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COVID-19 IMPACT ON FINANCIAL SERVICES RISK AND COMPLIANCE

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Introduction

COVID-19 is an unprecedented calamity on human beings, society and the world in general. This pandemic has already taken several hundred thousand lives and has impacted human health across the globe.

The pandemic has also given a massive jolt to the global economy. Consumption is declining. Industrial production is nosediving. GDPs of all major nations are falling. Unemployment is increasing. Interest rates are falling. Development projects are getting deferred. Workforce productivity is dwindling. Stock markets are collapsing. Supply chains are getting shattered. Overall the global economy is staring at a big recession. This is the biggest challenge we are facing after the great depression of 1930s.

Being a key sector of the economy, banking and financial services industry has been affected tremendously. Organizations are struggling to keep vital services up-and-running. Revenues are contracting. Cost reduction pressure is increasing. New forms of financial crimes such as fraud and cyber security are erupting. Liquidity risk is growing. Workforce productivity has reduced due to remote working. At the same time, new workload is getting added to manage relief package activities. On top of it, day by day regulators are providing new guidelines, and revised compliance obligations are being enforced. These business challenges are having profound impact on technology side too.

This paper provides insights on the business and technology challenges faced by financial institutions, and how the industry is coping with the pandemic and managing its risks. Firms' risk management actions include both the short terms measures, as well as the development of strategic roadmaps to make their systems and processes resilient to such debilitating events.

Key Regulatory Changes

Given the disruptions that COVID-19 has caused, it's not a surprise that ensuring economic and operational resilience of the global financial system has become the topmost concern of regulatory bodies across the globe today. For the past few months, governments and regulatory agencies have been pursuing a range of measures to alleviate the pandemic's impact on world's financial stability.

Crucially, these measures have focused on ensuring continued lending by banks and on facilitating the banks' ability to absorb losses in an orderly manner. Understandably, the regulatory changes following the COVID-19 fallout are still dynamic in nature — depending upon how the pandemic unfolds in the coming months, more changes are in order.

Regulators are focused on implementing adequate measures to get financial institutions back on the path of recovery. For example, they have:

- Relaxed the implementation dates of new regulations
- Extended the submission deadlines for existing regulatory reports
- Suspended non-critical supervisory examination activities
- Allowed early adoption of risk/exposure calculation methodologies — this would positively impact liquidity
- Relaxed various buffers, and reserve ratio requirements

Global Changes

- Governors & Heads of Supervision bodies have announced the **delay of "Basel III – Implementation"** to enhance the operational capacity of supervisors and banks. Following are the changes in implementation timeline of outstanding Basel III standards:

Standard	Original date of implementation	Revised date of implementation
» Revised leverage-ratio framework & G-SIB buffer » Revised standardized approach for credit risk » Revised Internal Ratings Based (IRB) approach for credit risk » Revised operational risk framework » Revised CVA framework » Revised framework for the market risk » Revised Pillar 3 disclosure framework	1st Jan 2022	1st Jan 2023
• Output floor	1st Jan 2022; transitional arrangements to 1st Jan 2027	1st Jan 2023; transitional arrangements to 1st Jan 2028

- 'Basel Committee on Banking Supervision' (BCBS) along with the 'International Organization of Securities Commissions' (IOSCO) have decided to postpone the implementation of final two phases of 'margin requirements for the non-centrally cleared derivatives' by 1 year
- BCBS has opted to postpone the implementation of revised G-SIB framework by 1 year
- BCBS has amended 'regulatory capital' treatment of expected-credit-losses (ECLs). As per BCBS' amendments and jurisdictions —

  a) may apply current transitional arrangements, even in cases where these were not originally implemented (when banks had initially implemented the ECL model)

  b) may allow banks to change from the static approach to dynamic approach for determining 'transitional adjustment amount'

  c) may utilize alternative approaches (that are similar to the cumulative difference between provisions under 'ECL accounting model' and that under 'prior incurred loss' accounting model)

  d) for a 2 year period (2020 — 2021), may permit banks to add-back up till 100% of the 'transitional adjustment amount' to CET1

USA

- **Capital & credit risk:** The federal bank regulators have:

  1) allowed early implementation of a new approach on how certain banks need to assess counterparty credit-risk derivatives contracts

  2) provided optional-extension vis-a-vis the transition of regulatory capital for new 'credit loss accounting standard'

  Also, Federal Reserve has taken steps to support credit flow to businesses and households. These actions pertain to intraday credit, discount window, bank capital & liquidity buffers, and reserve requirements.

