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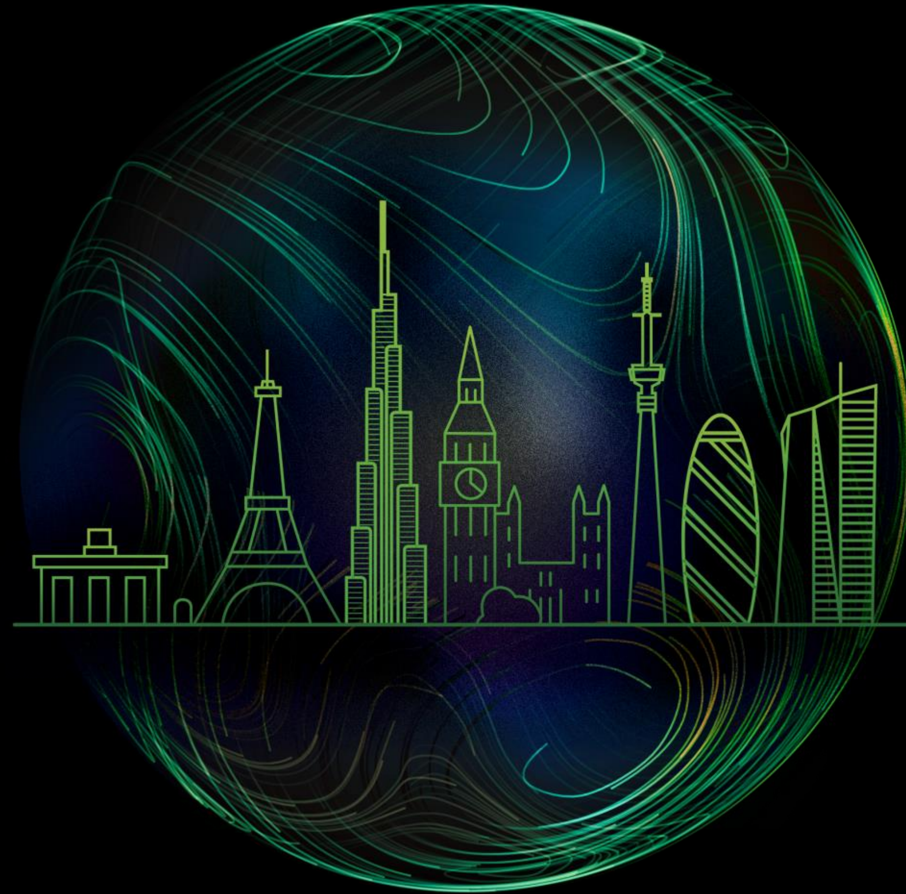

Retail and Commercial Banking

Financial Markets Regulatory Outlook 2024

CENTRE *for* **REGULATORY STRATEGY** **EMEA**

Regulatory Outlook 2024

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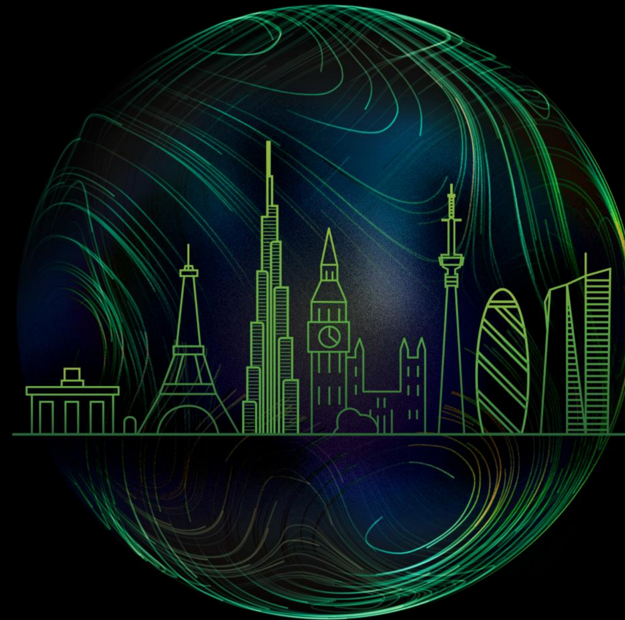

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Basel implementation

The final furlong in a tortoise race

Impact Areas

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

KEY CHALLENGES

- Well known Basel 3.1 implementation challenges – such as data sourcing, system modifications, changes to capital calculation processes and operationalising the Output Floor – remain prevalent. Banks have a lot to do in a relatively short implementation period and some have been slow to make a start.
- The key difference this year is that strategic work (e.g. understanding the impact of Basel 3.1 on competition between Standardised and IRB banks) can no longer be put on the back burner. Banks must ensure that they have sufficient resources lined up to progress this work quickly.

WHAT'S HAPPENING THIS YEAR?

