BANKING SECTOR - HOT TOPICS

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Welcome to the Autumn 2022 edition of our **Banking Sector - Hot Topics** series which discusses some of the key developments currently affecting the sector. Regulatory reform, both specific to the banking sector and across the financial services sector, pushes on, as does UK prudential policy and multiple workstreams in relation to sustainability and ESG factors. Significant developments have been seen on digital assets regulation and a number of other developments should see further activity later in 2022/early 2023, including LIBOR cessation, buy now pay later regulation and transactional activity.

1 Regulatory reform in the banking sector

Independent review of the UK's ring-fencing Regime

The Treasury published, in March 2022, the final report of the independent review of the UK's ring-fencing Regime (the Regime), which was required under the Financial Services (Banking Reform) Act 2013 and specifically mandated to consider the impact of the Regime on: (i) UK banking sector competition, including in the mortgage market, and the benefits and barriers the Regime presents; and (ii) the sector's competitiveness internationally (the Report).

The review generated significant interest in the banking sector, particularly given the significant costs, both from a restructuring and compliance perspective, for banks subject to the regime. Banks, both within and outwith the Regime, lobbied for particular Regime changes to improve their ability to grow, attract investment and remain competitive. These included increasing the current 'entry' threshold of £25bn of core deposits over a three-year period and reducing the current restrictions on the activities ring-fenced banks (RFBs) can undertake, the exposures they can incur to the broadly defined range of 'relevant financial institutions' (RFIs) and the entities they can set up overseas. The review panel's recommendations respond to some, at least, of these aspects.

The review report's recommendations

The interim statement released by the review panel in January 2022 foreshadowed some recommended revision to the Regime, indicating that, while the Regime has contributed to a more resilient banking sector, the UK's resolution regime has played an increasing role in this; and that while the Regime has not had a significant impact on competition, its current requirements have made the Regime overly rigid, particularly the restrictions on providing certain banking services, servicing financial institutions and operating in certain jurisdictions.

Overall, the Report concludes that the Regime is worth retaining 'at present' but needs to undergo operational changes to be made simpler, more adaptable and more coherent with wider regulation, specifically in the way that it interacts with the UK's resolution Regime. Its overly rigid and complex structure has the potential

to constrain UK banks' competitiveness, particularly in relation to innovation. The Report does, nonetheless, acknowledge the relative infancy of the Regime (coming into force in January 2019) and that other structural forces, including Brexit and COVID-19, may have masked its operation and impact to some extent. Specific recommendations made by the report include:

- entry threshold: rather than increase the Regime's entry threshold, removing banks subject to the Regime which conduct 'excluded activities' (namely those that must not be conducted by a RFB, such as dealing in principal) below a de minimis level (recommended at 10% of Tier 1 capital). This should mean the exclusion from the Regime of more retail-focused banking groups;
- alignment with the UK's resolution regime: in order to achieve greater alignment between the two regimes, introducing a new power for regulators to remove from the Regime RFBs deemed resolvable by the Bank of England. This recognises that the resolution regime is, in certain cases, more effective than the Regime in dealing with entities 'too big to fail';
- exposures to RFIs: easing the prohibitions on such exposures to allow RFBs to provide services to smaller, mainly SME, RFIs; moving the RFI definition from legislation to regulatory rules; and introducing a grace period to allow customers who become, or are no longer, RFIs to be transferred to non ring-fenced, or ring-fenced, banks respectively;
- excluded activities: reviewing these as a whole to assess whether any activities can be removed from the exclusion, thereby allowing these to be undertaken by ring-fenced banks;
- acquisitions and disposals: introducing transitional periods where an entity within a ring-fenced banking group merges with, or acquires, a non ring-fenced bank so that the non ring-fenced bank has a period of time within which to comply with relevant requirements under the Regime.

  This change could be potentially significant as, currently, relevant requirements apply to the non ring-fenced bank immediately and that bank has rarely considered in depth the potential operational and procedural changes required to ensure compliance. The change would provide ring-fenced banking groups with more flexibility in relation to their transactional activities and ensure transactions were simpler for all entities involved;
- establishing operations and servicing customers outside the EEA: removing the blanket prohibition preventing ring-fenced banks from doing either.

The Treasury immediately welcomed the review's recommendations and indicated it would establish a taskforce to assess the options for taking them forward and publish a response later in 2022.

Implications and industry reaction

If implemented, the recommendations should be welcomed by banking firms, allowing them to grow their retail operations without becoming subject to the Regime, allowing RFBs to expand both their UK and overseas operations more easily and facilitating greater competition and investment into the, certainly retail, banking sector. They should also encourage banks to focus on their resolvability as a means to remain outwith the Regime.

That said, the response from a number of banks has been muted, reflecting the uncertainty as to whether the Treasury will implement all or some of the recommendations and by when, and to what extent such banks will need to restructure their businesses in response to Regime change. The Treasury's intended response is awaited by the industry with cautious optimism.

> *// A key lesson from the last 50 years is that a sector as dynamic as the banking sector needs a regulatory Regime that is equally dynamic. //*
>
> RFPT Final Report, March 2022

Small banks' prudential regime

Following the PRA's discussion paper and feedback statement on its proposed simplified and graduated prudential regime for smaller non-systemic banks and building societies (the Small Banks Regime – see our Winter 2021/22 edition) and its intended focus on the smallest of these firms first, it published, in July 2022, its first consultation which focuses on the scope of the regime applying to those smallest firms (the Simpler Regime).

The PRA's focus on the smallest firms first is deliberate. As first set out in the PRA's discussion paper, given the Small Banks Regime as a whole would be a major change in UK prudential policy

and take a number of years to develop and implement, and the population of smallest firms is the largest, this focus means the largest number of firms would benefit from simplification as soon as possible.

The PRA's focus on the scope of the Simpler Regime first, before consulting on the requirements under that Regime (scheduled for 2023 and 2024) is also deliberate and intended to provide relevant firms with early visibility of, and the opportunity to feed back on, a key building block of the Regime. It will also allow the Simpler Regime, and the Small Banks Regime as a whole, to evolve alongside the introduction of further prudential regulation, in particular the Basel 3.1 standards (scheduled for January 2025 – see further item 4 below).

Simpler Regime – proposed scope

The proposed scope of the Simpler Regime is intended to capture existing and new small banks which operate primarily in UK domestic markets and are focused on deposit-taking from, and lending to, UK corporates and households. The PRA has developed a definition of 'Simpler Regime firm' based on objective and transparent criteria reflecting this population and indicates that it would capture 61 firms, including 34 building societies, of the 198 firms it regulates (as at 01.12.22). Key aspects of the criteria include:

- size: average total assets of £15bn or less across the previous three reporting years (and if not yet subject to reporting requirements, a reasonable forecast of not more than £15bn at the bank's first reporting point);
- domestic activity: at least 85% of credit exposures are to UK counterparties;
- trading activity: an on and off balance sheet trading book business of not more than: (i) 5% of the bank's total assets; and (ii) £44m;
- internal ratings based (IRB) approach: the bank does not apply the IRB approach to calculating risk-weighted amounts for credit risk; and
- clearing, settlement and custody services and payment system operation: the bank does not provide any of these services, including as an intermediary to another bank or building society wherever based, or operate a payments system.

Application of scope criteria

To fall within the definition, a firm must meet all the criteria and it should be applied on a solo basis for a standalone firm and, where a firm is part of a UK consolidated group, at the highest level of that group – which means that the firm, any other banking entity within the group, and the UK consolidated group on a consolidated basis[1] need to meet the criteria. Where a firm is a subsidiary of a non-UK entity, but otherwise meets the definition criteria, it will be permitted to apply for a waiver or modification to be deemed a 'Simpler Regime firm'.

