How can regulation keep up as transformation races ahead?

2022 Global regulatory outlook

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Introduction

As the pandemic drags into its third year, financial services firms face a range of challenges, from increased operational complexity and an evolving regulatory directive to address environmental and social issues to new forms of competition and evolving technologies, such as digital assets and cryptocurrencies. Banks, insurers, asset managers and other financial services firms (collectively referred to as "firms" in the rest of this document) must innovate more effectively — and rapidly — to keep up with the pace of change while still identifying emerging risks and building appropriate governance and controls.

Amid this uncertainty, firms need to find some clarity in terms of policy and regulatory shifts — as well as building up their regulatory agility — so they can effectively compete in the current environment while also planning for the future. Specifically, firms need to understand and prepare for supervisory and policy actions. For the present, that means sustaining their pandemic response, technology and data, legacy policy implementations, anti-money laundering (AML) requirements, prudential and operational risk. The future focus should be on policy evolution, sustainability, geopolitical uncertainty, financial inclusion, cryptocurrency issues and prudential regulation.

This publication gives firms a sense of the direction of regulatory travel in seven areas that we believe will shape regulation and policy. It also includes actions for firms as they grapple with the dual responsibility of responding to the impact of COVID-19 while addressing new and existing policies at the frontiers of technology, environmental, social and governance (ESG) measures and other factors.

COVID recovery, social responsibility and vulnerable groups

The role of the financial services industry has evolved over time to encompass greater social responsibility. This evolution was already underway prior to COVID-19, but the economic implications of the pandemic — which are continuing during the ongoing recovery — are serving as an accelerator by reversing social and economic development gains and exacerbating the digital divide.

Regulatory priorities are expanding beyond just financial stability to the broader principles of economic stability and financial inclusion. Just as regulators are starting to be a key part of the climate agenda, they are likely to be a key part of the social agenda as well.

During COVID-19, governments and regulators launched rapid initiatives to mitigate the worst of the pandemic's impact, many of which benefited both firms and their customers. In the UK, nearly 6 million people took mortgage or credit extensions. Measures in Germany, the Netherlands, France, the UK and many other markets supported small businesses through loans, grants or both. Australia put forth measures to protect vulnerable bank customers. The US issued a moratorium on foreclosures and evictions and, in exchange, relaxed leverage requirements on banks, extended credit and liquidity facilities and waived the fees for overnight extensions from the Federal Reserve.

Now, as business activity has resumed (albeit unevenly), many banks and other lenders no longer need this relief. But, many consumers and small businesses still do, and policymakers and regulators will likely focus more on creating an "inclusive recovery."

The impetus for firms to help create that kind of inclusive COVID recovery — and address broader social issues — is still largely informal. Unlike climate, for example, there is no drive toward global standards stipulating how firms should report social elements of their operations. Schemes, expectations and incentives vary by jurisdiction. Some regulators have suggested that banks have a duty to treat vulnerable customers with greater care, particularly in terms of how they explain their options.

However, a focus from regulators, and notably investors and more widely defined stakeholders, is growing and banks will need to adopt a more expansive view of their social obligations. Supervisors are increasingly examining and holding banks accountable, potentially using the same authority that they use to oversee stability, conduct and other traditional elements of operations to push firms as a means of promoting a more socially-minded policy agenda. In the European Union (EU), for example, the Taxonomy Regulation, is being reviewed with the intention of an extension to cover social objectives. This will help investors identify finance solutions for ensuring quality work, enabling inclusive and sustainable communities and providing affordable healthcare and housing.

The EU Taxonomy entered into force on July 12, 2020. The Taxonomy Regulation contemplates a phased implementation. From January 1, 2022, the climate change mitigation and adaptation objectives will apply. From January 1, 2023, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystem will take effect. Additional areas will be considered.

Specifically, firms may need to apply a broader mindset to financial inclusion, both in the types of products and services offered, and in the types of groups they are offered to. In many jurisdictions anti-discrimination laws ensure the provision of credit to legally protected groups. Firms can apply that same mindset to a broader set of financial services, ensuring that they are fairly priced and fairly offered. In addition, firms can expand beyond the narrow requirement to serve legally protected groups and take broader steps to ensure that those services are accessible to all. For example, many jurisdictions have a specific definition of vulnerable customers, yet other groups may fall outside the legal definition and are still vulnerable in some way. Access to a transaction account is a first step toward broader financial inclusion, since such an account allows people to store money and send and receive payments. According to The World Bank, one-third of the world's population is currently unbanked.[1]

In the past, many firms could address positive social impact as an ancillary component of their total business, whereas now it is integral to long-term, successful business models. Increasingly, they will need to consider the role they play in society at a time when the world economy is recovering and will continue to do so for years.

What's next for open finance and underserved populations

Open finance promises to harness data to create a wider range of financial services and products tailored to lower income populations, particularly women and owners of micro, small and medium enterprises, who remain disproportionately financially excluded. The UK has been a front-runner in terms of studying and implementing open finance, with the Financial Conduct Authority (FCA) publishing the results of an open finance consultation in March 2021.[2] More broadly, the EU is moving toward formal open finance regulations. The European Commission's digital finance strategy promises a legislative proposal on an open-finance framework by mid-2022, with the goal of having a framework in place by 2024.

