Regulatory Horizons

The outlook for financial services regulation

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Same agenda, new perspectives

Regulators and supervisors have returned energetically to their pre-pandemic agendas, but there are changes to relative priorities and new perspectives. Sustainable finance and use of technology (including digitalisation) are at the forefront of many policymakers' minds.

In this edition:

- Towards recovery
- Addressing cross-border barriers
- Sustainable finance regulation grows
- Digital Currencies move forward

In June 2020, Christine Lagarde, President of the ECB said, *"…this crisis can engender a period of positive transformation. It offers an opportunity to policymakers to take a decisive step forward towards more inclusive, greener and more digital growth".*

She added that a renewed focus on the digital economy could help break the negative feedback loop between fragmented markets, low economies of scale and weak investment in digital capacities. Also, greater digitalisation would help accelerate the shift towards "smart green growth".

In May 2020, the **European Commission** revised its 2020 work programme, which was first issued before COVID-19 took hold in Europe. As at May, the Commission had adopted 291 decisions and other acts since the beginning of the crisis, and it has now issued "Europe's Recovery Plan". We predicted in the last edition that some of the work on financial services legislation might be delayed or postponed due to the impacts of the pandemic, but that much would continue. The adjustments to the Commission's work programme bear this out.

There is no change to the six planks of the programme, but some initiatives have been extended by one calendar quarter, including the renewed Sustainable Finance Strategy, review of the Non-financial Reporting Directive (NFRD), a follow-up to the white paper on artificial intelligence and review of the Distance Marketing Directive.

> "extended timelines for ongoing and future mandates"

Work by the Commission on the **MiFID II review** continues. We understand that there is a focus on "quick fixes", with potential easing of the current rules in relation to the definition, available opt-outs and suitability assessment of professional clients, ex-post reporting, product governance and "complex" products. There may be a phasing-out of the paper-based default for communications, but new position limits for commodity derivatives.

Germany now holds the **Council Presidency** and has revised its strategy in the light of the pandemic but will continue to focus on pre-existing priorities. New top priorities are overcoming the pandemic crisis, formulating an exit strategy and rebuilding Europe's economy. Existing priorities are Brexit, climate change mitigation, digital transformation and the Conference on the future of EU. The articles in this edition touch on some of these priorities.

The agenda in September and October is likely to be dominated by defining future EU/UK relations, including access to each other's markets, a level playing field and governance of the future relationship.

ESMA's revised workplan includes additional work on the immediate reaction to the crisis and extended timelines for ongoing and future mandates, including certain aspects of the MiFID II review, sustainable finance, calculation of leverage in investment funds, market abuse and EMIR.

Meanwhile, ESMA continues its focus on supervisory convergence. For example, it has issued a supervisory briefing on costs in investment funds, focusing on how national regulators supervise the relevant cost-related provisions under UCITS and AIFMD, and on the managers' obligation to prevent undue costs being charged to investors. See the April edition for

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wider updates on performance and costs in retail investment products, which we said would be a key theme for supervisors.

In conclusion...

The recent flurry of regulatory outputs evidences rule-makers' determination to get back to their core business. Supervisors are also returning to their pre-pandemic agendas, although onsite inspection activity remains constrained or impossible in many countries.

The two broad themes of climate change/sustainable finance/ESG and technology/digitalisation/ innovation have been evident for some time in policy discussions, but the pandemic has heightened awareness of these themes. They will act as powerful filters or perspectives well into this decade.

Equally prominent will be **demands on the financial services industry to support economic growth and to demonstrate greater care for consumers in all aspects of business and decision-making.**

In this edition we consider how the regulatory agenda is turning towards recovery. We highlight the efforts to address barriers to cross-border business, but note that the imminent EU-UK border will create new challenges. Meanwhile, sustainable finance regulation is growing and the role of digital currencies needs to be re-considered.

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Towards recovery

As lockdown measures ease, many regulators start to consider what the recovery phase will look like and what lessons can be learned from recent events.

