SPRING 2021

BANKING SECTOR - HOT TOPICS

Focus on Financial Institutions – Part of the Horizon Scanning series

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Welcome to the Spring 2021 edition of our **Banking Sector - Hot Topics** series. Against the backdrop of COVID-19 and the end of the Brexit transition period, we discuss some of the significant developments currently affecting the sector, including future regulatory reform and the future banking prudential regime, operational resilience and sustainability, as well as the latest on the UK/EU's potential future relationship, the ongoing impact of COVID-19 and LIBOR transition.

1 UK regulatory reform

The UK government and regulators are considering reform to a number of aspects of the UK's financial regulatory regime, both in light of the UK's withdrawal from the EU and to bolster the UK's position as a global financial centre, and as required by legislation. These include the independent review of the UK's ring-fencing regime and regulatory consideration of a simpler regime for smaller banks, as well as the government's review of the UK's regulatory framework as a whole.

Independent review of the UK's ring-fencing regime

The government has commissioned an independent review of the UK's ring-fencing regime, as required under the Financial Services (Banking Reform) Act 2013, to consider the impact of the regime on: (i) UK banking sector competition, including the benefits and barriers that the regime presents; (ii) UK mortgage market competition, including mortgage pricing and risk-taking incentives created by the regime; and (iii) the UK banking sector's international competitiveness.

The review is being led by Ken Skeoch, ex-CEO of Standard Life Aberdeen, with a panel of policy and industry representatives, and its Terms of Reference state it 'aims' to report on its recommendations in February 2022.

The review has generated significant interest in the banking industry, particularly given the significant costs for banks subject to the regime, both from a restructuring and compliance perspective, with a number of banks lobbying for particular regime changes. Of particular interest is whether the Review will recommend an increase to the current 'entry' threshold of £25bn of core deposits over a three-year period (banks are reported to be lobbying for at least a £40bn threshold); a tiered set of requirements individually applicable as banks' core deposits increase; and a reduction in the current restrictions on the activities ring-fenced banks can undertake, the exposures they can incur to the broadly defined range of 'relevant financial institutions', and the entities they can set up overseas.

All of these aspects would have a significant impact on banking firms' ability to grow, attract investment and remain competitive. This would be the case for newer and smaller banks coming close to the current threshold and larger established investment and retail banks whose retail business expansion is currently being limited so as avoid reaching the regime entry threshold.

A simpler prudential regime for small banks

The PRA announced in November 2020, as part of the PRA Deputy Governor's Mansion House speech, that it is considering a simpler graduated prudential regime for smaller banks and building societies (termed 'KISS' – keep it strong and simple), commensurate with similar regimes in other jurisdictions, including Switzerland, Canada and Australia.

While the regulator is yet to put forward for consultation any formal proposals, the regime's underlying aim is to encourage growth and competition within the UK banking sector while also maintaining robust but proportionate prudential requirements for such firms.

The regime's scope and components are clearly still under development but entry eligibility may be set at a certain amount of total assets with a number of other conditions, including that the firm is not systemically important, not internationally active, not involved in trading activities and capable of exiting the market in an orderly way. The PRA ultimately intends there to be a graduated regime overall with a series of steps up to the full Basel requirements.

The PRA's idea comes not long after its July 2020 consultation on its supervisory approach to new and growing non-systemic banks (defined as prospective banks considering authorisation and those which have been subject to PRA regulation for, typically, up to five years). The proposed supervisory statement brings together in one place the regulator's expectations over the past several years with a number of proposed capital requirements' changes. These include in relation to the capital buffer calculation as it would apply to such firms; an end to 'just in time' capital planning; and a transition period to allow relevant firms to build up their stress-testing capabilities.

Both proposals would be welcomed by existing newer and more established smaller banks, as well as prospective entities considering entering the sector. The PRA indicated in its consultation that it intended the supervisory statement to take effect in H1 2021, but has yet to confirm its final policy. This may be deliberate so both initiatives, and the publication of the regulator's proposals on the small banks' regime, can be co-ordinated.

UK regulatory regime review

HM Treasury launched, in October 2020, Phase II of its Financial Services Future Regulatory Review with a consultation setting out a 'blueprint' for future UK financial services regulation. This follows a call for evidence on regulatory co-ordination and will be followed by a second consultation later in 2021 setting out a final package of proposals.

Overall, the Treasury proposes that the UK financial regulation framework will build on the structure originally set up under FSMA 2000 with clear allocation of responsibilities between Parliament, government and the regulators. The government and Parliament will, as now (with the exception of directly applicable EU law), be responsible for setting policy with additional powers in relation to specific regulated activity (e.g. insurance business prudential regulation). The regulators will be responsible for designing and implementing regulatory standards using their existing rule-making powers under FSMA and, in addition, any EU onshored law in-scope of these powers will be transferred from statute to the regulators' rulebooks. This should mean that all regulatory requirements for firms are contained in one place and their compliance costs are reduced.

