Grant Thornton

UK Regulatory Handbook 2021

Financial services group

Contents

Introduction

Despite our departure from the Brexit transition period, Brexit, along with COVID-19, continue to be catalysts for change across the regulatory landscape in 2021. We are seeing greater focus on mitigating risks in areas such as ESG and digital, which, along with operational resilience, we see as being the main drivers in the future of Financial Services. If the pandemic has taught us anything it's the importance of agility and resilience.

Most regulatory change programmes have been impacted, whether that is speeding up or slowing down the process to react to the market. The 'working from home' model with conduct, conflicts, governance, and control implications had a succession of 'quick fix' changes to facilitate market recovery.

The pandemic's impact on financial services firms will be evaluated by an organisation's ability to use lessons learned to improve readiness and response activity. The pandemic is a different kind of crisis to that typically envisaged and has outlined the need for business continuity planning and governance frameworks.

The details

This is the fifth edition of the Grant Thornton Financial Services Regulatory Handbook. This edition, we have produced predominantly online, enabling us to update it more quickly as new regulatory initiatives and responses emerge. We have also drawn on the new Regulatory Initiatives Grid, published jointly by the regulators (PRA, FCA etc), to provide a consistent and reliable source of information about what the regulators are planning, and we will reflect the grid's latest version in our future updates.

If you would like to discuss any of the regulations further, please do contact one of our partners on the contacts page at the back of the handbook.

"The ability to simplify the regulatory landscape and clearly understand obligations is one of the greatest challenges for financial institutions. The pace of regulatory change will continue to be demanding for the whole sector and events like COVID-19, Brexit and some of the mega trends like the rise of the emerging markets, demographic changes, greater focus on an agile workforce/the hunt for talent, technology/digital opportunities and ESG amongst others, will demand businesses to focus on implementing the necessary regulatory challenges effectively and efficiently."

Sandy Kumar
Global Head of Financial Services Group and Business Risk Services
T +44 0(20) 7865 2193
E sandy.kumar@uk.gt.com

2021 timeline by month

JANUARY

1 Jan | Premium listed companies in the UK required to make better disclosures about how climate change affects their business

1 Jan | UK ASPSPs to support eIDAS and an alternative certificate for TPP Identification

1 Jan | CRD V remuneration provisions applied to most banking groups

6 Jan | FCA rules prohibiting the sale of cryptoassets to retail consumers came into force

7 Jan | HM Treasury published consultation on cryptoassets and stablecoins

10 Jan | Any cryptoassets businesses not registered must cease trading

11 Jan | Final phase-in of EU SFTR reporting obligation for NFCs

11 Jan | PRA published consultation on its approach to the supervision of international banks

15 Jan | Supreme court delivered ruling on the FCA Business Interruption Insurance test case

21 Jan | FCA permanent ban on the mass-marketing of mini-bonds to retail investors takes effect

25 Jan | ISDA 2020 IBOR Fallback Protocol and IBOR Fallback Supplement become effective

25 Jan | Consultation on proposed rules closes on general insurance pricing reforms

28 Jan | Ban on motor finance discretionary commission models and new FCA rules on consumer credit commission disclosure enter into force

FEBRUARY

1 Feb | FCA COBS rules on switching investment platforms enter into force

1 Feb | Implementation of platform transfer rules

1 Feb | Implementation of FCA retirement outcomes review

Feb | FCA implementation of PS19/21 and PS19/30 rules on investment pathways and enhanced IGC responsibilities

Feb/Mar | MIFID II quick fix to be finalised

MARCH

8 Mar | EMIR validation rules apply

10 Mar | Majority of provisions of the disclosure regulation apply. FCA has confirmed that it will not be onshoring the SFDR into UK law

31 Mar | First signatories to the revised stewardship code submit their reports

31 Mar | Solo-regulated firms must submit their Directory Person Data via FCA Connect

31 Mar | FSMA authorised firms to apply conduct rules to all non-ancillary staff

Mar | Commission expected to publish reports on sanctions and consolidated tape for non-equities

Mar | TPR consultation on the regulatory framework for DB scheme funding

Mar | FCA expects to revisit its approach to DTO

Mar | UK and EU to agree a framework for regulatory co-operation in a MoU on financial services

Mar | FCA made LIBOR cessation/pre-cessation announcement. ISDA declared Index Cessation Event. Bloomberg confirmed credit spread adjustment fixing date

APRIL

1 Apr | Compliance deadline for the BoE's statement of policy on valuation capabilities to support resolvability

6 Apr | The Money Laundering and Terrorist Financing Regulations 2020 enter into force

19 Apr | Electronic messaging requirements and transparency rules for credit transfers apply under the cross-border payments regulation

30 Apr | End of FCA direction relating to a modification by consent allowing temporary arrangements for up to 36 weeks during COVID-19 for benchmark administrators

Apr | Final data template and qualitative questionnaire will be released on the 2021 Climate focused Biennial Exploratory Scenario (CBES)

MAY

4 May | Breathing space regulations expected into force

JUNE

1 Jun | Results of the next annual transparency calculations for non-equity instruments will become applicable

1 Jun | Commission to adopt delegated act on Article 8 of the Taxonomy Regulation

18 Jun | FRANDT and rules for trade repositories introduced by EMIR REFIT become applicable. Financial Services Bill makes provision for these to be implemented in the UK. Amendments to EU margin rules are anticipated

21 Jun | CRR2 applies in the EU. In the UK, the relevant enhancements will apply from 1 Jan 2022

26 Jun | IFR and IFD apply in the EU. In the UK, application of the new UK IFPR has been pushed back to 1 January 2022

26 Jun | EBA guidelines on internal governance under CRD IV are expected to enter into force

28 Jun 2021 | Deadline to meet Net Stable Funding Ratios (NSFR), SA-CCR, leverage ratio, Large Exposure requirements and Pillar 3 (with reporting requirements)

Jun | Firms to comply with FCA open banking identification requirements

Jun | UK prudential regime for MiFID investment firms - regime becomes effective in EU

Jun | Biennial Exploratory Scenario to stress test firms' resilience to climate risk

JULY

1 Jul | UK ASPSPs to support Article 34 compliant alternative certificate for TPP Identification

1 Jul | Compliance deadline for overseas IRB models that are not used for UK consolidated group requirements

4 Jul | Open access regime for the trading and clearing of ex-change-traded derivatives will apply

31 Jul | ESMA guidelines on outsourcing to cloud service providers will apply to new or amended arrangements

Jul | Commission expected to produce MiFID II provisions under review clause in MiFID II

Jul | ESMA to finalise report on algorithmic trading

AUGUST

1 Aug | Most substantive new requirements under the REFIT initiative on cross-border distribution of funds apply

2 Aug | ESMA to finalise guidelines for funds' marketing communications under the Regulation on the cross-border distribution of collective investment undertakings

SEPTEMBER

1 Sept | Bilateral margin obligations phase 5 new requirements for non-cleared over the counter derivative contracts

1 Sept | EBA ITS on specific reporting requirements for market risk under CRR applies

14 Sept | Deadline for implementation of Strong Customer Authentication under PSD

Sept I FRTB-SA Reporting starts for EU firms

OCTOBER

1 Oct | UK banks to submit first resolvability framework reports to the PRA

21 Oct | Handbook rule changes enter into force relating to pension transfer specialist qualifications and appropriate exam standards

31 Oct | FCA guidance on assisting borrowers with interest-only and partial capital repayment mortgages whose mortgages have matured since 20 march, or will do so in the next 12 months, expires

Oct | Resolvability Assessment Framework first assessment report to be submitted

NOVEMBER

Nov | Crowdfunding Regulation and Directive amending MiFID II relating to crowdfunding will apply. UK still to consider whether to implement a similar regime

Nov | Climate Change Conference of the Parties (COP26)

Nov | SWIFT's recommended migration to the ISO 20022 message format to commence

DECEMBER

1 Dec | Additional Disclosures Regulation RTS to be delivered to the Commission

1 Dec | Climate mitigation and climate adaptation sections of EU Taxonomy apply

7 Dec | Deadline for benchmarking administrators to certify relevant employees as fit and proper

31 Dec | LIBOR cessation for all GBP, JPY, CHF, EUR and two USD tenors

31 Dec | End of current transitional arrangements for third country benchmarks under EU BMR

2021 timeline by quarter and year

2021

IFRS 17 impact study, design, implement and test

UK Financial Services Bill progressing through Parliament to be legislated

Bank of England will review the MREL framework, including resolution strategy thresholds, the calibration of MREL, instrument eligibility and the application of MRELs within banking groups

Continuous FCA evaluation of improvements in the outcomes experienced by vulnerable customers

Basel Committee for Banking Supervision to finalise its approach to disclosures for market risk and sovereign exposures

Q1

FCA consultation for extending TCFD-aligned disclosures to asset managers, life insurers and FCA-regulated pension providers

PRA issues P5/21 consultation on Implementation of Basel standards

FCA made cessation and pre-cessation announcements for all LIBOR settings

BEIS to consult on TCFD-aligned disclosures obligations in relation to the 2006 Companies Act

FCA consultation for extending TCFD-aligned disclosures to a wider scope of listed companies

FCA aims to publish final guidance on fair treatment of vulnerable customers (following GC20/3)

HMT publish 'UK regulatory approach to crypto-assets and stablecoins: Consultation and call for evidence'

FCA and PRA to publish policy statements on operational resilience

The PRA will publish its final policy statement on outsourcing and third party risk management

FCA publication of final guidance on DB pension transfer advice

FCA consultation on default investments for non-advised consumers

Q2

Operational resilience – PRA to consider incident reporting requirements

PRA consultation on Implementation of Basel standards closes

Spring – FCA consultation on exit fees following the Investment Platforms Market Study

FCA expects to publish second consultation paper on UK IFPR

Spring – Fund liquidity Final rules issued, and implementation date confirmed

The FCA intends to publish a Policy Statement setting out the final rules for the General Insurance Pricing Reforms

FCA consultation on synthetic LIBOR settings expected

Q3

FCA expects to publish third consultation paper on UK IFPR

Government to publish a consultation paper on the second phase of the Financial Services Future Regulatory Framework

Q4

Operational resilience compliance deadline

LIBOR cessation for all GBP, JPY, EUR, CHF and two USD tenors

2022

1 Jan 2022 | Deadline for all firms using the internal ratings-based approach

1 Jan 2022 | UK target date for Basel 3.1 reforms analogous to CRRII

Jan 2022 | UK prudential regime for MiFID investment firms - regime implemented in UK

Jun 2022 | RAF summary of the assessment report

Jun 2022 | The Bank of England will issue the public resolvability statement

Sept 2022 | Bilateral margin obligations apply to phase 6 in-scope firms

31 Dec 2022 | End of current transitional arrangements for third country benchmarks under UK BMR

2022 | IFRS 17 comparative data will be required with an opening balance sheet on 1 January 2022 for entities with a 31 December year end

2022 | Continuous FCA evaluation of improvements in the outcomes experienced by vulnerable customers

2023

1 Jan 2023 | Compliance deadline for firms to update overseas IRB models for use in UK consolidated group requirements

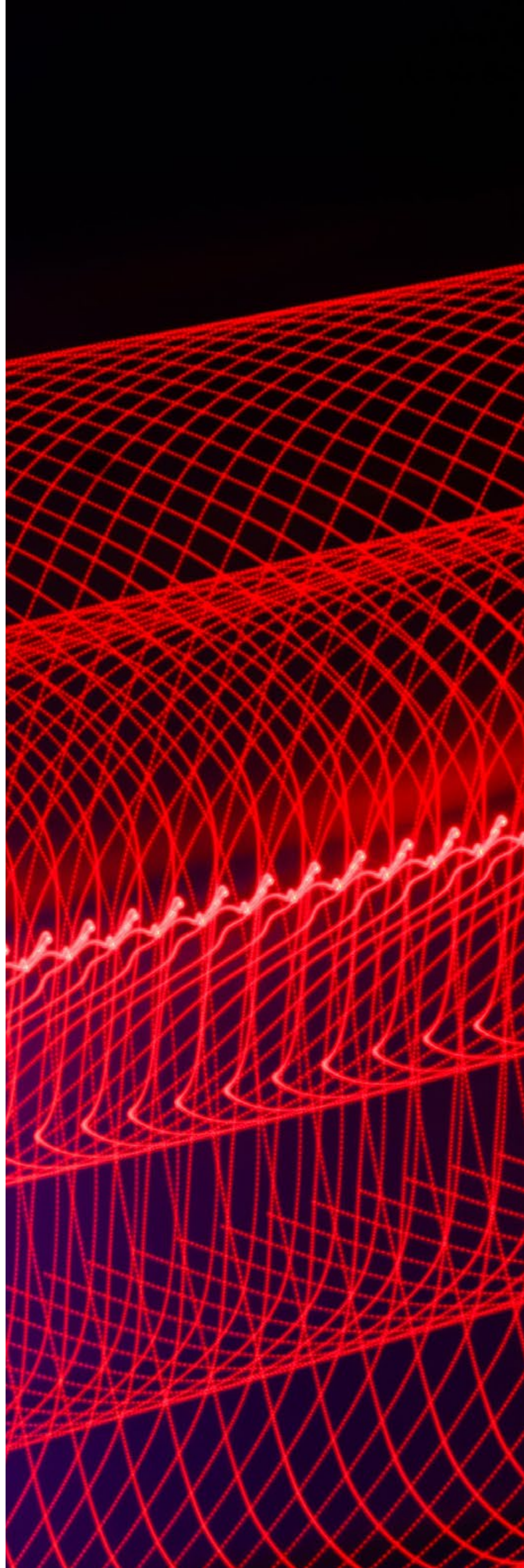
1 Jan 2023 | Basel implementation deadline

Jan 2023 | Resolvability assessment framework and minimum requirements for own funds and eligible liabilities (MREL) for mid-tier banks

June 2023 | Cessation of remaining USD LIBOR tenors

2023 | IFRS 17 Go Live

31 Dec 2025 | Proposed end of transitional arrangements for third country benchmarks under UK BMR



Cross-financial services

"Regulators focus extensively on what regulation applies to which sector across financial services, but the biggest challenges they are looking to solve cut across the sector – In this section, we look at some of the key cross financial services regulations and opportunities/demands these will throw out."

Sandy Kumar
Global Head of Financial Services Group
and Business Risk Services
T +44 0(20) 7865 2193
E sandy.kumar@uk.gt.com

Cross–financial services
Key regulatory developments

One of the most important decisions regulators take is how widely to apply a new regulation. Where possible, they will limit the number of firms affected but many of the biggest problems regulators are trying to solve have little respect for sectoral boundaries. Climate risk and operational resilience fall firmly into this category and, together with financial crime, form a trio of major external threats to the financial system that regulators are likely to prioritise over the coming years. Of these, the first two have risen rapidly to the top of the list over the last few years. The last of the trio, financial crime, has always been important but has recently become a greater risk, driven in part by the rise of online crime and our new post Brexit status as a third country in the eyes of the EU.

A second group of cross sector initiatives, around resolution, capital and benchmarks, forms part of the raft of reforms that were designed to prevent a repeat of the great financial crisis, while a third - cryptoassets, AI, Open Banking, fintech – attempts to look ahead and cover new and emerging areas of financial services. As the former group illustrates, regulatory initiatives can take several years to fully design and implement, and we should expect regulation of these new areas to evolve significantly over the coming decade.

Lastly, and in some ways bookending the spectrum of cross sector initiatives are Vulnerability Guidance and the Future Regulatory Framework. The former is a perennial regulatory issue that has been given added importance and much broader relevance by the COVID-19 crisis and is likely to be on the front line of the relationship between regulators and the industry for the next few years. Meanwhile, HM Treasury's consultation on the Future Regulatory Framework post Brexit will ultimately decide the overall shape of the UK's.

Climate risk

In a nutshell

Regulators expect firms to manage and disclose financial risks due to climate change. The Climate Financial Risk Forum (CFRF), chaired by the PRA and FCA, has published comprehensive guidance for risk management, disclosures, governance and scenario analysis. The guidance endorses the disclosure framework developed by the Taskforce for Climate Related Financial Disclosures (TCFD), which is fast becoming the industry standard.

In the UK, HM Treasury introduced a phased rollout for mandatory TCFD-aligned disclosures by 2025.

PRA regulated firms have until the end of 2021 to implement a climate related financial risk framework and approach to disclosures. The FCA requires UK premium listed companies to make climate risk disclosures for reporting periods from 1 January 2021.

2021 timeline

Early 2021	FCA consultation for extending TCFD-aligned disclosures to asset managements, life insurers and FCA-regulated pension providers
First half of 2021	FCA consultation for extending TCFD-aligned disclosures to a wider scope of listed companies
June 2021	Biennial Exploratory Scenario to stress test firms' resilience to climate risk
November 2021	Climate Change Conference of the Parties (COP26)

"Environmental, social, and corporate governance (ESG) has become increasingly topical as financial institutions need to adhere to frameworks including the Paris Agreement on climate change objectives. As financial services firms begin to embed ESG related financial risk into their organisation, they should expect climate-related financial risk to be integrated within the full range of regular supervisory activities, including the 2021 BES exercise. Consequently, it is important for management teams to provide periodic updates to the board throughout the process of embedding and then defining processes to monitor on an ongoing basis."

Bobby Console-Verma, CEO, 1fs Wealth

Climate risk

Core components

ESG vs financial risks

Climate change is a systemic risk to the financial system and regulators are seeking assurance that it is effectively managed, with greater transparency for both supervisory bodies and investors. By this point, businesses have a good understanding of environmental, social and governance (ESG) concerns but the financial risks due to climate change are not as widely recognised.

Physical risks relate to changes to our environment, which may reduce the value of assets and collateral, increasing market and credit risk. A disorderly transition to reduce carbon emissions may also cause a sudden drop in asset value, with the potential for financial shock.

Transition risks arise when adjustments are made towards a low carbon economy. Several factors are influencing this adjustment including regulatory requirements, new technology and societal changes.

Financial disclosures

Climate risk could lead to material losses, which must be disclosed under legislation and regulation such as the UK Companies Act, the Capital Requirements Directive and Solvency II, amongst others. TCFD has become the standard framework, and the key areas for inclusion are:

- Governance – board oversight and the role of senior management
- Risk management – identify, mitigate and integrate climate risk
- Strategy – balance risk and opportunity, identify the impact on business strategy and resilience
- Metric/targets – demonstrate metrics and performance, disclose greenhouse gas emissions if appropriate

The International Financial Reporting Standards foundation has proposed a Sustainability Standards Board, for greater consistency for investors and to reduce greenwashing.

HM Treasury's phased rollout

Using the TCFD disclosure framework as the best practice, HMT's phased rollout for mandatory disclosures is as follows:

2021

- Banks, building societies and insurance companies
- Premium listed companies
- Occupational pension schemes (>£5billion)

2022

- Largest UK authorised asset managers, life insurers and FCA-regulated pension providers
- UK registered companies
- Occupational pension schemes (>£1billion)
- Wider scope of listed companies

2023

- Other UK authorised asset managers, life insurers and FCA-regulated pension providers

2024

- Other occupational pension schemes
- Potential further refinements across categories, including in response to evolving best practice

PRA and FCA expectations

PRA regulated firms have until the end of 2021 to meet its expectations around disclosures, governance, risk management and scenario planning. In respect to governance, firms are expected to have clear roles and responsibilities. Firms need to assess the impact of physical and transition risks and integrate these into the existing risk frameworks. Scenario analysis are also expected to be conducted by firms addressing a range of outcomes over various timelines. When it comes to disclosures, firms must disclose key material risks under Pillar III of CRR and Solvency II and also explain how the risks are integrated into their climate related financial risks framework. Firms must also appoint a Senior Manager Function (SMF) to oversee climate risk, with effective scenario planning and testing in place.

The FCA has also adopted a comply or explain approach to disclosures, which initially applies to premium listed firms for reporting periods from 1 January 2021, at this stage, areas relying on quantitative data may be the most challenging to disclose against, as the underlying processes are not universally in place. This may include performance metrics or strategy, and the FCA would expect firms to undertake materiality assessment when deciding to comply or explain in these areas.

It's also worth noting that the FCA has included premium listed asset managers in the FCA's policy statement, with disclosures initially aimed at shareholders. The consultation in early 2021 will address disclosures for clients.

Future Regulatory Framework (FRF)

In a nutshell

This is a wide-ranging Government consultation on its proposals for re-shaping the UK regulatory framework post Brexit. It focuses on the relationships between the regulators, the Treasury and Parliament, and proposes delegating considerable authority to the PRA and FCA, with Government and Parliament setting out the framework and the key public policy issues. The other main proposals centre on making the regulators subject to enhanced transparency and accountability to Parliament and more systematic cooperation and coordination with the Treasury.

The proposals are strongly supportive of the existing Financial Services and Markets Act (FSMA) 2000 model, as adapted post the financial crisis. The decision to delegate so much responsibility to the regulators rather than retain it in Parliament, with the consequently technocratic as opposed to political focus, also reinforces the overall commitment to maintain the highest global standards.

2021 timeline

The consultation closed on **19 February 2021**. A further consultation, later this year, will set out a final package of proposals and how they will be delivered

Core components

The proposals are supportive of the existing regulatory model, based on FSMA 2000 and amended after the financial crisis, and rely explicitly on the technical expertise of the two regulators. Consequently, there are no proposals to change the regulators' objectives, and specifically there is no proposal to add a competitiveness objective.

This judgement also underpins the proposal that the PRA and FCA should be responsible for designing and implementing regulatory standards. The alternative to this substantial delegation of powers would have been for the Treasury and/or Parliament to take on a more detailed policy formulation and rule-making roles. This would have run the risk of regulation becoming more political, and the consultation argues that that it is unlikely either the Treasury or Parliament would have the time or expertise to perform these roles effectively.

The distinctions between the respective roles of Parliament, Government, and regulators, with the former two setting out the framework and key policy issues for each regulatory regime, is still at a high level and we will need to wait for the final consultation package to see how this will be implemented in practice.

There are also, as expected, enhanced transparency and accountability proposals concerning the two regulators. These envisage using existing parliamentary scrutiny arrangements, particularly the select committee system, and the belief is that these will be strengthened by Parliament's new role in setting the policy framework for regulation. Much of the detail remains to be filled in, and it may be, for example, that the Treasury Select Committee comes to develop greater specific expertise in financial regulation as it moves forward. To complement this, there are also proposals to make the relationship between the Treasury and the regulators a more systematic part of the UK framework, through legislative requirements and/or an MOU. The transparency this will bring and the way this relationship works in practice will be critical to reinforcing the independence of the regulators, the importance of which is emphasised throughout.

The proposals leave open the future arrangements for policy consultation and the role of the various independent panels, and presents various options for wider accountability. These range from relatively minor adaptations to the establishment of a new external, independent scrutiny function, and which option the Treasury opts for in the final package of proposals will be closely watched.

Existing EU regulation has been onshored and we can expect it to be reviewed incrementally over time. The Ministerial makes it clear that 'the UK remains committed to the highest standards of regulation' and the test of these proposals will be how this commitment is reflected over time, starting with the current review of Solvency II.

Vulnerable customers

In a nutshell

It is impossible not to notice the FCA's ever-increasing interest in how firms identify and cater for vulnerable customers, including the publication of the significant Guidance for firms on the fair treatment of vulnerable customers in February 2021 (FG21/1).

The COVID-19 crisis – which has some way to go, and whose long-term consequences are profound but uncertain – has, regrettably, created many vulnerable customers and worsened existing vulnerabilities for many more.

The FCA's supervisory work, both with individual firms and thematically, across all sectors, will therefore continue to look closely at the industry's identification and treatment of vulnerable customers during 2021, and well beyond. FG21/1 puts the industry on notice that the FCA will be notably more proactive and willing to use the full range of its powers, including policy and rule-making, over the next 2–3 years, if the improvements it seeks are not made.

2021 timeline

Q1 2021	FCA published its final guidance on fair treatment of vulnerable customers (following FG21/1)
2021 – 2023	Continuous FCA evaluation of improvements in the outcomes experienced by vulnerable customers

Vulnerable customers

Core components

In its February 2021 Finalised Guidance (FG21/1), the FCA identified four key drivers that may increase the risk of customer vulnerability:

- **Health:** conditions or illnesses that affect the ability to carry out day-to-day tasks
- **Life events:** major life events such as bereavement, job loss or relationship breakdown
- **Resilience:** low ability to withstand emotional or financial shocks
- **Capability:** low knowledge of financial matters, low confidence in managing money (financial capability), or low capabili ty in other relevant areas such as literacy or digital skills.

Crucially, firms can expect the FCA to ask them to demonstrate the actions they have taken in four key areas:

- understanding the needs of their target market/customer base
- ensuring their staff have the right skills and capability to respond to the needs of vulnerable customers
- responding to customer needs through product design, flexible customer service provision and communications
- monitoring that the needs of their vulnerable customers are being met and responded to, collect information on the impact of their policies and processes, and assess how they are resulting in good outcomes for vulnerable customers.

The FCA says that it will use the guidance FG21/1, to apply a 'vulnerability lens' to its supervisory and policy work, to monitor and evaluate firms' treatment of vulnerable customers.

Having done so, in 2023 the FCA plans to evaluate what action firms have taken and whether it has seen improvements in the outcomes experienced by vulnerable customers. The plans to make this assessment against its understanding of what firms do now and further intelligence gathered through its supervisory work.

Not for the first time, the FCA does not – helpfully or unhelpfully, depending on your point of view – specify precisely what it expects of firms, nor what these 'improvements in outcomes experienced by vulnerable customers' are.

Nevertheless, it is clear that during 2021 and beyond, the FCA expects firms to redouble their efforts to embed approaches that build tailored, supportive interactions for each customer, rather than treating the accommodation of vulnerability as a compromise or distraction from their main activities. While vulnerability is often very difficult to predict, it is vital that the entire organisation understands and recognises it in the context of its specific products and services, in order to support each vulnerable customer in an appropriate way and provide a good outcome.

The FCA expects firms to enable customers – whoever they are, whatever their characteristics – to engage with them in their own way, in their own time and on their terms, and to equip them with everything they need to make good decisions. In this way, the distinction between more and less vulnerable customers begins to fade.

