Aurexia

REGULATORY WATCH

Data Ethics

What does the future of regulation around data ethics look like?

SMCR for SMFs

Key lessons learned from banking as the 9th December deadline looms for firms

Horizon Scanning

Key regulatory highlights from the UK and global regulators

UK Edition, November 2019

Foreword

November has been a very exciting month for us here at Aurexia UK. We held our inaugural Digital Games event on the Future of Compliance, which brought together compliance professionals and fintechs to brainstorm innovative solutions for current industry issues. This reminded us of how far firms have come on data collation, data aggregation, and data usage.

As firms continue to focus on enhancing analytics, in the November edition of Aurexia's UK Regulatory Watch, we explore data ethics and the potential for regulatory intervention. The FCA may have delayed its Call for Input on the access and use of data in wholesale markets in September, however we predict the use of data will face increasing regulatory scrutiny over the next year.

Many firms are working at full throttle over the next few weeks, busy implementing the extension of the Senior Managers' and Certification Regime ("SMCR") to solo-regulated firms. We explore some of the practical challenges banks still face and the key lessons learned that all firms should be considering.

Lastly, we do not claim to provide you with a complete snapshot of the regulatory news from the past month, however we have included an extract from EROS, our regulatory horizon scanning tool, of regulatory developments in September.

If you have any comments, suggestions, or would like further details on any of the features included in this month's edition, please do not hesitate to contact me.

Manmeet Rana
UK Head - Aurexia

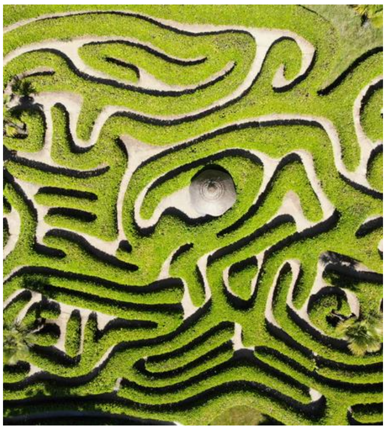
For further information, please contact

Manmeet RANA
Partner at Aurexia
manmeet.rana@aurexia.com
+44 (0) 7946 894918

1 Fore Street
London, EC2Y 5EJ

Contents

Data Ethics 04
What does the future of regulation around data ethics look like?



SMCR for SMFs 07
Key lessons learned from banking as the 9th December deadline looms for firms

Horizon Scanning 10
Key regulatory highlights from the UK and global regulators

Data Ethics

Overview

Data ethics is becoming an important area within financial services. This is hardly surprising.

As data analytics, including intelligent and autonomous systems, play an increasingly important role in our world – transforming many different areas of our lives in profound and positive ways - these new technologies and applications pose complex ethical and economic questions that need to be addressed.

The FCA delayed their Call for Input on the access and use of data in wholesale markets in September this year. However, there are growing regulatory questions around how regulated firms are using data. This extends beyond the implications of GDPR and the use of personal data.

The FCA has outlined a number of priority areas to better understand how the use of data and machine learning could shape products and services and the potential implications for consumers and the functioning of markets. These include exploring whether they, as a regulator, should put in place policy frameworks for how firms collect and use data, to protect consumers and enhance market integrity.

Separately, the Centre for Data Ethics and Innovation ("CDEI"), a UK Government body, was established in 2018. Responsibilities for the CDEI include:

- Analysing and anticipating risks and opportunities.
- Agreeing and articulating best practice, including identifying best practice for the responsible use of data and AI.
- Advising on the need for action, enabling safe and ethical innovation in the use of data and AI.

The UK Government updated its Data Ethics Framework in 2018. Given the direction of travel of other public sector requirements (such as IR35), we think it is only a matter of time before elements are transposed into the private sector, and in particular financial services given the FCA's expected focus in this area.

Why is Data Ethics important?

Understanding the moral dilemmas that underpin data ethics can help organisations to understand and mitigate reputational risks. This is also an important tool to drive stakeholder trust – with both clients and employees.

As the use of regulatory analytics increases, the rights of the individual need to be balanced with increasing regulatory-driven and business-driven opportunities for using data. For example, deploying facial recognition unlocking systems instead of passwords might enhance security, however it is increasingly intrusive to individuals.

We have set out the key ethical challenges firms are facing, along with the principles from the UK Government's 'Data Ethics Framework', which could form the basis of financial services regulatory requirements.