- The EU has published near-final CRD6 and CRR3 texts, and PRA has published part one of its near-final Basel 3.1 rules. **The countdown to implementation deadlines has begun.** There are, in broad terms, three areas where banks need to have clear views on delivery: timing; rule differences; and strategic and operational changes.
- On timing, in our view it is far from a "done deal" that the US will implement according to its originally proposed 1 July 2025 timeline. **Banks will need robust contingency plans and scenarios developed for the possible knock-on effect of a potential US delay** on UK, and potentially EU, implementation dates.
- **Banks need to make some challenging decisions on how to deal with rule differences**: whether to adopt a single version of a rule across all jurisdictions (even if that results in some competitive disadvantage relevant to local firms); or to build the ability to adopt different versions of rules in different jurisdictions. The answer will need to be driven by detailed analysis of the costs and benefits of each option.
- **Banks will need to decide on strategic and operational decisions**, such as whether (or how) to incorporate the Output Floor into pricing decisions and which portfolios lose attractiveness (e.g. BTL under Standardised).
- Many banks are likely to have Day 1 tactical solutions in place for at least certain parts of the new framework. Yet **supervisors will be concerned that in some cases those tactical solutions may become permanent**, and banks should expect questions on their implementation plans that look beyond Day 1.

KEY ACTIONS FOR BANKS IN 2024

Understand and manage the impact of divergence in timing

- Identify a range of alternative implementation delivery cases for which robust implementation contingency plans can be developed. Banks should take current announced implementation dates as the central case.
- Explore the impact of delays to Day 1 implementation as well as the potential for phase-in periods to extend or contract in one or multiple jurisdictions.

Understand the strategic implications

- Anticipate commercial opportunities arising from changes in IRB competitors' behaviour. IRB banks could choose to reduce their exposure to certain portfolios that no longer make economic sense in light of Basel 3.1 changes; Standardised banks may be able to take advantage.
- Accelerate progress on analysing the extent to which the RWA impact of the Output Floor can be mitigated, e.g. through pricing. Banks should prioritise analysis of the portfolios for which the Output Floor has the highest impact when fully phased-in (such as low risk mortgages or unrated corporates).

Be ready to move fast to secure model approval

- Ensure quick action after the publication of the final rules to update models as required and secure model approval, given constraints on regulators' capacity.
- Ensure that model submissions are as clear, concise and objective as possible. Alongside governance, validation, business involvement and data quality, poor documentation is often a barrier to swift approval.

Liquidity and funding

Back to the top of the agenda

Impact Areas

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

KEY CHALLENGES

- There will be a step change in the intensity of supervisory scrutiny of liquidity risk management in 2024. This could put strain on capacity in banks' treasury departments. Firms should expect authorities to take a more pre-emptive and interventionist approach to the supervision of liquidity risk management.
- Heightened risks in the NBFI sector will pose challenges for banks with heavy reliance on NBFI funding, and firms will need to ensure that they take a joined-up approach to managing counterparty credit risk and liquidity risk and have a diversified funding mix.

WHAT'S HAPPENING THIS YEAR?

- The BCBS has signalled that it will consider recalibrating regulatory deposit outflow rates following the banking turmoil of 2023, but we do not expect meaningful change at the international level in 2024. In the EU, however, we expect the EBA and the ECB SSM to withdraw the possibility for some banks to apply a 3% outflow rate to stable retail deposits.
- Nevertheless, supervisory scrutiny of liquidity risk management will intensify in 2024. Supervisors will challenge the assumptions in firms' ILAAP stress testing and the early warning indicators, thresholds and actions in firms' contingency plans. Internal stress testing will also have to involve specific metrics to measure social media sentiment and targeted action plans to avoid liquidity runs.
- This will likely include increased demands for high-frequency data, with the ECB now requiring weekly liquidity data from banks. Banks should be ready to disclose funding sources from NBFI, especially where such funding is concentrated and from institutions with considerable credit counterparty exposures.
- The results of the UK SWES may reveal behavioural assumptions on liquidity outflows under stressed market conditions, potentially prompting firms or supervisors to recalibrate liquidity outflow metrics. It could also identify interconnections with NBFIs with implications for banks' funding which will trigger supervisory scrutiny.
- The UK Trading Book Wind Down policy applies from March 2025, requiring banks to develop TWD scenarios capturing firm-specific and market-wide stresses and project the implications for financial resources.
- Smaller UK firms' Pillar 2 obligations will ease when the new SDDT Regime applies from 1 July 2024.

KEY ACTIONS FOR BANKS IN 2024

Data requirements and review

- Ensure the appropriate data infrastructure to respond to higher frequency (weekly) liquidity reporting requirements is in place, as well as adequate resourcing in regulatory reporting functions, with effective controls and governance.
- Design any new systems to be sufficiently flexible that they can accommodate daily liquidity reporting in a period of stress.
- Ensure there is capacity to communicate to stakeholders swiftly to address potentially misleading information, which unless corrected may lead to rapid deposit outflows.

Funding strategies

- Ensure that treasury functions have sufficient tools to take swift remediation actions in response to supervisory concerns around their funding profiles. Supervisors will focus on contractual and behavioural mismatches, funding diversification and deposit flight risk.
- Review reliance on funding from NBFIs. Banks will be expected to have in place tested contingency funding plans in case of NBFI-linked liquidity shortages and increased market volatility.

Preparation for the UK Simpler Regime

- Increase familiarity with new metrics (e.g., retail deposit ratio) and build expertise in capacity for simplified liquidity monitoring rules to enable adoption of the SDDT regime.
- Assess growth and business strategies for the long-term, to consider whether to commit to the SDDT Regime or the Basel 3.1 rules.

