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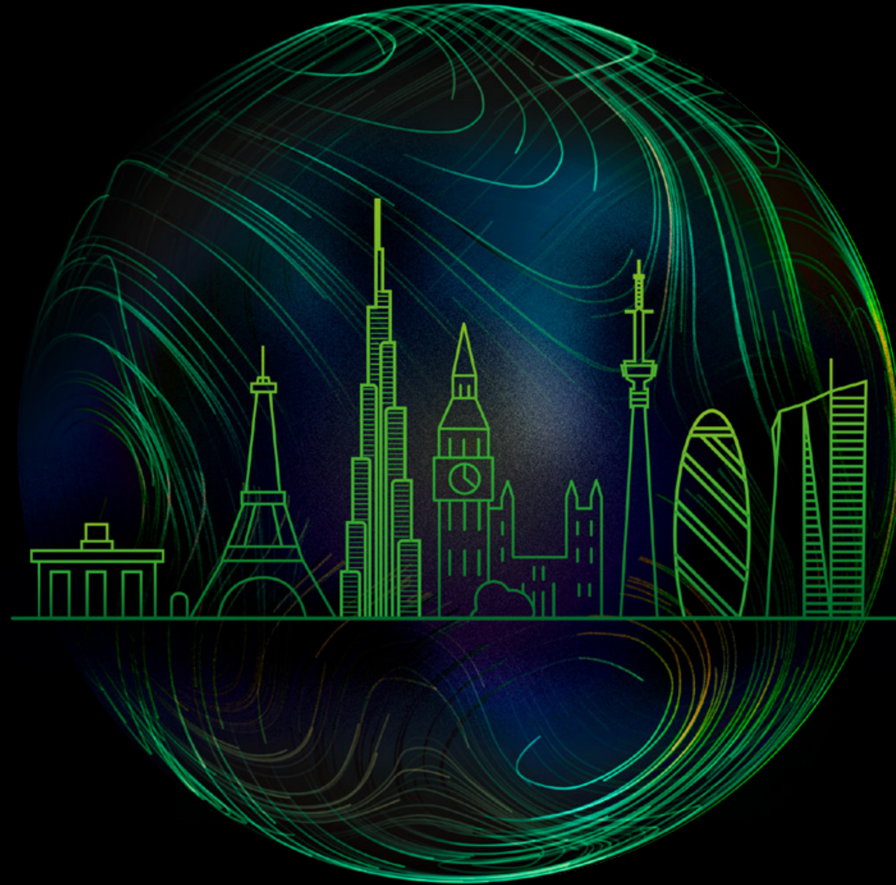


Are you ready for it?

Financial Markets
Regulatory Outlook 2024

CENTRE *for*
REGULATORY STRATEGY
EMEA

"I am convinced that our financial system, warts and all, is better than many alternatives. It has been tried and tested. By inflation and recession, by bank runs and financial crises, by innovation and incompetence... as money makes the world go round, the system that regulates and oversees that movement cannot stand still, but has to stay in constant motion. It has to change with the times, adapting to new demands from the public and changing political tides."

Klaas Knot, President of the Netherlands Bank[1]

"...The world does not stand still. We have seen unexpected political and economic headwinds and it seems prudent to assume more will come. With unexpected headwinds and limited bandwidth, longer-term issues can end up deprioritised. Issues do not though go away – quite the opposite, they build in the background."

Sarah Breeden, Deputy Governor for Financial Stability, Bank of England[2]

Navigating the report

Cross-sector

The global regulatory landscape:

Our view on the economic and structural forces shaping the global regulatory landscape

EMEA cross-sector perspective:

Our top-down view on the regulatory outlook for the EMEA financial services sector

In focus:

Our view on the outlook for sustainability and innovation, payments and digital assets regulation across the EMEA financial services sector

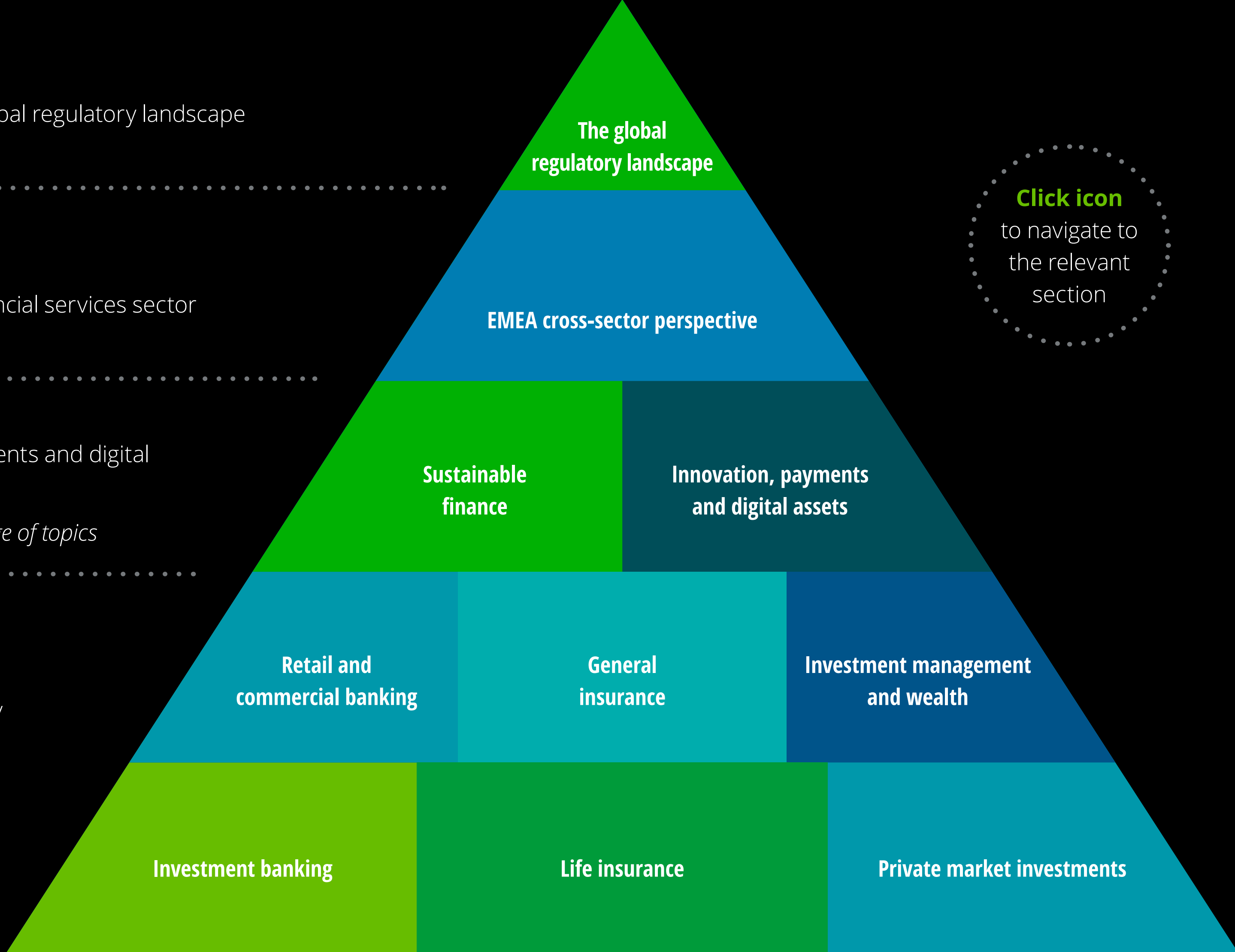
NB: both perspectives accompanied by detailed annex on wider range of topics