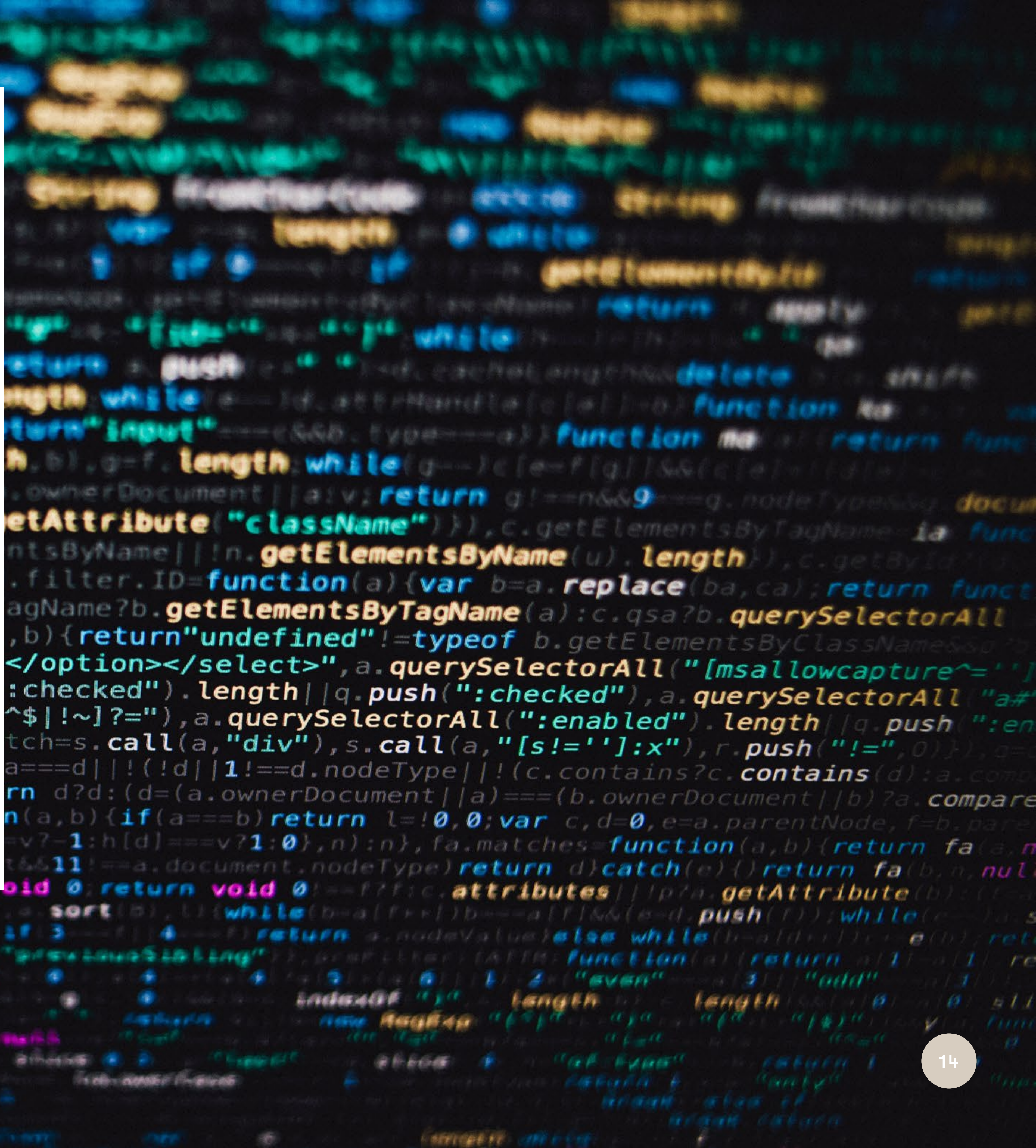
Cryptoassets

In a nutshell

Cryptoassets pose a risk to both investors and the wider economy and regulators have considered how to accommodate these new challenges. A key issue is defining which cryptoassets will be within the regulatory perimeter and subject to what kind of regulations.

At present, most cryptoassets fall outside the UK financial regulatory remit but HM Treasury has outlined two main measures:

- bringing some of them within the scope of financial promotions regulation
- formulating a suitable regulatory approach to cryptoassets in general, including stablecoins.



2021 timeline

2021 Q1 HMT ‘UK regulatory approach to crypto-assets and stablecoins: Consultation and call for evidence’

2021 HMT/FCA feedback expected regarding cryptoasset promotions regulation

2021 HMT/FCA feedback expected on the regulatory approach to cryptoassets in general, including stablecoins

Cryptoassets

Core components

The UK regulators interpret cryptoassets as digital representation of value or contractual rights that can be transferred, stored or traded electronically, and which may (though not necessarily) use cryptography, Distributed Ledger Technology (DLT) or similar technology. Some examples are below.

Regulated	Unregulated
Security tokens – Tokens that give holders similar rights to shares, which is likely to bring them under existing perimeter as it involves interests in securities.	**Exchange tokens** – Tokens that are used for exchange, for example Bitcoin or Litecoin. The holder does not have any rights associated with the specified investment.
E-money tokens – Fiat currency in electronic form. This is subject to existing 2EMD regulations.	**Utility tokens** - Tokens that give holders access to some service/ product or grant rights similar to pre-payment vouchers.

When the regulators update the perimeter, it is crucial that they can identify the key features of a product in order to capture them in scope, with reasonable legal certainty. The variety of cryptoassets make this challenging.

At present most investors see cryptoassets as an alternative investment and hold these products for speculative purposes. But some cryptoassets, like stablecoins, could have wider uses such as enhancing consumers' payment experience.

Note that most cryptoasset firms do not fall within the authorisation perimeter at present, the FCA is also anti-money laundering and counter-terrorist financing (AML/CTF) supervisor for this type of firms, which will register these firms for AML purposes.

Regulating stablecoins

For an item to function as a medium of exchange, it needs to be a stable storage of value and unit of account. Most cryptoassets do not possess this characteristic. Stablecoins are backed by traditional asset classes with a stable value. In other words, stablecoins could be supported by these underlying 'reserves'. They also have the potential to become more widely adopted through business processes such as cross border payments. As such, the Government has proposed that they become regulated under the category of 'stable tokens', to cover the range of different assets available – this will exclude algorithmic stablecoins, as they work in a similar way to exchange tokens.

The proposed changes will cover:

- Stable tokens linked to a single fiat currency. These will be subject to the FCA authorisation regime based on the payments regulation, with a systemic threshold for enhanced regulatory requirements.
- Stable tokens linked to an asset such as gold. These will be subject to the FCA authorisation regime, with specific requirements on the underlying asset. There will be a systemic threshold for enhanced regulatory requirements.

The proposed regulatory approach covers authorisation, prudential requirements, management of reserve assets, safeguards, reporting and notification, conduct, insolvency planning, financial crime controls and resilience elements, amongst others. Some stable tokens may meet the criteria of e-money and will become subject to e-money regulations.

Financial promotions

As mentioned, many investors hold cryptoassets for speculative purposes, and could potentially earn large capital gains. Equally, investors could lose a great deal if cryptoassets' market value fell – and historically this been a volatile market. As such, it is important that the promotion of this alternative investment class is suitably regulated to protect customers.

Following last year's consultation, HMT is considering brining cryptoassets under the current promotions regime. Regulated tokens, including e-money, are already in scope and this brings the remainder in line with the financial promotion order.

This aim is to give greater clarity to investors over the products available. Specifically, it aims to give suitable warning about the volatility of some types of cryptoassets and to highlight the fact that these products do not receive the same level of robust regulation as other traditional investment products.

To achieve this, unregulated cryptoassets will be classified as a controlled investment. This is defined as an unregulated cryptoasset that is fungible, transferable, is not e-money, is not currency issued by a central authority, and is not any other type of controlled investment.

The Government has also proposed amending the list of controlled activities to include activities around buying, selling or underwriting some cryptoassets. Some exemptions are available for cryptoassets, in line with other exemptions for controlled investments.

Operational resilience

In a nutshell

High profile service outages in the financial sector have drawn increased scrutiny from the regulators. Taking a coordinated approach, the Bank of England, PRA and FCA accept that outages will happen and have developed an operational resilience framework to minimise their impact. Firms must:

- identify important services that have the potential to cause harm to customers, the wider economy or financial stability
- map the supporting processes and make contingency arrangements to restore services within the agreed tolerance levels
- set tolerance levels for outages of these services, beyond which actual financial harm would occur
- supplement existing stress tests using severe but plausible scenarios to assess the effectiveness of operational resilience processes
- integrate existing processes and approaches such as BCM into operational resilience.

Key dates

Q1	Q2	End of 2021
FCA and PRA to publish policy statements	PRA to consider incident reporting requirements	Compliance deadline

Operational resilience

Core components

Scope
PRA/FCA regulated firms: UK banks, building societies, credit unions, insurers, overseas UK deposit takers with PRA regulated activity permissions, PRA regulated investment firms.

FCA authorised and recognised entities: Financial Market Infrastructure (FMIs) supervised by the Bank of England, recognised payment systems, enhanced scope Senior Managers & Certification Regime (SMCR) firms, specified service providers, central securities depositories and central counterparties.

Causes
Service outages may be caused by a range of environmental factors including COVID-19, change programmes, technology updates, terrorism or extreme weather events such as a flood. Outsourcing is a particular concern, especially in niche areas such as some data and IT services, where there may be few alternative providers, giving rise to concentration risk.

Identifying important business services (IBS)
IBSs are those that could cause economic harm to individuals or the wider economy if unavailable, and they consist of a chain of supporting activities. They must be viewed from the perspective of the client, consumer or the market, and are not be confused with individual service lines or products.

Mapping
Mapping the underlying processes is complex and will identify interdependencies, vulnerabilities such as concentration risk or single points of failure amongst others. A risk assessment will help firms prioritise critical supporting services, feeding into impact tolerances – this is particularly relevant for cases where one activity supports many IBSs.

From there, firms are expected to make contingency arrangements, which may include transferring some processes to other hardware or software systems, providing alternative resources or drawing on third party providers.

Impact tolerances
Once critical services have been identified, firms must establish the client's/market's tolerance limit for potential outages, beyond which actual economic harm may occur. To do this, firms must develop metrics to gauge the disruption, set appropriate thresholds, and be able to restore critical services within the pre-agreed tolerance limit. Regulators have emphasised that tolerance limits and risk appetite are not the same; while risk appetite acknowledges the potential for an event to occur tolerance limits assume the risk has crystallised. Tolerance limits need to consider the time needed to restore a service and the potential impact on the customer base.

Scenario testing
Firms must run severe but plausible scenarios to check tolerance limits can be maintained. They also aim to identify scenarios where tolerance levels would potentially be breached and the reasons why. Lessons learned exercises will inform key improvements needed and how to strengthen resilience in the long term. Existing scenarios can be adopted but need to incorporate operational resilience parameters.

Governance
Operational resilience is ultimately the responsibility of the Board, and regulators expect senior management to approve IBSs, impact tolerances and scenario testing. Significant investment may be needed and must prioritised at a strategic level. The Chief Operating Officer (SMF 24) will have ultimate accountability for operational resilience, and an appropriate management structure and reporting processes. Operational resilience is a group level concern and regulators expect consistent application across all in-group entities.

Reporting and attestation
There is currently no reporting requirement, but this may change in 2021. As it stands, firms are expected to undertake an annual summary of their operational resilience processes and a self-assessment. This must be approved by the Board and be available to regulators on request.

Communication
Firms must have a communication plan must, which can be activated in the event of a service outage.

Effective communication to all stakeholders and customers is essential for minimising harm.

Outsourcing and third party risk management

In a nutshell

Operational resilience has increased the focus on third party and outsourcing arrangements. Historically, many high profile service outages and broader operational incidents have been due to failings in third party provisions, particularly from IT providers. In December 2019, the PRA published 'Outsourcing and third-party risk management', giving guidance on contract provisions, concentration risk, subcontracting and material outsourcing.

The PRA's approach puts the EBA's outsourcing guidelines into practice and formalises existing industry good practice in the context of operational resilience. It's important to remember that organisations retain the regulatory responsibility for all outsourced services, and regulators highlight the cumulative impact of outsourcing in terms of oversight and influence.

2021 timeline

Q1 The PRA will publish its final policy statement on outsourcing and third party risk management

Outsourcing and third party risk management

Core components

Legacy outsourcing

Firms are expected to update and renegotiate existing contracts to meet regulatory expectations and have until the end of 2021 to complete the process. This may include structural changes to the contract, services delivered, and updating key clauses. This is particularly challenging due to changes in personnel over time, and many managers inherit contracts without fully understanding the extent of them. It can also be difficult to reconstruct a contract to reflect current regulatory concerns. Firms must remember that outsourced activities remain the responsibility of the firm.

Material outsourcing

Firms must notify the PRA if they intend to outsource any material functions. These are functions that could threaten authorisation conditions, affect service continuity or impact financial performance.

Maintaining influence

Regulators are concerned about the degree of influence over a third party and the loss of direct oversight of an activity. This risk is heightened by the outsourcing supply chain, which can reduce effective governance and management control. Longer supply chains create greater risk, and contractual clauses may consider the right to approve sub-contracting and terminating a contract if it introduces unacceptable risks. This is more difficult for smaller firms where it is a challenge to obtain assurance from outsource providers.

Conversely, firms are expected to take a proportionate approach to intra-group outsourcing due to the increased oversight and influence from the parent organisation.

Overseas outsourcing to third countries, as the UK is post Brexit, must include a co-operation agreement between the competent authorities of each country to promoted effective supervision. The third country regulator must be willing to investigate regulatory breaches and have access to all relevant information to support oversight. In the event of stressed conditions within another in-group entity, the service provider must have appropriate distance and financial independence to continue service delivery.

Governance

While firms are free to outsource activities, they are encouraged to think of the cumulative impact of outsourcing. It must not be so extensive that the remaining organisation becomes an empty shell. To prevent this, firms must establish an outsourcing policy, with board level support, outlining how the firm differentiates between types of outsourcing, vendor selection, exit planning and oversight arrangements. Controls must be fit for purpose, with operational resilience in mind. Oversight for board regulated outsourced activities is a prescribed responsibility under the Senior Managers and Certification Regime, and firms must demonstrate compliance with relevant documentation.

Oversight arrangements include retaining the right to audit third parties, and access to data for assurance over regulatory and contractual compliance.

Concentration risk

The use of cloud technology and IT services are of particular concern for regulators. Regulators expect firms to make contingency plans in the event of an outage. In practice, there are often a limited number of providers in this space and there may not be many alternatives, or the same event may affect all providers.

Outsourcing register

Firms are expected to create a register, available on demand, listing all outsourced services. From September 2019, new contracts must be on the register, and firms have until December 2021 to add re-negotiated contracts. In time, this register may be centralised to mitigate concentration risk moving forward.

AI in financial services

In a nutshell

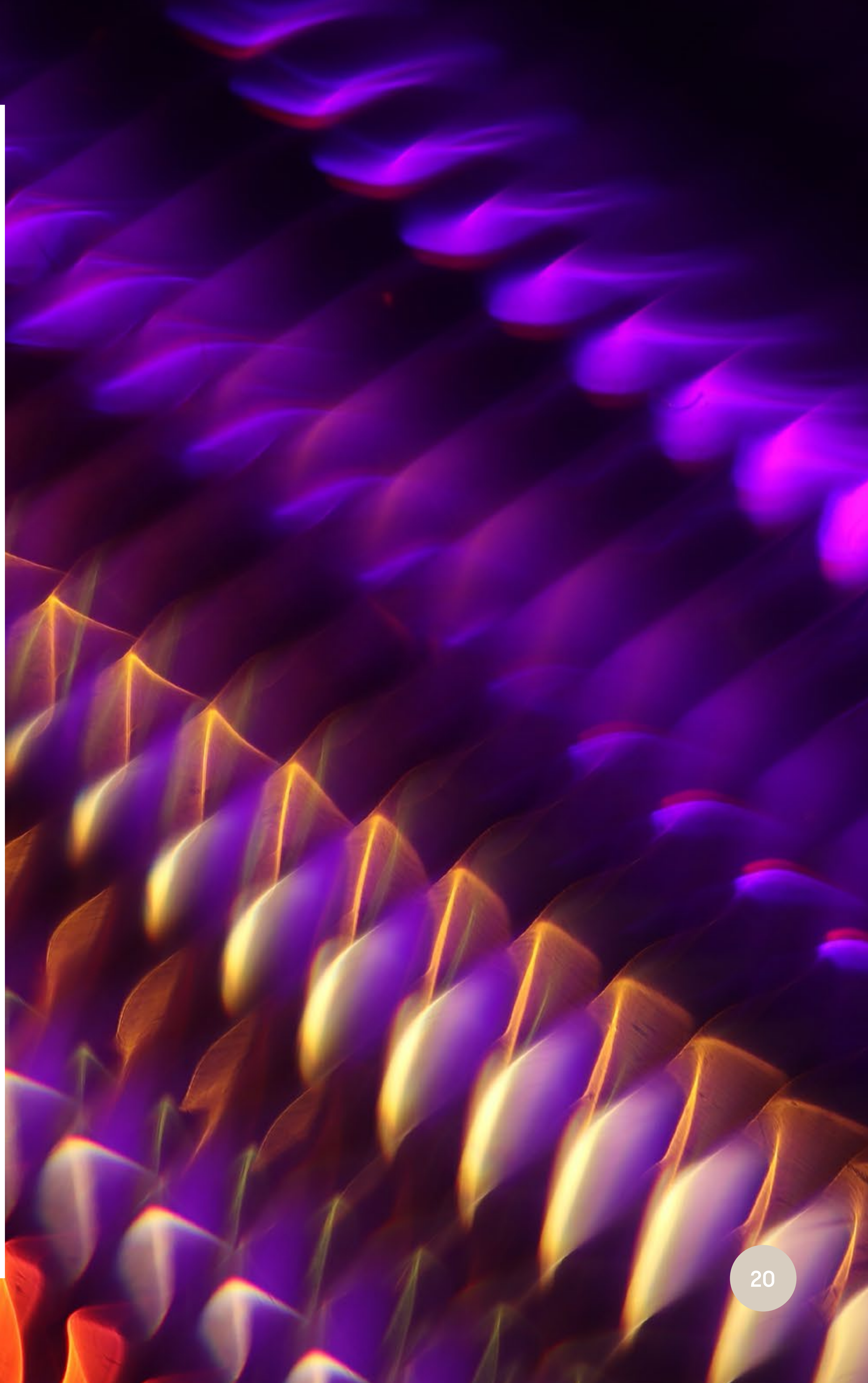
AI has an increasingly important role in financial services, as the volume of data expands, as well as the usability of tools and the growth in capable resource to support the development of AI-based solutions.
This is an area that has been subject to limited historic regulation, where current regulation covers elements of AI application. However, the FCA and the BoE are actively now looking at the use of AI through the AI Public Private Forum (AIPPF). It is likely further regulation, guidance, or oversight will be implemented in the years to come.

Core components

The BoE and FCA recognise the importance of innovation and the rise of fintech within the financial sector. However, the PRA and FCA have historically been slow to recognise the impact of AI on the industry, and how they are driving change across business models and key processes. In October 2019, the FCA published a research paper which noted key areas for use of AI, and institutions view of the risk posed by the technology.

As a result, the AIPPF was set up to:

- Share information and understand the practical challenges of using AI and ML within financial services, as well as the barriers to deployment and any potential risks or trade-offs
- Gather views on potential areas were principles, guidance, regulation or good practice examples could be useful in supporting safe adoption of these technologies
- Consider whether ongoing industry input could be useful and what form this could take (eg, considering an FMSB4 -type structure or industry codes of conduct)
- While this forum undertakes its work, firms should now look to understand their AI & Data Analytics footprint and key risks in preparation for future strengthening of the regulatory landscape



Operational Continuity in Resolution

In a nutshell

The UK's banks, building societies and PRA-authorised firms are subject to Operational Continuity in Resolution (OCIR) where they meet any one of these criteria: Total assets more than £10 billion, average safe custody assets over £10 billion or average total sight deposits (defined by the ITS on Supervisory Reporting) received exceed £350 million (all over the last 3 years).

The aim is to ensure the continuity of critical functions, from an operational perspective, through severe stress and resolution.

It is similar to operational resilience in its focus on the continuity of services, but it focuses specifically on 'critical economic functions' rather than 'important business services', and on resolution, and events that might occur in those circumstances.

OCIR includes requirements to have sufficient funds to support critical services, resolution-proof contracts with third parties and for firms to be able to map critical services supporting critical economic functions.

Key dates

1 January 2019

OCIR came into effect

31 December 2019

PRA109(OCIR) reporting date

October 2020

Updates to OCIR Policy published (CP20/20)

31 January 2021

Responses to the updates

Core components

OCIR consists of a number of components:

Critical Economic Functions (CEF's)
Identification of Critical Economic Functions (CEFs) to the systemically important services provided to the market.

Critical services
Identification, mapping of infrastructure to CEFs and processes to maintain the linkage to CEFs.

Financial resilience
Provision and maintenance of additional liquidity buffer required to cover fixed overhead requirements for critical services.

Operational resilience
Identifying critical services, adequacy of contingency planning and business resilience, arrangements to ensure adequate resources post resolution and impact of loss of key businesses.

Contractual service provisions
Arrangements that are robust post resolution, transparency of fee structures and arrangements to ensure transition of services to another body.

Objective service level agreements
Arrangements for objective SLA's where internal agreements are at arm's length (including clear rate schedules). Also, inclusion of stranded costs and transitional arrangements.

Access to operational assets
Processes to identify critical operational assets and arrangements (including agreements) for access to these assets post resolution.

Charging structures
Charging structures between recipients, inter-group suppliers and third party suppliers. This includes clear and comprehensive rate cards.

Governance arrangements
Governance arrangements over the critical service providers, including independence of the providers' governance and provisions for oversight. Also, the terms of provision of services to assess if these could disadvantage one of the entities.

Prevention of preferential treatment
The PRA has proposed amendments to support the Bank of England's approach to assessing resolvability as follows:

- There is a need for most or all functions to continue through the 'resolution weekend', in the bail-in period, and to allow for post-resolution restructuring
- In addition to critical functions, other business lines may need to continue to support the business while in resolution. In addition to infrastructure supporting its critical functions, consider operations that support the viability of the firm, and its key drivers of revenue and profit
- Financially, firms would need to cover group funding where these may not be accessible in time
- Amendments to the change capabilities are needed to support transitional service arrangements and the need for predictable and transparent charging structures
- There is a need take account of the differences between arrangements that occur within individual legal entities, within a banking group, or with third parties, based on the risks that each poses to operational continuity in resolution

"Given COVID et al, almost every financial services firm has adopted a working from home approach with varying degrees of success. Once lockdowns are behind us, we should be prepared for challenge and interventions from our regulators as to how control, supervision and oversight has been maintained and enhanced in line with activities conducted from home. Firms should be prepared to evidence controls, monitoring and risk management of such as well as how and when weaknesses in Operational Resilience have been identified, monitored and mitigated?"

Alex Shapland
Non-Executive Director, Financial Services

CRD V and CRR II

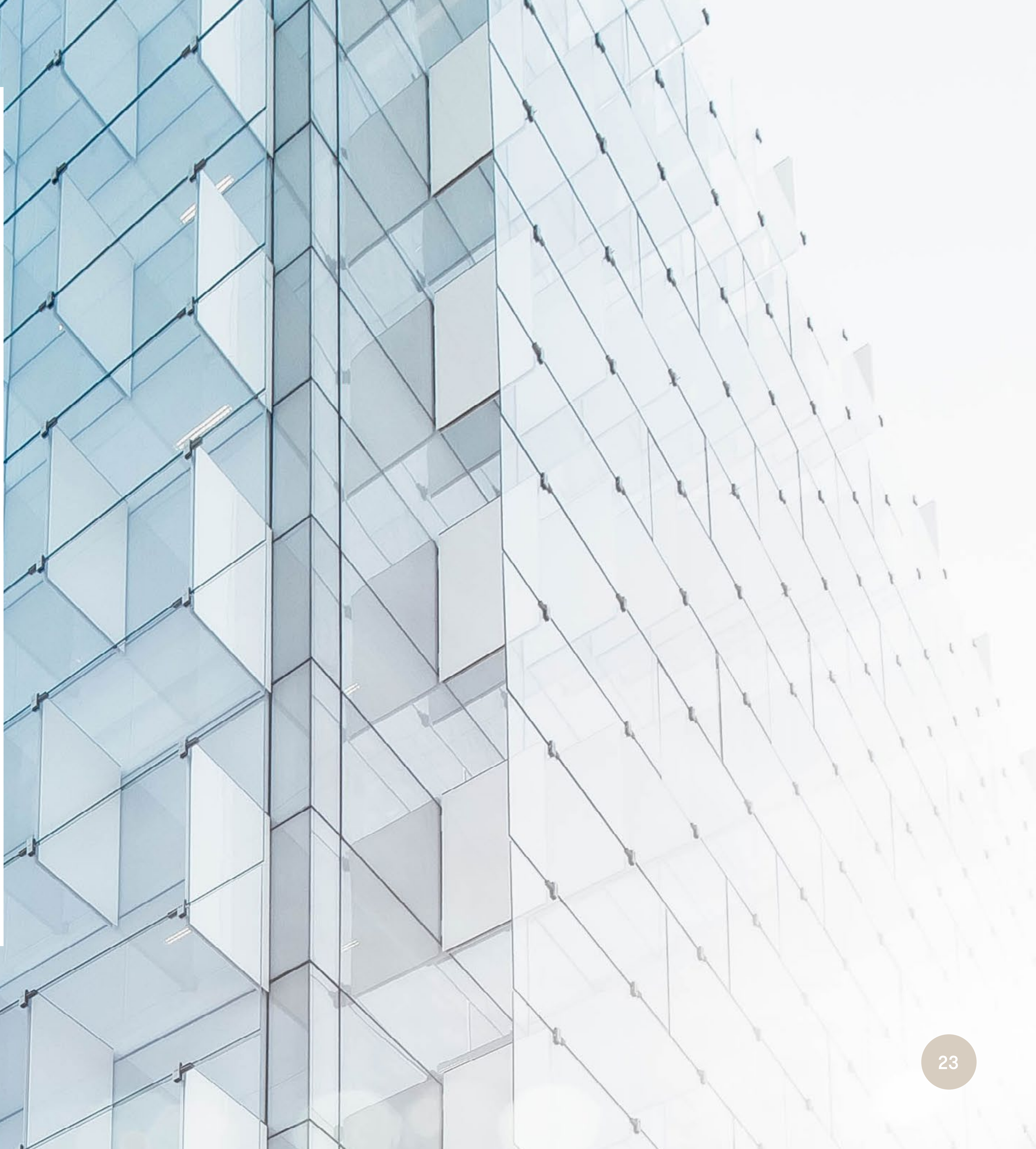
In a nutshell

CRD V implements Basel III, with additional prudential reforms through CRR II. To improve proportionality, CRD V introduces two new types of credit institutions – large institutions, and small and non-complex firms. From there, the regulations include changes to Leverage Ratios, Net Stable Funding Ratios, Large Exposures, Standard Approach to Counterparty Credit Risk, Pillar II and Pillar III requirements, consolidation and intermediate parent undertakings, and Environmental, Social and Governance (ESG) risks. CRD V/CRR II does not include the final reforms from Basel 3.1, which will be implemented in future regulation.

The UK has onshored CRD V and CRR II regulations and is in process of revisiting aspects as part of the on-going PRA consultation on implementation of Basel standards.

2021 timeline

3 May 2021	Closing date of on-going PRA consultation on implementation of Basel standards
28 June 2021	CRR II provisions apply in the EU, including Leverage Ratio, Net Stable Funding Ratio (NSFR), Large Exposure requirements, Pillar 3 and standardised approach for counterparty credit risk (SA-CCR)
September 2021	Reporting under standardised approach for market risk (FRTB-SA) start in the EU
1 January 2022	Expected UK implementation target date for CRR II analogous regulation in the UK



CRD V and CRR II

Core components

Leverage ratio

CRR II amends the own funds requirement to introduce a leverage ratio of 3% of tier 1 capital. It includes exclusions relating to Government lending, pass through promotional loans, officially guaranteed export credits, credit derivatives, and traditional securitisations, amongst others.

For G-SIBs, a buffer set at 50% of G-SIB risk weighted (range 1 to 3.5%). Capital distribution constraints on G-SIBs failing to meet leverage ratio buffer requirements.

Net Stable Funding Ratios (NSFR)

NSFR improves liquidity by making sure firms draw on a stable source of funding. The ratio becomes a binding commitment that it must be above 100% and is determined by Available Stable Funding (ASF)/Required Stable Funding (RSF), with some special treatments.

Large exposures

To reduce concentration risk, banks cannot have total exposures to a client, or group of connected clients, equal to or over 25% of its capital base (calculated on tier 1 capital). Any individual exposure that is 10% or over of a bank's capital base must be reported. The exposure limit between G-SIBs is reduced to 15%.

Standardised approach to counterparty credit risk

CRR II introduces a standard approach to counterparty credit risk (SA-CCR) for a more sensitive calculation of exposures against derivative transactions – specifically recognising hedging, diversification, and netting. It includes use of the original exposure method for firms with limited derivatives exposures and simplified SA-CCR for some organisations.

Pillar 2

Pillar 2 capital requirements have been applied inconsistently, and CRR II aims to improve standardisation through the following measures:

- The supervisory review and evaluation processes (SREP) should no longer address systemic risk but assess additional capital charges for micro-prudential risks only
- Pillar 2 cannot be used to address grandfathering or transitional risks
- Regulators must fully explain all Pillar 2 charges
- At least 75% of Pillar 2 charges to be met by Tier 1 capital (and at least 75% of this Tier 1 capital must be from CET1)

Pillar 3

New proportionality rules will impact Pillar 3 disclosures, including the content and frequency. Larger institutions must disclose information credit risk and mitigation, MREL, details of non-deductible holdings and ESG risks.

