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Financial Markets
Regulatory Outlook 2021

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'...we have a once-in-a-century opportunity to build forward better. Simply returning to the low-growth and high-inequality economy if the past is no longer an option.'

Antoinette M. Sayeh, IMF Deputy Managing Director, 15 December 2020[1]

' The challenges of the pandemic are daunting, but this crisis presents us with opportunities too. Opportunities to reshape our financial system to make it fit for the recovery and provide more sustainable investment and credit in the years beyond.'

Charles Randell, Chair of the FCA and PSR, 16 June 2020[1]

Global foreword

The world continues to face a formidable shared challenge in COVID-19. Yet the economic implications of the pandemic – along with government and regulatory responses – are increasingly variable between regions. Regulators and financial services (FS) firms have naturally prioritised financial and operational resilience, and navigating these critical challenges is no mean feat, particularly amid a continuing degree of regulatory divergence between jurisdictions.

Thus far, regulators have worked closely with FS firms to ensure they are a key part of the solution in pandemic responses [Figure 1]. Firms will understandably want to preserve this role. First and foremost, this means fulfilling the industry's primary function: channel credit and investment to where they are most needed. But FS firms will also need to deliver in three important areas: the increasingly urgent need to progress against sustainability objectives, fostering cultures that deliver good outcomes for customers and society, and making meaningful progress on the imperatives of diversity and inclusion.

These issues form the context of our *Regulatory Outlook 2021*, which we expand on in this global foreword, before turning to our respective regional concerns (United States, Asia Pacific, and Europe, Middle-East, Africa).

Financial resilience amid a bleak economic outlook

The market turmoil in early 2020 left central banks with little choice but to respond decisively to restore stability and order to financial markets. Thereafter the defining feature of central bank responses to the pandemic has been the increase in credit provided to the non-financial private sector, and the levels of public sector assets held [Figure 2].

Following sharp drops in GDP, 2021 will likely see a return to growth worldwide, albeit at variable rates. GDP in the Asia Pacific region is forecast to grow by as much as 6.9% this year,<?> though the US and parts of Europe will continue to grow more slowly, particularly as at the time of writing parts of Europe are re-entering or extending stricter national lockdowns. Even with this growth, world GDP will nevertheless remain below pre-pandemic forecasts [Figure 3], and the road to recovery remains extremely fragile.

Though Jay Powell, Chair of the US Federal Reserve Board (FRB), characterised progress on vaccines as 'good and welcome news', he noted that it remains too soon to assess the implications for economic recovery.<?> The challenge facing policymakers is bridging the gap until the roll-out of vaccines is further advanced and the recovery can build its own momentum.<?> In many countries, interest rates look set to remain low - or even go to negative - for an indeterminate period [Figure 4], compounding existing profitability challenges for FS firms.

Central bank actions coupled with widespread government fiscal support measures have helped cushion the blow to the real economy and financial markets, albeit raising concerns about elevated (and in some cases unprecedented in peacetime) sovereign debt levels [Figure 5].

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Yet the Many challenges lie ahead for the banking sector, with significant credit losses appearing inevitable in 2021 as some governments unwind their support measures.

We expect bank supervisors to take heed of lessons learned the hard way in Europe during the last decade and encourage timely recognition of impairments. We also expect a continued emphasis on the ability and willingness of the insurance industry to contribute to economic recovery by paying out pandemic-related claims where there are reasonable grounds to do so, with policymakers in jurisdictions including the UK and the US pushing for insurers to pay out COVID-19 related business interruption claims.

The prudential regulatory reforms that followed the Great Financial Crisis (GFC) have undoubtedly helped firms weather the initial storm, and have so far passed their first real test. Stress tests around the world[1, 2, 3, 4] suggest that the financial sector as a whole should be able to withstand very significant pandemic-induced losses. Nevertheless, the level of uncertainty remains high, and it is likely that some firms may fail, particularly at the smaller end of the spectrum.[5] In some more severe scenarios credit and valuation losses - combined with continued unprecedentedly low interest rates - could put some firms' capital positions under substantial pressure.

When it comes to appraising the effectiveness of the regulatory framework through the pandemic, attention will focus once again on systemic scope and resilience, the perimeter, and any threats posed by the non-bank financial sector to financial or market stability. To this end, as legislators, central bankers and regulators reflect on the resilience of markets to disruption and the effectiveness of their toolkits, more stringent regulation of certain types of investment funds and other non-bank financial institutions is in prospect.[6]

Operational resilience in a post-pandemic digital world

The global financial system may have coped well with the operational disruption caused by the pandemic. Still, supervisors will not allow firms to rest on their laurels, reiterating the message that the pandemic does not represent the most severe form of operational stress for which firms should prepare.[7]

Anticipated acceleration of firms' digitisation and automation activities due to cost pressures and changing customer demands also put operational resilience front and centre. Cloud migration remains a key enabler for digitisation. As more firms move to the cloud, long-standing regulatory concerns around the systemic importance of Cloud services providers will become more pertinent than ever. In the US, one recommendation to the incoming administration is for the Financial Stability Oversight Council to consider designating cloud computing companies as Systemically Important Financial Markets Utilities.[8]

