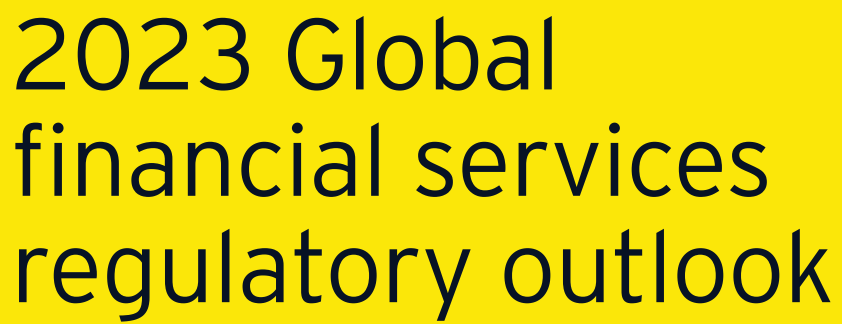

2023 Global financial services regulatory outlook

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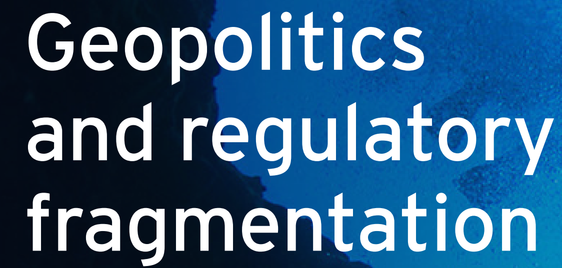
Introduction

At the beginning of 2022, it may have seemed to some as if the financial services industry was through the worst of the pandemic and returning to something approaching steady-state operations. However, as we noted in our 2022 outlook, a number of challenges were likely to shape the future landscape. Since then, the macroeconomic environment has sharply deteriorated, with geopolitical risks, high inflation, monetary measures by central banks, slowing economic growth and the potential for a full-blown recession in many countries. That all comes on top of existing challenges, including income disparity in many markets, populism and partisanship, rapidly evolving technologies, a greater push for environmental sustainability, crypto-asset risks and cyber threats. In all, the complexity of the operating environment for banks, insurers, asset managers and other financial services firms — collectively referred to as "firms" from this point forward — is arguably greater today than at any point in the past few decades.

Regulatory changes are both a reflection of these challenges and sometimes a complicating factor. In seeking to address and mitigate the risks of this new environment, regulators can create an additional layer of complexity for leadership teams in the industry. At the same time, by anticipating regulatory changes, firms can unlock new growth areas and reinforce competitive advantages. This publication aims to help those leaders make sense of the regulatory landscape and potential changes they may expect in the near-to-medium term. We discuss eight aspects of the regulatory environment that we believe will be key areas of focus:

- Geopolitics and regulatory fragmentation
- Economic environment and customer impact
- Digital assets
- The digitalization of financial services
- Environmental, social and governance (ESG)
- Financial crime
- Strategic agility and operational resilience
- Prudential



Geopolitics and regulatory fragmentation

Regulation is a creature of legislation and, by its nature, legislation follows wider societal and geopolitical concerns. During 2022, we have seen a spike in geostrategic risk – most notably in terms of the war in Ukraine and US-China tensions. The world is becoming more concerned with national and regional security. We have seen a number of strategic rules and laws proposed or passed in recent years that are heavily influenced by strategic autonomy or wider political considerations. These include European Union (EU) third-country branches, financial data processing laws in India and even opposing state-level policies regarding ESG in the US.

We see these pressures increasing in the short term and manifesting themselves in different ways, even where there are strong arguments and incentives for global cooperation; for example, when addressing climate change and where global bodies, such as the Financial Stability Board (FSB) or the International Organization of Securities Commissions (IOSCO), have sought to influence standards. Many of the examples in the following sections show how different jurisdictions are approaching key issues in different ways. This can lead to both additional regulatory costs for firms and greater operational risks.

Historically, global banks and other financial services firms have been able to remain largely neutral on internationally significant or domestically partisan issues. Today, they need to consider whether they can afford to operate in all jurisdictions, from both a legal and stakeholder perspective.

Implications for firms regarding geopolitics and regulatory fragmentation:

- Paying greater strategic attention to the divergence of regulation among jurisdictions and effectively managing those differences.
- Assessing the challenges that may influence where and how they invest or operate internationally. Regulation and political risk should be seen as key factors in such decisions, alongside the core economics of running a firm.

Economic environment and customer impact

As we noted in the 2022 global regulatory outlook, difficult economic circumstances are pushing conduct regulators around the world beyond their previous focus on financial inclusion to the broader concept of customer impact. They are not just ensuring that people have reasonably equitable access to financial products and services but also assessing the overall impact of those offerings. The precise approach and area of focus will vary by country. But in most developed markets, the ongoing – and, in many markets, worsening – economic challenges will keep the topic of customer impact at the top of regulatory agendas.

Thus far, the UK has taken the biggest steps in this direction, with the Financial Conduct Authority's new Consumer Duty rules.[1] The rules were finalized in July 2022 and take effect in 2023. They push firms to shift away from a compliance mindset based on a clear set of rules and requirements to a more holistic assessment of the overall impact of their products and services on customers. The new Consumer Duty means that firms have to center their attention on consumer outcomes at every stage of the product and service lifecycle, resulting in a strategic reevaluation of business models for many. Areas of focus include consumer understanding, the specific impact of products and services, consumer support, and price and value. The Consumer Duty will require firms to offer products that are fit for purpose, represent fair value and focus on the actual outcomes that customers experience. The rules also introduce the idea of supporting and empowering customers by adding board champions within firms to impact their culture.

Other jurisdictions are beginning to show interest in similar rules. In the US, for example, the Consumer Financial Protection Bureau (CFPB) is paying more attention to overdraft and insufficient-fund fees – and particularly the large share of overall fee volume comprised by these two categories.[2] The Canadian government introduced sweeping consumer protection reform that came into effect in 2022. Among the new requirements are consideration of whether a retail banking product is appropriate and mandatory naming for firms found in violation of these requirements.[3] Australia implemented product design and distribution obligations (DDO) in October 2021 which aim to support better consumer outcomes.[4]

Conversely, regulators in other jurisdictions, primarily in Asia-Pacific (APAC), are still focused on the baseline goal of inclusion and the digitization of financial services. In Hong Kong, for example, the duty to act fairly and in the best interests of customers essentially incorporates this notion, but Hong Kong regulators have not yet articulated the Consumer Duty as explicitly as the UK FCA.