- **Counter party credit risk rule:** The Fed, FDIC and OCC have permitted earlier adoption of standardized approach (SA-CRR) for calculating exposure amount of the derivative contracts under agencies' regulatory capital rule. Furthermore, the SA-CCR have undergone many other modifications to the capital rule

- **Current Expected Credit Loss (CECL) Accounting Standard:** The Fed, OCC and FDIC have issued interim-final-rule allowing banks to assuage the effects of CECL accounting standard on the 'regulatory capital'. Under this interim final rule, banks that implement CECL prior to 2020 end have the choice to defer for 2 years an estimate of the CECL's impact on regulatory capital

- **Intraday credit:** FRB has decided to defer by six months the implementation of changes to its 'Payment System Risk' (PSR) Policy related to the provisioning of intraday credit to U.S. branches and the foreign banking organizations' (FBOs) agencies

- **Lending:** FRB has made a technical alteration which allows banks to continue-lending to creditworthy households & businesses

- **Regulatory reporting:** US SEC has provided publicly traded firms with additional 45 days to file specific disclosures

Europe

- **Capital requirements:** ECB has allowed banks to for the time being operate lower than the capital level defined by Pillar 2 Guidance (P2G), capital-conservation-buffer (CCB), and liquidity-coverage- ratio (LCR). The ECB has also recommended that national authorities slacken their required countercyclical-capital-buffers. Instruments that aren't considered as CET1 capital can be used to certain extent for meeting the Pillar-2 Requirements (P2R)

- **Stress testing:** EBA has postponed its EU-wide stress-test until 2021. It has also advised that national regulators think of postponing non-essential supervisory activities & offer flexibility in banks' regulatory reporting dates

- **Trading:** Regulators in Austria, Belgium, France, Greece, Italy and Spain have all issued temporary short selling prohibitions in the wake of extreme volatility in trading

- **Regulatory reporting:** EBA has asked competent authorities for one-month flexibility in reporting dates of FIs' Pillar 3 disclosures for the reports with dates of remittance between March & May 2020