Business models and governance

Are you steering in the right direction?

Impact Areas

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

KEY CHALLENGES

- The banking turmoil in 2023 demonstrated the fragile nature of investor and depositor confidence in banks. Supervisors are of the view that, once lost, restoring market confidence is particularly difficult for banks with severe weaknesses in their business model and governance.
- We expect that supervisors will be hesitant to "let a good crisis to go to waste" and will pursue remediation of any residual long-standing weaknesses inhibiting bank management from steering their business effectively – such as internal governance, and risk data aggregation and reporting – with renewed vigour.

WHAT'S HAPPENING THIS YEAR?

- **The ECB has highlighted structural weaknesses in banks' business model sustainability** and noted limited progress in addressing findings on income generation, cost efficiency and business transformation. It also raised concerns around banks' forecasts, profitability analysis, product pricing and overall strategy processes. It also has ongoing concerns about banks' internal governance – in particular bank managements' ability to steer the business. This links to implementation of BCBS 239 – which is back near the top of the ECB's agenda.
- Following a 2023 expert review of the SREP, we **expect the ECB to use a wider array of enforcement tools to compel banks to remediate qualitative findings**. Future SREP scores are likely to be more closely tied to banks' willingness and ability to address identified weaknesses – including business model and governance issues.
- **EU and UK supervisors require banks to integrate climate and nature-related risks** into their strategies. For EU banks, this is an established part of supervisory assessments of banks' business models, and the quality and execution of banks' transition plans will be considered in supervisory business model assessments.
- In the UK, the Consumer Duty will affect banks' ability to generate returns, and **the effect of the Duty on product and service profitability needs to be factored into strategic planning and financial forecasts**. UK banks should also ensure they are progressing against the PRA's expectation that regulatory reporting is given the same attention and focus as financial reporting. The PRA continues to impose Section 166 reviews on UK banks in relation to regulatory reporting.,

KEY ACTIONS FOR BANKS IN 2024

Upscale strategic scenario analysis

- Use sensitivity analyses to take a "belt and braces" approach to testing the resilience of strategy – test differing outcomes to the base case, while running more exploratory exercises (including reverse stress tests) incorporating the impact of geopolitics, climate and nature risk, technological innovation and the Consumer Duty. The ECB has identified effects on market competition as requiring general improvement in banks' resilience assessments.
- Strengthen resolvability, further developing tools and techniques to identify resolvability challenges and taking action to address them. For EU banks, this will feed into the required resolution self-assessment, due by the end of 2024.

Tidy up the bank's pricing framework

- Strengthen governance processes and documentation around the bank's pricing framework. Recognise that, for supervisors, updating the pricing framework less than once a year can be perceived as a "red flag".
- Use, and document, back-testing as a tool to alleviate supervisory concerns about the alignment between business and risk strategies.

Provide management with the data to steer the business effectively

- Set a tone from the Board on risk data aggregation and reporting and ensure that employees have the correct incentives to address longstanding data gaps and deficiencies.
- Ensure there are costed and resourced plans in place to deliver improvements in regulatory reporting to meet supervisory expectations
- Ensure that KPIs and KRIs have well understood and documented early warning indicators and escalation procedures – including in less familiar areas such as climate, IT risk and concentration risk. KPIs should also aim to capture the whole financial planning period (3-5 years) rather than solely a one-year horizon.

Credit risk

Pressure continues to build...

Impact Areas

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

KEY CHALLENGES

- To date there has been little credit response to quite adverse movements in fundamental credit drivers (rate increases, inflation pressure, collateral price falls, company insolvencies). Lenders need to assess the extent to which any latent risk may be lagged and how this will flow through to impairments and business sustainability.
- While stress tests show that banks are well capitalised against significant credit stresses, supervisors are concerned that recent bank failures show that strong solvency may not protect against bank stresses/runs/failures arising from investor and customer concerns about business model sustainability.

WHAT'S HAPPENING THIS YEAR?

- Credit risk remains a significant concern for supervisors: the ECB has conducted a review of **leveraged and highly leveraged lending** exposures across several EU banks, with a focus on policies and controls, particularly around concentration risks and covenant-lite loans. CRE exposures are **also in the spotlight.**
- The BoE's credit conditions survey for Q3 2023 shows banks reporting a **significant increase in the number of customers in arrears on their mortgages**, while the ECB's bank lending survey shows a sixth consecutive quarter of **tightening of lending standards** and an ongoing trend of **reducing demand** for credit.
- Most UK residential mortgages are on 2-to-5-year fixed rate terms, so **circa half the base rate flow through to mortgage payments is still to come**, although the peak of cost increases for customers re-fixing their loans may have passed. A considerable portion of outstanding flow will occur in 2024, leading to further stress on disposable income. Concerns also exist over low income and/or vulnerable individuals using unsecured debt to cover ongoing living expenses and increasing "hidden debt" such as arrears on council tax and utility bills.
- Credit pressure is **not yet showing through to predicted defaults in some banks' credit models**, because some models do not accurately translate stresses into probabilities of default. This results in "overlays" to impairment figures, which was commented on in the PRA's review of auditors' written reporting.
- Banks must ensure **ECL represents their expectation of credit losses through PMAs**. Reflecting climate, Consumer Duty, changes in vulnerable customers, inflation, and geopolitical stresses in ECL will be a challenging endeavour, and one that needs to be subject to robust oversight.
- **Regulators face pressure too**: approvals of banks' credit models are typically taking years rather than months. If delinquency and defaults increase, banks will need to use more PMAs, demanding more governance effort.

