HERBERT SMITH FREEHILLS

#disruption

2020 GLOBAL BANK REVIEW

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Welcome to #disruption, our fourth edition of the Global Bank Review

Disruption has long been a force of change in the financial services industry. However, this year we have seen disruption on a scale as never before, with the emergence and impact of the Covid-19 global health pandemic and its subsequent ramifications.

While the banks sector has faced - and overcome - significant challenges before, the depth and breadth of Covid-19's disruption has left banks in the position of having to brace for material impact to their own businesses, whilst simultaneously demonstrating a change in culture, providing support to vulnerable customers, and supplying vital credit for regrowing our economies.

Banks have faced all of this while keeping pace with numerous other disruptive forces such as rapid technological, digital, regulatory, risk, operational, workplace, social and environmental change. It is by now clichéd to observe that Covid-19 has accelerated the pace of change in trends which had begun before the pandemic such as the move towards a cashless society; an increase in online banking; the conversion to agile or home working; and the increased threat of cyber attacks and online fraud.

In addition, quite apart from Covid-19, banks continue to operate in an uncertain environment of ongoing political and economic volatility caused by factors such as Brexit and ongoing tensions between the US and China.

Against this backdrop, as part of this year's *Global Bank Review* we surveyed over 300 senior executives and managers at banks globally and our findings suggest that senior executives regard their top concerns for the next three years as: how to deliver a digitally driven business, how to navigate regulatory change, and how to build operational resilience.

Almost half of respondents (45%) pointed to availability of new technology as the main driver of digital transformation. The survey responses indicated that the greatest challenge banks face in digitally transforming their business is implementing a digital culture and mindset (39%).

Banks are also increasing their investment in operational resilience, mostly driven by regulatory/industry guidance (29%) and service improvements for customers (27%).

Banks are also focused on environmental, social and governance (ESG) factors as a priority area for investment with 90% of respondents agreeing that ESG-linked lending and investments present major opportunities. Questions remain though as to who takes responsibility for this, with the data revealing that just 14% of boards and 21% of senior leadership teams are accountable for ESG.

Of course, with disruption comes opportunity, and we explore both the challenges and opportunities in this year's edition of the *Global Bank Review*. We look closely at the key issues facing global banks, including digital, data and technological transformation, the complex regulatory landscape, LIBOR transition, mitigating risk in the face of economic uncertainty, and the evolving opportunities for banks in relation to ESG, and more.

Despite the disruption of 2020, there is now, more than ever, a platform for banks to lead a fundamental shift towards further innovation and change, in the finance industry and the wider global economy.

Perhaps there is a glimmer of redemption too. Covid-19 has offered banks the opportunity to refocus on their purpose, and to re-build trust in the wake of the Global Financial Crisis, LIBOR and rates-fixing scandals, and fallout from the Australian Royal Commission. Further, unlike the Global Financial Crisis where the financial sector was seen as a major part of the problem, now, the financial sector is seen as forming part of the solution to the challenges we face from Covid-19.

On behalf of the Global Banks Sector Group, we hope you enjoy reading **#disruption**.

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The view from the top

The Covid-19 pandemic has presented extraordinary challenges for the banks sector, with many leaders sailing uncharted waters, navigating the crisis in a period of uncertainty. The *Global Bank Review* spoke with three senior bank leaders – Anna Bligh, Chief Executive Officer of the Australian Banking Association; Richard Meddings, Chairman of TSB Bank; and Mary Huen, Chief Executive Officer Hong Kong of Standard Chartered Bank – who have shared their personal insights on leadership, the challenges faced and the opportunities on the horizon for banks.

Can you describe what it was like for you as a leader as the pandemic unfolded? Are there any particular moments that you remember?

AB: For me it was a lot like it was for everybody at the beginning and I'd probably describe it as organised chaos. The incredible pace, extraordinary scale and intensity of this experience over a prolonged period of time is rare. Although this is generally the nature of a crisis, every time you go through it, it still feels like you physically have to lift yourself and rise to the challenge.

It's hard to remember back at the very beginning, but all of us as citizens were trying to absorb a fire hydrant of information about what the virus was doing—where it was, what we should be doing, whether we were allowed to work, and whether our businesses were open. When you've got that much information (some of which is life and death) you've got to be very clear and simple in the message you want to get out as there's already so much to absorb. If 15 banks had different packages, you just could never have really helped people to understand what they might be able to expect by way of support from their bank. So I think the two big shock absorbers have been the government income support and the bank deferral of payment for both households and businesses.

In terms of standout moments for me, like a lot of Australians, it was the sight of thousands and thousands of fellow Australians queuing for up to a kilometre outside Centrelink offices. This was a big moment that brought home just how serious this was and how many people were immediately impacted, and how terrifying it was for them, their families and everybody else who wasn't sure if they'd be the next one in the queue. For me, this was a very important crystallising moment.

Then there's also the little odd things that make you think, "Well, I didn't expect to be doing this." The extent of the change really hit me when the television stations stopped allowing external guests into studios and they started coming to your house.

There were days when I would do a press conference on the front footpath and another one an hour later in the backyard, with the kids from next door hanging over the fence.

That's an unusual experience and it just brings home that the world has turned upside down.

RM: It was a very intense time with frequent and high levels of engagement between board members and between the board and the executive team. There was a huge focus on the wellbeing of staff as we went into lockdown and in the weeks after that. We tried to overcompensate to provide reassurance to our staff.

Generally, the board and our people responded well to the crisis.

Our people put up with a level of inconvenience and disruption that in other times would have led to exasperation.

Their strong nature, generosity and resilience shone through even when we were still experiencing a minority of complaints and opportunists trying to commit fraud.

MH: There were many uncertainties and things were evolving quite rapidly, including social distancing measures, school closures, travel restrictions, infection rates, case numbers, and so on. We have a strong business continuity plan which gave us a good framework but given this is an unprecedented situation,

there was no playbook with all the right answers for every situation.

We had to make prompt decisions even though sometimes we didn't have all the necessary information. But we always tried to make the best decision possible using a few guiding principles—do what is best for the health and safety of our staff and clients, be more human and be empathetic.

Because of the unprecedented and uncertain situation, it is not possible for an individual to have all the answers. It is important to stay closely connected and take inputs as well as support from different team members and stakeholders so that, collectively, we can drive the best outcomes. What really stood out for me was how everyone, whether our crisis management group members, other SCB network markets or industry peers, came together to support each other to ensure staff and client safety while maintaining our operations.

Last but not least, it was about staying positive because we are all human, so we are not immune to what is going on around us. But the key for us was to take each day as it came. For me, it was about finishing a tough day, going home and getting some exercise so that I could refocus and get ready for another day with a fresh mind. It was also about being open-minded to look at what new information we had each day and assess whether there were any decisions that we needed to change or adjust based on this new information.

What has been the biggest challenge in managing the business during the pandemic?

AB: Generally, when banks are dealing with customers in hardship, even if there's been an event like a flood or a fire, they're generally dealing with a geographically distinct area and the way they provide relief to their customers in that circumstance is very much individual to each bank.

It was clear very early on that the way banks have managed these sorts of smaller disaster events was not going to be fit for purpose in this event.

It was at that moment that I started ringing a number of the senior leaders on the ABA Council and saying "I think in this event, we are going to have to have a uniform, consistent, industry-wide package that everybody will understand; that can be communicated in the most simple and transparent way and where everyone can know that, regardless of which bank they bank with, they can expect very similar forms of support".

While there was wide agreement with that proposition, there was also a lot of scepticism about whether they could pull it off because these are not usually things on which they cooperate; they're often things which are very attached to their brand and very attached to market share. However, to their credit, it's not an easy thing to do to bring a group of competitors around the table and ask them to talk quite explicitly about things like loan repayments and things which, in any other circumstance, would be illegal for them to have discussions about.

Anna Bligh, CEO, Australian Banking Association

In hindsight, I think that was one of the most important decisions the industry took.

RM: A significant challenge for us was that head offices closed completely but branches and call centres remained staffed at around 60-65%. We managed to get many staff members who could no longer go into branches or call centres working out of their homes. This was not an easy task as it required retraining and organising the necessary "kit".

It was a real test of operational resilience and the duration and scope of the crisis is beyond anything anyone had planned for.

We also had a challenging time engaging with government and regulators as they introduced intervention schemes. The policy ideas were good in theory, but implementation was very difficult as the operational demands on the banks to actually implement the schemes weren't properly understood and the schemes continued to change as practical issues emerged.

For example, the early expectation that we would follow normal credit procedures for government-backed loan schemes soon gave way to self-certification and a 100% government guarantee for the UK's "bounce back loan scheme". We were also administering a scheme where we could see there was likely to be a high level of fraud (which may run as high as 50%) and the granting of duplicate loans. The consequences of this are still to be worked through.

MH: The pandemic is first and foremost a health crisis and with Hong Kong's SARS experience still vivid in society's memory, there was a huge fear factor in the community. At one point there was panic buying—toilet paper, food, and so on—and clients and colleagues were also worried about potential exposure [to the virus] with many having caregiving responsibilities as well, so they were worried about family members.

Fear was high and a lot of uncertainties and pressure made the sentiment quite negative.

So, our first challenge was how to help staff stay calm and make them feel comfortable and secure despite the panic all around. The second challenge was how do we help colleagues transition from an environment of fear and negativity to one of collaboration and positivity, especially given the added challenge that large teams were working remotely from home. So as a leader, how do we build a culture of transparency with timely and relevant communication and help teams stay connected so that even though working remotely, they can feel engaged and bring out the best in themselves and each other.

People invariably look to compare the current situation to previous financial crises. What do you see as the similarities and differences?

AB: I think it's important to understand that banks went into this with two very important lenses. Firstly, they went into the crisis better capitalised than they have ever gone into any crisis, and that's as a result of the global reform post-GFC.

Their balance sheets were strong and so they had the financial firepower to lean in and be a shock absorber to the economy.

Secondly, they had not only the capability but also the willingness after having learned the lessons of the Australian Royal Commission. Australian banks had spent the last 12 months having a long hard look at themselves internally and had the opportunity to really refocus on purpose.

So they came into this event actively wanting to meet the expectation of the community.

The intersection of those two features have been critical to the way that this event has been managed by the banks.

Richard Meddings, Chairman, TSB Bank

RM: This is a very different kind of crisis. The effects are likely to be long-lasting and more widespread than other business disruptions. I fear we may see high levels of unemployment amongst 40-50 year olds and chronic unemployment amongst the young. Underemployment is the worst financial catastrophe that can befall an individual and we will see that as its malign consequence in the banking sector and across society.

When compared to the financial crisis of the early 2000s the solutions are very different. The strategies implemented in the early 2000s which were to focus on the balance sheets and the prudential rules—capital, funding and liquidity—are not the answer here. Having to keep up the higher levels of capital introduced after the last crisis will add to the challenges banks face in the years ahead as they work through the consequences of the pandemic at the same time as facing non-performing loans and margin pressure on revenue, and bearing the burden of default on loans granted on the basis of self-certification and government guarantee.

Has the pandemic changed the way banks do business? Have they become more innovative as a result of the crisis?

AB: I think the first couple of months bordered on overwhelming. Banks were reporting that they had as many calls to their customer assistance lines in one week as they would normally get in a year. So the ability to ramp up very quickly and to redeploy to call centres and change their capability online was a massive effort. Even the basic things that people don't necessarily think about such as logistics and whether it was going to be possible to get trucks to cash machines and cash to businesses.

I think Australians can be very proud of the way that banks pivoted very quickly and were very agile.

They're very big employers, with some 150,000 people and more than 90% of those started working from home in a very, very short period. The system hasn't missed a beat.

At a technical level, we've seen very significant increase in the mood, or acceleration of existing trends. There's been a very big drop-off in foot traffic in branches because people were self-isolating and therefore a very significant growth in the use of digital banking and banking apps. We've also seen a rapid acceleration towards cashless. Merchants around the country wouldn't accept cash, and so we saw a rise of tap and go. I would expect that as we get back to a more normal world, we will see some return of branch traffic, but I would expect cashless and the use of digital channels to remain at the levels they've been.

RM: The operational resilience of banks has proved to be a lot better than most expected. Nobody planned for a crisis of this scale and duration but banks have continued to operate. We found ways to support customers even when most people were in lockdown.

The pace of change—more specifically the pace of problem solving—has been accelerated.

People just had to get on and deliver solutions and that meant breaking through any bureaucracy that stood in the way, without compromising on customer protections. And technology has been a significant driver in finding those solutions.

MH: As we all know, the pandemic has disrupted daily lives because of large-scale travel restrictions, lockdowns (even though Hong Kong was never under lockdown) as well as social distancing measures. Because of this disruption, people have developed a greater appreciation for technology and we are seeing a rapid shift from offline to online models, be it e-commerce, online shopping, online education or entertainment.

This is true for banking as well and we have seen an acceleration in the pace of digital adoption among our clients. Clients have realised that digital can help them conduct essential banking transactions safely from home, so digital adoption increased significantly during Covid. On the other hand, we all know that digital/technology is a megatrend, so Standard Chartered has been investing in digital for several years ("digital disruption" is also one of our group's core strategies). Because of our multi-year investments, we have a high degree of readiness in terms of capabilities and we were able to quickly provide the necessary tools to our clients to help them bank from the safety of their homes. We introduced "My RM", which allows clients to stay connected with their designated relationship managers via our online or mobile banking channel. We also extended our online mutual fund sales capabilities to mobile. Even before the pandemic, we were the first to rollout "QR Cash", where clients can withdraw cash from our machines using their mobile phone, without the need for a traditional physical card.

Mary Huen, CEO Hong Kong, Standard Chartered Bank

From the staff lens, there is greater preference for more flexible ways of working. Many have caregiving responsibilities as well, so they appreciate this flexibility. We have had flexible work policies available to our staff for a few years already so this is not something new, but with Covid, adoption has also increased. Of course, large-scale remote working required technology enablement, so we scaled up VPN capacity and rapidly introduced collaboration tools to make sure teams could continue to work remotely with minimal disruption.

Along with greater adoption and demand for digital, many new ways of working are emerging and will continue to emerge. To stay relevant, we need to step up, continue to innovate and pick up 21st century skills, not just technical skills but also human skills, for example how to engage remote teams, how to handle uncertainty, how to build a learning culture. Otherwise we risk being left behind –

it's important to be a disruptor to avoid disruption.

Has the crisis created new opportunities?

AB: I think every crisis brings opportunity and

there's been an incredible opportunity for banks and for the community to refocus on the purpose of banking,

the critical role it plays in the economy, and the critical role it plays in the wellbeing and happiness of individual lives.

Having had an experience like this, I am now hearing the bank representatives that we deal with on a daily basis say things like, "I felt so proud to work for my bank today. I've had customers in here who have been in desperate circumstances and we've made a difference to them". It has been a long time since bank staff have felt like that and I think that will certainly persist. I don't think you can underestimate the power of creating momentum and rebuilding trust in organisations. Lifting morale across 150,000 people is a tangible thing and once staff have those experiences, they don't forget them.

I think the other thing that I've observed (and I've seen this in other crises as well) [is] they say that the friendships forged in fire are the friendships that last. One of the things we've done is bring together parts of banks (under the umbrella of an ABA working group) that have never come together before because they haven't needed to—for example all of the heads of people and culture. What that has become is a sort of community of practice where they're sharing good ideas, or something that worked, or something that didn't work. These people might come in and out of a particular issue with the ABA maybe once or twice a year—now they're meeting fortnightly. These relationships, as I said, that are forged in fire, are lasting. They've come out of this with even better, stronger contacts, networks and relationships that will empower them to get better outcomes in the future. This is a very powerful outcome which I think will have enduring impact.

RM: Many customers have now forever changed the way they bank. Changes that may have been 3–5 years away will now happen more quickly, and this crisis will accelerate trends and movements that were already underway. That is particularly true of digital banking. Necessity has forced many customers—who might otherwise have been resistant—to shift to online services.

MH: When I step back and reflect, Covid is a wake-up call for all industries, not just banking.

It is more than a global health crisis—Covid is a catalyst for change, or even a game changer.

And at the end of the day some things will change but there are some things that will remain the same, if not become more important.

Let me share some of the changes we are experiencing:

- **New client expectation:** As clients are becoming more used to the superior experience of using super apps and big tech, they are expecting the same from their banks—better experience, greater speed and a different communication tone (more friendly and authentic).
- **New staff expectation:** Staff are looking for flexibility and wellbeing. They are also self-driven, so they are taking control of outcomes including their own learning. The workforce is also becoming younger, so how to create the right environment for multigenerational teams to effectively work together.
- **New operating environment:** Firstly, the macro environment is tough; individuals and companies are facing financial stress, some more than others. New competition is also emerging, many from new business models, for example from virtual banks who recently launched in Hong Kong.
- **Need for new knowledge:** Our staff need to be more well-rounded, more than bankers. New skills such as digital knowledge will be the basic. More intraregional opportunities will emerge due to geopolitics, so regional knowledge and experience will be key.
- **Human skills:** Emotional intelligence and empathy will become very important. As leaders, we need to be more self-aware and find ways to build it; we need to be able to build resilience and emotional stability, and strengthen relationships even though our teams will be working remotely.

What do you think will be the greatest challenge in the next three years and what will be the long-term impact on the industry?

AB: What's becoming more clear is that the road out of the pandemic is going to be a much slower, much bumpier and more protracted process than we had hoped at the beginning.

