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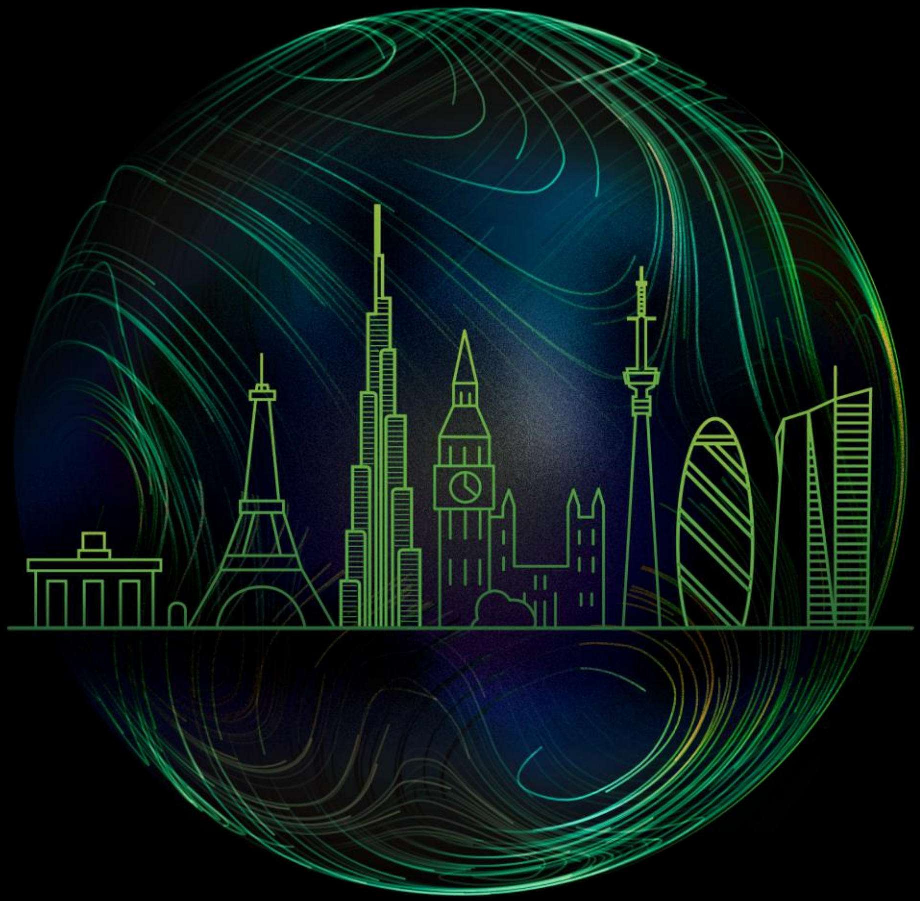

Investment Banking
Financial Markets
Regulatory Outlook 2024

CENTRE *for*
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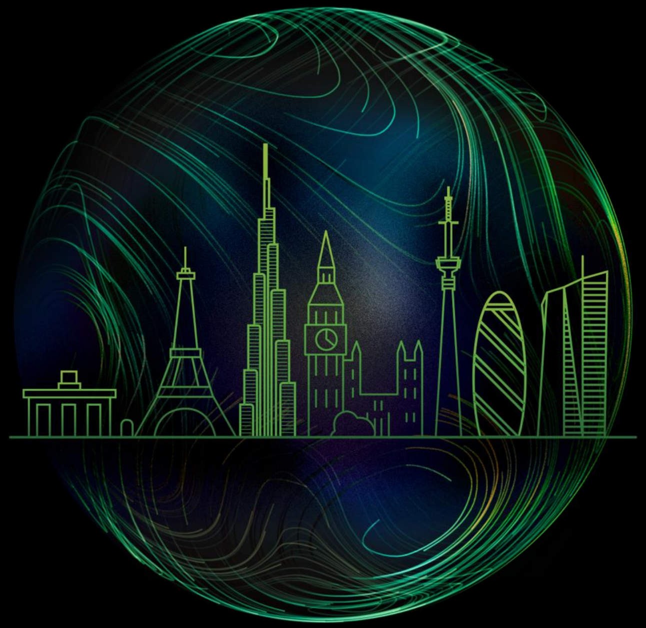
EMEA

Regulatory Outlook 2024

Investment banking – at a glance



Advancing capital markets

Regulatory change broadens and rebounds across Europe

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- As policy-making has progressed, answers to some of the major post-Brexit EU market access questions have become clearer. It now looks certain that third-country IBs will be able to continue to provide cross-border investment services into the EU under CRD6. The EU's drive to "onshore" the clearing of euro-denominated interest rate derivatives will culminate in an "active" account requirement at an EU CCP. Alongside these developments, the ECB and the PRA will be closely supervising IBs' trading activities. Many more changes to the UK's and EU's regulatory frameworks for capital markets are underway. This will stretch IBs' regulatory mapping capabilities, along with the capacity of their IT and operational teams.

