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Confronting the polycrisis
Financial Markets
Regulatory Outlook 2023

CENTRE *for*
REGULATORY STRATEGY
EMEA

"If we do not shift our trajectory this decade, we are cooked. And if you don't want to be cooked, then we should speed up"

Speech by Kristalina Georgieva, IMF Managing Director, on getting to net zero, October 2022[1]

"Our aim is to ensure that innovation can take place but within a framework in which risks are properly managed and which safeguards the sustainability of such innovation"

Speech by Sir Jon Cunliffe, BoE Deputy Governor, Financial Stability, on reflections on DeFi, digital currencies and regulation, November 2022[2]

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Introduction

FS firms face challenging operating conditions worldwide: high inflation, interest rate volatility, disruptions to global supply chains, and slowing economies. The IMF's sobering assessment is that "the worst is yet to come."[3]

These disruptive factors will understandably command attention in the near term. However, firms also face medium-term strategic challenges. The shift towards a multipolar geopolitical order creates new frictions and risks. Technology continues to transform the sector, creating new opportunities but also many challenges.

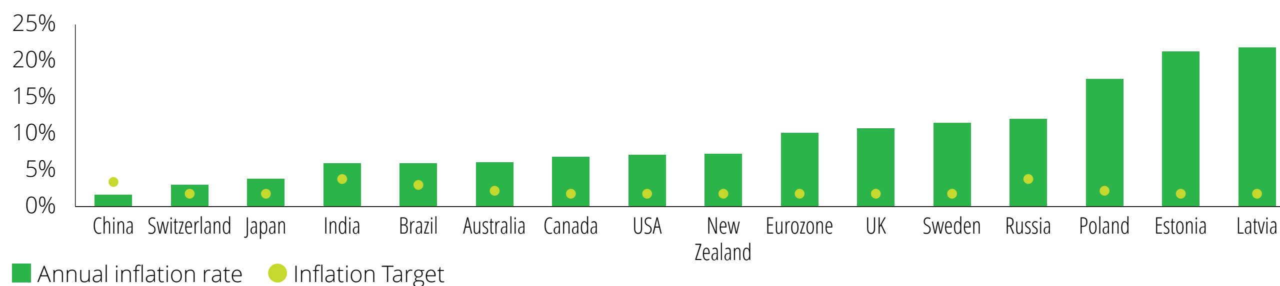
The twin sustainability crises of climate change and ecological degradation demand enormous reallocations of capital, not to mention vigilance for the risks they entail.

As we enter 2023, Boards and executive teams therefore face two major sets of questions. First, what steps are they taking to remain resilient and support customers through near-term economic pressures? Second, are their strategic plans aligned with the medium-term structural changes in the operating environment?

A strong grasp of the regulatory and supervisory environment must be central to how firms answer these questions.

In this global foreword, we set out our view of the major regulatory strategy issues facing the FS industry worldwide, first in terms of the immediate pressures created by the gloomy economic situation, and then in terms of the major structural changes highlighted above: geopolitical, technology, and sustainability.

Figure 1: Inflation at end-2022



Source: Refinitiv Datastream

The economic outlook

Global growth is slowing and, although a global recession is not the central case, the IMF says 2023 will nevertheless "feel" recessionary to many, with perhaps a third of the global economy set for contraction.[5] Households and businesses in many parts of the world are feeling the squeeze of persistently high inflation (Figure 1), particularly from commodity and energy prices, while sharply rising interest rates (Figure 2) are increasing debt service ratios. Credit risks are consequently elevated, and

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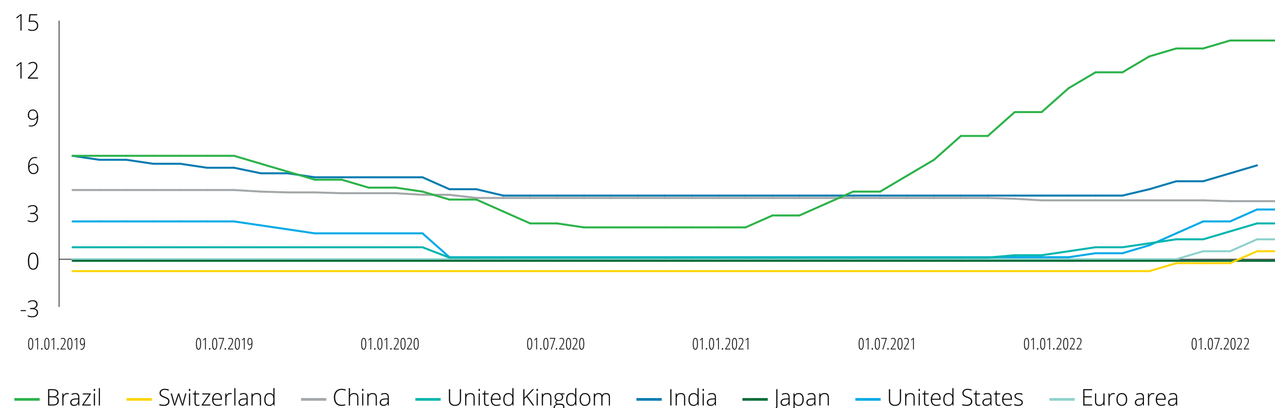
market confidence is fragile. Monetary and fiscal policies will need to be carefully balanced, and policymakers will be wary of what the IMF refers to as policy "miscalibration."[6] To weather the storm, firms should be vigilant on multiple fronts.

First, firms must manage their own financial resilience in the face of declining credit quality. The work of the last 10 years to build capital buffers means that, globally, the banking sector enters 2023 in a generally resilient position, although emerging market banks appear more vulnerable to a downturn than their advanced economy counterparts.[7] Many non-banks will also need to be on alert given the volumes of credit risk that have migrated outside the banking system in the last 10 years, including most recently to providers of buy-now-pay-later finance. Supervisors will focus on credit risk management (especially in relation to real estate and leveraged lending) across all regulated firms and will also scrutinise exposures to and connections with unregulated lenders.[8]

Second, firms will need to continue to support their customers through a period of economic hardship. Conduct supervisory expectations are now substantially higher than in previous downturns.

Figure 2: Interest rates



Source: Bank for International Settlements[4]

In some countries, how lenders treat customers facing financial hardship will be a supervisory (and in some cases a political) priority, and industry will need to identify vulnerable customers proactively and take measures to support them. Insurers are likely to see rising numbers of customers struggling to cover their premiums, creating the possibility of protection gaps that will also draw supervisory attention.

Third, firms should be vigilant for sudden bouts of market volatility. Even the archetypically stable US Treasury market will need to be watched closely given recent observations of low liquidity and volatility, combined with the uncertain impact of the SEC's new dealer rule.[9] Firms should be ready for regulatory and supervisory measures to address "unfinished business" around non-bank financial stability issues, with several recent episodes of market turbulence (such as the dislocation of the UK Government bond market in autumn 2022) thrusting these issues back up the agenda.[10] Open-ended funds are a particular focus, where market volatility has the potential to clash with market illiquidity to trigger asset fire sales. Although the FSB's latest

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progress report on addressing the risks from non-bank financial intermediation indicates an ongoing program of work, it remains unclear how far and how fast national authorities will implement any resulting regulatory changes.[11] We nevertheless expect central banks and regulators to be working hard to understand these vulnerabilities and other possible sources of market disturbance. This will likely manifest in a continued emphasis on stress testing for individual regulated firms and the system as a whole, revisions to fund liquidity rules, and a focus on firms' and counterparties' margining practices and ability to meet margin calls, including through data requests where gaps have been identified by supervisors.[12]

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These are regulators' near-term preoccupations. They demand strong Board engagement supported by robust management information, clarity around risk appetites, clear processes for escalation, and continuous internal communication between and across business lines and support functions to ensure consistency in messaging and decision-making. But they are by no means the only challenges facing industry or its regulators, and we now turn to three major sources of structural change with which firms must grapple: geopolitics, technological change, and sustainability.

Structural change

Geopolitics

Rising geopolitical tensions are contributing to the fragmentation of markets, with nations and business leaders looking at how to build supply chain resilience and security through greater localisation of production and supply. Firms operating across what are, in some cases, tense political borders will be directly affected by these tensions.

The Russia-Ukraine conflict provides a stark reminder that firms should be vigilant and cautious of geopolitical risks that can manifest very rapidly through numerous channels, whether in terms of operational resilience, financial crime, cybersecurity, or reputational risks. Many of these issues are not amenable to statistics-based risk modeling and require the use of more qualitative information to develop sophisticated scenario analyses. Supervisors will expect firms to have carried out "lessons learned" exercises from their experiences this year – for instance around sanctions and geographic footprints – and to have reviewed and, in some cases strengthened, their "severe but plausible" scenarios for evaluating their ability to withstand and recover from operational shocks. They will also have to "think the unthinkable" through reverse stress testing and emerging risk assessments. Supervisors will also expect firms to examine their own supply chains, which may in turn lead to more requests for "localisation," for example of data, IT infrastructure or people.

This is not only about weathering short-term shocks: it is also an issue of medium-term strategy, particularly around firms' geographic footprints and shifting patterns of international trade. At a minimum, this means Boards reviewing risk appetites for operating in specific countries and with particular clients, as well as the reputational risks that will inevitably surround decisions to operate in or exit certain markets.

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Technology
The financial system continues to undergo major technological transformations. New technologies enable both old and new firms to provide new and better products and services, develop better insights, and to do so ever more efficiently. But they have also complicated supply chains and service delivery models while creating new sources of competition.

In some areas, the regulatory regime has struggled to maintain pace with technological innovation, but so too have firms' risk management and control frameworks. This has been clearest in relation to the complex relationships between regulated FS firms and third-, fourth-, and even fifth-party technology service providers, including Big Techs. The regulatory framework around operational resilience is pushing firms to address the resulting risks, although different countries and regions are adopting different approaches. Regulated firms will need to get their houses in order by untangling (and where possible simplifying) networks of technological service suppliers and ensuring their operational resilience. And where firms are pursuing shared delivery models, Boards need to have strong assurance around their reliance on TPs.

Big Techs are also increasingly active in FS in their own right as competitors to and partners of incumbent firms. In the near term, technology firms should accept the reality of "extra-territorial" FS regulation which will either bring them within the supervisory perimeter, subject them to other direct forms of oversight, or see regulated firms being used as conduits through which such oversight can be gained. Over time, we expect FS authorities will feel the need to develop a more integrated approach to the regulation of Big Techs, recognising their multiple roles in FS. This will require them to work with data protection regulators and competition authorities. In the meantime, individual regulators are pursuing their own national approaches. In turn, regulated firms should factor in these different national requirements as they develop their global strategies for their overall relationships with Big Techs and other critical service providers, complicating the contracting process.

"As we enter 2023, Boards and executive teams therefore face two major sets of questions. First, what steps are they taking to remain resilient and support customers through near-term economic pressures? Second, are their strategic plans aligned with the medium-term structural changes in the operating environment?"

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The regulatory framework also continues to evolve in attempts to keep pace with innovation around digital (particularly crypto) assets. While issues have persisted concerning unregulated players seeking to organise themselves around developing regulatory regimes, regulated firms have increasingly been engaging with a developing ecosystem of digital asset technology providers to develop more credible and mature client offerings.[13] However, recent turmoil has changed the outlook, creating a potential crisis of legitimacy and trust around the fledgling industry. A further regulatory response seems inevitable, although we see little prospect of international convergence where rules are being put in place, with jurisdictions differing along all manner of issues, from regulatory classifications (as securities, currencies, and so on), through to the intersection with financial crime frameworks, further complicating industry efforts to grow the sector.

Cyber risks are ever-present for FS firms, but the increasing digitisation and use of TPs for services and support functions, combined with the geopolitical tensions referred to above, means that the threat perimeter is becoming more complex. These risks cut across all sectors of FS, and regulators are pushing firms to continue to invest in their capabilities. Insurers are doubly exposed, as potential targets of cyberattacks but also as providers of cyber risk insurance, in relation to which regulators continue to probe around the ambiguity of policy coverage and the risk of so-called "silent cyber."[14] Reporting of cyber incidents remains a key pillar of the regulatory framework, with some regulators moving to tighten reporting windows, and the FSB currently looking at the possibility of delivering more consistency in reporting.[15]

Climate and nature

The politics of sustainability have become more difficult with the ongoing debate, especially in Europe, about how to reconcile environmental goals with renewed energy security concerns, along with the emergence of an "anti-ESG" faction, and the spilling over of disagreements over the binding nature of some climate targets within the GFANZ.[16, 17]

But 2022 also provided ample evidence of how disruptive sudden swings in food and energy prices can be, as well as the impacts of increasingly frequent and intense natural disasters. These risks will only become more pronounced as the climate transition unfolds, and they will increasingly shape the FS operating environment. Insurers face particular challenges given the twin tasks of managing the solvency implications of exposures to physical risks while continuing to protect policyholders, many of whom may face escalating costs for coverage, creating the risk that protection gaps emerge or widen.

Regulation and supervision will be key determinants of how firms must respond to these risks. In some areas, there appears to be a degree of supervisory convergence, most notably around prudential risk management and risk governance. Climate-related stress tests and/or scenario analysis exercises are becoming features of supervisory frameworks in many major jurisdictions, being well established in the EU and UK, Japan and Hong Kong, and emerging onto the agenda in the US. Elsewhere, however, despite shared ambitions to address issues such as greenwashing (with investment funds in particular in the crosshairs around fund names, labelling, disclosure practices, and the green credentials of their underlying assets), firms are finding themselves contending with differing national requirements, particularly in terms of sustainability taxonomies. Even where supra-national attempts have been made, such as with the ASEAN taxonomy, national variants will persist.

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There have been more ambitious attempts to develop international standards around disclosure, most notably the ongoing work of the ISSB, which is driving toward the development of a global baseline with the support of international regulators such as the FSB. Some countries are continuing to develop their own frameworks, and while such frameworks may converge over time, in the near term firms will need to be able to store and manipulate data flexibly so that it can be moulded to meet the needs of different jurisdictions. Indeed, sustainability data quality and coverage remain significant challenges for firms and, with the use of proxy data still widespread, regulators are expected to push industry to address this in 2023.

There is divergence in the technical detail of regulatory frameworks to address sustainability, for instance in terms of how risks are captured in prudential rules, how funds are labelled, how insurance products are underwritten or offered, and what firms must disclose to the market. But the issue is fundamentally one of risk management, and to fulfil their risk management obligations, Boards need confidence that they understand their business footprint and risk exposures. This confidence will not be delivered through mere compliance with regulation, but through the development of better data, sophisticated modelling capabilities, plausible scenario analyses, and engagement with scientific expertise and judgement. The absence of harmonised rules should not be a barrier to action, and the onus will very much remain with firms to be able to meet multiple sets of expectations and reconcile them across their operations where necessary.

The need for risk management has its complement in the development of new opportunities for innovation and market development. The reallocations of capital required for the climate and nature transition are enormous, with trillions of dollars needing to be intermediated, invested, insured, and risk managed worldwide across virtually all areas of economic activity. And, put simply, the better grasp firms have of the risk environment, the better placed they will be to identify and exploit the corresponding opportunities in the years ahead.

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Taking the long view
Firms face many headwinds as we enter the new year. Our view for the last several years has been that global firms face increasing difficulties in maintaining common systems or controls across their geographic footprints as regulatory frameworks diverge. Last year confirmed our view further and, as we have suggested above, the deteriorating geopolitical situation compounds the problem. The obligation will be squarely on firms to accommodate local factors when designing and implementing processes, controls, reporting, and all manner of other requirements, with limited prospects for regulatory harmonisation.

The major challenge for the industry in the year ahead is to navigate the choppy near-term economic waters – including by engaging with supervisors in their efforts to monitor and address financial stability risks – without losing sight of the importance of the longer-term processes of change we have highlighted here, all of which demand ongoing investment. Regulation continues to be a major force that influences these trends, and a strategic view of the regulatory environment, as well as an ability to connect such a view with the review and challenge of business strategy decisions, remains an imperative for firms looking to stay at the forefront of the industry.

