2020 Global bank regulatory outlook

Four major themes dominating the regulatory landscape in 2020

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Introduction

Now: Disruption and fragmentation
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Beyond: A marathon, not a sprint

The 2020 Global bank regulatory outlook is set against a period of rapid technological innovation and change in the competitive landscape. The extant business and macro-economic environment, combined with the potential for new and more agile entrants to fragment traditional customer bases, presents challenges to banks that threatens their revenue generation. Supervisors are cognizant of pressures in the current market environment, with the need to maintain the improved capital base and to enhance the profitability of systemically important institutions. In a recent interview, Andrea Enria, Chair of the Supervisory Board of the European Central Bank (ECB), reflected on structural issues and possible consolidation in the sector, stating: "For our part, we need to keep up the pressure through our business model analysis. Healthy and profitable banks will be better able to withstand the next storm."[1]

Regulation itself is in a phase of adjustment, as the risk portfolio expands to include a set of less familiar challenges, such as personal data privacy, use of the cloud and climate risk. Consequently, the post-crisis period, which was characterized by amending and tightening existing rules, is now being followed by re-scoping and evaluation, as regulators decide how to create a proportionate framework that can strike a balance between allowing for change and innovation while preserving systemic stability and protecting consumers. In turn, industry participants will want to exert positive influence on the policy debate, while taking the opportunity to review risk and compliance resources that have built up over the last 10 years, to determine if greater efficiencies can be achieved. Looking ahead, the potential erosion of profitability, together with limited benefits for risk management (so far) from technology applications, means that cost control and rationalization may have the biggest influence on both future investments in risk and the sustainability of prior corrective actions.

In the wider environment, the geopolitical landscape continues to be both demanding and unpredictable. Political instability across key markets is hampering more collaborative efforts between Asia, Europe and the Americas to develop standards and frameworks that can address the new non-financial risk agenda.

As far as more orthodox market forces are concerned, after the earlier wave of FinTechs, another threat to profitability for banks is the potential impact of big techs. In its *2019 Annual Economic Report*, the Bank of International Settlement (BIS) highlighted the growth of big techs and their potential to bring a more seismic shift: "As yet, financial services are only a small part of their business globally. But given their size and customer reach, big techs' entry into finance has the potential to spark rapid change in the industry."[2]

1. Interview with Andrea Enria, *ECB Supervision Newsletter*, November 2019.
2. "Annual Economic Report" BIS, June 2019.

As always, there will be calls for a level playing field in terms of market access and the proportionate application of rules for big techs and other new entrants, but the regulatory roadmap is not yet clear. In East Asia, there has been a spurt in the recognition of digital banking and granting of new licenses; however, supervisors have also been raising red flags. For example, authorities in Hong Kong are concerned by virtual currency trading[3] and the sale of crypto-related products to retail investors. By no means are such responses being coordinated globally or even regionally.

The market fragmentation that we observed in last year's regulatory outlook has continued and extended from prudential and structural requirements to other areas, including data privacy and financial crime. The common agenda with global priorities that was seen in the immediate post-crisis phase is no longer a guiding factor. As the chairperson of the International Organization of Securities Commissions (IOSCO), stated recently: "There is and will continue to be significant differences between the rules and regulations of different countries ... and the reality is that incremental harmonization efforts aimed at reducing those costs for large firms is simply not a major global priority."[4]

Nevertheless, there are some major themes that will dominate the regulatory landscape in 2020. In this report, we look at resilience, ESG, data privacy and technology issues that are emerging as key themes from the non-financial risk agenda that has grown in prominence since the last financial crisis. These topics are relevant to other sectors beyond financial services. As such, it will be interesting to see the extent to which the policy responses in the banking sector, which could develop more quickly than elsewhere due to more intense regulatory scrutiny, resonate with political leaders in terms of developing broader economic and social policy, and how those policy priorities could shift as economic conditions change.

As yet, financial services are only a small part of their business globally. But given their size and customer reach, big techs' entry into finance has the potential to spark rapid change in the industry.

