COVID-19 in the Financial Services market

Perspectives on the non-financial impacts

COVID-19

As the impact of the COVID-19 pandemic reaches the financial situation of organisations, the pressure on financial institutions to develop resilient solutions is increasing. This requires reimagining ways to address compliance and related non-financial risks, as well as assessing and addressing the implications on organisations' governance model.

Background

In response to the COVID-19 outbreak, regulators are taking a number of actions to protect customers and markets. These actions, as well as the impact of the pandemic itself, have a number of far-reaching risk and regulatory implications for financial institutions. With this in mind, we'll analyse the non-financial impact on compliance monitoring and several operational risks, as well as various aspects of the governance model and internal control system of financial institutions.

Our focus is on the elements that directly affect the priorities and operational activities of the three lines of defence in relation to conduct and integrity rules, client management, contractual relationships and major governance implications. This is not an exhaustive list, but an overview of some key operational and non-financial risks that will be on the radar of financial institutions for the coming months.

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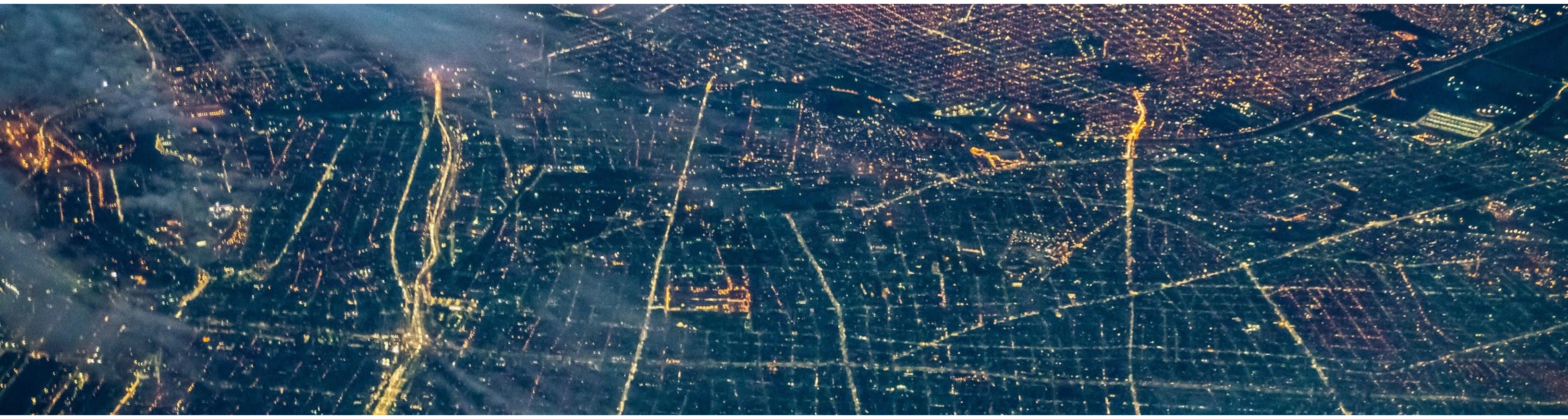
To address the economic effects of the pandemic, the European Central Bank (ECB) has taken measures to ensure that its directly supervised banks can continue to fulfil their roles. These measures should provide significant capital relief to banks in support of the economy.

The European Insurance and Occupational Pensions Authority (EIOPA) has issued recommendations with the aim to foster convergence and consistent supervisory approaches across Member States when dealing with reporting and public disclosure requirements for insurance and reinsurance undertakings. The recommendations aim to offer operational relief and to support business continuity.

In its recommendations, the European Securities and Markets Authority (ESMA) is insisting on business continuity plans while ensuring that regulatory obligations continue to be met. The ESMA is also drawing attention to the need for issuers and financial market participants to put all the required measures in place to fulfil their transparency obligations under the Market Abuse Regulation. Financial reporting duties based on qualitative and quantitative assessment on business activities and risk management requirements for fund managers are also part of these recommendations. Some flexibility of timing is however granted to execution venues and firms to fulfil their Best Execution reporting duties under MiFID.



