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BANKING SECTOR - HOT TOPICS

Focus on Financial Institutions – Part of the Horizon Scanning series

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Welcome to the winter 2021/22 edition of our **Banking Sector - Hot Topics** series which discusses some of the key developments currently affecting the sector. UK regulatory reform and changes to the UK banking prudential regime push on, with an emphasis on achieving growth and increased competition in the sector. Sustainability and ESG factors are now centre stage for banking firms following COP26 and LIBOR transition is reaching its culmination. Other developments on which more should be seen in 2022 include operational resilience, digital financial services and transactional activity.

1 UK regulatory reform

UK regulatory reform pushes on, with its key drivers of bolstering the UK's position as a global financial centre and, as the Chancellor stated in his Mansion House Speech in July 2021, a financial services sector that is 'open, competitive, technologically advanced and sustainable.', as well as being required by legislation.

Small banks' prudential regime

After announcing the same in late 2020 (see our Spring 2021 edition), the PRA published in 2021 its proposals and initial feedback statement on a simplified and graduated prudential regime for smaller banks and building societies.

The drivers of the regime are very much focused on encouraging growth and competition in the sector, while maintaining robust but proportionate prudential requirements for such firms. It builds on the PRA's supervisory policy in relation to 'new and growing' banks published in April 2021 and takes account of the Bank of England's updated MREL policy (see further item 3), both of which are intended to achieve the same. It is also consistent with a global shift in prudential regulation where a number of jurisdictions, including Switzerland, Canada and Australia, have developed similar regimes for smaller banks, and marks a divergence from the EU's approach, which broadly applies the same prudential requirements to all banking firms irrespective of their size or activities.

The proposed regime would apply to 'non-systemic domestic' banks and building societies, focusing on the smallest of these firms initially and being extended to larger, but still non-systemic and domestic, firms in time. Its central intention is to reduce the complexity and, therefore, the proportionately higher costs, of the prudential requirements that apply to such firms by omitting those requirements which do not reflect the financial risks they face and do not, therefore, make a material contribution to their resilience (those requirements reflecting the failure of larger banks on which the current prudential regime is based).

The regime is also intended to avoid barriers to growth when a bank is ready to move out of the simplified regime and is then 'hit' by significantly greater, and

therefore more costly, requirements. Proposals include the introduction of a limited number of interim requirements to 'bridge the gap' between the simpler regime and regime applying to larger banks and an option to 'opt-out' of the simplified regime if a bank knows at the outset (potentially at authorisation) that it is likely to grow.

This issue may, of course, in the longer-term fall away, or at least be reduced, if, as the PRA envisages, the UK's prudential regime as a whole comprises a number of layers from the small banks regime up to the full Basel standards through which banks can move gradually as they grow.

The proposed regime marks a significant change in UK prudential policy and the PRA's discussion paper and subsequent feedback statement are deliberate in order to gather industry views on the options and their wider implications, and inform more developed proposals on which it will then consult. The regime will also, as a result, take a number of years to design and implement and, therefore, while it will be welcomed by established smaller banks, new entrants and prospective entities looking to enter the sector, it will be some time before its impact is seen and assessed in practice.

> *"[The regime's] central intention is to reduce the complexity and, therefore, proportionately higher costs, of the requirements applying to [small banks]."*

UK regulatory framework review

HM Treasury published, in November 2021, the second and final consultation in 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 ensure it is 'fit for the future'.

The Treasury's first Phase II consultation, published in October 2020, set out an overall blueprint for financial services regulation, focusing on the split of responsibilities between Parliament, government and the regulators, and on regulatory accountability (see our Spring 2021 edition). The second consultation builds on these areas and feedback received, providing further proposals on regulatory rule-making responsibilities, accountability and objectives and principles.

The consultation confirms the Treasury's view that the FSMA 2000 regulation model remains the most appropriate way to regulate UK financial services and, with enhancements, is overwhelmingly supported by stakeholders. The PRA and FCA remain the appropriate institutions to deliver that regulation and macro-prudential regulation, including the FPC, will not be altered.