WHAT'S HAPPENING THIS YEAR?

- One key issue for IBs is whether EU-based firms subject to the clearing obligation will be required to maintain an "active" account at an EU CCP. Whilst EU legislators are still debating the details, the emerging consensus suggests that **the active account will have some operational and activity requirements in a first phase with any quantitative thresholds (if needed) unlikely to be applicable before end-2025**.
- With CRD6 being finalised, IBs will be able to continue to provide MiFID services cross-border, but **will need to account for additional TCB requirements to provide "core" banking services cross-border**, increasing financial and operational costs.
- **We expect the ECB's and PRA's supervisory scrutiny of IBs' trading activity to continue**, with an ongoing focus on: booking models; back-to-back transactions; remote booking; the type and volume of transactions booked in their EU/UK subsidiaries/branches; and the robustness of their risk management and governance arrangements.
- A significant volume of regulatory change affecting IBs' capital markets activity is underway in both the UK and the EU, with **material updates to MIFIR, EMIR and CSDR** especially. Both jurisdictions are aiming to improve the competitiveness of their respective capital markets, including by boosting retail participation. Despite some examples of regulatory convergence, enough differences remain in both the timing and detail of both jurisdictions' reforms that will challenge IBs' regulatory change management programmes.

KEY ACTIONS FOR IBs IN 2024

Assess EU footprint and business models in light of regulatory change

- Given forthcoming changes to the regulation of cross-border services and euro-denominated clearing, IBs should review EU legal structures and business models to assess scope for rationalisation and simplification.
- IBs should prepare for ongoing scrutiny and challenge of booking models, as well as associated controls from both the ECB and the PRA/FCA with a particular focus on undue complexity in booking arrangements, the balance between preventative and detective controls and how Boards and senior management satisfy themselves of the effectiveness of controls and oversight.

Keep investing in regulatory mapping capabilities to deliver synergies

- IBs should continue investing in regulatory mapping capabilities to form a holistic view of regulatory change. These should be able to identify synergies, develop a joined-up approach to enacting change across entities and jurisdictions, and ensure IBs stay on top of diverging details and timelines.
- Management should focus on the operational aspects of managing the large and increasing volume of regulatory transformation, ensuring that any changes to IT systems and processes are designed and implemented strategically.

Consider changes in the UK competitive landscape

- Whilst governments are looking to encourage retail participation in capital markets, IBs may consider developing products to fill the gap. This could include growing research in sectors which could benefit from re-bundling and building/partnering with businesses which could benefit from changes to the listing rules and prospectus regime.
- IBs should also be aware that some proportion (likely minor) of their IB activity may leave the sector, taking advantage of other tools designed by the government (such as the intermittent trading venue and research platform).

FRTB

Finalisation of SA and decision-making time for IMA

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- As the deadline for FRTB implementation approaches fast, IBs are getting ready to adjust to higher capital for market risk, calculated either using the SA or IMA.
- Many IBs are still assessing the capital benefits of IMA, and some may conclude that these are outweighed by the cost of seeking and maintaining approval. However, before making a final decision, IBs must consider the possibility that, even if they do not apply for IMA, supervisors may still require IMA-equivalent granularity of information, to satisfy their financial soundness and stability needs, with no respective capital benefit for IBs.

WHAT'S HAPPENING THIS YEAR?