KEY ACTIONS FOR BANKS IN 2024

Affordability

- Ensure that credit assessments and models accurately reflect specific increased stress events for borrowers, both retail and commercial.
- Ensure that the Consumer Duty implications of changes to credit decisioning models and processes are appropriately considered, such as by incorporating expectations of mortgage charter use or forbearance techniques into model outputs.

Understanding non-bank sources of credit pressure

- Make specific queries about hidden debt or exposure to alternative lenders when customers come under pressure from unsecured debt.
- Ensure corporate customers understand the implications of accessing funding from private credit sources: is the pricing and purpose of credit appropriate (e.g. not borrowing to fund interest payments); is funding sufficiently stable?

Governance of models and model overlays

- Make sure overlays to credit or impairment models and assessments are subject to rigorous oversight and documented challenge, up to and including Board level.
- Ensure senior management and Boards, particularly those who are less experienced in credit issues, are clearly informed about model weaknesses arising from changing market conditions (interest rates, Consumer Duty, geopolitical stresses, climate *et al*).
- Challenge assumptions on defaults and recoveries as part of the impairment review process and review model governance, in order to respond to the PRA's letter to banks providing feedback on its discussions with external auditors.

Implementing the Consumer Duty

Firms under intense supervisory scrutiny

Impact Areas

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

KEY CHALLENGES

- The FCA has shown it will use all its supervisory tools to enforce compliance with the Consumer Duty. The value of banks' products such as cash savings and overdrafts have been in the spotlight. The FCA plans to target outliers first, so banks should consider metrics and data that will help identify where FCA challenge is likely.
- With the FCA having shown its willingness to intervene on the pass through of changes in interest rates, banks now need to try to anticipate how it would respond in a falling interest rate environment.

WHAT'S HAPPENING THIS YEAR?

- Customers in financial difficulty will remain a central area of focus for the FCA. Banks will be expected to take a proactive approach to preventing consumer harm and poor value – for example, by offering structured loan products to customers who are permanently in overdraft to reduce their borrowing and interest cost over time.
- As interest rates rose in 2023 supervisors used the Consumer Duty to hone in on banks' pass through of rate rises to retail customers. If potential downward base rate movements occur in 2024, regulators will scrutinise how quickly and consistently base rate changes are passed through to deposit and lending rates.
- Closed products will be an area of focus as they will come under the Duty scope by July 2024. The FCA expects banks to accelerate their work on value for closed products if they suspect customer harm. An example would be to ensure previously issued savings accounts have comparable rates to newly issued accounts.
- Banks will be working towards compiling the evidence and engaging with the Board to produce and approve their first Duty compliance report before 31 July 2024. We expect the FCA to scrutinise at least some reports closely and challenge weak assumptions, lack of relevant data and evidence.
- We expect the FCA to challenge banks to build up their existing data sets to monitor customer outcomes at a more granular level, for example allowing comparison between distinct groups of customers and identification of areas of poor outcomes. Ensuring that micro- and small enterprise customers in the scope of the Duty are reflected in Duty processes and reporting may be challenging for some banks.

KEY ACTIONS FOR BANKS IN 2024

Evidencing compliance and greater data needs ahead

- Review current conduct MI and data set to evaluate if it is sufficient to evidence compliance with the Duty and enhance it where needed.
- Engage the Board in the process of evidence gathering and allow sufficient time for Duty champion and the Board to challenge the evidence effectively.

Identifying and reviewing closed products

- Assess changes needed to closed products following completion of fair value assessments and determine changes to customer support and communications required to enable customers to switch products.
- Ensure the impact of a fully phased in Duty in reflected in self-assessments of the medium-term sustainability of business models.

Assessing the impact of the Duty on the business

- Map product and customer profitability to identify potential over-reliance on low value products and practices.
- Consider how regulatory expectations around compliance with the Duty will affect product portfolio and profit forecasts for closed portfolios.

Embedding the Duty into the firm's culture

- Establish clear accountability and governance frameworks, setting the right "tone from the top" to foster an environment where all staff understand their role in delivering good customer outcomes
- Review recruitment processes, training, remuneration and incentive programmes to ensure they capture the Duty requirements.

CRD6

Reshaping EU footprint while containing costs

Impact Areas

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

KEY CHALLENGES

- We expect CRD6 to prohibit the provision of cross-border "core banking services" from outside the EU and/or from a branch in one MS into another, excepting MiFID services, reverse solicitation, intragroup and interbank transactions. TCBs operating in the EU will face a new harmonised regime in relation to capital, liquidity and governance requirements. Those TCBs deemed "systemically important" may have to subsidiarise, at NCAs' discretion. Non-EU banks will need to assess the impact of the new framework to make decisions about their future EU footprint, given the potentially significant cost increases of EU business.