> *"This should mean that all regulatory requirements for firms are contained in one place."*

On accountability and scrutiny, the regulators would be subject to enhanced transparency requirements in relation to their regard for Parliamentary public policy issues and there would be more systematic early-stage consultation between the Treasury and regulators in the policy-making process. Otherwise, the Treasury considers that existing Parliamentary scrutiny arrangements will remain effective, particularly given the role of the Parliamentary Select Committees. It does, however, acknowledge that these Committees may want to adapt their scrutiny approach in light of the new framework and indicates its desire to engage with them on this.

The consultation has generated strong views from both industry and Parliamentary groups that the regulators should be subject to greater scrutiny, both from Parliament and regulated firms, than is currently proposed by the Treasury. It will be interesting to see if the Treasury revises its proposals in response.

2 Looking beyond Brexit

The UK/EU deal

After much uncertainty throughout the Brexit transition period that any UK/EU deal was going to be possible, the Trade and Co-operation Agreement was finally reached at the last minute on 24 December 2020.

As widely anticipated, agreement in relation to financial services is minimal and effectively leaves firms in a 'no deal' scenario with the loss of passporting and minimal equivalence decisions reached by both sides (although the UK has been slightly more generous). The door has, however, been left open for further discussion and negotiation through the accompanying Joint Declaration (among others) on financial services under which both parties have agreed, by way of Memorandum of Understanding concluded at the end of March 2021, to establish structured regulatory co-operation on financial services with the aim of establishing a 'durable and stable' relationship. Among other aspects, it importantly provides for 'transparency and appropriate dialogue' on the adoption, suspension and withdrawal of equivalence decisions.

"Both parties have agreed [an MoU] to establish…regulatory co-operation..[aimed at] establishing a 'durable and stable' relationship."

Further equivalence?

This is a positive step and does avoid an abrupt end to the UK-EU financial services relationship, but it remains to be seen what further equivalence decisions can be reached by both sides and by when. The decisions reached by both sides before the end of the transition period very much focused on addressing financial stability risks that the immediate loss of market access might cause and, for the UK, to support open liquid markets and effective risk management. Both sides indicated subsequently that they would not make further decisions until they had further clarity on the other side's intentions and potential future divergence.

That said, there is mounting pressure on the European Commission, including from EU regulators and banking firms, to reach an equivalence decision on the MiFIR derivatives trading obligation. This is reportedly starting to hurt EU firms, whose UK clients wish to remain on UK venues, as much as it has hurt UK firms whose EU clients have transferred significant trade volumes to EU venues. Lobbying on other legislation, including the MiFIR share trading obligation, may follow.

Building presence without passporting

Many banking groups headquartered in the UK and EU with operations in eachother's jurisdictions took steps well in advance of the original exit day (29 March 2019) to ensure business continuity post-Brexit, primarily through the creation of new subsidiaries or branches, or increased authorisation of existing ones. Understandably, some banking firms did not make these entities fully operational or capitalised pending the outcome of the UK/EU negotiations. This is now the focus for such firms, particularly given some counterparties are reporting challenges in dealing, and doing business, with them given their small size. The ECB is also maintaining pressure on these firms, with its Chair stating in February 2021 that 'the bank continues to closely monitor UK firms' progress on relocating…their European businesses'. It estimates that approximately €810bn of capital market assets still need to move to EU entities.

EU banking firms, if they have not already done so, have slightly more time to achieve fully fledged UK entities given the existence of the UK's minimum three-year Temporary Permissions Regime. It permits such firms to continue operating for the Regime's duration provided they apply for full authorisation from the UK regulators before its end.

International firms

The UK regulators have also been turning their attention to their supervision of internationally headquartered banks, not simply those headquartered in the EU, with the aim of maintaining the UK's position as a preeminent global financial centre. The PRA estimates that a fifth of global banking activity is undertaken in the UK and almost 50% of UK banking assets are held by international banks.

The FCA published its 'Approach to international firms' in February 2021 following consultation, which sets out its approach to the authorisation and supervision of international firms and the circumstances in which they may need to establish

a UK subsidiary rather than a branch. The FCA indicates that relevant banks (and insurers), as dual-regulated firms, should consider the document as it (the FCA) will provide consent to any authorisation applications that they submit to the PRA.

The PRA is in the process of consulting on an update to its Approach document, originally published in March 2018, which it intends to make applicable in Q2 2021. It has made clear that, among other aspects, it will expect detailed information on banking firms' or groups' profitability, the market risk they pose (which will depend on their potential impact on UK financial stability), the degree of intra-group interconnection, as well as the existing requirement of equivalent home state regulation particularly in relation to the bank's capital requirements and applicable resolution regime.

3 COVID-19: maintaining capital resilience

The UK banking sector is continuing to be at the forefront of support provided to the real economy, providing ongoing finance to business through the government-backed loan schemes and temporary financial relief to individual customers. The Treasury reported in late March 2021 that £75bn of government-backed loans had been provided at that point, £46.5bn of which were under the 100% government-backed Bounceback Loan Scheme.

