What is upcoming on the Regulatory Horizon?

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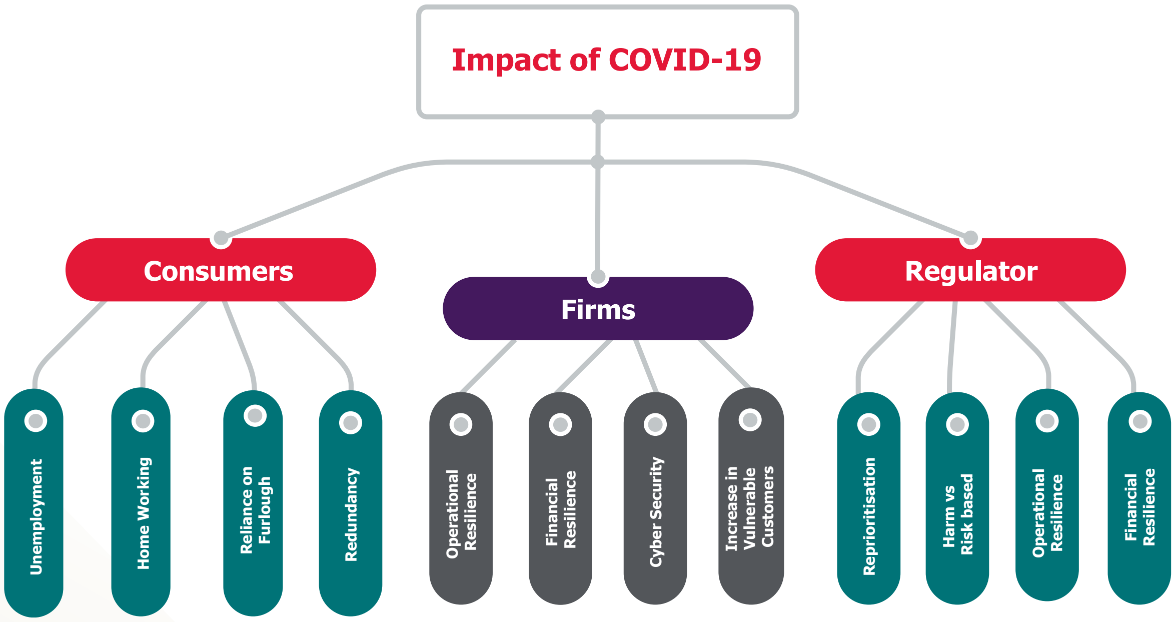
Introduction

It's clear that the last 18 months have proven incredibly challenging for the Financial Services industry. Numerous developments in relation to the COVID-19 pandemic, Brexit and climate change have demonstrated just how volatile the market is and therefore difficult to regulate.

Macro changes with huge impact to social, economic and trading conditions underline how difficult it is for businesses to predict and consequently plan for changes on the regulatory horizon. These macro changes have disseminated into numerous micro challenges for financial services firms and the regulators to respond to, with both having to show a level of agility which may not have seen before, in order to minimise the level of disruption caused by the pandemic.



Some of the challenges faced include:

- A likely permanent shift to digital and home working brings potential changes to employee pay structures and employability, heightened cyber security risks, business continuity and operational resilience challenges.
- The pandemic has led to redundancy programmes, and the full extent of future business failures and unemployment is masked by furlough schemes and business interruption loans. This is likely to create an increased flow of vulnerable customers, particularly as government support tails off.
- The health of the banking sector is crucial to the economic recovery, however, given the pandemic, this led to volatility in bad debt provisioning (and subsequent releases) and profits under IFRS 9.
- Government support to businesses via business interruption schemes have fed SMEs' debt when cashflow was required. Those businesses that survive may find servicing that debt challenging.
- Post the UK Supreme court decision to allow small businesses a right to pay outs for insurance business interruption losses caused by the pandemic, this has led to over £1bn being claimed to date.
- Extended furlough has had a prolonged impact on firms' credit policies and many consumers' ability to borrow/remortgage.

Regulators have had to prioritise their efforts on the areas representing the greatest probability of risk. For example, the Financial Conduct Authority (FCA) transitioned from a 'risk-based' approach to a 'harm-based' approach, focusing on those areas which could cause the most amount of customer detriment.

The regulator was quick to make a much-needed intervention in the mortgages, loans and credit card space. Their focus was on vulnerable customers, many of whom were facing significant financial difficulties due to the pandemic. Pre-pandemic, vulnerable customers were a high priority area of focus and that focus has, if anything, intensified, no doubt fuelled by concerns over the growing number of individuals that can be classed as vulnerable. As government support falls away, there is a risk that this population will grow even more leading to further activity by the regulators, given the increased potential harm to the end consumer.