Small and medium enterprises (SMEs) are another area in which regulators are paying close attention – particularly as government COVID-19 supports are starting to wind down. In the US, most of the Paycheck Protection Program loans were converted to grants and forgiven (provided small firms met a set of criteria). However, in other markets, those kinds of support loans have been repeatedly rolled over and are still pending – with an unclear outcome.

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[1] *"Consumer Duty," FCA.org*, https://www.fca.org.uk/firms/consumer-duty, accessed December 22, 2022.
[2] *"CFPB Research Shows Banks' Deep Dependence on Overdraft Fees," CFPB*, https://www.consumerfinance.gov/about-us/newsroom/cfpb-research-shows-banks-deep-dependence-on-overdraft-fees/, December 1, 2021.
[3] *"The Financial Consumer Protection Framework,"* https://www.canada.ca/en/financial-consumer-agency/services/ banking/rights-new-protections/consumer-protection-framework.html, accessed December 22, 2022.
[4] *"Design and distribution obligations," ASIC.gov*, https://asic.gov.au/regulatory-resources/financial-services/financial-advice/your-obligations-when-giving-financial-advice/design-and-distribution-obligations/, accessed December 22, 2022.

In some jurisdictions, regulators have sent an explicit signal that they are concerned about the impact of bank actions on SMEs, often through "Dear CEO" letters to banking leadership teams. For example, in July 2022, the UK FCA identified several issues (e.g., unaffordable payment plans and a lack of clear policies to identify vulnerable customers or detect unfair treatment) and reminded banks in a "Dear Chair" letter to ensure fair treatment of SME customers during collections and recoveries.

Imperatives for firms regarding customer impact include:

- Emphasizing the balance between the responsibility to shareholders and treatment of customers — particularly retail customers and small firms.
- Evolving beyond a strict, box-ticking mindset of compliance, and instead assessing the broader strategic implications of their products and services.

Digital assets

The oversight of digital assets, including stablecoins and other crypto-assets, continues to evolve. However, it will take time to establish the right level of regulatory clarity and balance the opportunities from digital assets (e.g., financial inclusion, resiliency and cost-reduction) with the potential downside risks. At the same time, the spectacular collapse of one of the biggest and reputedly most regulation-minded virtual asset exchanges for alleged failures in risk management, misuse of client assets, poor credit risk and conflicts of interest may oblige regulators and policymakers to intervene. Further, the plunge in the price of most crypto-assets in 2022 shows the scope of most risks and the likely need to take *significant* steps to protect investors. Still, some firms have already implemented targeted digital asset strategies due to increased customer interest, but they are doing so cautiously.[5] Policymakers are sensitive to regulation — over-regulating may hamper innovation, while under-regulating leads to market instability and leaves customers unprotected. For regulators, intervening without a sufficient understanding of the markets or powers to police them also carries political risk. The principal challenge for regulators and established firms is understanding the nuances and distinctions between crypto and wider digital assets and ensuring they can foster the value of these developments, while avoiding (both positive and negative) sentiment and economic harm. The recent digital asset intermediary turmoil and allegations may have significantly tipped the debate in favor of stringent regulation.

The EU has taken a step toward regulatory clarity for digital assets, with a provisional agreement on a Markets in Crypto-Assets (MiCA) proposal that will standardize rules for crypto-assets, crypto-asset issuers and crypto-asset service providers across the EU.[6] Among other provisions, MiCA includes protections for customers' wallets, anti-fraud measures and one-to-one reserves for stablecoins. The Monetary Authority of Singapore (MAS) also provided clarity, but not the type that crypto providers may have anticipated; it issued guidelines to limit the promotion of crypto to Singapore residents.[7] MAS issued two more consultation papers to more tightly regulate crypto exchanges and stablecoins: MAS proposes measures to reduce risks to consumers from cryptocurrency trading and enhance standards of stablecoin-related activities.

In the US, several bills are moving through Congress with the goal of creating a comprehensive policy framework for digital assets, though they face an unclear path forward in the current political environment. A more likely direction of travel in the US is that regulators will provide oversight using existing policies, under the principle of "same activities, same risks, same rules and same supervision."[8] The Financial Stability Board (FSB) recently proposed a framework with the same underlying logic.[9] The US Office of the Comptroller of the Currency, which oversees national chartered banks, has only authorized specifically prescribed types of activity for digital assets: reserves for stablecoins, participating in nodes for validation and custody of digital assets. We note that few national banks are actively pursuing crypto-related businesses. The Commodity Futures Trading Commission (CFTC) is asking for the authority to regulate spot markets, which is currently a hole in the regulatory perimeter.

Similarly, regulators are still watching and waiting in terms of how they are going to regulate the crypto exchanges. The collapse of one of the world's most popular crypto exchanges in November 2022 is likely to open a debate about tighter

[5] Kummer, Katie et al, *"What actions can drive responsible innovation in digital assets?", EY.com*, https://www.ey.com/en_gl/public-policy/what-actions-can-drive-responsible-innovation-in-digital-assets, September 30, 2022.
[6] *"Digital finance: agreement reached on European crypto-assets regulation (MiCA)", Council of the EU*, https://www.consilium.europa.eu/en/press/press-releases/2022/06/30/digital-finance-agreement-reached-on-european-crypto-assets-regulation-mica/, accessed December 22, 2022.
[7] *"MAS Issues Guidelines to Discourage Cryptocurrency Trading by General Public," MAS.gov*, https://www.mas.gov.sg/news/media-releases/2022/mas-issues-guidelines-to-discourage-cryptocurrency-trading-by-general-public, accessed December 22, 2022.
[8] *"Statement on Financial Stability Oversight Council's Report on Digital Asset Financial Stability Risks and Regulation Before the Financial Stability Oversight Council Open Meeting," SEC.gov*, https://www.sec.gov/news/speech/gensler-statement-fsoc-meeting-100322, October 3, 2022.
[9] *"FSB proposes framework for the international regulation of crypto-asset activities," FSB.org*, https://www.fsb.org/2022/10/fsb-proposes-framework-for-the-international-regulation-of-crypto-asset-activities/, October 11, 2022.

regulation for digital asset exchanges. Both Hong Kong and Singapore are considering the tighter regulation of virtual asset service providers (VASPs). Specifically, Hong Kong will prohibit the offering of crypto services to retail investors, and the Securities and Futures Commission (SFC) issued a circular that would restrict crypto providers from offering virtual asset-related products to retail investors.