While, in general, if a firm meets the criteria it will be a Simpler Regime firm, the PRA makes clear that it may need to assess, on a case-by-case, basis, a firm's eligibility and potentially exclude it from the Regime if the firm's complexity or risk profile is not consistent with it.

Industry reaction

The PRA's feedback statement indicated that the majority of respondents support the regulator's proposals on the Small Banks Regime as a whole and it will, of course, be important to await the PRA's consultation response for comprehensive feedback to the Simpler Regime's proposed scope (scheduled for late 2022/early 2023). That said, early respondents, including UK Finance, the Treasury Committee having launched an inquiry and issued a call for evidence, and a number of banks, have raised several points for the PRA's consideration. These include:

- size: increasing the £15bn threshold to be raised to £25bn to: (i) be in line with the upper end of the MREL £15 - 25bn balance sheet threshold; and (ii) allow the few additional firms that are above the £15bn threshold and best placed to compete effectively with the UK's larger systemic banks, but also hit with disproportionately high prudential requirements' compliance costs (commonly known as a the 'squeezed middle'), to benefit from the Simpler Regime and thereby be in position to more easily provide the greater competition and consumer choice needed in the UK banking sector.

  It will be interesting to see how the PRA responds to this point – its consultation specifically asks for views on whether the threshold is sufficiently high, which would suggest it is minded to raise it, but the

[1] The criteria in relation to clearing, settlement and custody services and payments services operation does not need to be met by the UK consolidated group.

feedback statement, in response to its discussion paper, also notes that the most commonly suggested threshold was £5bn. The regulator indicated in early September 2022, through a letter to the Treasury Committee, that it remains 'open minded' on the threshold;

- domestic activity: reconsidering the 85% UK exposures criteria, given this may lead to existing and new overseas customers being dropped, not taken on or having more limited loan and mortgage choices. Lending services to UK expatriates secured on a UK property or exposures in the Channel Islands, Gibraltar or the Isle of Man could be included in the definition of 'UK exposures' given they are all closely linked to the UK and arguably less, or no less, risky than lending to UK residents. The PRA indicated in the same letter to the Treasury Committee that it will continue to consider carefully the implications of the domestic activity threshold, which has been designed to ensure international banks do not unintentionally avoid application of the Basel standards.
- Timing: working to implement the Simpler Regime at the same time as the Basel 3.1 standards so that firms meeting the scope of the Regime are aware in advance of the capital requirements under both regimes, able to assess these against their projected rate of growth and make an informed decision as to which regime to join.

Given this is the first building block in a regime which would be entirely new in the UK and take a number of years to deliver, it will be interesting to see the extent to which the PRA revises its proposals in light of feedback, particularly in relation to the entry threshold, and the extent to which the shape of the Simpler Regime, and the Small Banks Regime as whole, starts to change as a result.

> *// The PRA's focus on the smallest banks first is deliberate….this focus means the largest number of firms would benefit from simplification as soon as possible. //*

2 Future regulatory framework

The Treasury published, in July 2022, its response to the second and final consultation of Phase II of its review of the UK regulatory framework (the Review), established to consider how the framework should adapt to the UK's position outside the EU and be developed to deliver a more coherent and agile regime better equipped to meet the specific regulatory needs of UK firms, markets and consumers.

The second consultation provided further proposals on regulatory rule-making responsibilities, accountability, and objectives and principles (see our Winter 2021/22 edition) and the Treasury's response indicates that the vast majority of its proposals will be introduced as consulted upon. These are now being legislated for through the Financial Services and Markets Bill 2022-23 (FSMB), introduced to Parliament also in July 2022. Key aspects of the Treasury's policy, and included in the FSMB, are set out below.

Overall regulation model

As confirmed in the Treasury's second consultation, the FSMA regulation model, with certain enhancements, will be retained, reflecting the view of the Treasury and the vast majority of stakeholders that this is the most appropriate way to regulate UK financial services. The PRA and FCA will continue to deliver that regulation and macro-prudential regulation, including the FPC, will not be altered.

Rule-making responsibilities

As proposed, the government and Parliament will remain responsible for the overall policy approach (as they have been with the exception of directly applicable EU law) and the regulators will resume responsibility for designing and implementing the direct requirements that apply to firms, as set up under FSMA 2000 (FSMA).

EU retained law in-scope of the regulators rule-making powers under FSMA will be repealed and replaced with regulatory rules, a process which will take place over several years through primary, including the FSMB, and secondary, legislation allowing Parliament to scrutinise the changes. The government and Parliament will retain some rule-marking powers where these are not appropriate to be transferred to the regulators, including the scope of regulated activities and provisions covering the UK's regulatory and trading relationship with other jurisdictions, such as equivalence arrangements and mutual recognition agreements.

A new Designated Activities Regime (DAR) will be set up under which the regulators will be given additional powers to regulate certain activities: immediately those currently regulated under EU retained law rather than FSMA and, in time, other new activities that emerge and existing activities which merit, potentially because of their risk profile, regulation.

The FCA's existing rule-making powers for trade repositories and credit rating agencies will be put on a statutory footing and the regulator will be given additional powers as needed in relation to recognised investment exchanges, and payments and e-money providers. Following the Treasury's separate consultation earlier in 2022, the Bank of England will be given a general rule-making power for central counterparties (CCPs) and central securities depositories (CSDs) modelled on the FCA and PRA's rule-making powers under FSMA.

Strengthening accountability and scrutiny

The Treasury has put in place a number of measures to strengthen regulatory accountability and scrutiny by Parliament and the Treasury, responding to the strong feedback received from industry and Parliamentary groups, and recognising the importance of this given the increased rule-making responsibilities of the regulators.

Such measures include requirements on the FCA and PRA to:

- notify the Treasury Committee of published consultations and respond to any Parliamentary Committee consultation responses received (which is, in practice, reasonably common now);
- respond, on an annual basis to Treasury recommendation letters (required at least once a Parliament) covering activity over the previous year;
- assess and consult with the Treasury on the impact of rule changes and supervisory policy on relevant deference arrangements (such as equivalence decisions and mutual recognition agreements), and, together with the PSR, where proportionate and relevant, their compliance with the UK's obligations under trade agreements with overseas jurisdictions; and
- publish statements of policy on how they review rules. This will also apply to the PSR in relation to its generally applicable requirements.

The Treasury will have a number of powers, including:

- in exceptional circumstances, such as a significant change to market conditions or where relevant rules are not acting as intended, and when in the public interest, to require the regulators to review rules;
- to set out in a proportionate manner 'have regards' that the regulators must consider when making rules in specific areas of regulation which cover public policy aspects not anticipated by the regulators' statutory objectives and principles; and
- to require the regulators to make rules in relation to specific regulatory areas when regulation is essential.

The Treasury has stopped short of a requirement, raised in its first consultation, that the regulators consult it on intended rule changes at an early stage and before these are made public, primarily because of the regulators' ongoing concern that this would significantly impact their independence (the PRA again reiterating the importance of regulatory independence in its September 2022 discussion paper on its policy approach to the regulator's wider rulemaking responsibilities).

The Treasury has also stopped short of introducing, at the FSMB's committee stage, the much publicised 'intervention power', which would allow the Treasury to direct the regulators to 'make, amend or revoke rules' where there are matters of significant public interest, on the basis it requires further time to consider such an amendment.

This decision is also likely to be because of the ongoing push back, from both the Treasury Committee and regulators, given the impact such a power would have on regulatory independence. The Treasury will be conscious that any amendment introduced needs to be robust and properly substantiated given the challenge it is likely to receive.