> *"Although some headwinds are expected in 2021, banks remain well-capitalised and able to continue supporting the economy."* PRA, Dec 2020

The sector has, so far at least, remained resilient, helped not least by the regulatory reforms put in place after the global financial crisis and also by the regulatory relaxation of some capital and operational requirements early on last year and the ongoing dividend distribution restrictions (although eased by the PRA in December 2020). The PRA reported in December 2020 that the FPC and PRC's two desktop stress tests of the UK's eight largest banks' capital positions indicate that, although some 'headwinds' are expected in 2021, banks remain well-capitalised and able to continue supporting the economy.

Regulatory focus

As indicated in the PRA's 2021 supervisory priorities for banks, the UK regulator remains, unsurprisingly, focused on: (i) banks' financial resilience, particularly given the continued low interest rate environment, pressure on net interest margins and the need to adjust to the 'post-Brexit world'; and (ii) their credit risk management arrangements and provisions in response to the potential increase in non-performing exposures (NPEs), expected to start occurring this year although to a greater extent in the medium to longer-term.

On the conduct side, banks must also continue to pay particular heed to their regulatory obligation to treat their customers fairly and act in their best interests (FCA Principle 6), particularly those who are most vulnerable. The FCA continues to publish extensive guidance on this obligation in relation to the ongoing temporary financial relief measures that banks must continue to offer their customers, and in relation to vulnerable customers generally. It has reiterated regularly that the guidance may be taken into account by the regulator, including in future enforcement cases, when considering whether firms', including banks', conduct met, or fell below, the standards required by Principle 6.

On a positive note, the FCA's review of firms' implementation of its temporary financial relief guidance and their operational readiness to support customers over the period November 2020 to March 2021 found that firms had made good implementation progress with no systemic operational issues identified, although customer access to non-digital channels remains extremely important.

Balancing regulatory obligations

The need for banks to remain capitally resilience and treat customers fairly are equal regulatory obligations. Balancing these may present real challenges for them in the context of ongoing lending and rising lending exposures. This is particularly given the reduced possibility of attracting investment while dividend restrictions remain, the continuing low interest rate environment and the possible introduction of zero or negative interest rates.

A combined government, regulator and banking industry approach is likely to be needed to manage the sector's NPEs. While government-backed loans carry an 80% (or in the case of the Bounceback Loan Scheme, a 100%) guarantee, banks still need to take steps to recover such

loans before relying on these guarantees, they are time-limited, and banks are continuing to provide significant other lending and financial relief to businesses and individuals.

Industry bodies, such as CityUK and UK Finance, have already held some discussions with all stakeholders on possible approaches. Clearly, the government will want to avoid the extensive recapitalisation support that was provided to banks in the global financial crisis but the volume of NPEs may need to be better known before it considers that a government-led sector-wide response is needed – the Chancellor was reported last year to have said that he was not 'completely persuaded' that the scale of bank debt will require such a response.

4 The UK's future prudential regime

The UK government confirmed, in its June 2020 statement, that the Capital Requirements Directive V (CRD V) and the vast majority of the Banking Recovery and Resolution Directive II (BRRD II) would be transposed by the required date of 28 December 2020. New regimes would be implemented in relation to the majority of the provisions of the Capital Requirements Regulation II (CRD II) and the Investment Firms Directive (IFD) and Investment Firms Regulation (IFR), both of which would apply after the end of the Brexit transition period.

Capital Requirements Directive V

CRD V was transposed by a mixture of secondary legislation (where required) and PRA rules (where secondary legislation was not required). Although the UK was not legally required to do so given its application after the end of the transition period, this included the new requirement that financial holding companies (FHCs) and mixed FHCs in existence on 27 June 2019 must obtain approval by 28 June 2021 and thereby become subject to the PRA's direct supervision.

An additional PRA rule was introduced, also from 28 December 2020, requiring PRA-regulated subsidiaries of FHCs and mixed FHCs to be responsible for ensuring the group's compliance with CRR consolidated prudential requirements until the above approval is received. The PRA considers this is necessary to preserve the continuity of consolidated supervision and the safety and soundness of such firms.

Banking Recovery and Resolution Directive II

The BRRD II was also transposed by the required date with the exception of a number of provisions which apply after the end of the transition period, including the revised MREL regime given it applies from 1 January 2024.

A number of provisions were 'sunsetted' on the basis they were not suitable for the UK resolution regime post-Brexit and would, therefore, only apply between 28 December 2020 and 1 January 2021. These included the provision introducing a pre-resolution moratorium power (which was introduced by including it within the definition of 'crisis management measure' in the Banking Act 2009).

> *"The new [prudential] regime for UK credit institutions…will largely mirror the EU CRR II with certain modifications."*

Capital Requirements Regulation II

HM Treasury's June 2020 policy statement indicated that a new prudential regime would be introduced for UK credit institutions through the Financial Services Bill 2020 and implemented through PRA rules on which the regulator would consult (the Regime). The Regime would be largely based on the EU CRR II but potentially deviate from it where necessary to reflect the number, size and nature of UK credit institutions and the structure and operation of the UK market.

