Regulating the temperature

A deep-dive into the effect of regulation on developing risk mitigation strategies

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Introduction

In my recent white paper, The Circle of Life, I explored the four forces of change that are impacting Banking and the wider Financial Services sector and that should be considered when developing risk mitigation strategies:

1. Capitalisation

Insufficient reserves to deal with downturns or incidents within prescribed tolerances to avoid the taxpayer bailouts of the past.

2. Regulation

Increased regulation from several organisations domestically (Bank of England, Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)) and internationally as well as the fines and penalties they can levy to organisations that they deem as non-compliant.

3. Competition

Particularly from those embracing technology and new business models that appeal to consumers who are willing and eager to self-educate and self-serve online.

4. Obsoletion

The opposite of Futurism or investing in science & technology to safeguard your future, leading to long term decline that cannot be reversed.

This article looks in more detail at regulation, how firms are responding to the changing face of our regulatory environment and how they embed compliance and risk management into their business change and transformation agenda. Just as the summer has presented wide extremes of weather from heatwaves to storms, regulated entities need to be prepared to regulate their temperature without creating unintended issues or unmitigated risk.

Our regulators and their objectives

The financial crisis demonstrated interdependencies in our ecosystem between financial services firms. However, it also highlighted the risk of certain functions within banks chasing growth and forgetting the consumer and, ultimately, market risk. In 2013 the UK's regulatory system was revamped to reduce this type of risk, leading to the formation of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

FCA objectives

Parliament has given the FCA a single strategic objective **- to ensure that relevant markets function well -** and three operational objectives:

Protect consumers - to secure appropriate protection for consumers.

Integrity - to protect and enhance the integrity of the UK financial system.

Promote competition - to promote effective competition in consumers' interests.

PRA objectives

For its part, the PRA's primary objective is to promote the safety and soundness of firms, mainly by seeking to avoid adverse effects on financial stability and, in particular, seeking to minimise any disruption to the continuity of financial services caused by the way firms run their business or upon their failure.

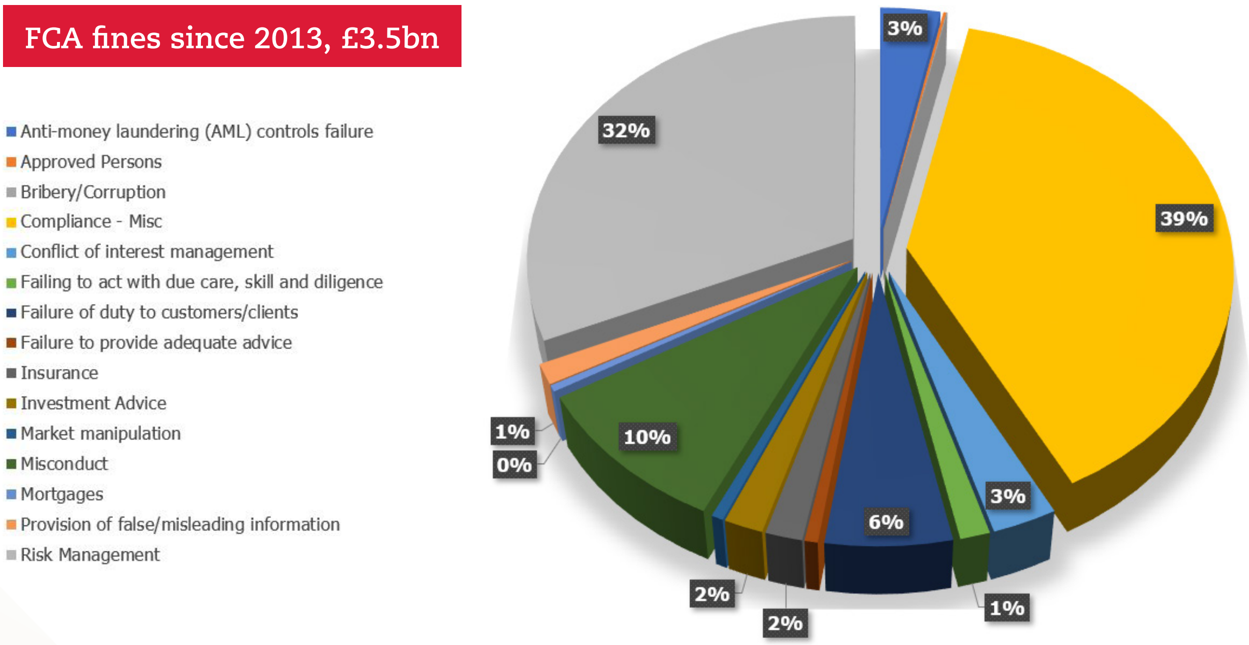
The PRA also has a secondary objective, that it must advance alongside its primary objectives, to facilitate effective competition.

The overall intent then is laudable and recognises lessons from our financial crisis a decade ago.

Looking back to look forward

The magnitude and scope of the fines issued by the regulators since their formation in 2013 are indicative of the emphasis they are placing on addressing the greatest shortcomings of financial institutions.

FCA fines since 2013, £3.5bn



It is notable that in recent years, the FCA has continued to impose significant fines for compliance failures.

In 2017, Deutsche Bank AG was fined £163m for failing to maintain an adequate Anti-Money Laundering (AML) control framework. This was the largest financial penalty for this type of failing ever imposed by the FCA.

In 2019 alone, Goldman Sachs International has been fined c.£34m for failing to provide accurate and timely reporting relating to 220m transaction reports, UBS AG has been fined c.£28m for failings relating to 136m transaction reports and Standard Chartered Bank was fined c.£100m for AML breaches in higher risk areas of its business.