Data Ethics
Challenges

Data analytics provides an opportunity to generate enormous positive outcomes, but also to create significant challenges. The first step in developing a more ethical approach to data is therefore to identify the threats that data analytics could pose. We think that the starting point to embedding data ethics in your organisation is by managing such challenges.

Privacy and transparency

Data can use large and sometimes sensitive datasets. This raises the question around privacy and the use of personal data. Thus, it is important to solidify the transparency in relation to personal data processing, ensuring better information is provided to individuals on the way in which their data is processed – this goes beyond making a generic GDPR disclosure to individuals stating their personal data may be processed.

Human agency and oversight:

AI systems should enable equitable societies by supporting human agency and fundamental rights, and not decrease, limit, or misguide human autonomy. Firms need to consider the impacts the broader application of AI may have in their organization, and what the long-term impacts could be, particularly their desired human to machine ratio, in order to ensure human interaction is not completely lost.

Governance and accountability

The creation and use of powerful new technologies requires effective governance and regulation, ensuring they are used safely and with accountability.

In the case of AI, new standards or institutions may be needed to oversee its use by financial institutions, particularly where the use case involves data sets that contain individual data.

Sustainability

To keep pace with evolving digital strategies, the evolution of sustainable data ethics codes must go beyond check-the-box compliance and enforcement of the rules. New data ethics codes must objectively consider the effects new technology and data-uses have on people. Banks must remember that not everything, that is legally compliant and technically feasible, is ethically and morally sustainable.

Managing the AI black box

AI applications often operate like "black boxes" for decision making. Ethics should be a key component in how algorithms are used. Firms should consider potential ethical implications when deploying an AI solution or use case and whether deploying certain use cases will in themselves produce attributable patterns on individuals or their behaviours.

Bias awareness

Erroneous decisions made by algorithms trained on biased data can lead to poor outcomes. Relying on these outcomes can lead to mis-judgements. Firms need to be more transparent, not just with clients but also with employees on how their data is being used.

Data Ethics

The future of regulation

The UK Government has established a data ethics framework for the public sector, which covers seven principles. We have provided an overview of these principles, as we think some of these could be applied across financial services. Firms should consider driving an industry solution, before there is regulatory intervention.

Principle 1: Be aware of relevant legislation and codes of practice

Individuals must understand the relevant laws and codes of practice that relate to the use of data:

- Legislation: individuals should be aware of existing regulation and legislation.
- Data protection by design: individuals should be aware of existing requirements around GDPR and how data usage is impacted by GDPR.
- Data minimisation: GDPR states that personal data usage should be limited to what is necessary.
- Information governance: personal data should be collected, stored, shared, processed and deleted as covered by the GDPR and DPA 2018.

Principle 2: Use data that is proportionate to the user need

Use of data must be proportionate. Individuals must not start any internal project if the use of data is not proportionate to the user need:

- Personal data can be de-identified, also known as pseudonymising or anonymizing.
- Data sources (how and where the data is from).
- Repurposed operational data.
- Repurposed third party data.
- Statistics: covered by the statutory Code of Practice for Statistics and subject to independent regulation.

Principle 3: Understand the limitations of the data

Though legal and proportionate, there may be limitations to the data that make the proposed approach inappropriate, unreliable or misleading.

Things to consider when deciding if a source of data is suitable include:

- provenance (for example how and why the data was collected).
- errors in the data.
- bias.
- if metadata and field names are ambiguous.

Principle 4: Use robust practices and work with the right skillsets

Individuals must ensure they employ robust and consistent practices.

This involves:

- ensuring accountability of algorithms.
- avoiding outputs of analysis which could result in unfair decision making.
- designing for reproducibility.
- testing models under a range of conditions.
- defining acceptable model performance: false negatives and false positives.

Principle 5: Make the development work transparent and be accountable

All work must be accountable, which is only possible if people are aware of and can understand the work being performed. How is that possible?

- Documenting work clearly (e.g. the construct of algorithms) is an essential part of working in an open and accountable manner.
- By giving transparency and interpretability to algorithms.

Principle 6: Embed data use responsibly

To embed data ethics responsibly, this last principle encourages individuals to put in place appropriate long-term processes to monitor policies by determining:

- the implementation plan, including ongoing agile iteration of your live service.
- sustainable and ongoing evaluation methods.
- the method for feedback into the data model, including when it is necessary to retrain using newly collected data.