As the financial sector emerges from the initial emergency response phase, many questions remain for policy makers and regulators, not least how best to unwind concessions and remove temporary restrictions, and how to rebuild economies, businesses and livelihoods, without creating unintended consequences.

The COVID-19 pandemic required swift and decisive action from financial regulators in order to maintain financial stability, bolster operational resilience and protect consumers.

"Swift and forceful reaction"

This was BIS's characterisation of central banks' responses in advanced economies, observing that they deployed "the full range of crisis tools within weeks". Securities regulators, too, sought to ensure that capital markets and infrastructure continued to operate during extreme market volatility. A handful of countries introduced temporary short selling bans, but most did not. Regulators are examining whether measures should be taken to mitigate the procyclicality of margin calls.

So far, the banking system has held up and continued to support lending. Post-2008 financial resilience measures have been effective, with banks across Europe entering the current crisis with much stronger capital and liquidity positions than in previous crises. Encouragement from regulators to use fully the buffers built up in the decade since the last crisis has enabled the system to function as intended under stress.

However, the EBA's preliminary assessment notes the unprecedented challenges facing EU banks and the expected impact on asset quality, which will affect bank profitability going forward. Banks have been using their liquidity buffers and are expected to keep using them for some time to come due to significant deterioration in funding conditions. In June, the Commission published a "quick fix" to the Capital Requirement Regulation to help mitigate the impact of COVID-19 and to provide incentives for banks to continue lending.

Operational resilience continues to be tested – many banks have activated their contingency plans in order to maintain core functions, but large volumes of applications for debt moratoria and guaranteed loans, together with the ongoing stress of remote working, continue to pile on the pressure. And already there are moves to extend some measures, for example the ESRB's call for the EU bank dividend freeze to be extended past October 2020.

The picture in the insurance sector is mixed, as the pandemic has stressed both sides of the balance sheet. Regulators are reflecting on whether they have sufficient tools to supervise firms throughout the cycle and not just during benign market conditions. Some business lines have seen a fall in claims due to reduced economic activity, but this may be only short-term as individuals and businesses return to more "normal" activities. Many businesses and their insurers are carefully scrutinising whether policy wordings cover business interruption in the case of a pandemic. Swift settlement of claims for those insured losses will be essential to the recovery of many businesses and is explicitly expected by some regulators.

> ***"There is no doubt that the economic situation we face today is characterised by profound uncertainty. Looking into the future has rarely been harder."***
>
> **Christine Lagarde, President of the ECB**

In the case of asset managers, the rebuilding of reserves will be more difficult for some than others. Revenue for the sector is predominantly based on assets under management. Depending on which markets firms invest in on behalf of

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clients, and how long asset values in those markets take to recover, revenue could be depressed for some time.

Investment funds have largely continued to operate throughout the crisis, but there has been a small number of temporary suspensions of open-ended funds. Market volatility has re-opened debates about computer-led trading strategies and certain types of funds.

Where next for regulators?

Timelines may have changed, but fundamental priorities have not. Sustainable finance remains high on the agenda (see next article) and operational resilience was a hot topic even before COVID-19, although perhaps no one had considered the impacts of a stress as far-reaching as lockdown on a global scale.

Regulators are seeking to encourage growth and innovation but are also still focused on resilience and good conduct. And all parties need to embrace an evolving new reality, in which an increasingly digital society and longer-term changes in working practices are accelerating the adoption of technology.

Once the dust has settled, expect to see conduct regulators taking a closer look at how customers have been affected by the pandemic and whether financial providers have acted in their best interests, especially where customers have suffered material financial difficulty.

Strong governance and good conduct have long been regulatory imperatives, but expectations about firms' behaviour in relation to generating good customer outcomes have been re-articulated, and firms' "culture" is being questioned. The challenge is whether pre-pandemic structures and behaviours can and should continue unchanged. Firms will be expected to ask themselves not "Can we?" but "Should we?".