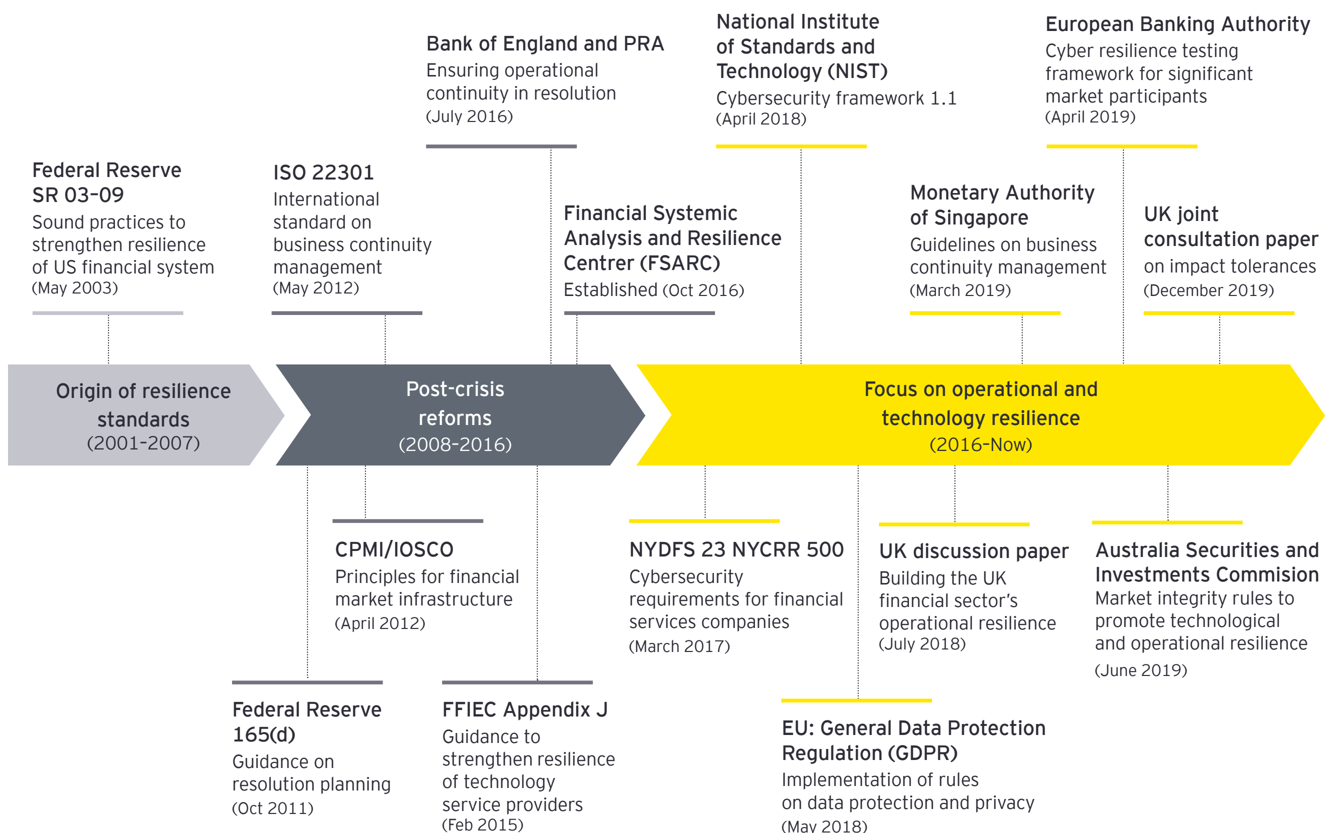
3. "Regulation of virtual asset trading platforms" Hong Kong Securities and Futures Commission (HKSFC) position paper, November 2019.
4. Remarks by Ashley Alder, chief executive of the HKSFC and chairman of IOSCO, at the ASIFMA (Asia Securities Industry & Financial Markets Association) annual conference in Tokyo, October 2019.

1 Operational resilience

What doesn't kill you can still make you extremely vulnerable

The traditional twin pillars of regulatory policy – prudential and conduct – have been joined by operational risk to form a trio for supervisors and firms to focus on. Driven by a renewed interest in issues such as cyber security, IT failures, business continuity and third-party risk management (TPRM), operational resilience has become a major area of concern for boards and risk officers (see timeline in Figure 1).

Figure 1: Operational resilience – the timeline to today[5]



5. "Supervisory perspectives and regulatory approaches to enterprise resilience" EY, November 2019.

Despite relatively little specific new policy on resiliency, with the notable exception of recent UK discussion and consultative papers,[6] regulators have been revisiting their existing policy and amending guidelines and supervisory examination manuals.[7] We can expect further progress in 2020, as policymakers move from discussion papers to issuing core principles and rule proposals.