- FRTB, which encompasses Basel 3.1 requirements for calculating market risk, is due to go live in the EU in January 2025 whilst in the UK the implementation has been postponed to July 2025 to align with the US. Regardless of the timeline divergence, IBs need to prepare to deliver a SA parallel run for the best part of 2024 to demonstrate usability.
- Success for the FRTB SA will be based on a scalable and robust implementation of the calculations which supports increasingly granular regulatory reporting and the requirement for daily capital monitoring. Despite the already long lead time, many IBs are still struggling with the availability and quality of sufficiently granular data and the IT infrastructure and operating model that will allow them to perform the calculation consistently on a daily basis. EU banks have a head start as they were required to report FRTB SA at part of CRR2, but their existing solution is unlikely to be sufficiently scalable to satisfy global FRTB reporting requirements.
- IMA will take the FRTB implementation a step further. IBs will need to apply for approval on individual desk levels resulting in a significant increase in data volumes. Some estimates suggest 20–50 times more data will be generated daily. The accuracy and timeliness of data and alignment between 1LoD and 2LoD will also be a challenge. To generate material benefits from IMA, firms will need to optimise the number of risk factors they can model and identify non-modellable risk factors in a way which is quite different from how IBs currently manage their trading book risks and adds significant additional complexity.

KEY ACTIONS FOR IBs IN 2024

Accelerate preparation for SA calculation

- To go live, IBs will need to be able to run SA calculations daily, at a time when many still struggle to run it quarterly. During the parallel run, IBs will need to deliver accurate and validated SA numbers according to a well-defined operating model.
- Before go-live, IBs need to assess the SA implications for existing processes, controls, SLAs and reporting requirements and forecast resources that may be required across different functions when SA becomes operational.
- IBs will also need to identify risk factors that SA is too standardised to capture and report them separately.

Overcome challenges of managing increasing granularity of data

- Managing additional granularity of data arising from adoption of SA and even more from IMA will be challenging. If gaps or errors are identified, IBs need to prepare to address them swiftly, as the time to remedy issues will be short.
- To address data challenges, IBs will have to invest significantly in upgrading their regulatory reporting infrastructure and improving data quality and lineage.

Prepare to demonstrate prudent risk management

- To satisfy regulatory requirements, IBs need to be prepared to demonstrate that they understand and manage market risk effectively, regardless of the calculation approach they take.
- To do that, IBs need to align data between Front Office, Risk and Finance; maintain policy documents detailing the rationale for including instruments in the trading book, modelling choices and assumptions; enforce better governance around data and their product taxonomy; and ensure the ongoing monitoring of sensitivities and risk drivers of capital.

Counterparty Risk Management

Step-up of supervisory engagement

Impact Areas

- Governance (red)
- Strategy (amber)
- Finance (amber)
- Operations (amber)
- Control functions (Risk/Compliance/IA) (red)

KEY CHALLENGES

- The recently ended prolonged period of low interest rates encouraged provision of capital market services to a wider variety of counterparties, often NBFIs, in search for higher yield. NBFIs now account for c50% of global financial system assets.
- Policymakers have not yet agreed, let alone implemented, a regulatory framework for how NBFIs should themselves manage risks, meaning that supervisors will continue to use the tools immediately available to them, namely calibrating IBs' counterparty risk management practices for exposure to NBFIs.

WHAT'S HAPPENING THIS YEAR?

- **We expect supervisors in the EU and the UK to step-up their engagement on CCR in particular in relation to NBFIs.** In October 2023, the ECB published the outcome of its review and highlighted 43 sound practices across CCR governance, risk control, stress testing, and default management specifically focusing on banks' exposure to NBFIs. **The** ECB expects **banks to "go beyond mere compliance with regulatory minimum requirements when designing their risk management and control approaches to CCR".**
- Shortcomings in CCR management frameworks have been cited as a "prioritised vulnerability" in ECB's supervisory priorities for 2024-2026. **The ECB expects banks to fix deficiencies in credit risk frameworks and effectively identify and mitigate risk build-ups.** Supervisors will further scrutinise the risk models and perform targeted follow-ups.
- **The PRA has also identified shortcomings in CCR management processes.** While IBs have made progress in strengthening this for hedge fund counterparties, PRA expects them to extend due-diligence principles, client disclosure standards and CCR management controls to all client types and in all relevant trading businesses and is likely to include this in its supervisory engagement programme for 2024.
- The FCA is concerned that market shocks in the past two years and broader challenges in the external environment could lead to transformed and interconnected risks that test IBs' business models and risk management frameworks. In particular, **the FCA found poor management of client relationships and inadequate knowledge of clients' business profiles leading to unknown concentrations and underestimation of client risk.**

KEY ACTIONS FOR IBs IN 2024

Ensure robustness of risk management practices

- IBs need to be able to demonstrate that their CCR management frameworks, including risk appetite, risk limits, and stress testing assumptions, incorporate lessons learned from recent market shocks. Senior management will need to demonstrate the embeddedness of improvements in risk management and sufficient oversight.
- 1LoD must focus on improving management of client relationships and knowledge of clients' business profiles to understand risk concentrations better, comprehensively capture WWR and ensure that risk limits and appetite are upheld.
- For material/complex CCR exposures, IBs should explicitly specify their willingness to accept this risk in their risk appetite statements.