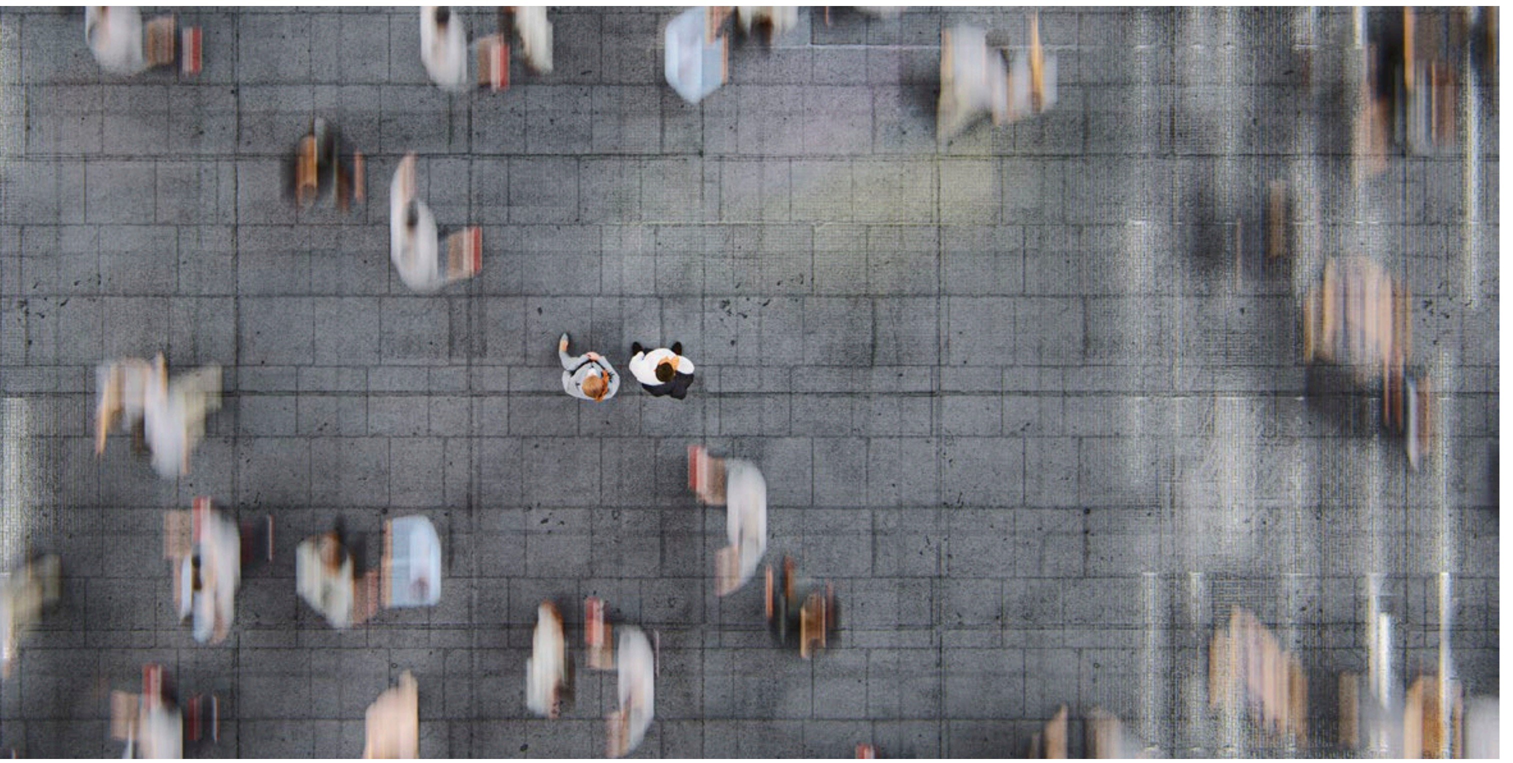
What we might have thought of as a linear process, where one step would neatly follow the other, is clearly not going to be that.

Banks are going to be responding to this crisis for some time and working with customers who find themselves living or working in new cluster outbreaks whilst working with other customers to recover and get back into a position of better financial wellbeing. They'll also be doing this at scale, in the most uncertain of environments, and without precedent. For example, every one of the 900,000 Australians who have deferred repayment on their loans are being contacted directly and bespoke tailored solutions are being crafted for each of those customers.

For banks to be able to draw on what they know from previous crises can only take you so far. Ultimately, at the end of the day it's still a judgement call and I think those judgements are going to be very tough at the kind of scale that they're doing. Everyday these decisions are being made by humans and it's inevitable that some of the apparently reasonable assumptions on which they base their judgement are going to be proved wrong, just because of the rapidly changing circumstances. There's also a whole lot of external factors to consider and if there's a vaccine next month, then that's a very different scenario than if there's a vaccine in 18 months' time.

On the other side of the equation, banks are going to be critical in funding the recovery. We will want to see the supply of credit into an economy as a critical ingredient to grow again.

If banks get this right, then they will play an incredibly important role in the recovery of the country.



RM: The banking sector faces an enormous challenge in managing out of the crisis. So much of the strategy for dealing with the crisis has been to throw money at problems—directly or indirectly with fees waived, evictions, enforcement actions stopped and so on. This response has had a positive effect but it has also stored up potential problems and the low base rate adds to the pressure. I expect that the crisis will accelerate a reshaping of the cost base for banks as we have already seen some redundancies.

The investment in digital banking will accelerate but we have also seen the importance many customers still place on branch banking as part of their community. However, this tends to be a generational thing and younger customers are not making the same demands. Cash is not dead and it remains very important for the small business sector.

Staff working patterns will change as they have in other sectors. More staff will work from home more often and as part of reshaping the cost base that will allow banks to reduce their physical footprint.

I expect we will see a significant consolidation in the sector. Some business models have come under greater strain than others, and add to that a low base rate and an effectively "semi-nationalised" industry by regulatory fiat. At the same time, banks will be expected to maintain high levels of capital and liquidity.

Some of the leaner banking models will struggle to maintain high standards of customer protection. Fintechs will struggle to manage customer distress on an individual basis—they aren't resourced operationally to meet the regulatory obligations to support vulnerable customers.

MH: These are unprecedented times, full of uncertainties and the situation can change quite quickly so we need to have robust scenario planning. Even when you are implementing Plan A, you need to be ready with Plan B and Plan C so that no matter how the situation evolves, we have a response ready.

Another challenge is about institutionalising the mindset shift needed for continuous improvement and learning. When we work in an agile way, especially dealing with incomplete information in a dynamic situation, sometimes you make good decisions and sometimes you don't, and it's okay if you are not able to make the perfect decision every time. What is important is that we learn from yesterday's mistakes and build on those. So building the mindset of continuous improvement will be required moving forward.

What is changing are the needs and expectations of our staff and clients, therefore we will see new digital-led business models and new ways of working emerge.

What has not changed is that human connection will always be important.

Survival in the long term will be about:

- digital and technology playing a bigger role
- evolving with new ways of working, for example flexible, remote and agile methods of working
- transforming skills for the future, for example digital, agile transformation, and
- integrating human and digital—"human digital" will become the way forward.

Digital transformation: Enabling digital

Digital transformation was high on the board agenda before Covid-19, however the pandemic has brought the benefits of technology into even sharper focus. Those that succeed in navigating the challenge are rewarded with unparalleled opportunities to optimise existing – and implement new – services and business models, reduce costs, and improve operational resilience.

According to our global survey of senior executives and managers,

68% of respondents see digital transformation as one of the biggest challenges of the next three years.

A key element of that challenge is being able to source the technological capability needed to become a digital business – ie skills, experience and tools. There are a number of different sourcing strategies that banks and other financial institutions could use, but there is no "one size fits all". Business leaders and their advisors need to find the right mix of strategies for their own business – what is "right" being dependent on factors such as broader objectives, technical infrastructure, budget and timing constraints, workforce capabilities and overall risk appetite.

There are a number of key advantages and disadvantages to the four main sourcing strategies – developing tech solutions in-house, sourcing from tech providers, strategic partnerships and joint ventures with tech companies, and acquiring tech businesses and their personnel.

Developing solutions in-house

For a long time, banks developed their own bespoke technology solutions in-house. While it is now common for businesses to source solutions from (or outsource functions to) technology suppliers, this continues to be a valuable strategy. This is especially true for businesses that want to position themselves nearer to the bleeding edge, as gaining an understanding of nascent technologies (such as machine learning, artificial intelligence and blockchain) often means experimenting in circumstances where failure is likely (and acceptably so).

There are a number of advantages to adopting this strategy:

- Practically speaking, employees will usually hold a deeper understanding of the business than a third-party supplier would and can deliver better-tailored solutions. In addition, as fewer regulatory requirements apply to internally developed solutions, removing third-party suppliers can provide greater flexibility around governance, oversight and operation.
- From a legal perspective, depending on the degree of bespoke development (for example, whether banks "roll their own" code or rely on libraries that may be open source or otherwise licensed by a third

KEY DRIVERS OF DIGITAL TRANSFORMATION

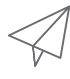
40% Improvements to remote working

28% Improved operational resilience

20% Improvements to existing services of distribution channels

10% Introduced new services or distribution channels

2% My organisation has not become more innovative



1% Other

DIGITAL TRANSFORMATION OPPORTUNITIES

45% Availability of new technology (eg digital platforms, AI, blockchain, smart contracts)

19% Operational resilience

16% New market entrants/peer competition

10% Covid-19

6% Regulatory change

4% Other

#survey

DIGITAL TRANSFORMATION CHALLENGES

31%
Optimising existing services and business models

30%
Implementing new services and business models

19%
Reducing costs

10%
Improving organisational resilience

9%
Improving working environment

2%
My organisation is not digitally transforming

COVID-19 IMPACT ON INNOVATION

39%
Implementing a digital culture and mind-set

21%
Pace of technological change

15%
Legal and regulatory red tape

12%
Cyber security

9%
Other

3%
Hiring necessary talent

2%
My organisation is not digitally transforming

party), banks will likely maintain a greater level of ownership of the intellectual property in the developed solution. It is also easier for banks to control confidentiality and trade secrets around bespoke and proprietary solutions, which can help gain a competitive edge in a market that typically sees banks using the same technology platforms.

However, boards and their advisors must weigh these advantages against the disadvantages. In particular, banks will need to appraise the technology capabilities that they have in-house and establish how they will plug any gaps in expertise or solutions – accounting for the development, support and maintenance of the solutions. This may require hiring additional resources or sourcing capabilities from specialist technology providers, which can prove costly.

Supplier-sourced solutions

It is common today for banks to source solutions from suppliers. This typically provides access to "best-in-class" technology solutions and specialist expertise, which factor in the learnings of other users (potentially including other banks), at a fraction of the cost of developing and maintaining an equivalent capability in-house. This is a particularly valuable strategy for traditional bricks-and-mortar banks, as some suppliers (including those providing cloud service, "bank-in-a-box", payments processing and related fintech solutions) offer highly scalable solutions that may help circumvent the issues caused by legacy systems.

As with other strategies, however, banks must also consider a number of trade-offs. Engaging with multiple suppliers can create complexity, redundancy and integration risks, while gaps may arise between the suppliers' respective roles and responsibilities that could result in banks assuming a greater degree of risk or responsibility themselves. On the other hand, by engaging with a single supplier for all (or a lot) of their technology capability, banks concentrate risk into one relationship and may find themselves "locked-in" to using reduced, or poor quality, services.

In either case:

- Parts of the technology sector are now dominated by a small number of suppliers, including some of the largest and most sophisticated technology companies in the world. With thousands (if not millions) of customers, these suppliers are often unwilling to depart from their standard terms or grant banks the contractual rights they require to satisfy risk and regulatory requirements.
- Issues with technology suppliers and their solutions can have a significant impact on a bank's operational, reputational and legal risks. As a result of this, when sourcing from a third party supplier, banks must comply with regulatory requirements that may reduce flexibility around governance, oversight and operation and increase the time it takes to procure the solution.

Partnerships and acquisitions

Following the rapid growth of digital-native startups, there has been a steady increase in collaboration and consolidation within the financial services sector through strategic partnerships, joint ventures and acquisitions.

These less traditional strategies provide an efficient pathway to access new technologies and expertise while also decreasing time-to-market.

Strategic partnerships and joint ventures

Strategic partnerships

Partnerships can be approached in a number of ways, including through contractual "strategic alliances", and are often combined with strategic equity investment (for example Lloyds Bank and Thought Machine, Barclays and Flux).

For banks, this strategy can offer a solution to the challenges caused by legacy systems and improve customer experience (including through white labelling). For fintechs, it provides the infrastructure, resources and market share they need to successfully launch and scale their products.

However, to enjoy these benefits, partners must work together to implement efficient decision making and governance processes that ensure fintechs maintain their agility and flexibility (which can be hard to do while navigating a bank's complex risk and compliance processes).

Joint ventures (JVs)

JVs can give rise to a range of benefits, including opportunities for data sharing, monetisation and obtaining valuable insights to improve customer experience.

While JVs provide a testing ground for banks to launch digital business models – giving quick access to technology, expertise, resources and customers while maintaining structural separation and minimising exposure to business risk – fintechs are able to avoid the administrative burden that comes with being acquired by a large incumbent and continue to operate with a degree of independence.

Capitalising on these advantages, however, requires the careful navigation of a number of drawbacks, eg slower coordination, difficulties negotiating minority shareholder protections, reduced product access, limited cost synergies and difficulties obtaining exclusivity.

Common issues

In either case, to benefit from this strategy, banks and fintechs must navigate a myriad of issues such as:

determining the appropriate regulatory structure and time it may take to obtain the necessary approvals;

reaching agreement on who "owns" the customer data and/or the customer relationship;

allocating ownership of intellectual property, including future innovations and technology;

agreeing on data opportunities and use cases;

implementing a robust governance framework; and

negotiating appropriate exit arrangements.

Acquiring digital businesses

Acquisitions of digital businesses can provide direct access to technology and expertise, as well as allow for the diversification of products and services. Unlike strategic partnerships and JVs, the level of control gained through an acquisition provides a time-efficient way for acquirers to exclusively access "ready-to-go" solutions while also reducing operational overheads. However, while acquisition of control may be desirable, acquirers of digital businesses will first need to address a number of issues such as:

- calibrating regulatory diligence, particularly for growth businesses which have been authorised for a short time;

- regulatory approvals or merger control filings, accounting for the extent to which the target's assistance will be required;

- early integration planning, including for migration of back-end information technology (IT);

- for certain businesses (such as e-money providers), determining how pricing mechanisms will account for variations in the target's investment portfolio (such as cash holdings); and

- transaction delivery practicalities, particularly if buying from individual investors or founders (often the case with growth businesses).

Banks and other financial institutions have at their disposal an arsenal of strategies for sourcing the technological skills, experience and tools needed to become a digital business. Each strategy brings its own benefits and its own constraints as well. Business leaders and their advisors are tasked with defining the ideal mix of strategies and this is paramount to ensure a successful digital transformation. That mix is, after all, part of the foundation of any digitally-savvy businesses – get it right and you have a sturdy base to build on; get it wrong and the whole transformation may come tumbling down.

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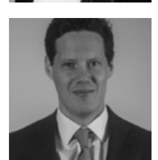

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Compliance disrupted: The forces shaping the future

Thanks to increased regulatory change, compliance has risen as a critical function within financial institutions across the globe. The impact of complex regulation, increasing data monitoring and reporting requirements, and more powerful regulators across jurisdictions, has been keenly felt. Strategic (and resilient) compliance teams will adapt their methods in line with these changes, and the new forces shaping the compliance agenda.

Anticipating emerging issues and responding to disruptions appropriately (eg regulation, technology or ways of working) could have significant impact on an organisation's future and the future of compliance teams.

Rapid regulatory change – from regulation to ethics

Helping businesses to keep pace with the regulatory reform agenda could become, in many countries, a full-time focus for compliance teams.

Effective compliance teams, of course, must be adept at scanning the horizon to distil and explain change as well as predicting future trends. Signposting early where existing systems and processes may need to evolve is critical.

However, highly valued compliance teams will be primed for two important additional shifts.

First, the volume of regulatory expectations means compliance cannot do it alone. To thrive, compliance teams need to guide and shepherd business colleagues in the first line, providing a two-way channel for regulatory engagement between the business (where compliance risk is created and owned) and regulators. To add most value here, compliance teams, together with their colleagues in regulatory affairs, will need to spot issues early enough to allow for engagement with regulators at a time when policies are still being consulted on and are not set in stone.

Second, expectations of corporates (including banks and other financial institutions) have moved beyond reactive compliance to incorporate the proactive management of conduct and culture, including non-financial risks and a wider set of ethical standards. These risks and standards may include:

poor conduct and/or culture;

an emphasis on doing the right thing for customers and markets;

remediation;

compensation;

reputational damage; and

a move into societal issues like climate change/environment, social, and governance (ESG), diversity and inclusion etc.

Future-ready organisations and compliance teams need to make this same shift, moving away from 'policing' compliance to 'spotting' emerging risks.

Teams that proactively anticipate, rather than simply react, to regulatory changes and expectations, will have a significant advantage. Bringing a wider ethical framework into compliance advice and applying judgment is also vital (for example taking ESG considerations into account) to both challenge and support business strategy.

"Compliance will no longer be just a conduit for regulatory expectations into the bank. Compliance needs to be a conduit for engaging out of the bank with regulators."

CHRIS LINDE, CHIEF COMPLIANCE OFFICER, NATIONAL AUSTRALIA BANK

Advancing technology and customer centricity

As the power of data in financial services grows, and the technological solutions to analyse such data become increasingly sophisticated (including the use of Artificial Intelligence, or AI), certain aspects of the compliance function become ripe for innovation.

While the take-up of new technologies has varied widely across firms and different markets, the potential for disruption of the compliance function is substantial, as with all areas of financial services businesses.

> "The positive side of doing compliance well, and using technology as an enabler, is better customer relationships."
>
> **JULIAN FENWICK, CHAIR, AUSTRALIAN REGTECH ASSOCIATION**

A conservative risk appetite, legacy systems, internal capability, upfront investment and ongoing running costs can present obstacles to the business case for early and/or rapid adoption of new technology solutions.

One trend that might just break the impasse is an increasing focus on customer centricity.

Compliance has traditionally been viewed as a cost centre with technology used primarily as a mechanism for streamlining processes and achieving efficiencies.

However, when viewed through a more "customer centric" lens, the compliance function takes on greater value. Technological solutions offer compliance teams the ability to provide a better customer experience resulting in wide-ranging, holistic improvements for organisations, including business reputation.

The evolution of work

2020 has seen a rapid acceleration in new ways of working across businesses and sectors. As banks and other financial institutions have transitioned operations online and adapted to remote working through the global pandemic, staff have shown they can deliver regardless of location.

This poses another challenge for compliance teams, who must address the disruption of these changes to ways of working on at least two levels.