In the meantime, supervisors have increased their expectations of how firms should be dealing with operational resilience. The key messages — and the likely foundation for forthcoming rules and guidelines — are that firms must:

- **Take an enterprise-wide, business service view of resilience** that prioritizes the most critical business services instead of focusing on individual systems and applications.
- **Map assets beyond the firm's internal ecosystem** to encompass reliance on critical third-parties, including outsourced service providers.
- **Establish impact tolerances**, with clear metrics and specific outcomes, for their most critical business services to quantify the amount of service disruption that could be tolerated.
- **Develop a comprehensive suite of capabilities** required to recover, resume and deliver business services during disruption, reflecting a transition from the traditional, siloed approach of managing distinct business function capabilities to an overarching enterprise-wide framework for service resilience.
- **Demonstrate greater integration between incident management and crisis management protocols** supplemented by a crisis management structure that is responsive to different types of disruptions.
- **Test recovery and resumption of business services** under a range of severe yet plausible scenarios, using a comprehensive testing strategy that clearly articulates enterprise objectives, approach and scope for resilience testing.
- **Require board and senior management to take an active role** in setting up the firm's resilience strategy in alignment with the enterprise strategy and risk appetite.
- **Adopt a risk-management based approach** that clearly articulates roles and responsibilities across lines of defense.

6. "Operational Resilience: Impact tolerances for important business services" Bank of England (BoE)/Prudential Regulation Authority (PRA)/Financial Conduct Authority (FCA) joint consultation, December 2019.
7. EY, November 2019 provides an overview of comparative regulatory approaches.

Since the crisis, regulators have largely focused on the challenges of financial and systemic risk. The resilience agenda brings the added complication that a growing source of risk is located beyond the regulatory perimeter. Firms are exposed to potential vulnerabilities and risks due to their interconnectedness with critical third parties, such as data providers, cloud service providers and technology vendors. Many of these providers cater to several firms within the industry, resulting in high concentration risks, knock-on impacts due to interdependencies, and potential systemic impacts from third-party outages. The UK Treasury Committee recently stated its concern over IT failures in the financial services sector and the concentration risk that cloud services present.[8]

The debate will continue over the degree to which supervision may have to be extended, but for now, it seems that the heightened expectations of supervisors on banks' end-to end risk management will serve as a type of indirect regulation of third parties. If in 2020, however, major incidents occur in the outsourcing or vendor space, we can expect to see renewed calls for re-assessment of regulatory capture, possibly in parallel with the growing focus on big techs.

The resilience agenda brings the added complication that a growing source of risk is located beyond the regulatory perimeter.

8. "IT failures in the Financial Services Sector" House of Commons Treasury Committee, October 2019.

2 ESG and other societal issues

No bank can do everything, but every bank can do something

Geopolitical and climate-change risks both feature in the list of 10 major risks to manage over the next decade.

The ESG criteria used to measure the sustainability and ethical impact of an investment in a business are now just one part of a wider agenda that encompasses climate risk, corporate behavior and social responsibility, inclusion, equality, diversity and an expanding range of other societal issues. Until recently, most banks would have ranked such an agenda toward the bottom of their priority list, and some individual components would not have been included at all.

However, as the latest EY/Institute of International Finance (IIF) risk survey shows,[9] geopolitical and climate-change risks both feature in the list of 10 major risks to manage over the next decade. The survey covered banks, not policymakers, which suggests that key decision-makers in governance and control functions across the industry are fully aware of the new agenda and the challenges that will come with it.