The PRA published its consultation in February 2021 which confirmed that the new Regime will largely mirror the EU CRR II with certain modifications to achieve closer alignment with the Basel III standards, increase proportionality and ensure consistency with the UK CRR. These include:

- software assets: as previously announced, the PRA proposes that software assets should be fully deductible, as intangible assets, from CET1 capital, having found no credible evidence that such assets can absorb losses effectively in stress (the EU CRR II exempts such assets from the deduction requirement);
- a number of proposed amendments to the large exposures framework to reflect changes made by the Basel Committee, including that the

definition of capital for large exposure purposes should be Tier 1 capital.

The consultation also omits any proposed amendments to the UK's leverage ratio framework given this is being reviewed by the FRC and PRC. Once that review is complete (expected in Summer 2021), the PRA is expected to consult on any necessary changes to the new Regime.

Firms will have been preparing, very sensibly, for the Regime on the basis of the EU CRR II as onshored into UK law, pending clarification of any modifications. Firms will now need to identify any further changes that are needed to their procedures, systems and controls to ensure compliance with the new Regime. This will be particularly important for firms and groups that operate in both the UK and EU, not least because of the different commencement dates (see below), and smaller banks for which the Regime provides some exemptions.

While the Regime had been intended to come into force at the same time as the EU CRR II's post-Brexit provisions (namely, 1 June 2021), it is now planned to come into force on 1 January 2022. Further requirements can also be anticipated beyond its introduction, following the UK's government's announcement in 2020 that it intends to implement the final 'Basel 3.1' standards by the required date of 1 January 2023. The Financial Services Bill provides the PRA with the power to implement those provisions.

Investment Firms Directive and Investment Firms Regulation

A new prudential regime for investment firms, the Investment Firms Prudential Regime, is also being introduced through the Financial Services Bill and implemented through FCA rules. The FCA began consulting on the regime in December 2020, which confirms, as indicated in the Treasury's June 2020 policy statement, that the UK's regime will be materially similar to the EU IFD and IFR. The regime is currently planned to come into force on 1 January 2022 and for further information on it please see the Spring 2021 edition of our Asset Management - Hot Topics series.

5 MREL policy review

The Bank of England has begun its intended review of its MREL policy (the Review), publishing a discussion paper (DP) in December 2020 with a consultation paper intended to follow in Summer 2021 and any consequential policy changes implemented by end 2021.

The completion of the Review in 2021 (rather than by end 2020 as originally intended) is deliberate so that the Bank can take account of the post-Brexit legal framework, the COVID-19 operational impact on banks and the FPC and PRC's review of the UK leverage ratio framework due to report in Summer 2021.

The focus of the Review and DP

As indicated in the DP, the Review, overall, is focusing on the resolution strategy thresholds, MREL calibration, instrument eligibility and MREL application within banking groups. The DP is focusing on 'mid-tier' banks (namely those currently within the Bank's stabilisation powers but which are not G-SIBs or D-SIBs (or their subsidiaries)) for the reason that the Bank's initial analysis carried out before the DP's publication identified that this group of banks has had mixed experiences and greater challenges in relation to meeting their interim MREL requirements.

> *"The DP is focusing on 'mid-tier' banks…given this group of banks has had mixed experiences and greater challenges meeting their interim MREL requirements."*

The DP is, therefore, considering: (i) the different resolution strategies and how they help with bank failure; and (ii) the consequences for mid-tier banks if their strategies, and therefore MRELs, were changed to an insolvency procedure in the event of failure.

This would, of course, have a major impact on such banks in terms of reduced capital requirements if it becomes a policy change. The Bank is seeking feedback and ideas from all stakeholders which will inform the policy proposals to be included in its consultation.

Extended deadline for end-state MRELs

The Bank also announced at the same point that the deadline for mid-tier banks' compliance with end-state MRELS has been extended to 1 January 2023 (unless already subject to a later deadline) given the challenges they've incurred in relation to interim MRELs, and to allow the Bank to engage with all interested parties on its Review. This extension will also help ease the current and

anticipated financial pressures that many of these banks are under, or facing, as a result of the impact of COVID-19 (see further items 3 and 10).

6 Operational resilience

COVID-19 has been a fundamental test and reminder of the importance of robust operational resilience, not only to ensure banks can continue operating effectively but also to ensure their customers remain protected and the wider industry remains resilient and trusted. The major operational resilience regulatory framework being implemented across the financial services sector from March 2022 is timely and should allow firms to draw on, and reflect in their implementation plans, the lessons learned during the pandemic and ensure they are able to respond effectively to future operational disruption.

COVID-19

COVID-19 has, of course, highlighted the critical importance for firms of robust operational resilience systems and controls, particularly in relation to technology systems, arrangements with third party providers and cyber-security procedures, given the almost entirely remote and IT-dependent working environment.

Firms' operational systems and controls have come under greater regulatory scrutiny as a result. The PRA, in its 2021 supervisory priorities for banks, makes it clear that it will continue to challenge banks on how they are ensuring risk and control frameworks operate effectively in the current working environment and that 'firms should not become complacent in their preparations for other operational disruptions or from the ongoing impact of COVID-19'.