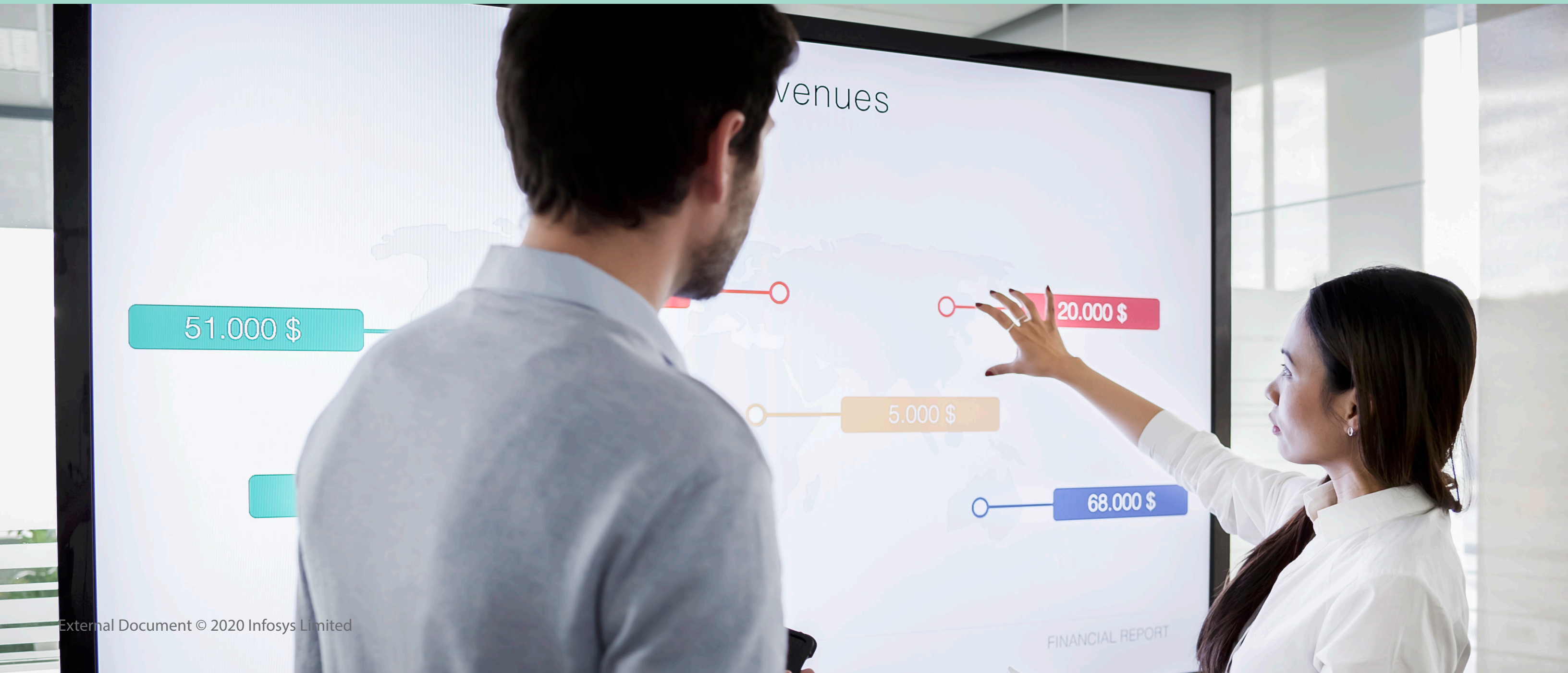
APAC

- In Australia, APRA, RBA and ABS have temporarily changed the reporting obligations of 'registered financial corporations' (RFCs) and 'authorized deposit taking institutions' (ADIs)

- The Singapore government has launched the COVID-19 Act to

  1) suspend particular contractual obligations

  2) limit certain insolvency & bankruptcy proceedings



Impact on Financial Risk Management Functions

Unlike the Great Recession of 2008, banks and financial institutions today are well-equipped owing to the various regulatory requirements. However high volatility in the markets, near-zero levels of interest rates, deteriorated credit quality, decline in collateral values, rapid liquidity shifts and tightening of liquidity, and deferred/ delayed or cancelled payments would continue to pose significant challenges to the industry for a prolonged period.

Refer below some of the key impacts of COVID-19 on the financial services industry, and the recommended actions for institutions.

Area	Key Impacts	Actions for Financial Institutions
Market & Liquidity Risk	• Increased volatility in markets cause high trading losses, affect earnings and capital preservations, generate big swings in the stress testing results, and lead to breaches limit/thresholds • Impact on trading books	• Review the internal models for 1) value at risk 2) asset liability management 3) funding liquidity, market liquidity risk, probability of liquidity shortfall 4) expected shortfall • Review and monitor liquidity stress testing reports, and liquidity coverage ratio results • Analyze the impact of liquidity shortfall, and secured funding/asset sales • Review capital allocations and hedging strategies • Communicate beyond the LCR requirements to the regulators • Contingency funding plan (CFP) — Liquidity preservation actions should be part of the plan
Credit & Counterparty Risk	• Decline in credit quality and value of collateral; and impact on valuations and funding costs • Freeze on loan payments, minimal or delayed loan payments • Current market & economic conditions would result in high probability of defaults — leading to loan losses • Change in overall creditworthiness of the counterparty	• Review the internal models for 1) probability of default, loss given default, exposure at default 2) current expected credit loss 3) risk rating and credit valuation adjustment • Conduct additional stress testing on loan loss under new scenario specific to COVID-19 • Frequently reassess counterparty's creditworthiness; diligently work with the intermediaries
Portfolio & Financial Risk	• Higher volatility, price movements and counterparty risks to have direct impact on risk-weighted assets • Fee income, net interest income to be much lower due to less banking activities and interest rate cuts	• Review the internal models for 1) capital forecasting 2) stress testing 3) estimation of forward looking P&L, balance sheet, cash flows 4) earnings/revenue loss • Create new scenarios specific to the coronavirus impact and conduct additional stress testing • Review the valuations and pricing computation models

Corporate Compliance

The COVID-19 pandemic is disrupting the global financial markets and is creating panic, uncertainty and distraction in the operations of global corporations. The severity and scale of the crisis has impacted business activity — testing the preparedness and effectiveness of firms' business continuity planning (BCP) decisions. The reliability and integrity of institutions' financial and operational information depends on strict compliance with new regulations, and the policy-based guidelines and processes put in place to protect the assets, resources, workforce and workplace required for conducting and sustaining business.

