capital markets

As the pandemic impacted capital markets across the globe in March 2020, there was a 'flight' to safe assets and cash, causing increased price volatility of riskier assets. This, in turn, led to increasing margin calls, which put even more pressure on market participants' need for cash, causing liquidation of traditional safe assets such as long-term government bonds. Central banks intervened to meet this demand for liquidity.

Regulators around the world announced that they were determined to keep capital markets open and to co-ordinate efforts, in order to support the real economy through access to funding and the ability to hedge risks. Regulators were focused on the operational and financial resilience of market infrastructures, the operational capability of market users, information flow and consumer protection.

Some policy makers suggest that computer-led trading strategies, short selling and certain types of investment funds exacerbate market volatility. Other commentators, however, think these are not to blame and that they make it easier for everyone to buy and sell at more accurate prices. Global bodies concerned with systemic risk will debate these points well into the future, which could lead to further scrutiny of some areas, including the use of leverage, the resilience of non-bank parts of the financial system and the procyclicality of margin calls.

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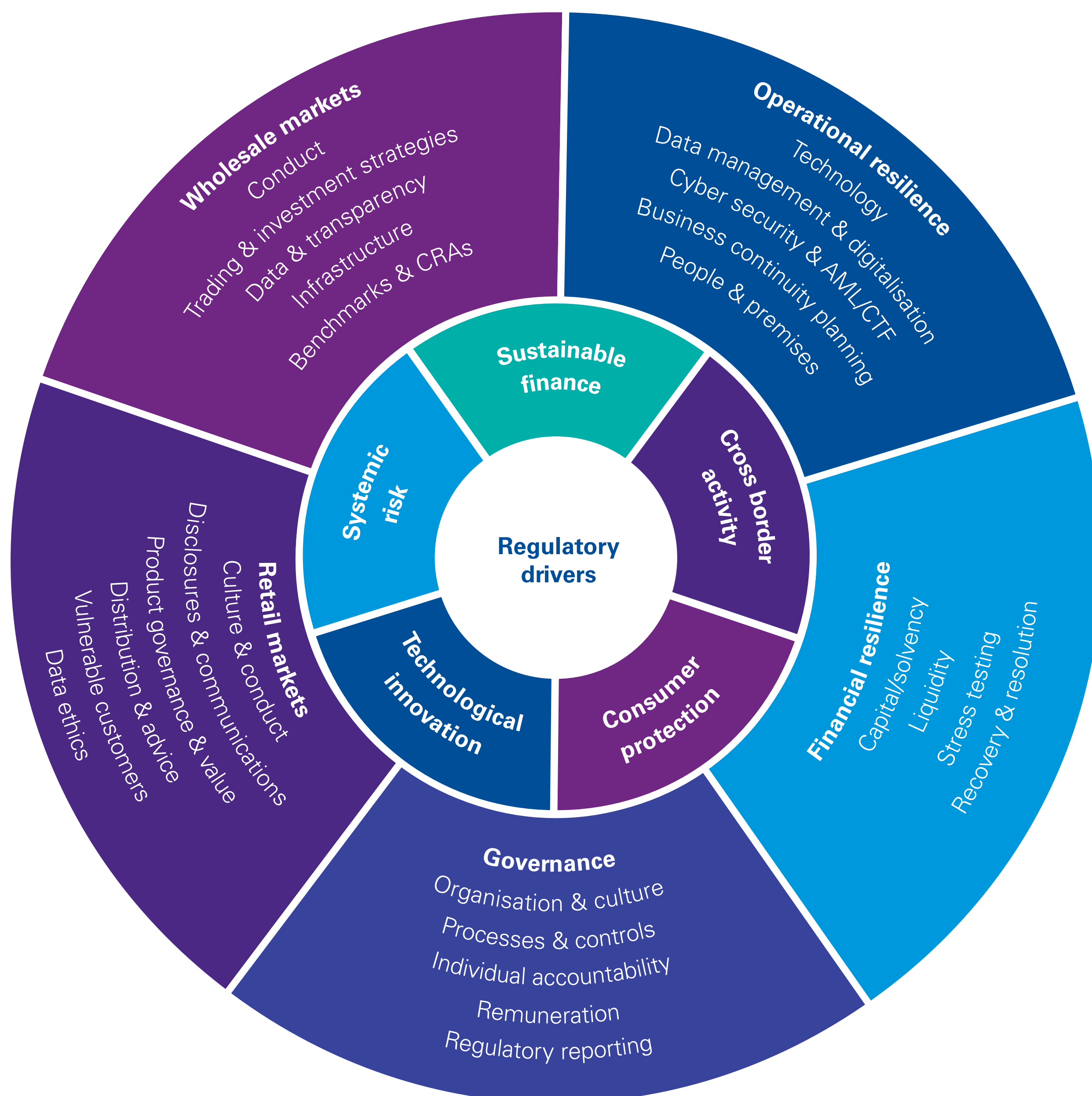
Five key drivers are influencing regulatory priorities



Five key drivers are influencing priorities in regulatory agendas. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lock-down measures have brought additional topics to the fore. Volatility in capital markets has led to a renewed focus on systemic risk in relation to computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

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Policy makers and regulators will also be examining how the financial sector and specifically the non-bank sector can support the re-capitalisation of the economy, reducing the amount of debt taken on by companies during the crisis.