Firstly, compliance teams must continue supporting their institutions, to reconcile risks and concerns arising from new ways of working, with refreshed measures to address these shifts.

How must supervision and monitoring mechanisms evolve to enable sustained working from home (or the local coffee shop)? Existing controls will need adjustment, but new controls may also be required to deal with new risks. Regulators have ultimately made it clear that organisations will be expected to maintain the same high standards of compliance (despite some flexibility during earlier stages of lockdown), and have effective systems and controls in place.

HOW COVID-19 IS CHANGING COMPLIANCE IN THE WORKPLACE

A client survey in June 2020 found only 55% of respondents had conducted a risk assessment to address Covid-19 related financial crime risks. Of those who had taken measures to address Covid-19 financial crime risks, respondents (who were asked to select all measures that applied) had:

43.6%
made minor changes to operational procedures, but the organisation is operating generally "business as usual";

35.9%
updated or flexed existing policies and procedures;

30.8%
introduced Covid-specific compliance procedures;

28.2%
provided additional staff training or awareness on Covid-relevant financial crime topics;

28.2%
taken other steps;

20.5%
done nothing; and/or

5.1%
deferred scheduled financial crime actions to free up resources.

Secondly, and on a more interpersonal level, how do compliance teams maintain effective stakeholder relationships in a virtual meeting world? How can compliance teams rethink mechanisms to monitor conduct risks, and ensure they remain controlled, when face-to-face interaction with teams is no longer the norm? Will issues be spotted and escalated to compliance in the same way?

The answers to these questions will become more important as the impact of Covid-19 continues and compliance leaders navigate the change.

Prioritising purpose

Another promising trend for compliance leaders is the opportunity to take advantage of wider workforce shifts, and reshape how compliance is perceived by employees, particularly younger team members and potential recruits.

Employees under the age of 35 repeatedly cite a "sense of purpose" as the key driver for their engagement in the workplace. Integrity, shared values and aligning to purpose are fundamental to what this generation expect now from their employers.

At the same time, compliance teams are in a competitive race for talent. Highly sought after attributes include curiosity, bravery, backbone and character. Compliance functions are uniquely placed to benefit from this increasing focus on purpose, and win in the talent game, if they can clearly articulate their mission and values.

Across the industry, compliance teams have long called for a "culture of compliance". Broadening this to include a greater emphasis on purpose and aligning to people's values offers a significant opportunity to attract staff to (often hard to fill) compliance roles and engage passionate compliance champions within the business.

This is supported by the implementation of various individual accountability regimes by regulators across the globe, with heads of compliance (and other senior business executives and employees) being fixed with personal accountability for their own areas. The response by senior leaders across businesses has been, in many instances, to elevate the role of compliance to help them achieve the demands placed on them as individuals.

These four disruptive forces shaping the future of compliance present a real opportunity to engage organisations around pressing compliance issues and deliver significant value to businesses, employees and customers. Together, for the teams that heed the call, they create a burning platform for meaningful and transformative change.

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ESG – An evolving opportunity for banks

The focus of external stakeholders and regulators on corporate accountability and financial resilience has meant that environmental, social and governance (ESG) risks have figured prominently on the corporate banking agenda for some time. However, quite apart from the risk and reputational impacts of ESG in a banking context, the impact of the recent Covid-19 pandemic has also highlighted the opportunities being created by ESG as a disruptive force for banks' business practices, lending and investing.

Disrupting business practices

Since the 2008 financial crisis, banks across the globe have generally been subjected to increased public scrutiny. The Covid-19 pandemic has created an opportunity for banks to reassert their role as critical institutions in the community. Together with governments, the financial sector can play a key role in designing and delivering response programmes, providing financial relief, and demonstrating leadership with product delivery and service adaptation, to support the broader public.

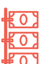
In our global survey of senior executives and managers, approximately 42% of respondents had made public commitments to reducing greenhouse gas emissions, 38% had committed to transitioning away from lending to investing in fossil fuel projects and 44% had committed to gender diversity targets.

Other significant areas subject to public commitment included supporting multicultural diversity and ensuring respect for human rights, including indigenous rights.

In this context, there is heightened awareness of the impact that banks can have on the key environmental and social issues that are dominating public discourse – from labour rights and supply chain challenges, to climate change and the energy transition. Such scrutiny is already serving as a catalyst for change, as banks look to evolve their business practices to better support and drive positive societal outcomes. Examples seen globally include:

- the adaptation of business models to align with improved customer outcomes;

- commitments to objectives on climate and decarbonisation;



- strengthened anti-money laundering processes to better identify criminal enterprise; and

- training for frontline staff to identify and respond to potential indicators of domestic violence, modern slavery and human trafficking.

A new approach to lending

The global political commitments made under the Paris Agreement and the United Nations (UN) Sustainable Development Goals have, over the years, evolved from the goals set out in "soft" law instruments to "hard" laws, and regulations with teeth. This has led to increasing demand from borrowers for sustainable lending products, such as green loans, green bonds, social bonds and sustainability-linked loans. There is also opportunity for banks to enhance their offering and entrench the use of sustainable lending products in the long term.

In our survey of senior executives and managers, 92% either agreed or strongly agreed that ESG linked-lending and investing is a signficiant opportunity for their organisation.

#survey

CORPORATE RESPONSIBILITY FOR ESG

40% Specialist sustainability/ ESG team

21% Senior leadership team

14% Board or board committee

12% Investor relations/ external affaris

7% Company secretariat or legal team

5% Other

WHAT ARE THE BLOCKERS FOR INTEGRATING ESG INTO DEBT FUNDING?

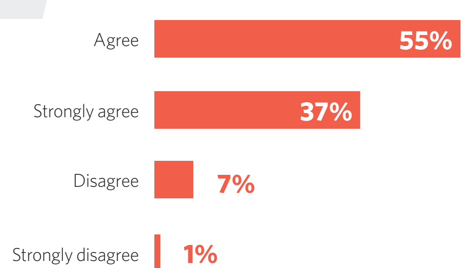
- 22% lack of standardised approach
- 21% don't know how it would work in the context of our business
- 17% pricing on debt not reduced by enough to make it worth our while
- 17% incresed reporting would be too expensive and/or time consuming
- 15% no obvious ESG metrics which we could use
- 8% other

HOW DO COMPANIES INTEGRATE ESG INTO THEIR DEBT FUNDING STRATEGIES?

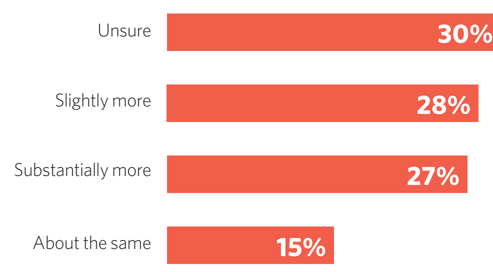
- 30% reporting on ESG to lenders/ stakeholders
- 26% use of ESG financial instruments/ sustainability linked loans
- 26% integrating ESG issues into decision making process
- 14% considering ESG credentials when selecting financial institutions
- 4% other

#survey

ESG LINKED LENDING AND INVESTMENT PRESENTS A SIGNIFICANT OPPORTUNITY



EXPECTATIONS OF FUTURE INVESTMENT IN ESG



PROPOSAL STAGE

While ESG factors will typically feature prominently in the "commercial" thesis underpinning a proposal, understanding the broader regulatory landscape, as well as societal expectations, is key to "unpacking" potential ESG risks and opportunities over the longer term.

ESG DILIGENCE

Unlike traditional due diligence used to verify asset ownership and key contractual risks, due diligence for ESG issues may involve a much broader analysis of potential ESG exposures or opportunities for that company, having regard to sector, products and geography, including "deep dives" on particular areas of concern.

INTEGRATION/MANAGEMENT

Although some ESG issues may form part of the "go/no go" investment decision, often they may be more relevant to price/risk profile and the longer term plans for the business. Where ESG risk areas are identified during the due diligence phase, that analysis can form a work plan for protecting and growing the value of the asset over time.

> "The global political commitments made under the Paris Agreement and the United Nations (UN) Sustainable Development Goals have, over the years, evolved from the goals set out in "soft" law instruments to "hard" laws, and regulations with teeth."

New products arising out of the pandemic include "Covid-19 bonds", a new category of sustainable bonds which has rapidly caught the attention of investors. Data published by Moody's shows that in Q2 of 2020, the issuance of social and sustainability bonds (including Covid-19 bonds) was as high as the issuance of green bonds. As these new products currently lack established market practices, lenders and issuers face the joint challenge of finding solutions for Covid-19-related funding, without prejudicing the integrity of the sustainable finance market.

Additionally, lenders are under increasing pressure to use their size and market power to promote corporate responsibility and, over time, this is expected to cascade down to the businesses they lend to and invest in. Activists are making increasing demands on financial institutions to "look through" their loan portfolios and disclose the risk profile and ESG impact of their underlying lending. This will likely result in increased informational demands placed on banks in the future.

Changing the investment landscape

Banks, like any investor, must also look further ahead than ever before when considering the ESG dimensions of proposed transactions to ensure broader risk and reputational impacts are being considered, understood and addressed throughout the lifecycle of an acquisition. Key considerations include:

The benefits of fulsome consideration of ESG risks are not limited to the acquisition process. Where ESG risks are well understood and appropriately managed, it will also help banks to achieve a "clean break" and minimise the risk of potential disputation by purchasers following an exit.

Global regulation and self-regulation in relation to "greenwashing" and disclosure will likely require investors to understand the ESG impact underpinning their investment activities. Of particular significance is the European Union (EU) classification system for climate change mitigation and climate change adaptation (the EU Taxonomy Regulation). The EU Taxonomy Regulation has been developed by the European Commission's Technical Expert Group on sustainable finance and will apply from March 2021.

The EU Taxonomy Regulation will establish the criteria for determining whether an economic activity qualifies as environmentally sustainable, for the purposes of determining the degree to which an investment can be considered environmentally sustainable. Importantly, for an activity to be "sustainable", it must also be compliant with minimum human rights standards as set out in the United Nations Guiding Principles on Business and Human Rights and the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises.

In our survey, less than half of respondents conducted ESG risk assessments across their lending and investing activities.

Activities most likely to be subject to ESG risk assessments were commercial lending excluding projects (42%) and project finance (also 42%).

Activities least likely to have ESG risk assessments were retail lending (14%), government lending (22%), product development, ventures and incubators (23%) and mergers and acquisitions (25%).

The EU Taxonomy Regulation will also impact non-European financial market participants offering financial products in the EU. Further, companies established outside the EU which have European shareholders may also come under pressure to provide sustainability related disclosures to enable such shareholders to fulfil their own disclosure obligations. The EU Taxonomy Regulation is also expected to form a foundation for similar regional and domestic frameworks, such as the Australian Sustainable Finance Initiative.

The disruption caused by increased focus on ESG offers banks the potential to evolve their business practices, develop novel lending products and incorporate ESG considerations in their investment activities to meet customer and regulatory expectations. Understanding the scope and application of the range of new legislation and regulations, benchmarks and various disclosure and transparency requirements, gives banks a competitive advantage. ESG is therefore offering a significant opportunity for banks to lead a fundamental shift in the finance industry and the wider economy.

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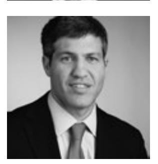

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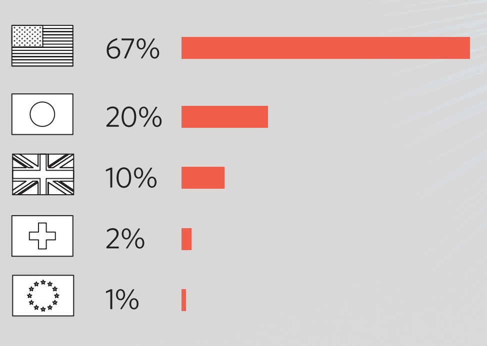
Leaving it late? Legislative fixes for LIBOR provide a glimmer of hope

The discontinuation of the London Inter-Bank Offered Rate (LIBOR) and other Inter-Bank Offered Rates (IBORs) at the end of 2021, has profound implications for the banks sector. LIBOR is a prominent floating interest rate benchmark, across multiple products and currencies, so its cessation has global ramifications. While some banks already understand their exposure and the risks arising from the transition to replacement rates (commercial, legal, operational, accounting), others are less prepared.

Until recently, regulators were reluctant to offer the industry a legislative solution to calm nerves about a cliff-edge scenario because they feared stalling banks' preparations. However, the combination of Covid-19, delays in industry efforts to reach consensus on fall-backs and the inherent challenges at play have resulted in key jurisdictions (the US, UK and the European Union) proposing legislative solutions.

The key message from the regulatory community remains that parties must not rely on a legislative solution as a panacea to the problems of IBOR transition. Instead, the focus should be on positive steps to amend legacy contracts and to transition to the new world without LIBOR.

US$300 TRILLION LIBOR MARKET EXPOSURE



"Legislative changes proposed to deal with 'tough legacy' are primarily intended for a narrow pool of contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended.

We do not have certainty over the implementation of these legislative fixes as yet. What we do know is that the proposed changes should not be considered a reason to slow down the transition away from LIBOR."

PIETER BIERKENS, GROUP LEAD INTEREST RATE BENCHMARK REFORM, COMMONWEALTH BANK OF AUSTRALIA

The challenge

One of the biggest issues for banks arising from the discontinuation of LIBOR is that the existing fall-backs (in legacy loans, other cash products and derivatives) are largely inadequate. Most of these:

- will not work in a post-LIBOR world (eg any rate derived or extrapolated from another LIBOR rate);
- are commercially unpalatable (eg using the last published LIBOR rate);
- are operationally unrealistic (eg quoted reference rates); or
- give rise to a combination of these concerns (eg cost of funds).

Overnight rates have been identified as the preferred alternative benchmark for each currency (the so-called Risk Free Rates, or RFRs). However, a straight replacement of LIBOR with these RFRs would result in a value transfer from one party to the other, because the RFRs do not contain any credit or term component (meaning that they are likely to be lower than LIBOR rates). In addition, the way RFRs operate creates practical difficulties in cash and bond markets (because they are inherently backwards-looking) so interest-paying parties will not know interest payment amounts in advance.

A tough legacy

Regulators argue the adoption of LIBOR as such a widely used benchmark was market-driven, rather than regulatory-driven, and propose the market carry the burden of identifying solutions to the issues caused by its demise. However, there is a category of legacy products (often referred to as "tough legacy contracts"), which pose a particular challenge in the transition. These contracts are recognised as difficult, and potentially impossible, to transition to RFRs within the required timeframe as the amendment requirements, or the characteristics of the product, render the RFRs unsuitable.

Proposed legislative solutions

In this context, regulators and legislators have been grappling for some time with a conundrum:

- delay taking steps to address tough legacy contracts and risk leaving insufficient time for a proper analysis of difficult issues; or
- signal that a solution is coming and risk slowing current progress on the market solutions underway.

However, calls for legislative solutions have been growing louder. In key jurisdictions, they have been proposed and are now receiving focus. The interventions by the US Alternative Reference Rates Committee (the ARRC), the UK Government and the European Commission suggest there is growing recognition that this issue cannot be solved by the market alone.

However, designing a solution is not straightforward. The following key challenges need careful attention:

- how to define "tough legacy";
- what mechanisms to use to avoid a blunt "one size fits all" solution;
- how to avoid interfering with parties' voluntary assumption of contractual risks; and
- how to navigate difficult issues regarding which legislation applies to which contracts.

By delaying the detail as to how each legislative replacement will work (including, critically, the economic consequences), the authorities have not yet addressed all of these key questions. This risks confusion, without significantly reducing the risk of litigation. How quickly the nature and detail of these proposals become clear (including how they will interact), and the extent to which other jurisdictions follow suit, will determine their success in overcoming the tough legacy issues.

In the meantime, banks that are advanced with transition will welcome the focus on legislative solutions – but even the prepared face the challenge of carefully monitoring the market, regulatory and legislative developments in all jurisdictions they operate in. Ultimately, financial institutions will need to unpick the different legislative regimes that are introduced and adapt plans to amend their contracts accordingly.

LIBOR projects in practice

The practical reality of managing the breadth and volume of products for LIBOR transition can be an overwhelming task. Issues range from locating potential documents for transition, assessing whether they are impacted and mining the contracts for a transition strategy. This is time consuming and creates business risk if key contracts are not identified. For large or international banks this challenge is further complicated by the need to address multiple systems, business units and regulatory environments. The scale can been seen in the breadth of the volume and financial value of exposures that mature after December 2021.

PROPOSED LEGISLATIVE SOLUTIONS

New York

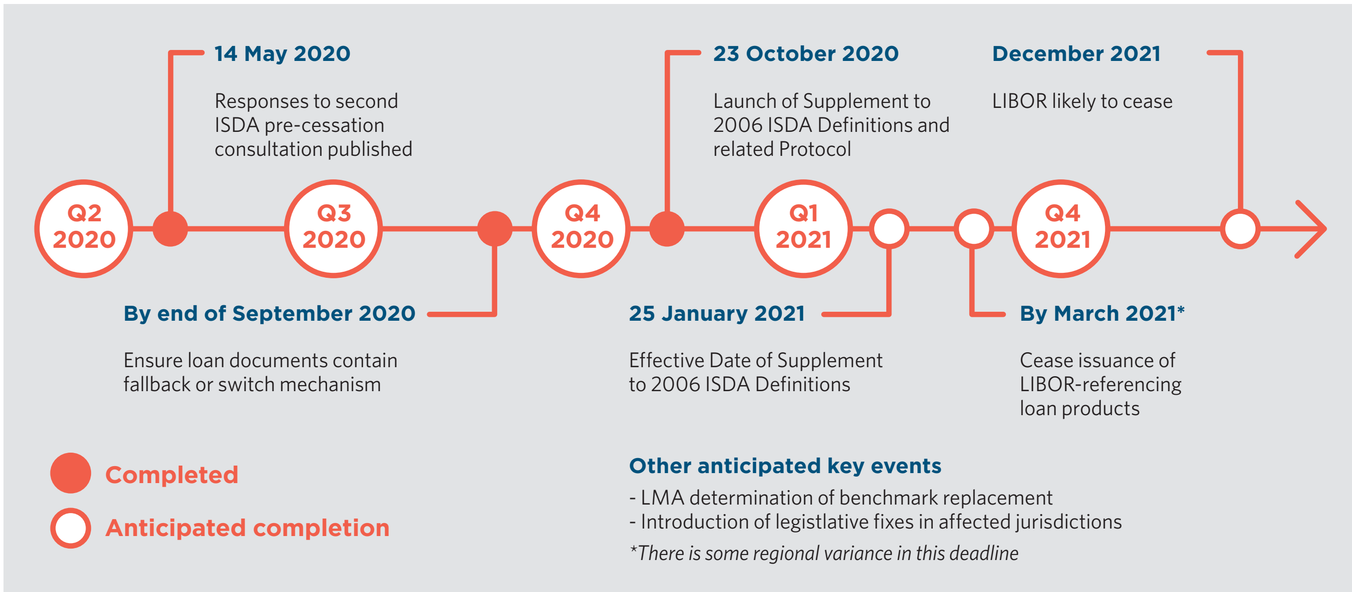
- Any contracts which do not contain fall-back language or fall back to a LIBOR-linked rate will automatically transition from LIBOR to the "recommended benchmark replacement" for US$. This will be the Secured Overnight Financing Rate (SOFR) plus a spread adjustment (to be selected by the US regulators).
- Where a contract gives a party a contractual right to choose the replacement fall-back, it will have a safe harbour from litigation if it selects the "recommended benchmark replacement".