As ever, this global assessment provides a broad setting for our more detailed regional Regulatory Outlooks. In what follows, you will find our analysis for EMEA, but readers with an interest in understanding the landscape in APAC and the Americas can find them in the corresponding reports from our teams in those regions.

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Our view of the trends and regulatory priorities that will shape financial services in the year ahead

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Firms must contend not only with the major global strategic challenges highlighted in the foreword, but also with the complexities of the changing regulatory and supervisory environment across Europe and the UK. Our 2023 Financial Markets Regulatory Outlook identifies nine themes and three spotlights that we believe will be of major strategic significance throughout the year. These themes and spotlights are analysed in detail in the full report, along with recommendations for how firms can respond.

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Making managing environmental risk business as usual

Digital assets and payments
Policy implementation begins

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In focus

- The cost-of-living and energy crises do not fundamentally change the science of nor the threat from climate change and nature loss, and regulators continue to work to ensure firms manage and disclose environmental risk exposures appropriately.
- Firms need to change gear on transition planning, from stating ambitions and setting targets to taking action. Supervisory focus will initially be on reviewing the credibility and effectiveness of transition plans in guiding risk management and business strategy.
- Firms need to develop the details of their transition plans, including by setting sector-specific pathways, validating science-based targets and deepening the assessment of their financed emissions.
- The foundational structure of corporate sustainability reporting requirements and the schedule for future developments is largely set, but substantial areas of detail remain to be elaborated or agreed , and there is much to do to implement the requirements.
- The EU CSDDD is expected to be finalised this year and will bring to the fore explicit and binding requirements around supply chain due diligence.

The cost-of-living and energy crises have complicated the net zero transition, giving rise to renewed debates around energy security. But the near-term macroeconomic situation does not alter the underlying science, or the imperative of addressing climate change and nature loss. The latest analysis from the UN HLEG, published during COP27, finds that emissions are on track to have increased by 11% by 2030, rather than being on a declining path.[18] Nor have near-term challenges substantially altered the commitment of financial regulators to ensuring that firms are actively engaging with the associated economic transition, are resilient to the effects of climate change and provide transparent disclosures to end-investors and the market.

"With the concept of transition plans familiar to firms, the focus is shifting to setting more specific, actionable targets and sector-specific detail"

Setting clear targets and actions for transition plans

With the concept of transition plans familiar to FS firms, the focus is shifting to taking action to meet the targets that have been set. Efforts are underway to improve the structure and content of transition plans, with the UK TPT, GFANZ and the UN HLEG having published guidelines to that effect at COP27. And although disagreements around aspects of the GFANZ framework spilled into the public arena in 2022, it has continued to develop guidance, for instance with its sectoral pathways and material on how firms can engage with clients to make a more significant impact on financed emissions. Sector-specificity will also follow in the EU through

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EFRAG's next consultation, and in the UK through a consultation expected from the TPT in the first half of 2023.

We expect rising awareness of nature and social risk factors will also drive many firms to encompass a more holistic view of sustainability in their plans, in particular, the climate-nature nexus.

Scrutiny of transition planning by supervisors and policymakers

Firms will find their transition plans increasingly becoming part of "business as usual" supervision, with supervisors treating plans as one tool in their kit for scrutinising sustainability strategies, risk management and governance across the industry. Supervisors' focus will initially be on the risks posed by climate change and the coherence of transition plans for managing them. The UK FSMB introduces a new regulatory principle: "the need to contribute towards achieving compliance with Section 1 of the Climate Change Act 2008 (UK net zero emissions target)"; and the EU has proposed in the updated CRD a new legal requirement for banks to prepare plans to address climate risks arising over the short, medium and long term. Once these new rules are in place, supervisors will also be equipped to take action when they see shortcomings in such plans. In the UK, this trend will be further bolstered through the FCA's anticipated increase in focus on how firms' governance and culture support their broader purpose and sustainability goals.

As firms progress with their work, it will become increasingly clear how pledges translate into day-to-day and strategic decision-making, and the implications for product and service offerings. These knock-on impacts will in some cases draw government and regulatory attention (including from macroprudential authorities), for instance around the possibility of gaps in insurance coverage or changing patterns of bank lending to particular customer segments. In the UK, these considerations

Has the "S" in "ESG" been paused?

While the "Social" element of "ESG" may appear to be on hold with the EU postponing the creation of a Social Taxonomy for now, regulators have still been thinking about specific pockets of the "S". For example, across Europe there are various initiatives to highlight where industry is linked to child labour and broader definitions of modern slavery. CSDDD will introduces minimum expectations in areas including human rights, child labour and exploitation of workers. In the UK, the FCA has also taken forward work to develop its policy on diversity and inclusion requirements on Boards for the firms it regulates.

There is a difficult balance to strike to ensure that steps taken to further a "just transition" do not lead to a decline in investment in developing economies and, in turn, broader global inequality. It will also be important for firms ultimately to take an aggregate view of social risk within their sustainability strategies, which looks across individual regulations and initiatives that fall within the social risk category – for example, employment rights, diversity and inclusion and secondary impacts on local communities. Policymakers need to play a role in achieving this. While there is plenty to do on climate some regulators are already upskilling their capacity on social policy. More broadly, the development of policies on social risk is likely therefore to re-emerge and potentially grow by the second half of 2023 – even as climate and nature remain in focus.

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will be picked up in the Government's updated Green Finance Strategy.

Expanding disclosure requirements

Firms will increasingly be pushed to report on their transition plans. Indeed, the TPT's proposed framework for mandatory transition plans will likely be integrated into the FCA's rulebook for those firms that are already subject to mandatory TCFD reporting.

Transition planning is only one of the avenues through which firms will need to engage with climate and nature, with reporting and disclosure requirements set to continue to occupy a prominent place in the broader policy landscape. The foundational structure of corporate sustainability reporting requirements and the schedule for future developments are largely set, but substantial areas of detail are yet to be articulated or agreed (and there is uncertainty whether timelines can be met).

Work is continuing at the international, regional and national levels, and firms operating across borders will face the corresponding challenge of reconciling multiple frameworks. Internationally, the ISSB's first set of standards is due to be finalised early this year, with the issue then becoming to what extent countries align their own reporting and disclosure frameworks with it.

Some countries, including the UK, will look to consolidate reporting and disclosure within the ISSB's framework. Others, including the EU, will look to deliver outcomes consistent with the ISSB, but with distinctive elements, as with the EU's CSRD. In parallel, the nature-focused work of the TNFD will also continue at the global level, creating further questions as to how far its final format – to be delivered in September 2023 – will be aligned with the ISSB, and to what extent it will be incorporated into binding domestic rules.

The unknowns for firms include: whether the planned "handoffs" of information between initiatives (e.g. as corporate disclosures feed into Article 8 disclosures under the EU Taxonomy) will work; the extent to which developments in the quality and availability of data will keep pace with disclosures; and the extent to which the potential for a proliferation of standards and requirements will be reined in.

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Clarity across investment chains

The investment management sector faces particular challenges around disclosures at the product level. The general principle remains that every layer of the investment chain needs to be clear about the green credential of products, and that they are labelled and marketed correctly. However, regulators in the EU and UK share concerns around the mismatch between the use of ESG-related terminology in funds' names and their underlying objectives, strategies and asset composition.

UK rules to mitigate greenwashing by asset managers, portfolio managers and distributors will be finalised in June 2023 in the form of the SDR, while ESMA's November 2022 consultation indicates a shared interest in ESG labelling issues, proposing thresholds connected to the environmental and social characteristics of underlying assets in order for funds' names to reference sustainability or other ESG-related terms. Indeed, these initiatives point to the wider regulatory interest in greenwashing, with the ESAs also undertaking their own work on greenwashing in FS.

The definition and classification of sustainable activities is also an important part of policymakers' sustainability strategy, but we expect further development of the details of the EU Taxonomy to progress slowly (at best) this year. In the UK, GTAG will continue its work on the UK Taxonomy but the legislative underpinnings for its work will be delayed.

Expanding requirements to TPs and supply chains

In its current form, the EU's CSDDD, expected to be finalised this year, introduces requirements for large companies operating in EU markets relating to transition plans and corporate governance, and the obligation to identify, prevent and mitigate actual or potential adverse human rights or environmental impacts in their own operations, subsidiaries or entities in their value chain. For all companies, the compliance challenge will be significant.

An important additional open question for FS firms is to what extent the CSDDD will include FS activity in its scope. If it defines the value chain for FS activity broadly, the resulting compliance burden and costs – over and above those faced by all companies - will be very material. Moreover, the CSDDD captures entities incorporated or located outside the EU – potentially requiring third-country FS firms conducting business in the EU to ensure that other group entities within the value chain of the EU entity comply with the list of international conventions set out in the Directive.

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Sustainability data

Across the sustainability agenda, poor quality and limited availability of some key elements of data continue to create significant challenges, limiting the accuracy and usefulness of disclosures; hampering risk assessment and management; and potentially creating legal and reputational risks including from allegations of greenwashing. Supervisors recognise these data challenges but nevertheless expect firms to make progress, whilst at the same time demonstrating they understand the limitations that exist and have a strategy for closing data gaps and remediating quality issues.

A starting point for firms is to consider what data can be collected (typically, through a questionnaire) from and/or validated with clients or customers at key touch points in the customer journey, such as onboarding new relationships or agreeing new loans or transaction. The data that can (reasonably) be collected will vary by type of client or customer, and firms should consider the training they give to staff to ensure data requirements are properly understood. These processes need to be supported by controls and due diligence processes. Internal systems and processes also need to be in place so that data can be shared between business lines, risk and finance functions.

As firms consider what data can be collected through this process, they should take account of how the reporting environment for their corporate customers is changing, what disclosures they should expect to be able to collect in future; and how initiatives such as the MAS Project Greenprint or NGFS data initiatives could help. At the same time, they should also factor in the broadening of data needs beyond climate. Most firms are currently not collecting nature risk data, but it would be advantageous in the medium term to consider now what data will be needed; where those data will be sourced from; and whether any of the steps being taken to support climate data should be extended or changed in anticipation of the future nature risk need.

It is neither possible nor efficient for firms to collect all data themselves, and certainly not in the near term. Where proxy data are used, firms need to take a prudent and well-documented approach. When using TP data, it is important to perform due diligence to gain comfort on the data received and a full understanding of what the data show.

Regulators are also taking steps in relation to TP data providers and ESG ratings providers. ESMA and the FCA both have concerns about the robustness of certain TP data, particularly data that is subsequently relied upon by ESG ratings providers. ESG rating providers are also likely to be brought within the regulatory perimeter as part of wider regulatory efforts to ensure that ESG ratings are credible and consistent. The UK Government, for example, announced that in Q1 2023 it would consult on bringing ESG ratings providers into the regulatory perimeter, to ensure products are transparent and use consistent standards. In the meantime, the FCA has launched an expert working group to develop a code of conduct for both ESG ratings providers and data providers.

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Actions for firms

Net zero transition plans

- Take a holistic, firm-wide approach that incorporates all functions and business lines. Take three pre-steps to setting plans:
  - Get clarity in the boardroom, including an agreed understanding of how transition planning is different and its full transformative scope.
  - Consult stakeholders and build support across the business.
  - Set the tone from the top of the organisation, and be clear how transition planning aligns with other strategic priorities.
- As plans are developed, ensure:
  - Clarity of senior management ownership.
  - Robust data checks to enable compliance with regulatory reporting and disclosure requirements.
  - Clear science-based targets for reaching net zero by 2050 are set, along with key interim milestones, and establish external assurance/verification in setting targets.

Integrated understanding of sustainability disclosure requirements

- Go beyond tracking of individual initiatives to develop an integrated understanding across emerging guidelines and requirements (including voluntary codes, standards and industry guidelines) for sustainability-linked disclosures to meet these effectively.
- Incorporate this integrated understanding into a data sourcing, quality assurance and validation strategy. This includes enhancing the quality and consistency of data used within the firm, including when using TPs.
- Ensure the development of an independent ability to check the robustness of sustainability data relied on by the firm.
- Ensure the incorporation of ongoing regulatory change within target operating models. See our sustainability data box for more on this topic.

Enhancing corporate governance and accountability, including for preventing greenwashing

- Respond to emerging binding and explicit requirements in relation to corporate governance and accountability by strengthening processes and controls, improving the quality of reporting to the Board and senior management team, and leveraging culture and remuneration to incentivise the required behaviours.

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In focus

- 2022 demonstrated the disruptive effects of both physical and transition risks, putting it beyond doubt that climate risks demand immediate and proactive risk management. Supervisory reviews conducted in 2022 highlighted that firms will need to make faster progress in integrating climate risks into their strategies and risk management frameworks.
- In 2023 nature risk will rise in prominence as a concern for regulators. Fully incorporating nature risk into risk management assessments will be challenging – an important and more tractable starting point is to focus on the climate-nature nexus. Nature risk is already "baked in" to extant rules and guidelines from the ECB and EBA, and we expect supervisory scrutiny to intensify during 2023..
- Use of Pillar 2 framework (for banks) is now established and will likely become more widespread in 2023.
- Supervisors expect banks and insurers to be able to demonstrate that climate risk management is having a consequential impact on business decisions.

The economic disruption and losses due to climate change and degraded natural environments were all too clear across EMEA – and globally – in 2022, as heatwaves, drought and wildfires wreaked havoc. Energy price rises and volatility – although not in 2022 triggered by environmental factors – also provided a stark illustration of how transition risks associated with climate and nature might rapidly feed through to the real economy. And while last year's climate stress tests in the UK and EU may not have demonstrated any near-term financial doomsday scenarios for banks or insurers, this was arguably due at least, in part, to limitations in the scope of the scenarios used. The environmental, political and economic turbulence of the past year should concentrate minds that management of climate and nature risks is a here and now problem.

Climate risk management

Firms have undoubtedly made progress in the foundational aspects of how they understand climate risks, and how they integrate that understanding into decision-making. The use of scenario analysis is becoming more widespread, models are beginning to incorporate more variables, transmission channels and risk types, and data is slowly improving. But, as emphasised by both the ECB and PRA in 2022, significant work remains.

The supervisory deep dives, stress tests and on-site inspections we saw in 2022 will continue. In particular, we expect banking and insurance supervisors in the EU and the UK to run scenario exercises in 2023, including to cover trading book risks for the first time. Supervisors will also emphasise firms making greater use of short-term stress tests to quantify exposures. Supervisors will expect all firms' practices to mature at a faster pace in 2023, and less advanced firms will be given progressively less leeway.

Improvements should not be confined to analytical processes, such as scenario analysis or credit risk modelling. Supervisors will expect the results of these processes to be integrated into a wide range of business as usual activities, ultimately enabling management to steer their firm's' balance sheet. Risks need to be incorporated in risk appetite frameworks (including quantitative and

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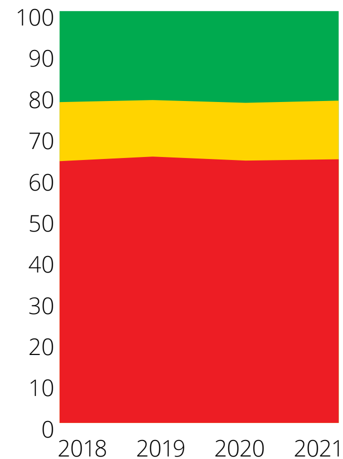
Figure 3: Share of banks' credit exposures to high emitting and low emitting firms (%)
The carbon footprint of banks' portfolios has not decreased significantly



Source: ECB, Financial Stability Review May 2022 [19]

consequential risk limits, early warning indicators and escalation procedures) and cascaded through to relevant business units and portfolios. Scenario analysis outputs need to be factored into first-line processes (such as client selection and lifecycle management, pricing, underwriting and product development), second-line processes (such as capital and liquidity adequacy assessments, macroeconomic forecasting, and impairment calculations) and strategy. In short, climate risks need to be calculated and then used to make or inform decisions, with scenarios designed to deliver decision-useful outputs akin to the "use test" that banks and insurers must satisfy when seeking approval to use their internal models for capital calculations.