One area of growing clarity is the regulatory requirements for stablecoins. Although there is some question around which types of institutions can issue stablecoins — banks, non-banks, other industry participants — there is growing agreement that they should be 100% backed by fiat currency, resulting in greater transparency and disclosure. For example, the Hong Kong Monetary Authority (HKMA) issued a discussion paper for the regulation of stablecoins, indicating a policy intention to regulate parties involved in material steps in the lifecycle of a stablecoin.[10]

Beyond that, more distinct signals are coming via enforcement actions, where regulators are applying the lens of safety and soundness of the financial system to go after high-profile targets. For example, several celebrities who pitched cyber-assets are under scrutiny by the SEC for not disclosing compensation.[11] Similarly, the SEC is looking at nonfungible tokens from high-profile crypto companies and considering whether they should be treated as financial securities — and subject to the same rules.[12] Crypto startups have criticized regulators for this approach, deeming it "policymaking through enforcement action." But, in the absence of explicit rules about emerging digital assets, such actions are likely to continue, and regulators will seek to protect the public by applying rules in line with the FSB's "same risk" approach. However, without some tailoring of rules, there may be unintended consequences driving items of value from the market and leaving it dominated by worthless tokens.

Given this increased number of regulations on crypto-assets across jurisdictions, the FSB in October 2022 proposed a framework for the international regulation of crypto-asset activities.[13] It aims to reduce the risk of regulatory fragmentation and arbitrage and includes recommendations on the regulation of global stablecoin arrangements.

Central bank digital currencies (CBDCs) are another rapidly evolving area. Most governments are not close to issuing a CBDC, with a handful of exceptions, but we see growing interest in this from central banks around the world.

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[10] *"Discussion Paper on Crypto-assets and Stablecoins," HKMA.gov*, https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/01/20220112-3/, January 12, 2022.
[11] *"SEC Charges Kim Kardashian for Unlawfully Touting Crypto Security," SEC.gov*, https://www.sec.gov/news/press-release/2022-183, October 3, 2022.
[12] *Kharif, Olga and Pan, David, "Bored Ape Metaverse Frenzy Raises Millions, Crashes Ethereum," Bloomberg.com*, https://www.bloomberg.com/news/articles/2022-05-01/bored-ape-metaverse-frenzy-raises-millions-disrupts-ethereum?leadSource=uverify%20wall, May 1, 2022.
[13] *"International Regulation of Crypto-asset Activities," FSB.org*, https://www.fsb.org/wp-content/uploads/P111022-2.pdf, accessed October 11, 2022.

The state of CBDCs in major financial markets

Eurozone: The European Central Bank and the nation central banks of the euro area are in a two-year investigation phase of the digital euro, looking at issues regarding design and distribution. The Euro Retail Payments Board (ERPB) is allowing market participants, including banks, payment service providers, consumer representatives and merchants, to provide their views on a digital euro.[14]

China: China is among the furthest along in developing a CBDC. As of August 2022, transactions using the digital yuan, or e-CNY, surpassed 100b yuan (US$13.9b), across 360m transactions in pilot areas in 15 provinces and municipalities. More than 5.6 million merchants could now accept payments with the digital currency. The government is considering linking it to the country's two biggest payment platforms, Tencent's WeChat Pay and Alipay, run by Alibaba affiliate Ant Group.[15]

Cross-border in APAC: In late 2022, HKMA, the Bank for International Settlements Innovation Hub (BISIH), Hong Kong Centre, the Bank of Thailand, the Digital Currency Institute of the People's Bank of China and the Central Bank of the United Arab Emirates, published the results of a pilot called "Project mBridge." As part of the six-week pilot, 20 banks in four jurisdictions conducted more than 160 payment and foreign exchange transactions totaling more than HK$171m — one of the first multi-CBDC projects to settle cross-border transactions for corporates.[16] In Singapore, the MAS is working on a similar cross-border CBDC initiative.[17]

US: The US lags most governments in terms of CBDCs , although there is a privately-run "Digital Dollar" project. In November, the New York Innovation Center, part of the Federal Reserve Bank of New York, announced a proof-of-concept project to explore the feasibility of an interoperable network, including both central bank wholesale digital money and commercial bank digital money, through **distributed ledgers**.[18]