Rule-making responsibilities

As proposed, the regulators will resume full responsibility for setting and implementing regulatory standards, as set up under FSMA 2000. They will be provided with additional powers to do so in relation to direct regulatory requirements under EU retained law through a new Designated Activities Regime (DAR). The significant process of repealing EU retained law and replacing it with regulatory rules will take place over several years through primary and secondary legislation, allowing Parliament to scrutinise the changes.

The government will also provide the regulators with rule-making powers in relation to e-money and payment providers, and recognised investment exchanges, where needed, and is considering providing the Bank of England with such powers in relation to central counterparties and central securities depositories. It considers the FCA's current powers in relation to trade repositories and credit rating agencies, are sufficient.

Strengthening accountability and scrutiny

The consultation also includes proposals to strengthen regulatory accountability and scrutiny by Parliament and the Treasury, recognising the importance of this given the increased regulatory rule-making responsibilities also being proposed.

Such measures will include formal statutory mechanisms through which the regulators will provide information to Parliament, particularly the Treasury Committee, on which it will exercise its scrutinising powers; a new requirement for the PRA and FCA to respond, on an annual basis, to the Treasury's recommendation letters, issued at least once a Parliament, covering their activity in the previous year; and a new Treasury power to require the regulators to review existing rules where the government considers this would be in the public interest.

These proposals have been welcomed by industry and Parliamentary Groups, both of which expressed strong views following the first consultation that the increased rule-making powers of the regulators needed to accompanied

by increased accountability and scrutiny. That said, there have been calls for the Treasury to go further and introduce a regular and independent review of the UK regulatory regime, with the industry body, CityUK, stating that this would 'ensure the rules are proportionate, coherent and achieve their goals in the most efficient way possible.'.

> *"[While] these proposals have been welcomed by industry and Parliamentary Groups.... there are calls for the Treasury to go further."*

New regulatory objective and principle

Also reflecting the regulators' greater responsibility for rule-making 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 consultation proposes 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.

In introducing the objective but placing it 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.

New Consumer Duty

The FCA is progressing its consultation, as required under the Financial Services Act 2021, on the proposed new 'Consumer 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. Its second consultation, published in December 2021, builds on the proposals set out in its first consultation with some changes, partly in response to feedback received.

The Duty in summary

The Duty is intended to apply to firms' regulated activities in relation to retail financial services and products, and, importantly, 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' has been revised (from the original proposal to only exclude professional clients and eligible counterparties) and will now follow the scope of relevant FCA sourcebooks.

The Duty, as proposed, would 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 would support the new Principle and require firms to act in good faith towards, and avoid causing foreseeable harm to, retail customers, and enable them to pursue their financial objectives; and
- four outcomes which would underpin the Duty and be underpinned by rules and guidance across the areas of product and service governance; price and value; and consumer understanding and support.

A private right of action?

Importantly, the FCA has decided, for the time being, not to extend a private right of action (PROA) to the new Principle (the existing right does not extend to the FCA's Principles), considering the current redress options to be sufficient and to avoid an inconsistent outcome (given existing Principles are not actionable). It will, however, keep this under review.

Key points to highlight

Retail banks will clearly be monitoring this development closely given the impact it would have on their business, but investment banks are not immune and key points to highlight include:

- the Duty is intended to apply 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 new Principle and cross-cutting rules would be incorporated into the SMCR's conduct rules, with individual conduct rule 4 (ICR 4) being amended in relation to retail business to reflect the wording of the Principle and the obligations under these rules. Current ICR 4 would continue to apply to non-retail activity;
- the FCA's rules and guidance in relation to the four outcomes are intended to meet industry concerns on outcomes-based regulation but this is not exhaustive and does leave significant scope for different interpretations of the requirements. 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 intends to back up its requirements with 'assertive supervisory and enforcement action', the industry is right to be concerned;

> *"We expect firms to step up and put consumers at the heart of what they do and we'll be holding senior managers accountable if they do not."* FCA, Dec 2021