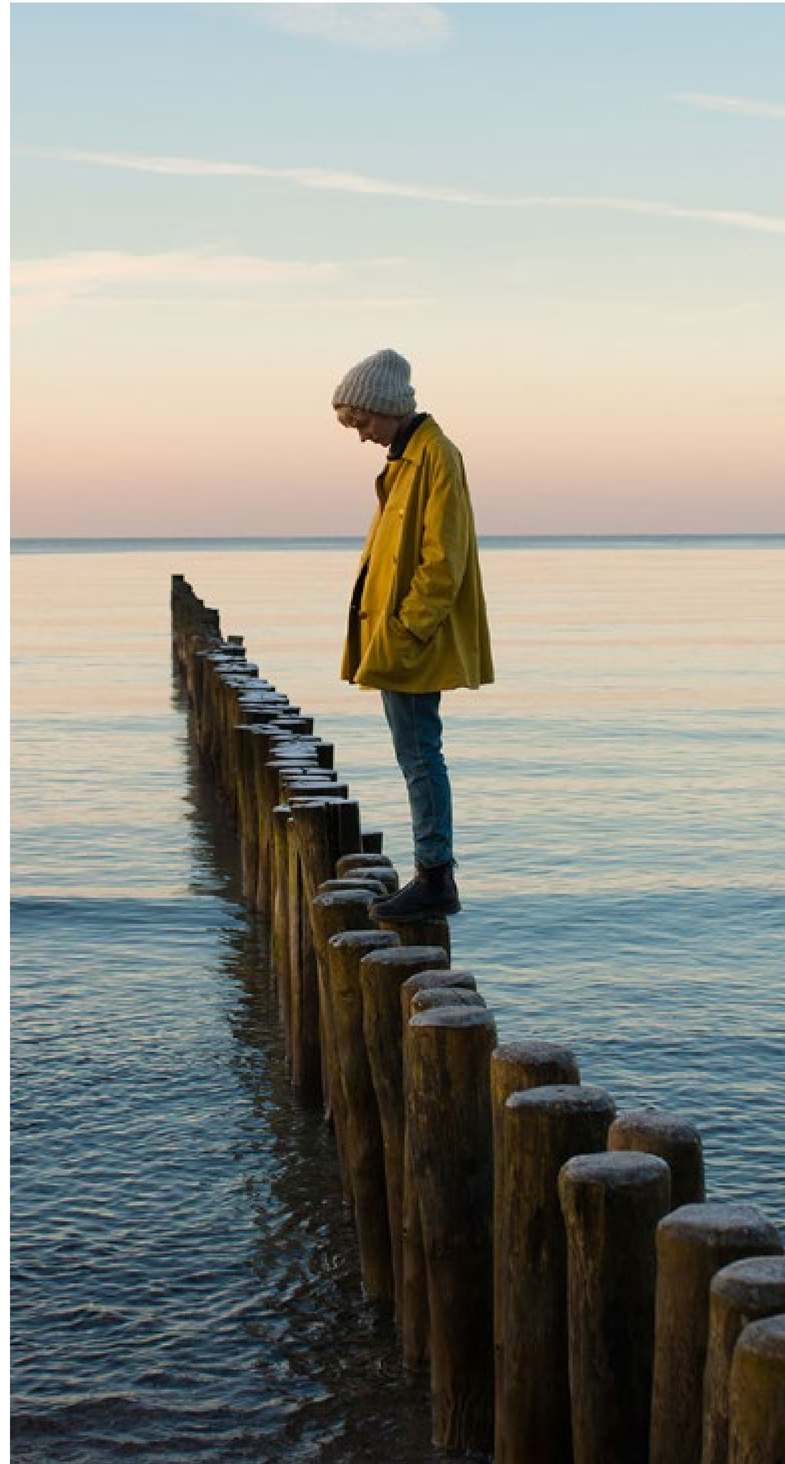
This wider set of issues places increased expectations on corporate risk management, including new board responsibilities and reporting to shareholders, along with enhanced internal governance and comprehensive mapping of rule requirements to bank processes and controls. The aim is for banks to evolve into more aware, more responsible corporate entities which, if they can successfully incorporate the new agenda, deliver improved conduct and ethical behavior and more desirable social outcomes. Initial steps have already been taken by supervisors in recent years with changes to rules on compensation that shift the emphasis from meeting short-term objectives to recognizing the importance of longer-term, more holistic goals and rewarding ethical behavior. The trajectory is set to continue with the emergence of sustainability and other societal issues.

These changes will have a significant impact on risk management frameworks. How will they need to evolve to encompass these emerging risks? How much more will they need to change if regulators are asked to promote broader social goals in the financial market space? For example, another area of focus may be issues in the workplace environment, such as pressure, stress and mental health that are perceived as contributing factors to poor culture and misconduct.

9. "Tenth annual EY/Institute of International Finance (IIF) global bank risk management survey — An endurance course: surviving and thriving through 10 major risks over the next decade" EY/IIF, November 2019.

Over the next 12 months and beyond, the climate risk agenda will certainly evolve. A commitment has been made by the United Nations and some leading international banks[10] to align with the goals of the Paris Agreement on Climate Change and Sustainable Development. The next steps are to develop a framework to cover taxonomy, disclosure reporting, target-setting and full integration of climate risk management into corporate governance and stewardship.

