DHG

PERSPECTIVES

March 2021

2021 Regulatory Outlook: Key Focus Areas for the Financial Services Industry

Given the continuing effect of the COVID-19 pandemic and shifting economic and political dynamics, regulatory oversight and potential enforcement actions are crucial watch items for those in financial services. The industry will also see the ongoing evolution of credit and capital monitoring, changing governance and control expectations, as well as enhancements to existing resolution planning and regulatory reporting rules.

As our clients look to 2021 and beyond, their focus should remain on the following:

Credit and Capital Monitoring

- Credit Risk (including Credit Loss Recognition), Loan Review and Accuracy of Risk - Weighted Assets
- Basel Changes Affecting UK and EU Regulations [including Capital Requirements Regulation (CRR) II / Capital Requirements Directive (CRD) V / Basel IV)

Recovery and Resolution Planning

- 2021 165(d) Targeted Resolution Plan
- Utilizing Recovery and Resolution Planning Strategies as Firms Focus on Resiliency
- UK Resolvability Assessment Framework

Regulatory Reporting and Data

- Swap Dealer Registration – Capital Requirements and Reporting
- Data Accuracy and Completeness to Meet Regulatory Reporting Expectations

Governance, Compliance and Controls

- Risk Management in Response to COVID-19
- Operational Resilience, including Cyber-Related and Information Technology Risks
- Change Management for Significant Operational Changes
- Compliance Risk Management, including Bank Secrecy Act (BSA) / Anti-Money Laundering (AML) Programs and OFAC Compliance
- London Inter-Bank Offered Rate (LIBOR) Transition Preparedness
- UK and EU Climate Risk Regulatory Actions
- Fair and Responsible Banking
- Paycheck Protection Program (PPP) Considerations
- Payment Systems, Products and Services

CREDIT AND CAPITAL MONITORING

Credit Risk (including Credit Loss Recognition), Loan Review and Accuracy of Risk-Weighted Assets

Credit risk management will be increasingly important given current and projected weakening economic conditions. Lending institutions should continue enhancing credit risk control functions while monitoring, identifying and evaluating credit risk levels. Independent loan review functions will continue to play an important role in monitoring asset quality within the loan portfolio and new lending activity. Additionally, the accuracy of risk ratings and the adequacy of risk rating systems will be vital to managing credit risk effectively.

To actively monitor the potential for rising credit risk in loan and lease portfolios, institutions should review the appropriateness of allowances for loan and lease losses and credit losses by assessing recent data related to the COVID-19 impact on borrowers.

Basel Changes Affecting UK and EU Regulations (including CRR II / CRD V / Basel IV)

In the UK and the EU, regulatory changes will continue to further address controls for market risks and Basel implementations. Companies should ensure they can handle the increased complexities brought on by CRD V and CRR II and put in place proper governance and risk controls to prevent a repeat of the 2008-2009 financial crisis. Having technology systems to handle all the data required for the new regulations will play a large role in proper implementation. In 2021, CRD V is expected to introduce further measures for implementing Basel III's enhanced Pillar 2 approach to managing and controlling Interest Rate Risk in the Banking Book (IRRBB). In addition, the Bank of England's Prudential Regulation Authority (PRA) and the European Banking Authority (EBA) intend to update the Prudential regime for credit institutions, including the leverage ratio, Net Stable Funding Ratio (NSFR) and market risk capital requirements for the trading book, along with several other standards. Financial institutions will need to address the composition of their balance sheets due to changing treatments of the sources of funding used in calculating the updated NFSR.

The EBA will implement CRR II on June 28, 2021. Meanwhile in the UK, the PRA is delaying adoption of the rule until January 2022 to ease the regulatory burden caused by COVID-19. Finally, the reformed Basel III banking standards (also known as Basel IV) must be implemented by January 2023, and new margin requirements are being introduced for non-cleared, over-the-counter derivative contracts based on Uncleared Margin Rules for firms with assets exceeding $50 billion (in Phase 5) and exceeding $8 billion (in Phase 6).

GOVERNANCE, COMPLIANCE AND CONTROLS

Risk Management in Response to COVID – 19

Certain geographies and industries will feel the continued effects of COVID-19, Brexit and shifts in business practices in the years to come. To better manage concentration risk within their various risk portfolios, financial institutions will need to continue to evaluate and monitor the soundness of their concentration risk management processes.