We expect regulatory initiatives on operational resilience to accelerate worldwide at the international and national level in 2021. Cross-border groups which implement a global approach to operational resilience will need to accommodate differences in emphasis - and in some cases substance - between national regimes, adding cost and complexity to the process. In the US, recent guidance from the FRB calls for federal banking examiners to review the use of remote work technologies and teleconferencing systems for work-at-home arrangements, along with the elimination of physical controls present in many office environments.[9]

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Dealing with divergence

Indeed, despite the common strategic and regulatory challenges facing the FS sector worldwide, divergence in the regulatory detail is increasingly the norm. Ninety-one percent of respondents to a recent Deloitte survey have observed at least some regulatory divergence across global jurisdictions that has affected day-to-day operations.[10] For many firms operating in Asia-Pacific coping with divergence is part of business-as-usual, but elsewhere there are new divisions for firms to deal with (most notably EU/UK divergence through Brexit).

The pandemic has effectively provided an ongoing stress-test of the regulatory framework developed since the GFC. Legislators and regulators will likely consider the effectiveness of those reforms, alongside their temporary pandemic response measures. There is an opportunity to avoid divergence through global coordination, but the prospect of this may be slim, particularly given that the rollback of temporary measures will depend on local economic conditions, which will vary regionally.

Looking forward

Looking ahead, FS firms will continue to have to make difficult decisions due to the highly uncertain economic outlook. Yet they will also seek to play their role in the economic recovery. Insurers and investment management firms in particular should consider contributing long-term capital towards supporting small and medium enterprises and infrastructure projects, providing funding to certain illiquid assets that create real long-term value. Banks will also be looking to maintain the flow of credit to the real economy.

In fulfilling these roles, however, we see three crucial areas in which we expect regulators as well as society to scrutinise the performance of FS firms. For FS leaders to continue to be regarded as part of the crisis solution, they will need to demonstrate progress in addressing these challenges.

Supporting sustainability objectives:
FS firms have an opportunity to help society tackle climate-related risks in their role as investors, advisers, lenders to the real economy and insurers of catastrophic risks. Authorities will want to enable green finance to help 'build back better' and accelerate the transition to a net-zero economy. The taxonomies being established in jurisdictions such as Canada, the EU and China will provide a useful starting point to support FS firms investing sustainably. Meanwhile, regulators worldwide are developing climate stress tests, while also pushing firms to develop their own capabilities to assess their financial resilience against climate risk. In the US, the sustainability agenda is expected to accelerate with the incoming administration. Environmental, social and corporate governance disclosure requirements are also becoming more prominent, and increasingly mandatory globally, though any convergence towards a coherent set of global standards will likely be slow.

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Creating cultures that deliver good customer outcomes and embrace social purpose: regulators will pay increasing attention to firms' treatment of customers experiencing financial distress as the effects of the pandemic linger, particularly as support measures are withdrawn. To continue to be regarded as part of the solution, firms will need to be flexible in dealing with their customers, considering the appropriateness of further forbearance and engaging with customers proactively before payment breaks end. The extent to which FS cultures deliver good customer outcomes through the next phase of the pandemic will bear heavily on judgements about how FS firms have performed and any associated reputational risks.

Diversity and inclusion: diversity and inclusion rose rapidly up the agenda around the world in 2020, through social movements. In the US, the FRB has devoted considerable attention to addressing social injustice issues and reducing racial inequalities. In Europe, regulators are reinforcing commitments to diversity and inclusion as a means of improving governance, culture and practical decision-making in FS. Firms will need to demonstrate to regulators, including through data and management Information, their progress towards achieving more diverse and inclusive boards and workplaces.

Conclusion

This, then, is our view of the backdrop for 2021. Economic prospects remain highly uncertain and variable between regions, while significant downside risks remain. For regulators, ensuring the ongoing financial and operational resilience of FS firms, so that they continue to meet the needs of their customers and the economy overall, will remain paramount. But the industry will also need to prioritise progress on sustainability, culture, diversity and inclusion if it is to play its full role in helping customers and society responsibly navigate this unprecedented environment.
We cannot understate the magnitude of the risks facing firms in 2021, but therein lies an opportunity for firms to lay the foundations of their future success..