> *"Firms should not become complacent in their preparations for other operational disruptions or from the ongoing impact of COVID-19."* PRA, Dec 2020

The FCA, as set out in its 2021 supervisory priorities for retail banks, considers, positively, that most banks responded resiliently to the immediate challenges of COVID-19 disruption and demonstrated agility, quickly moving to remote working while maintaining critical services. That said, it highlights the importance of technology resilience, particularly given firms' increased use of, and reliance on, third party technology providers and customers' increased use of, and reliance on, digital services as a whole. The regulator warns against technology changes being implemented too rapidly, causing system failures and conduct risks, and the importance of prioritising information security and pro-actively managing the increased risk of cyber threats to ensure firms' and customers' data is protected.

Operational resilience regulatory framework

After an extended consultation period as a result of COVID-19, the PRA, the FCA and the Bank of England jointly published, in March 2021, their final policy and requirements on the new operational resilience regulatory framework, which will now come into effect from March 2022.

As foreshadowed in the regulators' December 2019 joint policy summary and co-ordinated consultation papers, under the new framework firms and financial market participants (FMIs) will be required to:

- identify their important business services;
- set impact tolerances (i.e. their tolerance for disruption) for, and identify and document the people, processes, technology, facilities and information that support, each of those services; and
- ensure they can continue to deliver their important business services and remain within their impact tolerances during a range of 'severe but plausible' disruption scenarios.

As originally set out in the regulators' joint July 2018 discussion paper, their policy approach fundamentally stems from an assumption that disruption, and possible failure, *will*, rather than *may*, occur. Because many firms currently may not plan on the basis that disruption *will* occur, improvements to their operational resilience procedures are required to ensure they can respond effectively to such disruptions when they do occur.

COVID-19 has clearly, and understandably, informed the regulators' final policy. The PRA encourages firms to draw on the lessons learned from the pandemic and review how these may influence the development of their operational resilience procedures. The FCA sets out, in its policy statement, some of the factors to which a robust operational resilience procedure needs to respond, including:

- the interconnectedness of the financial sector and the inter-dependence between firms, and across sectors and markets;
- emerging 'people' risks from mass remote working, including in relation to conduct, data protection and professional indemnity; and
- the increasing dependence of firms on third party providers and outsourcing arrangements, and the heightened risk of service disruption where these are based overseas.

On the last point, the regulators' joint statement flags the importance of third party providers, making clear that firms are expected to identify and test their impact tolerances against all relevant operational resources, whether these are provided by the firm or wholly or partly by third parties. The PRA has helpfully, at the same time, published its final rules on outsourcing and third party risk management, which are intended to complement the requirements under the broader framework, to assist firms as they begin their implementation work.

The framework will be introduced by a one-year implementation period from March 2022 and a three-year transition period to March 2025. Firms and FMIs must:

- by March 2022: identify their important business services, set impact tolerances and develop a strategy for compliance with the requirements; and
- by March 2025: ensure they can remain within their impact tolerances in the event of a range of severe but plausible disruptions to their operations.

Senior management, led by the SMF24, are expected to take responsibility for implementation and the PRA has said that it will follow up with firms on their progress.

7 Digital financial services

Digital financial services have been growing rapidly over the last few years and seen further acceleration as a result of COVID-19. These services are increasingly disrupting traditional banking models, not least in the last year where customer demand and need for their quicker and more agile services has been critical.

Established banks have been responding to the competitive challenges, as well as the significant opportunities that digital technology provides. They continue to invest in, and collaborate with, fintech and technology companies as the market matures, as well as setting up their own digital arms to access new areas of growth – Standard Chartered Bank, Santander, HSBC and RBS are all good examples.

The UK government and regulators have been keeping pace with this rapid growth, while also taking a careful and considered approach. They are putting forward proposals for additional regulation and considering the future regulatory framework for digital financial services so that innovation continues to be harnessed and encouraged, while financial stability, market integrity and robust consumer protection are firmly maintained. Two key developments are considered below.

> *"The UK has long been recognised as a world-leader in financial technology. We are committed to maintaining this position."*
>
> HM Treasury, Jan 2021

Cryptoassets

This area is, in particular, attracting investment from banking firms, with a number setting up their own cryptoassets units and collaborating with other financial services firms and technology providers to provide cryptoasset services and products to both their professional, and certainly high-net worth retail, customers.

It is also an area of ongoing close regulatory scrutiny. Following the FCA's July 2019 policy statement on cryptoassets regulation (which remains the key guidance in force) and HM Treasury's July 2020 consultation on the financial promotion of cryptoassets, the Treasury published, in January 2021, its anticipated consultation and call for evidence on broadening the scope of cryptoassets regulation and the effectiveness of existing regulation.

One of the key proposals is bringing stablecoins, such as Facebook's Diem, within the scope of regulation by creating a new regulated class of 'stable tokens' (defined as tokens which stabilise their value by referencing one or more assets, such as a fiat currency or commodity). The Treasury is also seeking stakeholder views on the legal definition of security tokens (broadly digital forms of traditional securities, such as a share or debt instrument), and whether exchange tokens (primarily used as a means of exchange – Bitcoin

being the most well-known example) should remain unregulated.

The Treasury makes clear that it intends to develop existing, rather than create new, regulation and that its remit is to consider the policy approach to extending the scope of the regulatory perimeter, with specific regulatory requirements being set subsequently by the regulators.