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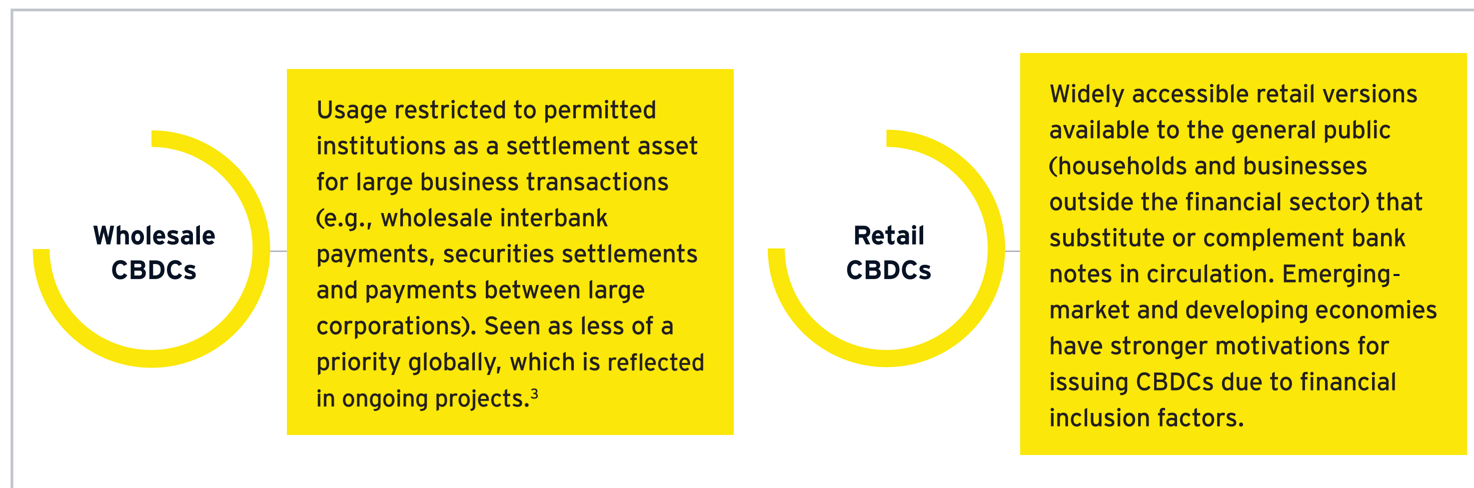
[14] https://www.ecb.europa.eu/paym/digital_euro/investigation/governance/shared/files/ecb.degov220929.en.pdf?8eec0678b57e98372a7ae6b59047604b
[15] *Kharpal, Arjun, "China is pushing for broader use of its digital currency," CNBC.com*, https://www.cnbc.com/2022/01/11/china-digital-yuan-pboc-to-expand-e-cny-use-but-challenges-remain.html, January 11, 2022.
[16] *"Project mBridge: Successful CBDC project for real-value cross-border payment and foreign exchange transactions," HKMA.gov*, https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/10/20221026-3/, October 26, 2022.
[17] *"MAS Launches Expanded Initiative to Advance Cross-Border Connectivity in Wholesale CBDCs," MAS.gov*, **https://www.mas.gov.sg/news/media-releases/2022/mas-launches-expanded-initiative-to-advance-cross-border-connectivity-in-wholesale-cbdcs, November 3, 2022.**
[18] **https://www.newyorkfed.org/aboutthefed/nyic/facilitating-wholesale-digitalassetsettlement**

CBDCs introduce a range of challenges, including major questions, such as monetary policy and privacy. In most G20 countries, there are also considerations of the type of CBDC (wholesale, retail or hybrid) and the interaction with the private sector. At a high level, all customer interactions would still happen through the banking system, with transactions recorded by the central bank. The government would develop a base-layer platform and banks would be able to innovate and create applications built on that platform.



The risks and opportunities that CBDCs present to firms depend crucially on the policy objectives and requisite design choices. For example, wholesale CBDCs could increase efficiency by releasing liquidity among banking operations and avoid many of the challenges associated with retail CBDCs. Each feature or technological detail comes with implicit policy trade-offs and requires specific attention.

Implications for firms regarding digital assets include:

- Traditional finance firms must decide how and why to engage prudently with digital assets, including CBDCs, in a manner consistent with their risk and compliance frameworks.
- Crypto natives must determine how to adapt their operating models to address risks that are top of mind for policymakers, as well as likely new regulations.

Digitization of financial services

Digital innovation continues to reshape the financial services sector, with the pace and scale of technological change only likely to increase due to factors such as artificial intelligence (AI), cloud and the market entry of new, non-bank players offering bank-like services, such as retail payments. Regarding AI, there is a clear acknowledgment of the potential for consumer harm but little in the way of regulatory clarity about how to mitigate it. In the US, Congress introduced a bill called the Algorithmic Accountability Act that would apply to companies in all industries — with banks and insurers as higher-profile targets — to assess automated decision technologies for bias and other factors. Enforcement would happen through the Federal Trade Commission,[19] but the bill will likely not advance to law.

Similarly, the European Parliament is considering the EU's AI Act, which again looks at all industries but has specific implications for financial service companies. High-risk activities, such as AI systems used to assess creditworthiness or establish credit records, would have mandatory requirements, including keeping decision logs.[20] Several EU member-states have offered opinions and amendments on the Act, which will become law once the European Parliament and Council agree on a common version. In the UK, the Bank of England and FCA are running a joint consultation on AI and ethics.

In the absence of new legislation or directives, most regulators are applying the concept of "same rules for same risks" and seeking to regulate bank and non traditional market entrant conduct that happens through the technology, rather than the technology itself. And, most large banks are embedding the unique risks from AI into their established practices around model risk management and model governance.

The regulation of cloud migration is following a similar path. In most jurisdictions, there are few specific requirements about cloud. Existing regulations in areas such as resiliency, business continuity and cybersecurity theoretically cover cloud, but those requirements are general and not specific to cloud technology, which could introduce new vulnerabilities and risks. Hong Kong is a notable exception, where the HKMA has introduced a circular on cloud adoption by banks.[21]

Some banks have been sanctioned or fined because they offered cloud services without the right controls or oversight, and they are now having to retrofit some of those onto cloud infrastructures — a costly and unwieldy process. Similarly, applying AI or machine learning to established, analog models without thinking through the ramifications will not only replicate risks but likely exacerbate them. As technologies evolve and banks continue to develop new offerings, a smarter approach is to embed controls and oversight into new solutions from the start, a concept known as risk management by design.

[19] *"H.R. 6580: Algorithmic Accountability Act of 2022," GovTrack.com*, https://www.govtrack.us/congress/bills/117/hr6580, accessed December 23, 2022.
[20] *"The Artificial Intelligence Act," The AI Act*, https://artificialintelligenceact.eu/, accessed December 23, 2022.