"Less advanced firms will be given progressively less leeway"

A similar point can be made for models – it will take time for all firms to develop the right in-house modelling capabilities. But supervisors will expect banks and insurers to become less reliant on TPs over time or, at the very least, to develop internal capabilities to customise, scrutinise and challenge model outputs from such sources, as covered in the model risk management chapter.

For non-life insurers in particular there is work to be done around developing data extraction and modelling techniques to examine climate litigation exposure (both direct and through policyholders) to identify data and modelling gaps; and whether coverage intent is aligned with contract wording, to identify areas of contract uncertainty. This will prove an important exercise ahead of the PRA's next insurance stress test, which will explore the implications of contract uncertainty.

Nature risk

This year climate risk will remain the area of focus for regulators, supervisors, and firms, but nature risk is rising in prominence. The ten-year strategy agreed at the biodiversity COP15 contributed to this, and the finalisation of the TNFD framework in September 2023 will further consolidate the place of broader nature-related considerations within the environmental agenda. However, firms should not wait for this work to be completed before taking action. Nature loss and degradation are clear and present sources of financial risk, and it is imperative that firms begin to understand their exposure. There are various ways that nature risk is already "baked in" to extant rules and guidelines from the ECB and EBA, as well as from the BoE. Supervisors

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in the EU and UK have already voiced concerns about nature risk and (in the EU) have started to ask firms about their action plans for managing broader environmental risks.

Nevertheless, full incorporation of nature-related risks will be every bit as - if not more - challenging a journey than the one already underway on climate. An important and more tractable starting point is to focus on the climate-nature nexus – where nature interacts with climate and has the potential to compound or ameliorate climate risks. That is, identifying those aspects of the broader nature-related risk landscape that intersect with climate risks already under assessment. This analysis could include a qualitative assessment of the firm's exposure, potentially including a "heatmap" approach informed by expert judgement (similar to many firms' early climate risk materiality assessments).

Prudential requirements

How climate risks will feed through to prudential requirements remains an open question. Banks and insurers' approaches to capturing material climate risks in their internal capital assessments (ICAAP and ORSA, respectively) should be maturing from descriptive to quantitative in 2023 and, in time, should begin to reflect broader environmental risks as well.

In 2022 the BCBS published FAQs clarifying that it expects climate risks to be integrated into certain parts of the Pillar 1 framework, but it is not yet clear whether and how the EU and UK will take forward those clarifications in 2023. What is more certain is that the use of Pillar 2 will become more prevalent this year. For the first time, in 2022 the ECB imposed Pillar 2 add-ons on some banks to incentivise faster progress on climate risk management. We expect this practice will be more widespread this year, and the PRA may adopt a similar approach for UK firms.

We also expect that climate risks will be progressively integrated into solvency stress testing by EU and UK supervisors, creating an additional channel through which climate risks influence Pillar 2 capital. We expect bank supervisors in the EU and the UK to consult on methodologies in 2023, although exercises may not be launched until 2024.

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Strengthening climate risk management

- Ensure that the firm's climate risk management is:

  (i) comprehensive, with the risk identification process covering a wider array of risk drivers and increasing in granularity;

  (ii) cascaded, with the overall strategy and risk appetite understood and implemented across the business; and

  (iii) consequential, with the policies and procedures put in place having a tangible impact on business decisions.

- Analytical processes such as scenario analysis should be designed in a way that delivers decision-useful, forward-looking information to management.
- Expand risk assessments to include broader environmental risks, at a minimum starting with the climate-nature nexus, and considering at least qualitatively how they could drive prudential risks and interact with climate risks.

Climate scenario analysis

- Develop more sophisticated climate scenario analysis capabilities, with internal capacity to design and interpret climate scenarios tailored to the nature of the firm's activities.
- For non-life insurers, focus on modelling and data capabilities in relation to climate litigation to enable scenario testing that helps to measure exposure to this risk and identifies contract uncertainty issues where coverage intent is unclear.

Counterparty engagement

- Proactively engage with counterparties, gathering risk-relevant data and a gaining a deeper understanding of clients' short-, medium- and long-term strategies for reducing their transition risk exposure or adapting to physical risks.
- Counterparty engagement should also play a role in firms' active management of climate risks, for example through setting client-specific transition targets and defining consequences for failure to meet targets.

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- In the short term, firms need to consider how to enable good outcomes for the increasing number of their customers facing financial difficulty due to the cost-of-living crisis and inflationary environment. In the medium term, firms will need to remove inefficiencies and improve TP relationships to monitor customer outcomes.
- We expect most firms to struggle to implement aspects of the Duty on time. Firms will need to apply a risk-based approach to completion of tasks and understand key dependencies with other parties across the distribution chain. Some firms might have to make difficult commercial decisions, for example whether they can maintain certain partnerships if price and value issues emerge.
- Successful implementation of the Duty will present an opportunity for firms to move towards a truly customer-centric business model. They could use the Duty framework to design and deliver products and services that adapt and evolve with the needs of their customers. A well implemented Duty framework will give market-leading firms an opportunity to win new customers and retain existing customers for longer.
- Firms need to embed the Duty in their culture. Boards and senior management must ensure there is substance to the implementation. The Board and Duty Champion have an important role to play by challenging whether a firm is directing its efforts to enable good customer outcomes.

Acting to deliver good customer outcomes

The UK Consumer Duty (the Duty) is the most material piece of cross-sectoral conduct regulation in the UK of the last decade. The Consumer Principle (the requirement for firms to demonstrate that they have acted to deliver good customer outcomes) puts the onus on firms to be proactive in their approach to conduct risk, striving to anticipate and prevent harm where it is foreseeable. It will require firms first to define good outcomes and then design the metrics to measure and monitor them. The Duty rules and guidance are structured across four consumer outcomes that reflect the journey from product development, pricing, customer communications and support. The Duty includes a requirement for firms' Boards to review and approve an assessment which confirms compliance on an annual basis. Firms will also have to ensure they can evidence compliance on an ongoing basis.

> "Be in no doubt: the Duty will be a significant shift in what we expect of firms. It means making lasting changes to culture and behaviour to consistently deliver good outcomes"

Speech by Sheldon Mills, FCA Executive Director Consumers and Competition[20]

From implementing the Duty to making it a success

The remaining timelines for the Duty are tight. Firms need to complete their product value assessments by the end of April 2023 and

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implement the Duty in full for open books from July 2023. Firms and their partners in the distribution chain need to unpack the complex web of roles and responsibilities involved in manufacturing and distributing financial products. For those using embedded finance and banking-as-a-service models these requirements can be particularly onerous as they lengthen and add complexity to the value chain. These new distribution models might make it harder to define value and to anticipate and prevent foreseeable harm.

Moreover, firms are having to implement the Duty amid high inflation, in the context of which customers' needs are changing and, in most cases, their own business and finance models are under pressure. For example, claims inflation in the insurance sector means that the general insurance industry is likely to record underwriting losses in some lines of business for 2022 and well into 2023. Firms will need to review and update the prices and fees for their products and services in light of inflationary pressure but will have to bear in mind that many of their customers may already be struggling to afford their products. The ESAs are also closely monitoring the impact of the current economic conditions on firms and customers.

Many firms will consider cost reduction drives, but the FCA has already raised questions about whether decreasing levels of customer support would be compatible with the Duty. For example, banks and consumer credit firms are expecting increasing numbers of customers in financial difficulty to need debt advice. Imminent changes in the overall operation of the provision of debt advice services from the MaPS[21] might result in firms needing to step up their efforts to ensure the most vulnerable are supported. Firms will be expected to rehabilitate customers quickly and in a sustainable manner. Firms have frequently fallen short of existing regulatory expectations for collections and recovery processes, complaints handling and arrears payments, suggesting these are areas where Duty compliance might be particularly onerous.

Developing a sustainable Duty framework

Beyond July 2023 most firms should look at streamlining their Duty frameworks to manage the costs of ongoing implementation. This means developing a Duty framework that is effective and efficient and also provides flexibility to evolve with changing regulatory expectations over the medium term. This will require engaging with TPs

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and outsourcers to understand how to automate processes and obtain data from different systems to allow for monitoring and measuring outcomes across different groups of customers. Some firms already use tools to track clicking behaviour through online journeys for marketing and sales purposes. Some of this data can be integrated into the Duty framework to help improve outcomes metrics and measuring. The Duty involves annual processes, such as Product Value Assessments, which again can be onerous given the need to obtain data from TPs to complete. Such processes would benefit from standardisation and a degree of automation.

The Duty as a catalyst for innovation

From a more strategic perspective, some firms will see the Duty framework as an opportunity to accelerate a more customer-centric approach, and for market leading firms it will be a catalyst for product innovation. The requirement for firms to monitor customer outcomes, including for distinct groups of customers, means that new forms of data on how customers engage with products and services can be leveraged in new product development (subject to data protection considerations).

Under the Duty it is possible that firms will approve complex products with dynamic features or involving hyper-personalisation, if they are underpinned by robust control frameworks that can convincingly monitor customer outcomes in real time, supported by AI systems where necessary. However, the BoE and FCA have also indicated that the Duty provides a framework within which supervisors will be able to scrutinise how firms' use of data and AI models affects customer outcomes, and to explore issues such as unfair bias, discrimination and vulnerability.

Cultural embedding of the Duty

In general, the Duty will be more successfully implemented by those firms that best embed it into their culture. The FCA expects firms to implement the substance of the Duty and several requirements should help this shift, such as the annual assessment, the appointment of a Duty Champion and the reflection of the Duty in the SMCR regime.

Firms might want to consider the scope and reach of the Duty for those customers that might remain just outside its scope, with BNPL products being one pertinent example. The FCA has signalled its concern that some of these products, and the way they are promoted and sold, might be putting customers at risk of harm. Reflecting this concern, the Government looks set to press ahead with its plans to bring BNPL products within the remit of the FCA and started consulting on proposed legislative changes in October.[22]

In the meantime, the FCA has stressed that all firms distributing BNPL products need to have their related financial promotions approved by an FCA-authorised firm. Given that many banks have launched their own BNPL products, they may want to consider how the Duty and other conduct risk responsibilities should apply to these and other unregulated products (for instance around payments or unregulated digital assets) regardless of whether, technically, they remain outside the regulatory perimeter for now. Can the Board justify a lower standard of protection for BNPL and similar customers, compared to customers who hold a regulated product with the same firm? And even if the Board can satisfy itself on this point, does it make operational sense to run two levels of consumer protection with the associated compliance complications (and costs) this entails?

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Consumer and investor protection: EU landscape

The ESAs are closely monitoring the impact of the current adverse economic conditions on financial institutions and their customers.

ESMA expects firms to incorporate the impact of inflation into information provided to retail clients, suitability assessments, and product governance processes.[23]

As part of its policyholder protection agenda EIOPA, is focusing on the impact on product value of differential pricing practices in general insurance [24] and value for money in unit-linked products. In this area, following a supervisory statement in 2021 EIOPA has now published a detailed methodology for NCAs to assess unit-linked products in their respective markets.[25] It is also concerned about credit protection insurance products and banks that distribute them, following a thematic review and a warning to the market.[26]

EU GI insurers and intermediaries should assess whether their current pricing practices include differential pricing and if so, whether they may lead to the unfair treatment of certain groups of customers. For those insurers and banks distributing credit protection insurance it will also be important to understand the value of these products and assess whether their design and pricing lead to the fair treatment of customers in light of the significant concerns identified by EIOPA.

In the asset management sector ESMA continues its focus on cost and charges for retail investors. A CSA was conducted through 2022 on MIFID II cost and charges disclosures and we expect a report in 2023.[27] This follows from a CSA on costs and fees in relation to UCITS products in 2021. This led to ESMA requesting NCAs to scrutinise fund managers that lack formalised and structured pricing processes with a focus on smaller firms where undue costs are cause for concern.[28]

Some NCAs have started to take action in their markets, with the Luxembourg regulator urging fund managers to conduct a comprehensive assessment of compliance with policy, approach and arrangements related to costs by the end of Q1 2023.[29] Other NCAs are likely to take similar actions during 2023.

EU fund managers may want to look at the actions taken by ESMA and some NCAs (e.g. the Luxembourg regulator) and assess their own policies and approach to fund costs to identify areas for improvement.

EU fund managers will also be affected by the Duty if their funds are distributed in the UK, since UK distributors will need to request information from EU fund managers to ensure the funds meet the Duty's price and value outcome if they are to continue to sell them to UK retail customers.

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Actions for firms

Responding to short-term challenges

- Determine the potential need for extra customer support in the next few months due to inflation and cost-of-living crisis, and changes to the provision of debt advice by the MaPS and how to mobilise increased capacity (including "surge capacity") as a priority.
- Identify price/value issues arising from the current volatile economic conditions and cost-of-living crisis. For example, firms are expected to reflect higher interest rates for savers within a reasonable timeframe and consider carefully the impact of withdrawing mortgage products. Insurers should be mindful of fairness in claims processes and ensure motor claims are not underestimated to the detriment of customers.
- Deploy a risk-based approach in areas where meeting deadlines is likely to be most challenging. Ensure decision-makers take into consideration the potential for customer harm when prioritising and that any such decisions are carefully documented and revisited in the light of changing market conditions.

Medium-term planning

- Assess how to comply with the Duty more effectively and efficiently in the medium term. Review the use of data, technology and TPs and find solutions to create a holistic approach to compliance and measuring customer outcomes.
- Transform the Duty into an opportunity for developing a more customer-centric approach. The Duty can be leveraged to accelerate product innovation, aided by AI and ML applications.

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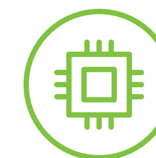

In focus

- New EU and UK regulatory frameworks will increase the oversight of digital assets firms and enable regulated firms to develop their medium-term strategies, although some detailed requirements will only emerge later in 2023.
- Regulated firms looking to offer digital assets services and products should review their risk appetite and enhance their risk management framework.
- Supervisors will scrutinise banks' risk management of DLT providers and compliance with existing securities regulatory frameworks when issuing or providing custody of tokenised financial instruments.
- In the EU, intermediaries in unbacked digital assets markets will need to consider how becoming fully regulated will affect their viability and competitiveness.
- EU and UK stablecoin issuers should kick off their compliance efforts without delay, considering whether to seek an e-money licence. E-money firms and banks should consider their role in the stablecoins ecosystem.

Digital assets markets experienced significant disruption and failures in 2022. While regulated firms' interest has remained resilient overall, calls for swift and effective regulation have grown louder. Against this background, policymakers continued to shape their future digital assets regulatory frameworks, which will increase oversight of digital assets firms. Nevertheless, some regulatory uncertainty and gaps will persist.

MiCA will enter into force in Q1 with a phased implementation starting one year later. It will harmonise the EU regulatory framework and expand the perimeter to capture most unregulated digital assets firms - notably stablecoin issuers, custodians and exchanges - for the first time. While MiCA will mitigate some issues highlighted by recent failures – especially concerning governance, organisational structures, and safeguarding client assets – some gaps will remain. For example, it will not regulate riskier activities such as leveraged trading and crypto lending.

In the UK, the FSMB - once passed - will give authorities the power to oversee digital assets markets as a whole. The secondary legislation that will clarify which activities and market participants they will regulate may not emerge until late this year, if not 2024. However, we expect the UK approach to focus initially on issuers of stablecoins used in payments, financial promotions, and exchanges and custodians, and to use existing regulatory frameworks (e.g. for investment products) as a starting point.

In general, across both the UK and the EU the impact will vary by firm type, form of digital assets, and the range of activities undertaken.