Sector-specific

Sector perspectives:

Our view on the most important, challenging or novel regulatory and supervisory issues in the year ahead for different sectors of financial services

NB: perspectives accompanied by detailed annexes on wider range of topics



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The global regulatory landscape

Short- and medium-term pressures require an agile strategic approach

The challenging and unprecedented operating conditions that Financial Services (FS) firms have faced for the last few years look set to continue in 2024. Although inflation is now cooling and increases in interest rates have slowed, both of those factors continue to weigh on economic activity. Considerable economic uncertainty persists, and financial and nonfinancial risks remain elevated.

Naturally, navigating these choppy waters will likely be front of mind for FS executives in the near term. Yet at the same time, the drivers of medium-term term structural change in financial services – such as geopolitics (and how they will be affected by elections taking place in several major jurisdictions),[3] sustainability and technological innovation – are no less relevant and will remain close to the top of Boards' and Senior Executives' agendas.

The global regulatory landscape

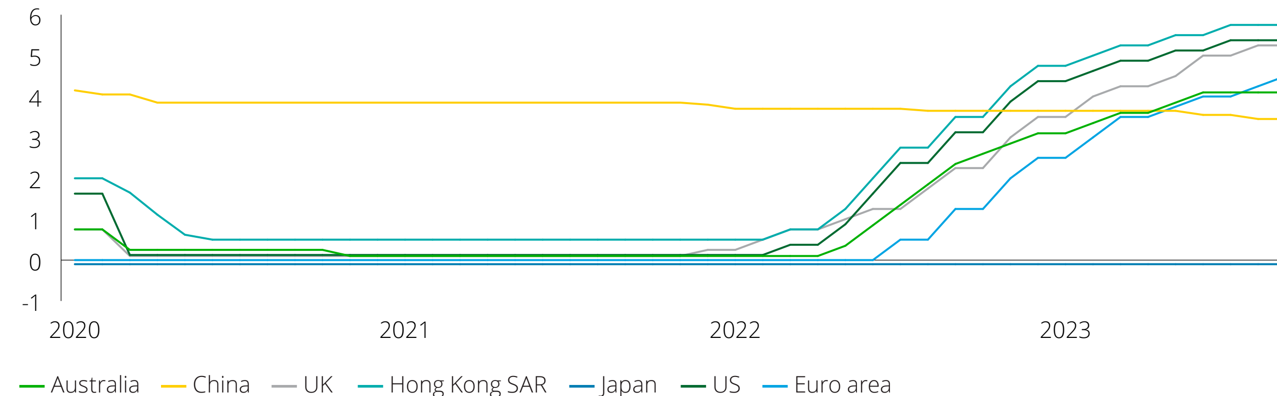
Short- and medium-term pressures require an agile strategic approach

The economic outlook

The IMF predicts a slowdown in global growth in 2024, from 3.0% in 2023 to 2.9% in 2024,[4] with growth in advanced economies set to slow to 1.4%. The World Bank has warned that growth in Asia's developing economies is expected to come in at its lowest rate in five decades (4.5%).[5]

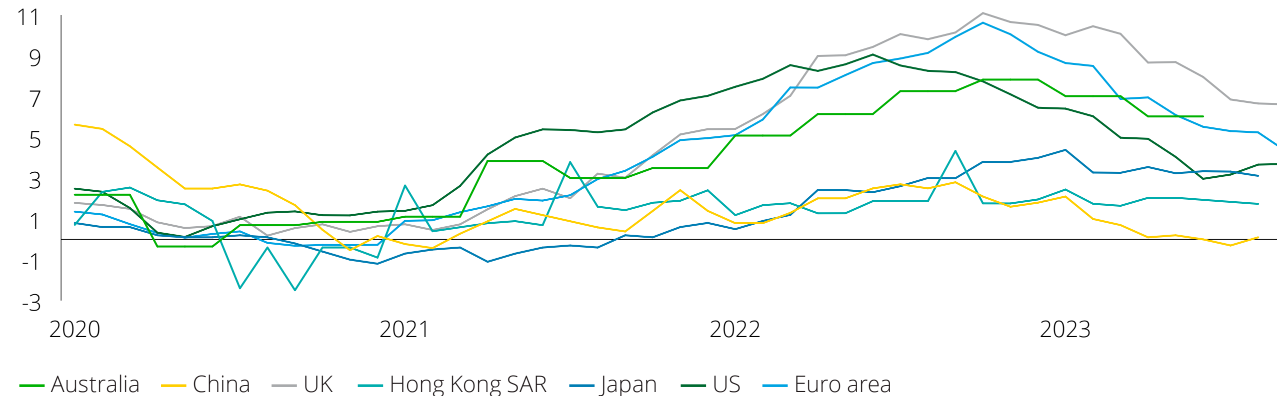
Households and businesses in many parts of the world continue to feel the squeeze of higher inflation (see figures 1 and 2). Although interest rates may not rise further than their current levels, the lingering impact of inflation and the rate rises of the last two years are likely to put prolonged pressure on debt servicing ability, increase claims' settlement costs, and drive market volatility. Given the long and variable time lag in the transmission of monetary policy, it is likely that a significant portion of the impact of rate rises has not yet been passed on to the real economy.

Figure 1: International policy rates (since January 2020, in percent)



Source: Bank for International Settlements[6]

Figure 2: International consumer price inflation (since January 2020, year-on-year changes, in percent, monthly data)



Source: Bank for International Settlements[7]

The global regulatory landscape

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Banks[8] and non-banks (which have significantly increased their exposure to credit markets in recent years) face elevated credit risks. Financial stability authorities have signalled particular concern about two areas: the commercial property sector (in particular office properties), given its vulnerability to lower growth, heightened inflation and higher interest rates[9] and reduced occupancy levels after COVID-19; and private credit markets, given their rapid growth, sensitivity to rate rises and covenant-lite loan practices.[10]

Concurrently, with cost-of-living pressures continuing to bite, firms should seek to ensure fair outcomes for vulnerable borrowers, and expect proactive supervisory intervention if they fail to do so. Although the circumstances are different (given the absence of government guarantees and moratoria) supervisors may start taking firms' actions during COVID-19 as the benchmark for fair treatment of customers.