The pandemic has highlighted our global interconnectedness and the need for collective action. As we move towards recovery and beyond, there may be opposing tensions of convergence and divergence in regulatory approaches. Firms will also have to navigate the raising and lowering of national borders, which may present both opportunities and challenges. (See the article on page page 6.)

Look out for our thought leadership series, Financial Services: Regulating the new reality, in which we consider these issues in more detail.

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Addressing cross-border barriers

With some notable exceptions, barriers to cross-border business are being eroded.

There are attempts to remove remaining distribution barriers within the EU and easing of the extra-territorial impacts of some jurisdictions' rules. On the other hand, Brexit has created new borders that the industry must navigate.

While regulators and firms continue to handle the impacts of the COVID-19 pandemic, negotiations about the future EU-UK relationship continue. Politicians on both sides say they are committed to the transition period finishing at end-2020. After then, barriers to cross-border distribution of services and products between the EU/EEA and the UK will be raised in both directions.

It is generally presumed that the EU and UK regulatory regimes will continue to be aligned in the short term, but in the medium term will tend to move apart, as the EU reduces its dependence on what is now a third-country financial centre and the UK looks to serve other financial markets operating under its own rules.

The UK Government has announced that it intends to implement immediate reforms in line with the EU, but in some areas the UK will take an approach better suited to the UK market, although consistent with international standards. Examples include not implementing the settlement discipline regime of the Central Securities Depositories Regulation (CSDR) and reviewing disclosures for retail investment products.

At global level, there could be greater pressure on regulators to avoid extraterritorial impacts and to accept supervision in other jurisdictions. However, Brexit has focussed attention on the different third-country rules in EU legislation. Some member states strongly object to what they regard as "free" access for third-country firms to EU markets, even though MiFID II/MiFIR allows firms to delegate regulated functions to third-country firms only if an equivalence judgement is in place, for example.

Firms will have to navigate a more complex and fragmented marketplace, as they seek to recover from the impacts of the pandemic. Firms that put their Brexit plans on hold, while focusing on their own resilience during the pandemic, need to re-activate them. There are other, more positive indicators, though.

Addressing extra-territorial impacts

The MiFID II review has again highlighted the wider impact of EU rules on investment research. MiFID II clashes with the US "soft dollar" rule that requires a US business that sells research for "hard" dollars to be a registered investment adviser, which US brokers, understandably, resisted. In November 2019, the SEC issued a three-year extension to its no-action letter of October 2017, to allow further time to monitor the evolving impact of the MiFID II rules and to decide whether additional SEC action is required. It said it was focused on *"ensuring that market participants have flexibility and choice in how they pay for research".*

In the investment funds sector, the European Commission has confirmed that non-EU AIFs, irrespective of manager location, will not be subject to the Securities Financing Transactions Regulation reporting obligation. Meanwhile, the US Federal Reserve consulted until April 2020 on proposed revisions to the so-called Volcker Rule. The Fed had mitigated the risk of a non-US fund being subject to proprietary trading prohibitions by announcing it would not take enforcement action against foreign funds that meet certain criteria. The proposals would codify this regulatory relief and create permanent exemptions for those funds.

On the other hand, the EU/US debate about the impact of the EU General Data Protection Regulation (GDPR) continues. The GDPR prevents EU firms from handing over information on individuals required by the SEC. The European Commission has provided assurances that SEC staff can have direct access to firms' books and records via the GDPR derogations,

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provided the request is thought to be proportionate, not excessive and does not go against national legislation. In return, the SEC is seeking guarantees from the Commission that EU national regulators will not oppose national exceptions under the GDPR derogations.

There is a broader concern about cross-border data flows and a working group is being set up by the G7 to discuss this issue.

Cross-border investment within the EU

The Commission wishes to boost private investment within the EU, amid concerns that banks remain too dominant across distribution channels. It issued a call for tender in March 2020 for analysis of the disclosure, inducements and suitability rules, and is now consulting until 8 September 2020 on "An intra-EU investor protection and facilitation initiative".