Tokenised financial instruments

In relation to tokenised financial instruments (e.g. bonds), wholesale banks are increasingly looking to provide institutional clients with issuance and custody services. Many are exploring partnerships with DLT providers to build the technology infrastructure. The risks, especially operational, arising from these partnerships will come under significant supervisory scrutiny. In January 2023 the PRA made clear that it expects firms to have fully understood the impact of offering crypto products on their operational resilience.[30]

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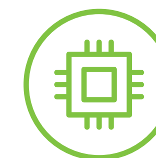

Banks will also need to meet the requirements of existing EU and UK securities frameworks, e.g., MiFID II and CSDR. Where possible, firms that offer CSD and MTF services should leverage the planned EU and UK FMI sandboxes to test their operating model and obtain regulatory feedback on how to overcome challenges in applying these frameworks in a DLT environment.[31]

Unbacked digital assets

Markets in unbacked digital assets[32] (e.g. Bitcoin) will be significantly affected by MiCA, under which intermediaries, such as custodians and exchanges, will be fully regulated for the first time beyond existing AML requirements. The UK is expected to clarify its approach in 2023/24 via secondary legislation and regulatory proposals. Intermediaries will need to understand the requirements and review the viability of their offerings, considering the costs and benefits of being a fully regulated FS firm. In most cases, this will require a significant shift in governance, compliance (e.g., client asset protection) and overall corporate culture, as recent market events underscored. We also expect these firms will experience increasing pressure from jittery institutional investors and commercial partners – including FS incumbents – to ramp up their risk management and compliance plans and prove their ability to fulfil new regulatory requirements while remaining viable and competitive.

> "Established banks must not let commercial pressure to adopt new technologies or enter digital asset markets get in the way of first ensuring that they can properly understand and manage the associated risks."

Speech by Nathanaël Benjamin, BoE Executive Director, Authorisations, Regulatory Technology, and International Supervision[33]

Stablecoins

Both the EU and UK are also bringing stablecoin[34] issuers and custodians within the regulatory perimeter. The UK is expected to focus on stablecoins used for payments backed by fiat currencies, while the MiCA will capture a fuller suite of stablecoins backed by either fiat currency or another asset or value. While stablecoins are currently used primarily for settling trades in other digital assets, regulatory clarity could spur new use cases, such as domestic and cross-border A2A retail payments. Their long-term viability will depend on whether the EU and UK launch CBDCs over the next three to five years, as expected. More details on potential key features of these CBDCs (e.g., limits on holdings) are likely to emerge in 2023 as both jurisdictions progress their exploratory work. However, our expectation is that any future EU and UK CBDC framework will support coexistence with private forms of money, including stablecoins.

While the key building blocks of the EU and UK stablecoins frameworks are in place, important regulatory details will only emerge in 2023. For example, amendments to the e-money and payment services regimes, which the UK confirmed will form the basis of its regulatory approach. Similarly, the

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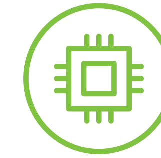

ESAs will have to issue detailed rules under MiCA, e.g. concerning authorisation and liquidity requirements.

Understanding new regulatory requirements, the path to authorisation, and implementing a suitable target operating model will be a priority for newly regulated digital assets firms. But a more developed regulatory environment should also help traditional firms determine their role in the digital assets ecosystem. In some cases, they may also enjoy comparative advantages. For example, under MiCA, EMIs and banks will be able to issue e-money tokens through a simpler regulatory notification. Similarly, banks and investment firms could leverage their existing MiFID permissions to provide similar services – e.g. custody or portfolio management – for unbacked digital assets. Firms can also leverage their existing governance and compliance capabilities. However, they will need to strengthen them to address new regulatory requirements and enhanced risks, such as insider trading or market manipulation.

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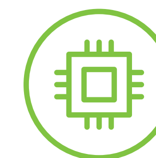

Actions for firms

EU and UK regulated firms

- Review and enhance capabilities to manage the risks of TP relationships with DLT providers. These include vendor due diligence, scrutiny of TPs' ongoing financial and operational risk management practices and resilience, fourth-party risk management, and real-time service quality monitoring against KPIs.
- Update risk appetite statement to reflect digital assets risks to a granular level, and define tolerances, accounting for types of clients and offerings, updating client suitability and product selection.
- Build dedicated digital assets governance capabilities, including a digital assets compliance capability, executive-level SteerCo oversight, and working groups to ensure risk alignment.
- Enhance internal audit capabilities, with focus on new product approval and effectiveness of firms' governance framework.
- Determine whether to become a first mover in the stablecoin market, either as issuer or custodian. For long-term use cases, consider different interaction scenarios with future EU/UK retail CBDCs.

EU and UK digital assets firms

- Conduct gap analysis against core regulatory requirements and assess their impact on the viability of current and planned offerings.
- Decide whether to become a regulated FS firm or pursue other options, including becoming a TP technology provider or merging with other digital assets firms.
- If planning to become regulated, start building key risk and compliance capabilities, including robust governance, RMFs and regulatory affairs functions to engage NCAs on authorisation and compliance plans.
- For issuers of currency-backed stablecoins, consider the costs and benefits of seeking an e-money licence in 2023.

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The implications for financial services

The DMA, which entered into force on 1 November 2022, introduces measures to limit the anticompetitive behaviours of designated "gatekeepers". By August 2023, the European Commission will designate the "gatekeepers" that will be required to comply with DMA requirements within six months – i.e. by early 2024.

Designated gatekeepers will typically be digital platform companies that, by meeting certain quantitative and qualitative criteria set out in the DMA, are regarded as having an entrenched position and acting as a gateway between businesses and their end users. The DMA forms part of the EU digital and data strategy to unlock innovation while ensuring its digital sovereignty by setting its own standards concerning data, technology, and infrastructure. Global digital and technology platforms, such as those providing online search engines, social networking, cloud services, or other online intermediation services – which the European Commission says could include those active in the field of financial services - are likely to be in scope of the DMA.

We believe that some of the DMA's measures will support competition in digital financial services. For example, where the digital gatekeepers generate and hold data about business and end users using their in-scope platform services, users will have the right to access that data or authorise TPs - including FS firms, in principle - to do so.

In addition, if FS firms use an in-scope platform to interact with or advertise to their customers, they too would be able to access relevant platform data, or have a TP do so, to improve their services and customer reach. The DMA will also prohibit gatekeepers from mandating the use of the gatekeeper's own payment service as a condition of using their core platform services, and require them to give users the right to choose TP payment options. App developers should also get access to and be able to interoperate with smartphone functionalities crucial to enable mobile payments, such as NFC chips.

Details on how things will work in practice (e.g., data-sharing with authorised TPs) will likely be clarified in upcoming secondary legislation and discussions between gatekeepers and the European Commission. But while the DMA's impact is not immediate, it will be significant – assuming the regulation is implemented and enforced effectively.

Therefore, FS firms' 2023 strategy decisions will benefit from considering how the DMA could change long-term market structures and their competitive landscape, and how to respond. They should also consider what additional DMA data they could utilise for product development and service improvement purposes, but also whether their digital growth strategies could put them in the scope of the DMA in the future.

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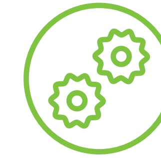
A year of real tests



In focus

- With policy work largely complete, firms need to focus on the implementation of operational resilience requirements, with supervisors set to be on the look out for tangible evidence of progress in building resilience.
- The DORA's January 2025 implementation deadline requires EU firms to make rapid progress in 2023 across new IT risk management, reporting, testing and TP risk management requirements.
- The volatile geopolitical environment may lead to heightened risk of cyberattacks, and supervisors will push systemically important firms to take additional measures to counter this.
- Regulators are designing CTP oversight frameworks but firms will still have to address vulnerabilities stemming from their own TP exposures.

UK operational resilience framework

The transition period for the UK's operational resilience frameworks will soon enter its second year and UK-based firms need to demonstrate that they are making measurable progress towards assessing the resilience of their IBS and taking remedial action where necessary. Key to this is a firm's capability to map the systems and vulnerabilities associated with each IBS and to develop testing methods based on "severe but plausible" scenarios. Supervisors expect a less theoretical approach to testing, with scenarios covering events such as data integrity being compromised and disruptions resulting from CTP failures.

Supervisors will also look for evidence that firms are investing in their resilience and embedding it into their routine activities. In this context, firms should explore how they can leverage the alignment of capabilities between operational resilience, TP risk management, and financial resilience functions. Finally, UK regulators are expected to consult on targeted initiatives in 2023, such as an operational incident reporting framework, which will put further pressure on firms' compliance responsibilities.

"The clock is also now ticking down on the 24-month implementation period for the EU's DORA Regulation, and work will need to begin in 2023 to meet the January 2025 compliance deadline"

EU DORA

The clock is also now ticking down on the 24-month implementation period for the EU's DORA Regulation, and work will need to begin in 2023 to meet the January 2025 compliance deadline. While the DORA's ICT risk management requirements are similar to existing ESAs' Guidelines and will allow firms to leverage their previous work, some of the DORA's requirements are more prescriptive. For example, firms need to articulate tolerances for disruption linked to their CIFs and to carry out concentration risk assessments of their TP exposures.

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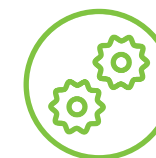
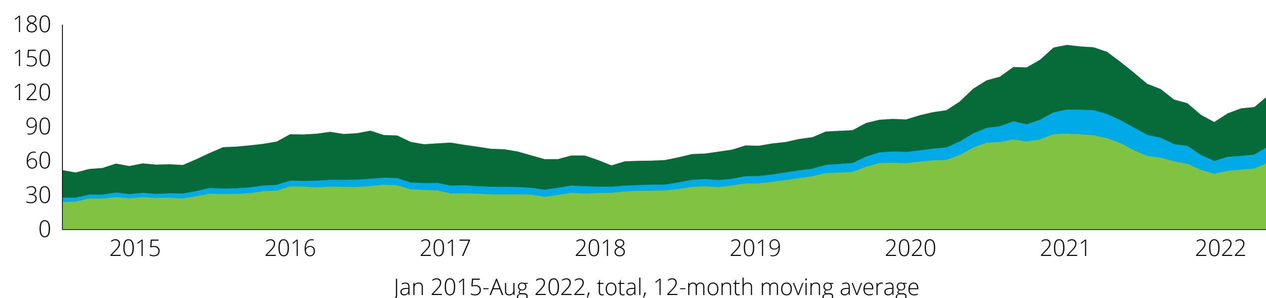


Figure 4: Number of publicly disclosed global cyber attacks over time



Source: Financial Stability Review, European Central Bank, November 2022[35]

The DORA's incident reporting and cyber threat notification rules could become significant compliance challenges, and therefore the technical details from the RTSs that are due to be consulted on in H2 of 2023 will be important. Firms should equally pay close attention to resilience testing RTSs, particularly if they do not currently carry out a TLPT testing programme but are at risk of being considered sufficiently significant under the forthcoming technical standards and thereby being scoped into the "advanced testing" requirement.

Running in parallel to the DORA implementation, EU supervisors, such as the ECB, will continue to expand their capabilities in cyber and IT risk and carry out further targeted investigations into firms' cyber resilience in 2023. For any domestically significant firms or larger, these may be substantial exercises that will require an organisation-wide response. The regulatory expectation around the close involvement of senior management and the Board will put even greater pressure on firms to build knowledge of cyber, IT risk, and operational resilience issues among senior leadership.

Oversight of CTPs

Regulators in 2023 will increasingly look at the sectoral resilience of FS more broadly, particularly in relation to CTPs.

The DORA's CTP regime introduces the world's first oversight framework for CTPs. UK regulators have also followed suit with a discussion paper in July 2022 and a subsequent consultation paper is due in 2023. Key issues for the UK this year will be around setting a standard for the resilience of CTPs and the possibilities for promoting international alignment. Some cross-jurisdictional differences are already visible, with the UK focusing on the oversight of significant services only and the EU opting for a broader definition.

Firms should consider which of their providers may be designated as CTPs and identify concentration risks that may attract further supervisory scrutiny. The development of CTP oversight frameworks will not replace firms' responsibility to conduct TP risk management or manage the operational resilience vulnerabilities associated with TP exposures; something that is emerging as the most challenging area in building operational resilience. To meet supervisory expectations, firms must develop exit

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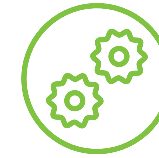

strategies and business continuity plans for their TP exposures, including substitute delivery methods and systems where needed.

Enhancing FS cyber resilience

Regulators will also make progress on related initiatives that target the cyber resilience of the technology ecosystem that FS firms operate in. The EU's recently proposed CRA may be agreed by the end of 2023. The CRA is expected to include the FS sector in its scope, compelling firms to provide more information and to comply with a set of standards on the cybersecurity of the digital products they develop in house.

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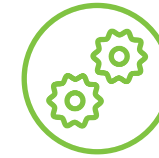

Actions for firms

Implementing operational resilience

- Embed operational resilience within operating models and turn it into a key driving factor for Board and senior management decision making.
- To do this, firms need to focus on building the resilience of their IBSs/CIFs by understanding the assets and processes that support their delivery, identifying key interconnections and vulnerabilities, and developing performance indicators to detect threats/incidents.
- In many cases, firms should consider the adoption of integrated tools to manage the operational resilience implementation process.

Convergence with other policies/frameworks

- Leverage existing capabilities to meet the policy outcomes required by regulators.
- For instance, integrating crisis communications planning across operational resilience and business continuity, or leveraging elements of scenario testing done for the operational risk component of the ICAAP or ORSA to support operational resilience testing.

TP risk management

- Work with TPs to ensure reciprocal alignment on key aspects of operational resilience, such as IBSs/CIFs and impact tolerances.
- Develop the ability to assess TP concentration risk and take mitigating action where necessary. Large firms may even have to explore TP multi-vendor strategies if resilience vulnerabilities to sole providers cannot be sufficiently addressed.
- Negotiate mandatory contractual clauses with TPs as required by the DORA (for EU firms in particular).

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In focus

- Lenders face considerable risk of increased impairments in 2023 and beyond, with insolvency figures trending up – UK insolvency figures in H1 2022 were at their highest rate since the GFC.
- Borrowers are facing significant pressure: retail borrowers primarily from increased interest rates and the cost-of-living crisis; commercial borrowers from increased input costs, higher interest rates and demand side challenges due to purchasers trying to trim their budgets as much as possible.
- If lenders restrict borrowing as a result of economic conditions, rather than using their capital buffers, we expect regulators to press for review of the buffer framework.

It has been clear for some time that rising credit risk is a significant issue, albeit one where the oft-threatened wave of defaults has yet to break. But the credit outlook now appears increasingly bleak owing to a combination of economic supply- and demand-side challenges for businesses.

Retail customers face increasing inflation, higher interest rates and the associated cost-of-living and debt service challenges, and in 2023 pent up credit pressure (including latent credit risk developed during COVID-19) will start to translate into increased impairments for firms. This pressure is already starting to show, with UK company insolvencies in the first half of 2022 at a 13-year high and interest rates on mortgages at their highest in over a decade.

Rising interest rates

Across EMEA, interest rates are increasing – rapidly – as central banks try to stem the rising rate of inflation. Although nominal rates are nowhere near the levels of the 1990s, many borrowers have mortgages at high income multiples, with the result that mortgage payments represent a significant portion of household incomes.

Notwithstanding the requirement for lenders in the UK and EU to undertake affordability assessments, significant increases in interest rates, when combined with other inflationary pressures, are leaving households with limited or no surplus income. Firms will need to ensure that their affordability assessments keep pace with changes in the economy. In lenders' residential mortgage portfolios, the prospect of material falls in house prices implies the potential challenge of dealing with customers in negative equity.