Operational Resilience, Including Cyber-Related and Information Technology Risks

Monitoring and oversight of third-party relationships has been, and will continue to be, a focal point in the post-COVID-19 environment, as regulators seek to understand where these relationships represent significant concentrations in operations, bank resiliency or other risks.

In 2020, the Office of the Comptroller of the Currency (OCC) provided guidance (i.e., OCC 2020-10) on governance and due diligence activities, how banks can effectively determine the risks associated with third-party relationships and their responsibilities regarding third-party subcontractors (fourth parties). The Frequently Asked Question (FAQ) alert also gave guidance on risk management when a third party has limited ability to provide the same level of due diligence-related information as larger or more established third parties.

The Financial Stability Board (FSB) also issued a discussion paper last year on this topic titled "Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships," which focuses on how financial institutions should manage their outsourcing and third-party relationships and related areas, such as business continuity planning, cybersecurity, data protection, operational resilience and risk management. Financial institutions should ensure that their contractual agreements with third parties grant them and the supervisory and resolution authorities appropriate rights to access, audit and obtain information from third parties.

Other key challenges highlighted by the pandemic are the management of subcontractors in the new remote working environment and the need for appropriate and effective business continuity and contingency plans. Financial institutions must be able to recover from an outage or failure at a service provider and, if necessary, exit these arrangements in ways that minimize potential disruptions.

Sophisticated ransomware attacks and costly breaches of confidential data continue to make headlines and have devastating effects on operations of financial institutions. As the likelihood of a cybersecurity incident increases, organizations must place additional weight on reducing the impact of any successful attack as well as limiting financial cost and interruption to business operations. Cyber resiliency—defined as how quickly an organization can respond and recover from a cybersecurity incident—has become a key component of effective technology risk management programs. By enhancing incident response and recovery capabilities, an organization can minimize the financial, regulatory and operational impact of an attack.

Enhanced requirements to strengthen operational resilience in the financial services sector are also being introduced by the PRA, the Bank of England (BoE) and the Financial Conduct Authority (FCA). A policy statement will be issued in March 2021, followed by a minimum 12-month implementation period. Companies will need to have proper risk and control frameworks in place to prevent disruption to any business service (via a Business Continuity Plan) that might harm market participants, market integrity, financial stability, policyholder protection or consumers.

Change Management for Significant Operational Changes

Regulatory change management functions have been, and will continue to be, required to quickly mobilize, strategize and execute large-scale, high-stakes regulatory initiatives. From ensuring the right platforms and guardrails exist, to serving consumers and small businesses through the Coronavirus Aid, Relief, and Economic Security (CARES) Act, to heavily investing in technology to support remote working for their employees, to sharpening their focus on Know Your Client (KYC) & AML vigilance, the pandemic created unique challenges not faced in recent history. All the while, the pandemic did not stop regulators from executing against their examination plans.

In 2021, financial institutions will no doubt face additional challenges, but much attention should remain in the rear-view mirror, ensuring the programs built during the chaos of 2020 do not become the audit or supervisory action of 2021.

Compliance Risk Management, including Bank Secrecy Act (BSA) / Anti-Money Laundering (AML) Programs and OFAC Compliance

While the main trends within BSA / AML will continue in 2021, Customer Due Diligence (CDD) and beneficial ownership will have further focus due to the passage of the Corporate Transparency Act (CTA) within the National Defense Authorization Act (NDAA). The expected new law will require the Financial Crimes Enforcement Network (FinCEN) to clarify and coordinate the CTA with its current CDD/beneficial ownership regulation. In addition, the AML Act of 2020, also within the NDAA, will make additional changes to BSA/AML laws, including but not limited to, establishing examination and supervisory priorities, extending BSA/AML requirement to antiquities dealers and convertible virtual currencies (CVCs), increasing subpoena power for records of foreign banks having correspondent accounts in the U.S. and streamlining the Suspicious Activity Report (SAR) filing process for noncomplex reports .

New areas that appear to be of heightened attention by regulatory bodies include the Advance Notice of Proposed Rulemaking (ANPRM) from FinCEN on making BSA / AML Programs more "effective." This includes the effectiveness of risk assessments, processes and systems in addressing the increasingly complex inherent risks associated with new financial products and services, adherence to two proposed FinCEN rules (NPRMs) regarding CVCs and digital assets with legal tender status, new intermediaries seeking to further obfuscate transactions from effective monitoring (e.g., digital forensics and incident response companies, cyber insurance companies and P2P exchangers, mixers and tumblers for CVCs).