Enhance counterparty monitoring capabilities and stress testing

- IBs have to consider CCR in all its materiality and complexity and model it effectively as part of stress testing frameworks – paying particular attention to riskier counterparties and those vulnerable to exposure to tail events.
- IBs need to monitor effectively counterparty concentrations to margin shocks and agree additional liquidity facilities or other mitigating steps where necessary.

Consider CCR exposure holistically

- IBs should enhance capacity and capability of risk management teams in 1LoD to ensure adequate coverage of all relevant counterparties and in 2LoD consider credit and market risk in combination to monitor overall risk to the IB.
- Adopt holistic approach to CCR audit to assess CCR processes and governance across all business units.
- Introduce (if one does not already exist) a dedicated committee/management forum to assess CCR topics holistically, ensuring that information is discussed on a regular basis and risk is captured as accurately as possible.

Wholesale conduct

Higher up the supervisory agenda

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- In a period of ongoing macroeconomic uncertainty, supervisors are increasingly concerned that the market environment could undermine IBs' controls via the emergence of new conflicts of interest or prioritisation of commercial interests over risk and regulatory responsibilities. Supervisors will challenge IBs on the robustness of their culture and controls in the face of revenue headwinds and associated cost-reduction pressures.
- IBs which may have a potential (indirect) exposure to retail clients in the UK will need to be able to interpret the Consumer Duty ("the Duty") and apply it effectively to reduce any tail risk of breaching the Duty.

WHAT'S HAPPENING THIS YEAR?

- **The FCA will focus its engagement on areas where new conflicts could have emerged as a result of changes in the market environment**. For example, the conflict may arise when an IB: (1) chases volume trading to achieve a high degree of balance sheet netting while ignoring the magnitude of gross exposures; (2) terminates client relationships in pursuit of its ESG commitments, at the expense of the client's best interests; or (3) develops new products that further the UK government's agenda of increasing retail participation in capital markets, but potentially overlooks aspects of the Duty in pursuit of higher volumes and/or margins.
- A focus on conduct and culture will continue to drive supervisory activity in some EU jurisdictions. IBs need to do more to ensure that they embed a conduct-focused culture effectively into their day-to-day operations. **Supervisors will be looking for evidence of a "speak-up" culture, in particular in areas of improper behaviour and non-financial misconduct, and the quality of relevant policies**.
- IBs in the UK will, where relevant to their product set, be working towards compiling the evidence and engaging with the Board to produce and approve their first Duty compliance report before 31 July 2024. Although IBs may feel that they are not at top of the FCA's priority list for Duty compliance, the FCA requires all firms to put their customers' needs first, in particular if they have a direct relationship with retail clients or manufacture products that can ultimately be sold to retail clients. **We expect the FCA to scrutinise IBs' reports carefully and challenge weak assumptions, lack of relevant data and evidence as well as effectiveness of the arrangements in place to assess the potential impact of changes in their activities on compliance with the Duty**.

KEY ACTIONS FOR IBs IN 2024

Maintain high standards of controls and evidence accountability

- Maintain a strong focus on conduct and culture across all three lines of defence especially where new conflicts could have emerged as a result of changes in the market environment.
- Prepare to demonstrate clear accountability between 1LoD and 2LoD, in particular when delivering on new commitments, such as ESG.
- Ensure that conduct risk MI is timely, appropriate and reflects the changing market environment. Ensure that Board minutes adequately capture conduct risk MI discussions, to evidence risk monitoring to supervisors.

Assess relevance of Consumer Duty

- Where an IB has a potential exposure to retail clients in the UK, assess implications of the Duty very carefully, in particular, if it manufactures complex structured products capable of causing significant harm. Be prepared to demonstrate how the IB has have taken account of the Duty.
- Review current data set and MI in relation to distribution of products to determine if the information is sufficient to evidence compliance with the Duty.
- Establish clear accountability and governance frameworks as well as the right "tone from the top" to foster an environment where all relevant staff understand their role in delivering good customer outcomes.