Horizon planning

Shifting focus

We can expect more of the same from the PRA. Their focus on financial stability and preventing contagion risk involves the regulation of around 1,500 banks, building societies, credit unions, insurers and major investment firms. The bigger organisations that dominate the UK financial landscape are 'front and centre' of their attention given the concentration risk they represent. However, the rapid growth of challenger banks and their particular influence on savings and transaction services has meant they have become a systemic risk and consequently are subjected to a higher level of scrutiny than before by the PRA.

Despite this increased interest from the challenger banks, the PRA will be limited to the better known and riskier players in the market. The FCA however, since taking on responsibility for entities previously falling under the scrutiny of the Office of Fair Trading in 2014, regulates the conduct of more than 50,000 firms which includes the conduct of smaller firms. These smaller firms can expect more data to be gathered on them to support the FCA's oversight efforts.

Interpreting guidelines

When firms undertake their change scoping, prioritisation and budget setting exercises, they should pay close regard to the regulators' Business Plans and not just for their risk and compliance activity.

Increasingly the regulators expect compliance to be an inherent part of a firm's business model rather than a tick box exercise. With a "guideline" rather than "rules-based" system, the onus is on an organisation and its Senior Managers to understand their business model, determine the proportionality of regulation to their model and take considered and logical decisions that they can evidence. This has implications for the whole business and not just the risk function – particularly when the firm is undertaking large scale change initiatives.

Priority areas

Given that both the reach of the PRA & FCA is extending and our regulatory environment relies on guidelines (which are subject to interpretation), we believe the following priority areas should be reviewed by all regulated firms on a continual basis as part of their 'change track'.

Senior Managers and Certification Regime (SMCR)

The FCA and the PRA are extending the SMCR to all regulated firms by the end of 2019 in order to increase individual accountability of Senior Managers. In order to make ready, firms will need to:

- Map & track key roles and individual responsibilities for all affected functions;
- Demonstrate how Senior Managers can evidence "reasonable steps" to fulfil their responsibilities assigned under SMCR;
- Validate and measure the steps they are taking to improve governance, culture and controls;
- Update the mapping of key roles to take account of new initiatives and organisationsal change.

Vulnerable customers

The FCA has published guidance consultation on the fair treatment of vulnerable consumers setting out the FCA's view of what it requires of firms to ensure that vulnerable consumers are consistently treated fairly across the financial services sector. All firms involved in the supply of products or services to retail customers, even if they do not have a direct client relationship with the customers, will be required to:

- Ensure they have a suitable policy that sets out how they treat vulnerable customers;
- Apply this policy consistently via their systems, processes, pricing and people;
- Be able to evidence that doing the right thing for vulnerable consumers is deeply embedded in the firm's culture.

Demographic change

The FCA now carries out much more research and investigation than it has traditionally done and considers what the industry's approach should be to vulnerable customers. In June 2018, the FCA released the results of a survey titled "The financial lives of consumers across the UK" which looks at changing demographics across the UK, exposure to financial services and the needs and preferences of consumers identified as "vulnerable".

The regulator expects firms to have the ability to identify and proactively contact and support their vulnerable customers. They also require these firms to embed support mechanisms into their organisational change projects and to fulfil their responsibilities via their systems, policies, processes and people.

Fair treatment of existing customers

The FCA has already reviewed the life insurance and pensions sector in relation to the fair treatment of long-standing customers and it is now taking action on overdraft products. Additionally, it has put in place price caps on high cost short term credit and it has signalled a review into pricing practices in the general insurance and savings markets.

Technology

There is an increasing understanding and involvement in sandboxing of "RegTech" i.e. the use of new technology to facilitate and monitor the delivery of regulatory requirements. RegTech automates or disintermediates elements of regulatory compliance processes, reducing the reliance on ever increasing risk teams and creating a greater dependency on data.

Brexit

The PRA and the Bank of England (BoE) have published a joint consultation paper on further amendments to financial services legislation following the extension of the Brexit deadline under Article 50. This considers how the PRA and BoE will use their temporary transitional powers and also their proposals to fix deficiencies arising from the UK's withdrawal from the EU and for consequential changes due to the extension of the Article 50 period. This of course has implications for financial services firms' operating models and capabilities in particular.

Summary

The thing that is most notable from the consultation papers is that the regulators are clearly signposting that their guidance should not be seen as a checklist of required actions. Instead, it provides options for ways in which firms can comply with their principles.

The deliberate ambiguity created by the FCA in particular, adopting a “guidelines” instead of a rules-based approach to regulatory compliance means that firms need to employ a holistic and comprehensive approach towards incorporating regulatory intent into their systems and processes. Furthermore, firms should be able to explain their rationale for the approach they have taken and be able to demonstrate that their compliance is embedded in their culture and that they are executing their responsibilities consistently and compliantly.

As the Nobel Prize winning economist Milton Friedman states, “One of the great mistakes is to judge policies and programmes by their intentions rather than their results.”

Those immersed in change will be acutely aware that it is hard to translate intent into effective delivery. Ensuring that the regulatory “guidelines” are adhered to and embedded effectively into your change programmes is no small feat. It requires intimate knowledge of the regulations themselves and their intent, engagement right across the business and ownership from the top.

If you would like to discuss any aspect of the design and translation of your proposed change to ensure that it is aligned to the evolving regulatory intent, then please contact Ewen Fleming or Scott Holmes.

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