LIBOR Transition Preparedness

The transition from the London Interbank Offered Rate (LIBOR) to alternative reference rates (ARR) is well under way. Financial institutions should continue updating technology platforms and products to reflect discounting and accruals using these new ARRs in time for the cessation date determined for each LIBOR tenor. The target date for cessation is Dec. 31, 2021; however, in a recent statement, the Federal Reserve Board discussed extending certain longer dated

LIBOR tenors to June 30, 2023. This would provide some relief in the transition of the back-book (existing pre-cessation positions) and contract remediation.

In 2021, we anticipate deliberations around the availability of a Secured Overnight Financing Rate (SOFR) term structure, an appropriate credit spread adjustment, and an increased focus on issuance of SOFR-based products. For a successful transition away from LIBOR, deep, liquid markets need to develop to provide market confidence in the viability of SOFR as a suitable LIBOR replacement. Additionally, 2021 could see wider adoption of non-SOFR alternatives, such as Ameribor, by banks with funding needs not adequately represented by SOFR. This could be particularly appealing to small and mid-size banks, since they might not be very active in the repo markets, possibly leading to a mismatch between SOFR and their true funding costs.

A key challenge the industry must navigate is a lack of clarity around how non-dollar LIBOR rates (especially those outside the major currencies) get transitioned. Currently, there is no market-driven consensus on how to proceed due to similar questions around term structure availability and lack of sufficient market liquidity in these currencies.

Another challenge that could arise as we enter the third and fourth quarters is the high volume of models and analytical tools needed to support these additional rates. The uncertainty around LIBOR replacements across various tenors may cause additional delays in development, raising the possibility that model risk management organizations could see significant increases in resourcing requirements in the second half of the year. Stress testing and resolution planning requirements could also place additional strain on developers, since the same teams are usually involved in those efforts, further exacerbating resource constraints.

UK and EU Climate Risk Regulatory Actions

Climate Risk Management is at the top of the agenda for 2021 for company boards and regulators alike. In the EU, regulators have been active for several years while other jurisdictions are quickly ramping up engagement and rhetoric. We anticipate a continued ratchet up in global awareness of climate change culminating into regulatory action over the next months and years.

In the EU, the European Climate Law was passed in December 2020 and gave a legally binding target for the EU to reduce greenhouse gas emissions by 60 percent by 2030. Companies will be required to make disclosures on this topic in their annual financial filings and are expected to align to the Task Force for Climate Related Disclosures (TCFD) framework. In addition, the European Central Bank (ECB) has published a final guide on climate-related and environmental risk for banks which expresses some concern regarding the state of climate-related disclosures. The ECB will also conduct supervisory stress tests on climate-related risks in 2022.

The UK is implementing a phased approach to ensure that companies are compliant with the TCFD reporting requirements. The Bank of England (BOE) announced the Climate Biennial Exploratory Scenario which will be launched in June 2021. The Prudential Regulation Authority (PRA) has also outlined their expectation that banks and insurers fully embed their approaches to climate-related financial risks into their overall risk management framework by the end of 2021.

Lastly, within the U.S., the Federal Reserve Board (FRB) announced in December 2020 that it has joined the Network for Greening the Financial System (NGFS) which belies an increased focus on climate-related risks. The New York Department of Financial Services (NYDFS) was the first U.S. regulator to publish expectations for their regulated institutions for climate change risk management. The Commodity Futures Trading Commission's (CFTC) Climate-Related Market Risk Subcommittee also released a comprehensive report outlining recommendations for managing climate risk in the U.S. Financial System.

Fair and Responsible Banking

The OCC's 2021 Bank Supervision Operating Plan emphasizes Fair and Responsible Banking during the COVID-19 pandemic. On Oct. 1, 2020, the OCC released its Fiscal Year 2021 Bank Supervision Operating Plan. Given the potential for increased customer harm during the 2020 pandemic, the operating plan stresses the importance of fair and responsible lending and adhering to legal and regulatory requirements while serving the credit needs of their communities. In particular, the OCC noted three risk areas:

- Compliance risk management associated with 2020 pandemic-related bank activities, such as CARES Act loan forbearance requirements or other bank-provided consumer loan or account accommodations, and the pandemic's effects on overall compliance risk and specific areas of risk [e.g., Servicemembers Civil Relief Act (SCRA) risk associated with increased foreclosure volume].
- Community Reinvestment Act (CRA) performance, including implementation of new guidance, procedures and tools related to the CRA rule issued on June 5, 2020.
- Fair lending examinations and risk assessments, including risks associated with 2020 pandemic-related loan accommodations, loss mitigation efforts and new technology used in underwriting processes.