[1] Financial Inclusion Overview, World Bank

[2] Open Finance Feedback Statement, March 2021, UK Financial Conduct Authority

Climate risk: now and in the future

As the momentum to mitigate climate change grows, regulators are considering how climate risks could affect financial stability.[3] Supervisors — formerly hesitant to address politically sensitive or social topics, particularly in the US — are increasingly using their regulatory authority to address nonfinancial risks and, more broadly, achieve a social policy of environmental sustainability. In the EU, supervisors are increasingly viewing climate-induced physical risks as a financial risk to banks, their clients and the overall financial system, and encouraging an orderly transition from fossil fuels to renewable energy sources. These interventions are normally couched in terms of the wider threats posed to financial stability or stress testing. In this effort, regulators can have a massive impact on policy and society overall, but the implications for firms are correspondingly large.

One challenging aspect of regulatory oversight on climate is the lack of a consistent framework or set of standards that can be applied globally. There is no common agreement on what sustainability and other nonfinancial information companies should measure, or how they should measure it. Bodies including the Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), International Sustainability Standards Board (ISSB), and Basel Committee on Banking Supervision (BCBS) are seeking to develop overarching principles, such as the Task Force on Climate-Related Financial Disclosures (TCFD)[4] framework.

But within individual jurisdictions, the degree to which those principles are applied and the areas of emphasis among regulators may vary considerably. Individual markets face different manifestations of climate change, have different starting points in terms of their reliance on fossil fuels, and different ambitions for their climate change plans. In many Asian countries, for example, there is a far greater need to recognize transitional activities as an intermediate step before companies can begin to actually mitigate emissions. Even among developed economies, countries such as Canada and New Zealand are being very detailed in their application of their TCFD standards. In addition, jurisdictions are advancing on different timetables. That creates complexity for global firms, their compliance and risk-management systems and the products that they develop to be traded across multiple regions. It will also inhibit the cross-border finance needed to fund the energy transition. The adoption of the recommendations of the US-China-co-chaired Sustainable Finance Working Group (SFWG) by the G20 at the COP summit in Glasgow provides a roadmap for consistency, including a call for harmonized reporting standards that include transitional projects within the definition of "green."

To give an example of the current differences, US banking supervisors have been focusing on scenario analysis to address their primary interest in financial stability (though they have yet to define specific objectives for firms), while supervisors in other markets have been more proactive across

[3] Climate change and sustainability: Global regulators step up the pace EY, 2021.

[4] See the 2021 EY Global Climate Risk Disclosure Barometer

a range of levers. In the UK, the government consulted in late 2020 and early 2021 on improving home energy performance through lenders, including a target-based approach that would consider the overall energy performance of lenders' portfolios.[5] The government's Net Zero Strategy: Build Back Greener [6] includes a reference to the government working with mortgage lenders to support homeowners and states that the response to the consultation will be published in due course. Regulators are also imposing obligations on firms to engage with stakeholders who are in higher categories of climate or environmental risk to advise them on transition strategies.

Thus far, market demand and awareness has raced ahead of regulators, who are trying to catch up. Firms are seizing the market opportunity for sustainable finance by developing new "green" products. And in most developed markets, this is the first point of regulatory clarity — not corporate disclosures, but product disclosures about new offerings. The EU, Switzerland and the UK all have disclosure requirements in place to prevent greenwashing. International Organization of Securities Commissions (IOSCO) aims to coordinate policy development among national regulators and has proposed that national supervisors should consider issuing new rules or guidance covering sustainable investment products.[7] The EU has a timetable for the adoption of the environmental objectives of its wider taxonomy, with the first set being published in 2021 and the second in 2022. In the interim, however, the gap between market sales and regulatory standards also opens up potential risk for firms operating now, should those standards differ significantly in the future.

Another challenge is that scrutiny will not come just from regulators. Many third-party entities such as non-governmental organizations (NGOs) are collecting, analyzing, and reporting data on climate performance, in the absence of any direct financial interest. That creates reputational risk, particularly for institutions that aim to meet the bare minimum regulatory requirements or, worse, attempt to greenwash.

How should firms move forward given these challenges? A critical first step is data. Most firms have significant gaps in the data they will need to assess their total climate impact — not just in their current operations, but the Scope 3 data from the operations of their customers or suppliers — so-called "financed emissions."[8] The information that does exist is siloed in different functions, preventing firms from developing a complete and quantitative picture.