- the FCA seems clear that the Duty is not imposing a statutory duty of care on firms, stating in the consultation that it does not, unlike Parliament, 'have the power to introduce a duty of care in statute'; the label of 'Consumer Duty' does not imply a 'legally enforceable obligation'; and that it (the FCA) has not 'branded the Duty as a duty of care'. That said, the FCA may need to provide further clarity as it also states that it does not agree its proposals 'would only amount to a duty of case under the Financial Services Act 2021 if combined with a PROA'; and
- the FCA's decision not to introduce, at least for the moment, a PROA is important and should be monitored. This would have been the first time a regulatory Principle was actionable and could have significantly increased the number of consumer claims made, particularly given it is arguably easier to bring a claim on the basis of a broad Principle than a specific requirement and, unlike FOS complaints, such a claim would not have been subject to compensation limits.

2 The UK's capital requirements regime

Implementation of international standards

The PRA published final rules in July and October 2021 introducing the Basel III prudential standards into the UK's capital requirements regime (the Regime) and which come into force on 1 January 2022 (see our Spring 2021 edition for the legislative background).

The rules confirm that the Regime will largely mirror the EU CRR II (which, as of June 2021 largely, brought in the standards for EU member states) with certain modifications to more closely align with the Basel III standards and ensure consistency with the UK CRR. Such modifications include that software assets will be fully deductible, as intangible assets, from CET1 capital (EU CRR II exempts such assets from the deduction requirement) and, in response to consultation feedback, will apply from 1 January 2022 (rather than earlier as proposed in the consultation) to allow firms to make the necessary adjustments.

The introduction of the Basel standards will make significant changes to the Regime, including:

- a number of amendments to the large exposures framework, including the definition of capital will be Tier 1 capital only (from Tier 1 and a limited amount of Tier 2 under the existing regime); and
- the introduction of a binding Net Stable Funding Ratio (NSFR) requirement of 100%. The NSFR is defined as the amount of stable funding available to a bank (ASF) relative to the required amount of stable funding (RSF), and the requirement of 100% will mean the ASF must exceed the RSF.

Firms will be well-advanced in their preparations for the new Regime but will have had to quickly assess, and make any adaptations to, their implementation programmes in light of the PRA's final rules. Firms operating in both the UK and EU face the particular challenge of implementing, and operating under, two somewhat different regimes in force on different dates and this will be made more complex by the fact that the UK Regime will be set out in the PRA Rulebook, rather than in legislation, with text taken directly from the Basel standards, rather than EU CRR II, making comparison between the two regimes more complex.

Hot on the heels of the Basel III standards will be the need to implement the Basel '3.1' (or Basel

IV) standards which the government has committed to implementing by the required date of 1 January 2023 and on which the PRA will consult in good time before then.

It will be the first set of international standards implemented in the UK entirely by a regulatory, rather than political and legislative, process since the UK first joined the EU. While the process of consultation is anticipated to be more expedient than the typically slower EU process, the PRA will be under pressure to ensure implementation maintains, and potential helps, the growth and competitiveness of the UK financial system, takes account of the significant lending that banks have undertaken in response to COVID-19 and the potentially high level of non-performing exposures they are facing as a result, and that any proposed requirements beyond those required under Basel 3.1 are properly substantiated.

For our thoughts on the impact of COVID-19 on bank resilience, see our Spring 2021 edition.