The United Kingdom

- There will be no direct amendment to LIBOR-linked contracts.
- Instead, the FCA will have the power to change the methodology used to calculate LIBOR so that it is calculated using the replacement rates.
- Contracts in scope which continue to reference LIBOR will incorporate the new "legislative LIBOR".

The European Union

- Any contracts which continue to refer to LIBOR will automatically be replaced by a statutory replacement rate.
- Parties can opt out by mutually agreeing to their own fall-backs.
- The replacement rate will be selected by the European Commission, taking into account the recommendations of the working groups which have been set up under the Central Banks relevant to each currency.



Leading with digital

Many banks are seeking to deploy eDiscovery techniques (more often used on legal disputes) to locate and mine large datasets on LIBOR document projects. Legal technology providers also offer services to help solve stages of the project, by offering tools using artificial intelligence to locate key LIBOR contract terms efficiently, and automated contract generation for new or amended contracts. All of these services and technology tools have a place in a transition project response, but with the complexity and uncertainty still surrounding transition a pure technology solution will generally not be robust. A more holistic approach to transition will be required.

Addressing legislation

In the context of legislative fixes in a number of jurisdictions, the solutions that will support LIBOR transition projects will need to be able to assist in categorising documents so they can be dealt with consistently. The solutions will also need to isolate contracts that require further analysis or that need to remain in a "holding pattern" while the legislative processes are complete. Moreover, a full transition management system and an end-to-end workflow will be needed to allow institutions to prioritise and pivot when/if legislative changes are introduced to prevent double-handling of contracts.

People first

Banks will also need effective management information during their transition projects. To be able to view a bank's LIBOR contracts by customer, product and jurisdiction will give banks options in their customer outreach strategy, allow a focus on the "quick wins" and prioritise single customer contacts. As with all document-intensive projects and technology-led solutions, the key component will be the people who are dedicated to the task. The experience of key people in managing complex legal projects and processes, that harness multiple documents in various stages of a lifecycle, will be critical. This approach will provide a complete oversight of where contracts are in the process and where there are roadblocks that may affect the transition deadline. The timeline for transition will be tight, even if banks start now.

The benefits of disruption

Are there any benefits from this process? In the short term, LIBOR transition is a burden on banks. But there are opportunities to leverage this process to digitise for the future by extracting key data on new contracts and categorising documents to improve internal data management systems. Planning the document management strategy at the beginning of the transition project with this in mind could provide real value to the business and enhance future contract management work. With further regulatory impacts on the horizon, the approach to this project today could help banks to prepare for disruption and contract management in the future.

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Operational resilience: Braving the unknown

"Operational resilience" was a regulatory buzz term well before Covid-19. However the pandemic has catapulted it to the top of the list, rivalling even the ubiquitous "regulatory tsunami" of the 2007/08 financial crisis. So how can firms begin to build greater resilience today, while facing into economic uncertainty, without finalised regulatory requirements?

In response to Covid-19, firms have had to move swiftly from thinking about operational resilience in the abstract, as they prepared responses to regulators' proposals (such as those mooted by UK regulators at the end of 2019), to deploying their skills in a live environment. Covid-19 saw the sector go from theory to practice, from beta to live.

Responding to crisis and disruption

Operational resilience is defined in quite broad terms, with a focus on outcomes and an expectation around responsiveness and time. As UK regulators put it in December 2019, it is defined as a firm's ability to "prevent, adapt, respond to, recover and learn from operational disruptions". [2]

The Basel Committee adds further detail, describing an operationally resilient firm (or more specifically, a bank) as one that can:

- identify and protect itself from threats and potential failures;
- respond and adapt quickly to a particular crisis or disruption;
- minimise impact on the delivery of critical operations; and
- maintain a sound business environment outside of the crisis.

At the most basic level, operational resilience means an organisation can get back up after it has fallen over and is more likely to survive once the storm has passed. The following elements are key factors in building resilience.

Taking a holistic view

Operational resilience concerns the whole of the operation – a firm's financial resilience, the resilience of its governance and people, the resilience of its structures, systems resilience and security (both physical and cyber).

Taking the holistic perspective, effective operational resilience is fundamental to an efficient, sustainable business. Good operational resilience does not take a "tick box" approach, as the UK Financial Conduct Authority's (FCA's) Meghan Butler said:

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CHALLENGES FOR DELIVERING OPERATIONAL RESILIENCE

31% The scale and complexity of the business

16% Lack of available budget

14% Skills of staff to carry out the work

11% Identifying appropriate alternative delivery mechanisms for key services

10% Effective oversight of outsourcing and outsourcing sub-structures

9% Lack of clarity around regulatory expectations

4% Board and senior management buy-in

3% Concentration risk at third party service providers

2% Other

"...I was asked to say a few words to a group of new Operational Risk managers. I told them that they would be pioneers. I foresaw that operational resilience would be seen to be on a par with financial resilience and a key part of a firm's risk profile. I felt that this would be transformational for many organisations. So an exciting time? Yes, but operational resilience is hard. However, given the nature of the financial system we have, it is of critical importance."

LYNDON NELSON, DEPUTY CEO, BANK OF ENGLAND SPEAKING IN JUNE 2018[1]

"It's the resilience outcome that's most important to the supervisory authorities, not simply a firm's ability to demonstrate compliance."[3]

Further, it reflects a supervisory perspective that operational resilience is part of a package; for example, the Monetary Authority of Singapore (MAS) offers a Digital Acceleration Grant which links operational resilience to process efficiency, risk management and customer service improvement.[4] This is similarly true in the context of fostering innovation, for example, Bank Indonesia, in its 2025 Payment System Blueprint promotes innovations like open banking alongside building resilience,[5] while Indonesia's financial services regulator, the Otoritas Jasa Keuangan (OJK), has set out plans for operational resilience standards for the fintech sector.[6]

Strong leadership

As key as strong leadership is during a disruption, senior managers have a particularly critical role to play in defining how their firm approaches operational resilience. The impetus to take an holistic view must come "from the top". A firm's chief executive and leaders are responsible for ensuring that throughout the firm and across its service providers, operational resilience is seen and understood as a real priority.

Evolution not revolution

Operational resilience is an evolution rather than a revolution; firms – or more specifically – firms' leaders – must "join the dots" across a range of practical risk management and governance activities. These activities include cyber security, data management, business continuity, outsourcing, culture and more.

Given the variety of business areas and processes that contribute to operational resilience, it is often the case that where a failure occurs, it is identified as an outsourcing, IT or other issue. To strengthen operational resilience, firms must look broadly and holistically across business disciplines, internally and externally, for risks and opportunities.

Planning is everything

Of course, operational resilience is easier described than achieved. While great effort and resources will always be put into preventing risks from crystallising, it is unrealistic to assume that firms and regulators can foresee and mitigate every eventuality. There will always be what could be described on the Rumsfeld continuum as "unknown unknowns", which no firm , regulator or government can take sufficient steps to prevent (and the pandemic has provided a salutary lesson on this). However, while governments and regulators initially drove a focus on operational resilience as they sought to develop policy, the pandemic illustrates a clear business case for maintaining operational resilience ongoing. This means, wherever possible, planning for the unknown and unexpected as a baseline.

Regulators help recalibrate and keep the balance

The recalibration of prudential regulatory requirements in response to the 2007/08 financial crisis has seen the banking sector better capitalised and better able to withstand the economic onslaught of the pandemic (albeit the circumstances are so extreme that some government guarantee, whether explicit or implicit, is certainly present).

Regulation and supervisors will also play a role in the wake of the pandemic. Changes in consumer and client behaviour, as well as the restrictions imposed to preserve health

RESPONSIVENESS IS KING

In September 2019, Hong Kong Exchanges and Clearing Limited suspended afternoon trading on its derivatives market as a result of outages. These outages caused connectivity issues on the futures automatic trading system, due to software issues in vendor-supplied trading systems. Although the issues were promptly resolved and trading resumed from the morning of the following trading day, this case illustrates how even some of the most sophisticated users of technology and systems can be caught out by a weak link (a vendor in this case). Had the issue not been resolved promptly, it may have weakened confidence in the markets due to public and media interest and potentially resulted in regulatory consequences.

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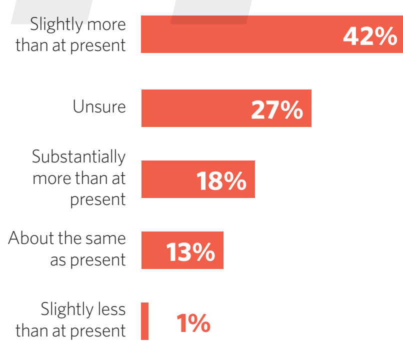
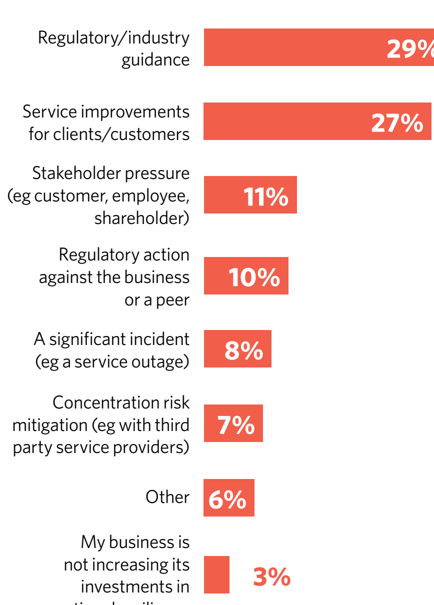
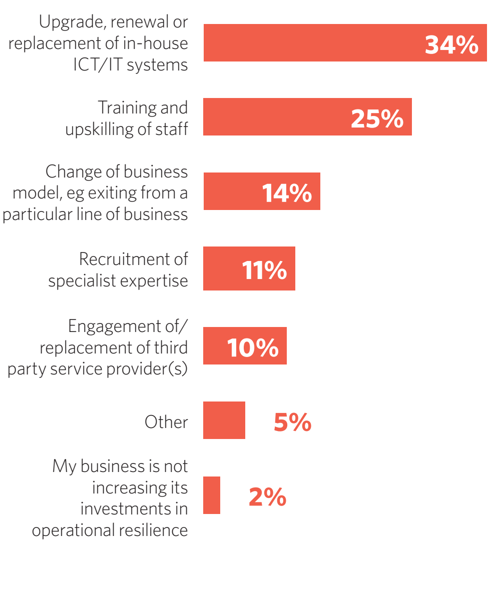
EXPECTATIONS OF FUTURE INVESTMENT IN OPERATIONAL RESILIENCE

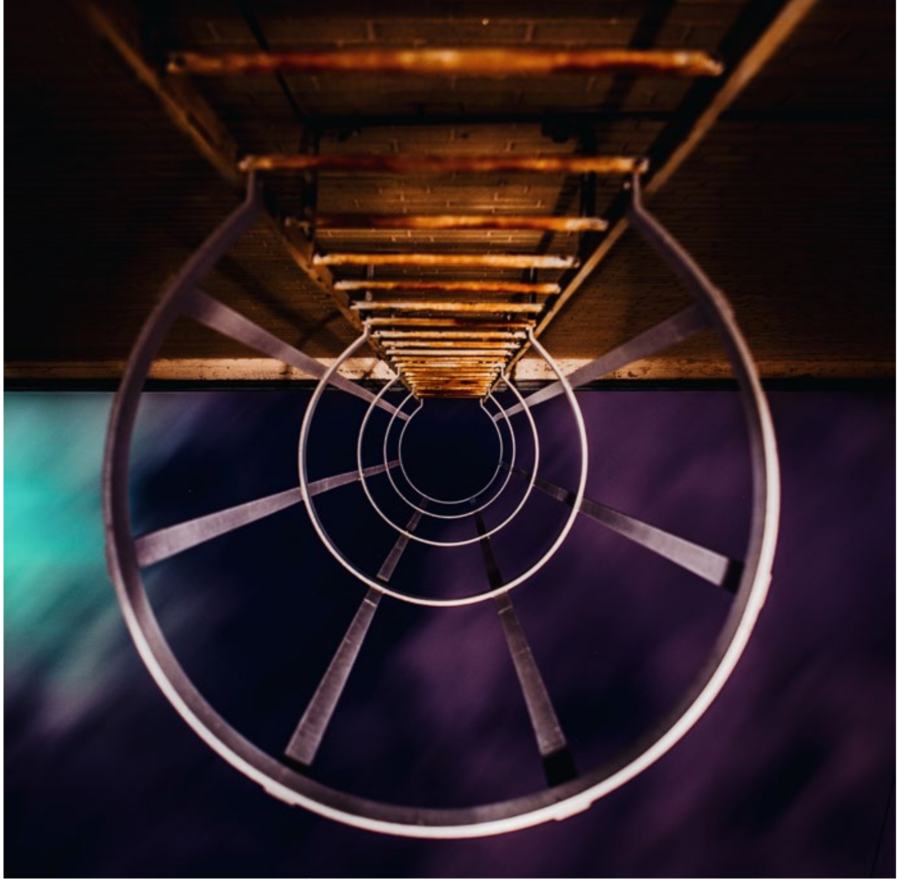


REASONS FOR INVESTING IN OPERATIONAL RESILIENCE



AREAS OF FOCUS FOR OPERATIONAL RESILIENCE INVESTMENT





during the crisis, will shape new regulation. In many jurisdictions, Covid-19 accelerated the trend to cash alternatives or "cashless". Such reliance makes the resilience of payment systems paramount. In Australia, regulators have been developing a set of standard operational performance disclosures, with the intention of focusing banks and their leadership on ensuring the reliability of their retail payment services.[7] In Indonesia, the fintech regulator has recently set out plans to introduce operational resilience standards.

Enshrining operational resilience standards in regulation will provide firms with a baseline. Direct engagement with supervisors will add tenor and character. But fundamentally, it will be down to firms to get their approaches right.

Getting it wrong can be costly – from enforcement actions which may result in fines, publicity, and/or operational restrictions, through to reputational damage, driving loss of business and downturn in market valuation.

It is true that Covid-19 has cast operational resilience in a new, and more immediate, light. It has tested the capacity of leadership and staff, of finances, of structures and systems.

When the immediate dangers of the pandemic have receded, firms will have substantial insights to inform the development of their own approaches to operational resilience to support robust, efficient and sustainable business.

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Unlocking the data-driven bank

Data is at the heart of disruption today, and continues to spur the digitalisation and regulatory changes of tomorrow. In this increasingly tech-driven world, customers are adopting digital channels rapidly, and their service delivery expectations are changing just as quickly.

A thematic shift in regulation has also commenced (eg the Consumer Data Right in Australia, Open Banking in the UK and digital only bank licences in various jurisdictions), which is actively encouraging innovation, competition and digital transformation. In order to keep up with these changing expectations and regulation shifts, while keeping a tight rein on security, banks need to adapt rapidly to stay relevant. However, a bank's success is not built solely on deploying new and innovative data-driven technologies. Leading organisations are now seeing the inherent value of implementing a customer-centric data strategy – which fosters customer trust, delivers value and promotes effective and ethical data usage – to create outstanding customer experiences, meet compliance obligations and deliver on strategic goals.

A holistic data strategy

Strict legal compliance with regulatory obligations today is crucial, but not everything. As financial technology (fintech) and digital banking grows, opportunity is emerging to develop consumer trust and ethical behaviour with respect to data. Regulatory compliance can tick a legal box but, just as importantly, a responsible approach to data can ensure greater success by building customer confidence. This is especially true as regulation typically lags behind the fast pace of technological change and community expectations.