In some jurisdictions, governments are stepping in to help fill the information gap. In addition, capital markets regulators are setting climate-related accounting standards and disclosure requirements for listed companies, which would help banks get a better sense of the risks inherent in the energy transition.[9]

In addition to data, the direction of travel for risk-management functions is toward integration, in which financial disclosures are integrated with nonfinancial disclosures. As banks did with cyber or privacy concerns, they are now adapting their risk-management infrastructure to embed the risks of climate. Nearly 40% of banks participating in the most recent EY risk survey reported very strong confidence in their environmental/societal resilience.[10] That requires moving climate considerations out of a firm's Corporate Social Responsibility (CSR) unit and, instead, placing them under the chief risk officer (CRO), who typically owns the database requirements and runs the stress models. Alternately, some firms are naming a chief sustainability officer (CSO), with a broad mandate to oversee and coordinate environmental initiatives across the organization.

Scenario analysis to better model climate impact

More regulators are undertaking scenario analysis, including climate-risk stress test exercises in 2022 by the European Central Bank, the Monetary Authority of Singapore (MAS) and the Australian Prudential Regulation Authority. Many of these stress tests are based on the scenarios defined by the Network for Greening the Financial System (NGFS), but there are differences in scope and approach among jurisdictions. The Bank of England is also scheduled to publish the findings from its Climate Biennial Exploratory Scenario in 2022, which will inform policy debate, including how it relates to regulatory capital framework in place by 2024.

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[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/936276/improving-home-energy-performance-through-lenders-consultation.pdf.

[6] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1033990/net-zero-strategy-beis.pdf

[7] Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management," IOSCO consultation report, June 2021.

[8] Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organization.

[9] "TCFD Guidance Template: A Voluntary, Open-Source Toolkit Drawing on Observed Industry Practices," Institute of International Finance, supported by EY.

[10] How resiliency in risk management is the new top priority for banks, EY, 2021.

Another area where most firms still need stronger capabilities is in the modeling of climate impacts. This is a two-part process that entails: 1) modeling changes in climate over time; and 2) modeling the impact to financial services across different scenarios. To remove uncertainty for the first step, the Bank of England established three baseline scenarios, two of which are related to the energy transition rather than physical changes from climate. As a result, firms are becoming far better at conducting detailed analyses that incorporate not just their current clients and the direct impact from specific scenarios, but also the second- and third-order effects from an energy transition across the supply chain for those clients.

For example, rather than just looking at fossil-fuel producers and the direct impact they could face as a result of the energy transition, firms are looking at the impact of a shift away from fossil fuels on the overall economy, in sectors such as transportation, manufacturing and agriculture. Similarly, banks several years ago would consider physical changes in terms of the direct impact on their customers — e.g., the mortgaged properties in a flood plain and the damage those properties might experience. Now, banks are expanding that lens to consider the broader impact on the construction and manufacturing businesses that support housing in those areas. The result is a more detailed understanding of the cascading ramifications of climate change — and these analyses will get even better as firms improve their data sources and capabilities.

The changing regulatory perimeter to address crypto and big tech

Incumbent firms face competition from new entrants that have traditionally operated outside the regulatory perimeter, but are now offering financial activities such as payments or credit. These new entrants either rely on regulatory arbitrage to operate without being subject to full-blown financial services regulation or are subject to much lighter regulation than, for example, banks.

Many jurisdictions have applied a hands-off approach in the past, to encourage innovation or because they felt the risks were not significant enough to warrant intervention. But as technology and consumer behaviors evolve and new players increasingly market financial-services-like offerings, there is a growing awareness that the sheer size of their market presence could pose financial stability risks – and regulators are responding accordingly. As a result, the regulatory perimeter of financial services is slowly expanding.

For example, the Consumer Financial Protection Bureau (CFPB) in the US recently issued a series of orders for large technology companies that operate payments systems to turn over information about their business practices and plans.[11] (The banking trade association in the US issued a statement in favor of the measure, a rare example of enthusiasm for new rules in the industry, primarily because it will create a more level playing field.) In December 2021, the EU's Internal Market and Consumer Protection Committee adopted the Digital Markets Act, which proposes constraints on technology companies that serve as gatekeepers to EU customers and function as payments providers. In several jurisdictions, including the UK, the rapid growth of buy-now-pay-later (BNPL) providers has triggered – or will likely trigger – increased oversight as well, especially given that these services trend toward lower-income, younger and potentially more vulnerable populations.

A second way that the regulatory perimeter is expanding is addressing cryptocurrencies, digital assets, tokens and related products and services.[12] As the acceptance and transaction volume of these assets has grown, there is increasing momentum to address regulatory concerns – along with financial stability and investor protection – head on.

As with the payments point above, however, some jurisdictions lack clarity on which regulatory body has the mandate to oversee digital currencies and digital assets, in part reflecting uncertainty about how they should be classified – as securities or payment methods. In the US, the Office of the Comptroller of the Currency (OCC) has contemplated for some time a specialized bank charter that would allow those companies to offer certain banking services and have the protection of a bank – something that traditional players have lobbied against. Similarly, the President's Working Group on Financial Markets (PWG) is finalizing its guidance on stablecoins and recommends that they be seen as systemically important, giving the US Treasury Department and Federal Reserve significant authority over that asset class. There are also jurisdictional questions between the Commodities and Future Trading Commission (CFTC) and the SEC on jurisdiction, although the SEC has tended to take a leading role, particularly under current chairman Gary Gensler.