> *"[The Basel 3.1 standards] will be the first set of international standards implemented in the UK by an entirely regulatory process since the UK joined the EU."*

Leverage ratio framework review

The FPC has completed its review of the UK leverage ratio framework (the Framework), undertaken in light of the Basel III standards and as part of its ongoing commitment to review its policy approach, and the PRA has published its concurrent policy statement (set out in the same document). While much of the Framework will remain in place, key changes include:

- extending the current minimum leverage ratio requirement[1] to CRR firms and consolidated entities with non-UK assets equal to or greater than £10bn (currently the requirement applies to banks with retail deposits of £50bn or more). It will apply on a consolidated basis at the UK consolidated group, or ring-fenced bank sub-group level, and to firms below the top level of these groups on an individual basis. Sub-consolidation will be available where a firm has subsidiaries that can be consolidated, subject to the firm meeting certain conditions (and making an application);
- revising the PRA Rulebook to introduce a single leverage exposure measure in line with international standards (there are currently two leverage ratio definitions under UK CRR and PRA rules respectively);
- incorporating into the PRA's supervisory expectations, an expectation that firms not in scope of the minimum leverage ratio requirement should, nonetheless, 'ordinarily' maintain the same ratio; and
- amending the central bank claims exclusion from the leverage ratio measure to permit it provided such claims are matched by 'liabilities' (rather than 'deposits' as originally proposed) of the same currency and of equal or longer maturity.

The extension of the Framework's scope will come into force on 1 January 2023 with other changes coming into force on 1 January 2022.

The changes will clearly impact firms which are being brought into scope for the first time. For firms already in scope which are subject to UK CRR and PRA rules, the changes should largely simplify the requirements. Firms not in scope but now subject to the new PRA supervisory expectation will need to monitor their compliance with the minimum requirement, take steps to maintain it and prepare for increased supervisory scrutiny if it is breached.

3 Updated MREL policy

The Bank of England published, in December 2021, its updated MREL policy, following consultation and its discussion paper, which will apply from 1 January 2022. The updated policy takes account of the FPC's review of the UK leverage ratio framework (see further item 2), and the PRA's proposed small banks' prudential regime and supervisory approach to 'new and growing' banks (see further item 1), and focuses on its application to 'mid-tier' banks (namely those (or their subsidiaries) that are not G-SIBs or D-SIBs but are subject to the Bank's stabilisation powers and, therefore, MREL requirements in excess of minimum capital requirements).

The updated policy seeks to address the challenges that such banks have faced in achieving interim MREL requirements and the barriers to growth and, therefore, competition, created by the 'step up' in MREL requirements as firms reach either of the two thresholds for MREL

[1] 3.25% on a measure of exposures that excludes qualifying central bank claims, with 75% being met with CET1 capital and the remainder permitted to be met with additional Tier 1 capital instruments, subject to certain conditions.

requirements at twice their minimum capital requirements (£15 – 25bn total assets or 40 – 80,000 'transactional' accounts (where more than nine withdrawals are made over a three-month period)).

The issue is exacerbated by the fact that these banks hold significant deposits, which are not eligible liabilities for MREL purposes, and, therefore, have to undertake the costly and challenging process of accessing unfamiliar capital markets to issue eligible debt.

To address these issues, the updated policy:

- introduces a 'stepped glide path' for new and growing banks to transition to end-state MREL requirements more gradually over a period of six, and potentially eight, years from a 'transition start' date set by the Bank and three years from a relevant bank's notification to it of a more than £15bn total assets forecast over that three year period (which might be at the point of authorisation);
- may, in the medium-term, include a possible increase or removal of the transaction accounts threshold (which moves relevant banks from the modified insolvency to the partial transfer resolution strategy), in light of the significant developments in retail banking technology, including open banking, which may mean disruptions to such banks' operations can be adequately mitigated in the event of failure. The Bank has initiated work in consultation with the PRA, FCA, FSCS and banking industry although changes will not be introduced before the end of 2022 at the earliest given the assessment and development work required; and
- in the interim, for banks that may exceed the transactional accounts threshold in the future, the Bank will make a firm-specific judgement when setting a resolution strategy against a number of factors, including the volume of transactional banking services or other critical functions that the bank provides.

While the policy's graduated approach will be welcomed by banks nearing the bail-in strategy threshold and may well encourage new entrants to the sector, the Bank has made clear that:

- it remains of the view that the £15 – 25bn total assets threshold for the bail-in resolution strategy is the most appropriate to ensure the continuity of banking services. This is despite a number of consultation respondents calling for an increase in the threshold as seen in other jurisdictions; and
- the basic MREL calibration (twice minimum capital requirements) will not be reduced, given the importance of MREL in achieving credible resolution, the continuity of critical functions and the reduction of the 'social costs' of bank failure.