Policymakers across Asia and Europe have made sustainability and climate risk a prominent feature of their work programs and, although ESG disclosure proposals in the US have only gained limited traction so far, the issue is gaining prominence. Federal Reserve Governor Lael Brainard said recently: "… the Federal Reserve needs to analyze and adapt to important changes to the economy and financial system. This is no less true for climate change than it was for globalization or the information technology revolution."[11] In 2020, we will look more closely at sustainability and climate risk as these policy proposals continue to develop.



10. "Principles for Responsible Banking" United Nations Environment Programme Finance Initiative (UNEP FI), 2019.
11. "Why Climate Change Matters for Monetary Policy and Financial Stability"; remarks made by Lael Brainard at "The Economics of Climate Change" conference, November 2019.

3 Data and emerging technology

Evolution not revolution: where do we go from here?

Those who believe that data is now the business world's most valuable commodity will probably have welcomed recent significant measures to regulate its ownership, use and processing, led by the European Union's General Data Protection Regulation (GDPR) and quickly gaining traction in other jurisdictions (e.g., the Personal Data Protection Act (PDPA) in Singapore and the California Consumer Privacy Act (CCPA)). However, by its very nature data is not easy to manage; it grows exponentially, travels fast and crosses borders easily. The case for an internationally coordinated approach is compelling, but data localization rules and differing views on the use of cloud storage, for example, may cause further fragmentation.

So, not for the first time in the post-crisis landscape, market participants need to navigate a complicated and inconsistent set of guidelines, laws and rules, trying to find standards and working practices that anticipate where data protection regulation is likely to land. A good foundation will include:

- A data governance program which clearly defines appropriate sources, uses, access, maintenance and protection across lines of defense. Clear allocation of responsibilities is necessary to ensure strong accountability and demonstrate to both internal and external stakeholders that the program is working as intended.
- An assessment of the range of laws and regulations applicable to data, including data managed by third parties.
- A review of all vendor agreements and contracts to determine whether practices with respect to third parties conform to data governance policies.
- Processes for responding to deletion or opt-out requests, verifying and determining access rights internally and addressing access requests.

Artificial intelligence (AI) and machine learning (ML) are now key topics. As evidenced by the recent EY/IIF survey, regulators and financial institutions are focusing on how existing risk management and governance practices need to be enhanced to capture the dynamic and inter-related risks (e.g., model, legal, compliance and cyber) associated with AI and ML. Until recently, most applications have been in low-risk automation, but now deployment is increasingly more decision-based (e.g., risk management and product pricing).[12] As technologies have impacted the end customer, they have attracted more scrutiny, particularly in the areas of bias and discrimination.

As with operational resilience and climate risk, a detailed regulatory framework has not yet been developed for AI and ML governance. As a result, there is an opportunity for firms to define what "good looks like" to inform and influence regulatory expectations. Regulators can point to existing guidance and risk management frameworks, but the public scrutiny of AI and ML may encourage them to provide new or enhanced guidelines. The absence of specific rules in most jurisdictions is partly driven by the desire of regulators to avoid stifling innovation, and to retain a technology-neutral approach to their rule-making. At the same time, they are more closely evaluating the risks underlying these applications, using the supervisory process to assess their risk profile and identify any concerns.

12. "Machine learning in UK financial services" BoE/FCA, October 2019.

Consequently, firms will be expected to enhance existing risk management and control frameworks to address AI and ML-specific risks. For applications considered to be high-risk (e.g., customer-facing), recommended strategy involves a process similar to that used for new product approval (NPA). This will require front-line units to perform an assessment of risk impacts, limitations, compensating controls and capabilities prior to application deployment (and indeed throughout the life of the application). Independent risk management functions would review and challenge the business case as part of the process. If such an approach fails to prevent the occurrence of control failures or misconduct risk (inherent bias, discrimination and poor customer outcomes), it will be a strong indicator to the regulator that specific guidelines or rules need to be developed, as already seen with the Monetary Authority of Singapore's (MAS) principles to promote fairness, ethics, accountability and transparency (FEAT)[13] in the use of AI and data analytics, and most recently by the Hong Kong Monetary Authority (HKMA).[14]

Apart from specific cases such as the issues around data and the growth of AI and ML, regulators will be looking at the impact of technological change across the risk and control infrastructure in banks. However, the limitations of legacy systems still prevail. Existing core banking systems have been pieced together over the years and maintenance is expensive and dependent on third parties; many banks still spend more money on their legacy systems than moving to new technology.