Worsening household finances

In the EU, the European Commission's economic forecasts from summer 2022 show that all households expect their financial condition to worsen in 2023, but the proportion of households that believe their financial condition will get "a lot worse" is predictably highest among households in the lowest income quartile.[36] This is further demonstrated by ECB data on available liquid assets for EU households [Figure 5]. This will likely result in challenges for firms in balancing their obligations to treat customers fairly and to fulfil their duty to shareholders to minimise losses.

> "...more than one in 10 [UK companies] reported a moderate-to-severe risk of insolvency in August"
>
> **Office for National Statistics**[37]

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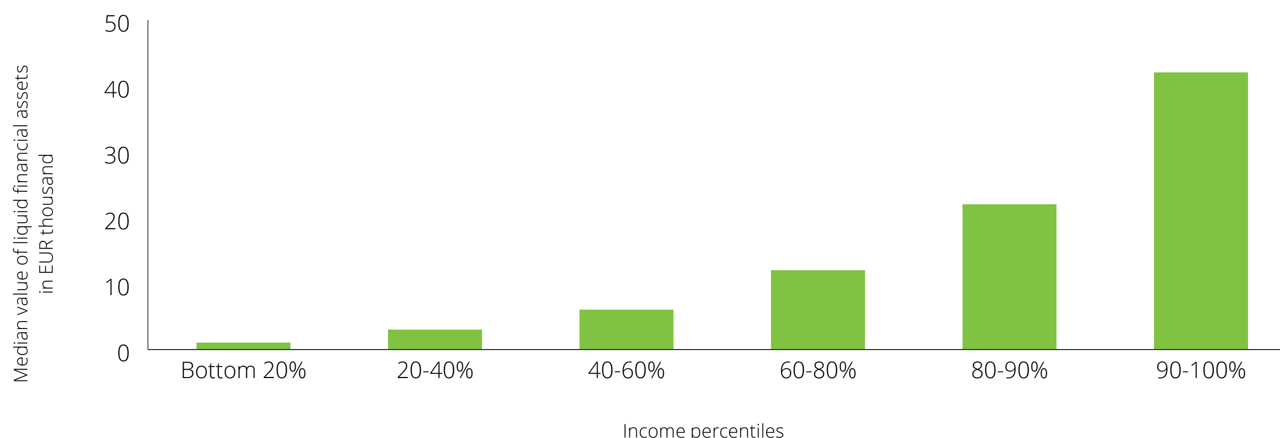
Figure 5: Household liquid financial assets



Source: ECB Economic Bulletin, November 2022[38]

"In the third quarter of 2022, the seasonally adjusted number of declarations of bankruptcies increased by 16.3 % in the EU and by 19.2 % in the euro area, compared with the second quarter of 2022"

Eurostat[39]

Given their concerns about worsening financial circumstances, it is no surprise that retail customers are putting off major purchases and looking for ways to stretch their household budgets as far as possible. The resultant depressed demand will flow through to yet greater revenue and profitability challenges for businesses, potentially leading to a downward spiral in profitability and reduced capacity for companies to service their existing debt burdens - just as rising interest rates are increasing those debt burdens.

Supervisors were already concerned about increasing volumes of leveraged and highly leveraged debt exposures. Moreover, as companies face earnings pressure the pool of exposures that meet the leveraged or highly leveraged definitions will increase. Banks will need to be able to explain how they are managing the associated risks to their supervisors.

Dealing with increased risk of defaults

Lenders, as well as other firms that are significant holders of issued debt or other assets with elements of credit risk, face a period of considerably increased risk of defaults and non-payment. This will manifest in an increase in the base level of IFRS 9 impairment allowances (Expected Credit Losses) in stages 1 and 2. Increased flow into stage 3 (default), a traditional measure of credit risk, will likely follow in subsequent years, but the financial impact on balance sheets will

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start earlier, reflecting the forward-looking nature of the accounting standards.

All this will happen as banks are in the midst of bringing back into their capital positions the deferred impairments arising from the COVID-related IFRS 9 transitional arrangements. Firms will need to ensure that they can demonstrate to supervisors and auditors that the underlying parameters in their IFRS 9 models accurately reflect the risk in their balance sheets.

Credit concerns exist in many sectors. In commercial real estate, the IMF recently warned about tightening financial conditions,[40] while a recent Deloitte global survey of the sector indicated that sustained high inflation is a significant concern for CFOs, and that as many as a third of respondents are looking at cost-cutting measures in 2023, up from just 6% the previous year.[41] The hospitality and tourism sectors face lower demand for their offerings in an environment where discretionary spending is constrained. Deloitte's October 2022 CFO survey shows UK CFOs in all sectors expressing concern over the cost of borrowing, with a resultant increase in expectations that cost control – including reducing hiring expectations – will be a key business priority in 2023 and possibly beyond. As commercial and corporate customers face reduced revenues and profits, the likelihood of lay-offs is considerable, and increased unemployment will exacerbate the pressures on retail customers already discussed.

Insurers and investment funds

Insurers and investment funds hold significant volumes of issued debt instruments, as well as investments in property and other assets, as part of their management of premiums and client investments. Changes in asset values have already led to challenges to some business models, and insurers and investment funds may face further asset price and credit-related pressures in their existing portfolios.

Insurers and investment managers are increasingly seen as potential investors for ESG and infrastructure projects, given the longevity of cashflows those projects generate. However, some insurers and investment managers may need to strengthen their credit teams to ensure that any investments made during a recessionary period meet long-term expectations. For UK insurers in particular, we expect the PRA to adopt a more granular approach to credit risk within the MA

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calculation for life insurers that use it to reflect the increased sensitivity of long-term productive asset classes that are more long-dated and illiquid.[42]

Use of banks' buffers

There is little chance that firms can avoid a significant rise in impairments, likely accompanied by a slow-down in demand for the financial services and products they offer. Firms will, at the same time, face pressure from regulators and finance ministries to continue lending and investing to support the economy. Regulators reviewed the operation of the buffer framework following the COVID-19 pandemic and concluded that banks are extremely reticent to utilise buffers that are not formally released by regulators. This led to calls from some regulators for the buffer regime to be amended to enable a greater portion of the buffers that banks hold to be formally released by regulators in times of stress.

Although no action is currently planned by the BCBS, should banks reduce their lending significantly in the face of increased impairments and related credit losses through P&L with the explicit purpose of preserving their buffers, then we expect to see regulatory pressure for amendment of the buffer regime to re-emerge.

Potential government intervention

The unknown in all this is the potential for further government intervention. Twice since the start of 2020, governments across the world have intervened to cushion the effects of large exogenous effects - firstly with unprecedented support through the COVID-19 pandemic, and now to mitigate the effects of rapidly rising gas and electricity prices. Spain is adopting a scheme to shield the most vulnerable segments of the population from rapidly increasing housing costs, albeit the cost of this will be borne by banks rather than by government. Other EU Member States are likely to follow suit.

In the UK, the FCA's recent review of the credit information market demonstrated that over 40% of consumers were not aware they are entitled to access their statutory credit report without charge.[43] The FCA has requested industry to set up a representative body in 2023 which will work with the FCA to address this and other shortcomings in the credit information market.

For many staff across the industry the economic conditions likely to prevail in 2023 will be somewhat novel, with junior and mid-level credit officers unlikely to have experienced a higher interest rate environment in their careers to date. There will be a need for those more experienced credit officers who have dealt with these conditions to share their experience and ensure that credit teams, including collections and recoveries teams, understand the challenges that higher interest rates pose for customers. More broadly, senior staff will need to draw on their depth of experience from previous decades to help navigate the years ahead.

"It has been clear for some time that rising credit risk is a significant issue, albeit one where the oftthreatened wave of defaults has yet to break. But the credit outlook now appears increasingly bleak owing to a combination of economic supply- and demandside challenges for businesses"

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Actions for firms

Dealing with risks and impairments

- Make sure the UK Consumer Duty plan is clear around the process for dealing with credit-impaired customers with repayment challenges (as per UK Consumer Duty spotlight).
- Undertake ongoing sector-level portfolio and market analysis to ensure supervisory concerns around exposures to high-risk sectors (including real estate, hospitality, energy and leveraged exposures) can be addressed.
- Enhance understanding of the drivers of impairment and potential future scenarios, to ensure impairment overlays can be clearly explained to supervisors; and to monitor and manage balance sheet impacts proactively. Stress testing assumptions will need to be updated to reflect updated impairment expectations.

Capacity, skills and resources

- Ensure capacity, skills and resources are in place and trained to deal with rising insolvencies, distressed borrowers, and borrowers transitioning to leveraged or highly leveraged status.

Models and indicators

- Apply greater focus to developing and implementing early warning indicators in order to undertake proactive sector-, region- and customer-specific credit analysis and risk management as necessary.
- Update affordability and income and expenditure validation models to reflect cost-of-living movements appropriately.

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Capital framework

More to come

In focus

- Banks and insurers are facing significant re-design of their respective capital frameworks, the final form of which will come into focus in 2023.
- We expect the EU and UK to finalise their approaches to implementing Basel 3.1. While this will narrow the policy uncertainty banks face, it will also usher in a more fragmented regulatory landscape for cross-border banks.
- The Solvency II reviews in the EU and the UK will continue developing over the course of 2023. These will provide insurers with more clarity on specific reforms and the level of regulatory divergence, and should prompt them to start more detailed implementation planning.

2023 will be the year the frameworks for banking and insurance capital requirements once again come into focus, as policymakers in the UK and EU look to finalise major packages of reform.

Given the macroeconomic context will likely have micro (and macro) prudential implications, particularly in terms of credit losses and diminished business opportunities, the remaining policy negotiations are likely to be buffeted by debates around the impact of revised rules on economic growth. Senior leaders in both sectors will need to invest time to ensure that they understand the strategic implications of changes to the relevant rules.

Banking

Banking regulators around the world will make substantial progress in 2023 towards completing their Basel 3.1 rules. Both the EU and the UK propose to implement Basel 3.1 by 1 January 2025, two years after the original BCBS target. However, both could still decide to delay further, depending on macroeconomic developments and/ or implementation progress made this year by regulators in the US.

As rules are finalised, understanding the relevant areas of regulatory fragmentation will become an imperative for internationally active banks. The publication of final rules will enable banks to finalise their analysis of how strategic positioning, capital consumption and profitability in the markets in which they are active might be affected.

The PRA's consultation on implementing Basel 3.1 in the UK, published at the end of November 2022, showed that UK regulators intend to implement capital rules that are much more aligned to the BCBS standards than the approach that is developing in Brussels. Although the PRA's consultation paper mirrored some the the EU's proposals, including setting the Internal Loss Multiplier for operational risk capital to 1, the PRA's proposals include a more restrictive treatment for unrated corporates than that set out by the EU and BCBS.

The most significant deviation between the UK and EU frameworks is the PRA's proposal to permit smaller firms to adopt a Simpler Regime. While consistent with the BCBS expectations that the full Basel framework should only apply mandatorily to globally active banks, this represents a material break with the EU's approach of applying a single rulebook to all credit institutions.

The PRA also proposed to implement the Output Floor without the majority of the EU's extended deferrals,

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Figure 6: Implementing Basel 3.1 in the UK

and also not to include the preferential approach for unrated specialised lending facilities that exists in the EU framework. Firms with subsidiaries in both the EU and the UK will have to ensure their systems can calculate solo RWA figures for rules in the UK and EU, while calculating Group RWA figures appropriately.

In the EU, the European Council's general approach to CRD6/CRR3, also reached in November 2022, set out a position that eases requirements for third-country branches (compared to those that the European Commission originally proposed), proposes that the Output Floor be applied at all levels of consolidation – albeit with a member state discretion, affirms support for changes to the fit and proper person elements of the package, provides for existing COVID-era public guarantees to be recognised under the new banking package, and supports enhanced ESG reporting. Further deviations from the Basel framework remain a possibility as negotiators continue their work to reach agreement in trilogues, expected before end-2023.

The inevitable reality is that Basel 3.1 adoption will mean more divergence in the rulebook for bank capital requirements between the EU and the UK than has existed before. This will place a greater operational burden on cross-border banking groups, but it will also give them an opportunity to assess how a more divergent rulebook might affect their pricing and their optimal product offering in different markets, for example by undertaking UK-based lending that benefits from preferential treatments under EU rules out of EU subsidiaries.

Insurance

The finalisation of the EU and the UK Solvency II frameworks will be particularly important for the life insurance industry, although some of the proposed reforms (including proportionality and reporting) will also be relevant to non-life firms. In the EU, we expect the final outcome of the reforms to look similar to the European Commission's original proposals for amendment. In the UK, the PRA will engage with insurers on the technical details of the Solvency II reforms during 2023 before issuing a formal consultation.

The ongoing EU and UK reviews of their respective Solvency II framework aim to achieve similar objectives - mainly to channel funds into green and sustainable investments. However, the mechanisms applied to achieve this in the two jurisdictions differ quite significantly.

While both the EU and the UK propose changes to the risk margin, UK reforms remain centred around amending the MA criteria, although the UK Government is leaving the fundamental spread calibration within the MA untouched as per its recent consultation response. The European Commission, meanwhile, is seeking to adjust the VA

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and LTE criteria. While different in substance, these sets of reforms provide both EU and UK insurers with an opportunity to review and adjust their overall investment strategies as well as MA/VA portfolios, in line with the new rules and, importantly, according to their own climate strategy.

Looking ahead, we expect the reforms to prompt insurers to review their product offerings and strategy, especially in light of the current macroeconomic environment. For life insurers, high interest rates coupled with capital reforms could prove to be a catalyst for re-designing existing products or exploring new product features.

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Actions for firms

Banks

- Enhance capabilities to support Basel 3.1 implementation, focusing on:
  - Understanding the strategic and operational challenges and opportunities arising from differences in UK and EU implementations of Basel 3.1.
  - The accuracy of RWA calculations (including Standardised RWA calculation for modelled portfolios in IRB banks).
  - Developing new data management and reporting capabilities.
- Smaller banks: assess the PRA's proposals and form a view on whether their growth plans mean they should opt into the full Basel 3.1 framework at the same time as other firms on 1 January 2025, or whether they want to opt in to the Simpler Regime. This option must be exercised by 1 January 2024.

Insurers

- Undertake a planning and prioritisation exercise to prepare for the implementation of specific Solvency II reforms, focusing on areas of reform that are unlikely to change over the coming months. These include changes to MA eligibility criteria in the UK and in the EU, the specific reforms to the VA and the reduction in the risk margin for both EU and UK. For example, insurers should consider their reinsurance programmes if they currently reinsure longevity risk abroad, since a lower risk margin will make these arrangements less commercially attractive.
- Where insurers make use of the MA or VA, they should explore whether the specific reforms warrant any changes to their investment and/or ALM strategies. Where they do not, they should explore whether they could benefit from applying for the VA (in the EU) or the MA (in the UK) under the new rules.
- Review and, where relevant, adjust their overall investment strategies as well as MA/VA portfolios not only in light of the reforms but also in view of their own internal climate and net zero strategies.

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Renewed focus on market resilience

In focus

- In the wake of very serious disruptions to market liquidity and extreme price volatility in the course of 2022, we expect supervisors to focus their efforts on firms' counterparty credit risk management frameworks, margining practices and booking arrangements to ensure that firms remain resilient to any future market dislocations.
- In particular, we expect the ECB's and PRA's ongoing scrutiny of banks' legal entity structures, booking models and associated risk management frameworks will require some banks to invest significantly to eliminate unnecessary complexity and to upgrade their governance, risk management, controls and MI.
- We expect increased scrutiny from financial stability authorities of the role of NBFIs in markets, their ability to withstand stress events and whether and how they transmit financial shocks to the banking and wider financial system.

Regulators have been concerned with risks arising from significant price volatility and abrupt disruptions to market liquidity since the March 2020 "dash for cash", following which central banks globally were forced into large-scale interventions to restore market order, including in the US Treasury market. In October, the IMF concluded that regulatory progress in dealing with these wider market issues was "lacking".[45] Although the FSB has since then given an update on its major policy programme, which includes its response to the role of NBFIs in the "dash for cash", the recommendations remain general, and it will be several years before any final policy frameworks are agreed and regulators enact them.