The Belgian Financial Services and Markets Authority (FSMA) is highlighting that all legal and regulatory requirements remain applicable to intermediaries and lenders despite the exceptional circumstances, and that there will be no valid reason linked to the COVID-19 crisis that will be accepted to justify potential regulatory shortcomings.

On its side, the National Bank of Belgium (NBB) has taken important steps to help non-financial companies and self-employed individuals (guarantee scheme and mortgage loans payment deferral).

The supervisory authorities in Europe and in Belgium are ready to open the dialogue with each bank individually in order to eventually adjust timetables, postpone meetings and/or inspections and deadlines, so as to limit the operational impacts on financial institutions (a concrete illustration thereof is the decision of the EBA to postpone the EU-wide stress test exercise to 2021).

In return, it is expected from the banks that the positive effects of these measures are leveraged in the most constructive way, so that financial institutions may continue to strengthen their procedures and controls in all domains, as well as their risk management mechanisms.

New challenges ahead

There are a number of impacts affecting firms in all sectors, such as ongoing regulatory change programmes. Responding to COVID-19 likely means a reduced operational capacity for many financial institutions, i.e. that active resources are removed from regulatory change programmes. Therefore, they may be unable to meet internal and/or regulatory deadlines.

In this context, it is essential for financial institutions to (re)assess their operational risks, their ability to effectively continue to operate and how the services they offer to their customers can be pursued while sustaining the measures to meet the underlying regulatory obligations. As a reminder, the sources of operational risks are mainly related to processes (data processing errors), people (misuse of resources, incompetency), and IT (system or program failures, cyber attacks), but also external events. In the current situation, all elements are combined to foster an increase in operational risks.

With the new economic crisis and an alternative way of working arise a number of operational challenges:

Conduct rules

As face-to-face meetings with clients are replaced by online communications, the means available for staff and customers to support these interactions need to allow for the high volume of demands and the application of recording obligations, as well as the ability to answer questions and register input received from customers on a digital platform. Online banking systems do not necessarily have the required capacity and/or functionalities, so alternatives should be defined.

Firms should continue to work in the best interest of clients (best execution, product governance, cost disclosure) alongside the multiple other actions requiring attention, all while clients are likely to expect even more from their banks/insurance companies. Financial institutions are expected to enter orders and transactions promptly into their systems, despite the fact that staff is working remotely.

The reporting duties towards regulators and clients also continue, with specific attention to the notifications sent to clients in case of 10% portfolio value declines.

The difficulties that many customers will face will likely lead to an increase in complaints. Responding to these in line with the regulatory obligations is essential, especially considering the potential shortage of resources to handle these complaints.

Integrity rules and ethics

In a crisis situation, it is expected that financial institutions increase the monitoring of personal transactions, insider dealing, unlawful disclosure of market or financial information, as well as (attempted) market manipulation. Measures to detect potential breaches and to reinforce awareness around the treatment of confidential information is critical (the protection of personal data, in particular medical data, is an obvious one, but it is also about financial and market data). These risks are inevitably enhanced by the need for staff and management to work from home.

Third-party contracts

The financial situation and operational resilience of significant external service providers need to be closely monitored. Their capacity to deliver agreed-upon services with a reduced capacity, and/or limited operational, financial and technical means may be heavily affected. This could result in delays, contract breaches or contract terminations. It is important for firms to maintain an open dialogue with their service providers in order to anticipate issues as soon as possible.

Client acceptance and management

The pandemic is already resulting in shifts in customer behaviour, i.e. cash withdrawals and growing use of digital payment means. In addition, the number of vulnerable clients is likely to increase over the coming months. Financial institutions will have to develop adequate mechanisms to identify these changes and potentially consider reassessing their clients' risk profiles. Making sure that clients are clearly and timely informed about their contractual rights is also strongly recommended. Each firm needs to define an approach on how to maintain the fair treatment of its customers and whether this approach is commercially viable.