The impact of digital transformation on risk management, therefore, has not yet been fully realized. FinTech, RegTech, SupTech and any other techs have disrupted but not yet revolutionized the industry. While some high volume and low impact tasks are being overhauled, in other instances development has resulted in solutions that are still looking for a problem, or niche applications that are beyond the capacity of smaller developers to introduce and support in the bigger financial institutions. In the search for scale, big techs will have a potential impact, presenting a competitive challenge to market incumbents, but likely to attract attention from supervisors due to systemic risk and consumer protection concerns.[15]

13.“MAS introduces new FEAT Principles to promote responsible use of AI and data analytics” MAS website, November 2018.
14. “Guiding Principles on Consumer Protection in respect of the use of Big Data Analytics and Artificial Intelligence” and “High-level Principles on Artificial Intelligence” HKMA, November 2019.
15. “BigTech in finance: Market developments and potential financial stability implications” Financial Stability Board (FSB), December 2019.

4 Completion of remaining post-crisis measures

Nearer the end than the beginning; but no time to relax

Despite changes brought about by the trends mentioned above, it is still not possible to move on completely from the last crisis due to the remaining pieces of policy remediation still to be implemented. The latest report on the G20 reforms from the FSB delivered a comprehensive checklist of the key measures.[16] Of these, Basel III and the interbank offered rate (IBOR) transition are areas where banks must maintain momentum.

At the start of 2020, market participants running Basel implementation programs are hoping for more clarity on implementation timelines; and signs of only limited regional divergence. They are likely to be less than fully satisfied on both counts. The picture is clouded by local market considerations, legislative backlogs, impact uncertainties and the political agenda. Uncertainty regarding timing and scope of implementation, particularly in the EU and US, is having a knock-on effect in jurisdictions that are keen to ensure banks are competing on a level playing field, resulting in a "wait and see" approach. Most implementation programs cannot afford a loss of momentum, however, so firms should:

- Continue to plan for implementation of the standard Basel III rules in line with Basel timelines.
- Remain closely monitoring the proposals for implementation in key jurisdictions that impact business.
- Understand the ongoing impact on capital and liquidity, and the interplay with existing regional requirements, and update these impacts based on deviations from Basel III on a jurisdictional basis.
- Monitor impact on a key legal entity and a group basis, as jurisdictional impacts will determine local entity capital and liquidity requirements.

As for the transition from IBOR to alternative reference rates, the current view from supervisors is that, although a major project for most banks, the overall level of preparedness appears to be below what might be expected.[17] The rate of progress, or lack of it, is manifested both operationally, in terms of stuttering implementation efforts, and financially, as IBOR exposures have not been reduced as much as regulators would wish.

In 2020 scrutiny of transition plans will intensify. For example, the HKMA recently announced it will look at IBOR exposures more closely and consider necessary follow-up actions.[18] Further policy measures by supervisors may include added risk charges and weightings on IBOR exposures, although this may be countered by concerns over regulatory arbitrage if policy action is not internationally coordinated. Nevertheless, the concerns of regulators worldwide are already clear and were recently reiterated in a report[19] by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). Banks should step up efforts to:

- Perform risk assessments and impact analyses of their IBOR exposures under different scenarios.

Basel III and the interbank offered rate (IBOR) transition are areas where banks must maintain momentum.

16. "Implementation and Effects of the G20 Financial Regulatory Reforms 5th Annual Report" FSB, October 2019.
17. "Tenth annual EY/Institute of International Finance (IIF) global bank risk management survey — An endurance course: surviving and thriving through 10 major risks over the next decade" EY/IIF, November 2019.
18. "Reform of interest rate benchmarks", Letter from the HKMA to authorized institutions, October 2019.
19. "Study on the Implications of Financial Benchmark Reforms" EMEAP Working Group on Financial Markets, September 2019.

- Develop their program governance by identifying key senior managers and providing transition plans toward alternative rates, particularly in terms of migrating legacy contracts.

In addition to the specific challenges of programs such as Basel and IBOR, firms should ensure that their risk and governance structures keep evolving, particularly in two key areas: accountability and financial crime.