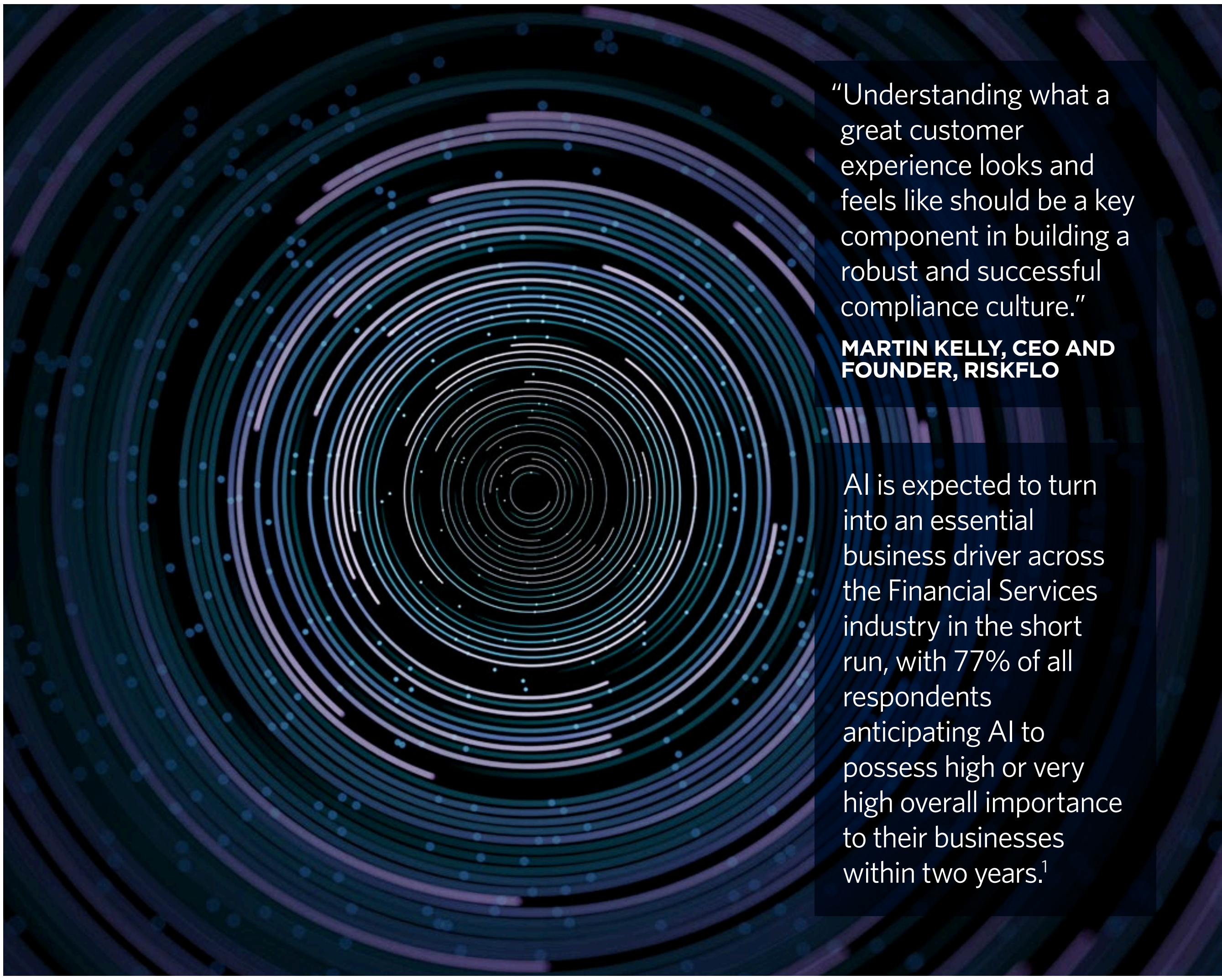
Customer values have also changed. Customers want to know and understand the 'values' of a company and how those values are embedded in its products and services.

In order to deliver innovative products effectively, organisations need a holistic data strategy that is entrenched in the company's values, and governs the responsible collection, use, management and disclosure of data. Transparency about these practices will encourage customers to trust an organisation with their data. To create an effective data strategy, organisations should:

- **Build the data strategy around key customer needs.** Only use data for genuine or forecasted legitimate business reasons that benefit the customer.
- **Address privacy and security concerns.** Match privacy, security and general protections with customer expectations. Customer expectations regarding data security and privacy may also be context-specific, and policies and processes should be adapted accordingly. Adopt the front-page test – would your data use concern customers?
- **Less is best – only collect essential data.** Weigh up the strategic considerations of seeking broad access to data sets, as data collection should be limited to the purposes for which it was collected. Less data collected also minimises associated risks in respect of security and potential data breaches. Use of particularly sensitive data, such as biometric data (eg in mobile logins), should also comply with privacy laws.
- **Keep up education and regular reviews.** Invest in ongoing training and education for key leaders and teams and regularly review governance practices. As the regulatory, social and technology landscapes are constantly evolving, frequent reviews ensure data governance remain best-practice and appropriate.
- **Engage enterprise wide.** Effective data governance requires active engagement from all levels of an organisation and should be driven from the top down, to ensure the value of data is realised.

AI and the art of trust

As the ease of customer portability increases, banks must gain a deeper understanding of customer preferences to provide greater personalisation and more user-friendly services. To demonstrate the value of their services, organisations are increasingly embracing artificial intelligence (AI) technologies and machine learning. High quality data is the crucial fuel needed to power these AI algorithms.



"Understanding what a great customer experience looks and feels like should be a key component in building a robust and successful compliance culture."

MARTIN KELLY, CEO AND FOUNDER, RISKFLO

AI is expected to turn into an essential business driver across the Financial Services industry in the short run, with 77% of all respondents anticipating AI to possess high or very high overall importance to their businesses within two years.[1]

However, in a recent World Economic Forum (WEF) survey, 64% of respondents noted that trust and user adoption was a hurdle to data-related AI implementation[3]. Accordingly, educating customers about how data-driven technologies are employed is critical. Before implementing new solutions, banks should:

MATCH INSIGHTS TO ALGORITHMS

Evaluate what insight the business is seeking to achieve, and assess whether the technology and algorithms are appropriate. This ensures businesses adopt a data-driven model grounded in the organisation's business purpose, values and fairness.

CONSIDER UNINTENDED CONSEQUENCES

Although technology that automates decisions can limit human bias, banks must consider what other unintended consequences may arise. Consider whether de-identified data can be re-identified, or if training data for algorithms may lead to indirect discrimination or unfair outcomes.

Apple Card's credit decision algorithm sparked discrimination claims when it granted a husband 20 times the credit limit that his wife was offered, even when she had a higher credit score.

BE UPFRONT ABOUT USAGE

Lack of transparency and explanations with regard to data usage could have a significant impact on a bank's reputation. Ensure you explain to customers at the point of collection how and why their data will be analysed by the particular tech solution.

STAY ACCOUNTABLE

Solutions (especially those that involve automated decision-making) should regularly be assessed and audited to test for fairness, accuracy, suitability and prevention of unintended biases. Consider introducing a level of human oversight for automated decisions, and processes for individuals to contest the use or output of an algorithm. Indeed, under the General Data Protection Regulation (GDPR), there are special rules around automated individual decision-making and profiling, and data subjects have a right to object to their personal data being used in such ways.

KEEP UP THE CONVERSATION

Maintain ongoing dialogue with regulators and consider whether authorities are looking to embed data ethics into their regulatory frameworks.

LEVERAGE PRIVACY-BY-DESIGN

Make the most of existing regulatory principles such as privacy-by-design, which was included in the GDPR to ensure organisations were doing the 'right' thing with data.

IMPLEMENT A DATA REVIEW BOARD

Establishing a data ethics review board for significant digital transformations or data-driven projects will help with governance, strategy and accountability to your goals.

REFLECT

Take time to reflect on whether you have built sufficient trust to leverage customer relationships for forthcoming technological changes.

Navigating regulation

Banks need to consider a multitude of data-related regulatory issues (viewed from competition, consumer, privacy, corporate, financial and security perspectives) that intersect, continue to evolve and can, at times, be hard to reconcile. Non-privacy regulators are also bringing more direct actions with respect to data and cyber security. For example, the Australian Securities Investment Commission, recently entered the fray by bringing proceedings against a financial services organisation, stating that it failed to meet reasonable standards in managing cyber security risks. The Australian Competition and Consumer Commission also fined another organisation A$2.9 million for deceptive conduct relating to its disclosure of personal information.

When navigating the complicated web of data-related regulatory requirements, the following key measures may offer the start of a roadmap:

Think across jurisdictions. Identify applicable regulations in all relevant jurisdictions, and thoroughly review policies and processes to ensure the most onerous obligations are met. Keep in mind some new privacy laws (such as the GDPR) are seeking to reach beyond geographical borders, meaning banks may also need to consider the laws of other jurisdictions which could also apply to them.

Prioritise privacy. Adopt and implement privacy-by-design and privacy-by-default practices, and build privacy considerations into processes for developing products and services.

Expect change. Structure compliance systems, policies and processes to allow for flexibility in the event of regulatory changes.

Monitor the evolving regulatory landscape. Actively monitor emerging regulatory developments, and engage in consultation processes, to ensure future rights and obligations are fit for purpose.

Review your reporting. Consider if internal reporting and escalation processes for information security decisions, incidents and control weaknesses are sufficiently clear and comprehensive.

Create a response plan. Develop a well-structured response plan to rectify breaches in an appropriate and timely manner.

Although implementing the measures above may be time consuming, they provide a critical path to ensuring compliance and mitigating against reputational damage. This is particularly true for new market entrants, as the regulatory ecosystem offers some comfort to customers while organisations build their reputations.

Creating a culture to drive change

Maximising the use of data will require a data-driven culture to be fostered within banks. Some hallmarks of better data culture typically include:

Leadership from the top. Senior leaders genuinely walking the talk and make it clear that data, and its use in the best interests of customers, is a priority.

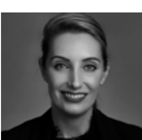
Transparency. A strong data culture means being transparent about how data will be used within the organisation.

Accessibility. In positive data cultures, data is trusted, effectively organised, and accessible for use within the organisation. Data "fiefdoms", where organisational silos lock up key data elements, should be avoided.

Socially and externally conscious. Leading organisations not only manage data to strict legal compliance, but also to issues of social licence and reputation.

By changing the corporate mindset from data governance, as a set of documented policies and procedures, to strategically entrenching it into an organisation's day-to-day operations, banks are more likely to succeed at capturing value for their customers.

Data will continue to be a major accelerator of regulatory change, innovation and disruption in the financial services industry. As the data ecosystem develops and presents new challenges and opportunities, organisations must constantly assess how to outperform for customers, ensure compliance and meet business goals. By focusing on building trust with customers, banks can better harness data to deliver holistically in all areas.



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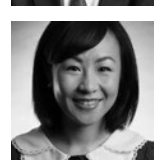

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An extraordinary year – 2020 global regulatory update

The global banks sector is currently experiencing a level of disruption not seen for at least 20 years. While grappling with the impact of Covid-19, the financial services industry is now facing a supply and demand economic crisis in most countries across the globe.

The sheer scale and depth of this disruption has generated prudential and conduct pressures for banks at a time when there are a suite of other disruptions including increased political risk, a widening range of stakeholders to appease, greater interventions from regulators and pressure for institutions to reassess their role in society.

Banks face all of this and more, in a landscape of increased competition and threats and continued regulatory change domestically and internationally. And yet, unlike previous crises, the financial sector is seen as part of the solution rather than the cause of the problem. In a world of reduced margins, these pressures may raise fresh questions about the shape of sustainable banking business models.

Prudential pressures

Since March 2020, banks have operated in economies buoyed by stimulus packages and state aid or, in some cases, in declared states of emergency (eg South Africa). The duration of the crisis and its impact on the wider economy has inevitably led to pressure on the capital and liquidity of banks. For the most part, banks have resisted the use of capital buffers but whether that can be sustained in the longer term remains to be seen, as the economic impact of the crisis is far from over. Generally banks have taken a strict approach to accounting for non-performing loans despite some hints from regulators that they would be willing to accept a degree of flexibility. Governments and regulators have given a range of prudential directions. For example, in Mainland China, banks are required to "transfer" their profits (eg RMB $1.5 trillion has been "transferred" by lowering loan and bond interest rates). In the United Kingdom (UK), the ability for banks to conduct share buy-backs, pay dividends or declare cash bonuses has been suspended and applies to the seven largest commercial banks until January 2021. This measure is also replicated across Europe (eg in Germany and France). In Singapore, locally incorporated banks were called upon to cap their dividends and offer shareholders scrip in lieu of cash. In Australia, APRA has indicated that banks should retain at least half their earnings when making decisions on capital distributions (as well as conducting regular stress testing), to more unusual measures (eg requiring banks to consider merging and consolidating, as in Indonesia).

Banks have also received other directions which will have a prudential impact, including offering payment holidays to personal and small to medium enterprise (SME) borrowers, with deferrals ranging from six months long (lasting until September 2020 eg Germany) to longer (eg the Hong Kong period is until April 2021) and other forbearance measures. Some of these measures include a mandate to provide "Covid-19" loans, funded in some cases from state aid (eg the United Arab Emirates Targeted Economic Support Scheme which has provided AED $256 billion to personal and business customers), state guarantee schemes (eg in Germany where the state is guaranteeing 90% of loans), directions to lend (eg in the UK, £46 billion was approved for 1.1 million businesses by mid-July) or relaxed capital reserves to enable credit to be granted (eg in France where the Higher Council for Financial Stability relaxed the counter-cyclical bank capital buffer to 0% of the risk-weighted assets on French credit institutions' exposures). Regulators have recognised the potential longer-term balance sheet consequences of this forbearance. In the UK, the Prudential Regulation Authority (PRA) estimated that banks could face up to £80 billion in credit losses over the next two years. There is a real concern about fraudulent loan applications and, as those loans fall due, there may be political pressure for banks to absorb losses even where loans were granted as part of a government guarantee scheme.

#survey

TOP CONCERNS IN THE NEXT THREE YEARS

Australia

24% Regulatory change

22% Digital Transformation

13% Operational Resilience

Asia

28% Regulatory change

18% Digital Transformation

15% Operational Resilience

Europe

35% Digital Transformation

14% Regulatory change

11% Capital Raising

UK

21% Regulatory change

20% Cyber Security

18% Digital Transformation

Conduct pressures

Banks are also facing major conduct pressures. Most jurisdictions are seeing a rise in vulnerable customers due to financial hardship from the pandemic (eg from unemployment, redundancies/furloughed workers and forbearance) with banks being asked to be flexible in their response to individual customer circumstances. This requires considerable resourcing and case-by-case judgement, in real time. For example, in the UK, the Financial Conduct Authority (FCA) expects banks to assess whether a customer's circumstances during Covid-19 justify early access to restricted access savings products.

In addition, as the pandemic has seen most workplaces move to agile delivery and to consumers conducting life digitally, there has been a significant increase in cyber security incidents. Banks are therefore seeing their operational resilience measures tested and subject to increased scrutiny (eg in the UK, the regulators have increased scrutiny of banks' operational plans, focusing on payments). In particular, there is a focus on outsourcing with regulatory standards and scrutiny on material outsourcings rising significantly (eg in Europe, new European Banking Authority, or EBA, guidelines are to be implemented by the end of 2021, and in Singapore, amendments to the Banking Act will strengthen the Monetary Authority of Singapore's (MAS) oversight of bank outsourcing arrangements) and IT governance (eg in Singapore banks became subject to legally binding cyber hygiene practices). Banks are having to "supervise" their suppliers (including technology giants) and fourth-party suppliers. The experience of the pandemic will, however, have left many banks feeling more confident about their ability to adapt and to remain resilient.

In particular, the compliance function is under greater pressure to monitor agile working and to monitor staff covering additional and unfamiliar roles (eg when staff are temporarily deployed to other organisational units to manage staff shortages). In some jurisdictions, like Germany, the Federal Financial Supervisory Authority (BaFin) still requires functional separation notwithstanding these changes.

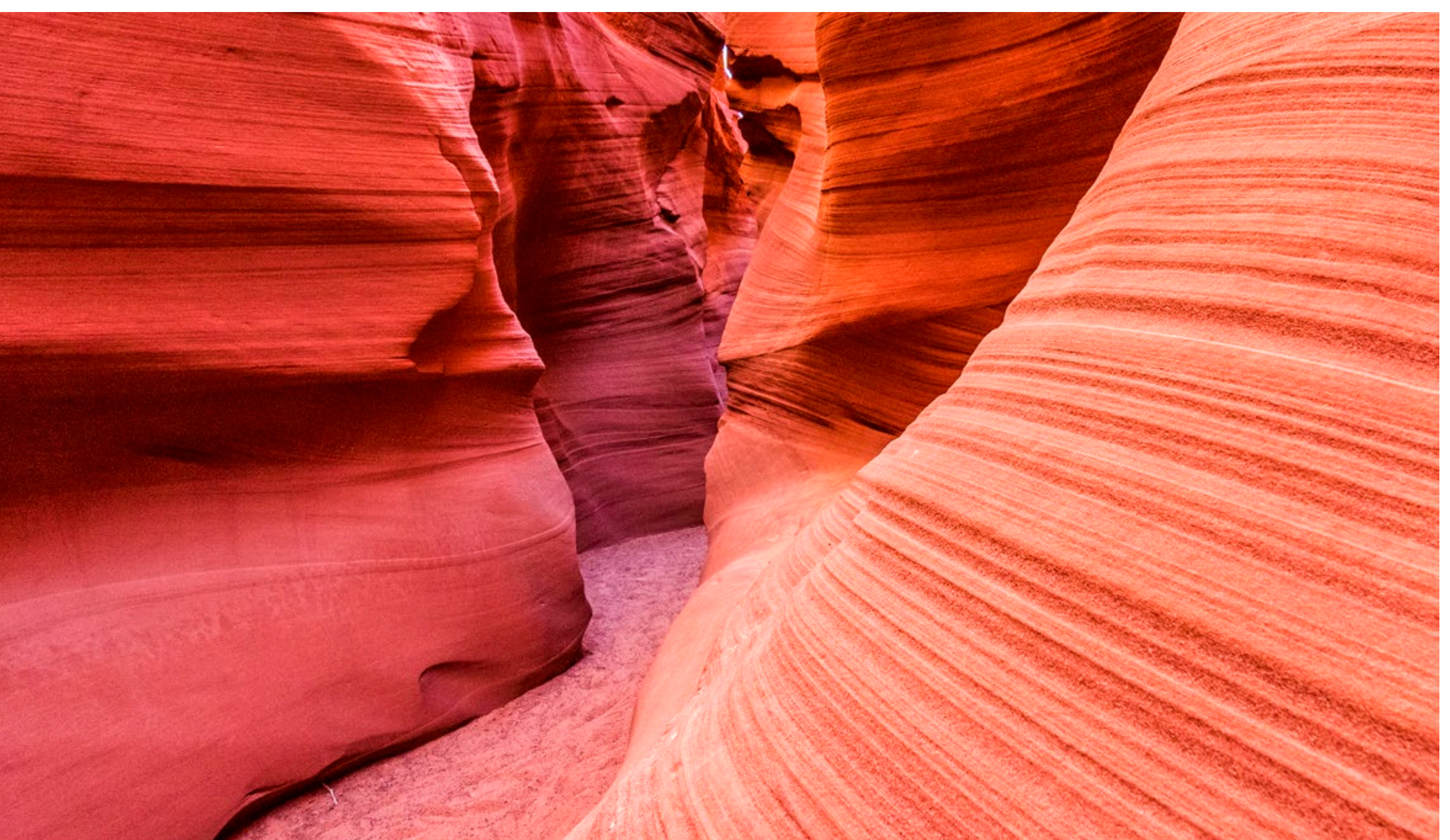
Most banks have had to accelerate their digital transformation projects to assist with their operational resilience and compliance monitoring, including running bots over emails and chats and using artificial intelligence (AI) to assist with identifying vulnerable customers. Early evidence suggests customers have accelerated their use of electronic banking channels, including in demographics that might have been expected to be slow adopters. It is too early to declare the death of branch banking or cash, but the pandemic seems likely to have accelerated changes that might otherwise have occurred on a five to ten year horizon.