WHAT'S HAPPENING THIS YEAR?

- The EU's CRD6 legislation, expected in March 2024, will have a significant impact on non-EU banks. These banks will no longer be able to provide "core banking services" into the EU using national access regimes, but will instead need to establish a European subsidiary or a branch in that particular MS.
- Existing branches carrying out "core banking" services may need to be re-authorised at NCAs' discretion. To aid this process, NCAs may also decide that TCB authorisations granted 24 months before CRD6 implementation shall remain valid, provided that the new minimum requirements are met.
- We expect that "Class 1" bank branches in EU MS (those with deposit-taking in excess of EUR 50 million, in excess of 5% of their total liabilities; or those booking and originating more than EUR 5 billion in the past year) will have to incur the additional cost of holding a 2.5% capital endowment.
- We also foresee a number of additional branch requirements that will increase financial and operational costs, including: holding 30 days' worth of liquid assets, maintaining a "registry book" of all assets and liabilities associated with the TCB and establishing a range of governance processes and controls, especially pursuant to managing intragroup relationships.
- We expect that branches in MS with assets exceeding €10bn, those groups with EU branches exceeding €40bn, or branches judged to pose a "significant risk to" "financial stability" can be considered by NCAs as "systemically important" and be required to subsidiarise (along with a range of other potential measures, including being compelled to restructure their activities).

KEY ACTIONS FOR BANKS IN 2024

Fortify existing branches under new requirements

- Assess the best approach to holding the requisite additional capital and liquid assets in the most cost-efficient manner.
- Implement the new processes, data gathering and governance structures necessary for TCBs to meet the new non-financial regulatory requirements – with special consideration afforded to implementing the new intragroup "registry book".

Optimise pan-European footprint across each Member State

- Evaluate activities in each MS to understand the relative costs and benefits of setting up a new/continuing to operate an existing branch compared with transferring business to a subsidiary or potentially even ceasing operations in that MS altogether. Any decisions to reallocate resources should be taken with an eye to rightsizing their entire European footprint.

Re-assess largest branches or prepare for subsidiarisation

- Evaluate the feasibility of reducing activities to below the quantitative threshold for being "systemically important" or consider the aggregate benefits for the rest of the European network of setting up a subsidiary.
- Assess the possible effect of subsidiarisation on LEs, given the reduced ability of a subsidiary's capital base to support LEs relative to the parent bank's capital. As part of this assessment, banks should explore risk transfer and risk participation approaches.

Accelerated Settlement

Navigating T+1 transition in the US and gearing up for it in the UK and EU

Impact Areas

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

KEY CHALLENGES

- At the end of May 2024, the US and Canada will transition to T+1 settlement for most securities transactions. All banks with exposure to the US capital markets will have to transition as well. Any T+1 transformation will be large and complex, requiring implementation of changes across a broad range of functions, including front office, risk management, operations, treasury, technology, legal and compliance.
- Banks will have to consider a myriad of operational aspects inherent in transforming their existing settlement infrastructure and additional capital, liquidity and failed settlement management costs.

WHAT'S HAPPENING THIS YEAR?

- US and Canada's move to T+1 settlement follows China's transition to T+0 for interbank market and government bonds and India's transition to T+1 for shares traded on exchange. While the move to accelerated settlement only affects banks with exposure to these financial markets, it has triggered UK and EU discussions about transitioning to T+1. **We expect the UK Accelerated Settlement taskforce to submit its final report on the costs and benefits of moving to T+1 in Q1**, as will ESMA at some point later in the year.
- All banks operating under T+1 will have to perform all settlement-related processes in a much shorter period. ESMA has found that market participants' **readiness for settlement shortening is uneven** with smaller firms finding it more difficult to prepare.
- Non-US banks active in or with exposures to US capital markets will also have to address a **liquidity mismatch** when transactions have both T+2 and T+1 settlement components. Banks which operate across multiple currencies will also need to account for an extra day of currency risk, or extra costs relating to hedging the risk in the derivatives market, leading to higher costs and liquidity risk. This is also true for firms which trade securities that are exchangeable for a foreign security (e.g. ADRs) or baskets which include foreign securities (e.g. ETFs). Banks will need to borrow these securities in advance, leading to additional costs. The issue is exacerbated by higher interest rates and instances where it is not possible to borrow a security.
- Banks will also need to prepare to address a **likely increase in settlement fails** for instruments traded in more than one jurisdiction with misaligned settlement cycles.

KEY ACTIONS FOR BANKS IN 2024

Get prepared

- Accelerate preparation and testing of T+1 processes and systems ahead of the May 2024 cutover.
- Watch for the implications of T+1 transition to be able to implement lessons learned for likely EU and UK transition in the future.

Understand the scope of operational adjustments

- Prepare to carry out all settlement-related processes in US financial instruments during night-time or consider relocation of the workforce.
- Design a robust testing plan and define stringent operational risk metrics during the testing phase to ensure minimal operational risk exposure when systems go live for T+1 settlement.
- Assess what more will be needed for any eventual transition to T+0 and consider taking "no regrets" decisions now.

Evaluate financial implications

- Calibrate liquidity forecasting to be able to adjust to more volatile markets and assess portfolio for potential settlement mismatches to understand additional funding needs.
- Assess costs of hedging additional risk when operating across jurisdictions with different settlement cycles or across multiple currencies to ensure business models remain viable.