The Commission notes that private investments are of key importance to create business and work opportunities and generate sustainable economic growth. Cross-border investments will play an important role in meeting commitments relating to climate change and digitalisation. However, evidence suggests that investors' low confidence in the rules protecting their cross-border investments and in their effective enforcement can play an important role in holding back citizens and businesses from investing in another Member State, says the Commission.

The consultation seeks views on respondents' familiarity with cross-border investments and linked issues, rules to protect intra-EU investments, enforcement of those rules (including dispute resolution mechanisms and cross-border remedies), the overall EU investment protection framework, and measures to facilitate and promote cross-border investment.

Commission President, Ursula von der Leyen has made the completion of Capital Markets Union (CMU) one of her key objectives for the next five years. The Commission is seeking views on the final report of its high-level CMU working group, which has three overarching themes: promoting simplicity, enabling competition and creating an equity culture.

Removing obstacles to cross-border investment is one of the four clusters of recommendations put forward by the group to help refresh the CMU project. Specific recommendations include targeted changes to the CSDR passport, supervision and cross-currency rules in CSDR, targeted review of the Shareholder Rights Directive to harmonise shareholder voting and ownership rights, a standardised system for withholding tax relief at source and harmonisation of insolvency law.

UK seeks to ease immediate Brexit impact

HM Treasury released a statement in March, outlining the government's intention to retain the regulators' temporary transitional power (TTP) – introduced in case of a no-deal Brexit – for a period of two years from the end of the transition period. Therefore, in all but a few areas, firms do not need to have completed preparations to implement changes in UK law by December 2020. Transitional relief will be granted on a broad basis for 15 months after the end of the transition period (i.e. until Thursday 31 March 2022).

Also, the government has proposed a special recognition regime for non-UK funds wishing to market in the UK. Under the Overseas Funds Regime, the UK government will make an equivalence determination in respect of an individual member state's (or a third country's) regime, rather than on an individual fund-by-fund basis.

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Sustainable finance regulation grows

After several months focusing on the impacts of COVID-19, regulators are returning to climate change risks and sustainable finance.

International bodies are issuing analyses, EU ESG (environment, social, governance) rules are increasing, and supervisors are setting out their expectations.

The pandemic has highlighted that business sectors are deeply interconnected across borders, that societies of all types and wealth levels are vulnerable, and that the environment is under increasing strain. Labour inequality and human rights are to the fore. Around the globe, investor and customer demand remains a key driver of change, but the regulatory initiative that started in the EU is spreading.

Impact of climate change risk on equity markets

The IMF Global Financial Stability Report of April 2020 said *"Disasters as a result of climate change are projected to be more frequent and more severe, which could threaten financial stability."* The report finds the impact of large physical disasters on equity markets generally to have been modest over the past 50 years. It notes that high levels of insurance penetration and sovereign financial strength can help preserve financial stability in the face of climatic disasters.

However, aggregate equity valuations as of 2019 did not reflect the predicted changes in physical risk under various climate change scenarios, which suggests that investors do not pay enough attention to these risks. The report argues that better disclosures and stress testing for financial firms can help preserve financial stability and should complement policy measures to mitigate and adapt to climate change.

Prudential risks for banks

In April 2020, the Basel Committee published a stocktake report prepared by its high-level Task Force on Climate-related Financial Risks. The report noted that most BCBS members are undertaking regulatory and supervisory initiatives on climate-related financial risks, and that future work includes analytical reports and developing effective supervisory practices.

In May 2020, the Central Banks and Supervisors Network for Greening the financial System (NGFS) published a guide for supervisors on integrating climate change into prudential supervision. It provides a snapshot of the state-of-play in several countries and sets out five non-binding recommendations for supervisors, intended to co-ordinate a common regulatory response to climate-related and environmental risks.

The ECB is consulting until September 2020 on a guide on how it expects banks to manage climate-related and environmental risks safely and prudently and to disclose these

NGFS recommendations to supervisors

- Determine how climate-related and environmental risks transmit to the economy and financial sectors in the jurisdiction and identify how they are likely to be material for supervised entities.
- Develop a clear strategy, establish an internal organisation and allocate adequate resources to address these risks.
- Identify the exposures of supervised entities that are vulnerable to these risks and assess potential losses should they materialise.
- Set supervisory expectations to create transparency for financial institutions in relation to the supervisors' understanding of a prudent approach to these risks.
- Ensure adequate management of these risks by financial institutions and take mitigating action where appropriate.