Establish and embed effective conduct-focused culture

- Develop Board-approved culture strategy supported by a defined plan on delivery and embedding. CEOs should lead by example and empower other senior management to foster an effective conduct-focused culture.
- Ensure the IBs' speak-up culture and relevant policies are well defined and adapted for specificities of local entities. Foster awareness and understanding of these frameworks and reinforce a culture of psychological safety.

Operational resilience

Last year of implementation

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- As operational resilience rules approach the final implementation year in the UK and the EU, IBs will have to move from building compliance to demonstrating actual resilience to the supervisors with no precedents in doing so. DORA's challenging implementation timeline may add an extra layer of complexity, as IBs will likely need to begin implementation before full ratification of secondary standards.
- New CTP oversight regimes will provide more supervisory oversight but will not replace existing and new TPRM duties for IBs which will continue to require significant effort.

WHAT'S HAPPENING THIS YEAR?

- EU's DORA will become fully applicable to IBs from January 2025 and the UK's operational resilience regime will apply from March 2025.
- In the UK, 2024 will be the last year for IBs to embed their new target operating models and address any regulatory feedback. IBs showing significant deviations from peers in their impact tolerances will likely need to revisit their framework. The BoE, FCA and the PRA will finalise the oversight regime for CTPs and consult on a framework for incident, outsourcing and third-party reporting. Even though the new CTP oversight regimes will contribute to generating a more secure outsourcing environment, regulators have been very clear that these new rules will not in any way detract from IBs' own TPRM duties.
- DORA secondary standards (providing key technical detail) will also be finalised during 2024 as the Commission ratifies the ESAs' final drafts. Similarly, the EU's Cyber Resilience Act is expected to be finalised in H1, although its relevance to IBs is still being debated. ESMA has announced that, from January 2025, it will adopt cyber risk and digital resilience as one of its key Union Strategic Supervisory Priorities, focussing EU supervisory attention. Meanwhile the ECB intends to launch a stress test on cyber resilience in H1 2024, testing banks' response to and recovery from a successful cyber-attack. The ECB plans to gather results by late Q2 or early Q3 2024.
- Supervisors expect IBs' operational resilience frameworks to continue to evolve, incorporating lessons from market events into stress scenarios. E.g. IBs need to consider a significant increase in the volume of margin calls and securities transfers during market stress that could strain their margining and settlements infrastructure.

KEY ACTIONS FOR IBs IN 2024

Demonstrate resilience maturity in different contexts

- Given the role IBs play in the safety and soundness of financial markets, supervisors will require banks to evidence the resilience of services they provide to the market as well as their own systems. IBs need to ensure that their operational processes and margining platforms are resilient and scalable enough to withstand extended periods of increased volatility and activity.
- Demonstrate resilience maturity. This will require high levels of Board/top management involvement. Senior managers need to prepare to demonstrate how they learnt the lessons from operational resilience events, even if they were not directly affected.
- In the EU, IBs will have to step-up their implementation efforts on emerging DORA technical standards to ensure timely compliance.

Focus on TPRM

- Continuously assess reliance on third parties. Map supply chains focusing on critical functions and ensure steps to mitigate potential impact from loss of services are robust and actionable, including by testing alternate suppliers.
- Move from preliminary evaluation to more detailed discussions with third parties on practical arrangements to ensure their inclusion in key resilience activities, such as participation in testing.

Engage with supervisors and industry

- Maintain an ongoing dialogue with supervisors and industry peers to understand what "good" looks like, and promptly notify the supervisors of outages or cyber-attacks affecting them directly or the third parties they rely on.
- Prepare for participation in the ECB cyber stress test. Further details around the nature and scope of tests will help shape data and capability requirements.

Model Risk Management

Casting the net more widely

Impact Areas

- Governance (red)
- Strategy (amber)
- Finance (amber)
- Operations (amber)
- Control functions (Risk/Compliance/IA) (red)

KEY CHALLENGES

- The PRA's SS 1/23 on MRM comes into force on 17 May 2024. Although only applying initially to UK banks with existing model permissions, it represents a considerable expansion of the scope of MRM, in particular the number of models to which model governance must be more formally applied.
- The ECB's Guide to Internal Models will be revised in 2024, and the consultation states *"Institutions are expected to implement an effective model risk management framework for all models in use".* EU IBs could look to the PRA's Principles as good practice for identifying and managing model risk beyond regulatory capital models.