The Bank's position on these aspects may be less welcome to a number of growing and mid-tier banks, including Paragon and Starling, which expressed concern in response to consultation about their impact on banks' ability to grow.

> *"The updated [MREL] policy seeks to address the challenges that [mid-tier] banks have faced in achieving interim MREL requirements."*

4 Sustainability and ESG

Sustainability and ESG factors have maintained significant momentum over the last year, focusing heavily on the 'E' in ESG and reaching a peak in the lead up to, and at, COP26 (the UN's 2021 climate change conference hosted by the UK).

The key role of financial institutions, including banks, in helping to transition economies to net zero is now centre stage, demonstrated particularly by the first 'Finance Day' at COP26 and the commitment of financial institutions, delivered at the conference through GFANZ, to align USD130 trillion (40% of the world's assets) of private capital to achieve net zero emissions by 2050.

As well as keeping pace with the volume of new legal and regulatory developments and requirements (see further below), banks, many of whom already have well-developed net zero strategies and targets, will need to ensure that these respond, and adapt to, new developments; are followed internally; and are clearly and consistently communicated externally.

It will become increasingly critical that banks' actions align with their stated intentions. Banks, like other financial institutions and corporates, have already been on the receiving end of activist activity, with a number of requisitioned climate change resolutions seen in 2020 and 2021, including by JP Morgan and Barclays. The current debate around divestment versus transition is very likely to trigger further activity - indeed, industry commentators are predicting a 'golden age' of activism in 2022 - and banks will need to continue

preparing for, and managing, such activity and adapting their strategies as appropriate.

> *"The key role of financial institutions, including banks, in helping to transition economies to net zero is now centre stage."*

Regulatory action: prudential requirements

Risk management plans

The PRA expects banks (and insurers) to have embedded their climate-related financial risk management implementation plans into their overall risk management frameworks by end 2021. Many banks will be well-advanced in meeting the deadline but, given the PRA's indication in October 2021 that, while progress has been good, some firms are 'materially' more advanced than others, some banks may need to accelerate their implementation work.

Banks will also need to keep their plans under review going forward, adapt these as necessary to remain compliant and, as the PRA has made clear it expects, demonstrate a good understanding and management of the risks on an ongoing basis beyond the deadline.

2021 climate change stress test

At a macro-prudential level, the Bank of England launched, in June 2021, its Biannual Exploratory Scenario (BES) (which compliments its annual cyclical stress test) to test the UK's largest banks' (and insurers') resilience to physical and transition climate change financial risks and help firms prepare for, and manage, those risks.

It is the first time that banks and insurers have been tested together in order to assess their interaction and interdependency, and the Bank expects participants to engage particularly closely with their largest counterparties to gather relevant financial exposure data. Firms have had to provide interim results by October 2021 and the Bank will publish results in May 2022 (with a possible second test launched in January 2022).

Increased capital requirements?

The regulators are also starting to consider whether increased capital requirements should be introduced to cover climate-related financial exposures. The PRA's risk management plans already expect firms to hold sufficient capital to cover such exposures, but the regulator is now undertaking work to identify whether changes to the regulatory capital framework as a whole are needed and will report by the end of 2022. The BES is not intended to set capital requirements but it may inform the PRA's review work if it identifies financial exposures not adequately covered by current requirements. The ECB and Basel Committee are also undertaking work in this area.

Government action: disclosures and taxonomy

Sustainable Disclosure Requirements Framework

Following the government's commitment in November 2020 to introduce mandatory climate-risk reporting across the economy by 2025, the government set out, in its October 2021 Report 'Greening the Financial System', the new Sustainable Disclosure Requirements (SDR) Framework. This builds on existing TCFD-based disclosures and is intended to be a fully integrated regime across all sectors of the economy and in line with international standards. The government confirmed at COP26 that the global baseline reporting standard being developed by the newly established ISSB will be incorporated into UK law and form a core part of the Framework.