Consolidation rules and the intermediate parent undertaking (IPU)

If a third country group holds assets over €40 billion in the EU, with two or more EU entities, it musthave one intermediate parent undertaking (IPU) in the EU. Organisations may have two EU IPUs for separate consolidation groups if; the laws of the parent group's jurisdiction would otherwise be breached, or if it would make resolution more efficient. EU IPUs must meet EU prudential standards and they can be:

- A credit institution or financial holding company (subject to approval)
- An investment firm (for investment only groups with two IPUs due to separation rules)

Environmental, social and governance (ESG) risks

CRR II addresses ESG disclosures for large organisations, capital relief for loans (subject to sustainable finance conditions) and a mandate for the EBA to report on supervision of climate risk (due 2025).

"The world continues to face a formidable challenge. In the UK, the economic implications of the pandemic has seen regulators working closely with financial services firms and naturally prioritising financial and operational resilience, whilst continuing to raise the bar in fighting financial crime and safeguarding financial services customers. The UK financial services regulatory change agenda is expansive and requires the close and immediate attention of boards of directors and senior management."

Mark Carawan
Former Chief Compliance Officer, Citigroup

UK benchmark regulation

In a nutshell

Benchmark Regulation (BMR) has applied in the EU since 1 January 2018. At the end of the EU Exit Transition Period, retained and amended EU law has become effective in the UK as UK BMR.

Third country benchmark administrators will need to be approved through the recognition or endorsement regimes under UK BMR, unless an equivalence decision was adopted by HM Treasury. Under the existing transitional arrangements applicable under EU BMR and UK BMR, supervised entities are permitted to use all third country benchmarks until the end 2022.

The Financial Services Bill introduced in October 2020 proposes to extend this transitional period for third country benchmarks further until the end of 2025, in view of complexities for benchmark administrators to secure approval under UK BMR and potential impacts of UK users losing access to widely relied upon benchmarks.

2021 timeline

2020

31 December 2020 – UK BMR became applicable after 11 pm

2021

UK Financial Services Bill progresses in Houses of Parliament to get Royal Assent and become an Act of Parliament

31 December 2021 – End of current transitional arrangements for third country benchmarks under EU BMR

31 December 2022 – End of current transitional arrangements for third country benchmarks under UK BMR

31 December 2025 – End of transitional arrangements for third country benchmarks under UK BMR proposed in UK Financial Services Bill

UK benchmark regulation

Core components

Benchmark regulation

The EU Benchmark Regulation (BMR) was introduced in response to LIBOR, FX and gold benchmark manipulations and misconduct, which were subject to high-profile regulatory enforcement actions. The regulatory framework applies to benchmark administrators, supervised contributors, and benchmark users.

It regulates requirements relating to quality of input data and methodology, benchmark process, governance and controls, and greater transparency. It aims to ensure robustness and reliability, minimise conflicts of interest, prevent manipulation, and protect consumers and investors.

The UK BMR

With UK's exit from the EU, onshore benchmark regulation was amended to address some shortcomings and became retained EU law, effective as UK BMR at the end of the EU Exit Transition Period.

The FCA has introduced a UK Benchmarks Register, which applies to UK supervised users and UK or third country benchmark administrators, intending to offer their benchmarks for use in the UK.

Under the UK BMR, the FCA is responsible for:

- authorisation or registration of UK benchmark administrators
- recognition of third country administrators
- endorsement of third country benchmarks
- supervision of benchmark administrators, users, and contributors in the UK
- enforcement action

Benchmark administrators

UK entities looking to act as benchmark administrators in the UK require authorisation or registration.

Third country benchmark administrators need approval through the recognition or endorsement regimes unless equivalence decisions apply, but here are concerns around the legal framework for endorsement and recognition. A UK administrator approved under the UK BMR or a UK supervised entity acting as endorser take on some responsibility for endorsed benchmark(s) to meet UK BMR requirements, whilst recognition requires a UK legal representative to be accountable to the FCA with respect to obligations under UK BMR.

Once approved, UK and third country administrators will be added to the UK Benchmark Administrator Register, whilst the Third Country Benchmarks Register is a public record of all benchmarks by third country administrators.

Equivalence

Benchmark administrators domiciled in jurisdictions granted equivalence need to notify the FCA formally, for their benchmark(s) to be used in the UK. Lack of benchmark regulation in most non-EEA jurisdictions make equivalence of regulatory outcomes in the context of benchmarks difficult to determine.

Transitional arrangements

Under existing transitional arrangements applicable under EU BMR and UK BMR, supervised entities are permitted to continue using all third country benchmarks until the end of 2022.

Given the concerns and complexities, HM Treasury has proposed in the Financial Services Bill introduced in October 2020, to further extend the transitional period for all third country benchmarks to 31 December 2025.

This extension aims to prevent UK users losing access to benchmarks, with potentially adverse economic impact and risks to financial stability, given their widespread use in risk management and treasury functions.

In parallel, a cross-industry request endorsed by EU financial markets trade associations also aims to extend transitional arrangements for third country benchmarks under EU BMR to end of 2025 and allow a comprehensive review of the regime.

Resolvability Assessment Framework

In a nutshell

The Resolvability Assessment Framework (RAF) sets out the next step in implementing the resolution regime ensuring that firms are, and can demonstrate that they are, resolvable.

Firms must have the capabilities to support their resolution. The RAF clarifies firms' resolution responsibilities and sets out how the Bank and PRA will increase transparency and accountability.

Firms will have to address three components:

- Outcomes to support resolution and the ability to mitigate barriers to resolvability
- Assess resolution preparations and to submit a report to the Bank
- The Bank will publish resolvability elements of each bank, highlighting shortcomings/weaknesses

This affects UK banks and building societies with retail deposits equal to or greater than £50 billion. The RAF affects firms where the BoE has notified them that their resolution strategy is bail-in or partial transfer or they are considered a material subsidiary of an overseas-based banking group.

2021 timeline

First assessment report to be submitted by **October 2021**

Summary of the assessment report by **June 2022**

The Bank of England will issue the public resolvability statement in **June 2022**

Resolvability Assessment Framework (RAF)

Core components

Outcomes for resolvability

Resources
Firms must have financial resources available to absorb any further losses and recapitalise. This includes resources to meet its financial obligations in resolution. This means meeting the 'minimum requirements for eligible liabilities' (MREL), ability to support a timely assessment of its capital position and recapitalisation needs and ability to utilise liquidity in resolution.

Operations
Firms should ensure that its activities can continue while the authorities take charge and begin to restructure the firm, including any parts of it being sold or wound down. This includes ensuring that resolution does not result in a firm's financial and operational contracts being materially disrupted or terminated and that direct or indirect access to services delivered by financial market intermediaries is maintained.

Communication
Firms must be able to co-ordinate and communicate effectively within the firm and with the authorities and markets so that resolution and subsequent restructuring are orderly.

Barriers to resolvability

Minimum requirement for own funds and eligible liabilities (MREL)
A firm should maintain a sufficient amount of resources, that can be used to absorb losses and recapitalise the firm to a level that enables it to continue to comply with the conditions for regulatory authorisation and sustains market confidence.

Valuations
A firm's valuation capabilities should enable a valuer to carry out sufficiently timely and robust valuations to support effective resolution.

Funding in resolution
To ensure it continues to meet its obligations as they fall due, a firm should be able to estimate, anticipate and monitor its potential liquidity resources and needs, and utilise liquidity resources in the approach to and throughout resolution.

Early termination of financial contracts (stays)
A firm should address the risk of early termination of financial contracts upon entry into resolution, to limit any impact on its stability and the wider financial system (eg, market contagion) resulting from resolution.

Operational continuity in resolution (OCIR)
These arrangements should ensure continuity at the point of entry into resolution and permit any post-stabilisation restructuring, to ensure the continuity of banking services and critical functions.

Continuity of access to financial market infrastructure
A firm should be able to take all reasonable steps available to facilitate continued access to clearing, payment, settlement, and custody services in order to keep functioning in resolution.

Restructuring planning
A firm should be able to plan and execute restructuring effectively and on a timely basis in the event of resolution, taking into account the objectives applicable to that firm's preferred resolution strategy.

Management, governance and communications
During resolution a firm should be able to ensure that their key roles are suitably staffed and incentivised, that their governance arrangements provide effective oversight and timely decision making, and that they deliver timely and effective communications to staff, authorities and other external stakeholders.

Report assessment of resolvability

Firms should cover the following:
- The group structure and the resolution strategy
- Capabilities of resources and arrangements for resolution
- Anticipated timeline for resolution steps
- Summary of internal testing
- Summary of the governance processes

Public disclosure should include
- Understanding of the firm's resolution strategy
- Capabilities of resources and resolution arrangements
- Steps still to be taken to address gaps
- Any issues which could prevent resolvability

Open Banking implementation

In a nutshell

Open Banking is driven by the EU's Payment Service Directive (PSD2) regulation which came into force on 13 January 2018. Open Banking provides Third Party Providers (TPP) access to customer data from banks and financial institutions based on consent from the payment service user.

Open Banking aims to achieve the below objectives:

- Enable Payment Service Users (PSU) to access account information such as balances, transaction for accounts held at Account servicing payment service providers (ASPSPs) via Account Initiation Service Providers (AISPs)
- Enable Payment Service Users (PSU) to initiate payment order with respect to a payment account held at Account Servicing Payment Service Providers (ASPSPs) via Payment Initiation Service Providers (PISPs)
- To provide good customer experience in terms of redirection between channels such as web and app
- Enable users to manage consents that have been granted to Third Party Providers (TPP) putting users in control of data

2021 timeline

1 January 2021	UK ASPSPs to support eIDAS and an alternative certificate for TPP identification
1 July 2021	UK ASPSPs to support Article 34 compliant alternative certificate for TPP identification

Open Banking implementation

Core components and scope

Account servicing payment service providers should establish a dedicated interface or allow the use of the interfaces used for authentication and communication with the account servicing payment service provider's payment services user for regulated TPP's. For the purpose of TPP identification, payment service providers shall rely on qualified certificates.

TPP Identification - Transition Period

UK ASPSPs need to comply with amendments to the open banking identification requirements (eIDAS certificates) from 1 January 2021. This requires ASPSPs to accept eIDAS certificates and at least one alternative form of certificate.

During the transition period, ASPSPs can accept a certificate obtained from a provider of an API programme that does not meet the requirements of the revised Article 34. The use of these certificates is only valid when TPPs have also presented a compliant certificate to that API programme and is subject to conditions in amendment. This transitional arrangement will end on 30 June 2021.

Continued conformance

The exemption from establishing contingency a mechanism can be revoked where obligations for dedicated interface or problems related to dedicated interface are not met by the account servicing payment service providers for more than two consecutive calendar weeks. In such cases, FCA will ensure that the account servicing payment service provider establishes a contingency mechanism within the shortest possible time and at the latest within two months.

Support for channels

ASPSPs are required to support redirection on all digital channels and support methods of authentication which PSU's are offered directly. To comply, ASPSPs offering online banking and mobile banking are required to support web-to-web redirection as well as app-to-app redirection for Open Banking journeys.

Propositions for 2021

The UK's Open Banking Implementation Entity has published an updated roadmap in May 2020 showing propositions such as variable recurring payments, consent, and access dashboards with proposed implementation dates in 2021.

Resolution/Valuation in Resolution

In a nutshell

Resolution is the process to manage the failure of a bank, building society, central counterparty and certain types of investment firm with the aim of minimising the impact on depositors, the financial system and public finances. Firms are required to have arrangements and plans in place should a resolution be needed.

These plans should consider whether a firm:

- Has enough resources to support a resolution considering its ability to absorb losses, recapitalise and continue to meet financial obligations
- Can continue operations during and after resolution
- Has effective processes to communicate within the firm, with the authorities and with the market

The valuation of assets and liabilities is a critical and integral part of the resolution process as it informs if the firm is failing, or likely to fail, and if it needs to enter resolution. Firms must be able to carry out valuations promptly, with appropriate data, management information and skilled resources.

2021 timeline

As detailed below, the Bank of England extended deadlines for firms to achieve compliance with resolution measures to alleviate operational burdens on PRA-regulated firms in response to the COVID-19 outbreak.

- Resolvability assessment framework for major UK banks and building societies – deadline extended by a year from **October 2020 to October 2021**
- Resolvability assessment framework and minimum requirements for own funds and eligible liabilities (MREL) for mid-tier banks – deadline extended by a year from **1 January 2022 to 1 January 2023**
- Valuation in resolution – implementation of controls and processes was extended by three months from **1 January 2021 to 1 April 2021**
- **During 2021**, the Bank of England will review the MREL framework, including resolution strategy thresholds, the calibration of MREL, instrument eligibility and the application of MRELs within banking groups

Core components

Resolution

Resolvability Assessment Framework

The Resolvability Assessment Framework consists of the following three key components which aim to address the typical barriers to an orderly resolution:

1 Firms must have adequate resources and liquidity to meet their financial obligations without the need to rely on public funds. This includes maintaining minimum requirements for own funds and eligible liabilities (MREL) to absorb losses and support re-capitalisation. Firm must also have an accurate and current valuation of their assets.

Continuity is key to a smooth resolution that will enable business services and operational processes to operate and support clients, counterparties and suppliers, and reduce the potential for economic harm or financial instability. To achieve this firms must have effective operational continuity in resolution processes (OCIR) with the ability to:

- Manage the risk of early contract termination, which could result in market contagion
- Ensure that market infrastructure services, such as clearing, can operate as normal
- Be able to plan and execute required restructuring activities

2 Effective management and oversight are critical to the resolution process as staff, regulatory authorities, legislators and market participants need clear communication on resolution plans, progress and timelines.

Types of resolution

Firms are required to develop resolution plans and agree them annually with the Bank of England. The preferred resolution strategy for each firm depends on factors such as how much harm its failure would cause to the wider economy and what kind of structure it has. The three main types of resolution as are follows:

1 Bail-in: this is the preferred strategy for the largest firms (i.e. with a balance sheet size of £15 billion to £25 billion) that provide vital services to the UK economy and covers the UK's G-SIBs and D-SIBS and a number of other medium sized firms. In this scenario the firm's equity is written off and debts written down in order to absorb losses. The firm is then re-capitalised with the debtholders whose debt was written down issued equity to become the new shareholders. The firm will then be restructured to address the causes of failure and restore market confidence.

2 Transfer: this is the preferred strategy for smaller and medium-sized firms that could credibly have a buyer for all or part of the business. These firms will tend to provide transactional accounts to customers relied on for day-to-day payments and cash withdrawals. The firm is sold as soon as possible and in the event of any delay its critical functions will be transferred to a temporary bridge bank controlled by the Bank of England until the sale is complete.

3 Modified insolvency: this is the preferred strategy for smaller firms that could be put into insolvency without risking financial stability or depositors. These firms would not supply transactional accounts or other critical functions on a scale likely to support the use of resolution. The firm would enter insolvency with compensation for eligible depositors or the transfer of depositor accounts to a healthy firm or a bridge bank.

Firms with a resolution strategy that involves bail-in or partial transfer must maintain sufficient equity and debt resources that can absorb losses and provide recapitalisation for resolution. MREL is the minimum amount of qualifying equity and subordinated debt that a firm must maintain to support an effective resolution. MREL must meet certain requirements to ensure it can be relied upon to support resolution. MREL ensures that investors and shareholders rather than taxpayers absorb losses when a firm fails.

Resolution/Valuation in Resolution

Resolution plan transparency and assurance

In addition to establishing effective resolution plans, firms are also required to provide transparency and assurance that adequate processes are in place. As such, major UK banks (that have potential to cause the most disruption to the financial system) must:

- Assess the extent to which resolution planning is fit for purpose and report findings to the Prudential Regulatory Authority (PRA)
- Publish a summary of that report
- Appoint a senior manager who will be accountable for resolution assessments and associated activities

The report to the PRA should include a summary of the group structure, including elements that would support or hinder resolution, as well as details of the resolution strategy. It should also include a summary of how to execute the strategy, any potential barriers and a timeline for mitigating any identified risks. Details of OCIR arrangements, resolution planning testing and governance processes should also be included.

Contingency planning

An orderly resolution requires effective contingency planning. The Bank of England (BoE) has provided a three-stage timeline to carry planning through to action as follows:

1 The BoE will look at a firm's financial strength under stressed conditions and decide if the firm is failing, its overall value, potential recapitalization needs and long-term viability. This requires timely and accurate valuations of a firm's assets and liabilities and may be impacted by market conditions and other factors such as potential restructuring options. Given the complexities, firms must test their capabilities and processes ahead of time.

2 Where possible, the resolution process for a failing firm would take place over a weekend to minimise disruption across the market with the BoE informing the public, appointing an administrator and ensuring clear communication to all stakeholders.

3 Within a month of the resolution weekend, the firm must submit its restructuring plan and details of how it will achieve viability. Key considerations include valuation capabilities, restructuring options and effective scenario planning. If the BoE is satisfied that plans are robust and credible, the firm will return to private control. This post bail in stage is expected to last between three and six months during which time the firm will remain under the control of the BoE.

Valuation in resolution

The timely and accurate valuation of assets and liabilities is an integral part of the resolution process as it informs if a firm is failing or likely to fail and if it needs to enter resolution. Firm's must therefore have in place robust governance and oversight, management information systems, and valuation and data provision capabilities to support valuation in resolution and test applicable valuation capabilities which should be able to periodically produce the following three valuation scenarios:

1 The accounting value based on the firm's regulatory balance sheet in line with normal accounting rules. This informs the assessment pre-resolution of conditions for use of resolution tools where a firm is failing or likely to fail.

2 The economic value which comprises:
   - An asset and liability valuation based on fair, prudent and realistic valuations based on hold or disposal scenarios. This informs the extent of losses to be addressed in resolution and any restructuring plans through scenario analysis
   - An equity valuation based on estimated market value of the firm's equity reflecting resolution and restructuring. This provides an indication view of the firm's post resolution value, informs the allocation of equity to bailed in creditors and determines the no creditor worse off (NCWO) compensation

3 A liquidation or 'gone concern' basis based on estimated recoveries to creditors in hypothetical insolvency. This is used to provide an indication of NCMO risks pre and during resolution to help determined NCWO compensation.

Firms must ensure that they have in place appropriate systems, processes, controls and appropriately skilled resources to produce these valuations. This requires establishing adequate governance and oversight over valuation processes, ensuring access to required data and information, establishing and documenting appropriate valuation methodologies (including the testing and validation of any valuation models) and performing a periodic independent review.

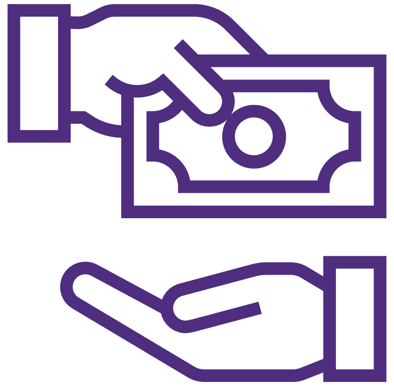
Financial crime prevention

Financial crime compliance continues to challenge both longstanding and recently regulated firms and is likely to remain a focus for regulators and law enforcement throughout 2021. In a post Brexit world, the UK is likely to have the opportunity to innovate in its approach to combating financial crime but this will be tempered by our new status as a 'third country' in the eyes of the European Union. Expect to see more examples of divergence, particularly in the Sanctions arena, over coming months.

What has been obvious to most financial crime professionals, that combating financial crime requires greater levels of collaboration across sectors and increasing use of technology, is likely to influence policy and the legislative agenda throughout the coming year. In particular, expect to see proposals for greater sharing of pre-suspicion information between institutions and more expansive exchange of data in payment pathways. Vulnerable customers suffering significant losses due to fraud has reached unprecedented levels that have only been exacerbated by the pandemic.

2020 arguably saw the successful application of the 'unexplained wealth order' and we are likely to see further examples of its successful deployment in 2021. We should also see some 'failure to prevent' cases come into the public domain which, depending on outcome, may influence the Law Commissions thoughts on whether the UK would benefit from the application of the same approach to 'Economic Crime'. Wider Government is likely to remain laser focused on delivering the many items of change set out in the UKs economic crime plan.

There has been a continued drive for greater transparency both in public and so-called private life over the last few years and we do not expect 2021 to be any different. Regulators in both the UK and our nearshore centres are likely to continue to develop their regulatory frameworks to facilitate greater disclosure by clients to their financial institutions. Those firms will, in turn, be expected to take risk-based decisions on customer retention consistent with their self-declared risk appetite. Firms who tolerate higher levels of risk without sufficient mitigants in place should expect greater regulatory scrutiny.



The UN Office on Drugs and Crime (UNODC) estimates that between 2 and 5% of global GDP is laundered each year - that's between[1]

€715billion &1.87 trillion

"The latest FCA Financial Crime Guide sets the bar high for firms operating in financial services, to ensure compliance with criminal financial and money laundering regulations. The Guide is no substitute for formal advice on procedures as the FCA makes clear that primary legislation and secondary regulations take precedence."

Chris Daw QC
Millennium Chambers, London

[1]https://www.europol.europa.eu/crime-areas-and-trends/crime-areas/economic-crime/money-laundering

Financial crime prevention

The Sanctions and Anti Money Laundering Act 2018

As a member of the EU, the UK was required to apply sanctions in accordance with regulations made by the European Council[1]. With the departure from the EU, the UK had to create a legislative framework to allow the Government to impose sanctions and perhaps more crucially to provide the means to ensure existing sanctions would continue to have effect so that the UK would remain in compliance with its obligations as a member of the UN Security Council[2].

The necessary powers were passed into law by the Sanctions and Anti-Money Laundering Act 2018 (SAMLA) which received Royal Assent on 23 May 2018 and for the most part came into force 21 November 2018[3]. The powers under SAMLA broadly mirror the approach to sanctions under the EU.

However, SAMLA also enables the UK to impose sanctions in response to acts of gross violation of human rights. This new power was first wielded in July 2020 when the UK Government announced financial sanctions against 49 individuals and organisations for their involvement in human rights violations including individuals involved in the torture and murder of Russian lawyer Sergei Magnitsky and the murder of the journalist Jamal Khashoggi.[4] The EU adopted a similar regime in Dec 2020[5].

Arguably the most significant change for the regulated sector in the UK is the provision which will allow the UK to impose sanctions not only on specified persons and entities, but also on a 'prescribed description of persons connected with a prescribed country'. This allows the Government to target groups of individuals, for example the board and senior management of an organisation, without specifying the names of the targeted individuals. For the regulated sectors and increasingly for corporates which operate internationally, a key control for sanctions compliance is the screening of customer and counterparty names against the OFSI published consolidated list of sanctions targets. This screening process is typically automated using technology to compare system-based records of customers against the list of sanctioned individuals and entities to identify matches between the two sources. Should the Government decide to sanction a 'class' of persons, the current automated screening processes would not be effective in identifying those matches.

Update to FCA guidance

FCA published changes to its Financial Crime Guide (FCG) on 30 September 2020[6].

The changes to the FCA Financial Crime Guide (FCG) were added to sections 3.2.4 and 3.2.7 and mirror the text of provisions relevant to CDD within the Money Laundering and Terrorist Financing (Amendment) Regulations 2019, but the FCG has not been updated to include guidance on FCA expectations specific to the new sections.

Given that the Firms were obliged to adopt the Regulations from 10 January 2020, the update of the FCA Financial Crime Guide should not oblige Firms to conduct additional gap analysis or implementation plans. The advantage is that the FCG now provides record of regulatory requirements which is consistent with the legislation.

An updated version of the Financial Crime Guide which incorporates these changes was made available from 1 December 2020 on the FCA website

(Source: https://www.handbook.fca.org.uk/instrument/2020/FCA_2020_45.pdf)

[1] Article 31(2) The Treaty of the European Union https://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_1&format=PDF

[2] Article 48 Charter of the United Nations https://www.un.org/en/sections/un-charter/chapter-vii/index.html

[3] The Sanctions and Anti Money Laundering Act 2018 (Commencement No. 1) Regulations 2018.

[4] OFSI Financial Sanctions Notice 6th July 2020 https://assets.publishing.service.gov.uk/Government/uploads/system/uploads/attachment_data/file/898044/Notice_Global_Human_Rights_060720.pdf

[5] EU 2020/1998 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R1998

[6] Financial Crime Guide (Amendment no.4) Instrument 2020

Financial crime prevention

‘Online harms’ consultation

Overview
The UK has published a response to its consultation on so-called online harms. The response indicates that the Government is to bring forward an Online Safety Bill that will set out the new regulatory framework which will be applied to in-scope firms.

The proposals can be found here.

The central pillar of the proposed Framework is a new duty of care, the aim of which is to make companies responsible for user safety and to prevent various types of harm arising from access to online content.

The proposals indicate that the new regime will be overseen by a regulator, expected to be Ofcom, who will be responsible for enforcing the new regime. Broadly speaking the powers that will be placed in the hands of Ofcom will be very familiar to those of us who deal with the FCA and other conduct regulators including establishing expected standards of conduct, reporting obligations for firms and substantial fines and penalties for non-compliance.

The Government’s initial response to the consultation noted that a number of respondents urged for the extension of the proposals to be extended to harms caused to users by online Fraud.

The financial impact of online fraud on customers is considerable and continues to be a scourge on users of financial services who are often too easily duped, through various social engineering techniques, into parting with their hard-earned funds to online fraudsters.

It is likely, in our view, that pressure to include online fraud will increase as the bill makes progress through both houses. We understand that some opposition MPs and key stakeholders are likely to promote amendments to the Bill as it is introduced. Financial Services firms should continue to keep “watching brief” on the progress of the Bill and look to engage in the debate if this becomes appropriate.

The response that Government will be pursuing ‘other mechanisms’ in the fight against online fraud should be read in the context of the UKs Economic Crime Plan.

One possible avenue of legislative change that might have been used to hold firms to account in this area was the proposed introduction of a ‘Failure to prevent Economic Crime’ offence that would most likely have included ‘Fraud’ within the definition of Economic Crime. The Law commission has been tasked with seeking expert input on the current legal framework and that will not be due to report until the 4th quarter of 2021.

In our view it is likely that proposals for the increased sharing of information between firms responsible for initiating, making, receiving online payments will be proposed at some point and firms should stand ready with their own views on what form those proposals should take. Sharing of information between firms involved in payment-pathways, across sectors, is likely to be a key element in combatting online fraud but is likely to face a significant degree of scrutiny given likely GDPR concerns over the exchange of personal information.

The UK imposed
£706 million
in AML fines in the first 6 million of 2020 (compared to £444 million in whole of 2019)[1]

The World Bank estimates
£1.4 trillion
(USD1.75 trillion) changes hands globally in bribes every year[2]

[1]https://www.ft.com/content/a547e6ed-5a2e-48c4-bbee-febbf975e4af]
[2]https://www.worldbank.org/en/topic/governance/brief/anti-corruption

Financial crime prevention

'Failure to prevent economic crime' offence?

November 2020 saw the Government publish its response to its Call for Evidence on the possibility of legal reforms relating to corporate liability for economic crimes.

In marked contrast with the approach taken for the 'failure to prevent the facilitation of tax evasion 'offence introduced in the Criminal Finances Act 2017 (where consultation was sought only on the draft legislation and guidance), the Government have taken a more gradual and measured approach on this subject to date.

The Government's November response essentially concludes that the CfE was inconclusive. Whilst the current requirement to demonstrate the involvement of the 'controlling mind' of a company makes establishing corporate liability difficult, there were insufficient examples where corporates had evaded liability as a result. In addition there was no clear preference amongst respondents between the proposed reforms.

The Government did recognise the need to assess the impact of changes to the economic crime legal landscape since the original CfE (including CFA 2017, MLR 2017 and 2019 and SM&CR), and have tasked the Law Commission with completing an expert review of the current law. This is set to report towards the end of this year and is likely to help shape the future of reform in this area.