Political influence

Separately, this year has seen extreme examples of political influence on banks' operating models, regulatory change and policy.

In the UK, four years after the Brexit vote, the future regulatory landscape for banks remains unclear. UK and European Union (EU) negotiations on a future trade agreement are ongoing, but there are already signs the UK may diverge from EU standards in some areas (eg on remuneration rules), although probably not the "bonfire of regulation" that some Brexiteers might have expected. So (absent an extraordinary deal on market access), while doing business cross-border with European customers and counterparties is likely to be more difficult, more liberal UK rules in some areas might help the competitiveness of UK banks in the London and global markets. The UK government's position is that it will adhere to agreed global standards (eg Basel III) and will focus on developing "outcomes-based mutual recognition" (a concept borrowed from the Swiss Chancellor's speech on the future relationship between the UK and Switzerland).

In the United States (US), the past four years have seen extensive regulatory rollback due to President Trump's "business-first" approach. In 2018, Congress re-wrote portions of the 2010 Dodd-Frank Act, raising the threshold for institutions to be considered Systematically Important Financial Institutions. And in June 2020, the Department of Treasury announced amendments to the Volcker Rule, lessening restrictions on banking institutions'



relationships with hedge funds and private equity funds. But this regulatory rollback could be short lived: if the 2020 election results in an administration change, new and more aggressive regulations are expected.

In Australia, the political fortunes of banks have changed remarkably in a relatively short period of time. Prior to Covid-19, the Financial Services Royal Commission heard evidence of various forms of misbehavior by financial services providers, focused primarily on banks. The level of trust and esteem in those institutions had been dramatically reduced to the point that politicians who would otherwise be expected to support sound and robust financial institutions were heeding the siren songs of social media outrage. The support that banks have provided the community during Covid-19 (eg loan repayment holidays) will go some way towards restoring their former positions in society. However, it will not stop the considerable government action that is already underway to amend laws which were (accurately or not) perceived to have facilitated widespread misconduct in the financial sector.

In Hong Kong, a new National Security Law (NSL) was implemented on 30 June 2020. Both the Securities & Futures Commission (SFC) and Hong Kong Monetary Authority (HKMA) published policy statements following the enactment of the NSL, emphasising that they did not consider the NSL would affect the operation of financial institutions in Hong Kong and noting that Hong Kong's markets have been unaffected by the new law. One area that market participants continue to watch closely is the US and wider international response to the NSL, including US sanctions against certain senior Hong Kong government officials announced shortly after the NSL's implementation. The HKMA has sought to distinguish between Hong Kong's targeted financial sanctions regime (under which banks are expected to uphold sanctions in compliance with United Nations Security Council resolutions) and unilateral sanctions imposed by foreign governments (which the HKMA described as having "no legal status in Hong Kong" and creating no obligation for banks under Hong Kong law). Similarly, the SFC reminded firms to "carefully assess any legal, business and commercial risks that they may be exposed to" in considering the implications of sanctions and expressed its expectation that "any response to the sanctions to be necessary, fair, and have regard to the best interests of their clients and the integrity of the market." On data, licensed corporations are preparing to comply with a range of onerous new requirements for the storage of certain records where they exclusively rely on electronic data storage providers.

Social, community and environmental progress

This year, banks have been asked to measure their success over and above assessing dividends paid and the share price. In a number of jurisdictions, banks have been asked to take into account a wider set of stakeholders, including communities and broader society. A clear and appropriate "purpose" is increasingly linked by regulators to a good corporate culture. This has seen banks consider their role in:

- environmental issues (eg with climate change), resulting in a greater focus on environment, social and governance (ESG); and
- banking products and services supporting positive social outcomes – meaning an increased focused on diversity and inclusion, the black lives matter movement, modern slavery and other social issues.

Climate change

The focus on climate change within banks has been driven by shareholders, other stakeholders (eg in South Africa Standard Bank has faced mounting pressure from numerous climate-justice non-governmental organisations, or NGOs) and by regulators. In some jurisdictions, the impact of climate change is now a prudential risk (eg in Australia, APRA intends to develop a climate-related financial risk prudential practice guide and undertake a climate change financial risk vulnerability assessment).

And most countries are adopting a disclosure-based regime, building on the Financial Stability Board's Task Force on Climate-related Financial Disclosures. This requires disclosure of a bank's approach to climate resilience as well as identifying a board's responsibility to oversee climate strategy development and implementation. For example, in Mainland China the China Banking and Insurance Regulatory Commission (CBIRC) requires banks to include ESG requirements in disclosure processes, and in France, financial services firms have been required since 2015 to publish information on how ESG criteria, including climate risks, are taken into account in investment policies. Across Europe, a new regulatory framework is also coming, focused on sustainability disclosures in the financial services sector. In some jurisdictions, banks are being assessed for their "greenness" (eg in Hong Kong the HKMA launched its framework to assess the "greenness baseline" of banks). In addition, the concept of operational resilience has extended to climate resilience (eg in Hong Kong the HKMA published nine key principles for building climate resilience and in Germany BaFin is encouraging a focus on sustainability risks). In other countries, climate risk measures already have tangible outcomes. For example in Australia, the 2020 Banking Code of Practice prohibits banks charging default interest on farming loans where the farm is affected by drought or other natural disasters.

Sustainable finance

Sustainable finance remains an important focus with Vision 2021 and the United Nation's Sustainable Development Goals, with a wider range of jurisdictions now embracing sustainable finance (eg the United Arab Emirates). In Singapore, MAS issued a consultation paper on 25 June 2020 on proposed Guidelines on Environmental Risk Management. The guidelines aim to enhance banks' environmental risk management practices and serve as a call to action to drive the transition to an environmentally sustainable economy. They do this by enhancing the integration of environmental risk considerations in banks' financing and investment decisions, and promoting new opportunities for green financing.

Purpose, community and inclusion

Having regulators challenge bank culture is nothing new, but now focus is moving to corporate "purpose" (what the UK's FCA calls a "healthy purpose"). The FCA challenges banks to have a meaningful purpose, foster an inclusive environment where it is safe to speak up, ensure effective leadership and governance, engage employees with the right capabilities and motivate teams with appropriate incentives. It is proposing to lead by example in applying the same principles to its business. Other regulators are doing likewise (eg in France the Bank of France has written corporate social responsibility into its 2020 strategic plan).

In the US, in August 2019, over 181 Chief Executive Officers, including those from major financial institutions like Bank of America, Citigroup, JPMorgan, Morgan Stanley, and Wells Fargo, signed a Business Roundtable Statement on the Purpose of a Corporation, committing to lead their companies for the benefit of all stakeholders, including customers, employees, suppliers and communities. But these words are unlikely to be enough. There has been frequent media coverage questioning whether the commitments amount to little more than an empty promise and the pressure for demonstrable progress will continue to build.

Financial inclusion remains a significant focus. In Indonesia, banks have implemented branchless banking programs to provide basic banking services to the unbanked and underbanked. In Australia, a new Banking Code of Practice in 2020 widened banking accessibility to include those with limited English, introduced the concept of a "basic account" designed for certain low-income customers and strengthened requirements to assist customers accessing banking services in remote areas.

Increasingly interventionist regulators

This year has also seen regulators globally increase their intervention powers or increasingly use their intervention powers, creating uncertainty for banks in understanding the approach of regulators. Some of this has been politically driven (eg in Australia, ASIC is now a more aggressive regulator with a "why not litigate" mentality in the fallout from the Royal Commission) while other drivers have been due to regulators sharing best practice ideas in their supervisory colleges (eg the UK's product intervention powers have resulted in Europe adopting similar powers and now these have extended to Australia from 2019). Another factor has been new mandates. For example, Australia's external dispute body, the Australian Financial Complaints Authority (AFCA), which appears to interfere with the fundamental nature of the contract between banks and customers.

Pragmatically, Covid-19 has moderated regulator enforcement actions. This has been necessary where workforces have more pressing issues to navigate and some regulatory processes, including embedded regulatory teams and compulsory examinations, have been curtailed. But as the economy seeks to reopen, regulators will adapt to the new normal. In testing whether prior enforcement settings and priorities still make sense, reflection is required as to whether the best use of regulators' enforcement resources are spent fighting expensive old wars, sometimes about conduct that occurred up to ten years ago, when our world has now changed so significantly. Once the impacts of the pandemic are substantially behind us, it will be important for our regulators to review how financial institutions, and other key businesses, performed during Covid-19. Key areas to explore in such a review, with regulators across the globe, will be business continuity and operational resilience.

Increased competition and threats

Across the globe, banks are seeing their business models further disrupted through measures such as "open banking" and the rise of financial technology (fintech). While open banking and other digitalisation measures are giving customers greater access to their data, more options to share it and to direct how it is used, banks are navigating the rapid technological, regulatory and operational changes, as well as increased competition and risks.

Open banking

Open banking continues to be a global theme with its recent introduction into new markets (eg Australia) and its scheduled introduction into other markets (eg Indonesia's 2025 Payment System Blueprint identifies open banking as a key initiative). Open banking will increase competition from fintechs and likely increase disintermediation of the customer relationship. But, as part of the wider digitalisation of banking, these changes will also generate opportunities for new customer products and services (enabled by new technology, such as an Application Programing Interface or API); and new ways for banks to use AI for risk and compliance management. Open banking is being seen as the final step towards accepting people do not want to buy financial products/services. Driven by customer expectations, it seems the future of financial services is moving towards blending products into consumers' lives (but with safeguards – essentially "coding" fairness into the product/service) rather than positioning them as distinct and standalone products. In Europe, many banks (with the exception of established financial institutions) have faced criticism for not treating the implementation of online banking seriously enough and failing the required tests. The EBA has recommended the deadline for completing the migration to strong customer authentication be extended until the end of 2020.

Growth of mobile banking in emerging markets

While the concept of mobile money did not arise as a result of the Covid-19 pandemic, the popularity and evident benefits of its practical application have been highlighted due to the physical restrictions imposed by lengthy lockdowns. The ability to transact without a bank account is becoming easier and potentially more attractive through digital channels. Traditional banking at the retail level is changing and with it, so will the regulations governing the way the industry operates. In emerging markets

"Many post-crisis policies, including those aimed at the implicit subsidy for "too-big-to-fail" institutions, have been in place long enough to allow for evaluation. We can now begin to ask fundamental, critical questions: What have the effects of these reforms been, whether intended or unintended, salutary or adverse? Have we successfully reduced or eliminated the problem? Has there been a tradeoff, in the form of new, unintended risks or costs?"

RANDAL QUARLES, CHAIR OF THE FSB, SPRING 2019.

(eg across the continent of Africa), regulators face balancing the risks associated with digital money solutions (in particular fraud, Anti Money Laundering and Counter-Terrorism Financing issues) and a lack of oversight, against the barriers that traditional banking presents to a large percentage of the population.

Continued growth of fintech

Fintechs and non-bank firms, such as tech giants and social media firms, continue to enter the financial services sector challenging traditional banking models. The focus of these firms on payments, digital banking and business banking, pose a particular challenge to traditional banking models. For example, in Hong Kong, the HKMA issued eight virtual bank licences to new entrants in 2019 and in Singapore, MAS is currently assessing the 21 applications that it received for five digital bank licences. In Malaysia, Bank Negara Malaysia has also issued an Exposure Draft on the Licensing Framework for digital banks, under which it is proposed that up to five digital bank licences will be issued. In addition, domestic markets are seeking to ensure the growth of fintech by breaking down barriers to their success and removing obstacles (eg in Australia, a Senate Committee Inquiry into fintech is due to publish its final report in April 2021 and in Spain, the legislative process to create a fintech sandbox has begun).

At a global level, the International Organization of Securities Commissions (IOSCO) continues to drive cooperation in developing internationally recognised and consistent standards of regulation, oversight and enforcement and to enhance information exchange (eg relating to crypto asset trading platforms).

Finally, domestic crypto-currencies are an emerging key theme. For example, the People's Bank of China (PBOC) launched a pilot scheme for internal testing of digital currency in August 2020. Banks are also being permitted to custody crypto-currencies. The US Office of Comptroller of the Currency issued an interpretive letter in July 2020, concluding that national banks and savings associations have the authority to provide cryptocurrency custody services for clients. In Australia, one of the large domestic banks provided the market's first crypto custody wallet. But more regulation in this area seems inevitable: in October in the UK, for example, the FCA announced a ban on selling derivatives and exchange traded notes referencing certain types of cryptoassets to retail clients.

Continued regulatory change

All of the above is set amongst the common theme of disruption for banks, continued regulatory change – whether that be increased regulation or deregulation. Some of the regulatory change is politically driven, where other changes are due to the global spread of similar regulatory initiatives and harmonisation with international standards.

Importation of regulatory initiatives

Some regulatory change is occurring as a result of countries importing (perceived) successful regulatory measures from other jurisdictions. For example, in Australia, 2021 will see the implementation of changes to the way financial products are designed and distributed to retail customers. Australia is adopting similar measures to the UK and EU's product governance regimes, as well as implementing changes to the way certain financial services sectors are remunerated to minimise conflicts of interest and introduce best interest duties. In the Middle East, the Dubai free zone is proposing to enact a new recovery and resolution regime for the Dubai International Financial Centre (DIFC) institutions experiencing financial difficulty. This builds on similar regimes in most other countries, changes to the suitability assessments in advisory business models and the EU standards in the Markets in Financial Instruments Directive (MiFID) II. Finally, most jurisdictions (such as the UK, Europe, Hong Kong, Singapore, the US and Australia) have implemented or are in the process of implementing (eg South Africa and Malaysia) measures designed to increase personal accountability by senior executives within banks. These measures are also being extended to other adjacent financial services sectors. We are seeing regulators take more action against individuals globally and have launched a client tool to help individuals navigate these investigations in the most harm-limiting way.

Global harmonisation

More and more markets are adhering to global standards. Some have been mentioned already (eg the climate change disclosure standards). Markets like the Middle East (Abu Dhabi) and South Africa are adopting liquidity risk management frameworks aligned with Basel III liquidity standards. Globally, anti-money laundering and counter-terrorism financing reforms have been enhanced.

Where to now? The way forward for global regulation

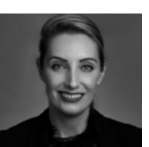
While there are some lessons the financial services industry can take from the previous global financial crisis when planning the way forward, a key difference is that the challenges the industry faces today are not focused in the financial services or banking sphere. In the main, the Group of Twenty (G20) reforms were delivered via the regulation of one sector. The Financial Stability Board (FSB) provided clear leadership at that time, and at regional and country levels, and responsible delivery agents could be reasonably and clearly identified, such as finance ministries, regulators and central banks. With Covid-19, and the converging environmental, social, technological and political challenges faced across the globe in 2020, an approach focused on one sector is impossible. A much more holistic perspective is needed, with banks and the financial sector potentially contributing to solutions. Those solutions will require considerably more political will and global cooperation than is currently present. However, there are shared and common challenges to unite the industry and begin paving the road out.

There is a leadership vacuum on a global level, a situation magnified by the current US administration stepping back from global bodies such as the World Health Organization. And while the outcome of the US elections in November 2020 will be important, overt focus on US politics risks not seeing the wider context in which other countries are emerging as increasingly influential, not least Mainland China. According to International Monetary Fund data, while the US retains its gross domestic product (GDP) prominence, in terms of GDP based on purchasing power parity (PPP), Mainland China has already surpassed the US.

The way through Covid-19 will require the financial services industry to collaborate and innovate on a scale not seen before. With the impacts on global regulation entrenched in complex social, environmental and political activities and changes, there is no space for siloes, nor for quick or simple fixes. However, the solutions and smart strategies out of the crisis will be found by facing into changing regulation, anticipating challenges and looking holistically, well outside of the banking industry, for threats and opportunities. A global perspective and multi-sector approach to tackling regulation will provide a solid platform to navigate through known, and unknown, changes and create a stronger, resilient sector into the future.

This article touches on a number of topics explored in greater detail in separate articles in this publication. For further reading, please visit the table of contents and navigate to the relevant article.

Asia



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Expanding horizons – The new banking workplace

Prior to 2020, remote work was often discussed in the financial services and banking industry, with some institutions adopting it as a flexible practice for suitable teams and divisions. However, in most jurisdictions it had not been fully embraced or utilised as the primary mode of working. The Covid-19 pandemic has since changed this, and has forced the virtual workplace upon the industry. The end result of experimenting with this way of working throughout Covid-19 has the potential to shape the future of the banking workplace.

The challenges of a remote workforce

Prior to Covid-19, remote working arrangements were sparingly utilised. Australia has consistently been ahead of the curve on remote working, while ironically, in Asia, where digital banking and technological innovation have been largely embraced, remote working arrangements were less popular. Stated concerns that have held institutions back from utilising remote work include:

- reduced productivity;
- a decrease in the quality of work based on reduced oversight;
- a fear of less innovation, based on less in-person interaction;
- regulatory issues for jobs with mandatory compliance requirements that require real-time communication;
- data security concerns;
- developing and mentoring employees remotely; and
- mental health concerns from isolation and finding a work/life balance.

Adapting to the new normal

Covid-19 has forced financial institutions to disregard these concerns temporarily. At the time the pandemic hit, there were a number of institutions unprepared to support a large workforce of remote users and/or to ensure the safety of data being accessed. Solving these problems became necessary, and based on technology upgrades, most institutions are now capable of supporting large-scale remote work.