WHAT'S HAPPENING THIS YEAR?

- Affected IBs in the UK will need to demonstrate they have in place:
    - Comprehensive model inventories, with robust, risk-based categorisation of models across the IB.
    - Robust model governance, with evidence of Board involvement and an assigned SMF holder.
    - Model development, implementation and use policies in place.
    - Independent model validation policies and processes.
    - Policies and processes covering model risk mitigants, particularly post-model adjustments.
- As the SS only initially applies to UK banks with approval to use models for capital purposes, the PRA will expect high levels of compliance from day one.
- UK IBs not yet in scope for SS 1/23 should review their internal processes and be able to discuss their MRM approach with their supervisors. We note the PRA's comment in its annual review of discussions with external auditors that "*model risk remains elevated*" and its encouragement to firms to "…*ensure robust governance over key modelling decisions*."
- Following consultation in 2023, the ECB will issue a revised Guide to Internal Models, which IBs will need to review and implement. Principal proposed amendments in the consultation include incorporation of climate risks into models, considerations for IBs wishing to give up model approvals and revert to standardised approaches, guidance on definition of default, treatment of instruments lent or repo'd out under the market risk framework, and clarifications around margin period of risk under the counterparty risk framework.

KEY ACTIONS FOR IBs IN 2024

"Day 1" compliance with SS 1/23 for UK IBs

- Determine where to "set the bar" for which models are included in the model inventories and model governance processes under SS 1/23. The PRAs intent is to define "model" broadly, not narrowly.
- Pay particular attention in plans for Day 1 compliance to climate risk models, and models utilising AI/ML techniques, given the PRA's stated focus in these areas. IBs will need to be able to demonstrate that these models are subject to rigorous review and challenge at all levels.
- Raise the standard of executive and Board education covering model risk issues, ensuring that model risk is understood to be a risk in its own right, and on a par with credit, market and operational risks.

Beyond Day 1 for UK IBs

- Prepare and communicate a robust plan to close any residual gaps, paying particular attention to any shortfall against elements of the MRM principles that relate to Board involvement.
- Demonstrate to supervisors that continuous improvement is built into MRM policies, governance and approaches.

ECB's Guide to Internal Models – impact on EU IBs

- Improve the quality and quantity of climate data and increase the effectiveness of climate modelling capabilities, including developing methodologies for validating climate models in the absence of specific outcomes.
- Plan for how to respond to the challenge of managing a significantly increased number of models in scope when broadening MRM to cover all models in use.

Transition planning

Turning ambitions and blueprints into action

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- Even before more detailed regulatory guidance on transition planning is finalised, IBs need to step up their efforts on transition planning, to have plans that drive the business and which they are confident to publish.
- Who pays for the transition to net zero will be a political battleground in the run up to parliamentary elections in the EU and UK, which will increase uncertainties for IBs about the direction and pace of the economy-wide transition. IBs will also need to consider how their transition plans might need to be adjusted to balance broader risks to society and to nature, particularly as recommendations from TNFD are taken forward.

WHAT IS HAPPENING THIS YEAR?

- In the UK, we expect IBs to progress transition planning, looking to ISSB standards and TPT recommendations (especially after the FCA pointed to the latter in their 2023 Dear CEO letter as a future topic of discussion with IBs), in advance of the FCA updating its disclosure requirements – which we expect to enter into force for accounting periods on or after 1 January 2025 (reporting in 2026).
- In the EU, CSRD includes transition plan disclosures and will apply to larger, publicly traded IBs from FY 2024 (reporting in 2025). CSDDD and CRD6 will also be agreed in 2024, introducing additional expectations and supervisory powers relating to transition planning and transition plan disclosures.
- We also expect policymakers to turn their attention to how the regulatory framework constrains transition finance. There are concerns that under current rules, as IBs seek to manage transition risk and meet climate targets, they may reduce funding and investment to areas that need it to transition. We anticipate that progress to balance that need alongside tackling climate risks will be slow.
- Policymakers' thinking on transition planning will continue to develop, including on how to assess transition plan credibility, and who is best placed to do so. Validation of targets will also increase in importance as some IBs set targets in line with the new SBTi FINZ framework, expected to be finalised in 2024.
- The quality of transition planning will increasingly inform the ECB's and the PRA's assessment of IBs' overall risk management, and prudential supervision more broadly.