In our view, it is unclear whether the measured approach taken so far represents a Government attempt to kick the can down the road, or reflects a real desire to work with businesses more collaboratively on legal reform in this area. Certainly Lisa Osofsky, Director of the SFO, has been vocal in backing a 'failure to prevent economic crime' offence, stating in October last year that it was at the top of her "wish list"8. Whilst a strict liability style offence would likely impose a significant compliance burden on businesses, it may remain a popular choice as an effective tool in the fight against economic crime.

The annual cost of fraud in the UK is

£190 billon

estimated at with £140 billion of this suffered by the private sector (NCA)[1]

Money laundering costs the UK more than

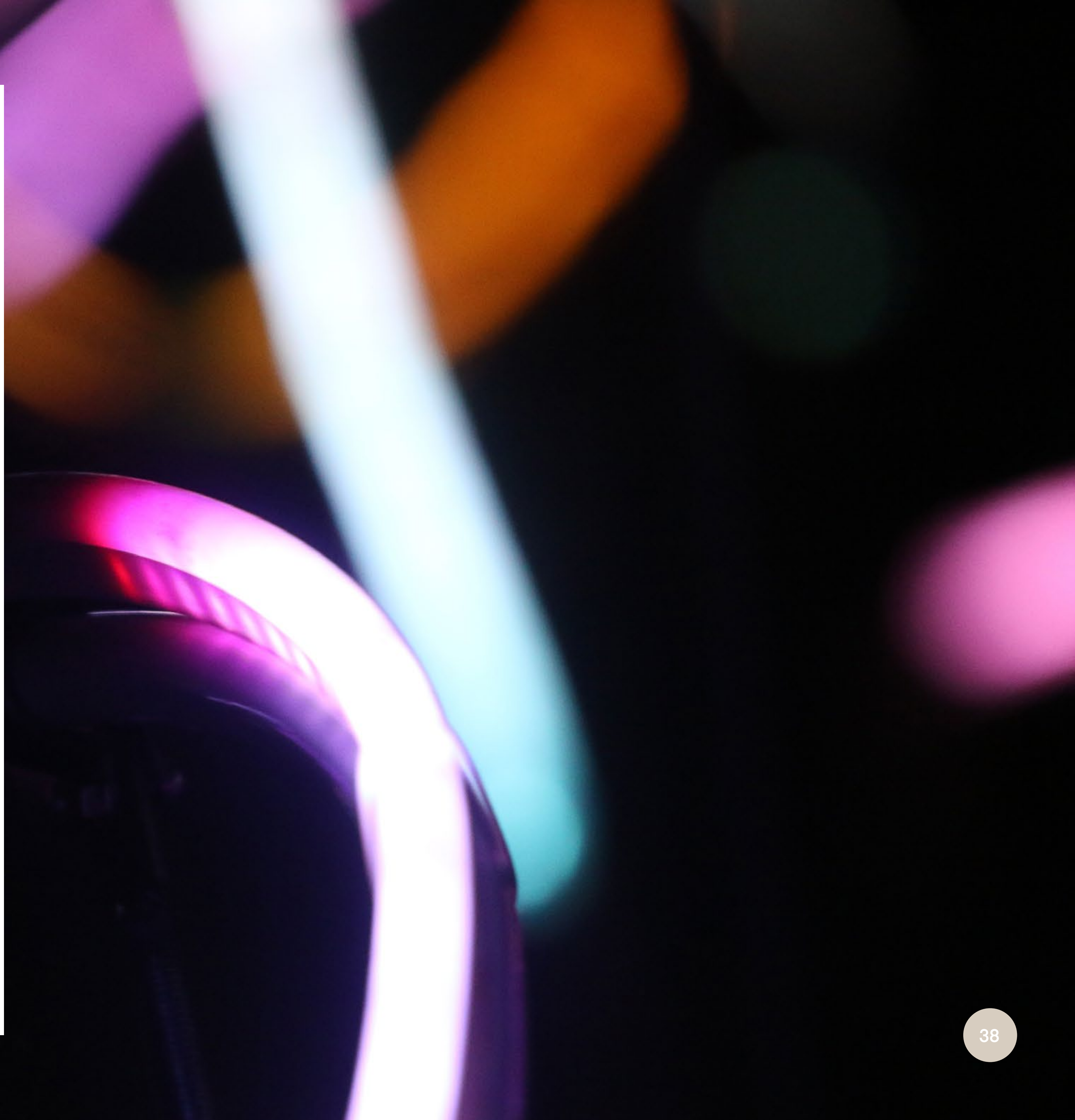
£100 billion

per year according to the National Crime Agency[2]

[1]https://www.nationalcrimeagency.gov.uk/what-we-do/crime-threats/fraud-and-economic-crime

[2]https://www.nationalcrimeagency.gov.uk/news/national-economic-crime-centre-leads-push-to-identify-money-laundering-activity

Fintech



In a nutshell

The fintech sector has been through turbulent times in 2020, as the level of uncertainty and volatility presented some tremendous challenges to a number of businesses. Yet, opportunities within the sector are only growing and so is its overall imprint in the financial services industry. In the last few years fintech firms proved that they are not only disrupting the market but that they can become serious players and present a real competition to many of the FS incumbents by offering innovative solutions and setting new standards in delivering customer satisfaction.

Latest figures estimate that the fintech market in the UK is approximately £11 billion and growing. With that, it is only expected that regulators take bigger and bigger interest in how the sector is regulated and what are the potential risks that it may present to consumers and the market.

The Kalifa review of UK Fintech, which was published on 26 February 2021, sheds more light on the Government's priorities with regards to Fintech and highlights a number of recommendations for strengthening the UK Fintech market. Alongside that though, there are a number of key trends and regulatory initiatives in the pipeline that will have direct impact and will further shape the fintech sector in 2021 and beyond

Core components

Regulating crypto-assets

A key development in the Fintech market was the introduction of the supervisory regime over cryptoasset activities with the implementation of the Anti-Money Laundering Directive 5 (AMLD 5) in the beginning of 2020, which required firms engaged in such activities to comply with the Money Laundering Regulations. Firms were given until 10 of January 2021 to register with the FCA under the new regime if they were to continue trading. Although the FCA's authority under the regime is limited to registration supervision and enforcement, it is clear that the regulator will apply a firm and robust approach so to ensure customer protection. The key message is that the FCA will make no exceptions and firms undertaking crypto-assets activities cannot avoid financial services regulation if they want to stay in business.

To further emphasise this, the cross-authority Taskforce on crypto-assets at the HM Treasury issued a consultation on expanding the scope of crypto-assets, which fall under the FCA Financial Promotions regime, with its results due in 2021, and has published a new consultation, which aims expanding the entire regulatory perimeter for crypto-assets. The move stems from the rapid growth in the use of stablecoins as a means of transaction, investing and storing funds and the risks these activities present. This is further enforced by the new EU regulations on Markets in Crypto-Assets (MiCA), which are currently in draft, but have a central place in the Digital Finance Strategy developed by the EU Commission. Although with Brexit this new piece of law may not have a direct application in the UK, given the digital nature of the crypto-assets market, it is likely that EU expectations for what constitutes safe investments, will have significant implications for UK registered firms too.

Update on the joint FCA/PRA Digital Regulatory Reporting Initiative

The joint FCA/PRA Digital Regulatory Reporting (DRR) Initiative, which aims to explore emerging technologies that can automate and digitise regulatory reporting, thus eventually reducing firms' costs, received its first independent review in September 2020. The report incorporates a number of recommendations with regards to proposed operating models, technical solutions and implementation of the DRR initiative. The FCA and PRA are jointly working on the response of these recommendations and we are expecting an update, next steps and more broadly further engagement with the industry throughout 2021 with a view to provide further clarity to firms. It should be noted that across the board regulators all over the world are exploring technology solutions to drive innovation internally and this will inevitably frame some aspects of the Fintech market; the UK being in the driving seat.

Fintech as an enabler of payment services

The payment services sector has seen significant growth in the last few years. Customer interest and demand for alternative finance solutions offered by fintechs have been on steady increase and in fact, further accelerated by the pandemic and the huge shift towards online payments. The EU Commission is due to publish in 2021 its Revised Payment Services Directive and taking into account the global nature of payments, this will inevitably impact on UK PayTech firms too. It is likely that the demand for alternative finance solutions, digital payments and peer to peer platforms will only increase going forward with no return to traditional payment methods, thus new regulations in the sector are only to be expected as the payments and supervisory regulators in the UK tend to have a pro-active approach in coining the consumer protection rules; fintech payments and COVID 19 only reinforcing this.

Open Finance

The results from the FCA's call for input on Open Finance are due to be published in the first quarter of 2021. The concept for Open Finance builds on the Open Banking initiative and is aimed to extend open banking principles to give consumers and businesses more control over a wider range of their financial data, such as savings, insurance, mortgages, investments, pensions and consumer credit. The 2020 CMA report on Open Banking highlights the benefits and the positive impact the reform has had since it was implemented in 2018, but it also points that there is much more to be done. This tallies well with the overall consumer trend of higher personalisation of products and services and the wider use of data insights by organisations. It is only natural that the FCA will take a leadership role in shaping Open Finance in a push to ensure consumers can benefit from more financial choices and solutions that can truly allow them to manage their money efficiently and safely.

Sustainability as a key fintech driver

Where Fintech firms can make a real difference, and much quicker than incumbents, is in the development and deployment of financial technology that enables ESG and sustainability. If there are any positive highlights from 2020, this is the focus on environmental, social and governance matters that the year has brought to all of us. There are a number of new regulations in relation to disclosure, transparency and risk management that are coming into force in 2021, and that present an incredible opportunity for the Fintech sector to be a driver for a real positive change. This can be achieved not only via sophisticated data analytics tools that support the Asset Management industry in satisfying the increasing demand for sustainable investments, and solutions that help firms measure, record and offset their carbon emissions, but also via crafting new ways of how things are done, how products are designed and how they deliver positive outcomes; we view Fintech as being at the heart of answering all these. These Fintech solutions should build on the sophistication of the financial services industry and the application of financial technology to make businesses more efficient but coupled with a bigger social goal in mind so not only that the Fintech sector grows and expands but society and we are the ultimate all winners by making our planet a better place to live on.

Transforming data collection, regulatory reporting and regtech 2.0

In a nutshell

Transforming data collection and regulatory reporting are key components of PRA, FCA and Bank of England strategy as evidenced by a number of Dear CEO letters, the Bank of England's Data collection review and the FCA's future Data collection work programme.

Regtech or regulatory technology is any technology, data or innovation which seeks to reduce the regulatory compliance burden resulting in a reduction in manual work, an improvement in sustainable compliance and generally a reduction in costs.

When implemented correctly regtech's intertwined with the appropriate operating model, governance, content and process changes results in improving regulatory reporting returns (as evidenced by the Dear CEO letter of 31 October 2019 from the PRA).

The regtech industry has matured significantly in the last 2-3 years. Regtech firms have become more innovative and 'solution orientated' as opposed to 'technology led'. Forward thinking regulated firms have developed both a regulatory change and regtech strategy with a clear target operating model. These forward thinking regulated firms have invested in implementing regtech's (externally) intertwined with inbuilt data models and technology architecture to develop best of breed models. Regulators have been very active in espousing the use of Data and Regulatory Technology in a number of announcements.

It is interesting to note that the global regtech market is ~$30 billion and is expected to grow to $55 billion by 2025 (source: Bloomberg).

2021 timeline

The PRA expressed focus on regulatory reporting and data collection with the Dear CEO letter on Reliability of regulatory returns on **31 October 2019**. It is to be expected that given wider challenges in 2020, this wasn't an area of focus.

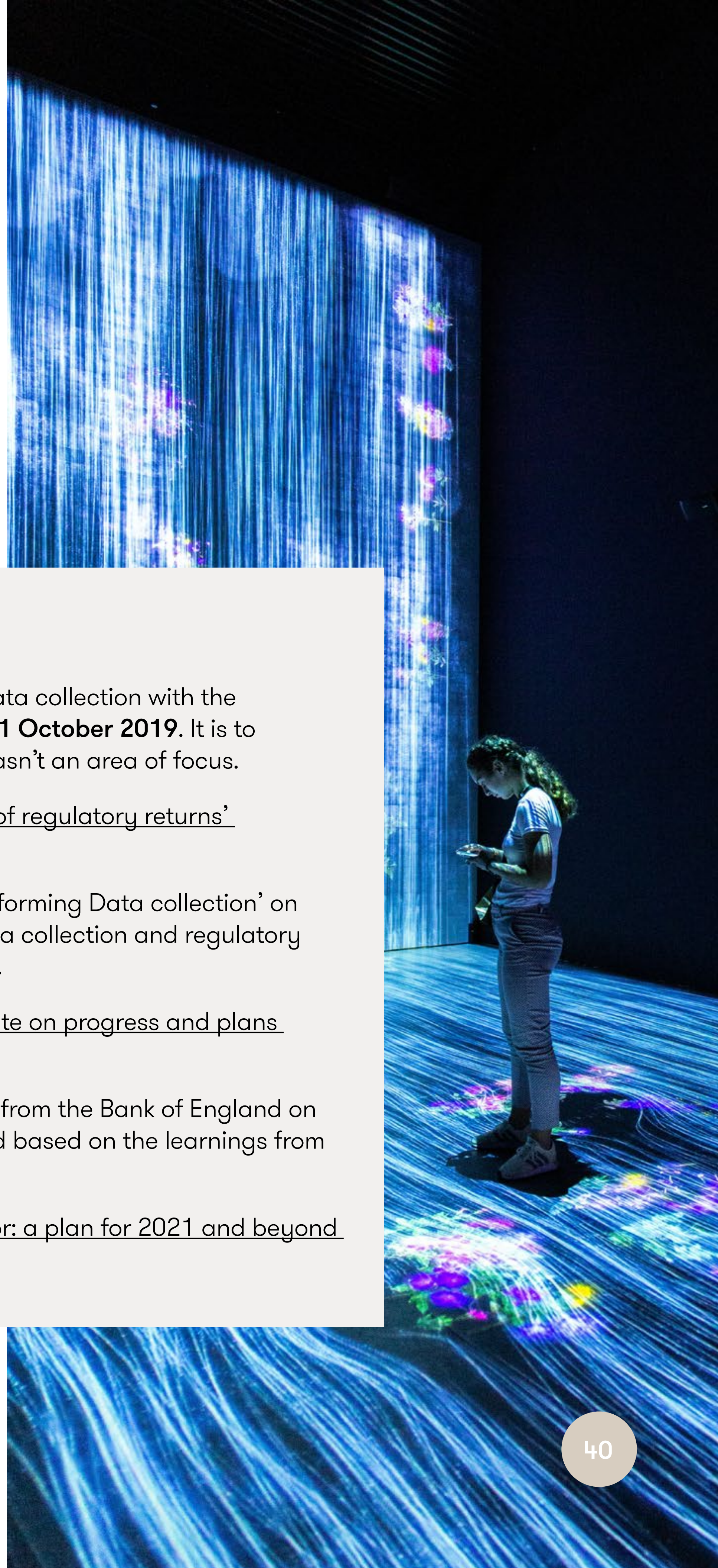
Letter from Sarah Breeden and David Bailey 'Reliability of regulatory returns' | Bank of England

However coupled with the recent Dear CEO letter 'Transforming Data collection' on **23 Feb 2021** from both the PRA and FCA, we expect data collection and regulatory reporting to be an areas of focus in 2021 and into 2022.

Dear CEO letter: Transforming data collection - an update on progress and plans for 2021 (fca.org.uk)

It is also worthwhile referring to the detailed publication from the Bank of England on 'transforming data collection' plan which was developed based on the learnings from the Digital Regulatory Reporting (DRR) pilot.

Transforming data collection from the UK financial sector: a plan for 2021 and beyond | Bank of England



Core components

As the various regulators continue to provide additional focus on data collection, regulatory reporting, preventing financial crime prevention, data protection, advances in tax data collection and reporting; regulated firms need to develop an effective regtech strategy to respond to the challenges and indeed opportunities this creates.

Approaching each new data collection, data quality, regulatory reporting or customer data protection, know your customer/know your business in a federated siloed manner will be extremely costly, will require re-work and will not enable benefits to be generated from this activity.

In our experience, leading firms approaching thee challenges are developing both a regtech strategy and Regulatory Data strategy (as part of the overall Data strategy) to respond to these challenges.

Regtech strategy

A regtech strategy is developed by first understanding the current state (1) the current regulatory platforms, applications and processes which are involved in responding to regulation, (2) the known issues, regulator actions (which could also involve section 166 reviews), audit issues, inefficient controls aligned to the risk framework; and the opportunities to leverage existing in-flight technology programs. Following this assessment, a focused view of the (3) forthcoming regulatory focus. It is clear from the recent FCA, PRA and Bank of England publications, that the data collection, good quality data, data governance, regulatory models, and regulatory reporting) will need to be prioritized and feature heavily. These three components will form the basis of the regtech strategy and will then enable firms to make build, buy or best of breed solutions.

Following the development of the regtech strategy, firms could undertake a horizon scan of the regtech software which is available in the market linked to some sort of regtech taxonomy. Grant Thornton's Data, Regulatory Change, regtech and Digital Assurance practice has developed a regtech Taxonomy with 14 components to enable regulated firms to navigate the complexity of the different solutions within the regtech market and how these address specific regulatory issues (from horizon scanning, regulatory controls to regulatory reporting).

If a decision has been made to buy, the regulated firm would generally need independent expert advice on evaluation, selection and implementation support for the most appropriate regtech software firms. It is critical that implementation of a regtech software solution is coupled with changes to the operating model, processes and procedures and governance (including roles and responsibilities).

Regulatory data strategy

Most companies already have a Data Strategy typically consists of both defensive and offensive approaches to reduce risk, streamline operations, and generate value. Key considerations include the market your business operates in, your regulatory profile, customer expectations, competitor behaviour and your supply chain. A Regulatory data strategy is a key component of the defensive part of your data strategy (customer data and financial data feature heavily) – it needs to be continually updated to keep upto date with what the regulators are expecting in terms of data collection, storage, processing and use for decision making, insights and importantly regulatory reporting and public company reports (ie annual report).

The Dear CEO letter on transforming data collection makes specific focus on three elements:

- Improving the quality of data and the processes and technology legacy to improve efficiency (in effect technology debt and data debt)
- Interpretations of regulatory requirements into machine readable formats and transmission methods to reduce any lost in translation issues
- Adopting common data standards across the industry

These are not small undertakings and the fact that both the PRA and FCA have aligned on data collection, data quality and regulatory reporting should indicate the importance. We would also suggest regulated firms pay particular attention to the Bank of England's 'plan for transforming data collection'.

The development of both an effective regtech strategy and regulatory data strategy is critical to respond.

Investment management

"While landmark changes to prudential rules will impact every investment manager this year, there are also several more focused changes which will impact certain business models."

David Morrey
Partner – Head of Investment Management
T +44 0(20) 7865 2657
E david.morrey@uk.gt.com

Investment management
Key regulatory developments

The investment management sector can rightly look back with a collective sense of achievement for how it dealt with the 2020 global pandemic and its myriad challenges. Firms showed an operational dexterity in almost overnight shifting entire workforces to remote working, whilst the investment management sector managed to withstand the most dramatic shock on financial performance with revenue performance and growth in AUM remaining relatively strong in comparison to other sectors.

However, the BAU factors affecting the sector have not gone away, and these challenges will continue through 2021. Some of those existing trends will be accelerated by the effects of COVID-19, whilst others that were previously background considerations are moving to the top of the agenda. The challenge many managers will face is how to deliver the strategic improvements they know are necessary for the long-term success of their business now, as some of the more tactical responses to COVID-19 continue through the year.

The FCA will continue to keep close watch on the operational and financial resilience of firms in the immediate future and will maintain its laser focus on customer outcomes across the sector as the wider economic shock of the pandemic continues to impact financial services retail customers. Criticism of the FCA in the Gloster Report on the LCF collapse has stung, and the implementation of the recommendations in that report will dictate much of the FCA's internal agenda for 2021, both in the sector and more generally in its wider supervisory approach.

There is a significant schedule of regulatory change across the sector for 2021, which will demand time and effort across front office, compliance and risk, finance function and system change resource. In this section, we look in detail at the regulatory developments that we consider will likely have most impact on Firms. Specifically, we consider:

Platform rule changes

Rules to simplify platform transfers have been produced and will become effective from 1 February 2021. A consultation will take place in Spring 2021 on whether a ban on exit fees may be appropriate, which we consider to be the likely outcome.

A new UK prudential regime for MiFID investment firms

Due to the industry raising concerns around the general volume of reforms in 2021, the FCA has decided to target an implementation date of 1 January 2022 for this new regime. The FCA published its discussion paper for the UK investment prudential regime (IFPR) in June 2020, with the first of its consultation papers and draft handbook text released in December 2020. Further consultations and the final rules will follow in 2021.

Pensions and retirement income

Since 2018 the FCA and The Pensions Regulator have pursued a joint strategy to co-ordinate and harmonise their efforts to improve access to and understanding of pensions, and consumer outcomes, across their respective remits. 2021 will see considerable further joint activity, particularly on improving value for consumers via a consistent approach.

Fund liquidity

The FCA is looking to make additional changes to the way that funds which invest specifically in property operate. The key new requirement would be a fixed notice period which investors must comply with before redeeming their investment. This notice period, of between 90 and 180 days (to be confirmed) would allow the property fund to sell underlying assets if it needed to.

Platform rule changes

In a nutshell

The FCA Investment Platform Market Study (MS17/1) identified two primary issues which it considered were inhibiting competition between different investment platforms, leading to poor customer outcomes. These were the difficulty consumers encountered in some cases in transferring their assets between platforms (requiring time and effort which could discourage such transfers from happening), and the application by some platforms of 'exit fees' creating a cost to transfer.

Rules to simplify platform transfers have been produced and become effective from 1 February 2021. A consultation will take place in Spring 2021 on whether a ban on exit fees may be appropriate, which we consider to be the likely outcome.

2021 timeline

1 February 2021	implementation of platform transfer rules
Spring 2021	FCA consultation on exit fees following the Investment Platforms Market Study

Platform rule changes

Core components

Platform transfer rules

In their Investment Platform Market Study, the FCA identified several practical challenges which made it difficult for investors to transfer their assets between platforms, discouraging competition. These included:

- Platforms which did not support in-specie transfers (an in-specie transfer involves the re-registration of an investment with a different platform without the need for that investment to be sold and then re-purchased in the market, thereby avoiding dealing costs and the potential crystallisation of a tax liability)
- Platform specific share classes on some fund investments which platforms were unwilling to have transferred to a platform which had not negotiated the same unit class attributes (usually fees) with the fund manager
- Receiving platforms not migrating new customers to the most cost-effective unit class they offered even though the customer would be eligible for that class

From 1 February 2021 the following rules, set out in PS19/29, apply to platforms:

- Both ceding and receiving platforms must offer consumers an 'in specie' transfer option when the same investment fund is available on both platforms
- If the fund on the ceding platform is held in a unit class that is not available on the receiving platform then the ceding platform must request the fund manager to convert that consumers investment to a share class accepted by the receiving scheme, and the fund manager must take reasonable steps to bring that about, this including a requirement that they process these conversions on a timely basis (waiting for a number of requests to accumulate before processing them on a periodic basis, for instance, being prohibited)
- Where a receiving platform has a fund unit class which is more favourable than the one being transferred in by a consumer, they must offer that consumer the option to convert to the more favourable unit class at point of transfer (or they may opt to automatically default the consumer to the new unit class if they consider this is in the consumer's best interest)

Exit fees

The Investment Platform Market Study identified exit fees imposed by platforms as one of the main barriers to consumers transferring their assets.These exit fees include fees levied on a transfer (either as a fixed charge or a percentage levy), account closure charges, withdrawal fees and fees for 'in-specie' transfers.

In CP19/12 the FCA included a discussion chapter (not a rule consultation) on whether exit fees should be banned, including consideration of alternatives such as an exit fee cap. To prevent firms circumventing any ban the FCA suggested it would word the ban in such a way that any charge which only arose on a transfer, even if it were worded in a way that it was not directly linked to the transfer, would be captured. The discussion paper indicated the FCA's view was that a ban was more appropriate than a cap.

Significantly the discussion included the proposal that, for there to be a level playing field between different types of financial services firm, any ban on exit fees should also apply to other firms which hold investments on behalf of consumers, such as wealth managers, fund managers and life assurers.

By including non-platforms, the FCA has stated its intention is to ban exit fees on like for like services provided by fund managers, life assurers etc., which means that exit charges for moving an investment product to a different administrator would be banned, not exit charges that might be embedded in the individual investment products themselves. How this ban is worded in draft rules, and therefore how it might apply in practice, will be more apparent following the publication of the consultation by the FCA in spring 2021.

UK prudential regime for MiFID investment firms

In a nutshell

On 26 June 2021, the Regulation (2019/2033) and Directive (2019/2034) on the prudential requirements of investment firms will be applicable to MiFID Investment firms. Whilst no longer members of the EU, and therefore not obliged to implement the EU's rules, the FCA has proposed to introduce a UK regime that will achieve a similar intended outcome as the IFD/IFR. Due to the industry raising concerns around the general volume of reforms in 2021, the FCA has decided to target an implementation date of 1 January 2022 for this new regime.

The purpose of the proposed framework is to simplify the prudential classification of investment firms and establish a single, harmonised approach by reducing the complexity of the existing system. This means that certain systemically important firms will be reclassified as credit institutions and subject to the prudential requirements set out in the CRR and CRD. All other investment firms will be subject to the new prudential framework and therefore subject to revised own funds requirements, remuneration and governance standards.

The FCA published its discussion paper for the UK investment firm prudential regime (IFPR) in June 2020, with the first of its consultation papers and draft handbook text released in December 2020.

Key dates

2019 - 2020

Final IFD/IFR published in the Official Journal

EBA produces RTS on the prudential requirements

FCA published discussion paper

FCA announce new implementation date

FCA published its first consultation paper and draft sourcebook

January to June 2021

FCA publishes consultation paper

June 2021

Regime becomes effective in EU

January 2022

Regime implemented in UK

Core components

On implementation of the UK specific rules, all existing prudential categories of investment firm will cease to exist. All in-scope investment firms will be subject to new the Prudential sourcebook for MIFID Investment Firms (MIFIDPRU).

Classification of investment firms

Investment firms that are authorised in accordance with the provisions of MiFID will be affected by the IFPR, and fall into one of four categories:

- Systemically important firms: firms with total assets over EUR 30 billion in value that carry out MiFID activities of dealing on own account or underwriting of financial instruments. These firms will meet the new definition of a credit institution under IFR Art 62(3)(a) and, therefore, be subject to the prudential requirements set out in CRR and CRD
- Certain large firms that deal on own account and/or underwrite on a firm commitment basis will remain classified as an investment firm (MiFID) but will be subject to the prudential requirements under CRR and CRD
- Small and non-interconnected investment firms (SNIs): these are very small firms with non-interconnected services and meet the criteria in IFR Art 12(1). As a SNI they benefit from additional proportionality and so less onerous prudential requirements. This includes their reporting, disclosure and remuneration requirements
- All other Investment firms: these are non-systemic investment firms that are not defined as SNIs investment firms

Own fund requirements

SNIs will have a minimum own funds requirement that is the higher of the PMR and the FOR. Investment firms that are not SNIs will have a minimum own funds requirement that is the higher of the PMR, the FOR and the KFR.

Permanent minimum requirement

An investment firm's PMR is the same as its initial capital that is required to be authorised with its current permissions.

The initial capital requirements for investment firms will be:

- £750,000 for investment firms authorised to provide one or more of the following MiFID services: dealing on own account, underwriting of financial instruments and operating an organised trading facility without a limitation
- £75,000 for investment firms not permitted to hold money or securities belonging to their clients and are authorised to provide one or more of the following MiFID services: receiving and transmitting orders, executing orders on behalf of clients, portfolio management and investment advice
- £150,000 for all other firms

Fixed overhead requirement

The IFR now applies the FOR to all investment firms, set as one quarter of the fixed overheads of the previous financial year.