New regulatory objective and extended regulatory principle

Also reflecting the regulators' greater rule-making responsibilities going forward and the fact that, while the UK was in the EU, the government was able to ensure wider public policy matters, such as growth and international competitiveness, were considered as part of the EU negotiation process, the Treasury has confirmed the introduction of:

- a new growth and international competitiveness regulatory secondary objective (the PRA and FCA, of course, have existing secondary objectives of promoting competition between firms and in the interests of consumers respectively); and
- an amendment to the existing regulatory principle - to take into account the desirability of sustainable growth in the UK economy – so that it is clear such growth is consistent with the government's commitment to achieve net zero emissions by 2050. This will also apply to the PSR;
- a Bank of England secondary objective to facilitate innovation in the clearing and settlement services provided by UK CCPs and CSDs. In relation to the Bank of England's existing financial stability objective, the Treasury will specify the issues to which the Bank should have regard when advancing the objective in the context of regulating these entities.

In introducing the growth and competitiveness objective at the secondary level, the Treasury may have satisfied both industry, which called for such an objective at the primary level, and the regulators, who expressed concern at its introduction at either level given, in the regulators' view, the FSA's similar objective was partly to blame for the light-touch regulation seen in the lead up to the financial crisis. That said, the Treasury is clearly mindful of the fine line it has had to tread, with the then Chancellor stating in his Mansion House speech in July 2022 that "we are, I think, taking a balanced approach - by making it a formal objective we are encouraging greater focus on [the UK's] medium to longer-term productivity but by making it a secondary objective, we are giving the regulators an unambiguous hierarchy of objectives, with financial stability and consumer protection prioritised".

// The government has stopped short of introducing [into the FSMB] an 'intervention power'. //

3 New consumer duty

The FCA has concluded its consultation, required under the Financial Services Act 2021, on the new regulatory Consumer Duty and published final rules and guidance in July 2022. The Duty, which is intended to set higher expected standards of care and conduct beyond the regulator's current Principles and requirements with the aim of achieving greater retail consumer protection, will come into force for: (i) new products and services, and existing products and services open to sale or renewal, on 31 July 2023; and (ii) closed products and services, on 31 July 2024 (to allow firms adequate time to review their legacy business against the new requirements).

The FCA's final rules indicate that the Duty will be implemented largely as consulted on with some revision and additional guidance. The regulator has also published, alongside its rules and guidance, separate substantial non-Handbook guidance (FG22/5) on the implementation and compliance with the Duty to assist firms which it will build on over time.

The Duty in summary

The Duty will apply to firms' regulated activities, and unregulated ancillary activities (namely those carried on in connection with, or for the purposes of, a regulated activity – for example product design or ongoing customer support services, neither of which is regulated), in relation to retail financial services and products. Importantly, it will include all firms involved in their manufacture and supply, whether or not they have a direct relationship with the customer. The scope of 'customers' will follow the scope of relevant FCA sourcebooks and include prospective, as well as new and existing, customers (for example, recipients of financial promotions). The Duty's main components comprise:

- a new Consumer Principle that 'a firm must act to deliver good outcomes for retail customers', which will replace Principles 6 and 7 in relation to retail business (those Principles continuing to apply to wholesale customers, and retail customers outside the Duty's scope);
- cross-cutting rules which will support the new Principle and require firms to act in good faith towards, and avoid causing foreseeable harm to, retail customers, and enable and support such customers pursue their financial objectives; and
- four outcomes which will underpin the Duty and be underpinned by rules and guidance

across the areas of product and service quality; price and value; consumer understanding; and consumer support.

Reasonableness and proportionality

The concepts of reasonableness and proportionality underpin the Duty with firms expected to achieve the objective standard of conduct reasonably expected of a prudent firm given their role, the product or service and their target market.

The requirements will be applied proportionately taking account of these aspects, but the FCA does expect that firms with direct customer relationships will have the greatest responsibility under the Duty.

Governance and senior manager responsibility

The FCA has emphasised the importance of governance and board oversight in relation to both implementation and operation of the Duty.

As well as an annual report assessing the firm's compliance with the Duty, signed off by the board with agreed action on any strategic changes needed, firms will need to have a board level 'champion', ideally an independent non-executive director, who, together with the chair and CEO, ensures the Duty is being discussed regularly and within all relevant discussions (the FCA has even included in FG22/5 a number of (non-exhaustive) questions that it expects the board to raise on a regular basis). The FCA expects the board to have taken responsibility for scrutinising, challenging and agreeing implementation plans by the deadline of end October 2022 and to maintain oversight of their delivery during the implementation period. Firms should expect to share their plans and underlying documents with their FCA supervisors and be prepared to receive challenge on them.

Senior managers will be accountable for ensuring the Duty is met across the business areas for which they are responsible, rather than one senior manager being allocated responsibility for compliance across the firm. Perhaps controversially, senior managers are also subject to a new requirement, introduced after the FCA's second consultation, to report breaches of the Duty by their firm, or other firms, in their areas of responsibility if the firm does not do so. The potential conflict of interest here is obvious. The Regulator has also made clear it will take into account their understanding of, and action to comply with, the Duty when considering SMF approval applications.

Operation of the duty - key points to highlight:

- application to wholesale business: retail bank business will, of course, be captured under the Duty but investment banks will also need to consider which, if any, parts of their business will become subject to the Duty. The Duty applies to firms operating in wholesale markets which have a 'material influence' over the design, operation, distribution or communications in relation to retail products and services. This would, for example, include investment banks that design structured products for distribution by another firm to retail customers.

  The FCA provides further guidance on what it means by 'material influence' in FG22/5 and makes clear that the Duty is to be applied proportionately to wholesale activity based on what is reasonable in the circumstances.

- retrospective effect: the Duty is not intended to have retrospective effect – actions taken by firms before the Duty comes in force are subject to the applicable rules at the time. That said, the Duty will apply, on a forward-looking basis, to existing products and services, including those sold or renewed, once it comes into effect, and to legacy business. New firms applying for authorisation will also need to demonstrate their ability to comply with the Duty at the point of their applications (albeit it will not actually apply until it comes into force);

- liability: firms will be responsible only for their own regulated activities and will not need to oversee the actions of other firms in the distribution chain (albeit normal outsourcer, and principals' appointed representative oversight, requirements still, of course, apply). That said, the FCA has introduced a new requirement, following its second consultation, that firms must report breaches of the Duty by other firms that they become aware of.

  The possibility of incorrect notifications seems stark here – where a firm's need to meet this requirement means a notification is made on limited information where, in fact, the other firm has complied with the Duty. While it would be hoped that the other firm is ultimately found to have acted compliantly, the time and resource involved of both firms and the regulator could be significant.

- interpretation: the FCA's publication of FG22/5 is no doubt, partly at least, in response to the industry's ongoing concern over outcomes-

based regulation and the broad scope for different interpretations of the requirements. That said, the guidance is not, understandably, exhaustive and with consultation respondents in agreement that the success of the Duty will depend on how the regulator supervises and enforces it, and the FCA making clear that it will back up its requirements with 'assertive supervisory and enforcement action', the industry is right to remain concerned;

- interaction with the SMCR: the new Principle and cross-cutting rules will also be incorporated into the SMCR's conduct rules, with a new individual conduct rule 6 (ICR 6) being introduced reflecting the wording of the Principle and the obligations under these rules. Current ICR 4 will continue to apply to non-retail activity;
- reporting and monitoring: while firms will not be subject to a new Duty-specific reporting requirement, existing reporting requirements under FCA's Principle 11 and relevant sourcebooks, including SUP, will apply to it in the normal way. Firms will be expected to assess, test and be able to demonstrate effectively the outcomes their customers are receiving (which is, in essence, the customer impact of firms' actions) and how they are monitoring, and identifying and addressing any issues in relation to, those outcomes.

