



# TAKING THE COMPLEX AND MAKING IT SIMPLE: GLOBAL RISKS AND TRENDS

For global firms operating in today's interconnected regulatory environment, there's an awful lot of complexity at work. And yet, if we don't embrace this complexity, how can we begin to deconstruct its component parts and more clearly identify the trends and risks that are likely to affect the way we operate? It is in this spirit that we approach some of the more complex issues facing the industry with the aim of better understanding them.

## Embracing (some of) the complexity

### Cyber risks

Large-scale cyberattacks are one of the top-rated global trends identified by the World Economic Forum Global Risks 2019 Report.<sup>1</sup> It is also one of the trends that have made it into position in our *Embracing Complexity* infographic.

While cybersecurity is a well-established area of focus for regulators and firms worldwide, the pace of developments on the regulatory and litigation fronts in 2018 and early 2019 suggests that cyber risk management will warrant even more attention, particularly by boards of directors.

Global businesses are increasingly gathering and monetising data and are at risk of significant cyberattacks. Such attacks can lead to reputational damage, negative media coverage and diminished customer confidence and trust. At a European level, regulators have tried to address such risks by introducing legislation such as the General Data Protection Regulation (GDPR), the Directive on security of network and information systems (NIS Directive) and the revised Payments Services Directive (PSD2). Outside Europe, other countries are also looking at cybersecurity issues (see Figure 1).

Boards are now recognising this problem as a major business risk, not just a technical issue, and are starting to act appropriately.

Figure 1. Outside Europe, other countries are also looking at cybersecurity issues:



### Sustainability and ESG

As well as being a hotly debated topic, the failure of climate change mitigation and adaptation is one of the top 10 risks for 2019 onwards, according to the World Economic Forum.<sup>2</sup>

Concerns about global warming mean that investing with a social conscience is rapidly becoming something that we must do, rather than something that we should do. Such considerations are currently in the process of being hardwired into EU legislation. Investment firms can expect further changes and consultations as the European Commission's sustainability action plan matures. Work will continue to develop through 2019 up to 2022.

European proposals are arguably the most ambitious: there are also a number of other global regulators and industry bodies looking to introduce their own strategies in this area.

### Systemic risks

For the most part, asset managers deal with risks according to market best practices. But what about risks for which best practices have yet to be fully established?

In February 2018, following work of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), the European Systemic Risk Board published its recommendations on liquidity and leverage risks in investment funds.

According to regulators, investment funds still have the ability to be a potential source

of systemic risk. Open-ended funds are of particular interest to regulators, who have a concern over so-called "liquidity mismatch", a situation in which some investment funds allow investors to redeem their holdings in a shorter time frame than that in which the fund could reasonably liquidate assets.

So far, anecdotal evidence suggests that most open-ended funds have been generally resilient, with the exception of some money market funds. However due to the sheer size and importance of the asset management sector, regulators feel they could still present a systemic risk.

In Europe, the European Securities and Markets Authority (ESMA) has been doing its own analysis on leverage and liquidity in alternative funds and on 28 February published a report on EU AIFs using data collected under the Alternative Investment Fund Managers Directive (AIFMD). The only concern it has identified so far relates to real-estate funds and ESMA says this finding merits further analysis.

Another area that ESMA will look at is hedge funds' use of leverage. Methods related to measurement vary across jurisdictions around the world. Here IOSCO has published a consultation.<sup>3</sup>

Regulators feel that it is essential that funds are adequately prepared for both normal and stressed market conditions, and liquidity stress testing has been identified as a means that funds and supervisors can use to monitor funds' resilience in the face of severe, but plausible, shocks.



Industry-wide macro stress simulations are increasingly being discussed at national and international levels, as a means supervisors can use to contribute to the monitoring of market and systemic risks.

As regards liquidity, international regulators are looking at exchange-traded funds, which seem to be increasingly used to gain exposure to less liquid assets.

#### **Darkening skies or lighter days ahead: geopolitical risk**

In the UK, Brexit deadlines continue to evolve. The European Union (EU) has agreed to a short extension to the Article 50 process, subject to approval of the Withdrawal Agreement by the UK.

European governments have also stepped up efforts to grant concessions to UK asset managers to limit the worst effects of a no-deal Brexit. France, Germany, Italy and the Netherlands are among countries that have so far amended their national laws to ensure UK investment companies can still serve their foreign customers in the event of a no-deal Brexit. Although firms will need to continue to assess requirements on a jurisdiction-by-jurisdiction basis.

The UK government has also rolled out its Temporary Permissions Regime, allowing EU managers to continue to sell investment products to UK consumers after Brexit. As the clock ticks down, some EU27 governments are introducing similar policies.