Navigating changing borders

Increased recognition of the global interconnectedness of capital markets runs counter to demands for national measures to protect national markets: the convergence versus divergence debate. Recognition or deference to regulatory frameworks (or "substituted compliance") and consideration of extra-territorial impacts will be on the table once again. However, regulatory demands for firms to have "substance" in their home jurisdiction will not be set aside and are likely to be amplified by fiscal authorities seeking to secure tax revenues.

Some markets, notably in Asia, are increasingly opening their markets to foreign investment and to foreign ownership of domestic companies, increasing opportunities for European firms. In the EU, there will be renewed attempts to encourage cross-border finance and investments. On the other hand, with the end of the Brexit transition period in sight, the future of the current "equivalence" provisions is coming under increased focus and firms need to be fully prepared for fall-out from the new EU-UK border.

Within the EU, the Commission President, Ursula von der Leyen has made the completion of Capital Markets Union (CMU) one of her key objectives for the next five years. The Commission is considering the final report of its high-level CMU working group, which has three overarching themes: promoting simplicity, enabling competition and creating an equity culture. Removing obstacles to cross-border investment is one of the four clusters of recommendations put forward by the group to help refresh the CMU project.

Embracing technology

The pandemic has provided a significant push towards a more digital society. As bank and building society branches closed, customer service centres moved to a remote-working model and cash transactions all but disappeared, firms had to adapt rapidly. Initial evidence suggests that adoption of technology and increasingly digitised processes has gone better than expected. It could be said that COVID-19 has, unexpectedly, acted as the catalyst for a more efficient, decentralised way of working. As normal supervisory processes are resumed, the challenge for regulators will be whether they, too, now need to engage in a different way.

Before the pandemic, many regulators were already seeking to leverage technology to improve the efficiency of their own processes. Examples include revamped websites, new data collection methods and acceptance of e-signatories. The regulation of Fintech firms and crypto-assets and the use of distributed ledger technology were already on regulators' agendas, but many more topics could now be in play.

ESG is a strategic issue that must be embraced.

There is a fundamental question whether current governance and conduct of business rules, which largely presume face-to-face contact, are fit-for-purpose in the digital age. Will virtual board meetings and AGMs (especially cross-border) be allowed to continue despite regulatory and fiscal concerns about substance? Will the opportunity be seized to convert static paper-based disclosure documents into dynamic online presentations that enable bespoke information and promote consumer understanding and engagement?

Transforming sustainably

Last, but by no means least, the pandemic has highlighted that societies of all types and wealth levels are vulnerable, and that the planet and environment are under increasing strain. It has accentuated demands around the globe for climate-aware investing and carbon reduction, the ethical treatment of employees, customers and other stakeholders, and well-managed companies.

Client demand for environmental, social and governance (ESG) investing remains the key driver of change, but the regulators are catching up. The regulatory initiative that started in the EU is spreading. Consistency of definitions and data remain elusive, though. Firmly on the agenda in Europe are requirements for banks and insurers to take full account of ESG impacts throughout their risk frameworks and operations, and in stress testing exercises. Consideration of labels and standards for investment products are also being developed.

The key message is that ESG is a strategic issue that must be embraced across every aspect of firms' business models, operations and communications.

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Questions for CEOs to ask

Financial resilience	How can we ensure that we remain financially resilient while continuing to meet pressure from regulators to support customers? How do we improve profitability given the current economic outlook and a low interest rate environment?
Operational resilience	What lessons have we learnt from large-scale remote working and increased use of technology/digitalisation? What changes should we be making to our processes to incorporate these lessons?
Governance & controls	Given remote working will likely be a significant feature going forward, are we reviewing what that means for our governance arrangements, controls, risk management and the three lines of defence?
People, conduct & culture	Have we embedded a fair balance between our own commercial interests and those of our customers throughout our business? How are we mitigating new or heightened conduct risks? Are we reviewing our employee working practices?
Systemic risk	Are we prepared for increased regulatory scrutiny of emerging systemic risks, including cloud outsourcing, use of computer-led trading strategies, treatment of margin, use of leverage and liquidity management in open-ended funds?
Cross-border business	Are we prepared for the new EU-UK border? Are we alert to business opportunities that are opening up in other markets around the globe?
Sustainable finance	Have we embraced sustainable finance as a strategic issue? Do we have a deep understanding of forthcoming rules and supervisory expectations? Do we have the necessary tools and expertise to deliver against these? Are we fully attuned to changing customer demands?

Look out for further articles and papers in this thought leadership series that will consider these issues in more detail.

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