Remote working – here to stay?

Importantly, just because the capability is there doesn't necessarily mean this way of working will remain in the future. Most institutions are hesitant to provide concrete long-term predictions based on what they perceive as a temporary situation. However, if the PwC study, that surveyed 50 executives and 144 employees at US financial services firms, is any indication, participants predicted that

70% of financial services companies will have 60% of their workforce working from home at least once a week after the pandemic has passed.

Virtual leadership

If remote work becomes the norm, other challenges will present themselves, not least how to develop junior talent and embed a positive and collegial culture from a distance. As institutions increasingly seek leaders with data and technology expertise, they will also need to find leaders who are capable of building relationships and trust in this unique virtual environment.

In demand – technology and people

Before Covid-19, banks were already updating their technological infrastructure and shifting away from legacy systems to be able to compete with agile fintech startups and big tech companies. Covid-19 has only highlighted why this is necessary and helped to accelerate the pace of change. This need for agility has extended to hiring, training, and leadership decisions. Banks are actively seeking employees and leaders with data and technology-driven expertise, in order to

Pre-pandemic statistics on remote working in the banking industry

Region	Remote working arrangements
EU-27 Countries	In 2018, approximately 5% of employees in the financial services industry typically worked from home and approximately 26% sometimes worked from home.[3]
United States	Prior to Covid-19, approximately 29% of financial services institutions had at least 60% of their workforce working from home at least once a week.[4]

"In the banking industry, automation, fintech startup companies, advances in robotics, machine learning and artificial intelligence (AI), as well as the increased use of algorithms and blockchain, are transforming the skillset needed by the future banker."

be able to effectively adapt to the changing market. This focus on flexibility, both in the bank's technology infrastructure, as well as its people, is a consistent trend across the globe.

Efficiencies and opportunities

In an oft-cited 2017 study from McKinsey, it was predicted that automation would eventually replace up to one third of the tasks currently performed by humans.[1] In the banking industry, automation, fintech startup companies, advances in robotics, machine learning and artificial intelligence (AI), as well as the increased use of algorithms and blockchain,[2] are transforming the skillset needed by the future banker. Unforeseeable advances will no doubt continue this process.

The McKinsey forecast – and similar studies that have followed – have not been overly grim in their outlook. Instead, the studies acknowledge that while a large subset of duties will be automated and job efficiencies created, other opportunities will evolve and come to the fore along with the change. This, by and large, has been the global banking experience.

So while technological advances are changing the job landscape, alongside the pandemic, opportunities are opening up where there is innovation and growth for institutions and individuals with the right capabilities.

Expanding horizons

While detailed predictions for the future based on a temporary response to a worldwide pandemic is impossible, we do believe remote work opportunities are likely to expand. As the pandemic continues to force banks to experiment with the virtual workplace, and the results become more quantifiable in both employee productivity and satisfaction, employers will be able to judge which of the above-stated concerns are legitimate – and if so, how best to address them.

1. Cognitive Technologies in Capital Markets, McKinsey & Company, July 20, 2017.
2. For a more complete list of digital technologies disrupting the banking industry, see OECD (2020), Digital Disruption in Banking and its Impact on Competition http://www.oecd.org/daf/competition/digital-disruption-in-financial-markets.htm
3. European Commission, Telework in the EU before and after the COVID-19: where we were, where we head to, June 2020.
4. PwC, US Remote Work Survey, July 2020.

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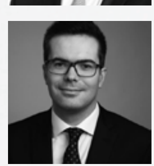

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In the spotlight: Syndicated lending

Syndicated lending plays a crucial role in funding corporate cashflow and major projects. However, considering the requisite level of interaction between competing institutions, it can pose significant competition law risk. With ongoing scrutiny of these activities by competition authorities, there is mounting pressure on lenders to minimise risks.

A sector under scrutiny

In recent years the financial services sector has attracted unprecedented attention from competition authorities globally. Previously, many in the sector believed competition law did not apply to syndicated loans in the same way as it applies to other financial activities. However, developments in recent years have confirmed this is not the case, with significant enforcement activity since the financial crisis. In 2014, the Loan Market Association published a note on the application of competition law to syndicated loans, strongly encouraging its members to take legal advice and adopt compliance measures.

A number of national regulators have investigated aspects of syndicated lending under competition law in the last decade. In 2017, the UK Financial Conduct Authority (FCA) issued warning letters to several lenders in relation to disclosures of competitively sensitive information, specifically regarding terms and conditions of syndicated loans. In 2018, the Spanish competition authority fined four major Spanish banks €91 million for colluding to fix the price of interest rate derivatives associated with the syndicated loans financed by those banks. The authority left the question open as to whether the requirement to take these ancillary products from the syndicated lenders gave rise to any competition issues in itself.

Close review in the EU

The European Commission, having voiced concern that syndicated lending was particularly vulnerable to anti-competitive conduct, commissioned a report by external consultants. The report, published in 2019, focused on loan syndication and its impact on competition in credit markets in the European Union (EU). The report concluded that although market features and safeguards tend to limit the risk of competition law breaches, certain practices could give rise to concerns about collusive behaviour and the exertion of bargaining power. The report made a number of recommendations for safeguarding competition in this area.

These findings may act as a platform for the Commission and/or national competition authorities to open sector enquiries, initiate competition investigations into specific firms or conduct, propose regulation or issue guidance. In current circumstances, the approach of lenders to refinancing where borrowers are in financial distress is likely to be of particular interest. The report noted concerns where lenders form a negotiating committee to agree key terms of the refinancing (which was said to enhance the risk of lenders exercising excess bargaining power), or bundle additional services as a condition of refinancing.

The Australian test case

The financial services sector has been an enforcement priority of the Australian Competition and Consumer Commission (ACCC) for a number of years. A dedicated Financial Services Unit within the ACCC was established in 2019 and is active in investigating and prosecuting allegations of anti-competitive conduct in a range of areas.

The ACCC has publicly indicated that it considers syndicated activity (including syndicated lending) to be an area with potential for competition law contraventions.

The most notable development in this area is the ACCC's criminal cartel prosecution (with the Commonwealth Director of Public Prosecutions, or CDPP) of ANZ, a number of underwriting banks and six senior officials from those banks. In what is being regarded as a test case for syndicated activity, the ACCC and CDPP are alleging there were discussions between the underwriting banks and ANZ concerning a shortfall in the share placement, which amounted to criminal cartel conduct. One of the underwriting banks obtained immunity from prosecution by reporting the alleged conduct to the ACCC. The progression of this case through the court system is being closely monitored by the banking and legal communities in Australia. It is hoped that the case will provide clearer guidance on the application of competition law to syndicated activities, as well as insight into the prosecution of criminal cartel conduct in Australia.

In the wake of this prosecution, the financial services sector in Australia has implemented measures to address potential competition law risks for syndicated arrangements. The Asia Pacific Loan Market Association has included language within its standard documents and created specific guidelines to support competition law compliance for lending syndicates.

A growing focus in Asia

Syndicated lending is not yet the target of enforcement action in Asia. However, given the similarities between many regimes in Asia and the EU competition law regime, it is widely expected that the EU approach to syndication and other joint activity will hold in many parts of Asia. Accordingly, there has been a significant increase in training and awareness of competition issues.

Earlier this year (28 April 2020), the Hong Kong Competition Commission and Hong Kong's Securities and Futures Commission (SFC) executed a memorandum of understanding (MOU), aimed at enhancing collaboration, particularly in respect of competition issues in the securities and futures industry. While the SFC does not have concurrent competition powers (unlike the UK's FCA), the MOU provides for greater scope to exchange information and for each authority to notify the other on issues that may have a significant impact on that other party.

In Mainland China, the overall trend for the financial sector is towards deregulation, in favour of competition and generally opening up the sector. While the primary competition authority in Mainland China is the State Administration for Market Regulation, the China Banking and Insurance Regulatory Commission (CBIRC) also has supervision of some competition cases. The CBIRC has actively pursued the tying and bundling of ancillary services with the underlying loan in the insurance market.

Most recently, a trade association has raised concerns that the fees provided by securities companies in the bidding for underwriting bonds were too low and out of step with the association's rules. This case may shine a light on the role of trade associations in these markets and lead to greater scrutiny of established practices in the sector.

Risk mitigations

In light of these developments, and against the backdrop of a challenging economic climate, financial institutions should anticipate further scrutiny of syndicated lending activities by competition regulators in the near future. Pre-mandate market soundings and refinancing negotiations may be particular areas of risk in this context.

Implementing measures to improve or reinforce competition law compliance can reduce the risk of competition law infringements occurring and mitigate the potential penalties or other sanctions that may result from a competition investigation. They can also help set a positive tone in interactions with competition regulators.

In an area as complex as syndicated lending, it is crucial that internal policies, procedures and training are appropriately tailored to ensure risks and safeguards are understood by the business in practical terms.

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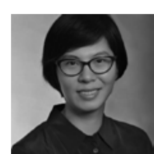

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Mitigating government risk through economic crisis or political change

In an economically and politically volatile world, a broad range of governmental or "state" actions (including legislative, regulatory, policy and even attitudinal changes, as well as the inability of a state to honour its debt commitments), can have a significant impact on the interests of banks and financial institutions.

Banks have turned to investment treaty protections to seek recompense when their investments have been undermined by state actions. This includes circumstances in which actions are arbitrary, discriminatory, unfair or breach a bank's legitimate expectations.

Past claims for breaches of protections under investment treaties have related to:

sovereign debt restructurings;

abandonment of exchange rate controls and mandatory re-denomination of loans;

compulsory acquisition of loans;

non-payment of principal and interest under state-issued debt instruments;

compulsory administration of banks; and

state bail-outs.

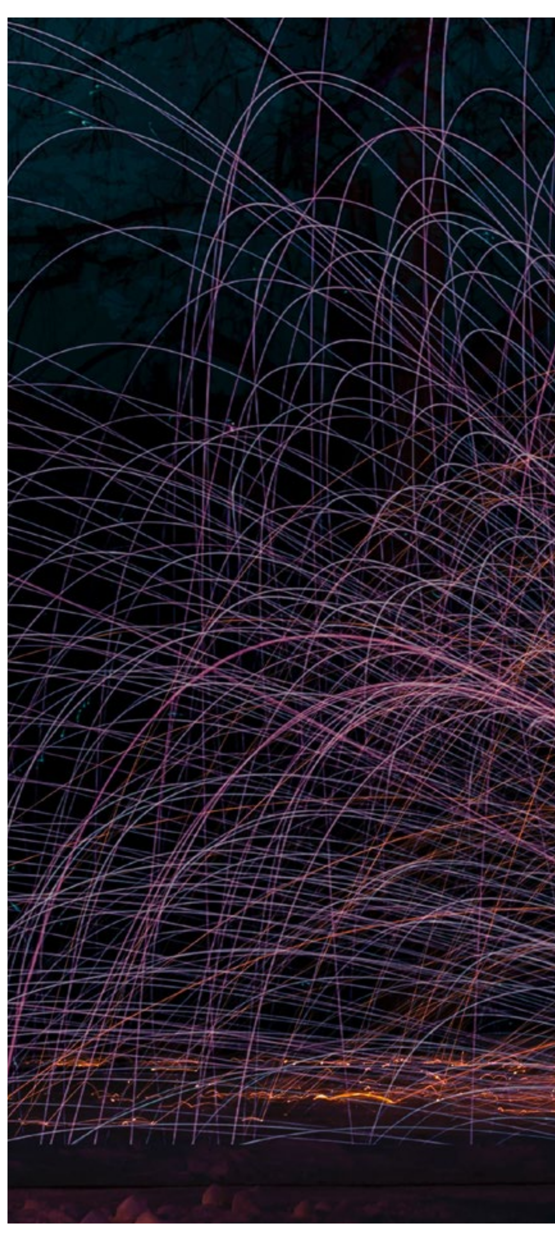
By structuring an investment in a way which brings it within the scope of treaty protection, banks and financial institutions may be able to mitigate against the risk of state action damaging their investment. Awareness of these protections can also help investors to enhance their negotiating leverage with the state.

Investment treaties in context

An investment treaty is an agreement between two or more countries (states), which contains reciprocal undertakings for the protection of private investments made by the nationals of one state (the "home state") in the territory of the other state (the "host state"). Such treaties usually allow harmed "investors" to make a claim directly against the host state, in respect of damage to the investment caused by the host state's action, which breaches the promised protections.

Protection under an investment treaty does not depend on a contractual relationship with the government whose actions harm the investment. Indeed, such protection generally exists in parallel to any claim under contract or domestic laws (see Deutsche Bank v Sri Lanka case study). Moreover, a treaty claim may enable an investor to recover damages in respect of the harm to its investment caused by the host state's action, where there may be no other avenue of recourse.

For example, a state may impose currency exchange restrictions and dramatically devalue its currency, wiping millions of dollars off the value of foreign investments and preventing investors from entering into currency transactions to lessen the impact of the measures. Provisions in the investor's contracts with private parties may respond to this change (such as force majeure provisions), but these are unlikely to allow investors to recover losses attributable to the measures. Domestic law may not offer any, or any effective, way of obtaining



compensation, even if the changes are unreasonable. However, the foreign investor may be able to seek damages from the state if there has been a breach of protections under an applicable investment treaty.

A bank or financial institution would usually qualify as an "investor" for the purposes of a treaty simply by being domiciled in a home state. The question as to whether there has been a qualifying investment will depend on the treaty criteria, but many investment treaties refer to "every kind of asset" with a non-exhaustive list of categories including shares in companies, claims to money and property.

An agreement between two or more countries ("states") containing reciprocal undertakings for the promotion and protection of private investments made by nationals of the signatories in each other's territories. Includes a right to arbitrate for the investor.

Protections under investment treaties

Investment treaties commonly promise a number of protections and standards of treatment to investors of the home state, in respect of their investments in the host state. These include:

- A promise not to expropriate an investment without payment of adequate compensation. This promise may catch a series of governmental acts which result in the investment being substantially deprived of value. For example, an expropriation has been found in the context of the interference by Sri Lanka with contractual rights under a hedging agreement between Deutsche Bank and the Sri Lankan state oil company (see Deutsche Bank v Sri Lanka case study).
- A promise to ensure fair and equitable treatment (FET). Claims under FET provisions typically involve a denial of justice in local courts, or a failure of governmental decision making (eg where the state's exercise of power is arbitrary, procedurally unfair, discriminatory, or failed to protect an investor's legitimate expectations at the time of its investment). For example, in *Saluka Investments BV v Czech Republic*, a breach of the guarantee of FET was found in the context of the Czech Republic's forced administration of a local bank and its sale at a nominal price. This sale impacted the investment in the bank by Nomura's subsidiary, Saluka Investments, and deprived Nomura of management control.
- A promise of full protection and security, which is generally understood to concern physical protection, but may also encompass legal protection.
- Promises of treatment no less favourable than that given to "host" state nationals or nationals of third states.
- The right to repatriate profit and capital. Particularly in the context of economic crises, where balance of payment issues may be at the forefront of state decision making, the promise not to restrict outbound transfers by an investor can be an extremely relevant protection.

When protections are breached: Investor-state dispute settlement (ISDS)

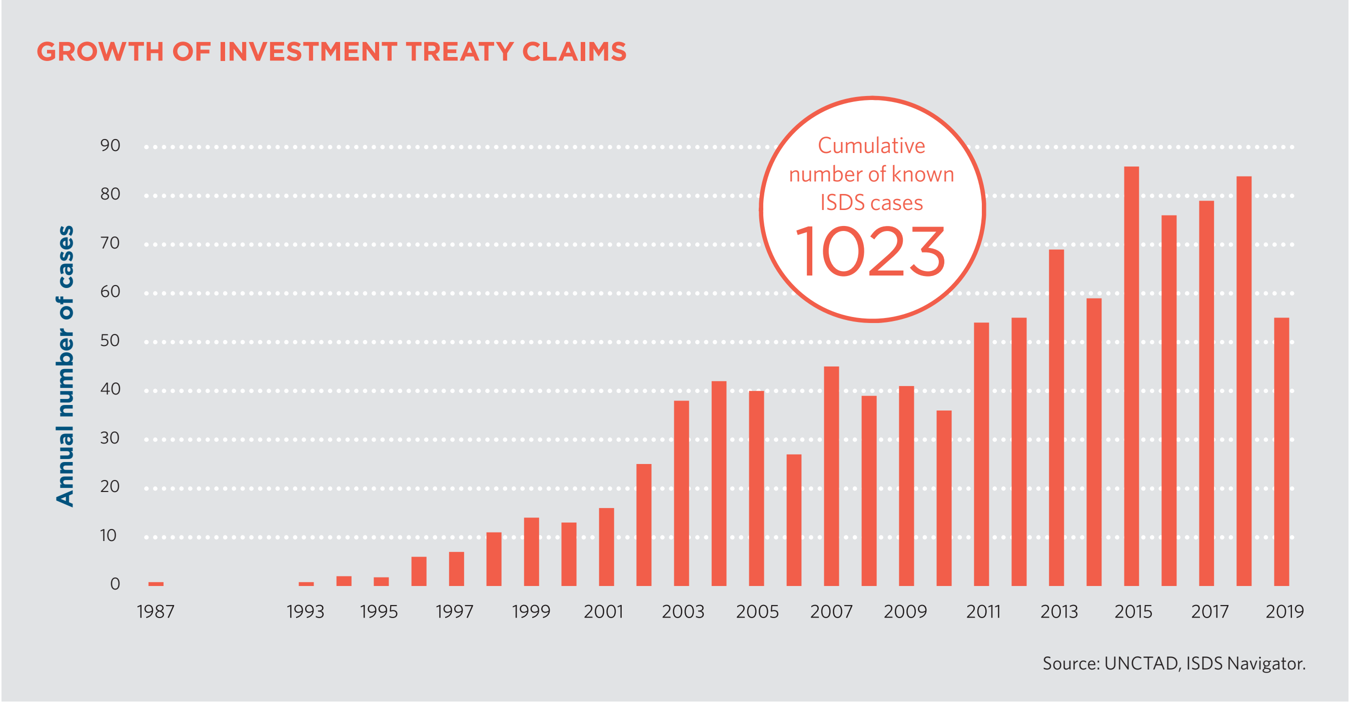
Most investment treaties provide for the investor to elect to arbitrate disputes between it and the host state before an independent arbitration tribunal. This avoids having to bring a domestic claim against the host state in its own courts, side-stepping concerns such as timely resolution or independence from the state.