A high level of uncertainty also surrounds the economic outlook generally: including trade tensions, a potentially more sharply slowing Chinese economy and abrupt changes in risk

sentiment and growth expectations.<sup>4</sup> In a recent speech made by Singapore's Minister in the Prime Minister's Office and Second Minister for Finance and Education Indranee Rajah states that the immediate future is marked by uncertainty. Geopolitical events that are being played out and the accelerating pace of technological change present ongoing challenges to all sectors.<sup>5</sup>

Weakness in Europe and some emerging markets, US-China trade tensions and a possible no-deal Brexit have led the International Monetary Fund to cut its world economic growth forecasts for 2019 and 2020 and the World Bank, has warned of "darkening skies".

#### **Shift from regulation to supervision**

Following a long period of regulatory change, international regulators are now moving their attention to making sure that the changes introduced are both fit for purpose and embedded appropriately into business as usual. This has been reflected in what the FSB sees as a "pivot" from further policy development to dynamic implementation.

While vigilance will remain in monitoring for new and emerging risks, rigorous evaluation of implemented reforms continues to be undertaken. Work continues on legislation such as MiFID II, PRIIPs, the AIFMD review, to name but a few.

#### **Why culture will always matter**

The need for a robust culture has been understood by regulators at both national and supranational levels ever since poor culture and conduct were identified as one of the primary drivers behind the global financial crisis of 2007/8.

Efforts to improve culture and conduct (they are inextricably connected) have been linked by a number of regulators to legislative developments that have seen a shift towards personal accountability.

Driven in the UK by the Senior Managers and Certification Regime, which will be extended to all UK-regulated firms, including asset managers in December 2019, other regulators globally continue to follow developments and introduce changes where necessary.

Of particular relevance to asset management firms, in Australia, the publication of the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry calls for the Banking Executive Accountability Regime (BEAR) to be extended to all Australian Prudential Regulation Authority-regulated entities including insurers and superannuation funds.<sup>6</sup>

The Central Bank of Ireland is also considering the introduction of a Senior Executive Accountability Regime (SEAR). Director General Derville Rowland recently stated that as a result of the findings from a recent review, it has now proposed to government that it legislate for individual accountability measures to drive better behaviour. These will include proposed Conduct Standards for all staff in regulated firms, such as acting honestly, ethically and with

integrity; additional conduct standards for senior management; and standards for businesses.<sup>7</sup>

**Fair treatment of consumers**

Across the regulatory environment, we can see a clear focus from global supervisors who want to ensure the fair treatment of consumers, including “vulnerable” consumers. This forms the underlying basis for the multiple threads of global trends and risks shown in our infographic.

Regulatory bodies specifically looking at this subject over the next couple of years include IOSCO, whose members in October 2019 will participate in World Investor Week (WIW), a week-long global campaign to raise awareness about the importance of investor education and protection and to highlight the various initiatives securities regulators are putting in place in these two critical areas.<sup>8</sup> WIW offers an opportunity for IOSCO members to work in collaboration with all investor education and protection stakeholders at both local and international levels.

In Australia, the Australian Securities and Investments Commission (ASIC) Corporate Plan for 2018 to 2022 is looking to build trust among the broader community as the financial sector is facing unprecedented scrutiny. ASIC plans to be a strategic and forceful regulator, identifying and addressing practices that target financially vulnerable consumers, among other priorities.<sup>9</sup>

Figure 2. ASIC Corporate Plan for 2018-2022 Priorities



### Financial crime

Two issues shaped AML discussion in 2018: money-laundering scandals in Europe and the implementation of the first wave of cryptocurrency regulations.

Criminal typologies are changing as well, so it's no surprise that banks and other firms are drafting robots in to help. Machine-learning tools seem ideally suited to weeding out suspicious activity, for example. But it can also be hard to explain to regulators how some forms of machine learning reach their conclusions, presenting the industry with a different challenge.

From an asset management perspective, firms will be aware of adaptations in the regulatory space in the shape of the forthcoming deadlines for MLD5/6 in 2020.

### Costs and disclosure

In the interests of consumers, regulators around the world continue to pursue simple and meaningful cost disclosures for funds, which remain elusive.

An increasing number of regulators are also scrutinising the level of costs and charges, with closet tracking, disclosure of benchmarks and performance fees continuing to be headline issues.

The industry's remuneration practices are also under the microscope, with different potential outcomes for asset managers and fund management companies as a result of proposed changes to the capital requirements legislation.

Simply disclosing cost information does not necessarily empower the consumer to make effective decisions. In the UK, the Financial Conduct Authority (FCA) believes it is not just what is disclosed that is important but how information is disclosed too.

Also in the UK, at the end of February, the FCA published its key findings of supervisory work to assess the effectiveness of disclosure by asset managers and intermediaries, such as wealth managers, to their retail customers.<sup>10</sup> This work was prompted by new disclosure requirements on costs and charges introduced by MiFID II and PRIIPs, which came into effect in January 2018.