Implementation aspects

The two-phase implementation approach is intended to strike a balance between the strong ongoing industry concern on the tight timetable, which the FCA acknowledges, and the regulator's firm desire to achieve the enhanced customer protections that the Duty is intended to deliver as soon as practicable. It has made clear that firms should use the whole implementation period to implement their plans, take a risk-based approach where needed and prioritise the implementation work that has the greatest impact on customer outcomes (for example, prioritising the most complex or risky products).

As required under Principle 11 and SUP 15, firms must notify the FCA if they will not be able to meet the implementation deadlines; are considering withdrawing any products and services which may have a significant impact on consumers (for example, affecting market supply or vulnerable customers); or identify significant breaches of existing requirements (for example, products causing immediate customer harm).

The FCA will monitor and engage with firms to assist them in the implementation process and firms under portfolio supervision can expect FCA communication later in 2022 on its implementation expectations and priority issues.

> *// The duty will lead to a major shift in financial services and will promote competition and growth based on high standards. //*
>
> FCA, July 2022

4 Prudential requirements

UK implementation of international capital standards

The PRA updated firms in March 2022 that it is continuing to develop proposals on the UK implementation of the remaining Basel III (Basel 3.1, or IV) standards and intends to publish a consultation paper on these proposals in Q4 2022, including a proposed implementation date of 1 January 2025 to allow firms sufficient time to prepare.

This follows the PRA's introduction of all other Basel III standards into the UK's capital requirements regime, which have applied since 1 January 2022 (see our Winter 2021/22 edition). The government originally committed to implementing Basel 3.1 by the Basel Committee's required date of 1 January 2023 but the PRA explains that the new proposed date reflects the development of new processes required for implementation and other priorities on which it has had to focus.

The Basel Committee has urged national regulators to finalise the full and consistent impelementation of the standards as soon as possible, stating that, while banks have remained resilient in the face of tough economic conditions, this is 'more important than ever' given the financial system's vulnerability to a deteriorating economic outlook.

Resolvability Assessment Framework - key milestones

The Resolvability Assessment Framework (the Framework) has achieved a number of milestones in the last year, culminating in the Bank of England's first biannual report on the resolvability

of the eight major UK banks currently subject to the Framework.

The Framework in summary

The Framework was launched in 2019, currently applies to UK banks and buildings societies with £50bn or more retail deposits (with mid-tier banks becoming subject to the Framework from 1 January 2023) and is the final major part of the UK's resolution regime, remaining a key strategic priority for the Bank and the PRA. While firms have made significant progress with their resolution planning since the financial crisis, including building sufficient MREL resources and meeting the PRA's operational continuity in resolution (OCIR) requirements (see below), the Framework is intended to:

- make resolution more transparent, better understood and more likely to succeed;
- ensure firms are adequately prepared for resolution and can demonstrate that preparedness; and
- increase firms' ownership, and accountability, for those preparations.

Firms subject to the Framework are required to:

1. submit a resolution assessment to the PRA every two years, which requires the firm to carry out a realistic assessment of their resolution preparations, any risks to that resolution and how these risks will be remedied or mitigated, with reference to three outcomes:
    - that they have adequate 'resolution-ready' financial resources to absorb losses and recapitalise without exposing public funds to loss;
    - that they can ensure business continuity while the firm is restructured, including no material disruptions or termination of fundamental operational contracts; and
    - that they can coordinate and communicate effectively within the firm, and with relevant authorities and markets, so orderly resolution and restructuring can be achieved.

The first of these reports were required to be submitted by end October 2021; and

2. publically disclose a summary of their reports also every two years. The first of these summaries were published in June 2022.

The Bank is then required to undertake an assessment, also every two years, of the banks' resolvability against the three outcomes and publish its findings. This is not intended to be a 'pass or fail' judgement on the banks' resolvability but rather to increase public knowledge, including that of shareholders and investors, of firms' preparedness for resolution and the risks that might arise if they fail.

The Bank of England's first resolvability report

The Bank's first report, also published in June 2022, indicates that:

- overall, each bank could fail safely while continuing to provide vital banking services to the economy with shareholders and investors, not taxpayers, bearing the cost – thereby overcoming the 'too big to fail' problems of the past;
- that said, for three firms the Bank has identified 'shortcomings' (namely, issues that may unnecessarily complicate the bank's ability to undertake resolution) and for six firms 'areas for further enhancement' (namely, specific areas where continued work is needed by the bank to embed capabilities and further reduce execution risks associated with resolution).

The Bank expects the relevant banks to address the issues and specific areas identified in its findings and ensure their preparations are tested and ready for use if necessary. It will continue to engage with the banks on these points, as well as with mid-tier banks before they become subject to the Framework on 1 January 2023.

Clearly the public disclosure of their own reports, and that of the Bank, are likely to be an impetus to relevant banks to ensure their resolution arrangements are robust and well-prepared on an ongoing basis. This is also likely to make a key contribution to achieving the Framework's intentions, including to make resolution more transparent and increase firms' ownership and accountability for their resolution preparations.

> *// Overall, each bank could fail safely ....thereby overcoming the 'too big to fail' problems of the past. //*
>
> Bank of England, June 2022

Updated operational continuity in resolution policy

The PRA's updated operational continuity in resolution (OCIR) policy, designed to support firms subject to the Resolvability Assessment Framework (see above) and the Bank of England's (the Bank) approach to assessing resolvability, and the Bank's updated statement of policy reflecting the PRA's changes, come into force on 1 January 2023.

The PRA's updated policy builds on firms' work already carried out to implement the regulator's existing OCIR requirements; overall, expands existing requirements rather than introducing new ones; and continues to apply to UK banks, building societies and PRA-designated investment firms meeting relevant thresholds. This means that for firms already subject to the policy, their existing arrangements may have already responded to the updated policy or been able to be developed to do so, rather than it being necessary to put in place entirely new systems and procedures.

For firms that are nearing any of the relevant thresholds and may, therefore, become subject to the policy, they will, of course, need to review their systems and procedures in good time before that point to identify if any adaptations are needed to meet the requirements (the PRA may grant a temporary waiver or modification to such firms to provide them with an appropriate implementation period).

Alignment with operational resilience framework

Firms have also had to make sure that any necessary update to their OCIR arrangements has aligned with their identification of 'important business services' under the regulators' new operational resilience (OR) framework (see item 5 below). The PRA made clear in its consultation on the updated OCIR policy that it considered it likely that firms' important business services would form part of its critical functions or core business lines and, therefore, expected coherency between relevant functions that are 'critical' or 'core' under OCIR requirements and those business services that are 'important' under the OR framework. It helpfully confirmed that work done to prepare for both the OR framework and updated OCIR policy should be leveraged to meet both sets of requirements.

5 Operational resilience

New regulatory framework – firms' progress

Under the new operational resilience regulatory framework, jointly introduced by the PRA, FCA and the Bank of England (OR Framework), firms and financial market infrastructure participants (FMIs) have been required:

- by March 2022, to set impact tolerances (i.e. their tolerance for disruption) for, and identify and document the people, processes, technology, facilities and information that support, each of those services; and
- by March 2025, to ensure, through mapping and testing frameworks, that they can remain within their impact tolerances in the event of a range of 'severe but plausible' disruptions to their operations.

The importance of robust OR within firms across the financial services sector has been highlighted, and tested, by COVID-19, the recent events in Ukraine and the increasing use of online outsourcing providers and these events should have allowed firms to draw on, and reflect in their OR Framework implementation plans, any lessons learned from them.