Moreover, the availability of a right of action against a host state can be a useful point of leverage in seeking to encourage a state to modify its damaging behaviour. An increasing number of governments are aware of the impact of their treaty obligations and are disinclined to face avoidable meritorious claims. Further, a considerable proportion of investor-state disputes settle. The United Nations Conference on Trade and Development (UNCTAD) reported at the end of 2019 that of all known claims brought by investors against states, 21% had settled.

Maximising investment treaty protections

Where there is no treaty in place between the investor's home state and the host state that incorporates substantive protections and ISDS provisions, it may be possible to structure the investment through an entity in a country which does benefit from such a treaty. For example, if an Italian banking group sought to establish a presence in Algeria, in the absence of a treaty in force between Italy and Algeria, the investment might instead be made by a Dutch subsidiary and would be prima facie covered by the investment treaty between Algeria and the Netherlands. Structuring for investment protection can be considered at the same time as reflecting on the other operational or tax efficient elements of the investment structure, and factored into the assessment of country risk.

Given the likelihood of continued regulatory interference, economic instability in the medium-to-long-term, and the pace of political change across many parts of the world, extra-contractual protections will continue to be relevant to banks and financial institutions. A sophisticated approach to risk management permits banks and financial institutions to consider the availability of investment treaty protections when making their investments, including structuring investments to maximise the potential benefits.



CASE STUDIES:

Deutsche Bank v Sri Lanka – bank successfully claims over US$60 million from Sri Lanka in relation to court and Central Bank actions

Deutsche Bank (DB) was one of a number of international banks that entered into a hedging agreement with Sri Lanka's National Oil Company, Ceylon Petroleum Company (CPC). With a drop in oil prices, CPC was left exposed and, after public pressure, the hedging agreements were targeted by actions of the Sri Lankan state. The Supreme Court prevented all payments by CPC under the hedging agreements and ordered the Central Bank to carry out an investigation. Around the same time, DB terminated the hedging agreement and was owed a close-out payment of around US$60 million.

Thereafter, the Central Bank's investigation alleged irregularities in relation to the hedging agreements and the Monetary Board ordered each of the banks not to "proceed with, or give effect to, these transactions".

CPC's failure to make payment to DB gave rise to a contractual debt claim against CPC. However, DB commenced an arbitration against Sri Lanka under the investment treaty between Sri Lanka and Germany on the basis that Sri Lanka's actions interfered with DB's contractual rights, modified CPC's obligations and prevented CPC from making payment. As Sri Lanka was likely to prevent CPC from satisfying any judgment in a commercial claim, a treaty claim offered better prospects of enforcement.

The majority of the tribunal found that DB's hedging agreement was an "investment", and that Sri Lanka had (i) breached the obligation to provide "fair and equitable treatment" and (ii) expropriated DB's investment. The tribunal awarded DB approximately US$60 million plus interest and costs. DB and Sri Lanka were later reported to have settled DB's claim.

Claims arising out of Argentina's sovereign debt restructuring

A number of investment treaty claims arose out of the Argentine financial crisis. In December 2001, Argentina defaulted on its sovereign debt, suspending payment of government bonds. Argentina sought to restructure its debt, offering a voluntary exchange of its sovereign bonds for new bonds on different terms, and then passed legislation which unilaterally changed the terms on which it would make payment. In 2007, certain Italian bondholders brought a claim that the terms of the exchange offer, and the restructuring, breached the fair and equitable treatment standard in the investment treaty between Italy and Argentina. The arbitration tribunal constituted under the treaty accepted jurisdiction over the "mass" claim and recognised that the bonds constituted an "investment". Against this backdrop, the bondholders then settled their claims.

Claims triggered by Croatia's response to the unpegging of the Swiss Franc from the Euro

A number of investment treaty claims are pending against Croatia in respect of legislation passed in 2015, following Switzerland's decision to unpeg the Swiss Franc from the Euro. This made it significantly more expensive for Croatian citizens to repay Swiss Franc-denominated loans, leading the Croatian government to pass a law permitting borrowers to convert such mortgages to Euros. Even before the law was passed, the validity of the Swiss Franc currency clauses and variable interest rate provisions were challenged in domestic litigation as being based on unfair banking practices. The Croatian Supreme Court upheld this, finding further that the banks had violated the consumer rights of the borrowers by making Swiss Franc denominated loans without negotiating the terms individually.

Faced with interference with their contractual rights, Société Générale S.A., UniCredit Bank Austria, Raiffeisen Bank, Addiko Bank and Erste Group Bank have all turned to investment treaties to bring claims.

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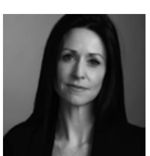

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Recalibration and resilience: Lending in Covid-19

The year 2020 has seen every business, in every sector, grapple with the effects of the global Covid-19 pandemic. The changes wrought by the pandemic's extraordinary circumstances are far reaching and continue to unfold.

In many jurisdictions, the banking sector found itself supporting state governments in their response to the crisis. The pressure has been on for banks to support consumers and the corporate sector, as salaries and business revenue streams falter.

Changes to local insolvency frameworks have been made in many jurisdictions – some temporary and some permanent – and counter-cyclical tools have been activated by regulators. Volumes of non-performing loans (NPLs) are predicted to grow, with losses expected to materially reduce banks' capital ratios over time.

Most bank balance sheets have changed substantially over the past six months. So what happens next? Some capital alleviation has been offered, but this can only go so far without threatening the stability of financial institutions.

The financial sector has collaborated with governments to support the economy through Covid-19.

Consumer and SME forbearance

Throughout Europe, regulators have issued directions requiring banks and other lenders to grant forbearance to consumer borrowers, focusing primarily on payment moratoria to bridge the period of greatest volatility. Small to medium enterprise (SME) lenders have tended to adopt a similar policy, out of necessity. In Hong Kong, the banking industry has also introduced various measures to help SME and retail customers, including repayment holidays, extension of loan tenors and special loans to customers impacted by the pandemic, among others. Similar measures have been introduced in Singapore to help individuals meet loan and insurance commitments, and to support continued access to bank credit and insurance cover.

Initial forbearance periods are now coming to an end in most cases, and initial indications are that the majority of consumers and many SMEs are choosing to resume payments. Nevertheless, as the wider economic effects of Covid-19 come to bear, the expectation is that NPL volumes will increase considerably over the short-to-medium-term, with consequential credit impairments and losses.

Government-backed loan schemes

Many European states have offered government guaranteed loan schemes to support the corporate sector, with varying degrees of success. Restrictions on participation in the schemes (on the borrower side) and dealings in the guaranteed credit assets (on the lender side), led to challenges in implementation, but most institutions participated in the schemes to a greater or lesser extent.

In France, Herbert Smith Freehills (HSF) worked with Bpifrance and the French Government to implement the legal framework for the French government-backed loan scheme, which has been successful despite the challenges associated with implementing a legal framework for both SMEs and large companies.

In Hong Kong, a 100% guarantee loan scheme backed by the government is aimed at alleviating the burden of between 20,000 and 50,000 SMEs struggling to pay employee wages and rents. Applications opened on 20 April 2020 and will close on 19 April 2021. The government already offered 80-90% guaranteed coverage under various schemes. However, many banks were still reluctant to lend to SMEs given the residual risk. By contrast, Singapore has eased monetary policy to maintain price stability, reinforced financial stability and ensured liquid and well-functioning funding markets so banks can continue to provide credit to individuals and businesses.

Some scheme windows are now drawing to a close, and already concerns are rising in relation to impaired assets on bank balance sheets and unsustainable debt.

Insolvency in the wider corporate sector

Many jurisdictions have also implemented temporary or permanent amendments to insolvency codes, in order to provide breathing space to businesses. Lenders will have to grapple with new and changing regimes in order to start to resolve problem credits.

Legislative changes and relief packages have provided some respite, but in many cases this will be temporary.

The most immediate challenge for banks (in connection with state-mandated payment moratoria and restrictions on enforcement) was the balance sheet treatment of impacted loans, both for accounting and capital purposes. Led by the Basel Committee on Banking Supervision (BCBS) and European authorities in the European Union (EU), many states and local regulators have issued guidance, and in some cases legislative amendments, to confirm that the existence of a payment moratorium should not automatically classify an exposure as "in default" or trigger "days past due" for capital purposes, particularly in the case of assets benefiting from a state guarantee. Relief has also been forthcoming in respect of the impact of "expected credit loss" accounting under International Financial Reporting Standards (IFRS) 9, including by extension of transitional arrangements. However, European authorities also emphasised that any prudential classification should be considered on a case-by-case basis and financial institutions are still expected to closely monitor their exposures.

As the initial period for Covid-19 moratoria comes to an end, lenders will need to look carefully again at their assets to determine whether borrowers who are not able to make payments on the revised schedule (whether benefitting from extended moratoria or not) have become credit impaired. Banks may also be left with residual risk in relation to state-backed loans, if the government guarantee does not apply to the full principal exposure or only applies once enforcement proceedings against the borrower are exhausted.

In the UK, the temporary restrictions on creditors commencing winding-up proceedings have been extended to 31 December 2020, with courts anticipating a deluge of work as the pent up demand is released. Some borrowers may seek formal protection by commencing either a moratorium or a restructuring plan, which are the two new procedures introduced in the UK in June 2020. However, these procedures are untested and it is not clear how effective these will be or what impact they will have in the UK's traditionally creditor-friendly regime, given a number of exclusions apply to financial institutions.

The response options for banks are: raise capital and/or sell assets. There are pros and cons with each option.

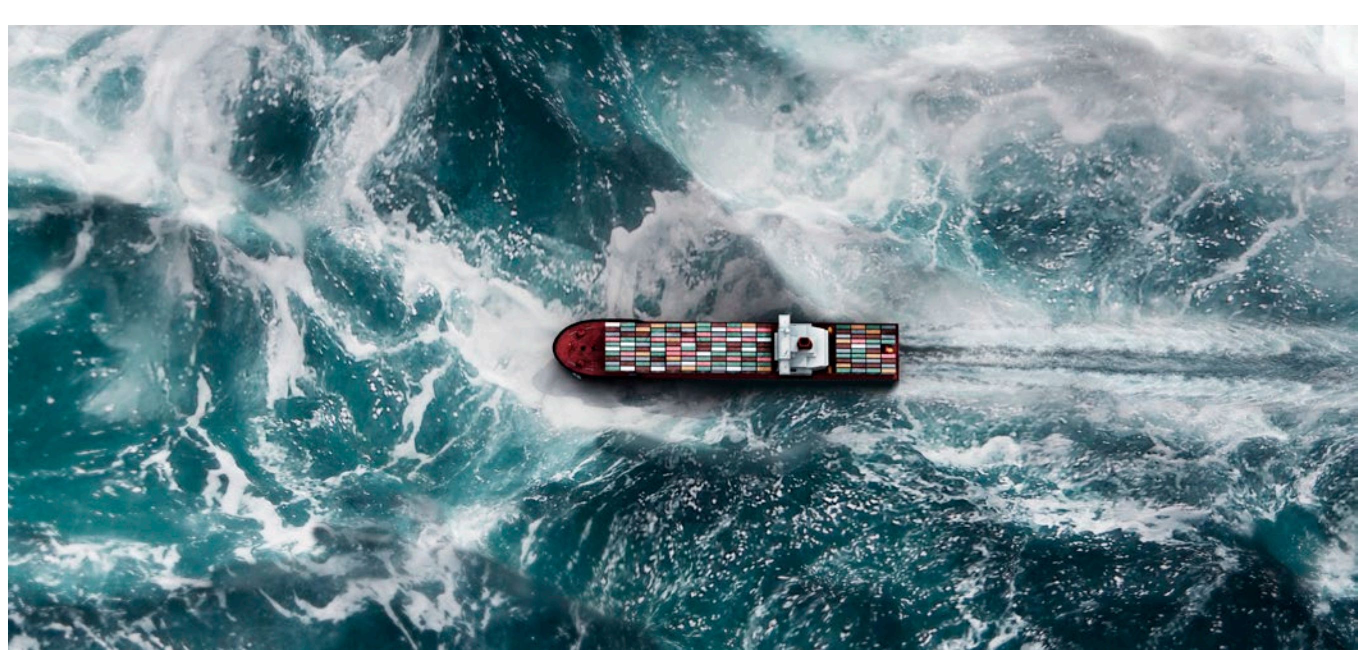
Rebuilding and recalibrating

As we move into looking at the longer-term implications of the crisis, the financial sector will need to take stock, and think about next steps. During the past few months, banks have been able to take advantage of certain relaxations of prudential capital requirements. Banks can leverage requirements (including use of counter-cyclical capital buffers, where implemented), to permit access to credit, notwithstanding the pressures on business and the economy as a result of lockdowns and reduced operations. In Europe, banks' balance sheets have also been strengthened by the dividend suspension guidance issued by the European Central Bank (ECB) and the UK Prudential Regulatory Authority (PRA). However, as time moves on regulators will expect institutions to start rebuilding their balance sheets, whether through capital raising, strategies to restructure or divest distressed assets and non-core assets, or a combination of these approaches. The ECB has reminded European banks that their targets to reduce NPL exposure may need to be recalibrated, but must remain a focus.

While bank capital ratios are much stronger today compared with even the recent past, this may provide only a partial defence against the severe shock that the pandemic has triggered. Where there is a material capital concern, the financial sector is likely to seek to pre-empt capital and liquidity concerns through rights issues, or other traditional forms of equity capital fundraising as part of their broader recapitalisation strategy, in addition to other capital preserving measures.

Large equity capital raisings, such as preemptive rights issues, are typically subject to long timetables. EU regulators have sought to accelerate the execution of large equity fundraisings (through the adoption of short form "recovery" prospectuses), in light of the exceptional circumstances. However, bank issuers are unlikely to enjoy the full benefits of these disclosure relaxations, given the need to comply with US securities law-based disclosure requirements.

In the UK, there has been a significant (but temporary) increase to the size of equity fundraisings that can take place without a full pre-emptive rights offering to all



shareholders. This is now up to 20% of a company's issued share capital (up from a maximum of 10% prior to the pandemic). This has been widely taken up, as UK listed companies sought to repair the immediate balance sheet impact or raise equity opportunistically. For example, Herbert Smith Freehills acted on the £375 million cash placing by the insurer Hiscox, which represented 19.9% of its issued share capital and was raised on an opportunistic basis.

A number of these capital raisings have featured concurrent debt or convertible/hybrid capital raisings. Cornerstone-style investments by private capital have also made an appearance. All of these options available to banks, subject to their Additional Tier 1 (AT1) and Tier 2 capital requirements. Recent experience suggests that investors are focusing on subordinated bank capital debt in their quest for yield, resulting in more favourable pricing for issuers.

Banks will also be conscious that their capital raising options will ultimately be dictated by the size of the fundraising exercise and investor appetite, as well underwriting capacity. And, in extreme situations, the regulatory toolkit under the applicable resolution regimes can also be called upon where necessary, including state-backed recapitalisation (with stateaid implications also a key consideration in this scenario). In the case of challenger banks, a combination of regulatory focus on profitability and sustainability, and the impact of the pandemic on their underlying businesses, may accelerate activity in that market, particularly consolidation and any associated capital restructuring.

Asset disposals

As was the case following the Global Financial Crisis (GFC) of 2007-2009, bank balance sheet rationalisation may also take the form of asset disposals, whether through third party sales or securitisations. As an interim measure, the European Central Bank and the Bank of England have extended their liquidity operations to provide, inter alia, liquidity against loans benefiting from the new guarantee schemes. More substantial state intervention may play a part. This could range from relief/recovery funds raised to acquire or provide funding against impaired assets, to more complex proposals to restructure SME debt. However, it is by no means certain that such support will be forthcoming (the UK Treasury in particular has pushed back strongly on industry proposals relating to this). It is expected the private sector will play a significant role in acquiring and, if applicable, restructuring performing and distressed assets to help repair bank balance sheets once the dust settles.

Outside of the Loan Market Association (LMA) secondary debt trading market (which is primarily relevant for large syndicated facilities), sales of credit assets are generally undertaken on a portfolio basis, often with leverage. For balance sheet management purposes, the bank would need to demonstrate that sufficient risk has been transferred to the counterparty or counterparties to achieve capital relief (known as "significant risk transfer" or SRT). In Europe, the NPL and SRT markets have grown materially over the years since the GFC. The BCBS and the ECB, among others, have acknowledged the utility of securitisation structures in bank balance sheet management.

Various proposals exist for regulatory changes which would facilitate the sale and financing of NPL portfolios, and the use of securitisation to manage risk. These include tweaks to the prudential and regulatory framework to take into account certain aspects of NPL financing, as compared to "traditional" securitisation. In Europe, this would mean more certainty in relation to the SRT requirements so parties can structure transactions in accordance with a clear set of criteria. These proposals were under discussion prior to the pandemic, but seem likely to prove timely given the significant wave of NPLs expected over the coming months.

Considerable and complex challenges lie ahead for the banking industry. Banks will have to assess and manage new risks arising from the impacts of the crisis. Challenges from the rapid balance sheet growth associated with participation in government schemes, and support for clients during these unprecedented times, will also need attention.

Lessons learned in the years following the GFC will prove useful, and some of the reforms to capital frameworks as a result of that period have already shown their value in mitigating the impacts of highly stressed conditions. The task will be a marathon rather than a sprint. But if the industry can work its way back to sustainable capital levels, having shown that banks can provide support to consumers and businesses when it is most needed, this could go a long way to repair reputations damaged in 2007-09. This time, the banks have been on the side of the angels. Now they need to get back to solid ground.

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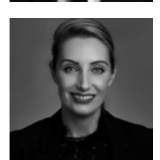
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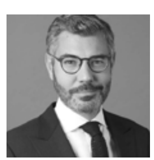
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