For both firms and their supervisors, maintaining financial resilience in this testing macroeconomic environment remains a top priority.

Figure 3: CET1 levels of top 50 global banks (by assets, Q3 2023)

Source: Deloitte analysis of banks' Q3 2023 financial reports[11]

Figure 4: LCR levels of top 50 global banks (by assets, Q3 2023)

Source: Deloitte analysis of banks' Q3 2023 financial reports[12]

The global regulatory landscape

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At first glance, the banking sector appears to be entering 2024 in relatively resilient shape, with strong capital and liquidity ratios (see figures 3 and 4 on previous page). Yet the failure in 2023 of several mid-sized regional US banks, followed swiftly by the rescue of a global systemically important bank (G-SIB), offered a timely reminder of two things: firstly, that customer and investor confidence in banks is far from unshakeable, and secondly, that robust capital and liquidity buffers need to be accompanied by strong risk management, controls and governance, robust recovery and resolution plans, and proactive supervisory oversight.

The latter of these points will be the focus of the near-term international policy response.[13] But even ahead of any near-term policy change, supervisors will expect banks to enter 2024 with a renewed focus on understanding how changing market conditions are affecting their business. Longstanding supervisory concerns around the sustainability of some banks' business models - including regional banks in the US, Europe and Japan - will come into even sharper focus this year given the banking turmoil in March 2023 and change in the interest rate environment – particularly as the initial positive impact of higher interest rates on bank margins recedes and risks that built up during the 'low-for-long' era begin to crystallise.

Supervisors will also be vigilant to the impact of inflation[14] and rising interest rates on insurers, although insurers may be able to offset inflation-driven increases in expenses and claims via increased premiums in the medium to long term. Life insurers may earn higher investment returns as a result of higher interest rates, but they may be subject to higher lapse risks if interest rates continue to rise.

> "Longstanding supervisory concerns around the sustainability of some banks' business models - including regional banks in the US, Europe and Japan - will come into even sharper focus this year."

Of equal, or perhaps greater, concern to financial stability authorities will be the resilience of non-bank financial intermediaries[15] (NBFIs) – especially in the context of elevated market risk and volatility in global bond markets. Financial stability authorities have expressed growing concern at the potential effect of the growth of speculative positions by hedge funds in US Treasuries, with net short positions in 2023 reaching comparable levels with Treasury market turmoil in 2020.[16]

Supervisors and central banks remain keen to intervene. A key priority is to improve understanding of market dynamics and fill in data gaps – through exercises such as the Bank of England's pioneering System-Wide Exploratory Scenario (SWES),[17] for example, as well as the ongoing work of the Financial Stability Board and the International Organization of Securities Commissions. In the US, the Financial Stability Oversight Council (FSOC) has finalised a framework for designating non-banks as systemic and the Securities and Exchange Commission (SEC) is considering a number of Treasury market reforms to increase transparency and support resilience. The Bank of England has taken tentative first steps towards the creation of a standing central bank liquidity facility for non-banks.[18] The Australian

The global regulatory landscape

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Prudential Regulation Authority has strengthened the recovery and resolution framework for insurers and superannuation funds.[19] Yet the European Commission's decision in 2023 not to reform its MMF regulation demonstrated that legislative change may be more difficult to achieve.[20]

Until a comprehensive, NBFI-specific framework is in place, supervisors will continue to use banks as proxies to manage risks in NBFIs – including through further stress testing and scenario analysis, and scrutiny of banks' ability to monitor leverage in NBFI counterparties. Longer term, we may see the macroprudential framework used to improve banks' resilience to NBFIs. The European Commission, for example, is considering[21] NBFI-related changes to the macroprudential toolkit.

"There is increased risk that geopolitical tensions fragment the global economic landscape further."

Structural change

While the above issues will draw the attention of both firms and policymakers in the short term, firms must not lose sight of the medium-term structural changes that are shaping the FS regulatory landscape. The three themes that we have picked out are unchanged from our 2023 Outlook: **geopolitics, technology** and **climate change**. Yet all three have experienced sufficiently significant shifts in the past 12 months that they require revisiting.

Geopolitics

The 'slowbalisation' of recent years – characterised by rising geopolitical tensions putting pressure on political support for open trade and investment – looks set to continue in 2024. Governments and business leaders are seeking to de-risk their value chains, with increasing 'friend-shoring'[22] and protectionist measures in critical sectors.[23] According to the IMF, mentions in companies' earnings presentations of reshoring, onshoring and near-shoring have increased almost tenfold,[24] and in our experience some firms are choosing to bring certain services back in-house to manage operational risk and resilience more effectively.

In our view, there is increased risk that geopolitical tensions fragment the global economic landscape further. Possible catalysts can be broadly split into two categories: foreseen catalysts (such as elections) and unforeseen catalysts (such as further escalation in the conflict between Russia and Ukraine, or in the Middle East). The latter category remains highly relevant, difficult to predict and potentially high impact. But looking ahead to 2024, the impending elections across multiple G20 jurisdictions in 2024[25] are the most likely catalysts for large-scale *policy* change.

If new administrations choose to adopt stronger positions on economic security, de-risking or de-coupling, FS firms could feel the impact through sanctions or indirectly through economic and trade flows. Geopolitical risks could also act as drivers of other prudential risks for both cross-border and purely domestic firms, for example: affecting market risk through increased market volatility; operational risk through increased risk of direct or indirect cyber-attacks; strategic risks where firms have to exit a market quickly; or credit risks to the extent that any of those risks affect clients' ability to service debt.

The global regulatory landscape

Short- and medium-term pressures require an agile strategic approach

For FS firms, navigating this uncertain geopolitical environment will be challenging, and it will be vital to set a robust risk appetite and tolerance levels, use scenario analysis and reverse stress testing, and put in place contingency and recovery plans where risks are particularly elevated.

Sustainability and climate change

The politics of sustainability are increasingly complex. Given the macroeconomic headwinds and impending elections in many jurisdictions described above, political impetus behind long-term measures in support of net zero could recede if they result in higher costs for consumers and businesses[26]. If this political dynamic persists, and the private sector in turn delays its ambitions, less favourable transition scenarios (such as an abrupt or even a failed transition to net zero) will become more likely. Moreover, climate stress tests undertaken in previous years by FS supervisors indicate that significant deferrals or weakening of sustainability policies could be costly for FS firms in the medium to long term.[27]

Despite this uncertain background, we do not expect deadlines for already agreed regulatory and supervisory deadlines to shift substantially in the near term. Regulatory requirements around disclosure, transition planning, and risk management continue to be developed and implemented, while supervisory scrutiny of climate-related (and increasingly nature-related) risks is now 'business-as-usual' in many jurisdictions. Rather, we expect that any shift in the political momentum around climate to have an impact on the next phase of action.[28]

If anything, the prospect of a delayed transition (and the increased transition and physical risks that it could imply) only reinforces the need for FS firms to invest time and resources in ensuring resilience against climate and environmental risks. Supervisors, particularly in Europe, have been clear that they are prepared to use the supervisory toolkit as a 'stick' to incentivise faster progress.