While the PRA is clear in its view that the sector has remained resilient in the face of recent challenges, its preliminary feedback[2] on firms' progress in implementing the first stage of the OR Framework is balanced. It indicates very clearly that, while firms have made progress, they have some way to go to fully meeting the Framework's requirements and the regulators' expectations under it:

- on important business services' (IBS) identification, firms across the sector have made positive progress. That said, while the Framework builds in flexibility to allow firms to reflect their own business models, the level of granularity in firms' approaches differs quite significantly and the PRA expects this divergence to narrow in time;
- on setting impact tolerances, while progress has been made, firms have found this aspect to be more challenging. Their approaches have not been comprehensive, have been impacted by the level of IBS granularity and the regulator's view is that impact tolerances seem 'surprisingly' broad in relation to certain

[2] provided in a Bank of England speech given by David Bailey, Director of Deposit Takers Supervision.

services. It expects firms to 'fill the gaps' as a matter of priority; and

- on firms' mapping and testing frameworks, while these are, of course, in the early stages of development (given the timeline to March 2025), firms have so far typically, in the PRA's view, leveraged existing frameworks, and their thinking and framework development work varies significantly. This indicates that firms have substantial work to do before March 2025 to embed fully coherent frameworks and carry out necessary testing.

The PRA will be engaging with firms through the normal supervisory process to seek clarity on their IBS identification processes and provide guidance on the level of granularity it expects to see; to understand their impact tolerance approaches and 'pushing' firms to justify their judgements; and to make clear its expectation that firms should proactively develop and progress their mapping and testing approaches to ensure these respond to identified vulnerabilities and are sufficiently developed to do so by March 2025. Firms can expect to be robustly challenged by the regulator on this aspects.

> *// Enhancing the operational resilience of the financial sector remains a strategic priority for the PRA. //*
>
> PRA, January 2022

Extension of resilience measures to critical third parties

The OR Framework makes clear that firms are expected to identify and test their impact tolerances against business services provided wholly, or partly, by third parties as well as the firm and that boards and senior managers remain responsible and ultimately accountable for those services' resilience. The PRA published its final rules on outsourcing and third party risk management alongside the publication of its final OR Framework policy (March 2021) to assist firms as they progressed their implementation work and made clear that these requirements are intended to complement those under the broader OR Framework.

The PRA, FCA and the Bank of England are now proposing to introduce measures to oversee and strengthen the resilience of services provided by critical third parties (CTPs) to the financial services sector and mitigate the systemic risks these services pose to financial stability and consumer protection if they fail or are disrupted. Those measures include:

- a framework for identifying potential CTPs, which would inform the regulators' recommendations for formal designation by the Treasury (see below for the Treasury's proposed designation regime);
- minimum resilience standards, which would apply to the CTP services provided to firms;
- a framework to test the resilience of material CTP services using a range of tools; and
- suggestions to improve coordination between the UK, international standard-setting bodies and UK non-financial regulators.

The Treasury published, in June 2022, a policy statement on its proposed CTP designation regime to be established by secondary legislation under which, it, in consultation with the regulators and other bodies, would designate certain third parties as 'critical' which would then become subject to the measures set out above. Provisions to establish the regime and provide the regulators with the necessary powers to implement those measures have been included in the FSMB.

The regulators make clear that the proposed measures are intended to complement, not replace, firms' existing obligations to manage the risks arising from third party arrangements and will only focus on the systemic risks arising from services that CTPs provide to them. They intend to further develop their proposals in light of consultation responses received and the FSMB's final content, and consult on these in 2023.

Cyber stress test

The PRA confirmed in late 2021 that it would take forward in 2022 a voluntary cyber stress test, following the FPC's announcement of the same in March 2021 (it having been delayed due to COVID-19). The FPC makes clear that the test will be complementary to the threat-led penetration testing (CBEST), sector cyber simulation exercises (SIMEX), and industry exercises and engagement, that make up the regulators' overall cyber resilience toolkit.

The test will focus on payment services and a scenario where data integrity has been severely disrupted, and assess relevant firms' ability to maintain their payment services during that disruption. It will include, on a voluntary basis, the most systemic contributors to the payments

chain, given the impact that the failure or disruption of such firms' services could have on UK financial stability. In addition, as proposed by the PRC, it will include a limited number of smaller firms so as to gain insight into the role and preparedness of such firms and the systemic implications that may arise.

The test is intended to be separate from but to compliment the regulators' OR Framework and participating firms are expected to be able to draw on their Framework implementation work to meet the requirements of the test. The PRA indicated in the same update statement that it will contact firms selected to participate and provide further information in due course (and with no further update on timing firms should anticipate the test taking place by end 2022.

6 Sustainability and ESG

Sustainability has remained top of agenda in 2022 for the government, regulators, corporates and financial institutions, including banks. Work has continued on disclosure and reporting requirements, with a focus on developing a common global reporting standard; on maintaining transition momentum with the development of common transition plan requirements; and on ensuring banks' climate-related exposures are adequately identified and managed.

It remains to be seen what impact the government's Review of its UK net zero target, announced in September 2022, has on government policy but for now banks, like other companies, need to continue keeping pace, as they have been doing, with these developments and respond to new requirements, while keeping their strategies on track and managing further activism. A number of these developments are considered below.

Prudential requirements

Climate-related financial risk management

The PRA expected banks (and insurers), by end 2021, to embed as far as possible their climate-related financial risk management implementation plans into their overall risk management frameworks. Since the start of 2022, the PRA's expectations have formed part of its core supervisory process and it is actively supervising firms to ensure they meet those expectations.

The regulator provided, in October 2022, further guidance on its expectations and feedback on firms' implementation progress seen through its supervisory engagement. Overall, the PRA indicates that firms have taken 'concrete and positive' implementation steps but need to continue their work 'to understand and address climate risks'. Specific points made by the regulator in its feedback include:

- governance: firms have made 'significant progress' in embedding the PRA's governance expectations with key personnel training to understand and manage climate risk and some now generating management information to allow boards and executives to lead and challenge effectively. The most effective firms have implemented a coherent approach across strategy, planning, governance and risk management;
- risk management: generally, firms have made progress on risk management but the level of progress varies significantly and further work is required by all firms on embedding climate risk considerations within their risk management frameworks, risk appetite statements, committee structures and three lines of defence;
- scenario analysis: firms' scenario capabilities are not sufficiently well-developed as yet to support effective decision-making, largely due to data-related constraints. Some firms are developing climate risk models but all are having to use proxies, manual adjustments and simplifying assumptions with limited information on how those data gaps and methodology challenges will be addressed;
- disclosure: most firms have developed a climate risk disclosure approach but its progress has been dependent on progress in the other three areas set out above. Firms demonstrating the most effective practice have adopted a consistent and integrated approach across all annual reporting, including financial reports, standalone climate reports and Pillar 3 disclosures. Interestingly, the PRA observes that most firms are not using Pillar 3 as their primary disclosure channel, instead using their annual reports or standalone climate reports; and
- data: all firms need more robust standardised data with broader coverage. Some firms are using data effectively but most remain reliant on third parties and have data gaps, and some firms report that this is having an impact on risk determination.

The PRA takes a tougher stance in its feedback. Rather than acknowledging the difficulties in relation to data unavailability, as it has done to

date, it states that firms need to be able to identify and address data gaps and should put in place 'conservative' assumptions, judgements and proxies where necessary.

The regulator highlights that firms demonstrating effective practice have identified their significant data gaps and developed a strategic approach to close them; have put in place an effective system of governance to oversee and integrate third party data; and use appropriately conservative assumptions and proxies, which are disclosed internally and form part of firms' external disclosures.