Financial crime/debanking

Data is the key – but how much should be locked away?

Impact Areas

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

KEY CHALLENGES

- The new offence of *failure to prevent fraud* in the UK's ECCTA will require action by all banks, as well as affected corporate entities.
- The UK focus on de-banking and review of the PEP regime will continue. The FCA's initial report showing no evidence of UK accounts being closed for political views has yet to calm the political debate significantly. In the EU, banks need to be able to demonstrate to supervisors that "de-risking" activities do not result in customers being refused access to banking services.

WHAT'S HAPPENING THIS YEAR?

- The ECCTA will impose greater requirements for all companies to provide information about their owners, directors and activities. This is not new for financial institutions, however it may affect their customers and customer due diligence/take-on processes. The Act's offence of *failure to prevent fraud* applies to all staff in a bank, as well as service providers to the bank. Heads of Fraud and Operational Risk will be key to ensuring banks have policies and processes in place to demonstrate they are taking reasonable steps to prevent fraud.
- There is considerable regulatory pressure for greater sharing of information between firms and regulators, and from firm to firm, to maximise protection for customers. Countries vary considerably on where they set the line between protecting individuals' personal information and sharing data that will allow effective fraud protection. Banks will need to develop data sharing processes that can comply with widely different national regimes. The UK has included requirements for "proactive" sharing of data between entities in the ECCTA.
- After lengthy delay, the EU has officially started considering applications from Member States which wish to host the AMLA. A decision will likely come in H1 2024, following which staffing and policy work will begin.
- EU member states continue to strengthen standards ahead of AMLA, including stricter AML enforcement, larger AML fines, and requiring identification of management body individuals with AML responsibility.
- In the UK, the PSR's new rules on reimbursement of APP Fraud will come into force on 7 October 2024. Payment providers should also note the UK Government's comments that it is "*looking at how to enable banks to have the ability to identify and pause suspicious payments in flight where appropriate.*"

KEY ACTIONS FOR BANKS IN 2024

Economic Crime and de-banking

- Ensure Fraud and Operational Risk heads lead plans to implement policy and processes to ensure banks are not failing to prevent fraud.
- Review and revise take-on and customer due diligence processes to reflect the greater requirement on companies to provide Companies House with information about the business, its owners and management.
- Review policies and procedures to avoid indiscriminate denial or termination of relationships to categories of customers

Data sharing

- Anticipate and prepare for requests to provide increased amounts of data either to other firms in the payment chain, or to regulators, for the purpose of financial crime identification and prevention.
- Ensure jurisdictional differences as to personal data that can and cannot be shared are well understood, given the variation in national approaches to the balance between sharing fraud data and protecting personal data. Banks should develop systems that are capable of distinguishing between different jurisdictional requirements and varying data submissions accordingly.

APP Fraud reimbursement and reporting

- Assess the PSR's guidelines on claim excess, maximum level of reimbursement and customer standard of caution (threshold for rejecting claims due to gross negligence by the customer) and incorporate them into fraud reimbursement processes and systems prior to implementation on 7 October 2024.
- Develop capabilities to provide data to the PSR to enable the PSR's increased reporting on firms' fraud protection effectiveness and to enable its plans for improved intelligence-sharing to identify and prevent fraudulent transactions.

Model Risk Management

Casting the net more widely

Impact Areas

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

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 banks 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 banks in the UK will need to demonstrate they have in place:
  - Comprehensive model inventories, with robust, risk-based categorisation of models across the bank.
  - 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 banks 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 banks will need to review and implement. Principal proposed amendments in the consultation include incorporation of climate risks into models, considerations for banks 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 BANKS IN 2024

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

- 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 on these areas. Banks 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 banks

- 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 banks

- 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.

Climate- & environmental-related financial risk

Making what you do, do what it is supposed to do

Impact Areas

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

KEY CHALLENGES

- Supervisors expect banks' capabilities in climate-related financial risk management to continue to develop, with the ECB currently standing out from other supervisors in terms of its proactivity in this respect. Coming to the fore is a focus on whether the capabilities that firms have are really driving business and risk decisions. Firms need to move on from "good enough to try'" to "just trying is not good enough".
- Full integration of C&E risks will mean overcoming longstanding sticking points, such as model validation and integration of climate risk into pricing. Nature and litigation risks also now (at last) need to be considered.

WHAT'S HAPPENING THIS YEAR?

- In our experience, banks in the EU and UK still, in general, have some way to go to **embed climate risk fully** into their risk management frameworks (including climate stress and scenario analysis) and integrate it into decision-making. Even in the absence of specific upcoming deadlines (except for SSM banks), firms need to demonstrate to supervisors that they are making progress. The detail of supervisory expectations is not changing, but the extent of progress firms are expected to have made – and the art of the possible – is.
- **Climate stress testing** should now be a "BAU" component of the ICAAP. Development of short-term scenarios by the NGFS in 2024 will be an important further step forward, marking the beginning of a shift to short-term supervisory climate stress testing. The ECB/ESAs' 'fit-for-55' stress test will kick this off in earnest.
- We do not expect significant revisions of the bank **capital frameworks** in 2024 to capture climate risks, beyond tweaks to align with the BCBS's 2022 FAQs. More substantial revisions to the capital framework may still come at a later stage but not in 2024.
- Supervisory pressure on firms to develop their management of **climate-related litigation risk** will increase, and this will become a more prominent part of supervisory dialogue in 2024. Firms are exposed to litigation risk through litigation against themselves, and also against their counterparties or borrowers.
- We also expect attention to **nature risk** to increase. In principle, this is not news for SSM banks. But for all banks in the UK and EU, assessment of nature risk needs to advance from the current very low base. Banks should start to build capability in the topic, and begin by identifying the highest risk portfolios or business activities.