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risks transparently under the current prudential framework. The guide includes supervisory expectations on governance and risk management frameworks, the formulation and implementation of business strategies, and enhanced disclosures.

Significant institutions are expected to review and, where needed, adapt their practices. As part of the supervisory dialogue, from end-2020 significant institutions will be asked to inform the ECB of any divergences of their practices from the supervisory expectations described in the guide.

The ECB acknowledges that the management and disclosure of climate-related and environmental risks, and the methodologies and tools used to address them, are currently evolving and are expected to mature over time.

The UK regulators are also requiring firms to reflect ESG factors in their risk frameworks and disclosures, but are not proposing new rules and are leaving detailed guidance to the industry.

More detailed rules on ESG

The ESAs are consulting until September 2020 on Level 2 rules to underpin the Sustainable Finance Disclosure Regulation (SFDR), focusing on "E" and "G". The proposals include mandatory indicators that firms should always consider as principal adverse impacts (such as greenhouse gas emissions and lack of adherence to fundamental labour conventions), together with a non-exhaustive set of indicators that might be helpful in identifying, assessing and prioritizing additional principal adverse impacts. The draft definition of fossil fuels was criticised by MEPs for excluding oil and gas.

The ESAs will draw up a mandatory reporting template and specify where firms should place disclosures on their websites. Integration of ESG factors into investment processes will not be sufficient to describe a product as promoting environmental or social characteristics, but only where selection criteria for underlying assets apply on a binding basis.

The proposals are prescriptive and will present significant challenges for firms, especially in current operating conditions, but there is no indication that implementation will be delayed.

The ESAs recognise, though, that firms will face several practical difficulties:

- lack of data, especially on principal adverse impacts
- that Level 2 rules under the Taxonomy Regulation are still under discussion (see below)
- fitting the additional disclosures into products with length-constrained pre-contractual information documents
- for portfolio managers with separately-managed accounts, balancing the website disclosure requirements with client privacy and data protection rules
- smaller firms may struggle with compliance costs, due to lack of economies of scale

In 2021, the ESAs will draft rules on social issues – the "S". Meanwhile, the Commission consulted for one month on draft delegated acts on the integration of sustainability factors under UCITS, AIFMD, MiFID II, the Insurance Distribution Directive and Solvency II. The rules require firms to consider clients' ESG preferences in suitability assessments and to embed consideration of ESG factors into their product governance and risk management processes.

Consistency of definitions and data remain elusive

Without consistent definitions and disclosures, it is difficult for regulated firms to determine the data required to measure ESG risks and exposures or to satisfy their own corporate reporting requirements. Corporates are responding to asset owners and activist investors by improving their ESG disclosures and credentials. Accountancy bodies and standard setters have joined forces to strive for consistency in financial and non-financial reporting.

The European Commission is reviewing the Non-Financial Reporting Directive to ensure a minimum level of comparability, relevance and reliability of current ESG disclosures. ESMA has called for general principles and disclosures to be specified, for non-financial statements in companies' annual reports to be subject to assurance and for consistency with the Transparency Directive.

Meanwhile, debates about the Taxonomy Regulation continue. The Regulation establishes a pan-

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European classification system to identify which economic activities are environmentally sustainable. The Regulation is, in effect, the dictionary for firms when implementing the requirements of other regulations, such as the SFDR. Level 2 rules are awaited and the Commission will later expand the scope of the Regulation to identify socially sustainable activities.

More EU rules to come…

The Commission is consulting until July 2020 on a renewed Sustainable Finance Strategy, which includes proposals that climate and environmental risks should be fully managed and integrated into financial institutions, and that social risks should be considered where relevant.