K-factor requirements

This is a new approach to determine the minimum own funds requirement.

There are three categories of k-factors:

- Risk-to-client (RtC) – covers risks carried by an investment firm during its services, actions or responsibilities, which could negatively impact clients
- Risk-to-market (RtM) – applies capital requirements against the impact an investment firm could have on the markets in which it operates, and on those counterparties it trades with
- Risk-to-firm (RtF) – is intended to capture risks to an investment firm's solvency from its trading activity and market participation

K-factors for RtC that could apply to any investment firm that undertakes relevant business

K-AUM	Assets under management
K-CMH	Client money held
K-ASA	Assets safeguarded and administered
K-COH	Client orders handled

K-factors for RtC that could apply to any investment firm that undertakes relevant business

K-DTF	Daily trading flow
K-NPR	Net position risk
K-CMG	Clearing margin given
K-TCD	Trading counterparty default
K-CON	Concentration risk

Liquidity requirements

The IFPR introduces minimum quantitative liquidity requirements to all investment firms. Currently, not all UK investment firms must satisfy quantitative liquidity requirements under BIPRU 12. Under the UK regime the FCA intends to extend new liquidity rules to all UK investment firms. The IFR requirements of one-third of the FOR held as liquid assets, will be recognised as a baseline, with FCA using the review process where necessary to require an investment firm to meet additional liquidity standards.

Regulatory reporting

The IFPR introduces a more appropriate and proportionate reporting requirements than that under the current CRR.

Pillar 2 requirements

The IFD introduces the concept of the internal capital and risk assessment (ICARA) and contains provisions on Pillar 2 requirements based on existing requirements in CRD IV. The FCA have suggested changing how they set supervisory requirements under Pillar 2. This would be a legal minimum requirement (P2R), replacing the current Individual Capital Guidance (ICG), and, where appropriate, also an additional buffer to sit on top of the minimum requirements (P2G). This is in relation to both the amount of own funds and liquid assets the FCA assesses the investment firm should hold.

Remuneration

The provisions on remuneration contained in the IFD do not apply to small and non-interconnected firms.

The key proposed changes are:

- The removal of a specific limit for the ratio between variable and fixed component of variable remuneration
- The introduction of the exemption for small and non-interconnected firms
- The introduction of the exemption from the variable remuneration requirement concerning deferral and pay-out in instruments
- Establishment of Remuneration Committee for certain non-SNI investment firms

Pensions and retirement income

In a nutshell

The pensions landscape has changed significantly during the last decade, following the introduction of workplace pension auto-enrolment requirements the so-called pensions freedom changes.

Since 2018 the FCA and The Pensions Regulator have pursued a joint strategy to co-ordinate and harmonise their efforts to improve access to and understanding of pensions, and consumer outcomes, across their respective remits. 2021 will see considerable further joint activity, particularly on improving value for consumers via a consistent approach.

The FCA will continue its intensive supervisory activity on DB pension transfer advice, following publication of its final guidance attempting to increase the clarity of its expectations following recent significant changes to rules and expectations regarding advice in this area.

The new FCA investment pathways regime for non-advised income drawdown will finally take effect in February 2021, alongside some associated increases in the responsibilities of providers' Independent Governance Committees.

2021 timeline

January – FCA publication of its Defined Benefit Advice Assessment Tool ('DBAAT')

February – FCA implementation of PS19/21 and PS19/30 rules on investment pathways and enhanced IGC responsibilities

TPR consultation on the regulatory framework for DB scheme funding

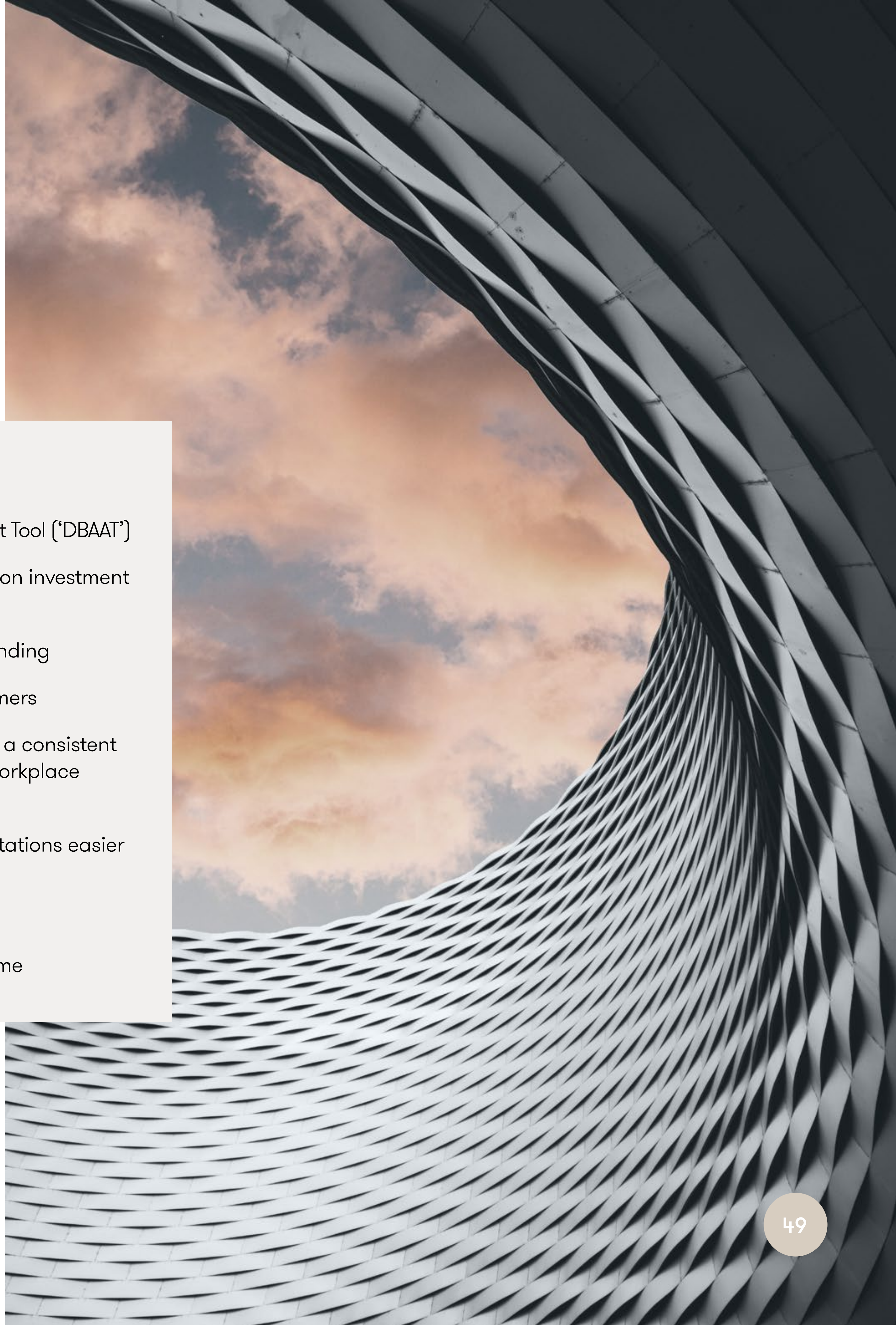
FCA consultation on default investments for non-advised consumers

FCA/TPR joint Discussion Paper on further measures to promote a consistent approach to the assessment of value for money across all DC workplace pension schemes

TPR – a single, consolidated Code of Practice, to make its expectations easier to understand

TPR – a review of TKU requirements

TPR – an initial assessment of superfunds under the interim regime



Pensions and retirement income

Core components

FCA and TPR joint strategy – value for money and the consumer journey

The FCA and The Pensions Regulator (TPR) have different statutory remits. However, they face similar fundamental challenges with Defined Contribution (DC) pensions, including improving access to and understanding of pension savings, reducing scams, increasing value for consumers, and improving retirement outcomes. Consumers are increasingly likely to have multiple DC savings pots – both workplace and non-workplace – whose providers are subject to supervision by both regulators.

In October 2018, the FCA and TPR launched a joint regulatory strategy, to extend and deepen their co-operation by coordinating their work to tackle their regulatory priorities over the next decade. An important part of this joint strategy is a commitment to improving value via a consistent approach across the pensions landscape.

Significant FCA-regulated providers of pension products are already required to have an Independent Governance Committee (IGC), to assess the value to customers of workplace pension schemes. FCA Consultation Paper CP20/9 (which closed in September 2020) proposed means to help IGCs compare the value of their products and services with similar arrangements, to drive improvements.

The CP20/9 proposals would require firms' IGCs to examine three areas of value: costs and charges, investment performance (net of fees) and services, including customer communications. This is with the aim of assessing, on an ongoing basis, whether there an alternative, similar scheme in the market offering materially lower costs and charges for a similar experience. The IGC would then have to inform the provider if that was the case. The IGC could also take up the issue with a sponsoring employer (and the FCA if it is not satisfied with the firm's response).

The proposed rules would require IGC annual reports to state, one way or the other, whether it considers the schemes and funds to offer value for money to customers. The FCA aims to publish a Policy Statement and Final Rules in respect of these proposals during 2021.

During 2021 the FCA and TPR will publish a joint Discussion Paper on further measures to promote a consistent approach to the assessment of value for money across all DC workplace pension schemes.

We expect the FCA and TPR to publish a joint Discussion Paper inviting views on how the pensions consumer journey works for savers and if it can be improved to help consumers make better decisions about their pension saving during 2021, followed by a Feedback Statement.

Defined Benefit pensions

The FCA will continue its ongoing wide and deep review of advice given to consumers to transfer Defined Benefit (DB) assets out of occupational schemes. The FCA has conducted four rounds of supervisory activity since the pensions freedoms changes in 2015, with the aim of preventing or rectifying unsuitable DB transfers. The latest, which began in mid-2019, is the largest and most in-depth industry-wide review of DB transfer advice yet, and firms with DB advice permissions were asked to submit more data on their activity to the FCA in November 2020.

Following a period of significant change on the rules and guidance for advice on DB pensions and transfers, including the introduction of the Appropriate Pension Transfer Analysis and Transfer Value Comparator, the FCA published PS20/6 in December 2020, with final rules and guidance intended to help advisers understand its expectations of them when giving DB pension transfer advice. Further supervisory activity and enforcement action is likely during 2021.

Away from DB transfer advice, TPR plans:

- A single, consolidated Code of Practice, to make its expectations easier to understand
- A consultation on the regulatory framework for DB scheme funding
- A review of the current knowledge and understanding requirements for trustees (TKU)
- An initial assessment of superfunds under the interim regime for the regulation of superfunds. Superfunds facilitate the severance of an employer's liability towards a DB scheme, either by replacing the employer with a special purpose vehicle (SPV) employer, or replacing the employer's liability to fund the scheme with a capital injection to a capital buffer

Pensions and retirement income

Retirement Outcomes Review remedies

As a result of FCA Policy Statement 19/21 (published in July 2019), from February 2021 consumers entering income drawdown, or transferring assets already in drawdown to a new provider, without taking advice must be presented with four options – 'investment pathways' – for how they might want to use their pot. The four investment pathways relate to consumers' intentions and timing for accessing their pension savings. (There is an easement for smaller providers – those with fewer than 500 members entering drawdown each year – who will have to present the investment pathways but will not be required to offer solutions themselves).

Pension providers must also ensure that non-advised consumers entering drawdown invest wholly or predominantly in cash only if they have taken an active decision to do so. They must give warnings to those consumers who decide to invest in cash, as well as those already in cash, that their investments will diminish in purchasing power.

Providers must give consumers in decumulation annual information on the costs and charges, expressed as a single pounds and pence figure.

In Policy Statement 19/30 (published in December 2019), the FCA confirmed that there will be a new duty for IGCs to oversee the valuefor money of investment pathway solutions for income drawdown.

PS 19/30 also confirmed a new duty for IGCs to consider and report on their firm's policies on environmental, social and governance (ESG) issues, member concerns, and stewardship, for all products that IGCs oversee.

These rules were due to take effect in August 2020 but were deferred to February 2021 due to the COVID-19 pandemic.

Non-workplace pensions

The FCA aims to consult on measures on default investments for non-advised consumers who do not or cannot engage with their investment decision, to protect consumers and promote competition.

Fund liquidity

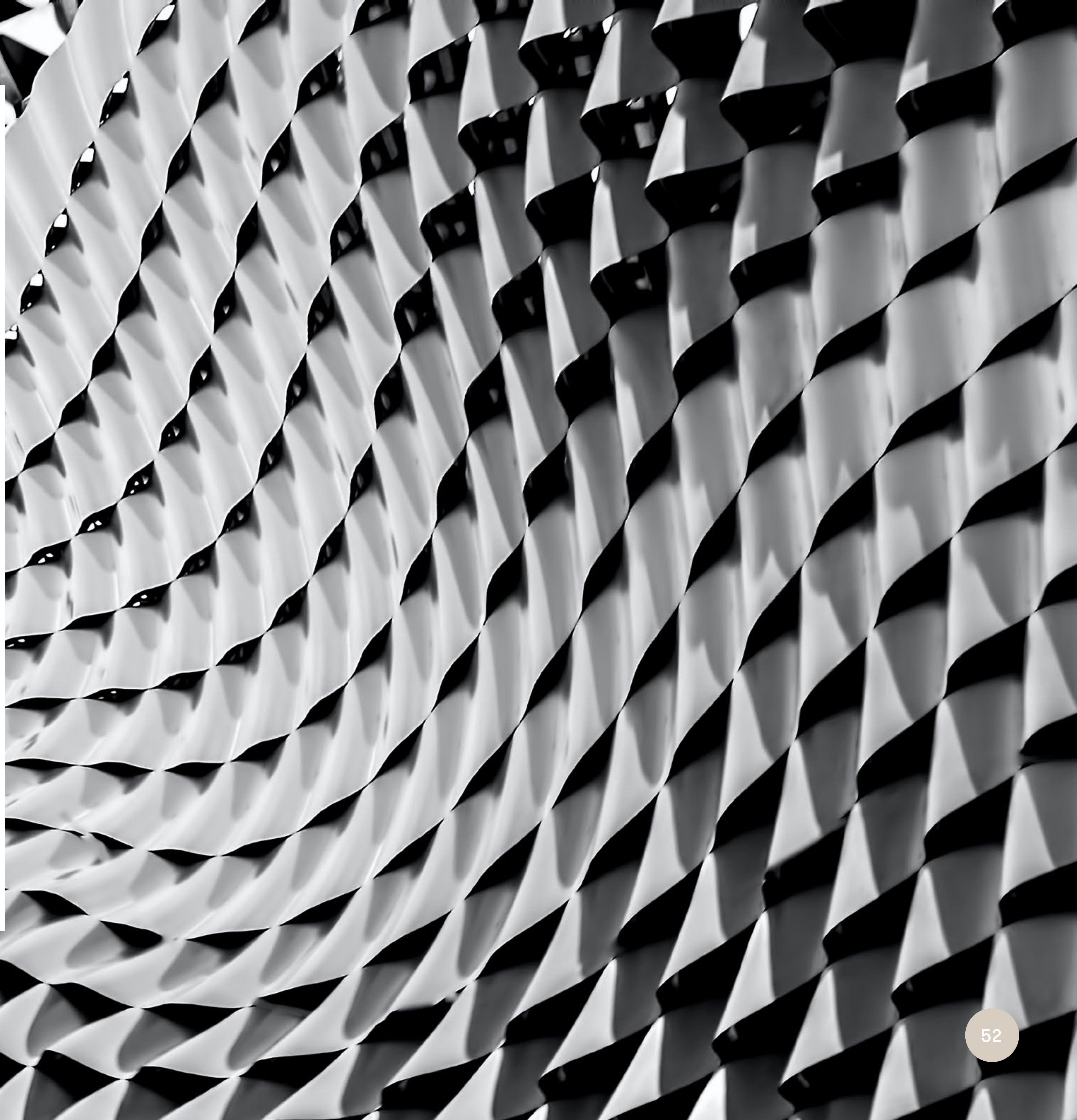
In a nutshell

From 30 September 2020 investment funds which are structured as Non-UCITS Retail Schemes (NURS) and hold a significant quantity of traditionally illiquid assets have been designated ‘Funds investing in inherently illiquid assets’ (FIIA). These must comply with specific rules on disclosure/risk warnings, suspend dealing where there is material uncertainty on the valuation of 20% or more of the fund’s assets, develop liquidity contingency plans and be subject to an enhanced role for fund depositories to oversee liquidity risk.

In addition to these recently introduced requirements, the FCA is looking to make additional changes to the way that funds which invest specifically in property operate. The key new requirement would be a fixed notice period which investors must comply with before redeeming their investment. This notice period, of between 90 and 180 days (to be confirmed) would allow the property fund to sell underlying assets if it needed to.

2021 timeline

Spring – Final rules issued and implementation date confirmed



Fund liquidity

Core components

The FCA is concerned that FIIA's invested specifically in property have an inherent mismatch between the dealing terms of their investors (often able to trade in and out of the fund daily) and the assets of the fund, which take weeks or months to sell. The result of this is that these funds carry large cash balances to meet the redemption requests of investors, which in turn suppresses investment performance for all investors as that cash is not invested in return generating assets. In addition, as the experience of Brexit and COVID has shown, daily dealing in these funds has had to be suspended on a not infrequent basis due to market uncertainty, which is detrimental to investors who expected the flexibility of daily dealing.

The FCA's proposals are that property funds structured as NURS should cease to offer daily redemptions, and that a notice period be introduced for any investor who wishes to redeem their position in one of these funds. The consultation is addressing the exact length of that notice period, with either 90 or 180 days being the FCA's current preferred options as it believes this will most closely align with the timescales needed to sell the property investments of the fund.

The operational effect of this change would be that any request by an investor to sell their holding in one of these funds will be held for a period of 90 or 180 days before they receive their money. The notice period will allow the fund manager to identify whether they need to dispose of assets to meet client redemptions, and give them time to do so, avoiding the situation where the fund needs to hold significant cash reserves to meet uncertain daily investor redemptions. The value the investor receives will be based on the market value of the fund at the point the payment falls due, and not the fund market value at the point notice is given. Notice once provided will be irrevocable. This should avoid a situation where investors attempt to 'game' market movements by rescinding notice then re-submitting that notice in response to market movements, as such uncertainty would make the fund unmanageable.

The FCA makes it clear that there may well remain situations where a property fund needs to suspend dealing due to material uncertainty over asset values. In these cases, redemptions which cannot be made as the due date for redemptions falls during a suspension must be redeemed on the first dealing day after the suspension ends.

There are no changes required to the handling of fund subscriptions, property funds will still be able to receive and immediately processnew investments daily (or whatever other frequency they choose).

As some existing investors may not want to be subject to a notice period the consultation is suggesting that investors be given at least 60 days to consider the change and liquidate their investment (under existing dealing terms) before the notice period comes into effect.

One consequence of introducing notice periods will be that property funds will no longer qualify to be held in Stocks and Shares ISAs. The FCA indicates it is consulting with HM Treasury on whether the ISA rules might be amended to avoid this issue.

The consultation for this change has now closed and the FCA's final rules are expected during 2021. The FCA have indicated they wish to have these rules in place 'as soon as possible in 2021'.

Insurance

"2021 will be another year of regulatory priorities for the whole market, with specific focus moving from operational to financial resilience, the preparedness for Solvency II equivalence in a form of sorts and the growing anticipation of game changing regulations and standards such as GI Pricing Practices and IFRS17."

Rob Benson
Partner – Head of Insurance
T +44 0(20) 7865 2415
E rob.m.benson@uk.gt.com

Insurance
Key regulatory developments

With 2020 being a year that can compare to no other, the regulatory landscape for the insurance market in 2021 will continue to be of a top priority for participants, policyholders, investors, and regulators. Last year saw much focus and scrutiny on the operational resilience of firms, while 2021 has already shown itself to be majoring on financial resilience and the impact this may have on upstream and downstream counterparties.

The early part of 2021 has shown a degree of competitiveness in rates, with some suggestions of under-pricing. The impact and need to retain margin levels will undoubtedly impact many and as such the need to ensure regulations are met through such times is paramount.

The FCA focus on vulnerability will continue, with the added consideration of the impact of how COVID-19 has affected policyholders another variable to be weaved into Customer Best Interest approaches. Linked to this is the Supreme Court judgement in relation to Business Interruption wordings and treatment of policies which for those impacted will cause greater degrees of complexity as well as volumes, with the regulator already setting out its expectations of the roles carriers and intermediaries should be playing to ensure appropriate conduct with policyholders is achieved.

In this section we look at in detail some of the more prominent regulatory requirements that will keep market participants busy, most notably:

Insurance – key regulatory developments

General insurance pricing reforms

Predominantly impacting the Motor and Home Insurance market, the current CP20/19 (which is being revised post feedback arising from the consultation process) fundamentally impacts existing pricing practices. The focus on reducing harm to policyholders requires entities to assess not only their pricing strategies but also their wider operational and distributions strategies. Requirements include coming into line with pricing reforms where rates for existing customers are to be consistent with those for new, while a material review of product governance processes to ensure product value is maintained is also required. In addition, firms must ensure that there is greater accessibility for policyholders to cancel auto-renew policies whilst additional reporting requirements are likely to be placed upon firms with regards to priding practices.

Solvency II

Following the UK's withdrawal from the European Union, the Brexit Trade deal did not include detailed agreement in respect of insurance regulation and as such there continues to be a need for greater clarification around any divergence from EIOPA requirements that firms have been regulated by for a number of years. Two key factors are considered here 1) the extent of any divergence of new UK standards from those of Solvency II, and how the concept of 'equivalence' for non-EU regulatory regimes will impact cross-border activity.

Risk-free rate publication

Following the UK's withdrawal from the European Union, UK Solvency II firms will now have to access the Solvency II GBP RFR (and 8 other PRA relevant currencies) directly from the PRA1 available in a format consistent with EIOPA. The PRA have suggested that firms applying the PRA issued Solvency II GBP RFR will only have to make limited changes to their processes which should allow for a smooth transition.

For use of the RFR in 2022, UK firms will need to change from the LIBOR basis used to value liabilities, to the Sterling Overnight Index Average (SONIA). This will not be a straightforward switch as there are considerations needed around the application of the Credit Risk Adjustment and the curve production methodology to be used.

IFRS 17

The landing plans for IFRS 17 for many are now firmly in place with 2021 being used to undertake an impact study if not already completed, with design, implement and test stages later in the year and before a dry run in 2022. Since its release in 2017, it has been known that IFRS17 will have a wide-ranging and significant impacts on an insurer's operations across its data, systems, processes and people. Stakeholders such as investors, analysts, auditors, the Board and senior management will take significant time to understand the implications of this new insurance accounting standard.

Orderly wind down planning

The FCA requires all Lloyd's and London Market Intermediaries as well as Managing General Agents (LLMI) to have a comprehensive wind down plan in place to mitigate harm to policy holders, counterparts, or the wider markets in general in the event of firm failure. Firms should plan and prepare for winding down in both solvent and insolvent scenarios.

While the requirement for insurance firms to maintain an up-to-date wind down plan has been in place under Threshold Condition 2.4, the issuing of a 'Dear CEO' letter by the FCA in which they outlined their concerns about firms' financial resilience and their ability for an orderly wind down has heightened the scrutiny of how firms have approached such scenarios.

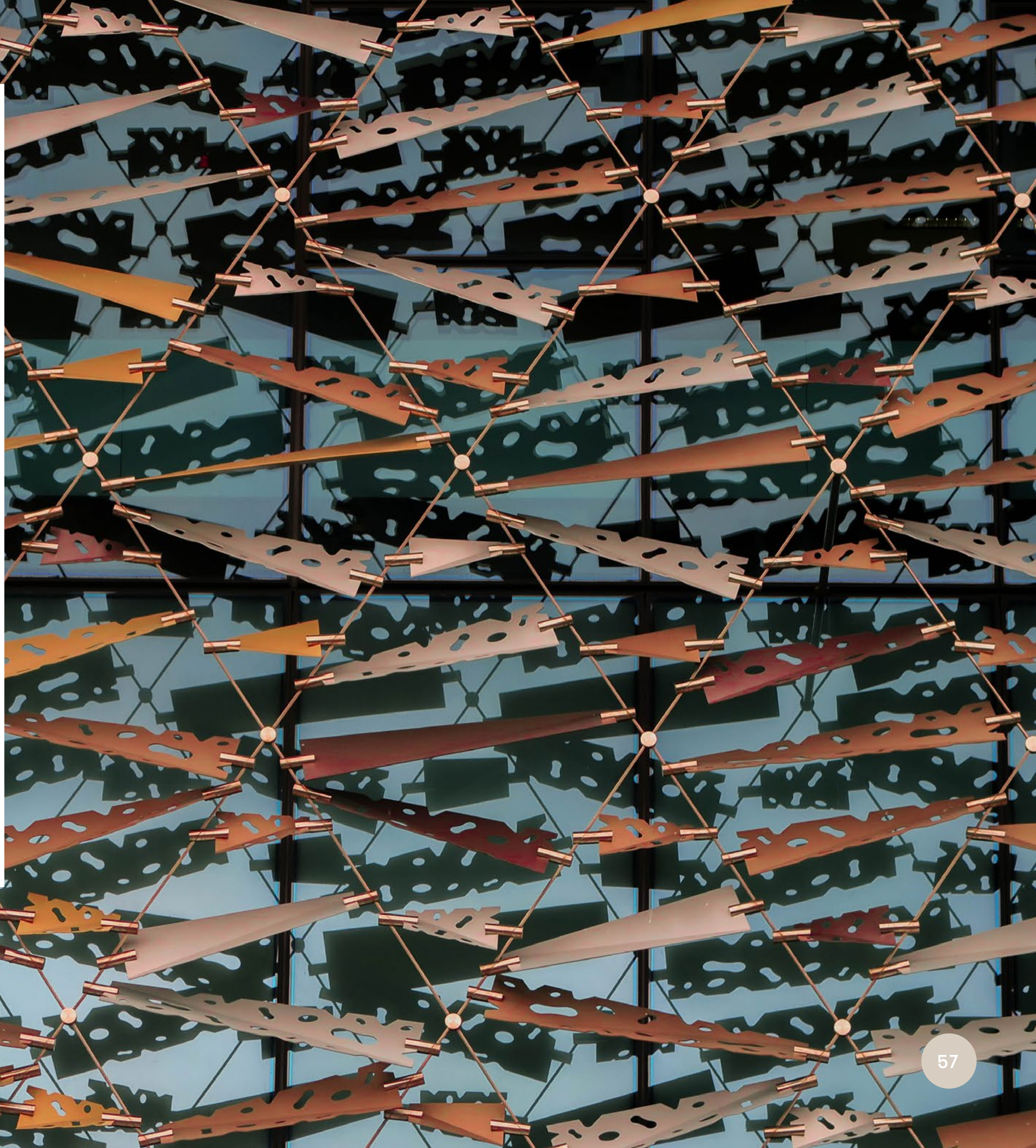
General insurance pricing reforms

In a nutshell

The FCA is finally nearing the conclusion of a market study into general insurance pricing that began in 2018 with the publication of its final report and associated consultation paper. Draft rules are currently under consultation which are intended to prevent the controversial practice of ‘price walking’ wherein existing customers are charged disproportionately high premiums to subsidise competitive pricing offers for new customers. This practice will be explicitly banned in the retail home and motor insurance markets. A range of data reporting requirements will be implemented to support the FCA in monitoring compliance with these rules. Other measures intended to promote competition, make it easy for customers to switch insurers and ensure firms consider value for money will apply to all general insurance products. The package of remedies is intended to eliminate the ‘loyalty penalty’ that results in long-term customers paying more than those who frequently switch provider, by equalising new business and renewal prices.