Financial institutions should continue to develop and fine-tune processes and practices designed to manage consumer compliance risk, including strengthening the third line, updating policies and procedures and enhancing their monitoring to respond to these emerging risks.

Paycheck Protection Program (PPP) Considerations

With the establishment of the PPP was via the CARES Act in March 2020, the program has helped millions of small business owners stay afloat during the global pandemic. However, for financial institutions that originate PPP loans, the rapid roll out, urgency and pace of change of the PPP has created fertile conditions for errors or even misconduct. Four separate laws have established and changed the rules of the program over the course of the last year. The SBA has posted more than fifty rules, revisions, additional guidance, procedural notices and other resources for lenders. Funding has been added to the program, and application deadlines have been extended several times. As of February 2021, approximately five thousand lenders have funded more than six million loans exceeding $625 billion.

Despite features of the PPP that limit lender liability, the consequences of overlooked errors or misconduct could be costly. The SBA has stated that it may review any PPP loan at any time. According to the SBA's Interim Final Rule published Feb. 5, 2021,[1] the scope of SBA reviews would likely include borrower eligibility, loan amounts and use of proceeds, and loan forgiveness amounts. Lenders would be well served to focus internal loan reviews on these areas. Other areas unique to PPP loans that warrant attention include the order of processing applications, timelines for loan forgiveness application decisions and documentation required for issuing loan forgiveness decisions to the SBA. Lenders should also confirm they are following proper BSA protocols when making PPP loans to either new or existing customers.

Payment Systems Products and Services

Pandemic response efforts emphasize the use of contactless payment methods, adding fuel to the growth of non-cash payments. Growth in debit cards, credit cards and ACH transfers has accelerated in recent years, while check payments continue to decline. Innovative retail payment platforms, such as smartphone and internet-based services, have made strides in usability and convenience for consumers, while payment systems are moving toward real-time payments. These trends place policy issues in the spotlight, including data privacy, cybersecurity and consumer protection from fraudulent or erroneous transactions.

The OCC's Bank Supervision Operating Plan lists payment system products and services among its priority objectives for 2021, but regulatory priorities will largely depend on leadership appointments made by the new administration, most notably at the Consumer Financial Protection Bureau (CFPB), the OCC and the Federal Reserve Board. Calls for greater regulatory scrutiny under the new administration are likely, tempered by continued support for innovation, possibly with increased guardrails and oversight. We can expect to see continued support for AML enforcement and stronger consumer protection in areas such as the Electronic Funds Transfer Act, implemented by the CFPB through Regulation E. Continued focus on achieving real-time payments might shine new light on the Expedited Funds Availability Act, implemented by the Federal Reserve as Regulation CC, which prescribes how quickly banks must make funds available to consumers. If recent trends continue, the new administration may face calls to consider how its authority under the act could influence transformational improvements to payment systems.

RECOVERY AND RESOLUTION PLANNING

2021 165(d) Targeted Resolution Plan

For the first time, the 2021 165(d) Resolution Plan requires qualifying institutions to detail the linkages between the COVID-19 response and all resolution-related capabilities through Dec. 31, 2020. Furthermore, we recommend that Resolution Plan submissions also acknowledge lessons learned that will be incorporated in their resolution planning infrastructure going forward. In doing so, financial companies should discuss the following key areas:

- Resolution Trigger Framework: An outline of the institution's resolution trigger framework, along with any trigger breaches and actions taken directly related to COVID-19.
- Forecasting Capabilities: The extent to which the firm's resolution capital and liquidity capabilities were leveraged, such as details of the use of capital (Resolution Capital Execution Need) and liquidity (Resolution Liquidity Execution Need); changes to Resolution Liquidity Adequacy and Positioning assumptions (including between the parent and material entities); considerations of the impact of market volatility on the accuracy of resolution forecasting capabilities; and operational challenges in producing accurate and timely capital and liquidity metrics.
- Reporting and Escalation of Information: Any use of governance and reporting procedures in response to COVID-19. This may include:
  - How ad-hoc information needs were met.
  - Operational challenges in producing accurate and timely capital liquidity metrics.
  - How and why reporting and escalation processes differed from business-as-usual practices.
- Resolution Planning Infrastructure: Support for how COVID-19 impacted the infrastructure, including capabilities supporting the continuation of critical operations; shared or outsourced services (e.g., operational impact of business process outsourcing); and access to financial market utilities.