A Chief Compliance Officer (CCO) along with the compliance team should revisit the corporate compliance framework and principles — taking the impact of the pandemic into consideration. Compliance function has the responsibility of enabling compliance policy management. It entails the sourcing & analysis of raw-data and info from several legal experts, regulators, and industry-bodies; and implementation of corporate best practices to sustain organizations' business continuity, operational efficiency, loss recovery and the overall resilience to rebound from COVID–19 impact.

Compliance function's preparedness should be examined on all parameters — including the people, processes and technology dimensions.

People

At a time when large firms are reeling under the crisis of the pandemic, it is important that institutions adopt principled and practical policies to maintain:

a) ethical employee behavior

b) upright relationship with business partners, government officials and shareholders, and uphold the integrity of corporate values

It is not only essential to mitigate the systemic risks to the industry, but also go above and beyond to inspire confidence in the concerned organizations to sustain various industries and the overall economy.

Employees should be made aware of the consequences of not following ethical practices and guidelines. Employee trainings can help in creating such awareness. These trainings can be done online using video calls, video streaming, or email distributions.

Communication strategy, processes and tools should be revised to address effective, apt and timely communication between the team members.

Process

Financial institutions' various compliance process objectives need to remain aligned with the organization's overall corporate GRC vision. This is imperative for effective evolution of the firm's existing business continuity plan in accordance with the communication from regulators and local governments.

To protect themselves from non-compliance, firms should revisit the measurable indicators and thresholds with regards to third-party risk management. Periodic re-evaluation of various thresholds is also needed. Firms should also consider reviewing and revising their supplier contacts, as appropriate, to ensure compliance with the new regulations.

Technology

Firms should strengthen their capabilities related to data assessment, news feeds analysis, preservation of electronic evidence, supply chain management, crisis management systems, and risk controls. This is crucial for:

a) detecting discrepancies in compliance systems that may impact the firm's brand, reputation, and operational recovery

b) ensuring sustained regulatory compliance & reporting during the crisis

Enabling secure and effective collaboration platform to address the work from home needs of employees is also important.

Key Best Practices

- Review the data security, storage & retention plan — to allow effective data retention, retrieval, and disposition
- Automate key process controls
- Automate regulatory requirement change management across geographies — vis-a-vis policy definition, communication and storage
- Ensure timely communication and awareness of policy changes — via conference calls, helplines, policy training modules, and accessibility of compliance officers for responding to inquiries
- Institute standards and mandates for conducting business in unpredictable times by improving confidence, trust, and reputation
- Conduct audits to find and report defective controls or any alleged misconducts. This is important to ensure transparency while operating in times of crisis
- Periodically review and update the risk thresholds
- With regards to new regulatory changes, ensure effective organization change management such that it does not disrupt the operations of respective business functions

Conclusion

Owing to the COVID-19 outbreak, the year 2020 has been posing significant challenges to the global financial markets. The stressed markets and the tightening of liquidity has started taking its toll on firms' balance sheets. Compliance management and operational resilience of firms too are being tested to the limits.

The role of organizations' GRC function has come in spotlight. Institutions' risk controls and thresholds are being reexamined. Firms' models and controls have come under review — as the underlying inputs and assumptions have become out of sync with the scenarios during the pandemic. The focus on firms' stress testing, liquidity coverage ratio results, and credit quality review too has intensified.

For the foreseeable future, ensuring effective risk and compliance management should remain on top of every executives' mind. Firms need to continue leveraging their cross functional teams — including from risk, finance, operations, compliance, and business lines — to monitor risks, assess impacts, and take timely mitigation actions. Agile and strategic action plans, backed by implementation due diligence, would continue to be the need of the hour.

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