The regulator's tougher stance means that firms remain under pressure to achieve compliance with the PRA's expectations and demonstrate effective climate-related risk management despite ongoing data challenges. This is made no less easy by the regulator's indication that where firms' progress is insufficient it will: (i) require firms to produce a 'roadmap' as to how they intend to address this; (ii) determine what additional steps are required; and (iii) may exercise its 'wider supervisory toolkit' if necessary.

Aside from implementation and more broadly, firms will need to demonstrate good understanding and management of climate-related financial risks on an ongoing basis, keep their risk management frameworks under review and adapt them to reflect changing risks to their businesses. They will also need to monitor the regulator's developing expectations and reflect these in their frameworks (including, for example, as a result of the Bank of England's climate change stress test (see below)).

2021-22 Climate change stress test

At a macro-prudential level, the Bank of England published, in May 2022, the results of its Climate Biennial Exploratory Scenario (CBES), launched in June 2021 and designed to test the UK's largest banks' (and insurers') resilience to physical and transition climate change financial risks over a 30-year period, and help firms prepare for, and manage, those risks.

The test was carried out against three 'plausible' 30-year scenarios: (i) early policy action from 2021; (ii) late and disorderly policy action from 2031 (both scenarios focused on transition risks and assumed net-zero transition achieved by 2050); and (iii) no additional policy action up to and beyond 2050 (which focused on physical risks), and applied to banks' end-2020 balance sheets.

Key points from the test results include:

- banks (and insurers) will be able to absorb transition costs without direct impact on their solvency but losses will reduce annual average profits by 10-15%;
- banks (and insurers') losses will, perhaps predictably, be lower if early orderly action is taken, but this means banks working with, not ahead of, the real economy and providing finance and investment to carbon-intensive sectors (such as fossil fuels, manufacturing, transport and trade) to facilitate their transition, rather than simply reducing their exposures to those sectors (on which the Bank notes most firms' transition plans currently focus); and
- overall, the conclusions drawn from the results need to be tempered by the exclusions applied under the CBES (for example, trading losses), the infancy of the scenario analysis and the data challenges (and, therefore, gaps) experienced by firms, including a lack of data from counterparties on their current emissions and future transition plans; their inability to capture data; and their differing risk modelling and assessment approaches.

Overall, the Bank concludes that banks (and insurers) have made good progress on their climate risk management but, perhaps as to be expected, need to do significantly more to understand fully, and manage, their financial risk exposures, including prioritising investment in risk modelling and assessment capabilities. The Bank will continue to work with firms both individually and collectively, and with the government and other regulators to increase communication and clarity on firms' transition obligations (as called for by firms in their CBES submissions).

> *// While the financial system has a crucial role to play in helping finance transition, it is the real economy where reductions in emissions ultimately need to take place. //*
>
> Bank of England, CBES results, May 2022

Capital requirements

The PRA and Bank of England are continuing their analysis on whether changes should be made to the regulatory capital framework to ensure firms are appropriately resilient to the financial consequences of climate change. The current capital framework

does, of course, already require firms to hold sufficient capital to cover all material, including climate-related, risks and disclose these in their Pillar 3 disclosure reports.

The regulators are also clear that government policy, not the regulatory capital framework, is the appropriate tool to address the underlying causes of climate change but modifications to modelling assumptions, and improvements to the regulators' and firms' data and modelling capabilities, may be needed to ensure the UK's capital framework is effectively capturing climate risks. While the CBES is not intended to be used to set capital requirements, its results, together with the findings from the regulators' Oct 2022 'climate and capital' conference and call for papers for it, may inform their ongoing analysis and ultimate guidance intended to be published by end 2022.

The Basel Committee, of which the Bank of England is, of course, a member, and the ECB are also continuing their work in this area and it will be interesting to see the view taken by the ECB following its own 2021/22 stress test of EU banks which concluded that 'substantial further progress' is required on their stress testing frameworks to meet the ECB's requirements.

Disclosure and reporting requirements

Following the government's announcement in October 2021 of the new Sustainability Disclosure Requirements (SDR) Framework, set out in its Report 'Greening the Financial System' (the Report) and intended to achieve mandatory climate-risk reporting across the economy by 2025 (see further our Winter 2021/22 edition), a number of building blocks for it have progressed this year, including those considered below.

Transition plans

The government indicated in its Report that transition plans across the economy would be a requirement under the SDR Framework and best practice would be established. To this end, it established the Transition Plan Taskforce (TPT) and mandated it to develop a common 'gold standard' transition plan for private sector financial and non-financial companies.

Having published a call for evidence in May 2022, and indicating it intends to finalise the standard by early 2023, the TPT published its first consultation in November 2022 on a proposed 'Disclosure Framework' with accompanying implementation guidance. It recommends that, overall, entities take a 'strategic and rounded' approach to transition planning and consider the 'full range of levers' at their disposal to contribute to, and prepare for, an economy-wide transition to net zero.

The Disclosure Framework appears well thought through, appropriate and achievable, comprising three high-level principles of 'ambition', 'action' and 'accountability', together with a number of disclosure elements, including preparatory steps, implementation and engagement strategies, metrics and targets, and, importantly, governance.

The TPT is clear that a 'good practice' transition plan should include an entity's: (i) net zero targets and commitments; (ii) short, medium and longer-term actions to achieve those targets and how those actions will be financed; (iii) supporting governance and accountability mechanisms; and (iv) adopted measures to address the material risks to, and leverage the opportunities for, the environment and the various stakeholders affected by the entity's transition plan actions.

The TPT's consultation proposes that entities publish standalone and clearly separate transition plans every three years (more frequently if plans change significantly) and that they report on progress annually as part of their TCFD (or ISSB once in force) disclosures.

As part of the FCA's existing comply or explain TCFD-based disclosure requirements applying to premium and standard listed companies from 1 January 2021 and 2022 respectively (and asset managers and owners on a 'reasonable steps' basis, also from 1 January 2022) these entities have, of course, already been subject to a 'comply or explain' requirement since 1 January 2022 that, where they make net-zero commitments, they provide transition plans consistent with the TCFD transition plan guidance.

Listed banks will, therefore, be well-placed to consider the TPT's proposals and engage in the consultation process if they wish. The FCA is centrally involved in the TPT's work and will draw on the Framework to strengthen its listed companies' requirement. It is also working closely with GFANZ, which has consulted and published, in November 2022, a 'Transition Plan Framework' to assist financial institutions globally, to ensure their Frameworks are as consistent and complimentary as possible.

> *// Transition plans should reflect the urgency to act. //*
>
> Transition Plan Taskforce, November 2022

Global baseline reporting standard

The government confirmed at COP26 that the global reporting standard being developed by the newly established International Sustainability Standards Board (ISSB) will be incorporated into UK law and form a core part of the SDR Framework.

The ISSB published, in March 2022, for consultation two draft standards covering general requirements for sustainability-related financial disclosures (IFRS S1) and on climate-related disclosure requirements, including industry-specific requirements covering a number of sectors including financial services (IFRS S2) (the Standards). Subject to consultation feedback, the ISSB intends to publish final standards by end 2022.

The draft Standards have been widely welcomed, including by the UK government, FCA and industry including banks, with feedback provided including on consistency, proportionality and interoperability with local regimes. A number of issues remain to be ironed out, including on the Standards' scope and coverage, the omission of the double materiality concept, and emerging and potential national and regional divergence globally. Notwithstanding these issues, the FCA made clear in its July 2022 Feedback to premium listed companies on their first year's disclosures under the listed companies' disclosure requirement (see 'Transition Plans' above) that entities should ensure they are ready to disclose effectively against the Standards once finalised and adopted in the UK.