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[11] "CFPB Orders Tech Giants to Turn Over Information on their Payment System Plans," Consumer Finance Protection Bureau, October 21, 2021.

[12] Four key drivers of the global crypto-asset regulatory risk agenda, EY, 2021

As banks' clients increasingly want exposure to these new asset classes, supervisors are addressing the issue of investor protection. The MAS is a good example. It recently developed a framework for trading, listing, tokenization, custody and other services, with the objective of enabling institutional and private banking customers to trade digital assets and tokens. Other licenses will likely follow.[13] However, some jurisdictions, seem to be adopting highly precautionary approaches to digital assets — including the UK, which had previously played a leading position in FinTech regulation.

In most jurisdictions, however, many of the considerations about digital assets, particularly custody, are similar to the regulations for handling other types of assets. After all, most firms introduce new asset classes all the time. That gives incumbents a critical advantage over tech players in the handling of digital assets — provided they understand the new risks that such assets introduce. In Europe, even non-fungible tokens, which can experience huge volatility and uncertain valuations, are being handled by some firms using processes similar to those for art or collectibles.

The main area of uncertainty regarding digital assets is whether legal entities within financial services should be allowed to hold certain types of digital exposures on their books. In addition, central bank digital currencies — which could potentially complement or replace fiat currency in some jurisdictions — pose an existential threat. If customers can keep their money with a central bank, they have no need for a retail bank, and firms will see their interest rate margins contract precipitously. But even that does not entail regulatory uncertainty, rather uncertainty about the future development of the market.

The direction of regulatory travel varies by jurisdiction. In the US, supervisors are addressing individual components of digital currencies and assets in a somewhat piecemeal fashion. The EU, by contrast, adopted a holistic framework — MiCA — to address custody, trading, exchanges and other services. In that way, the EU has reduced regulatory uncertainty for established firms.

A third area where the regulatory perimeter is likely to expand is in the realm of money market funds. After several incidents during the global financial crisis in 2008 and 2009, these funds did not face additional scrutiny or action. However, similar issues during the pandemic — due to intense market stress during the spring of 2020 — have pushed regulators to increase their level of oversight beyond traditional product marketing, sales and disclosure to include broader issues of stability.

In October 2021, the FSB issued a set of policy proposals to make money market funds more resilient in times of economic or market stress.[14] Regional and national regulators will now consider how they can apply some of those proposals. For firms, the challenge is to collaborate with regulators, understand what's coming and assess the implications for their overall business. Some firms may prefer a more structured market, and others may see that a highly regulated money market fund is only marginally different from a standard bank account. For a sense of what regulated money market funds may look like, firms can look to Singapore, where the MAS has had fairly strict oversight in place for more than a decade.[15]

Sustainability implications of crypto assets

In addition to other challenges, some digital currencies may carry environmental concerns due to their intense energy demands. In the EU, the Markets in Crypto-Assets (MiCA) framework, which should be in place by 2024, will include green principles about the generation of such assets.

[13] "MAS Grants Crypto Licenses to DBS Unit and Australian Exchange; More Licenses Expected to be Issued," Straits Times, October 2, 2021.

[14] "Policy Proposals to Enhance Money Market Fund Resilience: Final Report," Financial Stability Board, October 11, 2021.

[15] "MAS Releases Guidelines for Money Market Funds," Monetary Authority of Singapore," July 1, 1999.

Digitalization of financial services: new challenges, including AI and central bank digital currencies

If the challenges of big tech and crypto are one side of a coin, then the impact of digitalization on financial services is the other. The industry is seeing accelerated digitalization in the delivery of services, the form of products, and even in the assets themselves. That creates fundamental issues for regulators, and it pushes firms to adapt their risk management and internal control environment for a more digitalized environment. At the same time, central banks are beginning to enter the space themselves as providers of central bank digital currencies (CBDCs).

In many ways, digital solutions hold the potential to dramatically improve operations. Regarding compliance, for example, largely manual processes can be digitized, creating more transparency for firms and accelerating the operation of controls to something approaching real-time. Similarly, digitization can dramatically reduce settlement time, settlement risk and credit risk, all of which are huge drags on the balance sheet and capital requirements of firms worldwide.

Yet some digital solutions hinge on artificial intelligence (AI) and innovative analytics, where the internal control environment and the traditional model of risk management are likely to be supplemented by regulators. For example, firms see the potential in using alternative data sources and AI to identify and qualify customers and price and deliver services to new groups. Yet early initiatives have shown that these data sources — all essentially just records of past transactions — may contain unjustified biases that disadvantage certain groups.

This issue is compounded by the market entry of new competitors (as detailed in the previous section) — particularly technology firms that offer bank-adjacent services, such as payments, and that often operate with a lower level of regulatory oversight. To respond to this competition, incumbent firms are trying to move faster and offer more seamless, personalized products and services — often through "push" initiatives that capitalize on alternative data and AI to anticipate customer needs. But, implementing these tools without appropriate governance to make sure that the algorithmic models do not go off-course (including privacy and ethical considerations) will trigger serious regulatory repercussions.