As part of this, UK companies, including banks and insurers will be required to make mandatory sustainability disclosures and not only report on the impact of climate change *on* their business, as the TCFD requires, but also the impact *of* their business on the environment using the UK Green Taxonomy (see below) (known as 'double materiality'). The requirements will be subject to consultation and will be implemented by legislation and/or regulatory rules, intended to be by 2024 for 'economically significant companies' and by 2025 for other companies.

Many banks will have been reporting voluntarily for some time, publishing both TCFD and sustainability reports as part of their annual reporting. Once further information is provided via consultation, they will need to start considering the new requirement and whether existing processes and systems need to be adapted to meet it.

It also remains to be seen whether existing disclosure requirements introduced by the FCA on a comply and explain basis for listed companies (in force on 1 January 2021 and 1 January 2022 for premium and standard-listed companies respectively) and BEIS on a mandatory basis for listed and large private companies (and LLPs) (in force in April 2022) will be amalgamated into one

requirement under the SDR Framework. The government's intention that the Framework is intended to build on existing requirements and be a fully integrated regime suggests it may be, and this is certainly the approach the FCA has taken in relation to the SDR requirement for asset managers and owners (see further in the winter 2021 edition of our Asset Management – Hot Topics).

Either way, the incorporation of ISSB's global reporting standard into the SDR Framework will be welcomed by UK banks, and other companies, particularly if they operate overseas, given the current number of 'similar but different' existing disclosure regimes that apply both in the UK and other jurisdictions. Banks will be well-placed to start considering the IFRS Technical Readiness Working Group's prototypes of the standard and the adaptations potentially needed to their internal reporting processes and systems.

> *"The ISSB's global reporting standard will be welcomed by UK banks, and other companies, particularly if they operate overseas."*

Transition plans

Listed companies (as clarified at COP26) will also be required to disclose net zero emissions transition plans which set out their progress towards the government's commitment to net zero emissions by 2050. The requirement will be on a comply or explain basis until a common standard for such plans is developed (which the newly formed Transition Plan Taskforce, in co-ordination with GFANZ and other bodies, has been mandated to do) when it will then become mandatory. The requirement will be brought in by legislation and is intended to be in force by 2023.

A number of banks will, of course, be already developing such plans via their membership of GFANZ and will be well-placed to consider the Taskforce's prototype standard once developed.

UK Green Taxonomy

The government's Report also provided further information on the science-based UK Green Taxonomy which it intends to introduce, which will set out the criteria which specific economic activities must meet in order to be considered environmentally sustainable and, therefore, 'Taxonomy-aligned'. As part of the SDR, companies, including banks, will be required to disclose which proportion of their activities are Taxonomy-aligned and this will particularly feed into the requirement to report on the environmental impact of their businesses (see above).

The intention of the Taxonomy is not only to provide clarity on companies' activities for investors and investment product providers, but also to provide an informative performance target for companies themselves. This is a welcome, and much-needed, development given the current lack of a common standard that banks can use to assess their own financing products and the companies to which they lend.

Product governance and avoiding 'greenwashing'

Banks' wealth management arms will be particularly interested in the SDR Framework's requirements for asset managers and owners, the government's expectations of investment product providers and the proposed consumer-facing product labelling regime, together with the FCA's discussion paper developing these proposals and its ongoing consultation on TCFD disclosure requirements for asset managers and owners. For further information on these aspects, please see the winter 2021 edition of our Asset Management – Hot Topics.

Diversity

The regulators' focus has not been entirely on the 'E' in ESG, with an increasingly focus on the 'S' (social) and, in particular, diversity and inclusion across the financial services sector.

As foreshadowed in an FCA speech earlier in 2021, it, together with the PRA and Bank of England, published a joint discussion paper in July 2021 which sets out proposals to improve diversity and inclusion within all financial services firms on a proportionate basis, and on which they intend to consult in 2022.