2021 timeline

25 January 2021	Consultation on proposed rules closed
May 2021	Policy Statement containing final rules will be published
September 2021	Systems and controls rules and product governance rules will come into effect
December 2021	Pricing remedy, auto-renewal rules and reporting requirements will come into effect



General insurance pricing reforms

Core components

Pricing remedy

The FCA's proposed pricing remedy equates to a ban on the practice of 'price walking'. When a firm offers a premium to a renewal customer, this must be no higher than the new business price that would be offered to a new customer purchasing the same product via the same distribution channel. The proposed rules define a 'channel' as direct sales via telephone, internet or through a branch (each of which is considered a separate channel) or sales through a specific price comparison website, insurance intermediary or affinity/partnership scheme. The proposed remedy will only be mandatory for the retail home and motor insurance markets, however we expect this proposal to impact other general insurance products in the medium-term future.

For customers of 'closed book' products which are no longer sold to new customers, the renewal price must be no higher than the new business price of a "close matched product" which is available to new customers. A close matched product is defined as "a home or motor insurance product which provides a customer with core cover and benefits which are broadly equivalent to the core cover and benefits enjoyed by the customer under their existing policy."

When multiple parties are involved in determining the overall price paid by the end customer, these rules will apply at each stage in the pricing chain.

These rules will also apply to add-on products, including retail premium finance.

The FCA will require an annual attestation from a Senior Manager that their firm's pricing models comply with these requirements.

This pricing remedy is likely to have a transformative effect on the general insurance industry. In addition to impacting on the prices that insurers and brokers charge their customers, the ban on the practice of price-walking effectively undermines an entire business model that has been built around acquiring customers through low initial prices and then maximizing the value generated from those who remain with a firm. Distribution strategies, product offerings and operational arrangements associated with such approaches will therefore need to be rebuilt. In addition, price comparison websites have achieved their prominent position in the insurance distribution landscape largely through their ability to help shrewd customers avoid the loyalty penalty. If the FCA's reforms succeed in eliminating this penalty, comparison sites will need to find a new customer proposition to maintain their significance.

Product governance

The FCA also proposes strengthening product governance requirements to increase firms' consideration of value for money. Unlike the pricing remedy, these rules will apply to all general insurance products (except contracts for large risks and reinsurance). The product governance rules will be updated to require firms to consider whether insurance products offer fair value for money to customers as part of the product governance process.

The application of firms' product governance procedures will also be made stricter. Whereas the FCA's product governance rules currently only apply to products created or significantly adapted on or after 1 October 2018, the FCA proposes to extend these rules to all existing insurance products and to require firms to have completed a review of all their products within one year of the new rules coming into effect. The current requirement that firms should 'regularly review' the insurance products they offer will be strengthened with a new provision requiring each product to be reviewed at least once every twelve months.

Cancelling auto-renewing policies

While the FCA has stopped short of the ban on auto-renewal which it was considering, it has still proposed rules intended to make it easier for customers to prevent products from auto-renewing. In particular, firms must offer customers the option to prevent auto-renewal by phone, over the internet or via post, must make customers aware of these options and customers must be able to do so at any time during the contract of insurance.

Reporting requirements

The FCA will also require firms to report a range of data metrics about their pricing practices to them, in order to allow the regulator to monitor compliance with the new rules.

Solvency II

In a nutshell

Solvency II is the prudential regime for the regulation of insurance and reinsurance undertakings in the EU. It is a risk-based regime, with solvency requirements for firms determined with reference to their risk profiles. It was designed to create consistency of regulation across the EU, thus facilitating comparisons between firms regulated in different EU member states. However, though it increased comparability, this aim has not been fully achieved.

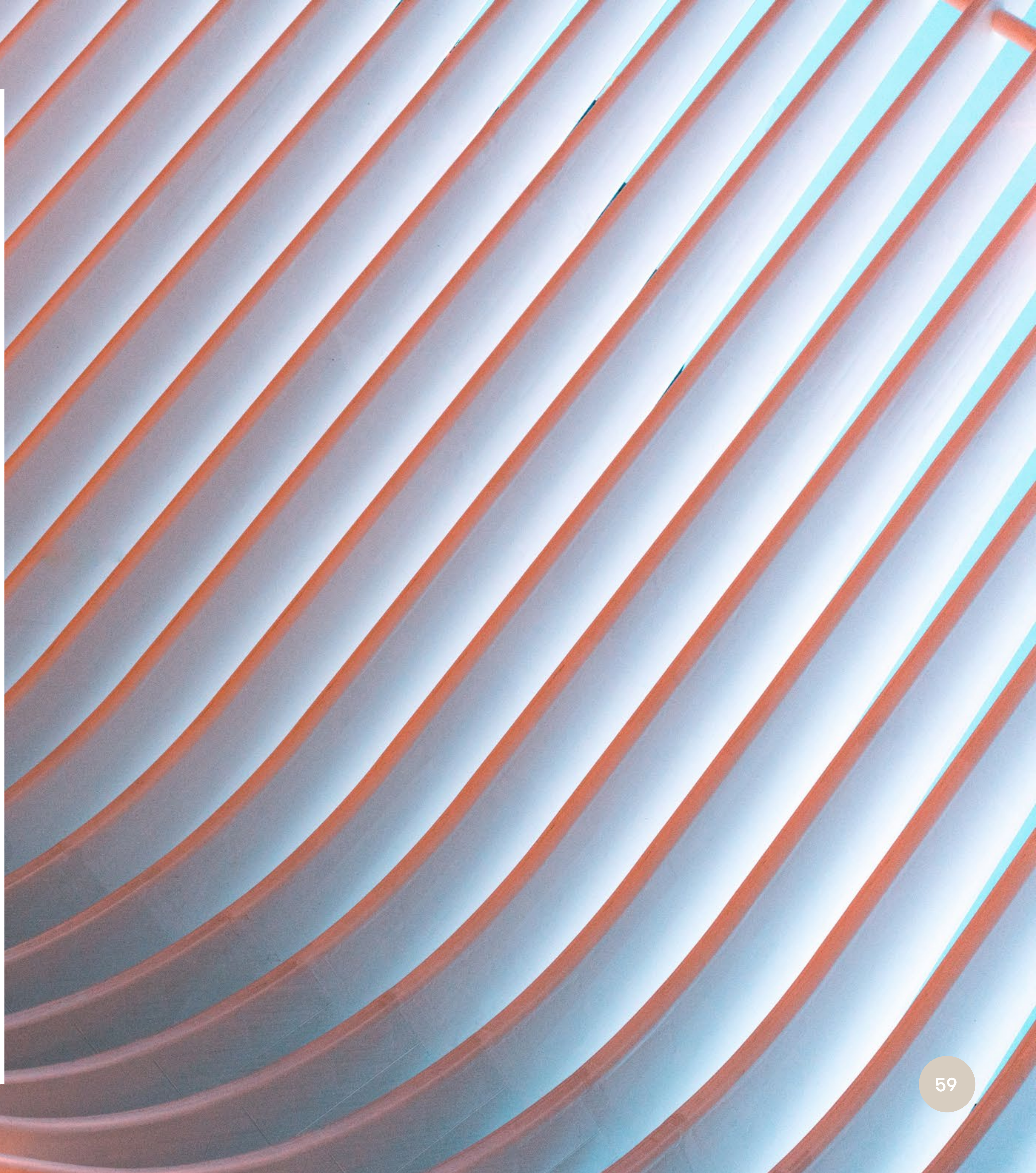
EIOPA describes Solvency II as having the following key attributes:

- Risk based, with higher risks leading to higher capital requirements
- Group supervision, supervision is at a group level with regulatory cooperation between member states
- Market consistent, with assets and liabilities valued at the amount for which they can be traded
- Proportionate, with regulatory requirements applied proportionately to the nature, scale and complexity of a firms risks

Current UK regulation implements the requirements of Solvency II, however as the UK is no longer a European Union member state divergence is now possible. Two related factors that will be core to the shape of the UK – EU insurance market regulatory landscape are:

- Extent of divergence of UK Regulatory Standards from those of Solvency II: initial indications and the questions in the FCA consultation published in October 2020 do not however give rise to an expectation of radical changes
- Equivalence: Solvency II contains within it the concept of ‘equivalence’ for non-EU regulatory regimes, whether or not the UK regime is granted equivalence status will have important implications for cross-border activity, as it has fundamental implications for how these firms are treated under Solvency II

The Brexit trade deal did not include detailed agreement in respect of insurance regulation. The accompanying declaration on financial services regulatory cooperation gave an intent to establish a framework for financial services regulatory cooperation by March 2021 that would include an approach to equivalence determinations in both directions.



Solvency II

Core components

Solvency II is made up of three parts, ‘pillars’:

Pillar I

Pillar one sets out the minimum capital requirements that an insurer or reinsurer must hold under the regime and there are two distinct capital requirements to be met:

- The Solvency Capital Requirement (SCR) which is the amount of capital needed to cover a 1/200 risk over one year
- Minimum Capital Requirement (MCR) which is the level at of capital below which the regulatory may employ its strongest intervention measures, including the withdrawal of authorisation

Together the SCR and MCR provide points on what is known as a ‘regulatory ladder of intervention’ with the measures that a regulator would taking in respect of a firm whose capital falls to inadequate levels increasing in severity between the SCR and MCR.

There has been quite a lot of debate around the underlying methodology of some of the quantitative components within pillar one such as the calculation of the Risk Margin. It is yet to be seen how the underlying methodology and approach of these components will change/diverge as a result of the UK no longer being part of the EU.

Pillar II

Pillar II is made up of the qualitative requirements for governance and the identification, management and reporting of risks as well as for supervisory activity. The requirements can be split into three main areas: Governance requirements, Risk Management systems and the Own Risk and Solvency Assessment (ORSA) and the Supervisory Review Process.

Firms with an approved Solvency II application have embedded these requirements as part of their organisational structures and reporting process and are less likely to see changes proposed by the regulator post Brexit.

Pillar III

The reporting requirements that make up Pillar III are designed to support transparency and consistent public disclosure across the EEA. The reporting requirements include both requirements for reporting confidentially to the regulator and publicly.

The Regular Supervisory Report (RSR), which includes the Quantitative Reporting Templates (QRTs), is where the results of solvency calculations and the ORSA are disclosed to the regulators.

The Solvency and Financial Condition Report (SFCR) is where information is disclosed publicly, including information from the RSR excepting items that can be demonstrated as confidential.

The regulator may consider reviewing the disclosures required however given most firms have these already embedded within their process, significant changes are less likely to be proposed.

Solvency II risk free rate

In a nutshell

As part of the Solvency II framework, Insurance firms have to value liabilities using ‘prescribed’ discount curves derived from the risk-free rate (RFR).

Following the UK’s withdrawal from the European Union, UK Solvency II firms will now have to access the Solvency II GBP RFR (and 8 other PRA relevant currencies) directly from the PRA available in a format consistent with EIOPA. The PRA have suggested that firms applying the PRA issued Solvency II GBP RFR will only have to make limited changes to their processes which should allow for a smooth transition.

For use of the RFR in 2022, UK firms will need to change from the LIBOR basis used to value liabilities, to the Sterling Overnight Index Average (SONIA). This will not be a straightforward switch as there are considerations needed around the application of the Credit Risk Adjustment and the curve production methodology to be used.

Solvency II risk free rate

Core components

Risk free rate structure

The RFR are based on swap rates where there is a sufficiently deep and liquid swap market and are then adjusted to reflect the risk of default of the counterparty, known as the credit risk adjustment. Insurers are allowed (post regulatory approval) to adjust the risk-free curve where they have long term predictable liabilities for which they hold assets to maturity. As they are not exposed to the risk of spread movements, they can adjust the RFR in line with the spread movement and this is known as the matching adjustment.

In some cases where insurers have liabilities that are not eligible for use of the matching adjustment, they can alternatively add a volatility adjustment to the risk-free discount rate. The purpose of the volatility adjustment is to reduce the risk of forced sales of assets in the event of extreme bond spread movements. The volatility adjustment is based on the spreads of a representative portfolio and is published by the regulator.

PRA publication of the Solvency II Risk Free Rate

The Solvency II technical information applicable to all UK Solvency II firms including the Solvency II GBP RFR was previously published by the European Insurance and Occupational Pensions Authority (EIOPA). Following the UK's withdrawal from the European Union, UK Solvency II firms will now have to access the Solvency II GBP RFR (and 8 other PRA relevant currencies) directly from the PRA[1] available in a format consistent with EIOPA.

As the PRA had contributed to the development of Solvency II requirements set by EIOPA, it thus considers the underlying methodologies and judgements still appropriate for use post withdrawal. The PRA have suggested in the recent Policy Statement (PS24/20[2]) that firms applying the PRA issued Solvency II GBP RFR will only have to make limited changes to their processes which should allow for a smooth transition.

The PRA has run a series of parallel runs pre implementation and had consistent RFR data when compared to the EIOPA issued data. The PRA are thus expecting firms to have a negligible difference in the level of the regulatory technical provisions as a result of the change in data source.

EIOPA will still continue to publish all Solvency II data as previously by working day 3 of the month. The PRA are however publishing RFR data by working day 8 of the month (earlier if possible) and this is likely to cause delays for firms with tighter timelines if they use the full time period to deliver the data.

The PRA have also confirmed that the ultimate forward rate for 2021 will be the same as that published by EIOPA in July 2020[3].

LIBOR to OIS transition

The Solvency II GBP RFR used by Insurance firms to value their liabilities are based on LIBOR, an interest rate benchmark used in financial markets.

LIBOR is expected to cease publication at the end of 2021 with the Sterling Overnight Index Average (SONIA) now being the recommended replacement for LIBOR. SONIA is the underlying reference rate for the sterling Overnight Index Swap ("OIS") market.

There are some issues arising from switching from LIBOR to SONIA, key of which are the application of the Credit Risk Adjustment (CRA) and the curve production methodology to be applied through the transition phase. The Financial Conduct Authority (FCA) and the Bank of England (BofE) are working closely with industry bodies and firms to produce appropriate guidance and have currently issued a consultation paper (CP1/2[4]) for feedback.

The PRA will be carrying out a depth, liquidity and transparency (DLT) assessment of the GBP SONIA swaps market data in the first half of 2021. The PRA intend to calculate the GBP RFR using SONIA reference data from the end of July 2021 in order to aid the transition process. EIOPA are also carrying out their own DLT assessment so it will be interesting to see the results presented by both regulatory bodies.

IFRS 17 and the RFR

Under IFRS 17, a company that issues insurance contracts must report them on the balance sheet as the total of the fulfilment cash flows and the contractual service margin. Based on the prescribed standards, firms need to estimate the present value of those cashflows using an appropriate discount curve.

IFRS17 provides clear guidelines but no detailed technical methodology on the discount curve to be used. Two approaches have been proposed, a bottom-up approach (using a yield curve adjusted for a liquidity premium) and a Top-Down approach (where the discount rate is defined by adjusting the yield curve based on the current market rates of return for a reference portfolio).

There are various similarities between Solvency II and IFRS 17 and one of them being that the Solvency II discount curve can be used for IFRS17 purposes if adjusted for a liquidity premium based on the characteristics of their business (the bottom-up approach). Under Solvency II, market consistency is fundamental to asset and liability valuations hence the Solvency II discount curve is constructed with discount rates implied from a sufficiently deep and liquid swap market. Use of the Solvency II discount curve in IFRS reporting is thus likely to reduce valuation misalignments between both reporting frameworks and is expected to be the choice of methodology adopted by firms.

1 As per Regulation 4B of the Solvency 2 Regulations 2015/575

2 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-technical-information

3 Available at: https://www.eiopa.europa.eu/content/eiopa-publishes-ultimate-forward-rate-ufr-2021_en.

4 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/january/solvency-ii-deep-liquid-and-transparent-assessments-gbp-transition-to-sonia

International Financial Reporting Standard 17 (IFRS17) Insurance Contracts

In a nutshell

In 2017, the International Accounting Standards Board (IASB) issued IFRS 17 Insurance Contracts. IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2023 and replaces IFRS 4 Insurance Contracts. IFRS 4 was issued as an interim insurance accounting standard and largely permitted existing accounting treatments to continue. Consequently, entities pursue a wide range of approaches in accounting treatment which has resulted in little consistency across countries and multinationals. IFRS 17 establishes internationally consistent accounting for insurance contracts and will drive greater standardization.

IFRS 17 will result in a wave of unprecedented change to current insurance accounting practices, fundamentally changing the content and the methods utilized to report insurance contracts in financial statements. IFRS 17 reporting is primarily based on cashflows and requires updated information regarding the obligations, risks and performance of insurance contracts. This new standard will impact how insurance contracts are recognized and measured, thereby impacting profit and equity as well as reserving and financial reporting processes, actuarial models and IT systems. It is expected to significantly increase disclosures in the financial statements and how key performance indicators are reported in addition to impacting executive remuneration and potentially tax.

IFRS 17 will have wide-ranging and significant impacts on an insurer's operations across its data, systems, processes and people. Stakeholders such as investors, analysts, auditors, the Board and senior management will take significant time to understand the implications of this new insurance accounting standard.

Key dates

2021	2022	2023
Impact study, design, implement and test	Dry run/parallel run	Go live

"IFRS 17 is the most radical global change ever seen in financial reporting in the insurance sector. Insurance entities reporting under IFRS 17 only have two more years to prepare for implementation of this new insurance accounting standard and most have many challenges to overcome in relatively little time."

Simon Sheaf, Partner - Advisory

IFRS 17

2021 timeline

In 2021, entities who will be reporting under IFRS 17 should accelerate implementation plans focusing on the following:

Governance

Technical accounting, actuarial and other decisions should be made to define subsequent actions in the IFRS 17 programme. During 2021, appropriate governance to challenge and anticipate downstream dependencies stemming from accounting and architecture system and data decisions should be put in place. IFRS 17 Interaction with other accounting standards (e.g., IFRS 9 Financial instruments) should also be assessed including considerations to reduce volatility on the profit or loss.

Phasing

IFRS 17 implementation impacts many parts of an organization and involves several workstreams that depend on each other. Strong implementation plans should be in place to identify interdependencies and the associated risks and seek to manage the sequencing of activities, mitigating the risk of delays to delivery.

Process and systems

IFRS 17 will require implementation of a new chart of accounts resulting in entities gathering new data leading to process and information system changes to satisfy requirements. If progress on implementation of new processes and systems is not well advanced during 2021, it increases IFRS 17 implementation risks.

Testing and dry runs to prepare for transition

IFRS 17 comparative data will be required with an opening balance sheet on **1 January 2022** for entities with a **31 December** year end. IFRS 17 transition requirements require a number of considerations and depend on the availability of historical data. Validation of data, technology, financial close processes and other aspects of IFRS 17 implementation should have been progressed in 2021.

Suppliers

IFRS 17 implementation is highly likely to require the involvement of several external suppliers. Implementation plans should be designed to manage execution risk as it relates to suppliers, including availability, oversight and cost monitoring.

Resourcing

IFRS 17 implementation will require significant internal resource to ensure a successful outcome. Furthermore, reporting under IFRS 4 will be required until 2022. Plans should be in place to ensure that resourcing is sufficient to implement IFRS 17 successfully.

IFRS 17

Core components

IFRS 17 is relevant to any entity that issues contracts accepting significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder; therefore, IFRS 17 is not solely relevant to insurers. For instance, it may be relevant to entities providing breakdown cover.

Key topics, judgments and accounting policy choices under IFRS 17 requiring consideration are as follows:

- level of aggregation: insurance business is required to be split into annual cohorts and further split into units of account which take account of profitability, risks and how the business is managed
- combining and separating out insurance contracts: certain components (e.g., investment components) of an insurance contract will require separating or, in other instances, contracts will require combining under certain circumstances
- contract boundaries: insurance contracts may have a different duration from an accounting perspective when compared to the coverage they provide
- measurement models: entities will need to decide which measurement model to use for each part of the business. The general measurement mode is the default model. For certain contracts with a shorter coverage period, a simplified approach called the Premium Allocation approach is available. For contracts with direct participation features it is mandatory to use the Variable Fee Approach (VFA)
- fulfilment of cash flows: estimating future cash flows, discount rates and risk adjustments will introduce greater complexity into insurance contract liability measurement
- contractual service margin (CSM): the CSM is a new concept and represents expected profit. IFRS 17 requires that this item is measured and recognized on the balance sheet
- coverage units: this is key to allocating the CSM over the period during which the entity provides insurance contract services and releasing it as the entity is released from risk
- onerous contracts: if a group of contracts is or becomes loss-making, an entity should recognise the loss immediately. This new requirement may have commercial implications as insurers may not be willing to acknowledge writing loss making insurance business
- reinsurance contracts held: such contracts may be recognized and measured differently when compared to insurance contracts issued under certain circumstances
- transition: there are three options to derive opening balances i.e., full retrospective approach (also the default approach and failing which there is an option to apply either of the other approaches), modified retrospective approach and fair value approach, thereby introducing complexity when calculating balances at transition
- primary financial statements presentation: the profit or loss statement (P&L) will undergo a radical change in terms of how insurance revenue (excluding receipt of any investment component) and insurance service expenses (excluding the epayment of any investment components) are shown. The P&L will show separate lines for insurance finance income or expenses and reinsurance income or expense
- financial statements disclosure: quantitative and qualitative disclosure requirements are more extensive than the current reporting frameworks leading to greater transparency and insight into drivers of profitability. The disclosures should enable users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of an entity

Wind-down planning

In a nutshell

FCA guidance can be found in its FCA Handbook - Wind down Planning Guide (WDPG), FG20/1 Our framework: assessing adequate financial resources and Threshold Conditions on adequate resources, section TC2.4.

"An effective wind-down plan aims to enable a firm to cease its regulated activities and achieve cancellation of its permission with minimal adverse impact on its clients, counterparties or the wider markets. This includes scenarios where the firm undertakes a strategic exit as well as unexpected crisis or insolvency that makes the firm unviable.

A wind-down plan can also help a firm to assess if it would have adequate resources (e.g., capital, liquidity, knowledge and manpower) to wind down in an orderly manner, especially under challenging circumstances."

FCA Handbook, WDPG, Para 1.1

2021 timeline

The requirement for insurance firms to maintain an up-to-date wind down plan is already in place.

However, in **November 2020**, the FCA issued a 'Dear CEO' letter to Lloyds and London Market Intermediaries and Managing General Agents (LLMI) in which the FCA outlined their concerns about firms' financial resilience and their ability for an orderly wind down.

In light of the pandemic, the FCA highlighted these key messages to LLMI:

"During this time of stress, we expect firms to plan ahead and ensure they manage their financial resources soundly. This means taking appropriate steps to conserve capital, and to plan for how to meet potential demands on liquidity.

If a firm needs to exit the market, it should plan ahead and consider how to achieve this in an orderly way by taking steps to reduce the harm to both consumers and markets. Firms should maintain an up-to-date wind-down plan that takes into consideration the current market impact of COVID-19.

If a firm is concerned it will be unable to meet its capital requirements, its debts as they fall due, or if its wind-down plan has identified the potential for customer harm, it should contact the FCA (or its named FCA supervisor), with its plan for the immediate period ahead."

During 2021 the FCA will be engaging with LLMI and testing firms to see what they have done to address their concerns as set out in the Dear CEO letter.

Beyond 2021, wind down plans should be constantly reviewed and updated to ensure they remain relevant and implementable.

Wind down planning

Core components

Key issues that should be considered when preparing a wind down plan include:

- Governance: management should consider how the company will make the decision to wind down, and how it will oversee its wind down plan. This should be discussed and agreed by the board and documented in the wind down plan. By identifying and stress testing scenarios, having a well-disciplined approach to the provision and monitoring of management information, a firm will be in a good position to identify early warning signs. They are then better placed to mitigate that risk or reduce the impact of a wind down
- Functional plans: having considered the necessary steps to take to execute a wind down, management will need to look across the business to identify each part of the business that is necessary to execute an orderly wind down and to ensure this is documented. This should include identifying inter-dependencies across functions as well as individual departments as well IT systems, infrastructure etc
- Granularity: Each stage of a wind down plan requires management to exercise and document their judgement regarding the appropriate level of granularity to include, as well as their readiness to implement them. This means asking at each stage: What would still need to be done? How long would it take? What resources are required?
- Communication: An implementable wind down plan should include a tightly documented and defined communication plan. In the period where the implementation of a wind down is imminent, it's expected that key documents, such as statements for your website, press releases, bespoke instructions to policyholders and counterparts are drafted and ready to go
- Stakeholders: It is important to identify your stakeholders and document the impact that your wind down may have on them. This should then be used to understand what actions they could take that may impact your wind down plans. These actions can affect both your practical plans, as well as the resources you may need
- Financial resources: Management should analyse and document assumptions about the resources required to deliver an orderly wind down. In its guidance, the FCA says that firms are to have adequate capital to incur losses and remain solvent, or to fail in an orderly way. The FCA also indicated that these resource estimates should include assessments of extra closure costs and potential litigation costs
- Solvent and Insolvent scenarios: A thorough financial resources analysis will enable management to consider whether a solvent wind down is practical or not. If it appears that it is not practical, it is essential to consider what the implications of an insolvency would be on your wind down plan. This should include the impact on policyholders and counterparts, and what the firm could do to mitigate those

Banking

"The evolution of the regulatory regime and the rules within which banks operate continues to be a vital theme for the sector as we move through 2021. 2020 saw an initial response between regulated and regulators where some of the work underway was delayed giving both sides time to respond to the immediate operational challenges imposed by COVID-19.

Paul Garbutt
Partner – Head of Banking
T +44 0(20) 7865 2170
E paul.garbutt@uk.gt.com

Banking
Key regulatory developments

The evolution of the regulatory regime and the rules within which banks operate continues to be a vital theme for the sector as we move through 2021. 2020 saw an initial response between regulated and regulators where some of the work underway was delayed in order to give both sides time to respond to the immediate operational challenges imposed by COVID-19. Once that passed – and almost entirely successfully it is worth recognising - we saw some of the benefits of the regulatory agenda work already undertaken since the financial crisis of 2008/9.

The banking system was seen as well capitalised with capacity to weather the consequent economic storm and was able to provide huge amounts of liquidity in the form of Government backed lending and forbearance into the UK economy.

Across the sector going forward we see ever more demands for technology and particularly data to support both customer interactions and internal processes. There is a near universal desire from banks to make themselves 'easy to do business with' from a customer perspective. From a regulatory perspective this also supports greater use of automated tools to assure that customers are being given fair outcomes and also to provide the numeric and transactional data that the regulators need. Whilst fully automated, self-serve monitoring by and reporting to regulators is still some years off we see that as the general direction of travel.

To get there it is vital that banks have clear data strategies and a path where they will, in time, be confident to share their data directly with their regulators. This is a global trend and the UK regulators are at the forefront of work in this area. Looking out from Q1 2021, we see the following key developments specific to the banking sector:

Overseas internal ratings based models

Whilst offering a chance to simplify process in a very data hungry set of calculations, this is also a good example of the need to keep on top of evolving regulation (Basel 3) due in 2023 and national divergence which will evolve in our post Brexit environment. Firms will need to keep on top of how they apply this rule in order to remain compliant. There is an inherent risk that future changes in portfolio or future details of local regulations will lead to material changes in the internal compliance process.

Banking – key regulatory developments

Internal ratings based approach to credit risk

The internal ratings based approach varies between banks, making it difficult for regulators to compare risk weighted asset calculations and credit risk management approaches. The EBA produced a roadmap to address these issues, adopted by the PRA, covering loss given default (LGD), probability of default estimation (PD) and treatment of defaulted exposures. The deadline for all firms using the internal ratings based approach for these calculations is 1 January 2022.

These changes sit alongside wider IRB reforms within Basel 3.1 (effective from the same date), which exclude some assets from the advanced IRB (A-IRB) approach and establishes pre-defined input floors for some calculations. The combined changes mean firms will need to split some models, such as LGD and EAD, with part of the model falling under A-IRB and part under the foundation approach (F-IRB). Ongoing attention to the details of the rules and portfolios will be key to compliance.

The 2021 Climate Biennial Exploratory Scenario (CBES)

The 2021 Climate focused Biennial Exploratory Scenario (CBES) aims to stress test firms' resilience to climate risk. It applies to the UKs largest banks and insurers, although other firms are encouraged to review their resilience based on the CBES. The CBES provides three climate scenarios covering physical and transitional risks.