KEY ACTIONS FOR BANKS IN 2024

Integrate and embed climate risk management across the business

- Discrete initiatives that firms have undertaken in the past few years to develop climate risk capabilities for specific tasks need to be joined up and integrated across the business. This means, for example, integrating modelling into strategy planning and the ICAAP, and ultimately into pricing - even if the impact on pricing will be small in the near term.
- Senior management need good data to steer the business, but banks cannot let perfect be the enemy of the good – at times, decisions will need to be made in the near-term based on imperfect measures. This will require bank senior managers to have a good understanding of the limitations in the data that they are relying on.

Model validation

- Integrating modelling outputs into decision-making across the business will ultimately require robust data, internal buy-in, and confidence in the results of climate modelling across the business.
- Achieving this will require firms to overcome long-standing challenges in validating climate models. In some cases, this will require recognising that established second line processes need to be amended for climate risk – for example, relying on model benchmarking rather than back-testing given that historical data is unlikely to be a reliable indicator of future climate impacts.

Get on top of litigation risk

- Build understanding of legal precedents, capturing historical information while also monitoring ongoing or new cases to understand risk.
- Embed legal and reputational risks in front-line client onboarding and monitoring process, with clear criteria for escalation. Engage with clients (e.g. on the execution of their transition plans) to reduce exposure.

Transition planning

Turning ambitions and blueprints into action

Impact Areas

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

KEY CHALLENGES

- Even before more detailed regulatory guidance on transition planning is finalised, banks 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 firms about the direction and pace of the economy-wide transition. Firms 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'S HAPPENING THIS YEAR?

- In the UK, we expect banks to **progress transition planning, looking to ISSB standards and TPT recommendations**, 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 EU banks from FY 2024 (reporting in 2025). CSDDD and CRD6 are also likely to be agreed in 2024, introducing additional expectations and supervisory powers related 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 banks 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.
- As the foundational aspects of transition planning mature, policymakers will switch their focus to some of the more complex aspects, including how to assess **transition plan credibility**, and who is best placed to assess it. Validation of targets will also increase in importance as some firms choose to set or update targets in line with the new SBTi FINZ framework, expected to be finalised in 2024.
- The **quality and execution of transition planning** will increasingly be looked at as a potential source of greenwashing risk, while also informing supervisors' assessment of banks' overall risk management.

KEY ACTIONS FOR BANKS IN 2024

Enable an organisational mindset shift

- Transition plans should be living documents that reflect how the Board is steering the bank 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.
- Banks 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

- Banks 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.
- Banks 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

- Banks have 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 to achieve the targets. It should set out and deliver a programme of sustained engagement with portfolio clients and companies. Banks can develop scoring tools to inform engagement and consider how engagement can be optimised to drive decarbonisation outcomes.

Diversity & Inclusion

Moving the dial up

Impact Areas

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

KEY CHALLENGES

- The FCA and PRA published consultations on D&I and NFM in September 2023. Proposals will require banks 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 . Banks 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 to a range of banks**. Larger banks (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.
- **Banks 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. Banks whose staff do not feel comfortable disclosing information around diversity characteristics may face queries from regulators as to whether they have an appropriately safe and supportive environment.
- Banks will welcome the fact that the regulators expect them to develop their own strategy and targets for progress on their D&I efforts. The high levels of disclosure proposed mean that **banks will need to work hard to make progress or face difficult conversations with regulators** and other stakeholders.
- Key senior managers such as the Chair of the Board and CEO are responsible for culture, **and D&I measures will need to be embedded more explicitly into their responsibilities**. This expansion of key roles' prescribed responsibilities needs to be reflected in role objectives, performance and remuneration and incentives practices.
- Banks 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 of low compliance with D&I policy disclosure and setting low D&I targets**. The EBA has warned NCAs that compliance needs to improve.

KEY ACTIONS FOR FIRMS IN 2024

Create a psychologically safe environment for employee disclosures

- Develop the systems and approach for D&I data collection. Banks may find collecting sensitive D&I data challenging and will need to be open with employees on their concerns around disclosing sensitive information. Banks will need to provide assurances around protection of individuals' identities.

Develop NFM clarity for employees

- Update internal policies, employee contracts, remuneration policies and employee handbooks to provide clarity on what constitutes NFM. New requirements on NFM will need to be communicated clearly to all staff.

Assessment and root cause analysis

- Assess current D&I policies, targets and metrics. Identify key areas of under-representation; these should be the focus for targets and improvement going forward.
- Identify and analyse the cause of 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.