More generally, macroprudential authorities will be wary that actions taken by firms to safeguard their own financial resilience may have unintended consequences for the resilience of the system as a whole. A high-profile example (which we will likely see repeated in the future) was the exit of certain US insurers from high-risk areas (such as Florida and California), citing increased risk of natural disaster such as floods and wildfires and an inability to secure state regulators' approval for rate increases to reflect the much-increased risk.[29]

Boards should, through their actions, set the expectation for their organisation that climate risk is integrated into all aspects of their decision making. In doing so, they should take steps to test and challenge the validity and effectiveness of the information they are being given.

The global regulatory landscape

Short- and medium-term pressures require an agile strategic approach

Technology

FS firms continue to seek ways to leverage new and emerging technologies. In the face of a challenging macroeconomic outlook, firms may be able to achieve short-term cost-efficiencies from use of new technologies, although truly transformational change will require significant up-front investment, a pro-innovation regulatory agenda and widespread adoption for inter-operability.

For firms with a global footprint, embracing technological innovation will require navigation of an increasingly complex global regulatory landscape with jurisdictions moving at different speeds. Regulators are grappling with the ever-challenging questions of when and how to intervene when a new technology emerges, and how to supervise, directly or indirectly, third party providers that are normally outside of their remit. Differing answers to those questions will inevitably fragment the regulatory landscape.

For example, regulators around the world are coming to terms with how to regulate the use of AI, and are doing so at varying pace and with varying approaches. The EU's AI Act[30] will set out a highly prescriptive set of requirements, while the UK and US are planning higher-level, principles-based approaches.[31] FS firms using AI also need to comply with potentially divergent cross-sector regulations (such as GDPR in the EU),[32] and sector specific regulations (such as operational resilience requirements, governance and risk management requirements, consumer and investor protection requirements).

The evolving digital assets regulatory landscape is similarly complex. Regulatory frameworks and perimeters across the globe tend to treat the different types of digital assets and underpinning activities in distinct ways. Unbacked digital assets are a case-in-point. Japan, Hong Kong SAR and Singapore are among the first movers globally, with rules already in place to capture key intermediaries. The EU is closely following. Meanwhile significant work remains to shape detailed rules for this segment of the market in the UK, USA and Australia. Frameworks for fiat-backed stablecoins are also emerging asynchronously across jurisdictions.

For global firms, this complex and potentially divergent supervisory landscape inevitably creates compliance costs and strategic challenges.

International firms operating in the EU, for example, will need to decide whether to 'gold plate' their AI practices outside the EU or to develop different systems. For instance, firms active in both the UK and the EU may start developing their strategy for both markets based on the more advanced EU framework.

International firms looking to develop their digital assets strategy face similarly challenging decisions when deciding which products to offer, when and where to launch, which clients to target and what target operating model to pursue.

Across all facets of technological innovation, previous experience suggests that treating the use of new technologies as a purely 'tech' issue will not work for supervisors. **Boards need to engage fully with, and understand the impact of, new technologies on their firm's risk appetite, risk profile, strategy and reputation, and ensuring that use of technology is supported by appropriate controls and governance.**

The global regulatory landscape

Short- and medium-term pressures require an agile strategic approach

Taking the long view

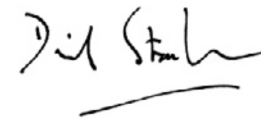
The last few years have been bruising for FS firms, and 2024 could be equally challenging.

In choppy economic waters, the natural inclination for FS firms will be to focus time, resources and bandwidth on short-term issues. But the structural changes to the FS sector driven by geopolitics, climate and technological innovation are not going away, and will shape the regulatory landscape and broader operating environment for years, or even decades, to come. Boards and senior executives have a crucial role to play in ensuring that firms take decisions and make investments now that future-proof their business models.

"Boards and senior executives have a crucial role to play in ensuring that firms take decisions and make investments now that future-proof their business models."

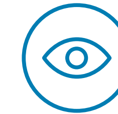
Seiji Kamiya
Centre for Regulatory Strategy
APAC

Irena Gecas-McCarthy
Centre for Regulatory Strategy
US



David Strachan
Centre for Regulatory Strategy
EMEA

EMEA cross-sector perspective



Managing the interconnectedness of risks, regulation, and public policy

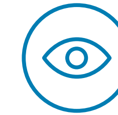
The challenging operating environment is creating a melting pot of interconnected risks

All things considered, the European financial sector has been remarkably resilient over the last few years – despite some notable scares (including the UK LDI crisis and the collapse of a European G-SIB). The combination of improved firm-level resilience and proactive government, central bank and supervisory intervention has enabled the financial services sector to stay on its feet, with only the occasional wobble.

Nevertheless, the outlook for European economies is highly uncertain, and supervisors in Europe will be on high alert going into 2024. The resilience of firms across the full spectrum of the financial sector will be put to the test by an operating environment in which inflation will almost certainly stay above target all year,[33] and the long-tail impact of the past two years' rapid rate rises will continue to be felt.

Geopolitical risks remain a particular concern, as demonstrated by the Bank of England's decision to base the scenario for its System-Wide Exploratory Scenario (SWES) on a geopolitical shock to global financial markets. Their crystallisation could lead to inflation and interest rates staying high (or increasing again), and drive volatility in energy, commodity and bond prices, with a consequent impact on asset quality, increased cyber and operational risk, market risk, or sanctions risk.