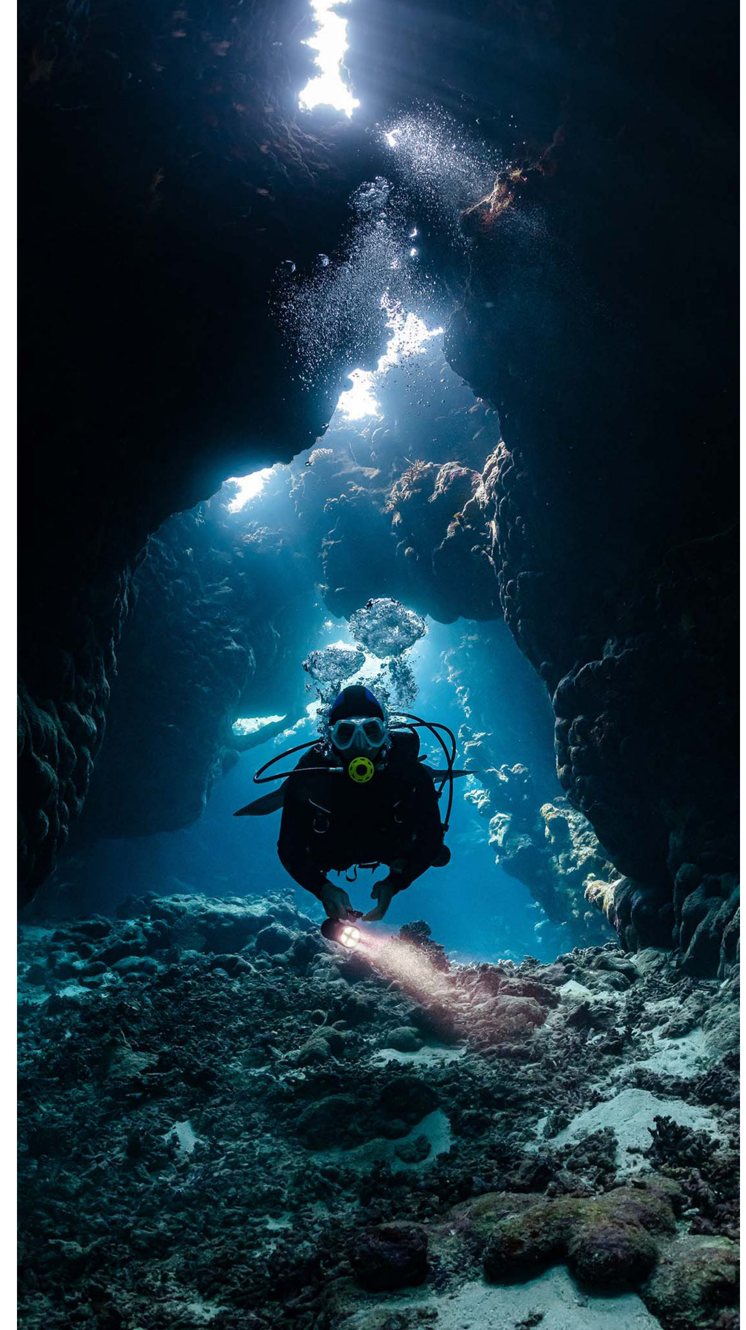
[21] https://www.hkma.gov.hk/media/chi/doc/key-information/guidelines-and circular/2022/20220831c1.pdf

Non-bank entrants, such as technology firms and FinTech players, are driving digitization in the financial services sector in areas such as lending, asset management and insurance services. At the same time, financial firms have increased their reliance on tech firms to either host core IT systems (such as cloud-based services to improve efficiency and security) or to make use of their deep experience with big data, machine learning, AI and other advances. This expansion of tech firms into financial services and their interconnectedness with the financial sector is creating new channels of risks. According to the International Monetary Fund (IMF), regulators may: a) apply a hybrid approach, consisting of entity- and activity-based regulations once the regulatory perimeter is expanded to include big tech firms; b) increase disclosure requirements for these firms (for example, on the risks of business activities, such as lending, consumer risks or firm obligations); or c) set up codes of conduct to address spill-over risks from unregulated activities. Whichever approach is taken, global consistency in the treatment of big technology firms will be essential.

Aside from the implications of newer technologies, certain product areas are likely to be subject to further change and disruption. At the forefront of these are payments. Although payments have been a leading area of FinTech change, payments markets globally are likely to experience more change.[22] For example, the EU's payments market remains to a significant degree, fragmented along national borders, as most domestic payment solutions are based on cards or instant payments. There is also a need for a clear governance framework to support the EU's retail payments market, and we can expect the European Commission to table plans for direct payments in the coming year.

Regulators, including the UK FCA and Competition and Markets Authority (CMA), are also increasingly active on issues linked to technology and financial services. The CMA is preparing to receive new competition powers, which would allow it to apply codes of conduct to large technology firms and set more stringent requirements on mergers. In the EU, the Digital Markets Act will become effective in May 2023. In the US, the Federal Trade Commission has signaled a focus on digital markets, and several antitrust bills have been tabled. China has been introducing tougher penalties for unfair pricing and failure to notify mergers; Australia is considering a new regime for digital platforms.

[22] Gancz, Alla et al, *"How the rise of PayTech is changing the payments landscape," EY.com*, https://www.ey.com/en_gl/payments/how-the-rise-of-paytech-is-reshaping-the-payments-landscape, October 21, 2022.



Recommendations for firms regarding the digitization of financial services include:

- Increasing technology understanding among senior managers and board members.
- Incorporating digital activity into existing risk management and compliance frameworks, especially operational resilience.
- Considering the broader ethical and antitrust implications associated with digital services.

Environmental, social and governance

Regulating ESG continues to pose challenges for financial institutions as regulations grow in volume and complexity. For most firms, the scale and scope of change, along with new thinking required to embed climate in virtually every decision regarding operations and business processes, will be a major adjustment. For now, the main areas of focus are greenwashing, disclosures and climate risk management via scenario analysis.

Regulators are determined to maintain the integrity of the ESG investment market and prevent greenwashing amid growing demand for, and offer of, sustainable investment products. The EU has recently taken important steps to address greenwashing in the financial market (e.g., the Sustainable Finance Disclosure Regulation (SFDR) Level II, effective January 2023), and the European Commission has asked banking, insurance and investment supervisory authorities in Europe to provide input regarding emerging greenwashing risks. It will consider enhanced supervision and enforcement measures based on these reports.[23] A progress report is expected by the end of May 2023 and a final report by the end of May 2024.

Beyond the EU, other national regulators and supervisory bodies have taken action or introduced new policies to counter greenwashing, including the US SEC, the UK FCA and the International Organization of Securities Commissions (IOSCO). Regulators are likely to introduce sustainable investment product labels, restrict how certain sustainability-related terms can be used in product names and require more detailed disclosures.