Operational resilience

Last year of implementation

Impact Areas

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

KEY CHALLENGES

- As operational resilience rules approach their final implementation year both in the UK and EU, banks will have to continue to embed and build compliance with their respective regimes, while demonstrating resilience in practice to their supervisors. The new regimes require banks to reach a level of maturity in their resilience skills; related compliance work will depend on capabilities already in place and the size and complexity of the bank.
- The DORA's challenging implementation timeline may add a further layer of complexity, as banks will need to begin implementation work before full ratification of level two standards.
- Finally, new oversight regimes for CTPs will not replace existing and new TPRM duties for banks, which will still require significant effort.

WHAT'S HAPPENING THIS YEAR?

- The UK's operational resilience regime will become fully applicable in March 2025. This means 2024 will be the last year for banks to embed their new target operating models and address any regulatory feedback. Banks recording significant deviations from peers in their impact tolerances will likely need to revisit their framework.
- The BoE, FCA and the PRA will use feedback gathered during the relevant consultation to finalise their proposed oversight regime for CTPs to the FS sector and will also consult on a framework for incident, outsourcing and third-party reporting. Additionally, TPRM rules for FMIs will become fully applicable in February 2024.
- The EU's DORA will fully apply in January 2025. Similar to its UK counterpart, 2024 will also be the final implementation year, during which secondary standards providing key technical detail will be finalised. The ESAs will submit their final drafts to the Commission in two main batches, due respectively in January and July 2024. The Commission will then review and ratify each standard.
- The EU's Cyber Resilience Act is expected to be finalised and published in the EU's Official Journal by H1 2024. While its applicability to FS is still under discussion, chances are that it will complement the DORA's organisational resilience rules with minimum cyber resilience standards for digital products.
- 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.

KEY ACTIONS FOR BANKS IN 2024

Demonstrate resilience maturity in different contexts

- Demonstrate to supervisors that operational processes are resilient and scalable enough to withstand extended periods of increased stress and volatility across a range of severe but plausible scenarios.

Engage with supervisors and industry

- Maintain an ongoing dialogue with the supervisors and reach an understanding of what "good" looks like, and ensure a direct line of communication with supervisors in case of outages or cyber-attacks.
- Develop sector-wide approaches to shared implementation challenges, such as negotiating third-party participation in banks' own resilience testing.
- 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.

Focus on TPRM

- 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 banks' own TPRM duties.
- Map supply chains focusing on critical functions and ensure steps to mitigate potential impact from the loss of services are robust and actionable, including by testing alternate suppliers.
- Move from preliminary evaluation to negotiations with third parties on practical arrangements to ensure inclusion in key resilience activities, such as participation in the testing processes.

Glossary

ADR
American Depository Receipt

AI
Artificial Intelligence

AML
Anti-Money Laundering

AMLA
Anti-Money Laundering Authority

APP
Authorised Push Payment

BAU
Business As Usual

BCBS
Basel Committee on Banking Supervision

BoE
Bank of England

BTL
Buy-to-Let

C&E
Climate and Environmental

CRD
Capital Requirements Directive

CRE
Commercial Real Estate

CRR
Capital Requirements Regulation

CSDDD
Corporate Sustainability Due Diligence Directive

CSRD
Corporate Sustainability Reporting Directive

CTP
Critical Third Party

D&I
Diversity and Inclusion

DORA
Digital Operational Resilience Act

EBA
European Banking Authority

ECB
European Central Bank

ECCTA
Economic Crime and Corporate Transparency Act

ECL
Expected Credit Loss

ESAs
European Supervisory Authorities

ESMA
European Securities and Markets Authority

ETF
Exchange-Traded Fund

FAQ
Frequently Asked Question

FCA
Financial Conduct Authority

FINZ
Financial Institution Net Zero

FMI
Financial Markets Infrastructure

FS
Financial Services

FY
Financial Year

IA
Internal Audit

ICAAP
Internal Capital Adequacy Assessment Process

ILAAP
Internal Liquidity Adequacy Assessment Process

IRB
Internal Rating-Based

ISSB
International Sustainability Standards Board

IT
Information Technology

KPI
Key Performance Indicators

KRI
Key Risk Indicators

LE
Large Exposures

MI
Management Information

MiFID
Markets In Financial Instruments Directive

ML
Machine Learning

MRM
Model Risk Management

MS
Member State

NBFI
Non-Bank Financial Institution

NCA
National Competent Authority

NFM
Non-Financial Misconduct

NGFS
Network for Greening the Financial System

PEP
Politically Exposed Person

PMA
Post-Model Adjustment

PRA
Prudential Regulation Authority

Glossary

PSR
Payment Systems Regulator

RWA
Risk-Weighted Asset

SBTi
Science Based Targets Initiative

SDDT
Small Domestic Deposit Takers

SMF
Senior Management Function

SREP
Supervisory Review and Evaluation Process

SS
Supervisory Statement

SSM
Single Supervisory Mechanism

SWES
System Wide Exploratory Scenario

TCB
Third-Country Branch

TNFD
Taskforce on Nature-related Financial Disclosures

TPRM
Third-Party Risk Management

TPT
Transition Plan Taskforce

TWD
Trading Book Wind Down

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