Evolving regulatory oversight on AI

Proposed rules in the EU could be the first step toward global AI regulation. The EU's digital package is quite comprehensive and includes the Digital Services Act, Digital Markets Act and Digital Governance Act. The EU's regulation released in April 2021 bans some uses of AI, heavily regulates high-risk uses but lightly regulates less risky AI systems. It requires providers and users of high-risk AI systems to comply with rules on data and data governance; documentation and record-keeping; transparency and provision of information to users; human oversight; and robustness, accuracy and security. In spite of some gaps, the proposal is a thoughtful start to the legislative process in Europe and might prove to be the basis for trans-Atlantic cooperation on emerging technologies.

In the US, by contrast, national guidance was issued by the Federal Trade Commission (FTC) in 2020 emphasizing the transparent, explainable and fair use of AI tools. In April 2021, an FTC update warned companies against biased, discriminatory, deceptive or unfair practices in AI algorithms. But, the only laws with significant guardrails on the use of AI are at the state level.

On the consumer front, for example, most global banks are now enabling new customers to open accounts via their mobile devices. But, firms still need to extend their know-your-customer, information security, privacy, access and identity-related controls across the new digital channel. On the market front, algorithmic trading is starting to apply essentially the same concept — using AI and data to make decisions.

The other major area in which digitalization is reshaping the industry is in firms' provision of digital currency, digital assets and related services. Supervisors' main concern here — other than consumer protection and money laundering — is that clients' interest in gaining exposure to these assets could outpace firms' internal control environment.

Overall, however, firms have the institutional expertise in areas such as suitability, custody, trading and controls in the banks' own financial statements and the valuation of client assets. They have the internal controls and risk-management processes. The challenge is to overlay the technology component.

For both elements of digitalization — alternative data sources and digital assets — there is a human-resources component. The people who understand risk and regulation often do not overlap significantly with the people who understand evolving technologies, such as application programming interfaces (APIs), cloud technology, crypto or related solutions. As a result, many firms need to find talent that can sit at the intersection of those realms and facilitate conversations so that risks can be identified and anticipated and controls embedded.

Finally, some jurisdictions, such as the Bahamas, have already launched CBDCs and a number have experiments underway (such as the US digital dollar and the Chinese digital Yuan) or policy plans (the Bank of England and EU) that would introduce retail or wholesale CDBCs. The Bank of International Settlements has suggested that a framework for an international approach to these and other digital assets could come as early as next year. The macroprudential or international implications of a major currency having a retail coin could be very significant for retail banks and the dollarization of smaller economies. For that reason, most central banks are likely to pursue a wholesale version. Even then, however, banks will need to think about the implications for their balance sheets and the possible interaction between central bank digital assets and private ones, such as stablecoins.

Collaborating on ecosystem infrastructure and a prudential approach

Operational resilience is becoming a bigger challenge for banks – and drawing corresponding increases in supervisory scrutiny – for two reasons. The first is that the scope, severity and frequency of threats are all increasing. Prior to COVID-19, regulators that focused on operational resilience, in some cases, were thought to be considering implausible scenarios. But the pandemic showed that firms need to prepare for a far greater range of potential disasters, even as other types of disruptive threats, including cyber and physical disasters, are growing in both frequency and severity.

Some firms have argued that COVID-19 was a worst-case scenario and that it did not lead to widespread service outages or financial instability. The counterargument from supervisors is that the pandemic affected the entire financial services sector – and all industries – meaning that its effects were not concentrated within a single organization. Also, because the impact was so universal, regulators were required to offer a level of forbearance that they may not offer in the future for resilience issues within a single firm. The changes to ways of working overall – including more employees working from home – all support the argument for increased regulatory oversight for resilience.

The second major factor leading to increased scrutiny is firms' growing reliance on third-party vendors. As operational components (call centers, cloud operations and application support) all move off-premises, firms need to address operational resilience beyond their organizational perimeter. The focus must extend across their entire ecosystem – the end-to-end network of people, processes, data, and third-party vendors that support the provision of critical services.

In some jurisdictions, regulators are creating clarity by identifying specific, tangible measures that firms need to take and document to boost their operational resilience.

The US issued new guidance this year regarding third-party risk management, which explicitly made resilience part of the assessment process for new vendors.[16] In the UK, a policy statement currently in development will be issued in March 2022 covering a range of institutions.[17] In the EU, the proposed Digital Operational Resilience Act (DORA) will serve the same purpose.[18]

Refining the requirements for operational resilience

In March 2021, the BCBS published high-level principles for operational resilience targeted at banks worldwide. These principles were published alongside an update to the Principles for the Sound Management of Operational Risk. Other jurisdictions, among them Singapore, Australia, Hong Kong and Canada, published supervisory or policy papers on specific aspects of operational resilience, including technology risk, business continuity management and outsourcing.