SMCR for SMFs

Introduction

As the Senior Managers and Certification Regime ("SMCR") requirements are extended to nearly all firms regulated by the FCA on 9th December 2019, we thought it would be an opportune moment to consider some of the challenges banks have faced and the subsequent lessons learned.

It is not only the additional firms to whom SMCR will be applicable from December who are concerned. The EU branches operating in the UK have previously been subject to a lighter version, with less SMF functions applicable to them. As they transition to third country branches, or even subsidiaries, if and when Brexit happens, there will be more SMF functions applicable to them and greater scrutiny.

There was no shortage of legal advisors and consultants supporting the banks with implementation, but SMCR is more than just a documentation exercise, as Senior Management Function ("SMF") executives are only too aware of.

As regulatory scrutiny of SMFs increases, we have set out the key areas we think firms, and individuals, should be focusing on to ensure they can demonstrate they are taking 'reasonable steps' and remain protected.

Culture remains critical to ensure the right outcomes are achieved, which means firms should be considering drivers of behaviour, governance, training, performance management, and incentives as part of their SMCR implementations.

SMFs should be proactive in reviewing and challenging the culture across both the teams that directly report into them, as well as teams where they have assigned delegated authorities. We consider the key lessons learned and some of the areas SMFs should be considering when taking reasonable steps to execute their responsibilities.

SMCR for SMFs

Challenges and Lessons Learned

Based on the experiences from the banking sector, we have set out some of the challenges we have identified, as well as lessons learned. SMCR implementation should be viewed as an evolution: there is no end point.

As organisational risks evolve, with market, technology, and regulatory changes, so too will the way in which SMFs execute their responsibilities. However, there are common challenges SMFs face across firms.

Aligning responsibilities and risks

Banks, as expected, have developed detailed responsibilities maps and detailed frameworks evidencing compliance with SMCR. The real challenge comes in ensuring the firm's risk management and regulatory framework, and ownership of risk, is aligned to what the responsibilities maps say.

Firms continue to run separate processes, where the SMCR framework is developed independently of the risk management framework and SMF responsibilities do not fully align to risks. Only by achieving this alignment and designating specific taxonomies to SMFs can the appropriate level of ownership be achieved (and importantly evidenced).

Data and Management Information ("MI")

In order to execute their responsibilities effectively, SMFs need access to the right data and MI. Often, this has resulted in manual processes (prone to operational errors) to collate reams of data, which is difficult to review, analyse, and use.

Given the level of data firms now collect and process, as well as the easy availability of data visualization tools, it will become difficult to blame data quality or poor MI for not identifying an issue. SMFs should take time to consider what data they want and work to get it.

Escalation of Issues

Ensuring issues are escalated to the SMF responsible, and the correct governance forum, is critical. Time and time again, we are still seeing known regulatory issues, for example in respect of MiFID II implementation, not being actively addressed or escalated.

Culture is critical. SMFs have a responsibility to ensure both their direct reports and their delegates are cascading the right culture. As more firms face budgetary constraints, it becomes even more important for individuals to understand they are expected to identify and escalate issues.

Risk Acceptance

Too much risk acceptance is still happening day to day, within individual teams. This leaves SMFs exposed. Firms may not have sufficient resources to ensure that there are robust controls across all risks, however risk acceptance should be formally agreed and documented to ensure SMFs are protected, if and when a risk crystallises.

Although there has been some regulatory action by the FCA already, SMFs need to ensure they are not caught out as regulatory scrutiny increases.

Managing Delegations

SMFs in banks are relying on delegations, as new SMFs no doubt will post 9th December. Individuals need to ensure that delegation is not viewed as an outsourcing of their responsibility.

SMFs remain responsible for providing oversight, particularly by way of review and challenge to ensure their delegated responsibilities are being performed in the same manner as they would have been performed within their own teams. This means SMFs need access to the right data and metrics, as well time with the relevant individuals to execute their oversight responsibilities.

When delegating, SMFs need to ensure they are comfortable with the knowledge, skills, and experience of the individual to whom they are delegating. This also needs to be periodically assessed.

Delegation does not mean the SMF does not need to worry about the risk.