The consultation closed in late March 2021 and the Treasury's response, including on how further cyptoassets regulation may be implemented in law, should follow later in 2021/early 2022.

Kalifa review of UK fintech

A potentially major development is the government-commissioned independent review of the UK's fintech sector as a whole, announced in the 2020 Budget and led by Ron Kalifa OBE. Its key objectives were to identify priority areas to support the growth and widespread adoption of UK fintech and, crucially, to maintain the UK's global fintech reputation.

The review published its final report in March 2021, which notes that, while the UK has undergone a fintech 'revolution' over the last decade, it is now at a critical point in its development. There is significant opportunity for further growth but also risks to its position as a world fintech leader, including competition globally, regulatory uncertainty as a result of Brexit and from COVID-19.

The report makes a number of recommendations across the areas of policy and regulation, skills, investment, international co-operation and openness, and national connectivity. Of particular note are:

- a new regulatory framework for emerging technology;
- a 'scalebox' that supports growth stage fintech firms, which would include entrants to the FCA's existing regulatory sandbox and make permanent the digital sandbox launched in 2020 in response to COVID-19;
- the creation of a new visa scheme to enhance the sector's access to global talent; and
- improvements to the UK's listing environment for fintech firms through free float reduction, dual class shares and the relaxation of pre-emption rights.

The report also recommends the creation of a £1bn 'Fintech Growth Fund' to support start-ups on the cusp of growth and the establishment of a number of collaborative groups, such as the Digital Economy Taskforce bringing together government, regulators and the private sector, and the International Fintech Taskforce comprising government, industry and fintechs to progress the UK's 'international plan for fintech'.

The recommendations are ambitious but, if realised, will establish a strong foundation for UK fintech growth over the next decade and beyond, and the maintenance of the UK's current pre-eminent position globally. The sector now looks to the government and the private sector to deliver the report's recommendations, as suggested by it, and will await with keen interest their progress report, due to be provided in March 2022.

> *"The trajectory of UK fintech is at an inflection point of opportunity – and risk. While the UK's position is well established, its future is not assured."*
>
> *Kalifa review final report, March 2021*

8 Sustainability and ESG factors

Sustainability, and within it ESG factors, has gained considerable momentum in the last year as a result of COVID-19 and remains firmly on the government's and UK regulators' agendas.

Financial institutions, like corporates across all industry sectors, are being put under increasing shareholder and investor pressure to demonstrate real commitment to ESG factors and 'live up' to their public commitment statements. JP Morgan was one of several FTSE 350 companies in 2020 to be on the receiving end of requisitioned climate change resolutions (it was narrowly defeated) and a significant number of shareholders continue to regularly vote against proposed executive remuneration (just under 30% of Paragon Bank's shareholders did so in 2020).

That said, banks, like other financial institutions, are also at the forefront of the transition to a sustainable economy. They are continuing to provide a key role in developing 'green' lending products, providing sustainable finance to the real economy and supporting the decarbonisation of carbon-intensive sectors. HSBC, as an example, has received recent recognition for its work in these areas.

Regulatory action: risk management and disclosure

The PRA expects banks (and insurers) to have embedded their climate-related financial risk management implementation plans by end 2021 and all banks have been required to have senior management responsibility in place since October 2019. The PRA's July 2020 feedback indicated mixed progress by firms and some, therefore, may need to accelerate their preparation work to meet the deadline.

At a macro-prudential level, the Bank of England will use its 2021 Biannual Exploratory Scenario (which complements its annual cyclical stress test) to test the UK's largest banks' (and insurers') resilience to climate change-related financial risks. The exercise launches in June 2021 and will report by end 2021.

The FCA's disclosure requirements for premium-listed issuers are now in force and require them, at their next annual reporting point after 1 January 2021, to make climate-related disclosures consistent with those recommended by the Taskforce on Climate-related Financial Disclosures' (TCFD) on a comply or explain basis. The FCA may also extend the scope of issuers to which the requirements apply.

Regulatory action: product design and governance

The FCA continues to be particularly concerned about product 'greenwashing', having originally identified in its initial 2019 review work that a wide range of products carry the label 'sustainable' when their features are not materially different from other products without that label. The regulator is considering a set of guiding principles for firms on product design and governance, emphasising the need for products to be genuinely sustainable and designed against clear criteria, as well as further requirements on product suitability and investment advice to ensure consumers can make informed investment decisions.

Banks will need to consider carefully these requirements when published to ensure the regulated sustainable lending, and other sustainable products, they provide are compliant.

Government action

The government published its '10-point plan for a Green Industrial Revolution' in November 2020, which indicates its intention to introduce mandatory reporting of climate-related financial information across the economy by 2025 (making the UK the first country to do so) with a significant proportion in place by 2023. HM Treasury's roadmap, published alongside the government's plan, makes clear that no additional requirements are proposed for banks, building societies or PRA-designated investment firms beyond the PRA's end 2021 requirement (see above), but that the regulator will review disclosures after this deadline and determine whether additional measures are required.