As managing the impact and affect effect of the pandemic becomes more 'business as usual', regulators are turning their attention to previous intended areas of focus, including areas such as operational and financial resilience. We will explore these below, noting both the required significant effort for the earlier part of 2021. This competing demand for resource is a common challenge for regulatory change planning. New challenges also arise, particularly in the rise of the Fintech sector, and how these firms need to keep the balance right between their ambitious growth plans but ability to be seen as financially resilient and stable organisations, noting these two do not always go hand in hand.

Areas of focus

Operational resilience

On 29 March 2021, both the FCA (via Policy Statement 21/3) and the Prudential Regulation Authority (PRA) (via Policy Statement 6/21) released their respective final approaches to **operational resilience**, which is the culmination of much effort and collaboration between the regulators and the Bank of England since 2018 through the publication of discussion and consultation papers.

Below are the first requirements, due by 31 March 2022:

1. Identify importantant business services (from a consumer lens).
2. Carry out mapping and scenario testing of important business services.
3. Identify any vulnerabilities.

The regulators have taken a phased approach in implementing the **operational resilience** requirements, which acknowledges the substantial work many firms will need to go through up until the final hard deadline of 31 March 2025. Existing process mapping in relation to business continuity has been documented from a business department perspective rather than end-to-end from a customer perspective. This therefore requires rework to ensure that the process mapping flows through multiple business units across organisations.

Acknowledging this transition, the FCA have noted this only needs to be done to "a level of sophistication necessary to accurately identify their important business services, set impact tolerances and identify any vulnerabilities in their operational resilience." This provides firms with some methodology flexibility but this could be detrimental if substantial rework is required whereby existing work has not been granular enough. Further, if mapping and scenario testing is not done to a sufficient level of detail, there is a risk that vulnerabilities are not identified within the first phase.

The FCA and PRA have been clear, as part of their respective business plans, that they will hold firms accountable by assessing implementation progress and identifying areas of improvement.

Financial resilience

On 1 January 2022, the FCA will implement a new prudential regime for MiFID investment firms - the Investment Firm Prudential Regime (IFPR). This is closely based on the European equivalents, given the UK was an active contributor to the EU's Investment Firm Regulation (IFR) and Investment Firm Directive (IFD) during the policy discussions.

A key focus area for the regulator is to ensure prudential requirements more neatly align to the risk of harm should such firms fail. This will allow firms to have appropriate capital, liquidity and reserves to cover outstanding redress liabilities, allowing for an orderly exit with the expectation this will also lead to a decline in compensation pay-outs in the medium to longer term if firms were to fail.

We have been tracking the development of the IFPR through multiple publications made by the FCA. The IFPR regime aims for a more proportionate approach to the prudential regulations of investments firms in the UK.

There is a significant level of change here, particularly for firms who haven't been exposed to this level of prudential scrutiny before, including:

1. Changes to capital requirements.
2. New rules on liquidity and consolidation.
3. New governance requirements in relation to remuneration.
4. New internal capital and assessment process.
5. Changes to reporting and disclosure requirements.
6. Changes to supervisory review and evaluation process.

Given the significant level of change, the regulator is moving away from minimum cycles to a more regular supervisory approach, supported through data collection of a number of key documents.

The regulator will make their own assessment of the validity and accuracy of your approach, with onward intervention if current calculations are deemed not robust enough.

Vulnerable customers

The support for vulnerable customers is not restricted to the financial help provided during the pandemic. The FCA have a clear focus on ensuring that vulnerable customers are treated fairly and have no appetite for ineffective identification of such customers and/or inappropriate recognition of their needs.

On 23 February 2021, the FCA released additional guidance which sets out the expectations of firms in ensuring fair treatment of vulnerable customers. Firms will need to put in appropriate systems and controls to identify vulnerability, therefore complying with the FCA Principles of Business, to which this guidance is published against.