Governance

An effective crisis management policy and dedicated crisis management team are essential to managing such an unprecedented situation. Not only do operational and practical impacts need to be identified, analysed and dealt with, but so do ongoing implementation programs, IT developments and strategic initiatives that are affected across all entities of the financial institution, including future business development/extension plans.

Communication flows need to be adapted to ensure that the Board of Directors and its Committees are informed adequately and in a timely manner. This information is essential to assess the impact of the current situation on the Risk Appetite Framework and on the Risk Appetite Statement of the firm. The Risk Committee has a critical role in this respect, as do the Operational Risk Management and Compliance departments.

It is also recommended to assign deputies to the key functions in the first line and second lines of defence, who can quickly and seamlessly step in as needed.

Other operational risks that are increasing due to the current situation include cyber threats, business continuity and fraud risk, which also need to be properly assessed in today's specific context.

Internal control system

As most people are working from home, the challenges mentioned above refer to the broader internal control system. It is certainly not the moment to reduce vigilance on controls, from the first to the third lines of defence.

As additional risks arise, it is essential to maintain an environment that will provide comfort to the different internal stakeholders, management, clients and external parties that activities are being kept under control. Controls execution gaps, consistency and documentation are probably the biggest concerns when it comes to a paperless and remote way of working. Firms need to closely monitor whether controls continue to operate effectively and rapidly adapt the way controls are performed and documented to make sure that all key controls can still be evidenced for upcoming reviews via a governance, risk and compliance (GRC) platform, robotics, artificial intelligence, or any relevant digital support and technology. The reorganisation of the operational functioning of the internal control system represents a significant effort that will inevitably leave a legacy for the future. Developing an effective evidence process now will be beneficial in the long term. Reiterating the importance of continued control mechanisms across the firm is also a must.

In its role as second line of defence, the Risk Management function is a central organisational feature of the financial institution that should be involved in the risk discussions and decisions of the business lines and management to inform them whether these remain within the risk appetite and strategy of the firm. The Risk Management function also needs to re-run an assessment of the risks in this crisis period to ensure all risks are identified in due time.

The Compliance function should be alerted to changes in customer behaviour (social risks). It is recommended to revise the thresholds applied on the monitoring of transactions to detect suspicious laundering activities, while making sure that the volume of alerts remains manageable. The detection of illegal transactions compared to legitimate activities is particularly difficult, and in the current context, several opportunities arise for criminals to exploit the existing vulnerabilities of people, processes and systems (e.g. fraud attempts such as raising funds for fraudulent charities).

Internal auditors need to consider the direct and indirect risks identified by management, starting from the assessment of the measures to ensure continuity (crisis management), then verifying that associated risks and medium to long-term implications have been considered.

A strong risk culture is now more crucial than ever. It includes risk awareness, risk management and related risk-assessment decisions. In the current climate, embedding risks within behaviour, attitudes and norms will help financial institutions overcome the difficulties they have to face. The tone from the top is one of the key drivers to reinforce risk culture, supported by the tone from the middle to ensure important messages cascade across and into the organisation.

Key takeaways

Our goal is to raise awareness of the less obvious or even indirect impacts of the crisis for financial institutions, while taking into account their highly regulated environment. These are summarised below:

- While the supervisory authorities are taking measures to help organisations manage the economic and financial effects of the crisis, they also expect that all efforts to comply with the applicable laws and regulations will be maintained.

- The systems to support daily operations, client transactions, related reporting requirements and control execution need to be organised in a remote fashion with the appropriate backup, storage and security measures.

- Monitoring of the use of market information and client behaviour should be enhanced, considering that the associated risk level has been adjusted to reflect the new norm.

- Specific attention to the resilience of significant service providers will enable firms to manage potential operational difficulties.

- Roles, responsibilities, and the communication mechanisms of the management body and independent control functions must be adjusted to adapt to crisis-related priorities.

The anticipation and firm-wide analysis of the indirect impacts of the pandemic will definitely be a differentiating factor for financial institutions in overcoming the crisis while minimising damages.

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