EMEA cross-sector perspective

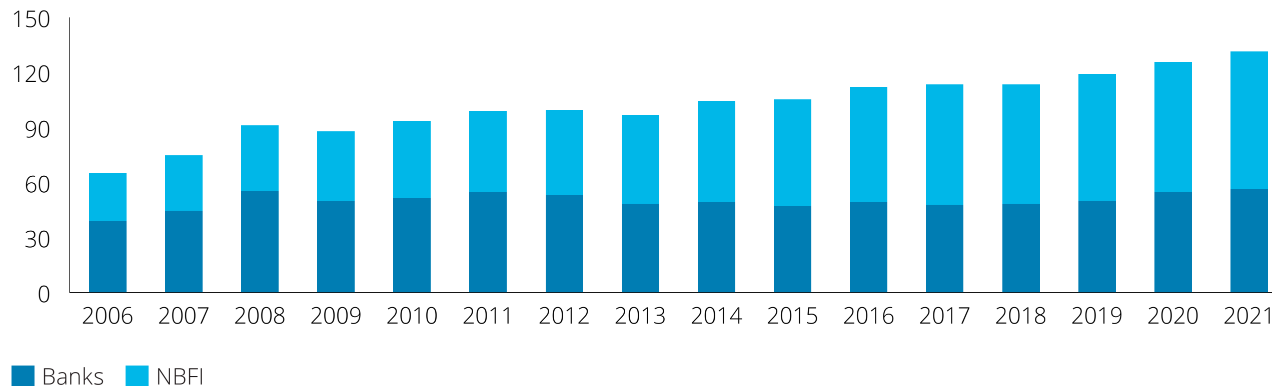


Managing the interconnectedness of risks, regulation, and public policy

A significant amount of risk has migrated outside the banking sector in recent years as banks have reduced their exposure to certain higher-risk activities following post-crisis regulatory reform. The worry for financial stability authorities is that risks outside the traditional macroprudential regulatory perimeter crystallise and ultimately affect the banking sector. Until a more comprehensive, NBFI-specific framework is in place (either globally or in Europe), supervisors will continue to use banks as a proxy to manage risks emanating from the NBFI sector and will expect banks to address identified weaknesses in counterparty risk management, liquidity risk management, operational risk management and margining practices. The limits to this "indirect" supervisory approach to NBFIs may not be far off, as recently acknowledged by one senior supervisor.[34]

When these developments are combined with the short-, medium-and long-term effects of climate change; increased cyber risks; risks from use of emerging technologies; and increasing geopolitical fragmentation; the cumulative effect is that Boards' and senior management's bandwidth will be stretched, especially in the Risk Function. Prioritisation will be even more necessary than usual – reinforcing the importance of robust and comprehensive risk identification processes that home in on the most material risks to firms.

Figure 5: Value of total financial assets of banks and NBFIs in the euro area and UK (in USD trillion)



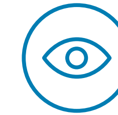
Source: FSB[35]

Maintaining both the short-term viability and medium-term sustainability of firms' business models is increasingly challenging – further complicated by the need to consider how actions taken in response to the broader macro environment interact with regulatory and supervisory objectives – such as the UK Consumer Duty. Firms will need to demonstrate that management has the appropriate capabilities and MI to steer the business in an agile and responsive way.

The volume and interconnectedness of regulatory change will require firms to take an integrated approach to regulatory change management

2024 will be a critical year for multiple significant regulatory change programmes for financial services firms. The list is daunting, including but not limited to: major prudential reforms (such as Basel for EU and UK banks and Solvency II and Solvency UK for EU and UK insurers

EMEA cross-sector perspective



Managing the interconnectedness of risks, regulation, and public policy

respectively); climate risk management, transition planning and disclosure rules, the UK Consumer Duty, the UK's Model Risk Management principles, the ECB's revised guide on internal models, the EU's Digital Operational Resilience Act, and more. The task is complicated by a breakdown of consistency between jurisdictions in the implementation of global rules (such as Basel), the absence of a coordinated approach in nascent areas (such as AI and Digital Assets), feedback from regulators and supervisors highlighting variability in firms practices, and the increasing prioritisation of measures to boost competitiveness and/or economic security relative to other jurisdictions.

Nevertheless, regulators and supervisors will expect firms to get implementation right first time across the board. The FCA's instant engagement with firms on the Consumer Duty demonstrates the lack of supervisory latitude for incomplete or patchwork compliance, even on Day One. UK banks' experience with regulatory reporting, or SSM banks experience with BCBS 239, shows how expensive it can be for firms that get this wrong.

All of this points to firms needing to take an integrated approach to regulatory change management. Taking a siloed approach not only misses opportunities for firms to exploit synergies between different implementation programmes (for example, where data collection exercises can kill two birds with one stone). It also increases the risk of 'getting it wrong' where different regulatory initiatives interact or conflict – for example, leaving prudential reform to risk teams, Consumer Duty to compliance teams and climate-related reforms to sustainability teams will inevitably result in sub-optimal outcomes for one or more of those workstreams.

Similarly, answering the question of how far and how fast to move on AI in 2024 will require involvement of multiple stakeholders within firms. Experience with the Cloud demonstrated that leaving technology issues such as AI to tech teams, with little regard for the impact on risk appetite, strategy or reputational risk, will not cut it with supervisors. Firms should look to identify where synergies in risk management and controls can reduce overall development and maintenance costs.

> "Taking a siloed approach not only misses opportunities for firms to exploit synergies between different implementation programmes. It also increases the risk of 'getting it wrong' where different regulatory initiatives interact or conflict."

EMEA cross-sector perspective

Managing the interconnectedness of risks, regulation, and public policy

Tensions between public policy objectives are complicating choices for firms

Navigating the regulatory landscape for financial services firms requires a strong understanding of not only the objectives of financial services regulators, but also of how government policy will shape the regulatory landscape. The goals of regulators, in particular prudential regulators, do not necessarily always align with those of government.

Climate policy in Europe is a good example. **As macroeconomic conditions have deteriorated, governments have prioritised easing the financial or operational burden on the real economy** – for example, by relaxing certain elements of climate policy (as was the case in the UK in 2023) or reducing the burden of corporate sustainability reporting requirements (as was the case in the EU).

To the extent that either of these shifts in government policy increases the likelihood of a bumpier transition to net zero, financial services regulators and supervisors are driven by their statutory objectives to take additional steps to ensure the resilience of financial services firms to physical and transition risks. Supervisors will also continue to be alert for evidence of possible greenwashing – the ECB, for example, recently highlighted that some EU banks' lending activities do not align with their climate disclosures[36] and will monitor EU banks' Pillar 3 disclosures on ESG risks closely in 2024. The challenge, for regulators, will be to avoid taking this too far and stifling the availability of transition finance or insurance coverage for climate-related risks. In connection, there are reports[37] that the issuance of sustainability-linked loans slowed following an FCA letter setting out greenwashing concerns, demonstrating the difficulty of striking the right balance.

For firms, increased uncertainty over the future path of climate policy in the UK, or limitations in (or delays to) the availability of climate data for certain portfolios in the EU (such as SMEs), complicate the task of complying fully with supervisors' expectations of a climate-resilient business strategy and risk appetite.

Another example of tension arising between government objectives and regulatory objectives arose in 2023 as the UK government set out a series of proposed reforms related to the pensions sector, aiming to channel investment into productive assets. Life and pension firms need to consider how the proposals will deliver good outcomes to customers under the Consumer Duty – pursuing higher returns when customers bear all of the investment risk could lead to conflicts and ultimately breach of the Duty if not managed appropriately. Governments and regulators equally need to consider how to strike the right balance to ensure that patient capital is channelled into infrastructure investment and productivity improvements.