While these instances of market instability are new in their nature and magnitude, some supervisors are concerned that their origins lie in firms' failing to learn from the GFC and embed the necessary changes to business and risk management practices in their operations. Other, idiosyncratic events - such as the collapse of Archegos and the disruption to the UK gilts market last autumn - amplify such concerns.

In November, the BoE highlighted a range of issues related to banks' interactions with NBFIs[46] – beginning with banks' failure to understand their clients' overall leverage (which left some banks overexposed to Archegos). It also highlighted the need for banks, alongside NBFIs, to improve the quality of their stress testing to incorporate non-normal events (such as an unprecedented rise in yields which triggered the LDI-related stresses in the UK gilts market). Lastly, it specified that banks must adopt a "laser like focus on wrong-way risk"[47] (which could have helped mitigate the impact of the UK gilt price spirals that exacerbated the LDI crisis).

The emerging supervisory response

We see these concerns leading supervisors to focus on three separate, but related, issues: firms' counterparty credit risk management frameworks; margining practices, including collateral management; and the effectiveness of firms' booking model controls and risk management. Given the absence of concerted global action in relation to NBFIs and the significant presence in some markets of unregulated participants, we expect national supervisors to focus most on investment banks and prime brokers over which they can exercise direct authority.

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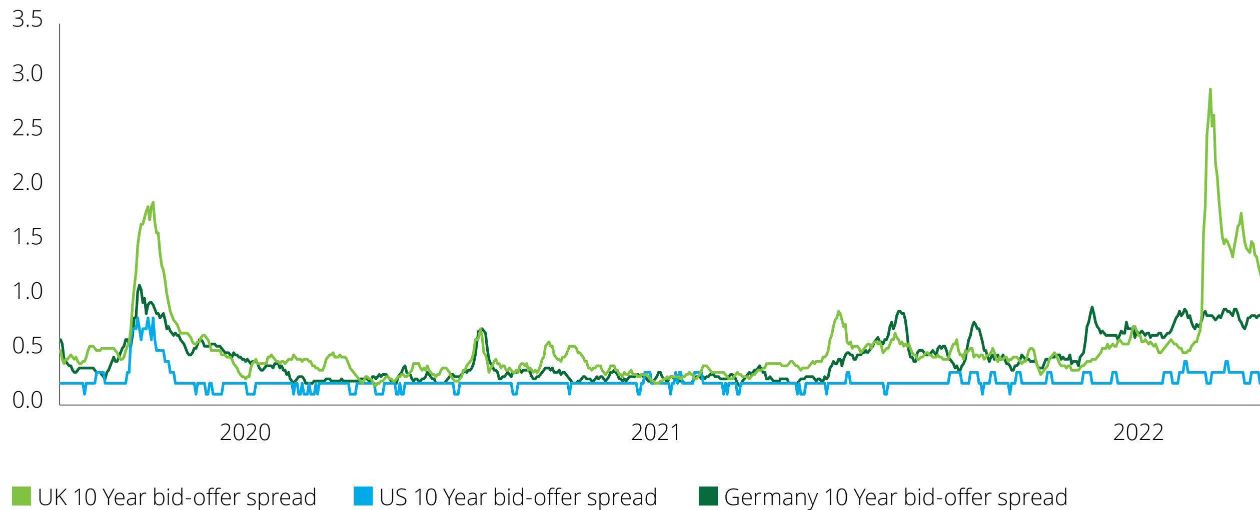
Figure 7: Bid-offer spreads on 10-year government bonds



Source: BoE Financial Stability Report, December 2022 [48]

On counterparty credit risk management, the PRA has already indicated that it expects firms to assess risk concentrations not only on an individual client basis, but across all clients combined and, most importantly, across each client's market-wide portfolio. This will require firms to collect significantly more data than they do at present, while their ability to do so will, in part, depend on counterparties' willingness to provide it.

Market participants' ability to meet margin requirements has been tested, and in some cases, found wanting during periods of significant market volatility. In the short term we expect this to result in supervisors scrutinising the ability of all types of regulated firms to manage their margin requirements, modelling collateral inflows and outflows under a range of scenarios, and testing their ability to mobilise collateral to meet margin calls under normal and stressed conditions. Supervisors have clearly been surprised by some firms' apparent unpreparedness for large collateral outflows and want to make sure that they learn lessons from this episode in advance of the next one.

Banking booking arrangements

These actions by supervisors to batten down the hatches after market instability align with their ongoing drive for banks to simplify their booking arrangements and strengthen related governance and risk management frameworks, improving resilience to any further disruption.

This has been visible for some time in the PRA's and ECB's evolving expectations and is therefore not a new topic on the supervisory agenda. However, recent scrutiny has forced some banks to invest significantly to improve their approaches in these areas, and has in turn raised supervisory expectations for all banks. Despite some banks having made real progress, supervisors continue to find that others still too often operate with complexities arising from historic acquisitions, tax structures and legacy booking arrangements. As a result, we do not expect any reduction of supervisory vigilance in this area.

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Both the ECB and PRA have conducted major thematic reviews in recent years on banks' booking arrangements. The ECB, through its recent desk mapping review, is continuing with investigations into firms' risk-shifting techniques and reliance on other group entities. Although we expect the findings of this review to be taken forward on a bank-by-bank basis, it is likely to drive further changes to booking models for large banks. In the UK, the PRA continues to ask banks to complete self-assessments against its current expectations - particularly around controls, senior manager accountability, risk oversight and MI. Most notably, banks still find it challenging to meet basic supervisory expectations, such as ensuring booking arrangements are transparent, permissible or "intended" transactions are clearly defined, and they establish an appropriate balance of preventative and detective controls to ensure adherence to their policies.

Interest rate risk

Meanwhile recent market volatility and the rising interest rate environment mean that interest rate risk management is a key priority for banks. Banks are focussing on reviewing IRRBB assessments to identify interest rate risk positions and considering the impact of hedging strategies on the balance sheet, while also assessing the trade-off between earnings, stability and capital volatility.

EU supervisory focus on market structure and infrastructure

In the EU, supervisory focus on individual capital markets firms has been complemented by two important developments in relation to market structure and infrastructure. The first concerns the European Commission's final EMIR proposal to require EU-based firms subject to the clearing obligation to maintain an "active" account at an EU CCP, although the Commission proposes to entrust ESMA with defining "active". In parallel, through proposed changes to the CRD and IFD, firms will be required to produce plans to meet this new requirement and competent authorities empowered to take action where they fall short. The ultimate aim is to reduce the EU's reliance on systemically important clearing services provided by UK CCPs substantially.

The second relates to EU policymakers' intent to future-proof their energy derivatives markets in the wake of price volatility that took European gas prices as high as 1500% of their long-term average.

"While these instances of market instability are new in their nature and magnitude, some supervisors are concerned that their origins lie in firms' failing to learn from the GFC and embed the necessary changes to business and risk management practices in their operations"

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Foremostly, the European Commission has tasked the ACER with the development of a new LNG benchmark by 31 March 2023 which reflects the price of LNG more accurately than the existing TTF benchmark and is expected to result in lower prices. However, new benchmarks generally take years to underpin a material number of derivatives contracts.

In this potentially long interim period, the new benchmark will split LNG derivative liquidity with its predecessor – potentially making derivatives pricing even more susceptible to the underlying fundamentals of volatile European energy prices. Given the wild swings in price, ESMA, ACER and NCAs have stepped up their supervision of "possible market manipulation and abuse" in energy derivatives markets.[49] Notwithstanding the view expressed by the Dutch Financial Markets Authority that there has been no sign of manipulation or excess speculation despite the sharp price rise of LNG",[50] we expect that ESMA and NCAs will be particularly vigilant for evidence of possible market manipulation and that market participants will receive requests for additional information when the supervisors identify unusual trading patterns.

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Actions for firms

All firms

- Focus on increasing the due diligence undertaken to understand their counterparties' ability to meet margin calls, including whether they set initial margin at sufficiently robust levels.
- Prepare for financial stability authorities to carry out stress tests to identify emerging market-wide vulnerabilities and whether and how NBFIs contribute to them.
- Spend time understanding the scope of the European Commission's proposed changes to derivatives clearing and how these will affect their business models and strategies. Monitor how the proposals develop as they progress through the EU's legislative machinery, although it will be difficult to assess the full impact of the proposal until ESMA has completed its work to define an "active" account.

Fund managers

- Establish that their stress tests are sufficiently severe, their fund redemption terms are adequately aligned to the liquidity of the underlying assets and that the quality of the data they use for fund stress testing and liquidity management is as robust as it can be.

Banks

- Demonstrate significant progress in improving their ability to detect counterparty risk concentrations, at various levels: individual counterparties; across all counterparties combined; and at the level of an individual client's market-wide portfolio.
- Simplify booking models – considering the number of booking entities and the nature of intra-group relationships that exist between the most significant of them. This needs to be done in a joined-up manner, overcoming operational siloes where different functions optimise to different constraints (capital, tax, funding, operating costs).
- Review risk management and control infrastructure for booking arrangements – especially preventative controls to mitigate the risk of impermissible transactions, operational booking errors or breaches of legal entity risk appetite. Consider the business case for using emerging TP technology solutions that enable preventative controls drawing on digitised regulatory rule-sets and decision engines.
- Review behavioural assumptions applied in interest rate risk modelling for key areas such as prepayment risk, non-maturing deposits and early redemption of term deposits.
- Ensure a clear understanding of the way in which increasing interest rates affect the calibration and outcomes of IRRBB models. Treasury and risk functions should challenge and revise IRRBB model assumptions to ensure they properly capture interest rate risk, including further scenario and sensitivity analysis.

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Model risk management

Do you know what you're looking for?

In focus

- In the UK the PRA's broad-ranging proposed principles for MRM will be finalised, significantly expanding the scope of models subject to MRM oversight.
- Climate risk and the use of AI/ML have emerged as specific areas of supervisory concern in the EU and UK, each of which creates novel challenges from a MRM perspective. Supervisors will expect firms to be able to demonstrate that they are not beholden to "black boxes" for climate risk modelling, and to demonstrate that people, not AI/ML tools, are ultimately responsible for understanding and taking business decisions.
- Supervisory capacity to review and approve firms' models is a potentially significant bottleneck in many jurisdictions, creating challenges for firms looking to adjust models in response to Basel 3.1 or Solvency II revisions.

The ever expanding use of models across FS to aid business decisions and risk management has prompted supervisory concerns around the extent to which firms appreciate and manage the possibilities that their models do not work as expected. These concerns span familiar areas, such as bank credit risk and insurance solvency modelling, but supervisors are also eyeing emerging and less well understood modelling challenges around climate risk and the use of AI/ML.

Proposed PRA principles on MRM for banks

The PRA's proposed principles on MRM for banks represent a significant elevation of the bar, and when finalised later this year will demand a significant programme of work to catalogue, categorise and risk-assess the models they use, and to improve governance and oversight processes. The PRA has said it expects an "Initial self-assessment" along with "prepared remediation plans" for them to comply with within a 12-month period.

MRM currently only applies to banks. However, the PRA intends to make MRM applicable to insurers once the Solvency II reforms are finalised. In the meantime, the PRA has indicated in its supervisory priorities for 2023 that insurers should consider how the MRM principles could be applied.

The PRA's basic concern remains that many banks are not monitoring or managing effectively the aggregate risks they face due to the broad range of models they use. The overarching aim is to ensure that senior management and Boards have clear sight of the aggregate risk that models represent and receive reporting to enable them to be confident that the risk is being managed.

The main challenge for firms will stem from the PRA's proposal for a very broad definition of what constitutes a "model" covering any instance where a qualitative or quantitative input is subjected to a transformation that produces a qualitative or quantitative output. This captures traditional credit and market risk models, but also extends to a wide range of algorithms, estimators, heuristics, decision trees and spreadsheet-based calculators that banks may not currently define as models. Banks with regulatory approvals to use models for credit and market risk capital calculations may have hundreds of such models; beyond these categories, large banks may count their "models" under the PRA's definition in the thousands.

The first stage of implementing the principles - subject to any changes the PRA makes to the definition of a model - will require banks to create an inventory of models and undertake a risk-

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classification exercise for all in-scope models. This will be challenging, not least because the technology capabilities required to support the expanded model inventories may go beyond those of existing systems. Furthermore, processes that may appear innocuous (for instance, a spreadsheet that collates inputs from three source systems and adds the figures together to form part of a finance/risk reconciliation adjustment for the monthly management accounts) may now count as a "model". The creation of the inventory will need to be iterative to deliver the appropriate scope.

Banks already have in place model oversight and governance processes for models subject to regulatory approval, but the order of magnitude increase in the number of models within the scope of the proposed principles implies a significant resource stretch for teams that are in some cases already struggling with existing supervisory modelling requirements, including on IRB repair, hybrid mortgage models, and preparation for Basel 3.1 implementation.

Firms will need to take advantage of the risk sensitivity and proportionality built into the PRA's proposals, to ensure that lower risk and less material models are subject to lighter touch oversight. Furthermore, not every component of a MRM process requires qualified, experienced statisticians, and firms should seek to identify aspects of their workflows that are amenable to automated solutions. The overall process may be time consuming, but it should bring transparency to decision-making and present opportunities for firms to rationalise what may be unnecessarily diverse and fragmented models across all areas of their operations.

Firms should look to develop remediation plans on the back of their implementation programmes, identifying opportunities to improve the consistency of model inputs and outputs by consolidating data sources and amalgamating models.

EU supervisory focus

There is no EU equivalent to the PRA's proposed principles, although EU banks face challenges of their own, continuing to deal with the findings of the TRIM exercise,[51] the resolution of which is expected to increase RWAs in affected firms by 12%, or €275 billion. The 2021 TRIM report indicated the need for extensive remediation work also. While EU banks have made improvements, this remains work in progress, with firms also having to face a similar set of economic, credit, IRB repair and CRD6/CRR3 pressures on model resources as those listed above.

> "Given that we are in the early stages of modelling climate risk, it is not surprising that firms differ in the degrees of sophistication that they exhibit in modelling. What was surprising to me was that even within a given firm there tended to be a lot of variation in how different parts of the organization modelled things"

Anil Kashyap, FPC member[52]

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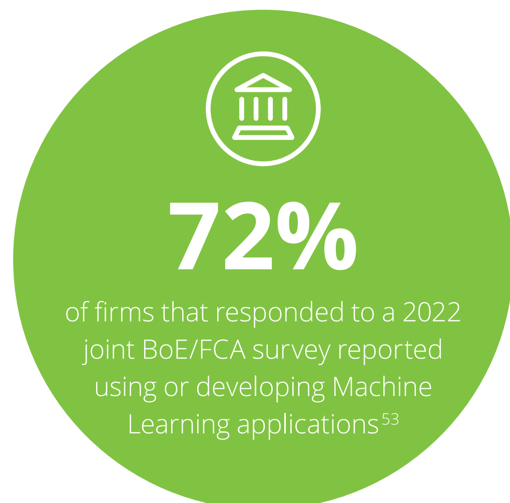
Figure 8: UK firms' use of ML



Meanwhile, the EBA and ECB are turning their attention to the robustness of the models underlying IFRS 9 impairments and IRRBB, given changes in economic conditions and in particular the reversal of a decade of low interest rates. One of the EBA's areas of concern is whether IFRS 9 and IRRBB models built during a low interest rate environment remain robust and reliable in the current higher interest rate environment.

Climate risk modelling

Supervisory attention on the incorporation of climate factors into risk modelling is also increasing. From a model risk perspective, two issues stand out. First, the challenge of building and validating models that can meet expected standards of accuracy and reliability given incomplete climate data that may rely on interpolation, extrapolation or proxies (see more on sustainability data here). Second, the potential for over-reliance on TP solutions for elements of climate modelling, particularly in climate stress testing.