Regulators across jurisdictions are increasingly requiring transparency on ESG matters whereby scope and applicability vary across jurisdictions. For example, the EU — the front-runner in global sustainability reporting standards — issued the EU Corporate Sustainability Reporting Directive (CSRD), which will apply starting between 2024 and 2028.[24] It introduces more detailed reporting requirements as firms will be required to report under the European Sustainability Standards (ESRS) on companies' impact on the environment, human rights and social standards. In comparison, the US SEC focuses on specific ESG topics, rather than mandating the publication of broad ESG reports as in the EU. A final US rule is expected in the fourth quarter of 2022, as is a proposal for enhanced human capital disclosures.

More broadly, the development of global guidelines and frameworks and increased multilateral cooperation will encourage national bodies to standardize ESG disclosure requirements for the sake of convergence and consistency. Overall, ESG standards are starting to coalesce around the International Sustainability Standards Board (ISSB), developed by the International Financial Reporting Standards (IFRS) Foundation in 2021. ISSB standards would increase reporting requirements to provide more transparency on physical climate risks, as well as their financial effects. The final standards are expected to be published in early 2023 and more thematic standards will be developed in due course.

IOSCO is considering adopting ISSB standards as well, which would give considerable weight to that framework and likely encourage its adoption by other national and regional regulatory authorities.[25] However, the European ESRS is prompting a more comprehensive ESG disclosure regime than the ISSB standards (and the SEC proposal). For companies wishing to comply with both regimes, it will be key to understand the similarities and differences to develop the necessary reporting strategy, data-gathering processes and controls.

Regarding scenario analysis, central banks and supervisors are likely to update their scenario analysis to integrate the third version of climate scenarios for forward-looking climate risk assessment published by the Network for Greening the Financial System (NGFS). The NGFS scenarios include new economic and climate data, policy commitments and model versions. For the first time, the scenarios include projections of the potential losses from extreme weather events (i.e., cyclones and river floods). Moreover, transition risks have been represented with increased granularity in certain sectors. In addition, socioeconomic trends (e.g., post-COVID-19 recovery), current technological advancements and the decreasing price of renewable energy are reflected in the scenarios' energy mix and mitigation costs. Despite some limitations, these new NGFS scenarios are the most comprehensive scenarios available to determine implications of the low-carbon transition, physical hazards and macroeconomic impacts of both.

In line with the NGFS, the FSB in October 2022 encouraged jurisdictions to expand the use of climate scenario analysis and stress testing as a tool for macroprudential purposes and to incorporate systemic risks that arise from climate change. The FSB recommends including physical and transition risks and expanding the scope to all key financial sectors as scenario analysis is currently commonly used for banks and insurers but less common for asset managers and pension funds. Supervisors should also consider interdependencies between physical and transition risks and geographical and sectoral risks. This includes an improved understanding of impacts on financial risks and system-wide aspects of climate-related risks, such as indirect exposures, risk transfers, spillovers and feedback loops.

[23] https://www.eba.europa.eu/sites/default/documents/files/document_library About%20Us/Missions%20and%20tasks/Call%20for%20Advice/2022/CfA%20on%2 greenwashing/1036482/Report%20request%20to%20ESAs_greenwashing%2 monitoring%20and%20supervision.pdf

[24] *Wollmert, Peter et al, "How the EU's new sustainability directive is becoming a game changer,"*, https://www.ey.com/en_gl/assurance/how-the-eu-s-new-sustainability-directive-is-becoming-a-game-changer, August 1, 2022.

[25] *IOSCO welcomes the strong stakeholder engagement on proposals for a comprehensive global baseline of sustainability disclosures for capital markets," IOSCO.org*, https://www.iosco.org/news/pdf/IOSCONEWS653.pdf, July 27, 2022.

In addition to ISSB standards, banks will soon need to engage with the framework from the Taskforce on Nature-related Financial Disclosures (TNFD), which looks at firms' impact on biodiversity and ecosystems.[26] A beta version of the TNFD framework is now available and it will likely be developed in a manner similar to that of the Task Force on Climate-related Financial Disclosures (TCFD) through a quasi-public-private initiative that leads to a voluntary standard for disclosure. The TNFD is currently far behind climate-related disclosures in terms of standardization and clarity, but it will bring new requirements to the firms that adopt it. In that way, TNFD is the latest — but not the last — example of the ongoing changes in ESG regulation overall.

Finally — and crucially — firms will need to engage more with the underlying quality of the data that they use in line with the FSB's recommendations. Much remains unaudited or of limited longitudinal range, and several jurisdictions have established or are establishing dialogues between regulators and industry to address this.

Imperatives for firms regarding ESG regulation include:

- Recognizing that net zero will require total transformation and a focus on tackling greenwashing. Understanding what this will mean for the business model over the next 5, 10 and 15 years and developing a fully-funded transformation strategy which is communicated to stakeholders.
- Assessing the resilience of the business to a range of physical and transition risk scenarios. Understanding how risk appetites need to change and how the organization can build resilience.
- Dissecting reporting changes and preparing for ISSB to ensure that the firm is ready to report on people and planetary value, not just financial value. Aligning structures and processes around new disclosures will take time and effort. Now is the time for action.

Key takeaways from COP27

COP27 led to a series of key updates regarding ESG regulation stakeholders.

- The Glasgow Financial Alliance for Net Zero (GFANZ, launched at COP26) now has 550 financial institutions around the world, with US$150t in assets under management, committed to achieving net-zero emissions by 2050. At COP27, several meetings were aimed at helping African and APAC financial institutions accelerate the transition, with measures to improve data quality, reduce the complexity of disclosures and help companies lay the strategic foundation required.
- The ISSB reaffirmed its cooperation with the European Commission and EFRAG on a framework for interoperable standards, along with the Carbon Disclosure Project (CDP) incorporation of IFRS S2.
- Regulatory and policy efforts to stamp out greenwashing continue to gain momentum. The EU supervisory authorities (European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA)) published a call for evidence on greenwashing to gather input from stakeholders on how to understand the key features, drivers and risks associated with greenwashing. For example, ESMA released a consultation to address funds' names by proposing quantitative thresholds criteria for the use of ESG- and sustainability-related terminology.