The FCA, as listing authority, is also consulting on proposed requirements for listed companies to disclose annually from 1 January 2022 on a comply or explain basis: (i) their progress against certain proposed targets (including that at least 40% of the board comprises women and at least one board member is from a non-white ethnic minority); and (ii) within their Corporate Governance report, how diversity policies apply to key board committees.

5 LIBOR transition – the final sprint

With the cessation of most LIBOR settings fast approaching at the end of 2021, financial institutions, including banks, have been pushing on with transition, with the FCA reporting in September 2021 that 'the taps of new sterling LIBOR have largely been turned off' across bonds, loans and derivatives in line with the UK Working Group's milestones.

Government and regulatory attention in recent months has been on the orderly wind down of 'tough legacy' contracts (those which cannot feasibly be converted to alternative risk-free rates (RFRs) or incorporate fallbacks), issuing 'synthetic' LIBOR for this purpose and providing a legal 'safe harbour' for parties who use it.

Tough legacy contract wind down

Since announcing in March 2021 the cessation of the majority of LIBOR settings, as planned, at the end of 2021, the FCA has taken a number of steps under its new powers in the UK Benchmarks Regulation (as amended by the Financial Services Act 2021) (UK BMR) to facilitate the use of 'synthetic' LIBOR for a limited period in relation to tough legacy contracts to allow further time for these to expire or move away from LIBOR permanently. These include:

- officially designating the one, three and six-month GBP and JPY LIBOR settings as unrepresentative from 1 January 2022 and confirming that it will, from the same date, compel ICE Benchmarks Administration (IBA) to continue publication of these settings until end 2022 on a revised 'synthetic' methodology.

  While the FCA has the power to compel the IBA to continue publication of synthetic LIBOR for up to 10 years, it has made clear that it will only do so in relation to JPY LIBOR for one year to end 2022, after which it will cease. It has also yet to make a decision in relation to the continued publication beyond 30 June 2023 of the five USD LIBOR settings due to cease or become unrepresentative at that point (although it has confirmed, following consultation, that their use to that point will be restricted to legacy contracts except in certain limited circumstances);
- confirming, following consolidation, that the synthetic methodology will be the SONIA and TONA forward looking term rates respectively plus, in both cases, the ISDA fallback credit spread adjustment; and
- confirming, also following consultation, that the legacy contracts in which supervised entities are permitted to use synthetic LIBOR will include all financial contracts and instruments within the scope of UK BMR with the exception of cleared derivatives. This will, therefore, include uncleared derivatives, bonds, regulated mortgages and consumer credit agreements, and investment funds which reference the unrepresentative LIBOR settings and do not have workable fallbacks or other provisions to facilitate transition (but does not include syndicated or bilateral business loans, which are outside the scope of UK BMR).

The publication of the FCA's final policy has left market participants with limited time before year-end to apply it and confirm which contracts fall within, and more importantly outside, its parameters. Notwithstanding this, the FCA is keeping up the pressure, indicating that the use of synthetic LIBOR should only be seen as a 'bridging solution' and reiterating its well-aired message that market participants should be actively transitioning contracts wherever practicable.

The regulator has also made clear that, while it may extend the permitted use of synthetic LIBOR for GBP LIBOR settings beyond the end of 2022, where market participants postpone efforts to transition from it, the regulator may need to impose limitations on its use, such as time-limited permission for certain contract types.

Legal 'safe harbour'

Market participants raised specific concerns in relation to the use of synthetic LIBOR and whether legal protections would be provided, as is the case in the US, to ensure contract continuity and prevent causes of action arising against, or between, the parties to relevant contracts.

Following HM Treasury's consultation on this point, the government introduced the Critical Benchmarks Bill which received royal assent in December 2021, having progressed through Parliament on an expedited basis.

The Act inserts two provisions into UK BMR designed to provide legal certainty and avoid breach of contract, or frustration, claims by deeming references to LIBOR 'however expressed' to be references to synthetic LIBOR from the inception of the contract: (i) where such a rate is available; and (ii) unless the contract expressly provides otherwise.