Supervisors want to ensure that firms are not dependent on black boxes and that any bias in models is understood and managed, and we expect supervisors to press firms to improve the incorporation of climate risk into their risk and stress test modelling frameworks in 2023.

External auditors also increasingly expect firms to demonstrate they have undertaken additional modelling to show that the impairment allowances held under IFRS 9 are appropriate in the context of financial risks from climate change. This additional layer of modelling, particularly if significant management judgement is incorporated, is an area where robust internal oversight and challenge should be applied. See [Climate risk and the climate-nature nexus] for more on climate risk.

AI/ML-based models

Model risks also arise from the incorporation of AI/ML into models across all sectors. Supervisors understand the potentially significant benefits of using AI/ML in risk assessment and management, but want to be convinced that Boards and senior management understand the strengths and weaknesses that AI/ML bring to models. No matter the level of analytical sophistication AI/ML may offer, supervisors in the EU and UK expect people, and not models, to be ultimately responsible for making decisions.[54] Firms making significant use of AI/ML modelling techniques are likely to need dedicated technical teams to undertake work around AI/ML model risk and validation.

Boards and executives of firms should be able to demonstrate that they understand the decisions that AI/ML models are intended to make and where the boundaries of those decisions are set, and this should be reflected in MI that enables model performance within those boundaries to be understood.

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Both climate and AI/ML modelling present opportunities and/or requirements for firms to broaden significantly the sources of data they use for modelling: in both instances the extent to which firms have challenged the availability, quality and relevance of new types of data is likely to be questioned by supervisors.

Supervisory review of models

Resource pressures around MRM are not unique to regulated firms, with supervisors themselves facing capacity constraints in many jurisdictions. With numerous current and upcoming priority and/or mandatory model changes for which regulated firms will need supervisory permission, including around Basel 3.1 for banks and Solvency II for insurers, supervisors will need to find ways to increase the capacity of their model review processes, while not compromising on their standards. This also puts a premium on firms' investments in their own capacity, skills and resources, in order to reduce the extent to which they will be vulnerable to deep or frequent regulatory intervention over the coming year.

Model risk management

Do you know what you're looking for?

Actions for firms

Model oversight

- Ensure that once the expanded model universe has been identified, the Board and senior executives understand and are able to explain to supervisors the level of the firm's reliance on models, and their models' strengths and weaknesses.
- Ensure that all options for taking a risk-based approach to classification and oversight of models are fully understood, and that where possible, model oversight processes take advantage of technology options to reduce reliance on scarce validation resources.

Supervisory review of models

- Ensure that where supervisory review of models is required, this is flagged as early as possible and that models are fully ready for supervisory review in accordance with agreed schedules.

Data and AI/ML

- Actively seek opportunities to expand sources of data, and improve the quality of data so risk models are robust, and ensure any weaknesses are understood by the Board and senior executives. Industry initiatives, particularly on climate data, may provide avenues to accelerate efforts.
- Ensure that where AI/ML models are used, the policy, development and control environments are sufficiently robust to ensure that models are fit for purpose and the Board understands the models adequately.

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Financial crime

Running faster just to stay in place

In focus

- Many firms' financial crime operating models continue to fall short of expectations. Fixing these issues requires significant organisational change to eliminate silos, to change resourcing models, and to leverage new technologies, in economic conditions where firms will be under pressure to control costs.
- While the EU's new financial crime supervisor - AMLA - will not be up and running this year, standards will be raised across the bloc in anticipation of its incorporation, and industry should treat 2023 as a "transition year" to the new regime.
- In the UK the FCA will maintain its intense supervision of financial crime, with the continued use of Dear CEO letters as a prompt for firms to act, the ever-present threat of broad and invasive skilled persons reviews where problems persist, and the likelihood of enforcement increasing as FCA patience wears thin.

Following several years of intense supervisory scrutiny, and the industry's continuing difficulty to meet expectations fully, many firms' financial crime operating models appear not to be fit for purpose. Financial crime teams rallied and worked overtime to keep up with the imposition of sanctions following Russia's invasion of Ukraine, but resource pressures remain and relevant skills are in short supply due to competition for staff.

Given the sheer volume of alerts generated by transaction monitoring systems, the inherent limitations of legacy systems and data, continued supervisory investigations, strengthened baseline regulatory expectations, and the ever-changing external environment (the cost-of-living crisis, for instance, implies an uptick in attempted fraud in 2023), it is no wonder that some firms feel they are having to run ever faster just to keep up. Efforts to address these issues in 2023 will be further challenged by the inevitable pressure to control cost that will accompany the deteriorating economic environment.

Financial crime operating model reform

The status quo is not sustainable. Some recurring problems are basic: on-boarding processes are not effective for particular clients; controls are not always properly documented; processes tend to remain "tick box" exercises rather than identifying risks; and transaction monitoring systems generate overwhelming numbers of false positives.

But more fundamentally the way in which financial crime risks are currently managed does not provide the foundations for sustainable improvement towards more effective systems that are better able to prevent financial crime.

Internal structures are not efficient, with responsibilities overlapping across multiple teams. Different elements of oversight can be siloed, with change in one area (e.g. fraud or sanctions) not being pulled through to others (e.g. AML). Fixing this requires top-down organisational change, but also changes in how financial crime officers implement on the ground.

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Backlogs will not come down without extra resource, whether hired externally or trained internally, but the Russia sanctions episode demonstrates that resourcing models also need to be able to flex to accommodate external "shocks" that otherwise draw significant resource away from business as usual processes.

Financial crime operating model reform must also incorporate technology strategy. Supervisors expect firms to be using technologies such as AI and ML, particularly given that supervisors are themselves using them, enabling them to explore significant volumes of data with analytics to target follow-up requests more accurately.

A central use case for new technology is to reduce the volumes of false positives in transaction monitoring systems to free up expert resource for higher value-added work. For firms not already moving in this direction, the starting point should be a review of existing systems to identify whether they enable new approaches; if they do not, firms should consider moving to tools which can. But the adoption of a new tool (and a potential change of vendor) is not a quick fix: a large institution could expect this process to take two years or more.

Nor should these technologies be treated as "plug and play" – they depend on data quality, training, and proper governance, and should be subject to model risk management.

Preparing for the EU AMLA

On the regulatory side, countries across the EU will be gearing up to implement the new AML supervisory framework, the central pillar of which will be the new AMLA. Details of the new framework, including AMLA's location once it is incorporated, should be finalised around the middle of 2023.

AMLA will not be operational until 2024, but as was the case in the run-up to the formation of the ECB SSM, the impact of the new authority will be felt before its formal arrival as authorities across the continent anticipate a boosting of standards and changes in home/host authority relationships. The Bank of Italy, for instance, has already incorporated a new AML unit it has said will enable it to engage more effectively with the new regime, and regulatory fact-finding initiatives are likely to follow.[55]

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Industry should therefore treat 2023 as a transition period in which to prepare itself for AMLA: issues that might be seen as tolerable weaknesses today could become "problems" under the new regime.

Furthermore, firms should not underestimate the potential for additional standardisation to change workloads significantly if AMLA converges on tougher baseline expectations or higher frequencies for certain processes than some firms may be used to. Other jurisdictions may observe progress with the AMLA and contemplate setting up similar structures.

FCA areas of focus

In the UK the FCA has made clear that firms should be working through the financial crime implications of the cost-of-living crisis,[56] and the FCA will likely follow-up on the issue in 2023.

The "Dear CEO" letter has become a favoured mechanism through which the FCA communicates expectations, with letters typically followed by supervisory visits 18 months to two years down the line. The October 2021 letter on trade finance is a case-in-point, where firms should be prepared for the possibility of supervisory follow-ups in 2023.

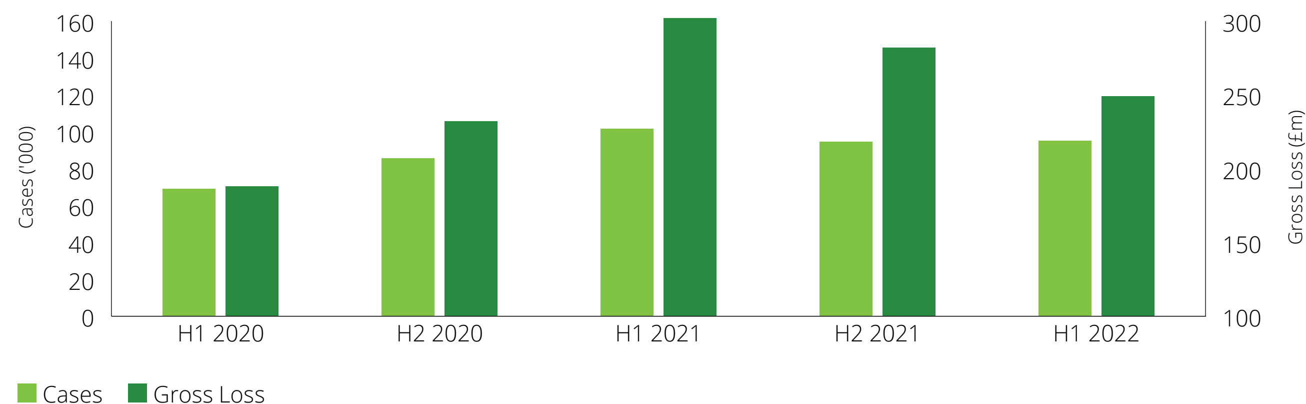
The FCA expects firms to demonstrate understanding of specific high-risk lines of business, for which some firms find that they cannot articulate their risk exposures or controls.

Dear CEO letters should be treated as guides to future action, providing a basis from which to extrapolate to other high-risk areas of business. Digital assets is a particularly pertinent example, in need of scrutiny now to forestall what otherwise feels like an inevitable build-up of problems. The cost of falling short of expectations can include being subject to increasingly expensive, invasive and resource-intensive Section 166 Skilled Persons reports, while the likelihood of enforcement also increases over time as FCA patience with slow rates of remediation and transformation wears thin.

APP scams

In the UK payments sector, the PSR's proposed new policy of (near) mandatory reimbursement for APP scams - which continue to be a significant challenge for the industry - will likely be finalised around mid-year, with an expected implementation deadline

Figure 9: Total losses due to APP scams



Source: UK Finance, 2022 Half Year Fraud Update[57]

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during 2024 (subject to progress on the FSMB which will give the PSR the regulatory powers to do so). The new PSR reimbursement policy will sit alongside a wider set of measures including the continued widespread rollout of CoP and the proposed publication of APP scam protection performance for the UK largest PSPs from summer 2023.

With the shift to a split liability model in which both senders and receivers of fraudulent payments are on the hook, and the proposed dispute resolution mechanism allowing for the costs of reimbursement to be re-allocated between firms "to better reflect the steps each PSP took to prevent the scam",[58] there are strong incentives for firms to invest in more sophisticated oversight of both outgoing and incoming payments.

But where large banks may have substantial data from which to build client profiles to distinguish between genuine and fraudulent activities, smaller PSPs may find themselves less equipped to make such distinctions within their relatively newer customer bases. Ensuring the availability of critical data points (such as fraud claim histories and device information), and selecting the right fraud detection vendor (for instance, those with consortium capabilities and access to broader intelligence such as suspect IP addresses), are crucial.

Rapid commercial growth has outstripped the capacity of some smaller PSPs to scale their risk management and controls. But regulators are unlikely to be sympathetic on this front, and there is no real substitute for using some of the financial capacity generated by business growth to improve fraud controls, even if that comes at the cost of higher frictions for client payments.

Data quality challenges

Lastly, data quality remains a critical challenge, particularly at larger firms that have grown through acquisition. The difficulties of sharing data – an area in which the regulatory framework does not always facilitate the best outcomes – further complicates KYC and customer due diligence processes.

Regulatory efforts to address some of these data challenges will progress in the UK in 2023 through the Economic Crime Bill, including through reforms to boost the reliability of Companies House data. The UK is also moving towards a regime in which aspects of data protection laws can be disapplied where there are legitimate financial crime concerns, paving the way for greater cooperation between firms regarding problem clients, and the further development of data-related public-private partnerships.

It remains to be seen whether the EU's efforts to promote convergence in financial crime supervision will facilitate similar levels of data sharing, or if the bloc aligns on a baseline that is more restrictive.

"Following several years of intense supervisory scrutiny, and the industry's continuing difficulty to meet expectations fully, many firms' financial crime operating models appear not to be fit for purpose"

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Actions for firms

All firms: invest in new capabilities

- Continued investment in financial crime capabilities is an absolute necessity, but firms should be looking at fundamental overhauls of existing ways of working by removing silos to join up AML, fraud and sanctions activities, developing better medium-term technology strategies, and changing resourcing models.
- Review financial crime technology strategies, beginning with an assessment of existing tools and capabilities. Where these do not enable the deployment of more advanced solutions capable of reducing workloads, firms should move to new tools, even where this entails a change of vendor relationships.

EU firms

- Treat 2023 as a transition period in which to prepare for the arrival of of AMLA, recognising that standards will likely rise across the bloc in anticipation of this.

UK firms

- Expect the FCA to return to issues raised in recent Dear CEO letters in 2023. Firms should treat existing letters as indicators of future supervisory focus by extrapolating FCA commentary to other high-risk areas of business that will likely be the subject of future investigations.

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Spotlight: Future UK regulatory framework

Significant change ahead

The UK Government is proposing widespread changes to its FS regulatory system, having set out it's "Edinburgh Reforms" in December, aimed at making the UK FS sector "open, sustainable and technologically advanced". The package represents the most significant and extensive package of regulatory change since the UK left the EU. It builds on the reform agenda that the Government is taking forward via the FSMB, expected to become law in Spring 2023.

We see the package as a collection of diverse initiatives – some of which may be significant and far-reaching – rather than a cohesive whole. The list of reforms is lengthy, made up of around 30 items of correspondence, draft policy papers and other announcements. However, it does not yet amount to a detailed blueprint for the future of UK FS regulation. In many areas, the Government has deliberately not yet set out concrete proposals but has instead launched a series of consultations and calls for evidence.

The absence of detail in many of the reforms has given commentators a blank canvas – some have painted a picture of widespread deregulation and a significant weakening of the post-crisis regulatory framework. Our view is that, in many cases, it is too early to tell. We will have to wait and see what emerges from the consultations and subsequent legislative and rule-making processes. This will take time, and the impacts are unlikely to filter through to firms' day-to-day operations in 2023. Some of the potentially most significant changes will only emerge at end-2024, while others will likely stretch beyond the next General Election.

One element of the package takes immediate effect – the new recommendations letters for the FCA and PRA. These reinforce the importance the Government attaches to the regulators facilitating the competitiveness of UK financial markets – anticipating the secondary objectives in the FSMB – and supporting economic growth. As they stand, the reforms address some opportunities for growth, but the UK will have to strike a delicate balance in terms of consistency with international initiatives. For example, the digital assets initiatives are largely as expected and deliberately do not pre-empt FSB efforts to establish global standards.

The package coincides with ongoing major regulatory change programmes, including the Consumer Duty, new bank and insurance capital regimes and new sustainable finance regulations. There is more to come this year, including a Green Finance Strategy and consultations on digital assets. We expect the regulators to press ahead with these major initiatives, but we may see some reprioritisation of others.

You can read our summary and initial assessment of the FS regulatory reform elements of the Edinburgh Reforms here.