Accountability regimes continue to be implemented or expanded in the major international financial centers and are now reaching the stage where the newer models are learning lessons from their forerunners. Most notably, firms operating in key jurisdictions can expect supervisors to place further emphasis on:

- Clearer statements of roles and responsibilities
- More rigorous self-certification by firms of individuals in senior management roles
- Incorporating new areas of accountability, such as data oversight, sustainability and diversity
- Higher expectations that all staff will understand what is meant by good conduct
- A cultural shift beyond doing simply what is legally permissible toward achieving better, more ethical outcomes that mitigate harmful conduct

In the immediate post-crisis phase, the call to address deficient standards of governance led to the creation of senior management regimes. Now, we can expect those regimes to be a vehicle to accommodate the expanded portfolio of risks that senior management is expected to oversee.

Another legacy risk that regulators and financial institutions alike must address more effectively is financial crime. Local and international pressures to reduce the volume of money laundering and other criminal activity remain high, but advancements in data analytics, AI and ML are offset by privacy rules and obstacles to information-sharing, which reduce the potential upside of collaborative, larger-scale solutions, such as industry utilities, public-private initiatives or strategic partnership with third parties. Criminal activity, of course, suffers no such legal and regulatory restrictions and continues to become increasingly sophisticated, using advanced technology to launder money and avoid detection. In 2020 and beyond, legislators and policymakers must address difficult questions on the trade-off between transparency and privacy, and use of data, so that technology can make bigger inroads in the fight against financial crime.

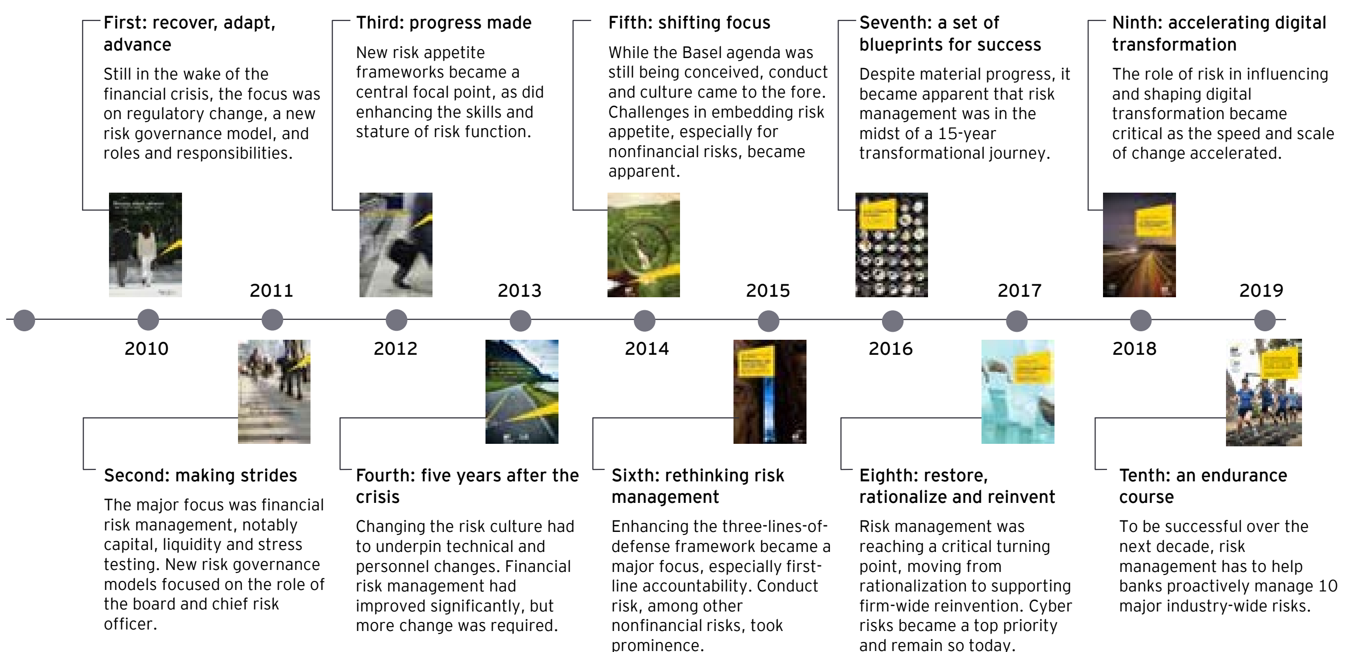
Firms should ensure that their risk and governance structures keep evolving, particularly in two key areas: accountability and financial crime.