The government's plan also indicates that it intends to implement a green taxonomy, based on the EU's taxonomy metrics, that defines which economic activities tackle climate change and environment degradation. This is a welcome development given the current lack of a common standard that firms can use to design and assess sustainable products and services, and assess companies' ESG credentials more broadly. The EU has, of course, brought into force the Taxonomy Regulation but it has not been onshored into UK law as it applies from January 2022.

> *"The UK will become the first country in the world to make TCFD aligned disclosures fully mandatory across the economy by 2025."* UK Govt, Nov 2020

Diversity and inclusion

While the regulators' focus to date has been primarily on the 'E' (environment) in ESG, they are increasingly focusing on the 'S' (social) and particularly on diversity and inclusion within financial services firms.

The FCA announced, in a speech given by its new CEO in early 2021, that it is working with the PRA on a joint diversity and inclusion approach for all financial services firms. It wants to see a sixth conduct risk question relating to senior management diversity and diversity formally included in its consideration of senior manager approval applications.

The FCA, as UK listing authority, is also considering a requirement that all listed companies' boards include at least two 'diverse' directors, as the Nasdaq as introduced in the US. This would, of course, complement such companies' board diversity requirements under the UK Corporate

Governance Code 2018 and the targets set by the 2019 Hampton-Alexander and 2020 Parker reviews.

9 LIBOR transition – latest developments

The pace of LIBOR transition has stepped up in recent months. The ICE Benchmark Administration (IBA) confirmed in early March 2021 its intention, following consultation and notification of future departure from the majority of panel banks, to cease publication of all GBP, EUR, CHF and JPY LIBOR settings, and one-week and two-month USD LIBOR settings, on 31 December 2021, and all remaining USD LIBOR settings on 30 June 2023, subject to any FCA rights to compel it to continue publication.

FCA and ISDA statements

The FCA published a statement on the same day indicating that it would not require any panel banks to continue to submit to LIBOR, or the IBA to continue publishing LIBOR, beyond those dates. As a result, the majority of these LIBOR settings will permanently cease at those points, the remaining settings (see below) will no longer be representative of the underlying market and that representativeness will not be restored.

The FCA indicated in the same statement that it will consult in Q2 2021 on the use of its proposed new powers under the UK Benchmarks Regulation, as amended by the Financial Services Bill, to require continued publication of:

- the one, three and six-month GBP LIBOR settings beyond 31 December 2021 for a limited period on a ‘synthetic’ basis in order to facilitate the orderly wind-down of certain LIBOR-referenced contracts which cannot feasibly be converted to alternative risk-free rates (RFRs) or incorporate fallbacks (termed ‘tough legacy’ contracts); and
- the same JPY LIBOR settings, also on a synthetic basis, for an additional year to 30 December 2022 to provide further time for JPY LIBOR transition to complete.

The consultation will specify the legacy contacts to which such synthetic LIBOR rates can be applied and the FCA will also continue to consider the case for continued publication of the same USD LIBOR settings on synthetic bases for a further period beyond 30 June 2023.

> *“The majority of LIBOR settings will permanently cease at [end 2021 and 2023], the remaining settings will no longer be representative of the underlying market and that representativeness will not be restored.”* FCA, March 2021

ISDA provided helpful clarification, on the basis of the FCA’s statement, that the ‘Spread Adjustment Fixing Date’ for the purposes of its IBOR Fallbacks Supplement (for use on new covered derivatives trades referencing these Definitions) and its Protocol (for use on legacy non-cleared derivatives trades between counterparties adhering to the Protocol) would be 5 March 2021 for all LIBOR settings, including those for which synthetic LIBOR might continue to be published.

Regulatory stance

The regulators have maintained a steadfast and clear message throughout the transition process that all affected market participants must have, and progress their, transition preparation plans and they have been somewhat more emphatic since the start of 2021. A joint PRA and FCA Dear CEO Letter to banks in March 2021 indicated that they expect all firms to meet the milestones of the Working Group (on Sterling Risk Free Reference Rates) and place responsibility for transition squarely with firms’ relevant senior managers (to whom they have written separately).

The Working Group published an updated roadmap and target milestones in January 2021 and reiterated in response to the FCA’s statement above that ‘it is now vital that all businesses take action to ensure they are ready to meet the next major industry milestone’ – namely, by 31 March 2021, the cessation of GBP LIBOR in new loans, bonds, securitisations and linear derivatives (except for risk management of existing positions) expiring beyond end 2021.

Industry progress

The Working Group reports good progress across all sterling markets. New floating rate bonds and securitisations have been almost exclusively linked to SONIA since end 2019; RFRs have been increasingly used in derivative trades over the last year, with SONIA-linked swaps exceeding LIBOR-

linked ones since mid-2020; and, although progress has been slower in the loan market, alternative RFRs for loan products have been widely available since September 2020, meeting the Group's milestone.

One key uncertainty that remains, and for which market participants may need to make provision, is in relation to synthetic GBP LIBOR and both the period of time for which it will be made available and for which 'tough legacy' contracts. The regulators have been clear that firms should continue to focus on active transition wherever viable and our view is that the use of synthetic LIBOR is likely to be strictly confined to those contracts which are impossible to transition.