The Bank of England will release more information on the scenarios in June, when the CBES is launched. Firms have until the end of September to submit their response, and feedback will be published in Q1 of 2022. Data volume and analytics will be key to future climate risk management and disclosures.

Transposition of Bank Resolution and Recovery Directive II (BRRD II)

After analyzing BRRD II requirements and consulting with industry, the Bank of England concluded that the UK had already established a comprehensive Resolution Framework in line with international standards. However, as recipients of the recent "Dear CEO" letter know resolution is still a top regulatory agenda item.

Strong Customer Authentication (SCA)

The revised Payment Services Directive (PSD2) brings fundamental changes to the payments market in the EU. One of the core elements of PSD2 requires Strong Customer Authentication (SCA) to be applied by payment services providers (PSPs) when carrying out remote electronic transactions.

> "2020 was expected to be our year of change as we had created a new EU entity as the key part of our response to BREXIT. In fact, we now find that the regulatory change journey continues at the same speed again into 2021 as we bed in our new booking structures, client relationships and CRR2. The regulatory technology and change process I have learnt is a matter of keeping ahead of a constantly evolving picture. It is vital to keep on top of what is coming and ensure the organisation is agile enough always to respond in an economic way."

European CFO, North American GSIB

Overseas Internal Ratings Based (IRB) models

In a nutshell

The PRA is reviewing the use of overseas internal ratings based (IRB) models, predominantly for those used in UK group-consolidated capital requirements. Essentially, overseas non-EEA models are built to meet local regulations, which do not universally align to the PRA's expectations. As such, many overseas subsidiaries of UK groups run two IRB models – one for the PRA and one for the local regulator. To reduce duplication of effort and gain greater oversight, the PRA has proposed that firms use one overseas IRB model per jurisdiction, and amend it to include key criteria to meet UK regulatory expectations.

The key challenge for firms is dual compliance, and there will still be instances where entities will need two models to meet local expectation. It's also important to note that the 1 January 2023 compliance deadline is also the Basel 3.1 implementation date, so changes to both must be aligned.

2021 timeline

1 July 2021	Compliance deadline for overseas IRB models that are not used for UK consolidated group requirements
1 January 2023	Compliance deadline for firms to update overseas IRB models for use in UK consolidated group requirements

IRB models

Core components

Organisations use IRB models to calculate capital requirements at an individual entity level, and at a group consolidated level. The PRA is seeking assurance on both fronts, to make sure:

- Solo capital requirement calculations for non-EEA entities are appropriate to safely manage local exposures and support group financial stability
- Where solo capital requirements feed into consolidated capital requirements, they collectively reflect group exposures, with appropriate risk weighted assets, and are prudently managed

Overseas IRB models are not currently subject to approval by the PRA, instead they fall under the jurisdiction of local regulators and are designed to meet those expectations. The PRA is concerned about supervision over those models, and the extent to which local regulation is equivalent to the UK's. These two sets of regulatory expectations leave room for arbitrage and may also lead to duplication of effort by creating two simultaneous models for the same exposure.

Groups may continue to use non-UK IRB models for consolidated capital requirements – on a case by case basis – provided they meet criteria below:

- Limited use of non-UK IRB models: A maximum of 5% of the group's credit risk RWA can be calculated using non-UK IRB models. To prevent arbitrage, a group cannot have more than 5% of its total exposure value calculated using overseas models
- Only to be used in equivalent jurisdictions: To achieve comparable prudential outcomes as UK-IRB models, non-IRB models can only be used for exposures in equivalent jurisdictions (as per CRR). The local regulator must approve the model, which must inform local capital requirements. Entities cannot use non-UK IRB models in non-equivalent jurisdictions
- For retail exposures only: Retail exposures, including small and medium enterprises, tend to vary by country so using a local, non-UK IRB model is appropriate in some instances. This is generally a key area of regulatory divergence, so will also reduce the need for two models
- Appropriate methodologies that are not judgement based: Model outputs, such as probability of default, must be based on material risk drivers, empirical evidence and historical data. Outputs must be plausible and intuitive and not solely based on judgment
- Sample data is appropriate: Data in the sample must be representative of current exposures and reflect current approaches and lending standards. The sample must be large enough and cover an appropriate timeframe for confidence in the model
- Meaningful differentiation of risk: Models must support risk differentiation, with accurate and consistent calculations. Outcomes must be quantitative, with appropriate post model adjustments as needed
- Effective governance and oversight: Internal governance and supervision is essential to maintain model performance. This includes an understanding of the firm's ratings systems and management reports
- Appropriate validation processes: Model validation processes must be objective, consistent and accurate, this will allow groups to assess overseas model performance
- It must inform credit risk decisions: The PRA is specifically interested in overseas IRB models because they inform credit risk decision making, group capital requirements and have an impact on sound prudential management. Groups must also include local regulatory floors and capital add-ons to reflect regional exposures when calculating consolidated capital requirements

Internal Ratings Based (IRB) approach to credit risk

In a nutshell

The internal ratings based approach varies between banks, making it difficult for regulators to compare risk weighted asset calculations and credit risk management approaches. The EBA produced a roadmap to address these issues, adopted by the PRA, covering loss given default (LGD), probability of default estimation (PD) and treatment of defaulted exposures. The deadline for all firms using the internal ratings based approach for these calculations is 1 January 2022.

These changes sit alongside wider IRB reforms within Basel 3.1 (effective from the same date), which exclude some assets from the advanced IRB (A-IRB) approach and establishes pre-defined input floors for some calculations. The combined changes mean firms will need to split some models, such as LGD and EAD, with part of the model falling under A-IRB and part under the foundation approach (F-IRB).

2021 timeline

1 January 2022 Deadline for implementation

IRB approach to credit risk

Core components

The PRA expects firms to comply with the EBA's roadmap and has set out its IRB expectations as follows.

Downturn LGD estimates

Approaches for calibrating LGD include:

- Downturn LGD estimation based on observed impact - firms carry out a component-based modelling approach and direct estimates approach using observations
- Downturn LGD estimation based on estimated impact - If there is not enough observed data, firms will carry out a component-based modelling approach using estimates. This is the appropriate approach for residential mortgage

When using a component-based approach, it is important to use the same peak value for the downturn across all components and consider the time lag between the downturn and the data becoming available. The time lag should not be so considerable that the data reflects improved conditions.

PPGD for UK residential mortgage exposures

For UK residential mortgages, economic downturn conditions must be reflected in the probability of possession given default (PPGD), with an estimate due to house price deflation of at least 5% below its current value and at least 25% below its previous peak value. Where limited information is available on a downturn, an additional margin will be applied.

Discounting cash flows

When discounting cash flows, the PRA expects firms to adjust cash flows to certainty equivalents or use a discount rate that include as an appropriate risk premium (or a combined approach). This is to address uncertainties around the receipt of recoveries regarding defaulted exposures. If firms are not doing this through the discount rate, the PRA expects firms to explain how their LGD calculations are otherwise taking account of that uncertainty.

The minimum discount rate to estimate downturn LGD is 9%. Firms are expected to use the Sterling Overnight Rate Index Average (SONIA) at the moment of default plus 5% for GBP denominated exposures.

Recoveries that are recognised as a cash flow and discounted should not exceed the recovery value they are contractually entitled to retain for that exposure.

Identifying a downturn

Firms are expected to use observed data over 20 year period to identify potential economic downturns. A longer timeframe should be used if the data is not severe enough. Long run average PD for residential mortgages should be calibrated to economic conditions comparable to the early 1990s in the UK.

Treatment of defaulted exposures

Where impairment models are used to calculate Best Estimate of Expected Loss, should a change be needed to the approved IRB model (due to changes in the accounting impairment model), the models may diverge for a short time frame, subject to PRA approval and notification.

Rating and calibration

The PRA expects residential mortgage exposures to be calculated using an approach somewhere between a point in time and through the cycle model, but at neither end of the extreme.

"The interaction between different regulations is key to encouraging competition in the UK banking sector and ensuring proper alignment of risk v reward. For new entrants and faster growing banks it is important to be able to act swiftly as new market needs or opportunities arise. For us it is imperative to constantly monitor evolving regulation and engage in early dialogue with our regulators – for us and peers the impact of growth in 2020 and the interaction of MREL and Leverage requirements has been the focus of much recent challenge."

CFO, Challenger Bank

The 2021 Climate Biennial Exploratory Scenario

In a nutshell

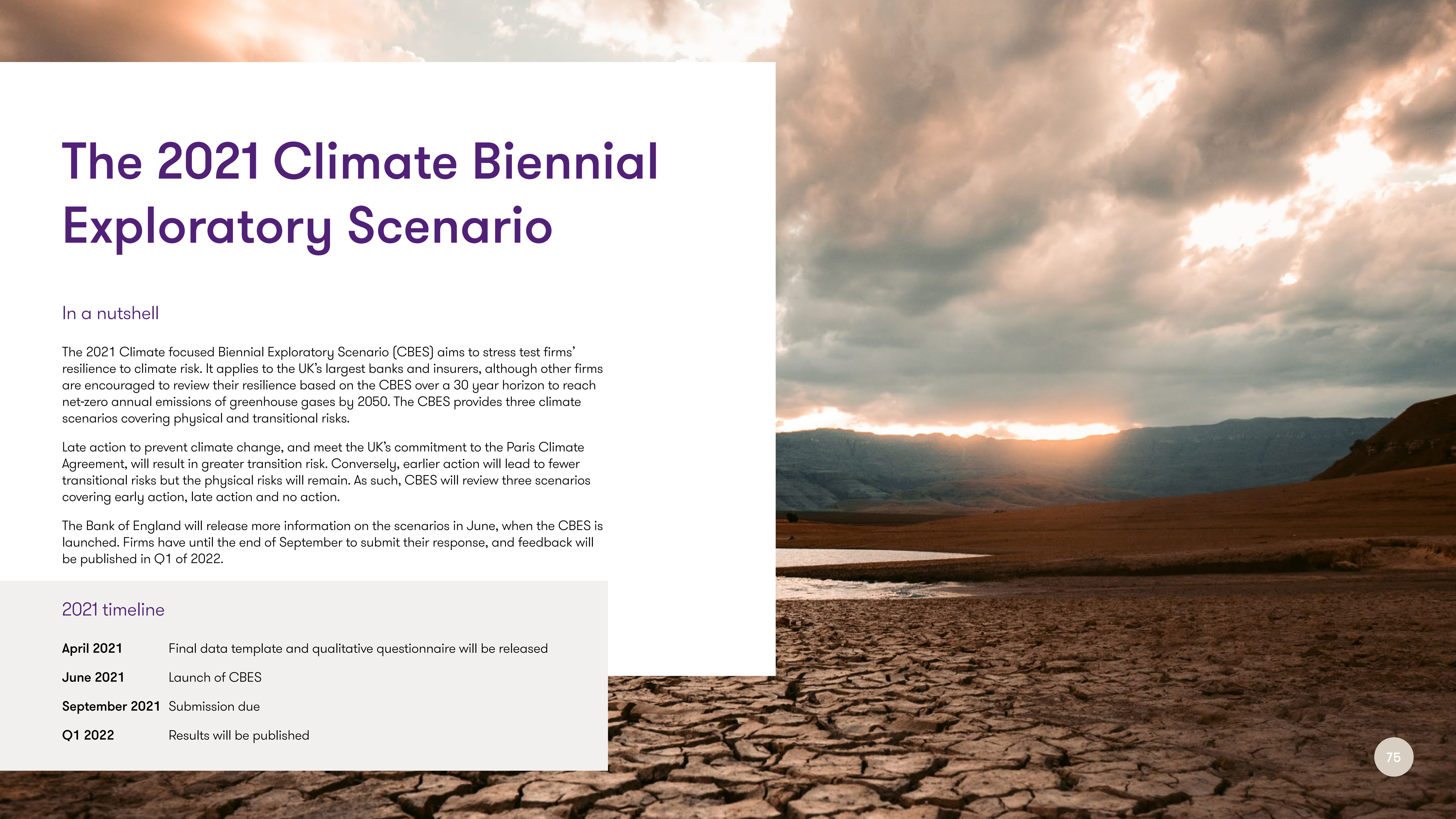
The 2021 Climate focused Biennial Exploratory Scenario (CBES) aims to stress test firms' resilience to climate risk. It applies to the UK's largest banks and insurers, although other firms are encouraged to review their resilience based on the CBES over a 30 year horizon to reach net-zero annual emissions of greenhouse gases by 2050. The CBES provides three climate scenarios covering physical and transitional risks.

Late action to prevent climate change, and meet the UK's commitment to the Paris Climate Agreement, will result in greater transition risk. Conversely, earlier action will lead to fewer transitional risks but the physical risks will remain. As such, CBES will review three scenarios covering early action, late action and no action.

The Bank of England will release more information on the scenarios in June, when the CBES is launched. Firms have until the end of September to submit their response, and feedback will be published in Q1 of 2022.

2021 timeline

April 2021	Final data template and qualitative questionnaire will be released
June 2021	Launch of CBES
September 2021	Submission due
Q1 2022	Results will be published



The 2021 Climate Biennial Exploratory Scenario

Core components

In 2019 the General Insurance Stress Test (GIST) reviewed similar climate scenarios and found that firms had gaps in data, capabilities, and use of tools to assess climate risk. Looking at the biggest banks and insurers in the UK, CBES 2021 aims to get a coherent picture of climate risk management for the financial institutions that could cause the most damage to the economy in the event of a failure.

It's important to note that CBES specifically refers to the financial risk due to climate change, rather than broader ESG concerns. This includes the impact on traditional areas of risk management including credit risk, operational risk and market risk, amongst others.

Scenarios

The three scenarios cover the following:

- Early policy action: Where early action is taken to reduce climate change and the global temperature stays below a 2°C increase from pre-industrial levels
- Late policy action: Where organisations across the globe are initially slow to respond to climate change, but the 2°C limit is maintained. This would lead to a rushed transition, with a greater impact from the transitional risks
- No additional action: Where no further action is taken, beyond existing measures and the target goal is not met. There would be no transitional risks, but the physical risks could be considerable

Preparation

Firms are encouraged to start work before the stress test is officially launched. In December 2020 the Bank of England published an update on CBES, covering the following expectations for the stress test:

- Collect and incorporate data in scenario analysis and conduct stress tests to assess resilience
- Reviewing portfolio alignment in terms of climate targets and qualitative information on developing metrics
- A qualitative and quantitative approach to measuring risk is required to be applied across banks and insurers

The Bank of England also released draft variables that will apply to all scenarios.

Structure of the test

The test is in two parts:

1. Sizing the risk and identifying how asset values would change at different points in the scenario.
2. Sizing the response and how the identified risks would impact the business model.

Participants are required to submit the 'temperature alignment' of their balance sheets and portfolios.

Results and feedback

In December, the Bank of England will assess if they have the information they need and will decide if there should be a second stage of testing. If so, the results of both tests will be published towards the end of Q1 2022. Otherwise, the results will be published earlier in Q1.

The key outcomes from the 2021 CBES will include analysis of key exposures such as:

- Corporate exposures (eg loans, equities, bonds, commercial real estate) – up to 80% of the portfolio should be reviewed
- Household exposures (eg mortgages, unsecured lending) – to be assessed at postcode level
- Government exposures (eg sovereign and municipal securities) – to model against set bond yields per country

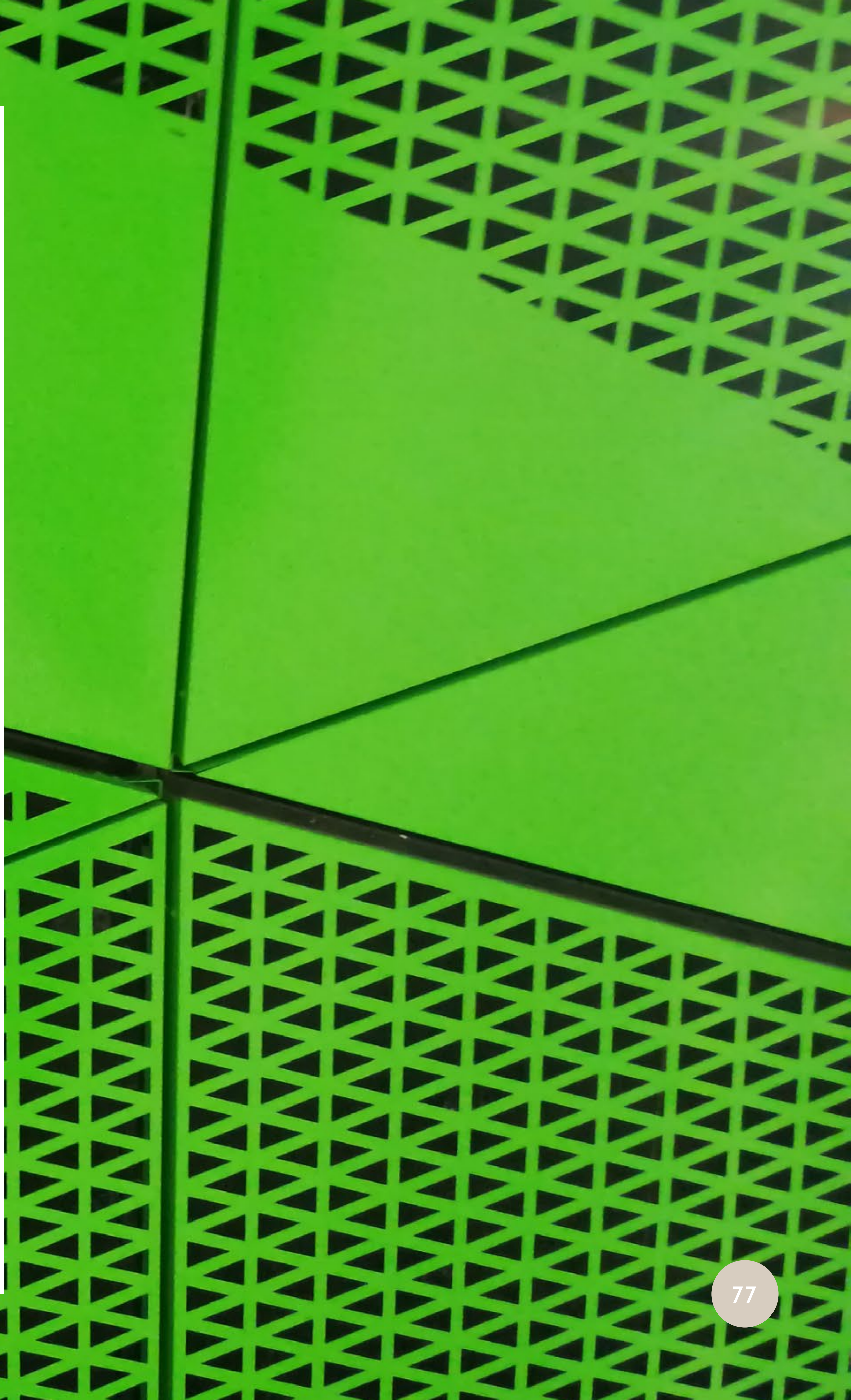
Transposition of Bank Recovery and Resolution Directive II (BRRD II)

In a nutshell

The Bank Recovery and Resolution Directive II (BRRD II) was published by the European Union in June 2019 and made amendments to the original BRRD requirements to update the EU's resolution policy and Minimum Requirements for Own Funds and Eligible Liabilities (MREL) framework. The transitional arrangements under the EU-UK Withdrawal Agreement required the UK to continue adhering to EU law from exit day to December 31 2020 (the IP completion day) and transposition was the process by which the UK adopted EU directives into UK law.

BRRD II provisions that were not required to be complied with until after the end of the EU Exit Transition Period were not transposed, most notably related to MREL. While certain temporary policy changes were made to the Contractual Recognition of Bail-In and Stay In Resolution sections of the PRA's rule book to meet the December 28, 2020 implementation deadline, these were largely rolled back on the IP completion day.

The UK played a pivotal role in the design of EU financial services regulation and remains committed to maintaining prudential soundness and other important regulatory goals such as consumer protection and proportionality. After analyzing BRRD II requirements and consulting with industry, the Bank of England concluded that the UK had already established a comprehensive Resolution Framework in line with international standards.



Strong customer authentication (SCA)

In a nutshell

The revised Payment Services Directive (PSD2) brings fundamental changes to the payments market in the EU. One of the core elements of PSD2 requires Strong Customer Authentication (SCA) to be applied by payment services providers (PSPs) when carrying out remote electronic transactions.

SCA is defined in the Directive as an "authentication based on the use of two or more elements categorised as knowledge (something only the user knows), possession (something only the user possesses) and inherence (something the user is) that are independent, in that the breach of one does not compromise the reliability of the others and is designed in such a way as to protect the confidentiality of the authentication data." The Directive also provides that SCA is to be applied to all electronic payments including e-commerce transactions, unless one of the exemptions applies.

2021 timeline

14 September 2021 Application of SCA in e-commerce card transactions

Core components and scope

Payment Service Providers are required to apply SCA when:

- Payment Service User accesses their payment account online
- Payment Service User initiates an electronic payment transaction
- Payment Service User carries out any action remotely that may imply a risk of payment fraud, unless an exemption applies

The scope covers both electronic remote and face-to-face transactions and includes channels such as online banking, mobile banking and card terminals.

Exclusions

Certain transactions are out of scope for SCA. The key exclusions include Mail and Telephone Order (MOTO) Transactions, Direct Debit transactions, Merchant Initiated Transactions (MITs) and Phone banking.

SCA elements

SCA elements should be independent, such that the breach of one does not compromise the reliability of the other elements and should be designed to protect the confidentiality of the authentication data. Payment Service Providers should ensure that authentication code generated for payment transaction is dynamically linked to amount of payment transaction and payee.

SCA for e-commerce

SCA applies to all payment transactions initiated by a payer, including card payment transactions that are initiated by the payee within the EEA and apply only on a best-effort basis for cross-border transactions with one leg out of the EEA unless exemption is applied.

Geography

Where both PSPs are, or the sole PSP in a payment transaction is, located within the EU, strong customer authentication (SCA) must be applied in accordance with Article 97 of PSD2 unless an exemption is applied. For payment transactions which involve more than one PSP, if one of the PSPs is located within the EU, strong customer authentication (SCA) has to be applied to those parts of the transactions which are carried out within the EU. In the case of card-based payments where the payee's PSP (the acquirer) is located outside the Union (the so-called 'one-leg out transactions'), the acquirer is not subject to PSD2. Where the payer wishes to make a card-based payment at the point of sale (POS) or in an online environment of a merchant whose acquirer is located outside the Union and the issuer cannot technically impose the use of SCA, the issuer shall make its own assessment whether to block the payment or be subject to the liability requirements under Article 73 PSD2 vis-à-vis the payer in the event that the payment has been unauthorised.

Compliance and monitoring

In accordance with article 64(2) of Directive (EU) 2015/2366, a payment Service Provider must have an infrastructure and mechanism with capability to monitor and record data for each payment instrument serviced, providing a detailed breakdown of remote and non-remote payment transactions, reporting at-least on quarterly basis with value and volume, and make it available to the regulators on demand.

Post-Brexit view

Even though the UK is no longer part of the European Union, there is an expectation that SCA is applied on best effort basis and where infrastructure supports SCA.

Therefore, SCA should be applied for transactions unless exempted where:

- Issuer/cardholder and merchant/acquirer is in UK
- Issuer/cardholder is in UK and merchant/acquirer is in EEA

Capital markets

"This year is pivotal for capital markets regulatory change, with LIBOR transition in critical execution and post-financial crisis prudential reforms in advanced implementation stages, whilst at the same time the UK has the opportunity to optimise its regulatory framework, as well as needing to address market impacts and risks that have arisen in the pandemic."

John Da Gama-Rose
Partner – Head of Capital Markets and Head of Business Consulting
T +44 0(20) 7865 2658
E john.da.gama-rose@uk.gt.com

Capital markets
Key regulatory developments

The COVID-19 impact has created unprecedented challenges for the real economy and financial services, yet markets have proven remarkably resilient. Financial institutions were bolstered through effective regulatory measures introduced after the global financial crisis and supported by Government and central bank relief measures to tackle the health crisis and its economic impacts.

Capital markets firms have secured an increased trading revenue in volatile markets and fees from record debt and equity underwriting, accelerating significant operational change simply as circumstances left no other choice. The shape of the recovery and the global geopolitical outlook, including regulatory equivalence decisions remain key uncertainties. The appeal of post-Brexit deregulation has been constrained by the need for regulatory equivalence to retain market access.

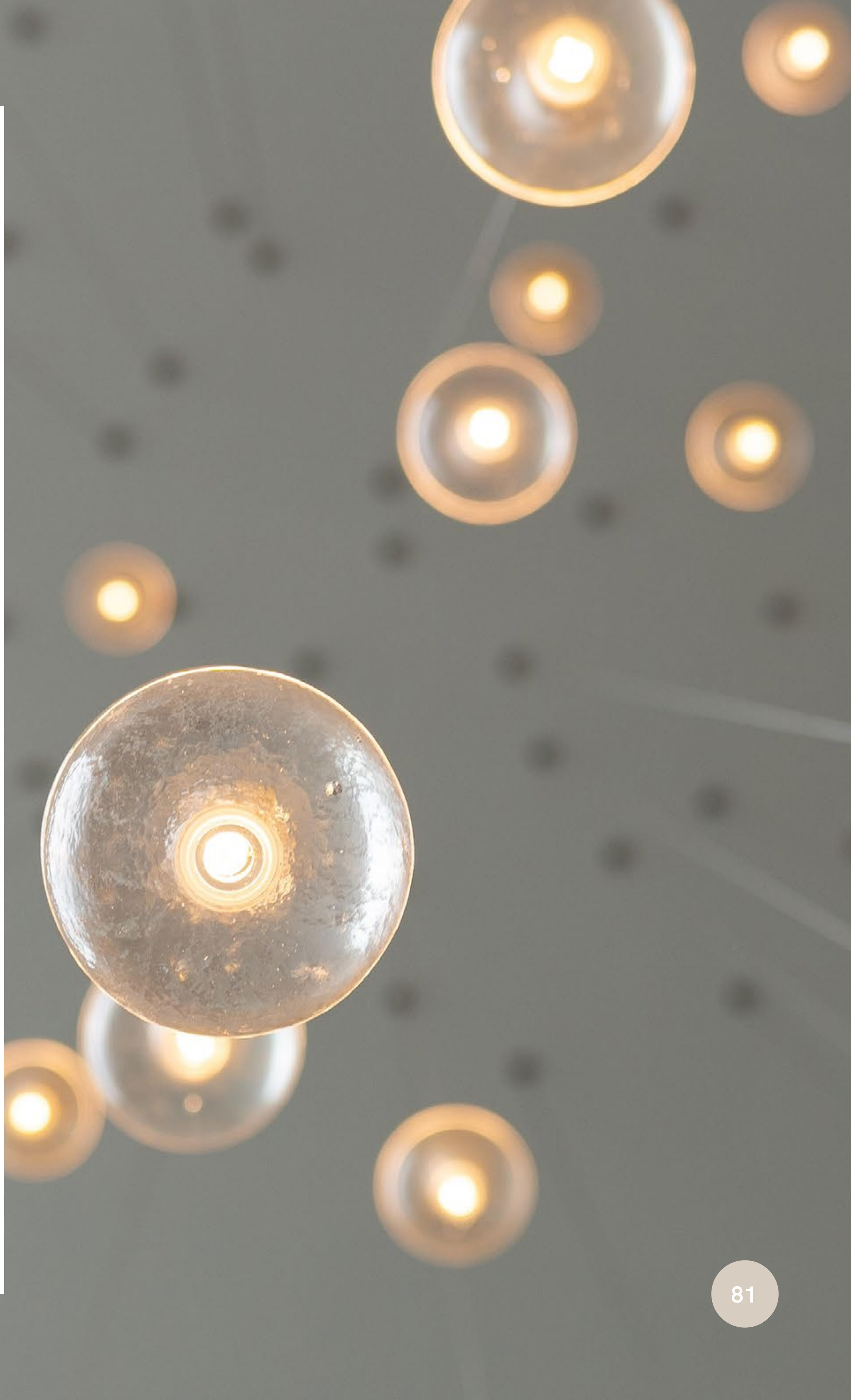
The Financial Services Bill currently progressing through parliament proposes to give the UK regulators new powers, and their aim for the UK's future legislative and regulatory framework remains to protect markets and consumers. Hence, provisions emphasise LIBOR transition and prioritise reforms to the UK prudential framework, with implementation of Basel III and a new Investment Firms Prudential Regime (IFPR), while Market Abuse Regulation (UK MAR) is also tightened.