At the same time, the FCA also issued a consultation paper on publishing and disclosing costs and charges to workplace pension scheme members and amendments to COBS. Specifically for asset managers, the review identifies problems with the way some calculate transaction costs and how prominently they disclose them. The FCA also finds that asset managers generally do not disclose all associated costs and charges, and where full disclosures are made, inconsistencies between documents and website mean consumers can find the information difficult to understand.

More broadly, other initiatives are applying competitive pressures on asset managers, such as the UK FCA's Asset Management Market Study (Assessment of Value).

In practice, investors continue to demand fee discounts from asset managers, while regulators expect asset managers to assess value for money, one element of which is cost.

### LIBOR transition

Regulators globally have signalled that firms should transition from LIBOR to alternative risk-free-rates, so market participants need to plan accordingly.

LIBOR underpins contracts affecting banks, asset managers, insurers and corporates estimated at USD350 trillion globally on a gross notional basis.

Given its degree of uncertainty and complexity, LIBOR transition is likely to be one of (if not the) biggest transformation programmes many firms will undertake over the next couple of years. Areas to focus on are most likely to be:



Mobilising a project with dedicated resources to address transition.



Building an inventory of exposures and understanding of the economic impact and operational impact.



Beginning transition of investment activity where there is sufficient liquidity (e.g. derivatives).



Internal and external communications and awareness-raising, including engagement with working groups and industry bodies as well as clients.

## Financial Innovation

Potential benefits from regtech and fintech are widely acknowledged, but there is an emerging sense of pragmatism concerning the adoption of new technology, as firms deal with implementation challenges and work through how they will achieve the efficiencies or improvements promised in practice.

It is an added challenge for firms to determine whether or not technology providers themselves will be able to deliver the solutions under consideration. The need for risk, compliance and all other parts of the business to have the appropriate technological skill sets has never been more pertinent.

In addition to building and maintaining the appropriate skill sets to evaluate possible regtech, fintech or insurtech solutions, many firms have to revamp legacy systems while continuing to embed regulatory rulebook changes.

In February 2019, the FSB reported on its assessment of fintech developments and potential financial stability implications.<sup>11</sup> Key findings were that:

- To date, the relationship between incumbent financial institutions and fintech firms appears to be largely complementary and cooperative in nature.
- The competitive impact of bigtech (established technology companies) may be greater than that of fintech firms. Bigtech firms (such as Google, IBM and Apple) typically have large, established customer networks and enjoy name recognition and trust.
- And the reliance by financial institutions on third-party data service providers (e.g. data provision, cloud storage and analytics, and physical connectivity) for core operations is estimated to be low at present. However, this warrants ongoing attention from authorities.

## Not forgetting crypto!

There has also been massive growth in the market for crypto assets such as bitcoin and tokens issued in initial coin offerings, but market participants have faced uncertainty as to whether crypto assets may be regulated financial products (and subject to scrutiny by regulatory authorities).

Different jurisdictions' regulators approach to the crypto asset market has varied, some adopting a bespoke regulatory regime for such assets, with others seeking to incorporate these assets into existing regimes.

Given the decentralised and international nature of crypto assets and related activities, we may also see international collaboration on enforcement activity, for example on questions of jurisdiction and applicable law.

## Making the complex (a little more) simple

While we stay away from absolutes – as each firm has its own unique risks – whatever approach we take to ready ourselves for the regulatory environment that will emerge over the next few years and beyond, there's no escaping one simple fact: at the very least, we'll need to equip ourselves not just for the challenges but also for the opportunities that will present themselves along the way.

*To discuss any of these areas in more detail, reach out to me or the regulatory services team.*

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<sup>1</sup> Find the report at <http://www3.weforum.org>. [Link Here.](#)

<sup>2</sup> Covered in detail within Global Trustee & Fiduciary Services News & Views Issue 50, 2018.

<sup>3</sup> Policy measures to protect investors of OTC leveraged products available at <https://www.iosco.org>. [Link Here.](#)

<sup>4</sup> Winter 2019 Economic Forecast available at <http://europa.eu>. [Link Here.](#)

<sup>5</sup> "Window to the Past, Portal to the Future" speech available at <http://www.mas.gov.sg>. [Link Here.](#)

<sup>6</sup> Access the report at <https://treasury.gov.au>. [Link Here.](#)

<sup>7</sup> "Why culture matters: Insights from the Central Bank of Ireland Review of Behaviour and Culture in the Irish Banking Sector" available at <https://www.centralbank.ie>. [Link Here.](#)

<sup>8</sup> See <http://www.worldinvestorweek.org>. [Link Here.](#)

<sup>9</sup> ASIC's Corporate Plan, 2018-22, available at <https://download.asic.gov.au>. [Link Here.](#)

<sup>10</sup> See "FCA calls on firms to act following review of costs and charges disclosure in the investment sector" at <https://www.fca.org.uk>. [Link Here.](#)

<sup>11</sup> "Market developments and potential financial stability implications" accessible at <http://www.fsb.org>. [Link Here.](#)

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