Utilizing Recovery and Resolution Planning Strategies as Firms Focus on Resiliency

Recovery and Resolution Planning strategies are transforming over time to include new capabilities and accelerated processes that not only support global wind-down strategies but will be implemented in business-as-usual processes, allowing for more robust contingency and resiliency plans. These accelerated processes and robust contingency plans are crucial as institutions continue to rely on digitized products and services that consumers can access in real time. As such, financial institutions are now susceptible to the reputational risk of real-time consumer feedback.

While these efforts continue to improve, a financial institution's resilience (see "Operational Resilience, including Cyber-Related and Information Technology Risks" above for more information) is ultimately based on how effectively it can identify issues and implement plans within already established processes. From a Recovery and Resolution standpoint, this is done through various testing and forecasting exercises that span all levels of the organization. These concepts should be expanded to include additional resiliency strategies.

UK Resolvability Assessment Framework

The BoE has been reviewing aspects of its Minimum Requirement for Own Funds and Eligible Liabilities (MREL) framework, publishing an initial consultation paper in November 2020. The goal is to have all major UK banks compliant by 2022. The paper states that in-scope firms must meet the resolution outcomes in the Resolvability Assessment Framework (i.e., the BoE's mechanism for making the resolution process more transparent).

In addition, the PRA, in coordination with the BoE as resolution authority, is reviewing its Operational Continuity in Resolution (OCIR) policy to improve firms' resolvability and to support the BoE's approach to resolution.

Companies can benefit from running parallel tests internally on their ability to handle a resolution event while they await full results on calculations from regulators.

REGULATORY REPORTING AND DATA

Swap Dealer Registration – Capital Requirements and Reporting

The Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) have both issued requirements for Capital and Reporting of swap dealers that must be implemented by Oct. 6, 2021. Firms should ensure they do not underestimate the amount of work required to implement the rules for entities not previously subject to capital requirements. It is crucial that firms understand the new requirements and establish processes for all entities registering as swap dealers to ensure rule adherence. It is especially important to include Operations, Compliance, Legal, Technology and Finance—and imperative that senior management is aware of the requirements and prioritizing these efforts. By having a formal program management in place, the firm can create one unified, cohesive implementation.

Data Accuracy and Completeness to Meet Regulatory Reporting Expectations

Following the 2008 financial crisis, the influx of data requirements and expectations from global regulators drove the financial services industry to establish effective data governance and controls. This data management journey resulted in various data capabilities and components that now ensure data assets can be formally managed and trusted to drive an organization forward.

Still, regulatory expectations for data management and usage continue to evolve. Understanding current data issues that organizations are working to remediate gives further insight into where the bar has been set. Based on feedback provided during examinations and ongoing oversight, regulators expect continued improvement in data infrastructure, process controls and overall data governance, including:

- Controls for data capture and manual touchpoints
- Robust understanding and governance supporting manual adjustments
- Comprehensive policies for governance and accountability across the lifecycle
- Data quality standards and controls for critical data to ensure accurate, timely and complete data
- Advancement toward Target State Data Architecture throughout the lifecycle to increase automation
- Transparent data models inclusive of data dictionaries, lineage, metadata and transformations

To effectively embed and implement data management practices, organizations should structure their data programs around key workstreams and strategic initiatives. As organizations move along the data maturity lifecycle, they should periodically assess and monitor program effectiveness while establishing a clear target operating model to realize target state benefits. Doing so requires them to:

- Address regulatory expectations and requirements (e.g., BCBS 239, CCPA, GDPR)
- Implement effective training and communication programs
- Establish a comprehensive policy landscape and data accountability model
- Implement data controls and document data lineage for all cross-domain enterprise (CDE) services
- Reduce the number of data provisioning and manual touchpoints

Now that we have turned the page on Q1 2021, financial services firms face significant challenges throughout the remainder of the year—but none that cannot be overcome. We stand ready to assist our industry clients as they manage COVID-19's impact and power forward, transforming operations in a new era of oversight. Learn more at https://www.dhg.com/services/advisory/regulatory-advisory.

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SOURCES

[1] , Business Loan Program Temporary Changes; Paycheck Protection Program – Loan Forgiveness Requirements and Loan Review Procedures as Amended by Economic Aid Act. Small Business Administration. Feb. 5, 2021.