EU developments

Banks with significant European operations are beginning to consider the EU's proposed Corporate Sustainability Reporting and Due Diligence Directives (CSRD and CSDD). The Directives are intended to capture non-EU companies with significant activity in the EU and significant EU subsidiaries of non-EU companies. The CSDD is on an ambitious legislative timetable and may come into force by end 2022 with member states required to implement it within two years. The CSRR is intended to apply to non-EU companies from 2028.

Investment product disclosure regime and Taxonomy

Of particular interest to banks' wealth management arms will be the FCA's long-awaited consultation, published in October 2022 and following its November 2021 discussion paper (DP21/4), on its proposed investment product disclosure regime. As announced in the government's Report, the regime forms part of the overall SDR Framework and, in the first instance, will apply to: (i) broadly, asset managers and, on a limited basis, product distributors; and (ii) in relation to UK-based funds and, to some extent, portfolio management. The FCA is also seeking views on extending the regime to asset owners in respect of their investment products, and to overseas funds and other investment products, including pension products.

The regime principally comprises an investment product labelling regime and consumer-facing disclosure requirements, together with additional product and entity level disclosure requirements which build on the regulator's existing TCFD-based requirements for asset managers and asset owners. The FCA makes clear that its proposed disclosure requirements will take account of the ISSB standards once finalised and their alignment with the UK's anticipated Green Taxonomy will be considered once the latter is developed. For further information on these proposals, please see our November 2022 briefing.

The Treasury's first consultation on the Taxonomy is planned for later in 2022 and expected to focus on the first two environmental objectives, climate change mitigation and adaptation. This will be of interest to banks and their wealth management arms, not only in light of the FCA's investment product-related proposals but because the government's report indicated that companies, including banks, will be required to disclose more broadly the proportion of their activities which are Taxonomy-aligned (see further our Winter 2021/22 edition).

Divestment versus transition

The majority of banks are working to transition, rather than outright divest, their carbon-intensive clients and assets to net-zero and doing so through increasingly structured processes, including placing transition targets on existing clients as a condition of continued service, and the same on new clients as a condition of support, both of which are vital if banks are to achieve their own net-zero commitments and targets.

> *// 'The financial sector cannot run ahead of the real economy. //*
>
> PRA, May 2022

Regulatory stance

Helpfully, the regulators have become more vocal and firm in their view that banks should be facilitating orderly transition as the appropriate way to achieve net-zero across the real economy as a whole. The Bank of England's stress test conclusions (see

'Prudential requirements/Climate change stress test' above) make clear that banks should continue to provide finance and investment to carbon-intensive sectors to aid their transition, rather than simply reducing their exposures in these sectors. The PRA has also made clear its view that 'early action' means banks moving *with*, not *ahead*, of the real economy.

Impact on activism

This stance is likely to help banks who continue to be on the receiving end of activist activity seeking divestment commitments and criticising banks for their continued ownership, investment and funding of carbon-intensive sectors.

That said, 2022 has not been, for banks at least, the 'golden age' of activism predicted by some industry commentators and, while a number of global banks have received shareholder resolutions and at a higher number than 2021, including notably HSBC (for the second time), Credit Suisse (the first for a Swiss bank), Goldman Sachs and Standard Chartered, with some calling for divestment, the banks have been able to pass their own resolutions which more closely reflect their transition strategies, or make particular commitments, which saw shareholder resolutions not passing or withdrawn.

The key overall point is that banks need to continue ensuring their strategies and objectives clearly state their intentions, their actions align with those intentions, and both are modified on an ongoing basis to reflect their own changing business risks, commitments and targets, as well as developing legal and regulatory requirements. The introduction of the TPT's common transition plan standard and the ISSB reporting standard, and consequent development of market practice, including in the banking sector, may help banks achieve this more effectively.

7 Digital financial services

Digital financial services continue to grow unabated and have emerged strengthened from COVID-19 where consumer demand and need for their quicker and more agile offerings was critical and understandably grew exponentially overnight.

While traditional banking models continue to be disrupted by the rise of digital technology, banks have maintained a solid response to the competitive challenges and continue to embrace the opportunities for growth, not least in the area of cryptoassets where a growing number of global banks are investing in, acquiring and collaborating with cryptoassets' providers – Standard Chartered, Goldman Sachs, HSBC and JP Morgan are all good examples.

The UK government is keen to encourage this activity, from both UK and overseas firms, as it drives to maintain and grow the UK's pre-eminent position as a world fintech leader, despite the challenges of global competition, Brexit and COVID-19 in recent years, and, as part of this, develop the UK as a 'global cryptoasset hub'. The previous Economic Secretary to the Treasury told the Innovate Finance Global Summit in April 2022 that "if there is one message I want you to leave here with today, it is that the UK is open for business - open for crypto business".

Regulators, both in the UK and globally, have also stepped up their work in line with market growth, but, understandably, are taking a careful and considered approach, particularly given the instability of cryptoassets' markets and the failure of several cryptoassets providers in late 2021/early 2022.

Their aim is to ensure innovation continues to be harnessed and encouraged, while financial stability, market integrity and robust consumer protection are firmly maintained. Some of the key developments in 2022 are considered further below.

> *// If there is one message [from the UK government] it is that the UK is open for business - open for crypto business. //*
>
> HM Treasury, April 2022

Cryptoassets regulation

Financial promotions

Following the Treasury's July 2020 consultation on the financial promotion of cryptoassets, it confirmed in its January 2022 consultation response that certain 'qualifying cryptoassets' will be brought within the financial promotions regime by way of amendment to the FSMA 2000 (Financial Promotion) Order 2005 (FPO).

While the Treasury is finalising the definition of 'qualifying cryptoasset', its provisional proposal is 'any cryptographically secured digital representation of value or contractual rights which is fungible and transferable'. It has confirmed that the definition will include cyptoassets already

regulated (those akin to traditional securities, such as a share or debt instrument, in digital form) and unregulated cryptoassets used as a means of investment (exchange tokens, such as Bitcoin and Ether and utility tokens) but will exclude non-fungible tokens.

The FCA's consultation on proposals to strengthen the financial promotion rules for high risk investments generally, and its final policy published in August 2022, include 'qualifying cryptoassets', although the precise application of its proposals to such cryptoassets is subject to confirmation once the definition is confirmed and FPO amendment approved by Parliament.

Clearly, the inclusion of certain cryptoassets in the financial promotion regime will mean such promotions are more restricted and costly to issue. The FCA's final policy on high risk investment promotions, which includes increased requirements on authorised firms that approve them, may exacerbate this if fewer firms remain willing to do so. The Treasury and FCA see the increased requirements as critical for investor protection, a view likely to have been galvanised following the cryptoassets market volatility seen earlier in 2022.

Regulatory perimeter

The Treasury's April 2022 response to its January 2022 consultation and call for evidence, which contained proposals to broaden the scope of cryptoassets regulation, confirmed that stablecoins used as a means of payment (namely those which stabilise their value with reference to one or more fiat currencies) will be brought with the regulatory perimeter. A further consultation will follow later in 2022 on the appropriate regulatory response to other, currently unregulated, cryptoassets, such as Bitcoin and Ether, used primarily as an investment and means of return.

The regulation of stablecoins will be legislated for largely by amendment to relevant existing e-money and payments legislation and relevant amendments have been included in the FSMB. These include:

- amendments to the Electronic Money Regulations 2011 and Payment Services Regulations 2017;
- extending the application of the Banking Act 2009, Part 5, to include stablecoin activities where the risks posed by those activities have the potential to be systemic and, therefore, meet the threshold for Bank of England supervision; and
- extending the scope of the Financial Services (Banking Reform) Act 2013 to ensure relevant stablecoin-based payment systems are subject to appropriate competition regulation by the PSR.