The Act stops short, however, of providing the broad safe harbour introduced in the US, namely provisions protecting parties that use synthetic

LIBOR from litigation as a whole. Instead it confirms that the deeming provisions neither create any new liabilities nor extinguish any existing causes of action, which is more akin to the EU approach. It also, naturally, only extends to contracts governed by the laws of England and Wales, Scotland and Northern Ireland with local regimes governing the position in relation to contracts subject to the laws of other jurisdictions.

The Act also provides some protection for benchmark administrators, inserting a third provision into UK BMR which provides that the administrator of an unrepresentative benchmark will not be liable if it takes action, or inaction, in accordance with requirements imposed by the FCA in relation to the calculation and publication of an unrepresentative benchmark, including synthetic LIBOR.

> *"Market participants raised specific concerns in relation to the use of synthetic LIBOR and whether legal protections would be provided."*

Market participants are likely to welcome the protection the Act seeks to provide, albeit this does not go as far as seen in the US. That said, participants should still take time to identify which contracts should be able to benefit from the protections and still be prepared for possible claims despite them. Conflicts of law points could also arise given the tough legacy contract regimes of other jurisdictions have also limited the publication of synthetic LIBOR in only certain LIBOR settings.

6 Other developments in brief

There are number of developments on which further activity should be seen in 2022. Further background on these is set out in our Spring 2021 edition.

Review of the UK's ring-fencing regime

The independent review of the UK's bank ring-fencing regime is progressing, with the publication of a call for evidence requesting stakeholder feedback on the regime's impact on financial stability, competition and customers, and its operation in practice. A summary of responses was published in July 2021 and a report is still expected by February 2022.

Operational resilience

Banks (and insurers) will be progressing implementation of the first set of operational resilience requirements before the March 2022 deadline. The FPC has announced that its long-awaited cyber stress test (postponed due to COVID-19) will launch in 2022, focusing on payment services and a scenario where data integrity has been compromised. The PRA will take this forward and seek voluntary participation from the 'most systemic' contributors in the payments chain. It will be in touch with those firms selected to participate and provide further information in due course.

Digital financial services

HM Treasury's response to its consultation on crypto assets is anticipated by the end of 2021/early 2022. The Law Commission is also anticipated to consult on digital assets following its call for evidence earlier in 2021 and its advice on smart contracts provided to the government in December 2021 (see further in our client briefing).

Transactional activity

Significant transactional activity in the banking sector has remained muted in 2021, as it was in 2020, although private equity investment and regular funding rounds have been seen, including Softbank's investment into Revolut, Monzo's third funding round following two in 2020 and Starling Bank's funding round led by Fidelity.

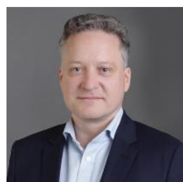
There is an increasingly strong view among industry participants and commentators that activity, and particularly consolidation, is likely in 2022 and the key drivers of this activity as discussed in our Spring 2021 edition remain relevant.

Brexit

Very little in the way of equivalence decisions from the UK or EU have emerged since the end of the transitional period (TP), with the exception of the temporary equivalence of central counterparties (CCPs). The EC announced in October 2021 that it will extend, in early 2022, the temporary UK CCP equivalence beyond the current expiry date of June 2022 although it has not, as yet, indicated the length of that extension. The Bank of England has welcomed the move, stating 'it is a sign….that constructive working together can emerge'.

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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This briefing is part of the Slaughter and May Horizon Scanning series

Click here for more details or to receive updates as part of this series. Themes include Beyond Borders, Governance, Sustainability & Society, Digital, Navigating the Storm and Focus on Financial Institutions. Focus on Financial Institutions explores the financial services sector which continues to be affected by digital/technology disruption and regulatory reform. COVID has added to the burden as financial institutions adapted to a new operating model overnight. This focus brings together our thinking on these points and aims to promote discussion and debate in relation to financial institutions' responses.

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