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[16] FRS FDIC OCC: Proposed Interagency Guidance on Third-Party Relationships: Risk Management, July 2021

[17] Bank of England: SS2/21 Outsourcing and third-party risk management, March 2021 (effective 31 March 2022)

[18] "What will the proposal for a Digital Operational Resilience Act (DORA) bring to the financial sector?" EY, 2021.

A notable aspect of these new criteria is indirect regulation — supervisors oversee the banks and put the onus on banks to ensure operational resilience among their own vendors. Some may ask why regulators do not simply oversee financial services vendors (such as cloud-services providers) directly, particularly if they pose a credible point of vulnerability and/or concentration risk. The answer is that doing so would require a level of technical expertise that many agencies may not have — particularly given the accelerating pace of technological change and the competition for talent.

For all these reasons, firms need to develop a more comprehensive approach to anticipating and mitigating the full range of threats that could disrupt operations in any way. Specifically, they need to be more proactive and integrate their approach to business continuity, resilience, third-party vendors and information security. The technology and resilience functions should apply a true partnership approach to disaster planning and resilience. And firms should be moving toward genuinely integrated testing of all people, processes, data, suppliers and other essential components of critical services from end to end.

In addition, firms can apply the concept of "resilience by design," in which they consider the resilience implications of a vendor as part of the bidding and assessment process, not after it has already been implemented. As part of that assessment, firms will need to apply an ecosystem approach, looking at resilience several rings out from the organization — not just to their vendors but to their vendors' vendors, and the broader impact of disruption on these third parties across markets.

The changing business environment encourages collaboration and an ecosystem approach to meeting customer needs. But, it also raises supervisory concerns about firms' reliance on third parties and new vulnerabilities as a result of this broader network of players. Firms need to adjust their risk management accordingly.

On the prudential front, the implementation of the Basel III package (sometimes referred to as Basel IV) will dominate prudential requirements. Some jurisdictions, including Japan, have indicated they will implement now. The EU timetable extends to 2025 and reduces some of the main perceived burdens of the package. All eyes will now be on the US (which has always limited Basel measures to the most significant banks) and the UK and Hong Kong. There is a risk of quite different approaches to Basel requiring firms to allocate capital and make other operational decisions over an extended period of transition.

Geopolitical risks and regulatory fragmentation are still top of mind

In the 2021 EY/IIF global bank risk management survey, 49% of CROs cited geopolitical risks as a major emerging risk. Yet until the late 2010s, the financial services industry had seen a growing trend toward globalization, with regulatory standards that were becoming more aligned across jurisdictions. In the past several years, however, that trend has reversed, leading to a world that is more fragmented and resulting in greater complexity for large global firms that operate across borders.

Perhaps the biggest driving factor behind fragmentation is shifting political relationships, borne out through growing US-China tensions, the EU's push for strategic autonomy and rising nationalism and protectionism in many markets (in some cases exacerbated by COVID-19).

The traditional implications of fragmentation for firms are a lack of efficiency, trapped capital and increased operating costs. However, as fragmentation accelerates, there are new risks associated with a firm's stance (real or perceived) on sensitive topics or being caught in the middle of competing sanctioning regimes. More problematic are the outlier events that fall outside a firm's walls. For example, if a public figure or government official makes a statement critical of a country overseas, that government could respond in ways that impact a firm's operations in that market.

Part of the challenge is that geopolitical risk does not fall neatly into most firms' traditional risk domains. Instead, it cuts across those domains — and can even amplify those risks, often in unpredictable ways. For that reason, geopolitical risk needs to be front-and-center in a firm's risk considerations. Moreover, risk analyses and the modeling of reasonable worst-case scenarios need to be conducted in a regular, proactive manner.[20] This is a marked departure for many firms, which often may not assess the implications of a scenario until after it happens. As fragmentation increases and geopolitical risks grow, that kind of retroactive approach will become more perilous.

Specifically, firms need to adopt a structured approach to improving their political risk management: identifying and collecting quantitative geopolitical risk indicators, assessing the business impact of geopolitical risk, integrating geopolitical risk into enterprise risk management (ERM), engaging the board and C-suite to integrate geopolitical risk into strategic planning and, for the largest firms, possibly setting up a cross-functional, geostrategic committee.[21]

Regulatory fragmentation poses challenges for firms as well. We've discussed the lack of climate and ESG regulatory alignment in a previous section. But, fragmented regulatory standards are also a significant issue in the realm of data privacy. The EU has a clear set of practices and principles for firms to apply through General Data Protection Regulation (GDPR). But, a global company must also meet the requirements in other markets to make much of their firm's data on customers and suppliers available to regulators and authorities. In contrast, only a limited number of states have laws covering data privacy.

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[19] "Resilient banking: Capturing opportunities and managing risks over the long term," EY, 2021.

[20] "How banks can turn political analysis into strategic decision-making," EY, 2021.

[21] "The CEO Imperative: Are you making political risk a strategic priority?" EY, 2021.