The Treasury will also legislate to bring the regulated activity of providing services of custody or arranging the custody of stablecoins used as a means of payment within the regulatory perimeter.

Regulation of certain cryptoassets is likely to have a reasonably significant impact on the sector, not least the costs of compliance and the need to understand and implement regulatory requirements, and continue to respond to ongoing regulatory developments. It may mean that some providers exit the market but may also mean that those that seek authorisation improve their attractiveness to both customers and investors, including established banks who have already began to collaborate with certain providers. Smaller providers may also look to consolidate to achieve cost efficiencies and remain competitive.

// Regulation of certain cryptoassets is likely to have a reasonably significant impact on the sector. //

Prudential requirements

One of the key developments in relation to cryptoassets, the need for which will no doubt have been strengthened in the minds of UK and global regulators over the last year, is the prudential treatment of banks' cryptoassets exposures.

The Basel Committee published its second consultation in June 2022 and, despite push back from the banking sector, is remaining firmly committed to its key proposed requirement that banks hold capital equal in value to their cryptoassets exposures, albeit it has introduced some modifications. The Committee has been clear that the argument put forward by banks that tough prudential rules would encourage cryptoasset activity to move outside the regulatory sphere and lose transparency 'is not convincing'. It intends to finalise its requirements towards the end of 2022.

The PRA has also addressed the issue in its second cryptoassets-focused Dear CEO letter published in

March 2022, which is helpful given the lack, currently, of a set framework. The regulator indicates that firms should consider the full existing prudential framework when assessing and mitigating risks and exposures to cryptoassets, including in the context of cryptoassets-related outsourcing arrangements. This includes consideration of the relevant PRA Fundamental Rules, Pillar 1, the ICAAP and related Pillar 2 aspects.

The key message is for firms to take a conservative approach, particularly where there is doubt or a choice. The regulator also flags the fact that the current framework may change, given the ongoing discussions internationally, and it will consult on any proposed changes once known.

Central bank digital currency

The joint Treasury and Bank of England Central Bank Digital Currency (CBDC) Taskforce set up in April 2021 is continuing to consider the development and introduction of a UK CBDC (often referred to as the 'Britcoin'), helped by the CBDC Engagement and Technology Forums comprising financial institutions and industry bodies.

Following the Bank's discussion paper, which considered the opportunities and risks involved in a CBDC, and responses to that paper published in June 2021, which indicated a range of industry views on whether a central currency is needed or desired, the Taskforce indicated in late 2021 that it intends to publish a consultation in 2022 to further explore the opportunities and risks involved and begin an open discussion on these aspects.

The Treasury has made clear the consultation would then inform a decision by the relevant authorities on whether to move to a 'development phase' over a number of years, which would include publication of the proposed architecture of any CBDC and which may require in-depth testing of its design and feasibility. If the development phase concluded that the proposed CBDC was operationally and technologically robust, thereby making the case for one, the earliest launch date would be towards the end of the decade.

It will be interesting to see how this progresses, particularly given the UK is not alone in considering a central currency. Quite a number of UK businesses are supportive, particularly retailers who see it as a possible means to ending, in their view high, interchange fees, which have of course been the subject of long-running litigation between them and the relevant payment processors.

// If the development phase concluded that the proposed [Central Bank Digital Currency] was operationally and technologically robust…the earliest launch date would be towards the end of the decade. //

HM Treasury, Nov 2021

8 Other developments in brief

There are a number of developments on which further activity should be seen later in 2022 and in 2023, including those set out below.

Brexit

The European Commission confirmed in February 2022 the extension of the temporary equivalence of UK central counterparties (CCPs) to June 2025 to ensure short-term market liquidity and stability while the EU considers measures to reduce its dependence on these CCPs and develops, and builds up use of, EU-based ones.

Proposed measures from the European Commission are anticipated later in 2022 and aspects being considered include an extension of the EU CCP use requirement for derivatives trades, a graduated cap on derivatives exposures to UK CCPs and potentially additional capital requirements when certain UK CCP clearing services are used, as well as EU-wide supervision of EU CCPs.

The Treasury has also extended the UK's Temporary Recognition Regime for non-UK CCPs to end 2024, with legislation coming into force by end 2022. While it has not indicated the reasons behind this, it may well be to create a level playing field for UK CCPs operating in the EU and non-UK CCPs operating in the UK and may also be to provide further time in which to process such CCPs' applications for recognition.

Separately, the UK regulators' use of the Temporary Transitional Power (TTP) came to an end in March 2022 requiring firms to comply fully with EU onshored regulation from that point, with the exception of the share and derivatives trading obligations to which the TTP will continue to apply until end 2022 (and it, of course, did not originally apply at all to the contractual recognition of bail-in, contractual stays and FSCS protection requirements).

Libor cessation

As discussed in our Winter 2021/22 edition, one, three and six-month GBP and JPY LIBOR settings continue to be available on a synthetic basis until end 2022 to facilitate the transition of tough legacy contracts. Synthetic JPY LIBOR will cease at that point as planned. Following consultation, the FCA has confirmed that publication of the one and six-month GBP LIBOR settings will continue to end March 2023 and is seeking views on the cessation timing of the three-month GBP LIBOR setting.

The regulator is also seeking views on the continued publication of the one, three and six-month USD LIBOR settings after end June 2023 on a temporary and synthetic basis, particularly given their wide use globally. These, plus the overnight and 12-month USD LIBOR, settings, will cease or become unrepresentative at that point and the FCA has permitted their use until then to transition tough legacy contracts (no new use is permitted except in certain limited cases).

Unsurprisingly, the FCA has continued to strongly encourage firms to transition their remaining contracts wherever practicable and, in relation to USD LIBOR settings, not rely on their continued publication beyond June 2023.

Buy now pay later regulation

Following consultation, the Treasury has confirmed its intention to legislate to bring currently unregulated interest free buy now pay later (BNPL) (and potentially other short-term credit (STIC)) arrangements within the regulatory perimeter, currently scheduled for mid-2023 with a consultation on the draft legislation and STIC arrangements later in 2022.

While the Treasury has indicated that regulation will be proportionate and low risk products will remain outside regulation, the market impact could be significant. The increased cost of regulation could see a number of providers exit the market or seek further investment, particularly given the financial pressure they are already under as a result of several factors. Customer numbers have dropped, both as a result of the regulatory scrutiny of BNPL products and worsening economic conditions. Some providers' valuations have fallen significantly as a result, prompting them to undertake cost reviews and workforce reductions. They are also facing increased competition from established banks who, despite regulatory scrutiny and the risk of customer default, are providing their own BNPL products to retain customers.

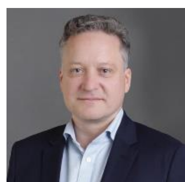
Transactional activity

Significant transactional activity in the banking sector has remained limited in 2022 and may remain so given the worsening economic conditions, both domestically and globally, and ongoing UK political change. A good example is the postponement of planned IPOs by a number of private equity-owned private banks and non-bank lenders until conditions are more favourable.

That said, a number of fund raisings have been seen, largely among challenger banks, and opportunistic activity may be seen as private equity and other investors take advantage of lower valuations, particularly among fintech and neo banks. Consolidation, which was widely tipped by industry participants and commentators to be likely in 2022, may now be seen as banking groups seek to manage cost pressures, achieve cost efficiencies and remain competitive. In the medium to longer-term a number of the key drivers set out in our Spring 2021 edition remain relevant.

Contacts

If you would like to discuss any of the issues highlighted in this publication or any other legal or regulatory matter, please do contact us or speak to your usual Slaughter and May contact.



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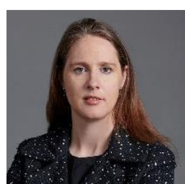

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