SMCR for SMFs

What does ‘Reasonable Steps’ look like?

Based on the challenges we have identified, and the SMCR requirements, we have set out below a few areas that we think are critical for SMFs to consider when ensuring they are taking ‘Reasonable Steps’ to execute their responsibilities.

Governance

- Each SMF should be aware of what they are responsible for and their areas of responsibility and accountability should be clearly documented.
- Direct reports of SMFs should understand what their responsibilities are and they should be assessed against these responsibilities as part of the performance management process.
- Accountability extends beyond the prescribed responsibilities. Ownership of specific risks should be aligned to SMFs, as should sponsorship of material change programmes.

Regulatory Requirements and Risks

- Each SMF should be aware of the regulatory requirements for which they are responsible for ensuring compliance with.
- SMFs should understand, and actively put in place plans to deal with, upcoming regulatory changes impacting their areas of responsibilities.
- Ideally, regulatory requirements should be linked to a risk taxonomy to ensure SMFs can track exposure to potential breaches.

Risks and Controls

- SMFs should be aware of which elements of the regulatory, risk, and control framework they are responsible for.
- SMFs should ensure there are appropriate policies, procedures, and controls in place to manage the risks for which they are responsible. This includes ensuring the control framework is updated in line with regulatory changes.
- Breaches should be identified and remediated.

Delegations

- SMFs should ensure they have accurately identified which responsibilities are being delegated and to whom.
- SMFs should ensure they have assessed that the individuals to whom they are delegating have capacity to perform the delegated tasks and have appropriate knowledge, skills and ability.
- SMFs should ensure they are proactively identifying training needs of individuals.
- SMFs should ensure they retain appropriate oversight (including periodic review and challenge) of delegated responsibilities.

Culture

- SMFs should assess and ensure that they are comfortable with the culture across both their teams and the teams to whom they have delegated responsibilities.
- Focus should turn to middle management to ensure key messages are cascading through the organization.

Risk Acceptance

- In order to execute their responsibilities, SMFs need to ensure they are aware of all material issues within their remit.
- It may not be feasible, or even possible, to remediate all issues as they arise. However, SMFs should ensure that where they are accepting risk, this is done through an appropriate governance forum and is documented.

Regulatory Radar

Summary of the News

Scanning the regulatory horizon can be a time consuming exercise. Each month, we will set out an extract of regulatory updates from our European Regulatory Oversight & Screening ("EROS") tool. There are a significant number of publications, as you would expect. This extract covers the month of October and has been arranged by taxonomy. The extracts in this section are limited to: FCA, PRA, ECB, EBA, ESMA, IOSCO, and FSB publications. This extract is not intended to be an exhaustive list or relied upon.

Key October highlights:

Brexit

The FCA will be extending the date by which firms and funds should notify their entry into the temporary permissions regime to the 30th of January 2020. Fund managers will have until the 15th of January 2020 to inform the FCA if they want to make changes to their existing notification. Firms should continue to comply with existing regulatory requirements (e.g. MiFID II, EMIR).

PRIIPs

The European Supervisory Authorities ("ESA") are promoting a consistent application by National Competent Authorities of the PRIIPs regulation to bond markets.

ESG

October was a turning point for ESG in the UK. First, the Financial Reporting Council ("FRC") released a strengthened and revised UK Stewardship Code for 2020, based on a collaborative work with the FCA around governance and stewardship. Secondly, the FCA published their objectives and potential future actions on climate change and green finance, in line with their strategic goal of ensuring markets function well.

Regulatory Radar

Summary of the News

- Capital Markets
- Asset and Wealth Management
- Retail banking
- Insurance

Basel III

Basel III capital monitoring report

This latest Basel III monitoring exercise report from the EBA is based on December 2018 data, and provides an impact assessment of implementing final Basel III reforms on EU banks.

Brexit

UK's exit from the EU delayed

The EU and the UK have agreed to extend the date for the UK's departure from the EU. The FCA will be extending the date by which firms and funds should notify it for entry into the temporary permissions regime (TPR) to 30 January 2020.

CSDR

Final report on CSDR guidelines

ESMA published final report on CSDR guidelines on standardised procedures and messaging protocols.

EMIR

EMIR peer review

ESMA published the results of a peer review it conducted into supervisory actions of six National Competent Authorities on their approach at enhancing the quality of derivative data reported under EMIR.

