Thomson Reuters™

Slaughter and May's banking and investment services column: December 2024

by Financial Regulation group, Slaughter and May

Status: **Law stated as at 18-Dec-2024** | Jurisdiction: **United Kingdom**

This document is published by Practical Law and can be found at: **uk.practicallaw.tr.com/w-045-3595**
Request a free trial and demonstration at: **uk.practicallaw.tr.com/about/freetrial**

The Financial Regulation group at Slaughter and May, including Nick Bonsall, Selmin Hakki and Emily Bradley, regularly share their thoughts with Practical Law Financial Services subscribers on topical developments in the banking and investment services sector.

In their column for December 2024, as the year draws to a close, the group considers how the regulators have been supporting the government's growth agenda, future prospects for the tech-agnostic regulatory approach to AI, the culmination of the ring-fencing review and the passage of the Bank Resolution (Recapitalisation) Bill.

Supporting growth and competitiveness: under pressure

Readers will be aware that the Financial Services and Markets Act 2023 (FSMA 2023) tasked the PRA and the FCA - as secondary objectives - with facilitating the international competitiveness of the UK economy and its growth in the medium to long term.

Since then, both regulators have been proactive about sharing examples of their growth-enhancing work. The PRA noted, for instance, that when designing the Solvency UK reforms it "thought hard" about what more it could do to "help firms play a bigger role in productive investment in the UK economy". Meanwhile, the FCA pointed in a report to an increase in "the speed and efficiency" of its decision-making and administrative procedures, which it claims "facilitates firms' productivity and the ease/attractiveness of doing business in the UK". Published last month, HM Treasury's call for evidence on the first Financial Services Growth and Competitiveness Strategy also refers to several examples of recent pro-growth regulatory initiatives (such as changes to the UK's listing regime and the launch the Pensions Review, among others).

Yet there are grumblings that the regulators have not been living up to their new objectives. "The UK has been regulating for risk, but not regulating for growth," the Chancellor said in her Mansion House speech. An FCA survey showed that nearly half of closely supervised UK financial services firms aren't confident that the FCA can deliver on its aim. Meanwhile, there's ongoing parliamentary scrutiny into how the objective is being implemented and integrated with the regulators' other goals.

There are inherent tensions here, for example: how does one repair the public finances while encouraging investment in the UK? Can the regulators respond to complaints about over-regulation while maintaining an internationally respected system? There is also a growing consensus that more research and evidence is needed to explore the links between regulation, competitiveness and growth. HM Treasury's call for evidence asks specifically for feedback on the role that regulation plays in the growth of the financial services sector. The FCA recently attempted to delve into the connections between regulation and economic growth in a literature review; last month it launched its first ever research competition to award funding for several projects focused on growth and competitiveness. In a speech, Nikhil Rathi has also called for further examination of the link between higher economic growth and increasing financial inclusion.

The real question is whether it will ever be possible to achieve an effective balance between the protective role of regulation now expected in the UK, and the style of regulation that would in fact promote growth.

Reproduced from Practical Law, with the permission of the publishers. For further information visit uk.practicallaw.thomsonreuters.com or call +44 20 7542 6664. Copyright ©Thomson Reuters 2025. All Rights Reserved.

Uncertain prospects for the tech-agnostic approach to AI

At the end of October 2024, the Bank of England published a speech delivered by Sarah Breeden, the Bank's Deputy Governor for Financial Stability, on the impact of artificial intelligence (AI) on financial stability. We found her comments on AI governance particularly interesting. We were struck by the speech's revelation that only a third of respondents to the Bank and FCA's latest survey on AI described themselves as having a complete understanding of the AI they had implemented in their firms. As firms consider use of AI in higher impact areas of their businesses such as credit risk assessment, capital management and algorithmic trading, Ms Breeden says the Bank should expect "a stronger, more rigorous degree of oversight and challenge", and think about "where we might be content for AI models to make automated decisions and where (and to what degree) there should be a human in the loop." Establishing this bright-line is going to be a significant challenge for both firms and regulators.

Also of interest was Ms Breeden's suggestion that the Bank may need to "think again about the adequacy of the regulatory perimeter and whether some requirements applying directly to model providers themselves might be necessary", particularly if AI starts to be used in a material way for trading or core risk assessment. This possibility marks the latest development in a series of regulatory projects - including around Big Tech and critical third parties to the UK financial sector - which speak to the increasing enmeshment of technology and financial regulation, set to continue in 2025.

Modest adjustments to the ring-fencing regime

On 11 November 2024, a draft statutory instrument amending the UK bank ring-fencing regime was laid before Parliament. On the same day, HM Treasury published a response to its September 2023 consultation on "near-term reforms" to the regime (undertaken in response to the 2021-2022 independent ring-fencing and proprietary trading review led by Sir Keith Skeoch).