Tony Wood
Centre for Regulatory Strategy
APAC

Irena Gecas-McCarthy
Centre for Regulatory Strategy
Americas

David Strachan
Centre for Regulatory Strategy
EMEA

Global foreword - Figures

Figure 1: Bank lending to the non-financial sector[11, 12]

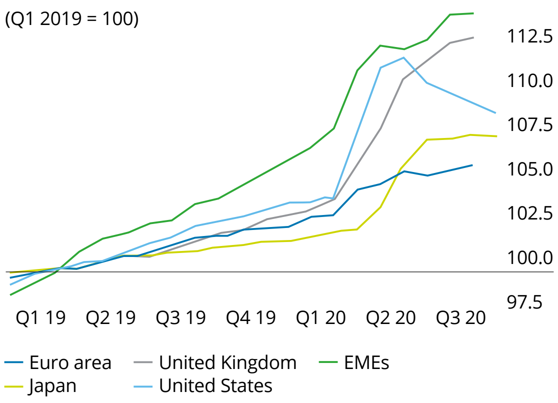


Figure 2: central bank responses to the GFC vs. COVID-19 crisis (% of pre-crisis GDP)[13, 14]

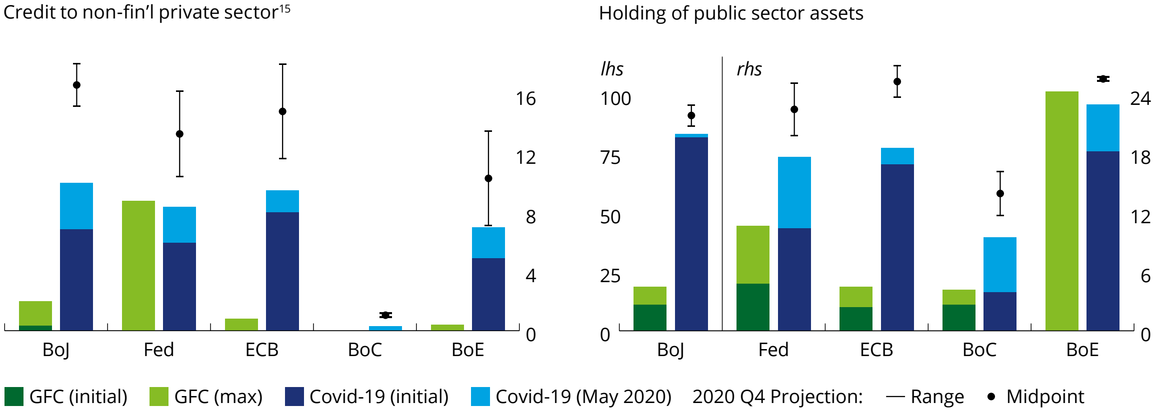


Figure 3: GDP in 2021Q4 relative to November 2019 projection % difference

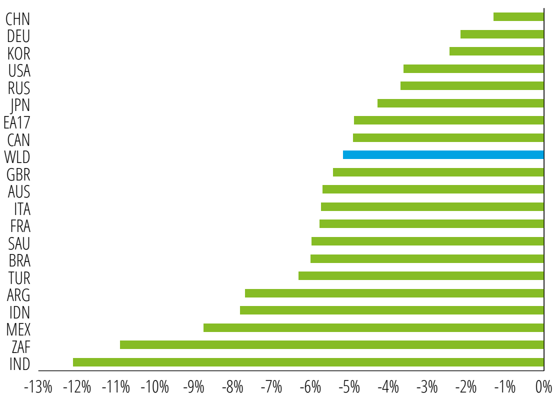


Figure 4: Global central bank policy rates

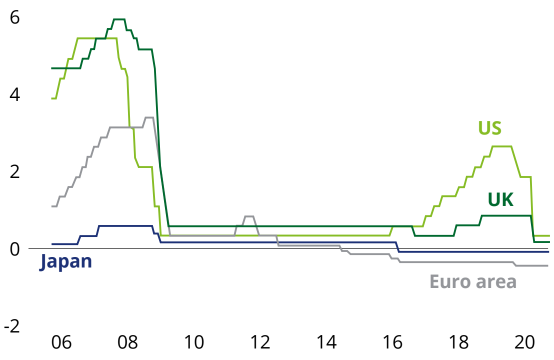
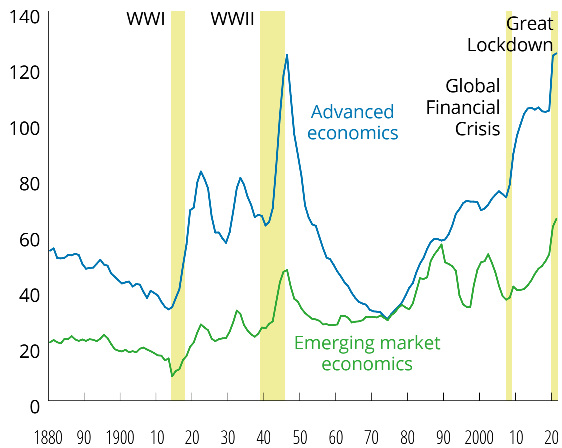


Figure 5: Historical patterns of general global debt percent of GDP



Endnotes

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13. BIS, *BIS Bulletin 21: Central banks' response to Covid-19 in advanced economies,* June 2020, available at https://www.bis.org/publ/bisbull21.pdf
14. GFC period defined as Q3 2007 to Q4 2012; COVID-19 period defined as March to December 2020. Pre-crisis GDP is Q2 2007 GDP for GFC and Q4 2019 GDP for COVID-19
15. Targeted lending operations and central bank holding of private sector assets

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