Conclusion

Navigating this complex and changing environment will, as ever, put senior executives and Boards at European firms to the test. Firms that succeed in connecting the dots – between managing short-term and long-term risks, between different regulatory implementation programmes and between their objectives and those of their stakeholders – will be best placed to prosper in the year ahead.

Sustainable finance

Don't stop now

In Europe, the sustainability transition continues to reshape the economy and the financial system, creating new opportunities and altering the cost of doing business for financial services firms. Regulation is an important driver of these changes and a critical consideration for firms as they plan how to meet the commitments they have made to transition their own businesses to net zero and support the transition of the real economy. Climate will continue to dominate discussions, but nature will become a greater priority for policymakers following the finalisation of the TNFD framework. This is especially true for banks supervised by the ECB, which has already explained its expectations to firms. In 2024, firms will need to invest significant resources to tackle the implementation of new sustainability regulation requirements.

The outlook for sustainable finance regulation in 2024

Uncertainty about the pace of change and direction of travel of sustainability regulation will increase, but that should not delay action by firms. During 2024, we expect regulatory change driven by sustainability to hit an inflection point. The case for sustainability and the momentum behind the transition are established and will not be reversed, but other priorities are competing for policymakers' attention. In particular, upcoming parliamentary elections and the turning economic cycle have led policymakers and others to examine perceived short-term trade-offs between the sustainability transition and economic growth, and to ask whether the costs of the transition are distributed equitably within society and between countries.

If the political orthodoxy on the urgency of transition does shift, we see the greatest impact as being on the *next* phase of regulatory activity rather than on more immediate deadlines. That said, these developments undoubtedly increase uncertainty in the nearer term. On the one hand, concern about

Sustainable finance

Don't stop now

entering the political fray may lead supervisors and standard setters to act in a more muted manner, saying less, delaying decisions, or being less proactive on supervisory interventions. On the other hand, a ramp-up in supervisory activity could occur quickly as the economic cycle turns again or concern about the real effects of climate change increases. Firms may therefore debate whether to adapt to any delay in timelines or continue to invest at the same pace. The decision ultimately comes down to a firm's risk appetite, including reputational, franchise and litigation risks. Through this lens, many firms will conclude they cannot afford to delay.

"If the political orthodoxy on the transition does shift, however, in our view the greatest impact will be on regulatory activity in the next phase of activity rather than more-immediate deadlines."

The priority for firms in 2024 is to address corporate sustainability reporting requirements. For most firms work remains to be done to meet new reporting requirements in full, most immediately for those firms that need to report under CSRD in 2025. For later reporters under CSRD and for those firms that will report under SDS in the UK, however, implementation still needs to begin in 2024 given the complexity of the work required. Finance teams will usually lead these projects but should not run them alone: if positioned correctly, reporting projects can be used to drive a wider set of changes across the organisation – in operations and business strategy – and demonstrate how risks and opportunities are being managed across the three lines of defence. A disclosures strategy, encompassing a firm's obligations across all disclosure requirements and commitments, will further support the overall effectiveness of the implementation of reporting requirements by helping to identify synergies and dependencies.

Firms have more to do to meet expectations on transition planning, climate-related financial risk management and managing greenwashing, in particular, to put ambition into practice. Climate transition plans, for example, need to reflect how the Board is in practice steering a firm towards its sustainability commitments and transforming the business. Some firms have already disclosed transition plans, but the introduction of requirements to do so in the EU (formalised under CSRD, CSDDD and CRR3) will enhance scrutiny. In the UK, the TPT framework will update expectations for disclosures compared to the TCFD framework that preceded it. Most firms will find they need to step up their efforts. As they do, they should also take account of how the sophistication of their plans will need to develop as regulations evolve. For example, firms will need to consider how their transition plans might adversely affect, and depend on, society and the natural environment, particularly as TNFD recommendations are taken forward. Consideration of supply chains, the credibility of transition plans, and of adaptation and transition finance are also coming to the fore. And for banks in particular, we expect the *quality* of transition plans will also begin to be tested by supervisors.

Sustainable finance

Don't stop now

We do not expect significant revisions to the banking and insurance capital frameworks in 2024 to accommodate climate-related financial risk, although more substantial revisions may still come. Nonetheless, supervisory expectations for banks and insurers have moved on from focusing on firms putting in place the right building blocks of an approach to increasingly looking at whether climate capabilities are embedded within organisations. For example, have firms integrated climate into pricing and risk management? That said, although supervisory expectations *will* evolve, we expect divergence between supervisors in terms of how changes in focus are implemented. The ECB recently said it will use "all measures in [its] toolkit"[38] to ensure compliance during 2024, whereas the PRA seems to accept firms having multi-year plans to meet their goals. Firms should also not overlook the extent to which climate- and environmental risks are captured within the existing prudential framework. The ECB, for example, has increasingly considered these factors in determining capital add-ons for the banks it supervises.

Many firms are still unclear what greenwashing means for their products and firm-level commitments. Boards should be concerned about the latent greenwashing risk that may be building up on their balance sheets, and to understand how the risk is being managed across risk, compliance and the first line. This latter point has been flagged by the FCA on several occasions. Following the FCA's final SDR rules (published in November 2023), naming and marketing of funds will be a point of focus. Firms that want to market sustainable funds will need to have evidence that the funds have robust, evidence-based sustainability objectives, aligned investment policies and strategies, appropriate KPIs, strong governance, adequate resources and an appropriate stewardship strategy. The targeted consultation on the SFDR launched last year by the European Commission considered similar issues, and the ESAs will publish in May final recommendations to the European Commission on possible changes to the EU regulatory framework for greenwashing.

In the UK, in 2024 the FCA will begin to supervise under its new anti-greenwashing rule, which will spur work across all asset classes. Whilst the rule underscores the importance of firms tackling greenwashing, it is not clear that the rule will mark a step change in supervisory scrutiny. Looking across the FCA's interventions on greenwashing over the past year, it – and possibly regulators more generally – are still finding the right balance between taking action and supporting new product development. At the same time, firms need to be alert to the reputational and litigation risks that could arise from greenwashing. Litigation risk in particular is already on the radar of insurers, and the ECB has highlighted reputational and litigation risks arising in particular from transition objectives and net zero commitments, as an area of focus for supervisors this year.[39]

Many firms are looking to support companies as the transition in the economy accelerates and this was a key theme at COP28 in November 2023. We expect policymakers in 2024 to increase attention on how the regulatory framework supports transition finance. For example, the Fit-for-55 climate risk scenario analysis in the EU will assess the capacity of the financial system to support the transition to a lower carbon economy under conditions of stress. A number of factors currently make it difficult for firms to finance transition projects or companies that have a plan to transition towards a 'green' business model. In the regulatory domain, a key challenge is the inconsistency of terms used to define green finance. We expect progress to be slow to address this though, given the lack of consensus on how terms should be defined. In the meantime, firms will

Sustainable finance

Don't stop now

need to decide an internal definition of transition finance that they can use consistently and justify externally.