We have summarised the anticipated impact of these reforms and commented on some of the implications in a briefing. Overall, the contents of the draft SI are broadly consistent with the proposals of the Skeoch review and the 2023 consultation. The main points to note are that:

- A UK bank is currently subject to the ring-fencing regime if, together with any other UK bank(s) in its group, it has "core deposits" (broadly, retail and small business deposits) of more than £25 billion, averaged over a prescribed calculation period. This threshold will rise to £35 billion.
- There will be a secondary threshold to exempt retail-focused banks with trading assets of ≤10% Tier 1 capital from the ring-fencing regime (calculated on a UK consolidated basis), except where they are a member of a group that the Financial Stability Board has designated as a Global Systemically Important Bank (GSIB).
- Ring-fenced banks (RFBs) will be permitted to establish branches and subsidiaries and to hold ≥20% minority investments in companies incorporated outside the UK and EEA.
- There will be a new four-year M&A transition period to prevent UK banks entering the regime for the first time immediately upon, and as a result of, an M&A transaction.
- Some of the existing restrictions on the permitted activities, products and services of RFBs will be eased, including by:
  - permitting RFBs to make minority investments in SMEs;
  - to a limited extent, liberalising the prohibition on exposures to relevant financial institutions (RFIs);
  - broadening RFBs' ability to undertake debt restructuring for borrowers in financial difficulty; and
  - widening the range of hedging activities in which RFBs can engage.

The changes are likely to take effect in late January 2025, subject to Parliamentary approval. And so, we have an arguably anticlimactic end to the re-examination of one of the most significant UK post-financial crisis reforms. The groups that stand to benefit most from the changes are retail-focused banking groups, and other banking groups whose UK retail deposits are less than £35 billion (but close to or above £25 billion). They will fall outside (or remain outside) the ring-fencing regime entirely, and in some cases indefinitely. For most banking groups that will remain subject to the regime, the reforms are likely to have a modest, albeit broadly beneficial, impact. Many would have preferred there to be a more bold approach.

Reproduced from Practical Law, with the permission of the publishers. For further information visit uk.practicallaw.thomsonreuters.com or call +44 20 7542 6664. Copyright ©Thomson Reuters 2025. All Rights Reserved.

Small bank resolution: winners and losers

The Bank Resolution (Recapitalisation) Bill continues to make its way through Parliament.

In short, the Bill will allow the Bank of England to require the Financial Services Compensation Scheme (FSCS) to provide funds - known as a "recapitalisation payment" - to meet some of the costs associated with resolving a failing bank when the Bank exercises its stabilisation powers to achieve a transfer to a private sector purchaser or a bridge bank. The FSCS will be able use its levy-raising powers on the banking sector to recoup these costs.

The size of the bank for which this new mechanism might be used has attracted significant comment and debate. The policy motivation for the Bill was initially expressed as ensuring "that the Bank [of England] has a more flexible toolkit for managing the failures of smaller banks in a way that strengthens protections for public funds". The latest version of the Bill is now consistent with that explanation, through the addition of an important proviso to new section 214(3) FSMA (see Hansard record): the Bank of England cannot require the FSCS to transfer a recapitalisation payment to it in respect of a bank that is required to maintain an end-state Minimum Requirement for Own Funds and Eligible Liabilities (MREL) exceeding minimum capital requirements (MCR).

So, the mechanism can be used only in respect of small and medium-sized banks, and those on the MREL glide path. Within the banking sector, some stand to lose more than others. The largest banks will be required to issue MREL to finance their own recapitalisation and to fund the FSCS to recapitalise their smaller counterparts. Small banks will be the greatest beneficiaries, effectively outsourcing their recapitalisation to the rest of the industry.

Meanwhile, proposals to streamline the Bank's approach to setting MREL, spelled out in a Statement of Policy, are out for consultation (see our briefing). If implemented, the changes will mean that MREL for transfer preferred resolution strategy firms would generally be set at a level equal to MCR. Where additional loss-absorbing capacity is required in resolution for these firms, after having written down regulatory capital, this could, where needed, be met through the mechanism to support small bank resolution in the Bill. HM Treasury published a ministerial statement welcoming that consultation, which it says is consistent with the government's intention that the mechanism is primarily focused on the resolution of smaller banks.

Check back here for further updates on the passage of the Bill in 2025.

Legal solutions from Thomson Reuters
Thomson Reuters is the world's leading source of news and information for professional markets. Our customers rely on us to deliver the intelligence, technology and expertise they need to find trusted answers. The business has operated in more than 100 countries for more than 100 years. For more information, visit www.thomsonreuters.com

Thomson Reuters™