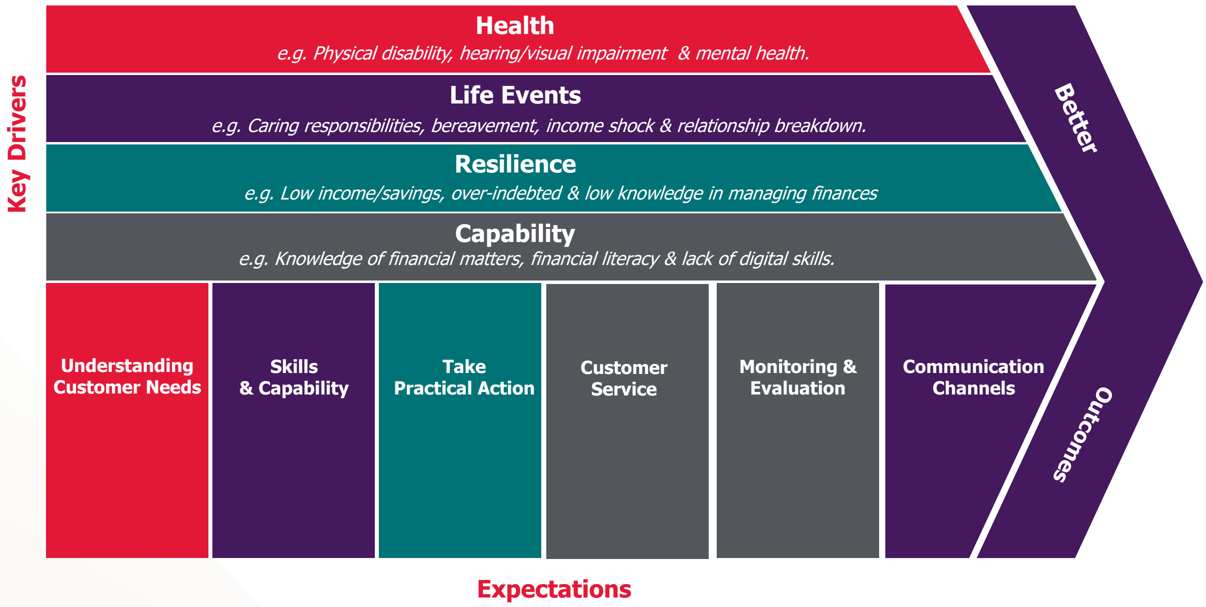
Firms will be required to be able to demonstrate how their business model, the actions they have taken, and their culture, ensures the fair treatment of all customers, including vulnerable customers.

To assist with this, the FCA have defined the term 'vulnerable' as:

"Someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care."

They have also clarified:

1. The key identifiers which lead to vulnerability - firms will be required to be include these as part of firm's initial risk assessments.
2. Expectations on firms - firms will need to perform a total capture assessment of their own governance against these.



The detail within the guidance is helpful as it allows firms to identify the key requirements of any good governance programme, giving them the opportunity to put in appropriate processes, controls and procedures to quickly identify and take measures to ensure fair treatment of vulnerable customers - leading to better consumer outcomes.

Approach to Regulatory Horizon Planning

Given the volume of ongoing regulatory change across all of the regulators, firms' governance structures need to remain nimble and ensure risk is managed responsibly and effectively. The pandemic has shown that, given the breadth of risks firms face; many risk functions are not built to scan the full horizon or the risk spectrum that organisations face. Firms also need to continue to embed customer's best interests in everything they do. Time itself is not infinite and firms' management need to implement sound governance practices early over their regulatory obligations to identify potential gaps and allow sufficient time to identify and implement remediation activity.

Management need to continue to manage through governance structures but also ensure actions are followed through in a timely manner. One challenge management continue to grapple with, as part of this dilemma, is access to appropriate skilled resource which can be in short supply. This resource need to be carefully managed when obtained effectively, by directing tactically to the increasingly complex level of regulatory change and/or flag early, where a skills or resource gap exists.

Where skilled resource does exist in house, they are often over-stretched across a variety of competing demands which also creates both a quality risk, in terms of end delivery, but also a retention risk in that, those individuals may be close to burn out and may look to move on.

To avoid this, the earlier firms can implement regulatory horizon scanning, the more time they will have to:

1. Mobilise effort when it comes to planning for upcoming regulatory changes.
2. Perform gap analysis on work of current vs future state.
3. Identify weaknesses and implement new controls.
4. Ensure new controls are operating as intended via monitoring and adjustment.

Summary

It is more important than ever to understand what is going on in the world, ensuring that changes can be made quickly and firms can prioritise and adapt effectively to future regulatory change. Assessing the regulatory horizon is a key component for firms to monitor any incoming changes and manage onward risk on non-compliance.

Given the level of incoming change from the regulators, alongside limited skilled resource, we are prepared and ready to support you and your business. Our team of dedicated regulatory specialists will be on hand to help with common challenges, assisting you with your initial impact assessments and onward remediation.

Historic approaches are not wholly relevant for what now lies ahead. The wheels of regulatory changes will continue to turn and therefore, upfront planning is critical to ensuring your firm is adequately managing its regulatory risk appropriately.

If you have any questions, please do get in touch with us:

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