UK competitiveness clearly remains in focus too. UK market access for overseas firms under UK Markets in Financial Instruments Directive (MiFID), as well as for funds, has been addressed, while amendments to European Market Infrastructure Regulation (EMIR) aim to improve clearing access.

Strengthening operational resilience remains high on the agenda, with regulatory policy statements and implementation expected to progress throughout the year.

In 2021, key components of those regulatory and market reforms initiated in response to the global financial crisis, will be delivered and executed. The UK also has an opportunity to revisit aspects and optimize its regulatory framework, as well as considering market insights, new challenges, and heightened risks, identified during the pandemic crisis.

The regulatory landscape will no doubt be in flux, as several regulatory consultations have already been announced, ahead of the Financial Services Bill being enacted in Parliament. We decided to focus on those initiatives emphasized by regulators, which we consider the most impactful for the Capital Markets sector.



Capital markets – key regulatory developments

LIBOR transition

In a year with no shortage of regulatory and best practice milestones for the vast market-driven LIBOR reform, the FCA's crucial cessation announcement for all LIBOR settings, and associated fixing of credit spread adjustments, provides market participants the clarity that should ignite active transition in line with regulatory expectations. Further legislation and development of SOFR term rates as well as consultation on synthetic LIBOR settings should also provide a path for tough legacy contracts.

Basel 3.1

Implementing final Basel III standards, some Basel 3.1 key components will apply in the EU from this year, whilst other aspects are subject to the CRD VI and CRR III legislative process in the EU. UK regulated firms will have some additional time, as the PRA has issued a consultation on implementation of international standards through a new PRA Capital Requirements Regulation (CRR) rule instrument, revisiting some aspects of onshored CRR II regulation as well as Basel rules that remain to be legislated.

EMIR REFIT

European Market Infrastructure Regulation (EMIR) on derivatives, central counterparties and trade repositories was introduced to improve transparency and reduce risks in derivatives markets. EMIR REFIT amendments were also onshored into UK legislations, and make the regime more proportionate for certain firms, through reduced clearing and streamlined reporting obligation. Legislation that will apply from 2021 aims to ensure fair, reasonable, and non-discriminatory, transparent access to clearing services and to improve trade repository data through control measures.

Bilateral margin obligations phases 5 and 6

Bilateral margin requirements are risk mitigation measures introduced as part of EMIR, that apply to non-centrally cleared OTC derivatives for financial and non-financial counterparties. Two remaining counterparty categories will come into scope of initial margin, driven by the size of their aggregate average notional amount (AANA) of non-centrally cleared derivatives: above €50 billion in Phase 5 later this year and above €8 billion in Phase 6 from September 2022.

LIBOR transition

In a nutshell

The global LIBOR transition reached a milestone in its critical execution year.

Initiated in 2017 by the FCA, due to reduced benchmark validity in the underlying market, uncovered manipulation, and new benchmark regulation, the global regulator of London Interbank Offered Rates has announced official LIBOR cessation dates: End of 2021 for most settings and June 2023 for five major USD tenors.

Market participants have had programmes in flight, whilst official sector and industry initiatives established timelines, best Practices, and standards to facilitate the reform. The five currency jurisdictions selected transaction-based overnight rates as alternative reference rates (ARRs):

- **SONIA** – Sterling Overnight Index Average
- **SOFR** – Secured Overnight Financing Rate - launched in the US
- **ESTR** – Euro Short-Term Rate
- **TONAR** – Tokyo Overnight Average Rate
- **SARON** – Swiss Average Rate Overnight

The ISDA index cessation event triggered fallback spread adjustment fixings for all 35 LIBOR settings. This clarity is expected to ignite active back-book transition.

2021 timeline

The key dates indicate milestones for market participants and operators, reflecting market events and targets set by official sector working groups, such as the Risk Free Rates Working Group (RFRWG) in the UK or Alternative Reference Rate Committee (ARRC) in the US.

Q1 2021

11 January
- IBA and Refinitiv launched SONIA Term rates

25 January
- IBOR Fallback Supplement effective for all new derivative contracts
- ISDA 2020 IBOR Fallback Protocol effective for legacy derivatives of adhering counterparties
- IBA consultation on proposed cessation dates for each LIBOR setting completed

29 January
- New York State includes proposed LIBOR legislation in FY22 executive budget

5 March
- FCA made cessation/pre-cessation announcement for all LIBOR settings
- ISDA confirmed FCA announcement as Index Cessation Event
- Bloomberg declared FCA announcement date as credit spread adjustment fixing date

8 March
- IBA and Refinitiv launched SONIA Term rates

31 March
- No new GBP LIBOR loans, bonds, securitisations, or linear derivatives expiring after 2021, unless managing risk.
- Full identification of contracts expiring after 2021, where active transition is viable

Q2 2021

- FCA consultation on continued publication of some LIBOR settings on a synthetic basis

30 June
- No new GBP LIBOR non-linear derivatives and ETDs expiring after 2021, unless managing risk
- Progress active transition of all legacy GBP LIBOR contracts expiring after 2021, where viable
- Most new USD LIBOR linked business expected to have ceased
- SOFR Term rate expected

30 September
- Complete active transition of all legacy GBP LIBOR contracts expiring after 2021, where viable

31 December
- Cessation of 30 LIBOR settings, including all GBP, JPY, EUR, CHF and two USD tenors
- Synthetic LIBOR for select GBP and JPY tenors, subject to FCA powers under UK BMR
- US regulators require cessation of new USD LIBOR business for any tenors

Q3 2023

30 June 2023
- Cessation of USD LIBOR settings for major tenors, including O/N, 1M, 3M, 6M and 12M
- Synthetic LIBOR for select tenors, subject to FCA powers under UK BMR

LIBOR transition

Core components

Enterprise readiness
LIBOR benchmarks have been deeply embedded across Financial Services products, operations, data architecture and systems. Due to this complexity, UK regulators have monitored supervised firms' change programmes, expecting robust governance and Senior Manager accountability, as well as periodic reporting of LIBOR exposures, progress in offering alternative reference rate (ARR) products, and preparations to transition legacy portfolios. Firms need to consider business and product strategy as well as transition impacts.

Front to back to risk enablement of ARR products is reliant on the pricing and risk model life cycle, from development and validation to regulatory approval. Equally critical are operational changes and system upgrades to ensure trade capture and booking models can accommodate business in new overnight rates for all products.

Back book transition
Transition of the LIBOR back-book to robust replacement rates has legal risks and pre-requisites, from policies, contract templates, fallback clauses to contract reviews, renegotiation, and dispute management. Contract identification, repapering of client contracts and rebooking can be supported by technologies leveraging NLP, advanced data management and bulk rebooking tools to make the transition more efficient.

Active transition of the legacy portfolio may also affect collateral and margin management, as well as prudential risk measures, liquidity and treasury asset and liability management, hedging strategies and funds transfer pricing, to ensure continued profitability of new ARR product lines or replacement contracts.

Hedge accounting and tax impacts of LIBOR transition have also been important focus areas, where accounting standard setting bodies have granted relief, whilst HMRC provided guidance on LIBOR transition impacts, to allow consideration in firms' transition planning.

Conduct risk
Transitioning LIBOR-linked business or updating fallback clauses, and offering new rate products have heightened conduct risk, whether considering product suitability or value transfer to ensure fair treatment of customers or avoiding conflicts of interest. Timely and auditable client communication, query and transition outreach case management and training of client-facing staff are important mitigation steps.

Derivatives
Overnight rates are quite established in bilateral and cleared derivatives. The IBOR Supplement and ISDA 2020 IBOR Fallbacks Protocol were developed to provide contractual fallbacks, where existing ones are not suitable for permanent cessation. Spread adjustments have now been fixed, providing more clarity for transition. CCPs have consulted market standard OIS swaps, to better meet obligations although cash settlement of value transfer was less welcome by market participants.

Cash products
Transition of many cash products is more challenging as the backward-looking compounding rates are new to the loans market. Clients dislike cashflow uncertainty, whilst processes and loan systems need more reengineering.

Bond transition
Transition of floating rate notes (FRN) or LIBOR-linked securitizations have other complexity, as bondholders need to be identified for consent solicitation, and transition may need to be initiated by corporate issuers, too.

Regulatory and legal powers
The FCA should get new powers under proposed UK Benchmarks Regulation (BMR) that enable publication of synthetic LIBOR based on changed methodology, to support transition of tough legacy contracts. Proposed NY legislation may help mitigate litigation risk for challenging contracts under NY law.

Basel 3.1

In a nutshell

Basel 3.1 implements the final Basel III prudential reforms, introduced by the Basel Committee for Banking Supervision (BCBS) over the decade following the global financial crisis. The remaining or revised capital requirements, sometimes labelled Basel IV, focus on market risk, credit risk, credit valuation adjustment risk, operational risk, leverage ratio revisions and output floor.

Some UK rules are on-shored EU regulation (CRRII), some will be further legislated through HM Treasury's Financial Services Bill, currently progressing through parliament. The PRA has issued a consultation paper for review, setting out Capital Requirements Regulations (CRR) in full.

Most significant changes for capital markets firms include the market risk framework known as Fundamental Review of the Trading Book (FRTB), CVA and counterparty credit risk.

Due to COVID-19, the final implementation timeline was extended to 1 January 2023, although there are important milestones this year.

2021 timeline

12 February 2021 – PRA Consultation Paper CP5/21 on Implementation of Basel standards released

3 May 2021 – PRA Consultation on Implementation of Basel standards due to end

Summer 2021 – Review of the UK leverage ratio framework

28 June 2021 – CRR II provisions for leverage ratio, net stable funding ratio (NSFR) and standardised approach for counterparty credit risk (SA-CCR) to apply in the EU

September 2021 – Reporting under standardised approach for market risk (FRTB-SA) due to start in the EU

2022

1 January 2022 – IRB approach for credit risk applies in the EU

1 January 2022 – Delayed UK implementation target date for Basel 3.1 reforms analogous to CRRII

2023

1 January 2023 – Basel implementation deadline

Basel 3.1

Core components

Standardised approach for credit risk

A revised standardised approach (SA) applies a more detailed risk weighting approach to increase risk sensitivity, assigning weights by exposure class for externally provided credit ratings. It enables more granular risk weighting, particularly for real estate, where a 20-70% range, based on LTV replaces a flat 35%. An alternative not based on ratings is available for jurisdictions not supporting external credit ratings.

Internal ratings based approach for credit risk

Supporting internal credit risk models, the revised internal ratings-based approach (IRB) considers variability across industries to increase comparability and effective supervision. Minimum levels for probability of default (PD) apply to both Foundation IRB (F-IRB) and Advanced IRB (A-IRB), and for the latter also to loss given default (LGD) and exposure at default (EAD) input parameters. A-IRB can no longer assess exposures to banks, financial institutions, and large corporates, whilst the standardised approach is prescribed for equity exposures.

Minimum requirements for market risk

The revised market risk framework (FRTB) addresses previous framework limitations under market stress and emphasises rigorous boundaries between trading and banking book.

A new internal model approach (IMA) replaces VaR and stressed VaR measures with expected shortfall (ES), to better reflect tail risks, adding default risk capital (DRC), which is VaR-based with extended liquidity horizon, and non-modellable risk factor (NMRF) charges. IMA requires risk factor eligibility tests (RFET), and back testing and profit and loss attribution (PLA) to assess model accuracy.

Whilst IMA is optional, requiring desk level approval, a more sophisticated, sensitivities-based standardised approach (SA) is applicable to all firms, for ineligible or as fallback for disqualified desks. Reporting requirements under SA start this year. Further legislative processes will specify capital requirements.

CVA risk framework

The credit value adjustment (CVA) risk framework considers MTM losses from OTC derivatives trading counterparties and aims to align calculations to final market risk and counterparty credit risk frameworks, to enhance risk sensitivity and hedge recognition by assessing the exposure element of CVA.

The basic approach applies exposure-based calculations whilst the standardized approach (SA-CVA) makes sensitivity-based calculations, and there is no internal model approach.

In response to industry feedback final changes were made to risk weights, capital multipliers and aggregation formula for SA-CVA, or discount scalar for BA-CVA to avoid disproportionately conservative capital outcomes.

Operational risk framework

A single risk-sensitive standardised approach replaces the four current methods of calculating operational risk. The framework applies gross income and historic operational losses, whereby calculations use an internal loss multiplier (ILM), business indicator (BI) and business indicator component (BIC).

Output floor

The output floor limits the minimum of banks' risk-weighted assets (RWA) generated by a combination of their internal and standardised models compared to the RWA calculated purely by the framework's standardised approaches. The output floor will gradually increase from initially 50% of RWA in 2023 to 72.5% in 2028.

Proportionality

UK authorities are considering proportionality in their Basel 3.1 implementation to simply compliance for smaller firms.

EMIR REFIT

In a nutshell

EMIR was introduced in 2014 to improve monitoring of counter party credit risk and increase transparency over trades in the derivatives market. The approach was complex and financially burdensome for smaller and non-financial counterparties, prompting a review by the European Commission in 2015. This resulted in the EMIR REFIT for greater proportionality, to simplify requirements and improve clearing processes.

Key changes include:

- fair, reasonable, non-discriminatory and transparent (FRANDT) clearing activities.
- notifications of clearing thresholds
- intragroup exemptions for clearing and margin requirements

The majority of the EMIR REFIT has already been applied, with outstanding elements around FRANDT and notifications of clearing thresholds to take effect during 2021.

2021 timeline

By 17 June 2021	First notifications of clearing thresholds to the FCA
From 18 June 2021	Application date for FRANDT

Core components

FRANDT requirements

The clearing obligation within EMIR means counterparties must use a central counterparty (CCP) to clear over the counter (OTC) derivatives. To achieve this, firms must be a direct or indirect clearing members or clients of a CCP. In effect, this means counterparties trading OTC derivatives have to rely on a small pool of providers for clearing services., Such barrier may cause market participants to cease trading derivatives or to engage in non-cleared OTC derivatives trading. It is a particular concern for small and medium sized counterparties with a low volume of trading activity in OTC derivatives.

To address the issue and improve access to clearing services, the EMIR REFIT:

- stipulates that commercial terms for clearing services must be fair, reasonable, non-discriminatory and transparent (FRANDT). FRANDT principles have been used in different subject areas within financial markets, in particular, regarding public disclosure and risk assessments under MiFID II
- limits the scope of the clearing obligation to reduce demand for clearing services
- clarifies that CCPs should not be prevented from following default management procedures in relation to EEA Member States' insolvency laws

Provision of clearing services have historically contributed to the leverage ratio calculation, leading to potentially higher capital requirements under CRR. This meant that provision of clearing services was expensive and CRR has been updated to remove a key barrier for providers.

Additional requirements under FRANDT include:

- Clearing members must have access to a simulation tool providing information on the initial margin models used and determining the amount of additional initial margin on a gross basis
- Clearing Service Providers (CSPs) must undertake a risk assessment of their clearing clients, which will ensure unbiased and rational commercial terms and conditions
- CSPs must ensure that differences in prices charged to their clearing clients are proportionate to costs, risks and benefits
- CSPs must manage conflicts of interest with a particular focus on onboarding, commercial terms and fees
- CSPs should provide the competent authority with information on the fees charged to clearing clients

Notification of clearing thresholds

EMIR REFIT introduces a new regime to determine whether and when a financial counterparty (FC) and non-financial counterparty (NFC) is subject to the clearing obligation, by calculating the counterparty's aggregate group, month end, average position of each asset class of OTC derivatives; for the previous 12 months and comparing such calculation against the clearing thresholds.

- If a counterparty (either a FC or a NFC) does not calculate its position against the clearing thresholds, it will be subject to the clearing obligations for all asset classes of OTC derivative contracts in scope
- If a FC's calculation of position exceeds the clearing threshold for any asset class of OTC derivatives, it will be subject to the clearing obligations for all asset classes of OTC derivative contracts in scope
- A NFC is only subject to the clearing obligations for the specific asset classes of OTC derivative contracts where the calculation of position exceeds the clearing threshold
- Regardless of whether UK FCs and NFCs choose to calculate their positions, If they are subject to the clearing obligation, they must submit a first notification to the FCA. If they choose to calculate their positions, this must be done every 12 months but they do not need to notify the FCA unless there is a change in the output of any subsequent calculation
- UK FCs and NFCs must notify the FCA when the calculation of their positions no longer exceeds the clearing thresholds

Intragroup exemptions from clearing and margin

UK firms who currently benefit from intragroup clearing exemptions with their EU or third country group entities and from intragroup margin exemptions with their EU group entities, may continue to benefit from these exemptions from 1 January 2021 until the 'relevant day' as defined in EMIR SI, without reapplying for these exemptions to the FCA. However, UK firms who benefit from intragroup margin exemptions with their third country group entities where no equivalence has been determined, will be required to reapply those exemptions if they want to benefit from the transitional regime in the EMIR SI.

Bilateral margin obligations phases 5 and 6

In a nutshell

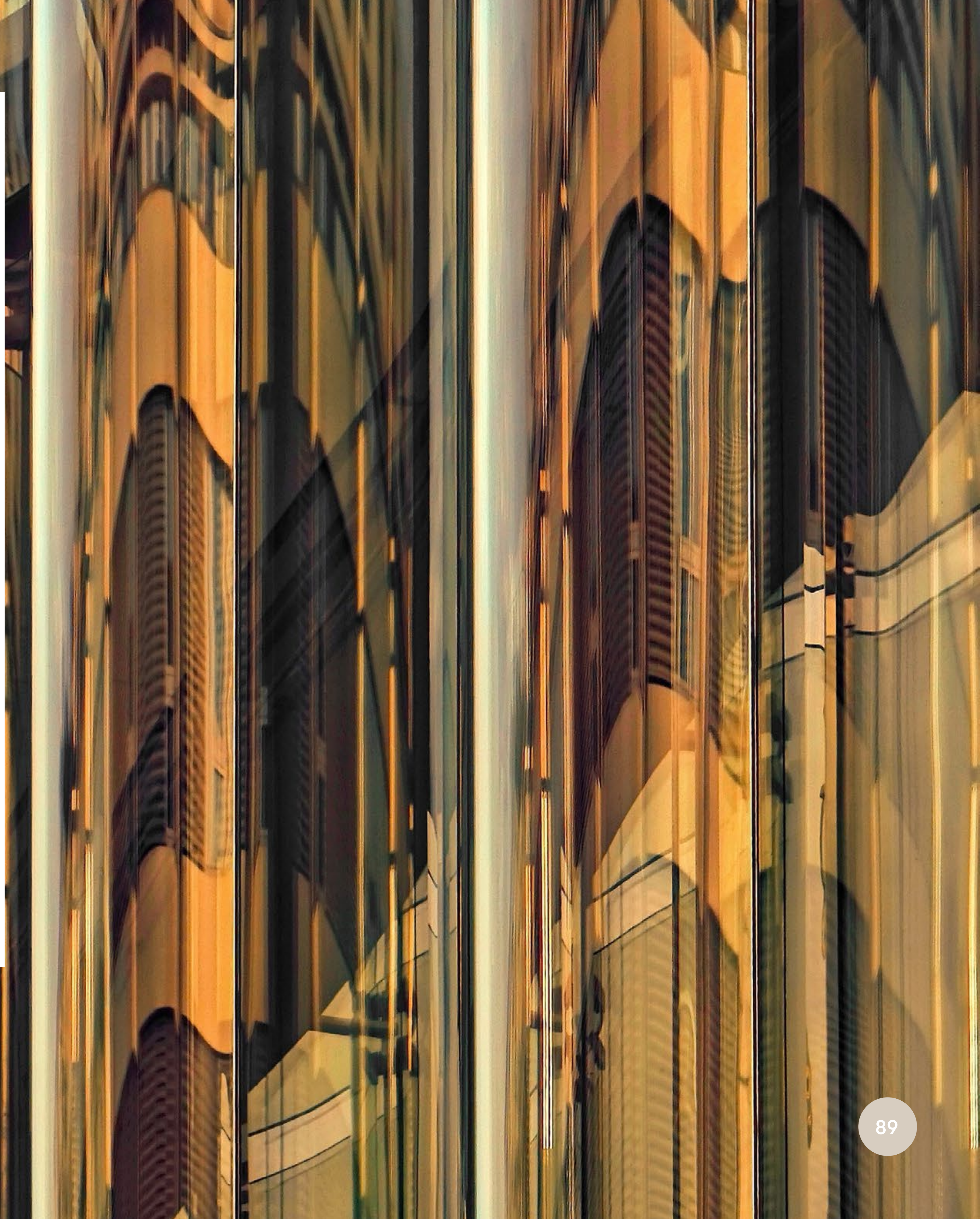
Bilateral margin requirements apply to all non-centrally cleared OTC derivatives, and took effect under EMIR in 2017. They are designed to reduce systemic risk, promote central clearing and reduce losses in the event of a counterparty default. This may have an impact on a counterparty's liquidity, and as such the margin obligations have been phased in gradually to give firms time to meet the liquidity requirements. The majority of these phases are now complete, with two remaining categories coming into scope for initial margin requirements in September 2021 and 2022.

The regulation applies to financial institutions and systemically important non-financial institutions (above the clearing threshold), and consists of two types of margin:

- Initial margin – reflecting the expected future exposure
- Variation margin – representing the current exposure

2021 timeline

September 2021	Initial margin requirements apply for entities with a aggregate average notional amount of uncleared derivatives (AANA) of non-centrally cleared derivatives above €50 billion
September 2022	Initial margin requirements apply for entities with a aggregate average notional amount of uncleared derivatives (AANA) of non-centrally cleared derivatives above €8 billion



Bilateral margin obligations phases 5 and 6

Core components

Scope

The margin requirements apply to all OTC derivatives that are not cleared through a central counterparty. This is subject to a clearing threshold, in line with the clearing obligations under the EMIR REFIT. There are exceptions, some of which are subject to further conditions:

- FX forwards and FX swaps (physically-settled) and currency exchanges – variation margin only, no initial margin
- Single-stock equity options and index options – delayed implementation
- Covered bond swaps – subject to conditions (if so, variation margin only to covered bond entity)
- One-way obligations (e.g. options) – one-way margin
- Intragroup exemptions – subject to conditions

EEA states have been granted equivalence for intragroup exemptions and margin requirements. As such, UK firms previously granted an intragroup extension must reapply or renotify the FCA of their equivalent status. If equivalence has not been determined between UK and third countries, the transitional regime will continue to apply.

Baseline methodologies

The initial margin could be calculated by reference to a quantitative portfolio margin model or a standardized margin schedule; however market participants should not be allowed to "cherry pick" the most favourable initial margin terms by switching between model-based and schedule-based margin calculations. The variation margin should be calculated and exchanged regularly (e.g. daily) subject to a single and legally enforceable netting agreement between parties.

Eligible collateral for the margin

Collateral must be provided in a form that firms can liquidate quickly, especially in times of financial stress. A wide range of collateral can be used, including cash, Government and central bank securities, corporate bonds, covered bonds, equities and gold. Non-cash collateral such as securities or bonds may, be subject to a haircut for margin valuation. Haircut levels should be risk-based to reflect the underlying risks such as market price volatility, liquidity, credit risk and FX volatility during both normal and stressed market conditions. The same approach (either standardized tables approach or internal/third party models approach) should be consistently adopted for all the collateral assets within the same asset class. It's important to note that assets such as shares, bonds, debt securities or securitisations cannot be issued by the counterparty entity or its wider group.

Treatment of the initial margin

Initial margin should be exchanged between counterparties on a gross basis rather than on a net basis. The initial margin collected should be held in a manner that:

- the margin must be immediately available to the collecting party in the event of the counterparty's default;
- the margin must be subject to arrangements (e.g. use of third party custodians) that protect the posting party in the event when the collecting party enters bankruptcy

In general, cash and non-cash collateral collected as variation margin may re-hypothecated, re-used or re-pledged whereas cash and non-cash collateral collected as an initial margin should not be re-hypothecated, re-pledged or re-used (except where initial margin collected from a customer may be re-used or re-pledged to a third party only for the purpose of to hedging the initial margin collector's derivative position arising out of transactions with that customer and subject to conditions that protect that customer's rights in the collateral.

Treatment of transactions with affiliates

As the specific legal and regulatory frameworks governing transactions between a firm and its affiliates vary considerably across jurisdictions, such transactions are subject to appropriate regulation within each jurisdiction's legal and regulatory framework.

Interaction of national regimes in cross border transactions

As capital markets are global in nature, margin obligations work on the basis of that these requirements are consistently applied across territories. This aims to reduce arbitrage and prevent creating an advantage in some territories by reducing the margin obligation.

Phase in of requirements

The margin requirements apply to all new contracts entered into during the prescribed periods rather than to existing derivatives contracts. Margin obligations will require operational changes and effective liquidity planning. They may be particularly challenging for smaller firms.

Financial services team

Our financial services group is committed to working with our clients to shape a successful economy founded upon sustainable growth, trust, integrity and innovation. We work with many of the world's most influential growth businesses, building long-term relationships founded upon exceptional client service, trusted and reliable delivery and a shared desire to achieve transformational results.

Sandy Kumar
Global Head of Financial Services and Business Risk Services
T +44 0(20) 7865 2193
E sandy.kumar@uk.gt.com

Alex Ellerton
Partner – Advisory
T +44 0(20) 7184 4627
E alex.ellerton@uk.gt.com

Dana Ward
Partner – Tax
T +44 0(20) 7728 3316
E dana.ward@uk.gt.com

David Morrey
Partner – Advisory
T +44 0(20) 7865 2657
E david.morrey@uk.gt.com

Ian Woodruff
Partner – Tax
T +44 0(20) 7728 2735
E ian.woodruff@uk.gt.com

James Cruttenden
Partner – Advisory
T +44 0(20) 7865 2495
E james.r.cruttenden@uk.gt.com

John Da Gama-Rose
Partner – Consulting
T +44 0(20) 7865 2658
E john.da.gama-rose@uk.gt.com

Manu Sharma
Partner - Advisory
T +44 0(20) 7865 2406
E manu.sharma@uk.gt.com

Paul Flatley
Partner – Audit
T +44 0(20) 7728 2779
E paul.flatley@uk.gt.com

Rob Benson
Partner – Advisory
T +44 0(20) 7865 2415
E paul.m.benson@uk.gt.com

Sam Pointon
Partner – Audit
T +44 0(20) 7728 2167
E sam.w.pointon@uk.gt.com

Sarah Talbott
Partner - Advisory
T +44 0(20) 7865 2815
E sarah.d.talbott@uk.gt.com

Simon Sheaf
Partner - Advisory
T +44 0(20) 7865 2815
E simon.h.sheaf@uk.gt.com

Terry Heatley
Partner - Tax
T +44 0(20) 7865 2685
E terry.j.heatley@uk.gt.com

Tom Townson
Partner - Advisory
T +44 0(20) 7865 2175
E thomas.f.townson@uk.gt.com

Marcus Swales
Partner – Audit
T +44 0(20) 7865 2320
E marcus.swales@uk.gt.com

Paul Garbutt
Partner - Advisory
T +44 0(20) 7865 2170
E paul.garbutt@uk.gt.com

Roy O'Neil
Partner – Consulting
T +44 0(20) 7865 2540
E roy.oneil@uk.gt.com

Phil Roberts
Partner – Consulting
T +44 0(20) 7184 4557
E phil.e.roberts@uk.gt.com

grantthornton.co.uk