Financial crime

While financial crime has always been a major part of the regulatory agenda, the war in Ukraine, subsequent sanctions and events in the crypto market have given it new impetus. The overall direction of financial crime regulation is greater harmonization of standards, with the goal of eliminating discrepancies among jurisdictions and gaps in enforcement. In the US, for example, much of the current anti-money laundering (AML) guidance seeks to apply a risk-based premise, with only a small number of prescriptive rules in place. However, over time, practice in both US and other global jurisdictions has often become quite detailed and focused on compliance rather than outcomes. According to United Nations research, only 1% of global money laundering is effectively intercepted.

In 2021, the European Commission put forth a broad AML and countering the financing of terrorism (AML/CFT) package — a big step forward in terms of addressing financial crime in the EU.[27] That package is working its way through the EU-level standard setters and will likely be approved in 2023. It includes several new regulations; one establishes a single AML/CFT rulebook across the entire EU, and a second establishes a new AML Agency for the EU (AMLA). The latter will directly oversee some large firms and indirectly supervise others in conjunction with the national regulators in their home countries (with the focus on firms with significant cross-border activities).

The EU package also includes a crypto component — a proposal to extend the existing transfer of funds regulation to crypto-asset transfers. That reflects a broader push to regulate virtual assets and VASPs through the lens of financial crime. Specifically, the Financial Action Task Force (FATF), the global AML/CFT watchdog and standard setter, recently updated its standards for virtual assets and VASPs. In particular, it updated the implementation of Recommendation 15, which requires that VASPs are licensed, registered, regulated for AML/CFT purposes and subject to monitoring or supervision.[28]

Singapore has gone further than most countries in terms of financial crime regulation — and in using technology to support compliance. The MAS is building a safe-harbor platform for banks and other financial institutions to share information about suspicious transactions and individuals.[29] The MAS and the HKMA are also coordinating public-private working groups in which firms and regulators collaborate to identify best practices for financial crime.

Financial sanctions are another current area of global focus. The war in Ukraine has underscored the degree to which sanctions can be a foreign policy tool — and how complicated a sanctions regime can be. Firms must look not just at sanctioned entities by name, vessel and business type, but also at beneficial ownership and controlling-party considerations, making compliance more difficult. Sanctions may be agreed upon internationally, but are implemented and enforced nationally.

[27] *Anti-money laundering and countering the financing of terrorism legislative package," European Commission*, https://finance.ec.europa.eu/publications/anti-money-laundering-and-countering-financing-terrorism-legislative-package_en, July 20, 2021.

[28] *Virtual Assets and Virtual Asset Service Providers," FATF-GAFI.org*, https://www.fatf-gafi.org/media/fatf/documents/recommendations/Updated-Guidance-VA-VASP.pdf, accessed December 23, 2022.

[29] *"Singapore: New AML/CFT sharing platform," Eltoma*, https://www.eltoma-global.com/knowledge-base/singapore-new-aml-cft-information-sharing-platform, August 2, 2022.

As the war in Ukraine continues, sanctions implementation will continue to be a priority in 2023, with new measures and associated rules being proposed. For example, in May 2022, the European Commission proposed new rules about asset seizures from Russian oligarchs violating restrictive measures.[30] And in October 2022, the EU Council announced a new package of economic and individual sanctions.[31]

Some firms are responding to the changes in financial crime regulation by expanding their focus — rather than looking at individual areas such as AML, know-your-customer, risk assessment, fraud or governance, they are instead taking a more holistic, program-wide view.

Imperatives for firms regarding financial crime regulation include:

- Recognizing that an increased focus on financial crime and sanctions will be a feature of the regulatory landscape for some time to come, all firms will need effective change functions in place that can monitor regulatory developments, react quickly and enhance controls as required.
- For EU firms, it may be too early to implement control changes given that AML/CFT legislation is not finalized, but firms can still assess the impact that the regulations will have on any large-scale transformation projects (planned or ongoing).
- Non-EU firms should consider the likely extraterritorial reach of the new AMLA.

[30] *"Ukraine: The Commission proposes rules on freezing and confiscating assets of oligarchs violating restrictive measures and of criminals," European Commission,* https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3264, May 25, 2022.
[31] *"EU adopts its latest package of sanctions against Russia over the illegal annexations of Ukraine's Donetsk, Luhansk, Zaporizhzhia and Kherson regions," Council of the EU,* https://www.consilium.europa.eu/en/press/press-releases/2022/10/06/eu-adopts-its-latest-package-of-sanctions-against-russia-over-the-illegal-annexation-of-ukraine-s-donetsk-luhansk-zaporizhzhia-and-kherson-regions/, October 6, 2022.

Strategic agility and operational resilience

In the past, supervisors have focused on firms' ability to respond to large-scale disruptions and minimize the negative impact on their operations and customers ("respond to disruptions"). Today, regulators are still focused on enterprise resilience and risk management, but they are combining that with two related objectives: ensuring that firms can operate in a business-as-usual environment that is far more complex ("run the bank") and that firms can implement positive changes — such as integrating a merger, upgrading technology or improving business processes — without introducing new risks ("change the bank"). That is a three-part challenge, but the common thread across all three is organizational agility.

In this area, the regulatory standards are clearly defined and well understood, and the rules are reasonably consistent across most major bank centers, so fragmentation is not an issue. The central challenge is that, as the operating environment has become more complex, some firms still have a tactical, compliance-oriented mindset about merely meeting supervisory expectations. Moreover, many institutions treat "run the bank," "change the bank" and "respond to disruptions" as separate activities with non-overlapping objectives.

As regulators connect the dots between business change management and business continuity, supervisory guidance is that firms should have a set of business control processes that can be applied to business change management (developing new products, setting strategy or investing in technology) and enterprise resilience (responding to cyber threats and understanding climate impact). The same organizational muscles get used in both endeavors. What's needed is a management mindset that treats all three as part of an integrated whole — a spectrum in which change is a constant, even in business-as-usual conditions, and firms can apply the same agile mindset to implementing all forms of change.