5 What’s next?

Time to get better at the old stuff and get good at the new stuff

Regulators will expect boards and risk functions to take responsibility for the expanded range of issues that are now an inescapable part of their environment, particularly the non-financial risks presented by data, conduct and sustainability. Over the last few years, it was still a matter of debate as to how much the landscape would change, but now it is clear that a tipping point has been reached: the world of governance and risk management has been irrevocably transformed.

A decade of risk management transformation[20]



20. “Tenth annual EY/Institute of International Finance (IIF) global bank risk management survey – An endurance course: surviving and thriving through 10 major risks over the next decade” EY/IIF, November 2019.

The transformation will be accelerated as banks reach the end of post-crisis implementation programs and increase their focus on cost reduction and reviews of resources that have built up to deal with high volume tasks, such as Know Your Customer (KYC), transaction monitoring and anti-money laundering and financial crime surveillance.

Nevertheless, as noted in the EY/IIF survey, the regulatory microscope will include a focus on operational and cyber risk across the entire business model. The very public IT platform failures that have affected major banks, and the ever-present threat of cyber-attacks, caused policymakers and supervisors to emphasize the importance of operational resilience. This pattern of breaches, followed by heightened scrutiny, is being repeated in the data space, as illustrated by recent major incidents at international companies both inside and outside the financial sector. Supervisors will be increasingly inclined to respond to specific incidents by requiring clearer allocation of responsibilities at senior levels, using accountability regimes as a key driver.

Market fragmentation remains a stated priority issue for policymakers,[21] but it is difficult to see a way forward with Brexit, Basel implementation, climate risk and other challenges likely to have implications for cross-border activity, equivalence regimes and regional implementation and regulatory arbitrage. Against such a backdrop, regulators will need to prioritize an answer to the equivalence question and figure out a practical mechanism that will allow deference to each other's rulebooks where appropriate, without undue delays or uncertainty, to preserve the smooth operation of markets and good customer outcomes.

However, there may at least be some potential for progress in the part of the landscape that is relatively less developed and not so weighed down by embedded approaches and entrenched opinions. Convergence and standardization have more potential where established rules and taxonomies do not already exist and there are limited vested interests to promote, or simply defend, a familiar local standard. In the digital era, many of the newer challenges come with a global aspect built in, and a coordinated response seems a more attainable goal. For example, the Financial Action Task Force (FATF) is exploring how digital identity systems can be aligned and used for customer due diligence.[22] We also hope to see coordinated action on sustainable finance, data protection and digital currency, where the FSB has highlighted the need for multilateral responses to risk concerns over stablecoins.[23]

In the digital era, many of the newer challenges come with a global aspect built in, and a coordinated response seems a more attainable goal.

21. "Updates on the Work on Market Fragmentation" FSB, October 2019.
22. "Draft Guidance on Digital Identity" FATF, October 2019.
23. "Regulatory issues of stablecoins" FSB, October 2019.

Conclusion

Previous EY regulatory outlooks have emphasized that boards and risk functions needed to find the right balance between managing legacy risks and the fresh challenges arising from the new digital landscape. The search for equilibrium is still crucial; but, it is now further complicated by the need to update compliance and risk management models to incorporate a much more varied set of dynamic and inter-related operational and non-financial risks, and to meet the enhanced expectations of supervisors, investors, clients and other stakeholders.

Firms will also have to adjust to new sets of requirements. Market fragmentation is not going to recede any time soon. However, regulators, whether as part of a coordinated international strategy or in response to pressures closer to home, will look to set standards across several newer portfolios, notably operational resilience, climate risk, data and AI and ML that have largely been uncharted until now. In 2020, we may see significant steps in those journeys.

To help meet the upcoming challenges discussed in this Outlook, EY strategic solutions provide a platform for focused, timely and valuable review and assessment, providing leading advice and guidance on these issues and many other risk and regulatory topics.

The solutions are often cross-service line and are grouped by global themes that are consistent across financial services. In addition, EY growth drivers and enablers are applied across our solutions, either integrating new technologies into our solutions or providing new service delivery models.

https://sites.ey.com/sites/DS_BCM/Pages/SolutionOverview.aspx

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Other related material

"Information Technology Examination Handbook: Business Continuity Management" US Federal Financial Institutions Examination Council (FFIEC), November 2019.

"Proposed Revisions to Guidelines on Business Continuity Management" MAS consultation paper, March 2019.

"Market integrity rules for technological and operational resilience" Australian Securities and Investments Commission (ASIC) consultation paper, June 2019.

"Circular to licensed corporations — Use of external electronic data storage" HKSFC October 2019.

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