Policymakers and standard setters sought to reset perceptions around carbon markets at COP28 to reinvigorate the market. Consultations published at end-2023 by the CFTC and IOSCO marked a new phase of regulatory activity. We expect activity to promote the development of carbon markets to be increasingly prominent through the course of this year.

We do not expect policymakers to make concessions on the prudential treatment of green assets to incentivise the transition. Instead, firms should look to understand better – and be able to explain to supervisors – the extent to which more sustainable investments are less risky, and how that risk profile is reflected in lower probabilities of default and higher recoveries. Other steps, such as introducing internal carbon pricing or greater recognition of reputational risk, could also help distinguish the incremental value of green assets.

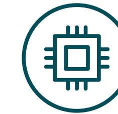
Availability and quality of data remain the elephant in the room that runs across all of the topics discussed. Across all of these developments, firms need to consider how they will mitigate the challenges and risks from key data gaps. Firms' product and business development decisions may need to be constrained by the uncertainty about data. This challenge is not new. In 2024 the issues though become more critical to address given the progress of regulatory requirements. And as companies publish more information on climate transition plans, firms need to demonstrate that they are making effective use of those data. New rules and guidelines on ESG ratings and data in the UK and EU will also shape developments in this area.

A call to action

Firms need a plan that connects all the moving parts on sustainability across regulation and business strategy. Within this plan, firms can factor in what leading practice looks like, the most effective way to manage and sequence the changes required and what further changes to requirements are expected. A plan will also enable them to identify, for example, what optionality exists; and where they need to make progress despite uncertainty because of other dependencies or opportunities in their strategy. Ultimately, firms need a willingness to make real change and tackle tough decisions. Boards should, through their actions, set the expectation for their organisation that sustainability is integrated into all aspects of their decision making. In doing so, they should take steps to test and challenge the validity and effectiveness of the information they are being given.

As firms navigate these topics, they need to factor into their planning the acute shortage of technical skills. Following the UK CMA's clarification of competition law rules, firms can also consider where there are opportunities to collaborate in the market to find solutions to the most complex challenges.

Innovation, payments and digital assets



Regulation will (re)shape markets and digital transformation strategies

In 2024, AI, retail payments and digital assets are set to be top priorities on the EU and UK innovation policy agenda.

Retail payments

The convergence of market dynamics and new regulations will further accelerate the transformation of the payment sector. EU and UK consumers and merchants are demanding more convenience and value amidst a challenging economic environment.[40] Policymakers in both jurisdictions are introducing new regulations to bolster consumer protection, choice, and resilience. These include promoting instant, open banking payments, and Digital ID; finalising stablecoins frameworks; and enhancing anti-fraud measures.

The implementation of virtually all these regulations is set to start in 2024/2025.[41] Their impact will coalesce over the next two to three years, with significant implications for PSPs.

First, new regulations will intersect with evolving payment preferences of customers and merchants, and growing adoption of enabling technologies such as digital wallets, connected devices, biometrics, and DLT. This will expand the range of APMs and distribution channels that PSPs can, or must, offer.

Second, competition will increasingly come from multiple fronts, including traditional players, FinTechs, and non-financial entities such as digital platforms or smart product providers. For many, the priority will be owning the customer relationship and payment initiation process, leveraging policy enablers, such as open banking, Digital ID, and fairer access to payment systems to gain a competitive edge.[42] This is likely to lead to a further separation of the customer payment journey from the provision of payment infrastructure and accounts.

Innovation, payments and digital assets

Regulation will (re)shape markets and digital transformation strategies

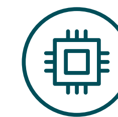
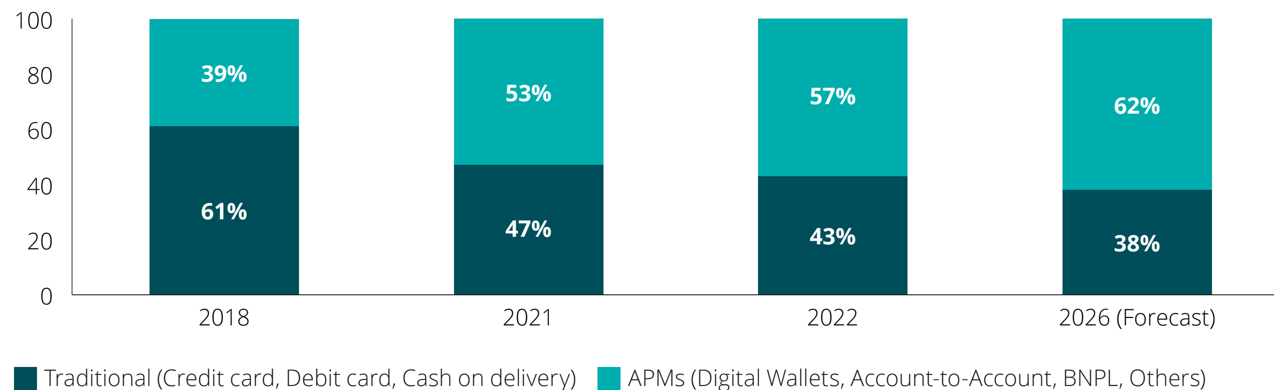
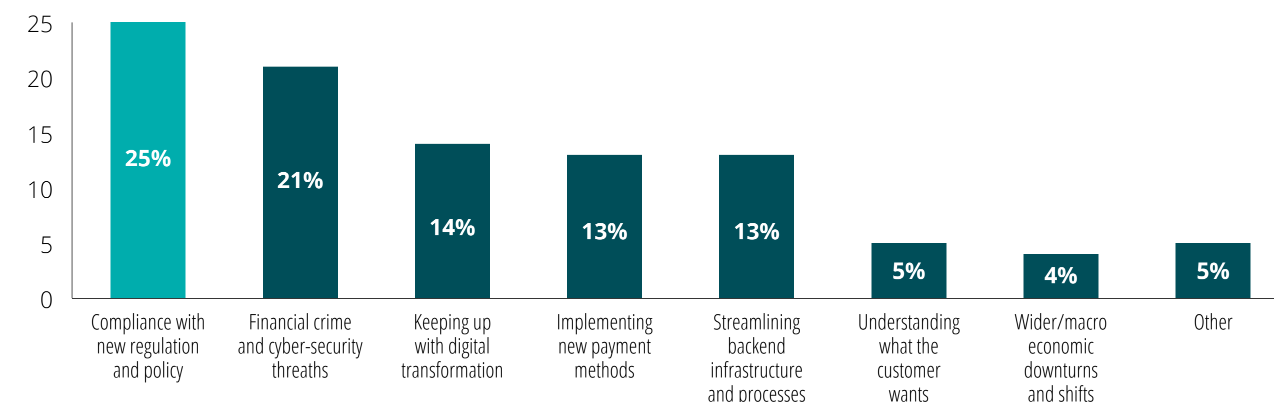


Figure 6: Alternative payment methods continue to gain share in Europe



Source: Worldpay from FIS[43]

Figure 7: Biggest challenges ahead for the payments sector



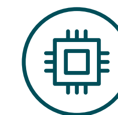
Source: Payments Association/Pay360[44]

Third, complying with this complex web of new regulatory requirements will require significant skilled staff and financial resources. This will challenge PSPs' capacity to invest in new business and technological capabilities, particularly amidst higher interest rates, margin pressures, and declining venture capital.