The challenge is difficult today, but it will likely grow as the bank ecosystem expands and institutions rely more on third-party vendors for operational aspects, such as call centers, cloud operations and application support. Firms are only as secure as their weakest link; vulnerabilities in any critical vendor put the entire organization at risk. Moreover, regulators will continue to focus their supervisory scrutiny on the firms themselves, and firms will be responsible for building agility and ensuring enterprise resilience among their growing vendor networks — including the people, processes and data across those networks.

Imperatives for firms regarding strategic resilience include:

- Applying agile methodologies for all three broad areas of change: "run the bank," "change the bank" and "respond to disruptions."
- Implementing strong governance and change management approaches so that the best strategic options are implemented.

Prudential

Given the more challenging economic environment worldwide, regulators have a renewed focus on firms' financial condition, especially against the backdrop of ongoing regulatory changes. In the UK, for example, the Prudential Regulatory Authority (PRA) is ramping up reviews under Section 166 of the Financial Services and Markets Act, which allows the government to commission an independent skilled person review into issues that regulators have flagged as a potential cause for concern.[32] Specific areas of focus include end-to-end risk-weighted assets (RWAs), model risk management, and the validity and accuracy of regulatory returns. In particular, data quality has been a long-standing concern that regulators now consider even more crucial in the current environment.

In the US, supervisors are focusing prudential scrutiny on middle-market banks. There is a consensus that the global systemically important banks (G-SIBs) have sufficient oversight, and that the smaller banks are likely not systemically important enough to warrant significant changes. But, supervisors are applying standards for systemically important financial institutions (SIFIs) to mid-tier banks. In addition, the US is using merger approvals to push for higher standards — in some cases attaching resolution conditions to mid-market banks that would typically have been found only at the G-SIB level.

The finalization of Basel reforms will compound the challenges of the current environment.[33] Virtually all jurisdictions want to get across the finish line in implementing the Basel Committee reforms — without having the transition be overly disruptive as they deal with worsening economic conditions. Bank leadership teams agree that implementation is necessary, but they also have greater regulatory priorities.

The timing will vary somewhat by jurisdiction. Both the EU and UK have postponed implementation of the Basel reforms to on or around 1 January 2025. The US will likely come later, as with previous Basel implementations. While each jurisdiction will adjust some of the specific rules, the main elements — particularly the output floor and the need to apply risk weightings to lower levels of capital, not just enterprise capital — will remain intact worldwide. As a result, while the overall impact for the industry will be higher capital requirements, the precise impact on an individual institution will vary, and overall fragmentation and complexity will increase for global firms.[34]

In the EU, however, there is controversy between regulators and politicians about the dilution of the Basel III reforms. The UK PRA has set out plans to comply almost fully with Basel III and adopt the likely European timetable, and one of the few major global jurisdictions to confirm its intentions to implement the whole package is Japan.

In some ways, current economic conditions may push some countries to scale back their ambitions for Basel reforms. The fundamental parameters themselves likely will not change, but the timeline for implementation may get extended. Supervisors may opt for less-stringent requirements around the margins, with the goal of ensuring that firms can mitigate the damage from the economic slowdown and support growth. This is especially true in cases where conservative political parties are ascendant and seeking to ease the regulatory burden on financial institutions.

Yet, some regulators remain wary. In a recent speech, the chair of the supervisory board of the European Central Bank argued that the relatively strong position of firms thus far may be making them overly confident about addressing downside risks. One potential cause is the regulatory concerns about asset deterioration at the onset of COVID-19. "[W]e might be suffering the same fate as the boy who cried wolf in Aesop's Fables, and a tendency might be spreading among banks to dismiss their supervisors' calls for prudence as unjustified conservatism," the regulator said. "[E]xogenous shocks to the economy and the banking sector require supervisors to exercise extreme caution. [i]t is generally better to be safe than sorry."[35]

For insurers, the Insurance Capital Standard (ICS), due to be implemented by 2025, aims to provide a globally comparable risk-based measure of the capital adequacy of internationally active insurance groups (IAIGs) and G-SIIs. It could improve comparability between groups that operate under different solvency regimes if all major jurisdictions implement it consistently. Furthermore, the ICS will reflect all material risks to which an insurer is exposed and strike a balance between risk sensitivity and simplicity. Currently, insurers are struggling, dealing with varying solvency solutions within and across regions or countries. While ICS requires a more comprehensive approach to risk management (e.g., insurers must anticipate and address the regulatory and risk changes ahead), firms that have the right systems and processes in place to adapt to the change will benefit from lower compliance costs.

Implications for firms regarding prudential include:

- Assessing the impact of varying Basel requirements and timetables across jurisdictions, particularly for global firms.
- Preparing for greater scrutiny from supervisors in areas of perceived risk and a potentially lengthy period of low appetite for prudential and other risk.

[32] *"Skilled person reviews," FCA.org*, https://www.fca.org.uk/about/how-we-regulate/supervision/skilled-persons-reviews, accessed December 23, 2022.

[33] *Chebib, Jared et al, "How the EU's Banking Package 2021 has started the Basel 4 endgame," EY.com*, https://www.ey.com/en_id/banking-capital-markets-risk-regulatory-transformation/how-the-eu-s-banking-package-2021-has-started-the-basel-4-endgame, November 15, 2021.

[34] *Chebib, Jared et al, "Why global regulatory standards are fragmenting as Basel 4 is implemented," EY.com*, https://www.ey.com/en_gl/banking-capital-markets-risk-regulatory-transformation/why-global-regulatory-standards-are-fragmenting-as-basel-4-is-implemented, July 21, 2022.

[35] https://www.bankingsupervision.europa.eu/press/speeches/date/2022/html/ssm.sp221004~9c9e9504c2.en.html

Conclusion

The picture we can see for those running firms is an increasingly complex one. Regulators will be focused on the basics, particularly in relation to prudential matters in what is a difficult economic environment and one fraught with wider uncertainty. At the same time, the pace of digital change is high, and more is expected from firms — in terms of both ESG and the treatment of consumers. Place that all within the context of increased regulatory fragmentation and a shifting geostrategic environment, and this is one of the most complex times to operate a financial services firm for many years. Understanding regulation and placing this as a key component of firm strategy is going to be vital in the years ahead.

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