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Regulatory deadlines

Below are a selection of major regulatory deadlines that firms need to prepare for in 2023

Legend
- Investment Management
- Banking
- Insurance
- Capital Markets
- Expected (not confirmed as of 13 Jan 2023)

Q1 2023

UK
- BoE deadline for mid-tier UK banks to comply with MREL resolution requirements (01 Jan)
- Application of BoE's revised policy on operational continuity in resolution (01 Jan)
- 1 and 6 month synthetic GBP LIBOR rates to be discontinued (31 Mar)

EU
- Application of the EU Taxonomy final Complementary Delegated Act on additional climate change objectives (01 Jan)
- Application of amended PRIIPs Level 2 Regulation (01 Jan)
- Application of SFDR RTS (01 Jan)
- Application date for the Leverage Ratio G-SIB buffer in the EU (01 Jan)
- Application date for disclosure of non-financial undertakings under Article 8 of EU Taxonomy (01 Jan)
- Expiry of MIFID II Quick Fix temporary suspension of quarterly best execution reports (27 Feb)
- Deadline for SSM banks to have conducted a full climate and environmental risk materiality assessment (Mar)
- Application date of EU DLT pilot regime regulation (23 Mar)

Q2 2023

UK
- Deadline for manufacturers to complete all reviews according to the Consumer Duty and share necessary information with distributors (30 Apr)
- Expiry of pension scheme arrangements; clearing obligation under onshore Refit (18 Jun)
- Publication deadline on FCA TCFD disclosures for largest asset managers and asset owners (30 Jun)
- Overnight and 12 month USD LIBOR settings to cease (30 Jun)

EU
- DMA starts to apply (02 May)

Q3 2023

UK
- Implementation date for countercyclical capital buffer rate of 2% (05 Jul)
- Implementation date for FCA Consumer Duty (existing and open products and services) (31 Jul)
- Application of pensions dashboard rules (31 Aug)
- Deadline for firms to use new mortality tables when providing consumers with information about annuity income (01 Oct)
- Application of FCA extended financial promotions regime to capture digital assets promotions
- Launch of sandbox for FMI firms (Q3/Q4)

Q4 2023

UK
- Group 1 PSPs required to have and use a Confirmation of Payee system with send and respond capability (31 Oct)
- Deadline for principals to prepare and approve the first self-assessment of compliance with the new appointed representatives rules (08 Dec)
- UK Temporary Permissions Regime expires (31 Dec)
- Deadline for firms to comply with the FCA's policy statement on improving outcomes in non-workplace pensions (01 Dec)

EU
- Expiry of transitional arrangements for critical and third-country benchmarks
- Application date for Intermediate Parent Undertaking requirements (31 Dec)
- First reference date for Green Asset Ratio in EBA Pillar 3 disclosure requirements for ESG risks (31 Dec)
- Disclosure reference date for first EU Taxonomy Article 8 alignment disclosures (31 Dec)
- Deadline for SSM banks to integrate fully climate and environmental risk into their business strategy, governance and risk management (31 Dec)

Please see our detailed regulatory timeline tool for a more granular view

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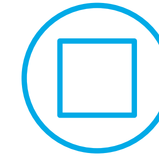
The regulatory perimeter

The regulatory perimeter continues to evolve



Much of this year's Regulatory Outlook covers topics we expect to be of immediate relevance to firms in 2023. Here we look ahead to what new activities, products, technologies and firms are likely to be included within the regulatory perimeter (the boundary of which entities and activities are regulated and supervised by FS authorities) over the next five years or so.

The charts on the following pages sets out where we anticipate changes to the regulatory perimeter:

- **Innermost circle:** products or firms that are certain to be regulated shortly, as regulators have finalised plans for doing so.
- **Middle circle:** areas where regulators have already announced their intentions, or published proposals, discussion papers or consultation papers for action.
- **Outermost circle:** a broader regulatory or social concern about a type of product or firm that we believe could lead to regulatory action in the medium term.

The charts are further split into four quadrants to reflect:

- New products or activities to be brought within the regulatory perimeter.
- New entities or persons brought within the perimeter or change in authorisations.
- Widening of existing regulatory regime to new products or services.
- Cross-sectoral regulatory regime affecting the FS sector.

This year we highlight 11 new initiatives that are emerging – albeit with differences in terms of speed and detail currently available – that may amend the regulatory perimeter.

New systemic payments firms (UK)

As the role of non-bank payments firms in FS continues to grow, HMT has proposed bringing a new category of systemically important payments "providers" under the oversight of the BoE which will supervise them from a financial stability perspective. We do not expect HMT to use absolute thresholds for designating systemic payments firms, but rather to look more holistically across firms' business models and systemic risk profiles, including the relationships with other payment providers and the substitutability of their services. This approach would align with the one for designating systemic stablecoins set out in the FSMB.

DeFi (UK & EU)

EU and UK authorities are both considering the necessity and feasibility of regulating decentralised crypto systems and service providers - DeFi.
The European Commission will publish a report and potential legislative proposal on the topic by July 2024.

NFTs (UK & EU)

EU and UK authorities are also considering the need to develop NFT-specific regulatory frameworks. NFTs are typically outside the EU regulatory perimeter,

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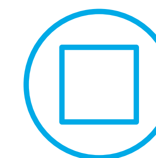

except in specific cases, for example, if issued in a large series or collection. By September 2024 the European Commission will prepare an assessment and, if deemed necessary, propose a tailored framework for NFTs.

UK Online Safety Bill/EU Digital Services Act (UK & EU)

The UK Online Safety Bill and the EU Digital Services Act introduce measures with the broad aim of making the internet safer and more trustworthy, focusing on certain internet services, including online platforms services that host or disseminate service users' content and specific provisions around content which constitutes online advertising. Both the Online Safety Bill and Digital Services Act include requirements around protecting users against illegal content. The Online Safety Bill also includes specific requirements to operate regulated services using systems and processes designed to prevent fraudulent adverts (which we consider could include financial scams) from being encountered by users.

Cyber Resilience Act (EU)

To mitigate the risk of cyber-attacks, the CRA sets out a series of cybersecurity-related requirements for any product with digital elements. Its scope includes manufacturers, importers, and distributors of such products.

Corporate Sustainability Due Diligence Directive (EU)

Requires firms to identify and potentially mitigate adverse environmental or human rights impacts from their own business operations and across their value chain, including those arising outside of the EU. We explore the CSDDD in the Strengthening transition plans and disclosures chapter.

Corporate Sustainability Reporting Directive (EU)

CSRD will significantly expand the scope of sustainability reporting requirements, requiring EU firms with more than 250 employees to publish sustainability data according to ESRS. It will apply from 2024, although there are longer transitional periods for firms that are not currently in scope of sustainability reporting requirements under NFRD.

Climate transition plans (UK & EU)

Long-term plans developed by firms to align their business models with climate targets (such as net zero emissions) are set to be made mandatory through a number of channels – TCFD disclosures in the UK, CRD6 and CSDDD in the EU.

Extending securitisation rules to new entities (UK)

Legislation to replace the existing securitisation directive and expand the scope to include some market participants that are not FCA- or PRA-regulated.

Prudential regime for banks' exposures to digital assets (UK & EU)

The BCBS finalised its standards on the prudential treatment of banks' exposures to digital assets at the end of 2022. The UK and EU will now consider how to implement these in jurisdictional frameworks.

Prudential treatment of climate risks (UK & EU)

Prudential regulators are considering how best to ensure climate risks are appropriately reflected in the prudential regime for banks and insurers. Policymakers in the UK and EU are expected to provide further detail on their planned approach in 2023, having set out their initial views in 2022.

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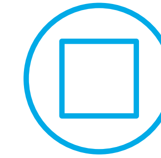

New product or activity brought within the regulatory perimeter

- NFT markets (UK)
- NFT markets (2026/27*) (EU)
- Unregulated payments services (2025/26*) (EU)
- DeFi markets (2026/27*) (EU)
- DeFi markets (2026/27*) (UK)
- BNPL (2024/25*) (EU)
- Stablecoins used for payments (2024*) (UK)
- Other unregulated digital assets (2024/5*) (UK)
- Unbacked digital assets and stablecoins (2024) (EU)
- BNPL (2024*) (UK)

New entity or persons brought within the regulatory perimeter or a change in authorisation

- Software providers operating trading platforms (EU)
- Third country algorithmic & HFT firms (EU)
- ESG and ratings providers (UK)
- ESG data and ratings providers (EU)
- Investment consultants (UK)
- Corporate Sustainability Reporting Directive (2024) (EU)
- New systemic payment firms to come within BoE oversight (2024/25*) (UK)
- Oversight of critical TPs under DORA (2025) (EU)
- Oversight of critical TPs (2025*) (UK)

Likelihood **Certain** **Likely** (proposal, consultation or regulatory announcement) **Possible** (regulator has raised concerns or open consultation)

* Date is an estimate as at 13 Jan 2023; where no date is included it is because there is insufficient information to make an estimate.

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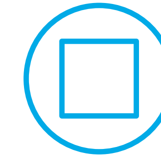

Cross-sector regime affecting FS sector

Widening of the regulatory regime applying to a product or activity

Climate Transition Plans

Corporate Sustainability Due Diligence (2025*)

AI cross-sector legislative framework (2024/25*)

AI cross-sector regulatory framework (2024/25*)

Climate Transition Plans (2025*)

Competition regime for digital gatekeepers (2024/25*)

Data protection regime review (2023)

Cyber Resilience Act (2026)

Competition regime for digital gatekeepers (Q2 2023)

Open Finance (2025/26*)

Prudential treatment of climate risks

Open Finance and Smart Data (2025/26*)

Prudential treatment of climate risks

Prudential regime for banks' exposure to digital assets (2025)

Financial promotions extended to digital assets (Q3 2023*)

Prudential regime for banks' exposure to digital assets (2025)

FX spot and commercial forwards brought into the scope of MAR

Likelihood **Certain** **Likely** (proposal, consultation or regulatory announcement) **Possible** (regulator has raised concerns or open consultation)

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Climate risk and the climate-nature nexus	Emerging climate-related risks Climate and bank capital requirements: where now and where next? The Bank of England's Climate Biennial Exploratory Scenario | 'Climate KYC' and other initial reflections for banks	Climate risks in ORSAs – Key considerations Taking stock of climate risk in your ICAAP: Flying blind is not an option
Digital assets and payments	Big Tech expansion into financial services: FCA kicks off debate on competition risks Expansion of the systemic perimeter for payments in the UK and broader reforms to payments regulation	MiCA – a new crypto asset regime for the EU Building a digital assets strategy for the wholesale bank in the EU and UK
Operational resilience and critical third parties	The EU Digital Operational Resilience Act (DORA) is here: what are its strategic implications for the Boards of FS firms? UK to expand FS regulatory perimeter to capture critical third parties Operational resilience for UK investment managers – how firms should use the transition period	UK financial regulators propose oversight regime for Critical Third Parties: key takeaways and implications The EU's Digital Operational Resilience Act has been agreed: implications for the financial services sector Next steps in building operational resilience in financial services firms
Capital framework	The PRA's approach to Basel 3.1 | Now the hard work begins The UK implementation of Basel 3.1 – a difficult balancing act for the PRA Implementing the Fundamental Review of the Trading book: state of play and key challenges ahead A concept-ual approach to buffers The UK Government's consultation on Solvency II: Part 1 – Risk Margin and Matching Adjustment eligibility impacts	Implementing the Basel 3 final reforms in the EU: the European Council agrees its General Approach Solvency II: PRA settles on a high bar for mixed-activity group designation The UK Government's consultation on Solvency II: A green and competitive future
Capital markets	EU announces its plan to reduce reliance on third country CCPs: the "active" account requirement Beyond Brexit: Regulatory considerations for banks and the future of European capital markets	FSB recommends addressing structural liquidity mismatches and greater use of anti-dilution tools in open-ended funds The ECB publishes the findings of its desk-mapping review

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Other	Weathering the storm: Overcoming the challenges in the UK general insurance personal lines market UK data protection reform: what does it mean for innovation in financial services?	Embedded Finance: regulation and strategic choices

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A2A
Account-to-Account

ACER
European Agency for the Cooperation of Energy Regulators

AI
Artificial Intelligence

AML
Anti-Money Laundering

AMLA
Anti-Money Laundering Authority

APAC
Asia Pacific

APP
Authorised Push Payment

ASEAN
Association of Southeast Asian Nations

BCBS
Basel Committee on Banking Supervision

BNPL
Buy Now Pay Later

BoE
Bank of England

CBDC
Central Bank Digital Currency

CCP
Central Counterparty

CEO
Chief Executive Officer

CFO
Chief Finance Officer

CIFs
Critical or Important Functions

CoP
Confirmation of Payee

CRA
Cyber Resilience Act

CRD6
Capital Requirements Directive 6

CRR3
Capital Requirements Regulation 3

CSA
Common Supervisory Action

CSD
Central Securities Depository

CSDDD
Corporate Sustainability Due Diligence Directive

CSDR
Central Securities Depositories Regulation

CSRD
Corporate Sustainability Reporting Directive

CTP
Critical Third Parties

CVA
Credit Valuation Adjustment

DeFi
Decentralised Finance

DLT
Distributed Ledger Technology

DMA
Digital Markets Act

DORA
Digital Operational Resilience Act

EBA
European Banking Authority

ECB SSM
European Central Bank Single Supervisory Mechanism

EFRAG
European Financial Reporting Advisory Group

EIOPA
European Insurance and Occupational Pensions Authority

EMEA
Europe, Middle East and Africa

EMIR
European Market Infrastructure Regulation

EMIs
E-money Institutions

ESAs
European Supervisory Authorities

ESG
Environmental, Social and Governance

ESMA
European Securities and Markets Authority

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ESRS
European Sustainability Reporting Standards

FCA
Financial Conduct Authority

FDIC
Federal Deposit Insurance Corporation

FMI
Financial Market Infrastructure

FPC
Financial Policy Committee

FS
Financial Services

FSMB
Financial Services and Markets Bill

FX
Foreign Exchange

GFANZ
Glasgow Financial Alliance for Net Zero

GFC
Great Financial Crisis

GHG
Greenhouse Gas

GI
General Insurance

GTAG
Green Technical Advisory Group

HFT
High-Frequency Trading

HLEG
High-Level Expert Group on the Net-Zero Emissions Commitments of Non-State Entities

HMT
His Majesty's Treasury

IBS
Important Business Services

ICAAP
Internal Capital Adequacy Assessment Process

IFD
Investment Firms Directive

IFRS
International Financial Reporting Standards

IMF
International Monetary Fund

IRB
Internal Ratings Based

IRRBB
Interest Rate Risk in the Banking Book

ISSB
International Sustainability Standards Board

IT
Information Technology

KYC
Know Your Client

LDI
Liability Driven Investment

LIBOR
London Inter-Bank Offered Rate

LNG
Liquified Natural Gas

LTE
Long-Term Equity

MA
Matching Adjustment

MaPS
Money and Pensions Service

MAR
Market Abuse Regulation

MAS
Monetary Authority of Singapore

MI
Management Information

MiCA
Markets in Crypto Assets

MiFID
Markets in Financial Instruments Directive

ML
Machine Learning

MREL
Minimum requirement for own funds and eligible liabilities

MRM
Model Risk Management

MTF
Multilateral Trading Facility

NBFI
Non-Banking Financial Institutions

NCA
National Competent Authority

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NFC
Near-Field Communication

NFRD
Non-Financial Reporting Directive

NFT
Non-Fungible Tokens

NGFS
Network for Greening the Financial System

ORSA
Own Risk and Solvency Assessment

P&L
Profit and Loss

PRA
Prudential Regulation Authority

PRIIPs
Packaged Retail Investment and Insurance-based Products

PSP
Payment Service Providers

PSR
Payment Systems Regulator

RMF
Risk Management Framework

RTS
Regulatory Technical Standard

RWA
Risk Weighted Assets

SBTi
Science Based Targets Initiative

SCA&CSC
Strong Customer Authentication and Secure Communications

SDR
Sustainability Disclosure Requirement

SEC
Securities and Exchange Commission

SFDR
Sustainable Finance Disclosure Regulations

SMCR
Senior Managers and Certification Regime

TCFD
Task Force on Climate-Related Financial Disclosures

TLPT
Threat Led Penetration Testing

TNFD
Task Force on Nature-Related Financial Disclosures

TP
Third Party

TPT
Transition Plan Taskforce

TRIM
Targeted Review of Internal Models

UCITS
Undertaking for the Collective Investment in Transferrable Securities

VA
Volatility Adjustment

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