Global regulatory standards for data unlikely in the near term

For emerging technologies such as cloud and AI, data is likely to increase regulatory fragmentation in the financial sector. While data democratization helps combat inefficiencies, it also raises concerns regarding data ethics, misuse of data and compliance. A global governance framework for emerging technologies would be required to achieve global convergence and there are calls for the G20 to take the lead integrating the FSB and regulators.

Data privacy and data security laws between the US and China are almost mutually exclusive, making it impossible for a firm to comply fully with the legislation of both countries. The newly implemented Chinese Personal Information Protection Law (PIPL) is arguably stricter than the GDPR, particularly on cross-border data processing. PIPL limits the movement of customer records out of mainland China without regulatory approval, with punishments that are quite severe (though enforcement standards are often not well-defined). One possible scenario is that Hong Kong may revise its personal data protection standards — which date from 1995 as part of the prior generation of data privacy laws — to mirror the PIPL in mainland China.

Varying privacy regulations complicate the data initiatives that large global firms now have in place, which are predicated on using and analyzing information across consolidated data pools worldwide. Instead, many global firms are setting up separate entities in individual markets and operating them in isolation. Firms seeking to operate in China, Indonesia and other large countries are all essentially required to set up a new bank or new securities company, holding data locally.

Accelerating the need for greater organizational agility

Because of all the challenges discussed above, firms face an urgent need to become more agile and implement change more effectively. This will require strong governance and change management capabilities to enable real organizational, technological and cultural change, in a way that increases competitiveness while aligning with regulators' expectations.

There are several reasons for the lack of agility. Legacy IT infrastructure and organizational silos at many organizations have evolved in a piecemeal way over time, rather than being sufficiently future-proofed to capitalize on new solutions and opportunities. Large firms tend to have complicated, matrix structures for governance, risk-management and control functions. Perhaps the biggest challenge at many organizations is institutional inertia, with firms focusing more on responding to the issues that regulators flag, rather than identifying and rectifying those issues proactively.

But as the pace of change in the industry accelerates, the need for agility will only grow. Firms need to become more nimble and responsive, in a way that satisfies regulatory concerns about fixing problems by implementing change while ensuring that the right risk management capabilities and controls remain in place.

In some cases, regulators are supporting banks as they become more innovative. In 2019, the Hong Kong Monetary Authority (HKMA) established a framework for eight firms to set up digital banks in that market. The idea was to inoculate legacy players from disruptive change. In a similar initiative, all Hong Kong banks now have three years to develop plans for embracing FinTech and innovation end-to-end while transforming their controls to work in their new digitized processes. Regulators in Singapore and Malaysia have taken similar steps with the same objective: spurring incumbent players to change under somewhat controlled market conditions.

In the US, some firms are becoming more agile by adopting a platform approach to risk management and controls as they develop new products and services. That concept originated from a mid-2010s requirement that consumer banks assess all of their product and service offerings – including the incentives for new customers – to determine whether those incentives were being managed appropriately and used by customers.

Now, the platform-wide approach is being extended from the rear-looking assessment of a firm's existing products and services to the development of new offerings. For example, as firms use agile methodologies to develop software and new products and services, they can accelerate their time to market and compete more effectively by building in regulatory and compliance obligations as part of their development process, rather than as an afterthought. This concept, called risk management by design (RMBD) entails identifying risks early on, building in guardrails and ensuring that data governance is in place to capture the right information at the right time.[21] Critically, it also entails incorporating the ongoing testing and monitoring of controls, so that firms can assess compliance performance over time.

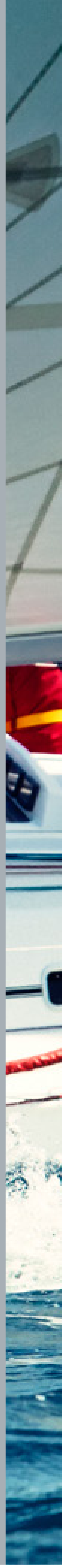
RMBD is one powerful tool to increase organizational agility, but it's only one tool. More broadly, firms need to rethink accountability and culture, to enable them to respond and develop more quickly in a more dynamic and competitive market.

[22] How risk management-bya-design can generate value in financial services | EY – Global

Platform-based business models proliferate

The platformization of the banking sector will accelerate in line with the digitization of the financial sector. These models — for example, banking-as-a-platform — may integrate new technologies, such as artificial intelligence, machine learning or data analytics, and facilitate processing, increase efficiency, promote innovation and improve customer relations. However, many banks are struggling to follow this trend because of their legacy systems and product-oriented culture.

From a regulatory perspective, digital platforms come with new forms of financial, operational and reputational interdependencies, over which supervisors currently have only limited visibility.
In 2022, the European Banking Authority (EBA) will help authorities to deepen their understanding of platform-based business models. However, EBA has not identified the need for any legislative changes at this stage, taking account of existing European Commission legislation in the areas of digital operational resilience, digital markets and digital services.