> "The Commission is working on an EU Eco-label for investment products"

The Commission suggests that asset owners and asset managers should be required, as part of their fiduciary duty, to consider whether their investments are having a negative impact on the environment or society. This would go further than the SFDR requirements and the industry has expressed concerns that it would remove choice for investors and contradict a manager's fiduciary duty to those clients.

The Commission is working on an EU Eco-label for investment products (see the January edition) and is consulting until October 2020 on an EU Green Bond Standard (GBS) and whether a similar standard should be developed for social bonds. The proposed contents of the Green Bond Framework and of the "allocation" and "impact" reports are as recommended by the Technical Expert Group in its detailed report of March 2020. The GBS would apply to any type of issuer: listed or non-listed, public or private, European or international.

The Commission is also considering rules requiring the incorporation of ESG factors into banks' risk assessment frameworks and on gender diversity. The Commission's five-year Gender Equality Strategy includes a proposal for a Directive to introduce binding measures on improving the gender balance on corporate boards. Such measures already exist in a small number of European countries.

The GBS is based on four components:

1. Alignment of the use of the proceeds from the bond with the EU Taxonomy
2. The publication of a Green Bond Framework
3. Mandatory reporting on the use of proceeds (allocation reports) and on environmental impact (impact report)
4. Verification of compliance with the Green Bond Framework and the final allocation report by an external registered/ authorised verifier

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Digital currencies move forward

Approaches develop as regulators seek to keep pace with innovation and its advantages, but concerns remain.

In January, we commented on emerging crypto-asset regulation. There have been further developments. In addition, lockdown measures have resulted in reduced use of cash, which could lead to a permanent change in habits and a need for regulators to re-think.

IOSCO's February 2020 report set out key considerations to assist regulatory authorities in addressing the issues and risks associated with crypto-asset trading platforms (CTPs). Many of the issues relating to the regulation of CTPs are common to traditional securities trading venues but may be heightened by the business models used by CTPs - for example, how exactly assets are safeguarded and held.

In April, the European Commission launched a consultation on its new Digital Finance Strategy/FinTech action plan with the aim of ensuring "that European consumers and the financial industry can reap the potential of digital transformation while mitigating the new risks digital finance may bring". This follows the Commission's December 2019 consultation on "An EU framework for crypto-assets", the outcomes of which are expected to lead to a legislative proposal in Q3 2020.

Meanwhile, discussions around a regulatory framework for stablecoins continue. The Financial Stability Board (FSB) is consulting on ten high-level recommendations to address the challenges to financial stability and monetary policy that global stablecoin arrangements could pose. The recommendations call for regulation, supervision and oversight that is proportionate to the risks of global stablecoins, which may evolve over time. They also stress the need for multi-sectoral cross-border cooperation, coordination and information sharing arrangements.

The debate around central bank digital currencies (CBDCs) also continues. The BIS Annual Economic Report recognises that the "rapid reshaping of payment services requires central banks to keep evolving as they support the safety and integrity of the payment system". Earlier, in March, a Bank of England discussion paper recognised opportunities that a CBDC could present. These include supporting a resilient, efficient and innovative payments landscape and providing a building block for better cross-border payments.

In April, the Dutch Central Bank offered to play a leading role in the development of a CBDC within the euro area, when publishing its study on CBDCs. In May, ECB Board Member, Yves Mersch highlighted that introducing a retail CBDC could have major consequences for the financial system as households might find it more attractive to hold a risk-free CBDC than a 'private' bank deposit, leading to the disintermediation of the banking sector. The ECB is exploring, through a task force, ways to mitigate this impact and other design options around a CBDC.

Despite the rapid increase in interest in digital currencies and crypto-assets, and their potential applications, their use in mainstream financial markets is still at a relatively early stage. However, during the COVID-19 pandemic, the speed at which technology evolved to play a key role in enabling remote working and allowing financial markets to continue to function may require regulators to accelerate their thinking.

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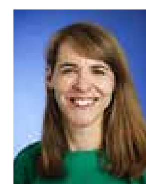

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