KEY ACTIONS FOR IBs IN 2024

Enable an organisational mindset shift

- Transition plans should be living documents that reflect how the Board is steering the IB towards its sustainability commitments and transforming the business to respond to sustainability risk and opportunities. Transition planning should be viewed as an aspect of strategy, rather than solely a disclosure exercise and be embedded across the organisation, including financial planning.
- IBs face significant uncertainties, such as on policy action and technological developments, and the TPT provides guidance to identify and assess key assumptions and external factors on which transition plan success depends.

Take a strategic and rounded approach to transition planning

- IBs can use the transition planning process to drive discussion internally on potential tensions between transition risk, transition ambitions and the economy-wide transition and how to navigate them.
- IBs should assess how their transition levers affect or depend on e.g., society and nature, and identify interconnections with related regulatory workstreams e.g., the UK Consumer Duty and supply chain management, to avoid undermining the transition plan or broader strategic ambitions.

Set out an implementation and engagement strategy

- IBs need to secure the resources and individuals with climate expertise required for transition plan implementation. The project needs to define the incremental steps and delivery teams needed to achieve the targets. It needs to set out and deliver a programme of sustained engagement with portfolio clients and companies. IBs can develop scoring tools to inform engagement and consider how engagement can be optimised to drive decarbonisation outcomes.

Digital assets

Navigating an evolving and fragmented landscape

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- Tokenisation – the issuance of a digital representation of an asset on DLT – will dominate IBs' digital asset pilots, with a particular focus on the issuance of tokenised bonds.
- Participation in EU/UK regulatory sandboxes will be helpful for IBs with ambitions to establish trading and settlement venues to pave the way for secondary markets. Alternatively, some IBs may choose to partner with sandbox projects as they mature, e.g. to test secondary market trading or provide custody.

WHAT'S HAPPENING THIS YEAR?

- **Two regulatory developments may facilitate IBs' tokenisation pilots. A new UK sandbox will enable firms to set-up and test DLT-based FMI, complementing the EU version launched in 2023**. Meanwhile regulated stablecoins under new EU/UK regimes may enable faster settlement of tokenised securities transactions.
- **Building initial capabilities in the sandboxes will be a helpful investment for IBs with ambitions to establish leading trading and settlement venues**. These include FMIs leveraging existing licences and capabilities. But IBs will also need to determine what role to play in the tokenised securities value chain. Those with ambitions to play a broader role – beyond issuance – may also benefit from seeking licences to participate in the sandboxes. Sandbox participants can seek certain exemptions from securities rules (e.g. MiFID/MiFIR and CSDR) necessary to trade and settle tokenised securities. To maximise chances for selection, applicants must demonstrate a viable growth plan and the ability to scale risk management capabilities.
- **Instead of participating directly, IBs may partner with sandbox projects as they mature**. This includes to test secondary market trading of issued tokenised securities and acting as custodians. Designing an operating model is a crucial first step for IBs building a custody business. For UK IBs, compliance strategies will need to remain agile as the FCA consults on new detailed custody requirements for tokenised securities in 2024.
- In our experience, IBs' current interest in unbacked digital assets (e.g. Bitcoin) is overall limited following market disruption in 2022. **However, increasing regulatory clarity following MiCAR entry into force may enable EU IBs to start to consider future offerings as part of digital asset strategy expansion plans, particularly custody**.

KEY ACTIONS FOR IBs IN 2024

Strategy

- Consider role in future DLT-based value chain and business case for participation in sandboxes, assessing cost of getting additional regulatory licences, if required.
- Prepare to articulate clearly scope of testing plans and business model in sandbox application. Expect supervisory focus on technology, resources, third parties, and links to firms outside the sandbox.
- Determine approach to settlement of tokenised securities – e.g. experiment with tokenised deposits or stablecoins, or "wait and see" and use traditional payment rails for now.
- Maintain view of partners and competitors as tokenisation pilots progress.

Operations

- Refine tokenisation operating model based on sandbox lessons learned and regulatory feedback.
- Determine approach to build infrastructure for digital asset custody – partner with or acquire a specialist provider or build in-house.

Control functions

- Embed risk and compliance in tokenisation pilots, building knowledge of new/enhanced DLT risks. May reduce time-to-market if pilots mature.
- Enhance capabilities to manage the risks of third-party providers supporting digital asset strategy implementation. These include vendor due diligence, scrutiny of ongoing financial and operational resilience and risk management, reputation, and real-time service quality monitoring.