Conclusion

As we work through the pandemic, society has greater needs and greater expectations of the financial services industry. At the same time, firms must operate in a far more complex environment, due to evolving technology, global fragmentation, environmental challenges and other factors. Technology firms and other non-traditional players pose new forms of competition. And the industry must become more resilient and agile, even as disruptive threats grow. Regulation will drive some of these changes but also respond to others.

In this current environment, regulatory certainty — or even regulatory clarity — may not be possible. But by understanding the broad direction of regulation, firms can take proactive steps to prepare for what's coming.

For more information, contact the authors of this report:

Christopher Woolard CBE

Partner, Financial Services Consulting, Ernst & Young LLP; EY Global Financial Services Regulatory Network Chair and EY EMEIA Leader, Financial Services Regulation

+44 20 7760 8166
christopher.woolard@uk.ey.com

Marc Saidenberg

EY Americas Financial Services Regulatory Lead, Principal US Financial Services Consulting, Ernst & Young LLP

+1 212 773 9361
marc.saidenberg@ey.com

Eugène Goyne

EY Asia-Pacific Financial Services Regulatory Lead

+852 2849 9470
eugene.goyne@hk.ey.com

EY Global Regulatory Network executive team

Jamila Abston
Jamila.abston@ey.com

Jamila Abston was an Assistant Regional Director with the U.S. Securities and Exchange Commission's Division of Examinations. Jamila partnered with FINRA, the Federal Reserve, CTFC, NFA, US Attorney's Office, FBI, and other regulators to improve compliance and monitor risk as a regulator.

Meena Datwani
meena.datwani@hk.ey.com

She has over 35 years experience in government of which the last 23 years were in senior regulatory roles. She was the Executive Director of Enforcement and Anti Money Laundering Supervision at the Hong Kong Monetary Authority (HKMA). Prior to that she was the Executive Director for Banking Conduct and Chief Executive Officer of the Hong Kong Deposit Protection Board. She also served as Deputy General Counsel and before that Senior Counsel. Prior to the HKMA, she was a Senior Government Counsel with the Department of Justice of the Hong Kong Government.

Mario Delgado
mario.delgadoalfaro@es.ey.com

Mario's former roles include: FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy: Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF.

Marie-Hélène Fortésa
marie.helene.fortesa@fr.ey.com

Marie-Hélène's former roles include: Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank.

Itsuki Fukasawa
Itsuki.fukasawa@jp.ey.com

Itsuki Fukasawa has over 20 years of experience responding to laws and regulations at regulated firms. Itsuki was a Deputy Director, Legal and Planning Division, Planning and Coordination Bureau, the Financial Services Agency (FSA) of Japan, involved in designing financial regulatory frameworks and drafting laws and regulations.

Eugène Goyne
eugene.goyne@hk.ey.com

He has over 20 years in government and senior regulatory roles. He was previously deputy head of enforcement at the Hong Kong Securities and Futures Commission (SFC). Prior to the SFC, Eugène worked at the Australian Securities and Investments Commission and the Australian Attorney General's Department.

Alina Humphreys

alina.humphreys@au.ey.com

Alina worked for 20 years in financial services and legal roles before joining EY. She worked in senior leadership roles at the Australian Securities and Investments Commission and across regulatory enforcement and supervision, corporate finance and strategic policy. During this time, she led the advocacy for and, later, development of several key policies, including those relating to product governance, complaints and regulator funding and powers.

Alejandro Latorre

alejandro.latorre@ey.com

Alejandro (Alex) has over 20 years of experience at the Federal Reserve Bank of New York in monetary policy, capital markets and financial supervision and regulation. He was a senior supervisor involved in the oversight of large and systemically important FBOs in the US. Prior to his role as a senior supervisor, he was involved in many of the Federal Reserve's financial crisis management efforts.

Shane O'Neill

soneill2@uk.ey.com

He has 20 years of experience in banking, capital markets, asset finance and prudential regulation in a variety of CFO, COO, strategy and planning, and regulatory roles. Following the financial crisis, Shane was Head of Banking Supervision at a Eurozone Central Bank for four years, during which he influenced significant restructuring, recapitalization and change in the banking sector and in credit institutions, and executed numerous stress tests and asset quality reviews.

Keith Pogson

keith.pogson@hk.ey.com

Keith has more than 25 years of experience advising governments and regulators across Asia-Pacific on banking reform. He is particularly knowledgeable about market reform across banking, asset management, securities and insurance. He is the Deputy Chairman of the Listing Committee of the Stock Exchange of Hong Kong, as well as EY's representative on the Bank Working Group of the Global Public Policy Committee.

Marc Saidenberg

marc.saidenberg@ey.com

Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning.

Christopher Woolard CBE

christopher.woolard@uk.cy.com

Christopher had a 25-year career in public service before joining EY. He joined the Financial Conduct Authority in 2013 and served as Executive Director of Strategy and Competition, a member of the FCA's Board and last as interim Chief Executive in 2020. He founded Project Innovate and the FCA regulatory sandbox. He has served as a member of the Bank of England's Financial Policy Committee, the IOSCO Board and the FSB's Strategic Risk Committee.

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EYG no. 000217-22Gbl

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