Financial Crime

Market abuse standards on supervisory cooperation

ESMA published draft RTS on cooperation arrangements under the EU Market Abuse Regulation.

Risks of money laundering and terrorist financing

The three European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) published their second joint Opinion on the risks of money laundering and terrorist financing affecting the EU's financial sector.

Governance

UK Stewardship Code 2020

The Financial Reporting Council (FRC) published a strengthened and revised UK Stewardship Code, which sets enhanced standards for asset owners and asset managers, and for service providers that support them.

Building a regulatory framework for effective stewardship – FS from the FCA

Following the release of a discussion paper on stewardship and governance in January 2019, the FCA published a feedback statement, which was also used by the FRC to update its Stewardship Code (cf. above).
The FCA and the FRC have been working closely in framing their future work, and will continue to do so.

Liquidity

Interactions between bank liquidity requirements

The ECB published an article on the interaction of different regulatory metrics by empirically examining the interaction between the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) for banks in the euro area.

Report on compliance of EU banks with liquidity measures

The EBA published a report, providing an update of the EU banks' compliance with the liquidity coverage ratio (LCR).

Open Banking

Report on cross-border access of EU payment services

The EBA published a report identifying potential obstacles to the cross-border provision of banking and payment services in the EU. Developed under the EBA's FinTech Roadmap, this report calls on the EC to facilitate cross-border access.

Strong customer authentication

The FCA published a policy statement on strong customer authentication and common and secure open standards of communication, to make electronic payments more safe and secure. In the context of Brexit, it forms part of the EU law and will supplement PSD2.

Regulatory Radar

Summary of the News

Capital Markets
Asset and Wealth Management
Retail banking
Insurance

Reporting

Reliability of Regulatory Returns

The PRA released a 'Dear CEO' letter, encouraging firms to submit complete, timely and accurate regulatory returns, as the integrity of regulatory reporting is the foundation of effective supervision.

Validation rules and XML schemas for SFTR Reporting

ESMA published further technical details for the reporting of Securities Financing Transactions (SFTs) as required under the SFT Regulation (SFTR). The publication includes the validations rules applicable to SFTR reports, as well as the XML schemas reporting entities should use.

EU enforcers must monitor closely new reporting standards

ESMA published the priorities that European enforcers will consider when examining the 2019 annual financial reports of listed companies, including IFRS financial statements, and ESG disclosures.

Governance of key OTC derivatives data elements

IOSCO has developed global guidance on the harmonisation of critical OTC derivatives data reported to trade repositories.

Retail Conduct

Promoting consistent application of PRIIPs to bonds

The European Supervisory Authorities (ESAs) have issued a supervisory statement in order to promote a consistent application by National Competent Authorities of the PRIIPs Regulation to bond markets. The objective is to achieve a consistent level of regulation promoting the protection of retail investors.

Disclosure to consumers buying financial services through digital channels

The EBA published an Opinion addressed to the EC with recommendations to ensure that disclosure requirements in EU law take account of the increasing use of digital marketing channels for financial services and the issues affecting consumers.

Changes to mortgage responsible lending rules and guidance

The FCA released a policy statement setting out the changes to their responsible mortgage lending rules based on their proposals and the feedback they have received on them.

Overdraft pricing and competition remedies

The FCA published a policy statement on overdrafts pricing, with new rules designed to reform the overdraft market and address the harm to consumers.

Sustainable Finance

The FCA's future work on climate change and green finance

The FCA published a feedback statement following a discussion paper released in October 2018. This sought views on potential FCA action on climate change and green finance, in line with their strategic objective of ensuring relevant financial markets function well.

Climate-related corporate reporting: Where to next?

The FRC published a report on climate-related corporate reporting, to assist companies and provide practical guidance on how to meet investor expectations using the TCFD framework. It is structured around the four TCFD (Task Force on Climate-related Financial Disclosures) core elements: governance, strategy, risk management and metrics and targets.

Strengthening the foundations of sustainable finance

Speech given by Mark Carney, Governor of the Bank of England, on TCFD and strengthening the foundations of sustainable finance. The Governor made various recommendations, including: working to increase the quantity and quality of disclosures by sharing best practice; refining TCFD disclosure recommendations to those that investors consider most decision-useful; or using TCFD to manage risks and realise opportunities.


Aurexia
Bringing value, together