Market participants have also been concerned as to whether a legal 'safe harbour' will be made available that would:

- preserve the status of a critical benchmark deemed non-representative (as synthetic LIBOR will be); and
- provide that such a benchmark would not in itself be a basis for a cause of action between, or liability of, the parties to such contracts.

HM Treasury's consultation on this aspect, published in February 2021 with its response due in Q2 2021, indicates that its fundamental intention is to minimise, as far as reasonably possible, any market disruption from LIBOR transition. However, it is also clear that any legislation needs to be supported by strong evidence of actual detriment and would need to be proportionate, given the unlikely possibility that it could cover every issue. The consultation is also considering legal protections for benchmark administrators.

> *"market participants must now complete [their transition] plans and…expect further engagement from the PRA and FCA to ensure the timeline is met."* FCA, March 2021

10 Transactional activity in the banking sector

Transactional activity in the UK banking sector has, understandably, been more muted over the last year than it was in 2019 when a number of notable deals completed, including the mergers of Clydesdale Bank and Virgin Money plc and OneSavings Bank and Charter Court Financial Services (both of which we acted on). This has, of course, been due in large part to COVID-19 and the banking sector's focus on lending to the real economy and remaining capitally resilient.

That said, activity did pick up in the second half of 2020, including private equity investment into Monzo Bank and Zopa, two of the UK's growing number of fintech banks, and that activity is showing signs of continuing with further investments into Shawbrook Bank and Starling Bank in early 2021. There are a number of drivers which may sustain that activity over the next year and beyond, including those set out below.

Impact of COVID-19

Banks are under increased financial pressure as a result of COVID-19 and specifically the low interest rate environment, potentially high lending exposures and the increased customer use and demand for digital financial services. Attracting investment also remains more challenging while dividend restrictions continue (albeit eased by the PRA at end 2020).

These aspects are likely to trigger divestment of non-core assets and, potentially in time, distressed assets, as well as diversification into business areas providing more stable and recurring revenue, such as wealth management and brokerage. It may also see consolidation in the sector as banking entities seek to achieve cost efficiencies while maintaining scale and market share.

Consolidation of challenger and tech-focused banks

Consolidation among newer and smaller tech-focused and challenger banks is a real possibility where banks with similar models look to join forces to meet the challenges of ongoing government lending requirements, rising lending exposures and the need to remain capitally and operationally resilient, as well as competitive.

In the more medium to longer-term UK regulatory reform, including the possible introduction of a simplified regime for smaller banks, may encourage transactional activity and investment in the sector (see further below and item 1).

The continued rise of digital financial services

The rapid development of digital financial services pre COVID-19 has continued over the last year given the increased customer demand and need for such services during the pandemic (see further item 7).

Banks have been, and will continue to be, active in this space as they seek to bolster their digital offerings and maintain their market share with acquisitions and investment in, and partnerships with, smaller niche financial services business and technology providers.

There is, however, more realism in the fintech sector now and acquisition targets are increasingly likely to be established players with proven business models.

Private equity investment

Private equity investment in the banking sector was an increasing trend pre COVID-19 and private equity firms remain well-placed to continue this trend given their level of available committed funds.

That said, many industry commentators consider that such investment may focus on capital-light financial firms in the first instance and renewed banking investment will only follow in the medium to longer-term once banks' financial positions post COVID-19 are better known. Proposed UK regulatory reform, which would arguably make banks a more attractive target, may also encourage such investment if introduced (see further below).

Sustainable investment

As discussed under item 8, corporates, including financial institutions, are under increasing and sustained pressure from shareholders and investors to demonstrate real commitment to sustainability and 'live up' to their public commitment statements.

This may see banks, as well as providing sustainable finance, seek to divest their 'brown' assets and acquire entities with high ESG standards so as to bolster their own ESG credentials and ensure their investment portfolios match their publicised ESG commitment statements.

"Transactional activity [in the UK banking sector] did pick up in the second half of 2020...and that activity is showing signs of continuing."

UK regulatory reform

In the medium to longer-term, potential regulatory reform (see further item 1) may encourage expansion, new entrants and investment into the sector.

This includes the possible increase to the UK ring-fencing regime's 'entry' threshold, which would allow smaller established banks to expand more easily, potentially encourage new entrants and see larger established investment and retail banks grow their retail banking business (where currently this is being limited by certain banking groups so as not to meet the regime's threshold).

The proposed simpler prudential regime for smaller banks with lighter capital requirements should, if introduced, also stimulate their growth, encourage new entrants and potentially investment from both UK and overseas investors. The Bank of England's announcement in early 2021 that 'mid-tier' banks (those within the Bank's stabilisation powers but not G-SIBs or D-SIBs (or their subsidiaries)) will have an extended period to January 2023 to meet their end-state MREL requirements could help existing challenger and tech-focused banks expand, particularly given the current and anticipated financial pressures that many of these banks are under, or facing, as a result of the impact of COVID-19.

Contacts

If you would like to discuss any of the issues highlighted in this publication, or any other legal or regulatory matter, please do contact us or speak to your usual Slaughter and May contact.

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

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

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