Diversity & Inclusion

Turning up the dial

Impact Areas

- Governance
- Strategy
- Finance
- Operations
- Control functions (Risk/Compliance/IA)

KEY CHALLENGES

- The FCA and PRA published consultations on D&I and NFM in September 2023. Proposals will require IBs to set up D&I strategies and targets and publicly disclose their progress. Collecting sensitive data from employees and showing tangible progress will be particular challenges.
- In 2023, the EBA warned about lack of progress on D&I, with only 25% of female board representation across a sample of 800 EU banks. National supervisors are likely to enforce the requirements more rigorously . IBs should also consider CSRD compliance which is set to expand D&I disclosures significantly.

WHAT'S HAPPENING THIS YEAR?

- A set of minimum requirements will be applicable for a range of regulated firms. Larger IBs (over 250 employees) will be required to develop, maintain and publicly disclose D&I strategies, set targets against key demographics and report data across a range of metrics on an annual basis.
- The FCA has previously indicated that it will focus on how IBs are helping to accelerate the pace of meaningful change on diversity, equity and inclusion in the sector in its supervisory engagement this year.
- IBs will need to develop their approach to data collection, whilst also communicating with employees to understand their concerns and potential barriers to providing the D&I information the regulators expect. IBs whose staff do not feel comfortable disclosing information around diversity characteristics may face queries from their supervisors as to whether they have an appropriately safe and supportive environment.
- Key senior managers such as the Chair of the Board and CEO are responsible for culture and D&I will need to be embedded into their responsibilities. This expansion of key roles' prescribed responsibilities needs to be carefully reflected in role objectives, performance and remuneration & incentives practices.
- IBs subject to the CSRD will need to report on the social aspects of their operations by 2025. This will involve disclosing D&I policies and data. This comes against a general backdrop in the EU of low compliance with D&I policy disclosure and weak D&I targets. The EBA has warned national supervisors that this should improve.

KEY ACTIONS FOR IBs in 2024

Create a psychologically safe environment for employee disclosures

- IBs may find collecting sensitive D&I data challenging. They will need to develop the right systems and approach for data collection, whilst being open with employees on their concerns and potential barriers for collecting and disclosing sensitive information and providing assurances around protection of individuals' identity.

Develop NFM clarity for employees

- IBs will need to provide clarity on what constitutes NFM. New requirements on NFM will need to be highlighted in internal policies, employee contracts, remuneration policies and employee handbooks.

Assessment and root cause analysis

- IBs first need to assess their current D&I policies, targets and metrics. They might want to identify key areas of under-representation which should be the focus of targets and improvement going forward.
- Ultimately, IBs might want to work to understand the root causes of the barriers to D&I progress so far. This analysis could provide valuable insight to feed into the action plan for implementing the D&I strategy and ensuring its effectiveness in the years to come.

Glossary

BoE
Bank of England

CCR
Counterparty credit risk

CCP
Central clearing counterparty

CRD
Capital Requirements Directive

CRR
Capital Requirements Regulation

CSDR
Central Securities Depositories Regulation

CTP
Critical Third Party

DLT
Distributed Ledger Technology

DORA
Digital Operational Resilience Act

EBA
European Banking Agency

ECB
European Central Bank

EMIR
European Market Infrastructure Regulation

ESMA
European Securities and Markets Agency

FCA
Financial Conduct Authority

FINZ
Financial institutions Net-Zero

FMI
Financial Markets Infrastructure

FRTB
Fundamental Review of the Trading Book

FSB
Financial Stability Board

IA
Internal Audit

IMA
Internal Model Approach

ISSB
International Sustainability Standards Board

LoD
Line of Defence

MRM
Model Risk Management

MiCAR
Markets in Crypto-Assets Regulation

MIFID
Markets in Financial Instruments Directive

MIFIR
Markets in Financial Instruments Regulation

NBFI
Non-Bank Financial Intermediaries

NFM
Non-Financial Misconduct

PRA
Prudential Conduct Authority

SA
Standardised Approach

SBTi
Science Based Targets initiative

SLAs
Service-level agreements

TNFD
The Taskforce on Nature-related Financial Disclosures

TPRM
Third-Party Risk Management

TPT
Transition Plan Taskforce

WWR
Wrong-Way Risk

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REGULATORY STRATEGY
EMEA

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