With over 6,500 and 1,000 estimated PSPs in the EU and UK respectively, the payment market is highly competitive.[45] The trends described earlier are likely to lead to some PSPs exiting the market, while others may become attractive targets for mergers and acquisitions. Few PSPs will be able - or want - to compete across all channels, products, or the entire value chain.

All must incorporate regulatory considerations into their strategic decisions, addressing frictions, but also identifying synergies between business and regulatory change programmes. For instance, mandated EU Digital ID wallets can aid AML compliance while offering cost-effective and user-friendly identity verification across channels, potentially opening new revenue streams beyond FS. Similarly, using AI can improve fraud detection and enhance the customer experience, meeting both supervisory and customer expectations.

Innovation, payments and digital assets



Regulation will (re)shape markets and digital transformation strategies

However, PSPs must also consider the impact of policy interventions that are still in flux on their investment choices and timing. For example, the finalisation of EU and UK stablecoins frameworks could boost their use in retail payments. However, other outstanding policy factors will affect PSPs' business case to invest in the infrastructure or ecosystem of a new form of private money. These include PSD3/PSR, the UK payment regulations review, success in promoting A2A payments, upgrades to existing infrastructure, such as the UK NPA, and the potential launch and key features of EU/UK CBDCs.

Industry has been calling for greater coordination among different in-flight policy initiatives.[46] While hopes for enhanced coherence in the long term persist, in 2024 firms must chart a strategic course that can contend with the status quo.

Digital assets

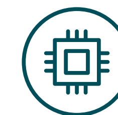
The impact of regulation on firms' digital asset strategies will depend on the assets and activities involved.

Tokenisation, the issuance of a digital representation of an asset on DLT, will likely dominate regulated firms' digital assets pilots, particularly for bonds. The UK's long-awaited tokenisation regulatory sandbox, set to launch by end-Q1, marks the first step towards the emergence of secondary markets in tokenised financial securities. The UK sandbox, which complements its EU counterpart, will be helpful for firms seeking to establish market-leading trading and settlement venues, whether they are existing FMI providers or new entrants.[47] Successful applicants can seek targeted exemptions from securities frameworks, such as MiFID/MiFIR and CSDR, and refine their business model based on regulatory feedback.

However, 2024 will be the beginning of a journey for tokenised securities markets. Any benefits from sandbox participation, or permanent rule changes that would encourage growth are at least two-to-three years away. For now, tokenised issuance remains relatively low.

> "Estimated digital bond issuances in recent years are less than 1%, for example, of the $20.6 trillion issued globally in long-term fixed income instruments in 2021"[48]

Innovation, payments and digital assets



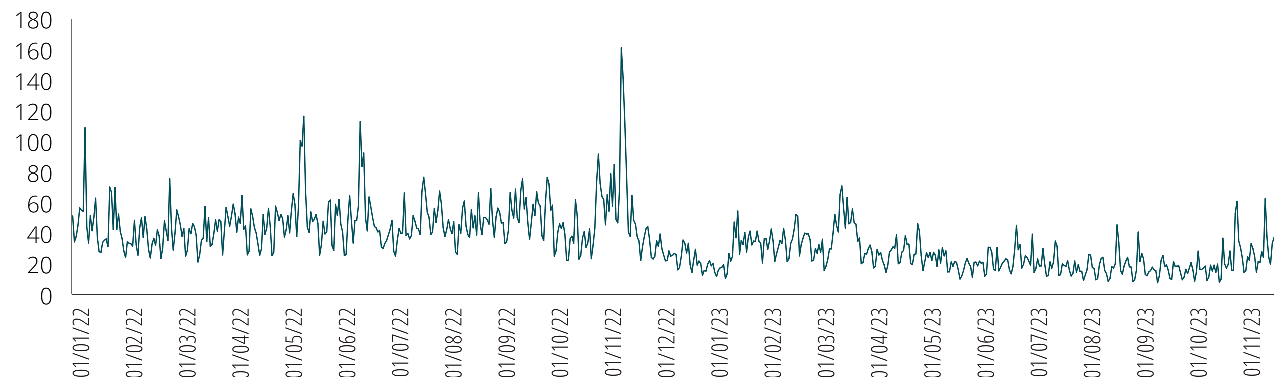
Regulation will (re)shape markets and digital transformation strategies

Meanwhile crypto natives operating in unbacked digital assets markets (e.g., Bitcoin) face a fragmented regulatory landscape, despite EU MiCAR technically going live in 2024.[49] MiCAR empowers individual MS to delay compliance deadlines and maintain local regimes for custodians, exchanges, and other intermediaries to July 2026. MS must declare their plans by June 2024, and some have already done so, e.g., Spain has postponed its MiCAR compliance deadline to December 2025.[50] Adding to this complexity, in our experience, timings to obtain local licences vary between two weeks and two years across the EU27.[51] As firms determine their location strategies, local approaches to MiCAR will be a key decision factor, along with access to talent, bank accounts, payment infrastructure, and other factors.

The combination of MiCAR compliance costs and persistent revenue pressures, with trading volumes remaining suppressed, will exacerbate profitability challenges for crypto-native firms. Therefore, firms will need to evaluate the regulatory implications for their viability. They must consider not only MiCAR, but also broader FS rules to which they will be subject as regulated firms. A key example is DORA, which will require enhanced operational resilience capabilities and business continuity planning. Therefore, we expect some firms may consider exiting the EU market in 2024, as we saw in the UK in 2023 after the implementation of digital asset financial promotion rules.

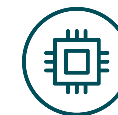
The UK regulatory framework for unbacked digital assets remains uncertain. Final rules are unlikely before year-end, but we know they will be based on securities rules. Also, existing AML registrations will not automatically convert to full digital asset services licences, meaning that all firms should prepare for heightened scrutiny.[53] Links to wider group entities and client asset protection will be focus areas, drawing on lessons from the 2022 market disruption. Benchmarking against comprehensive MiCAR requirements may help firms prepare until more detailed UK rules emerge.

Figure 8: Daily Bitcoin and Ether trading volumes (in USD billion)



Source: CoinMarketCap[52]

Innovation, payments and digital assets



Regulation will (re)shape markets and digital transformation strategies

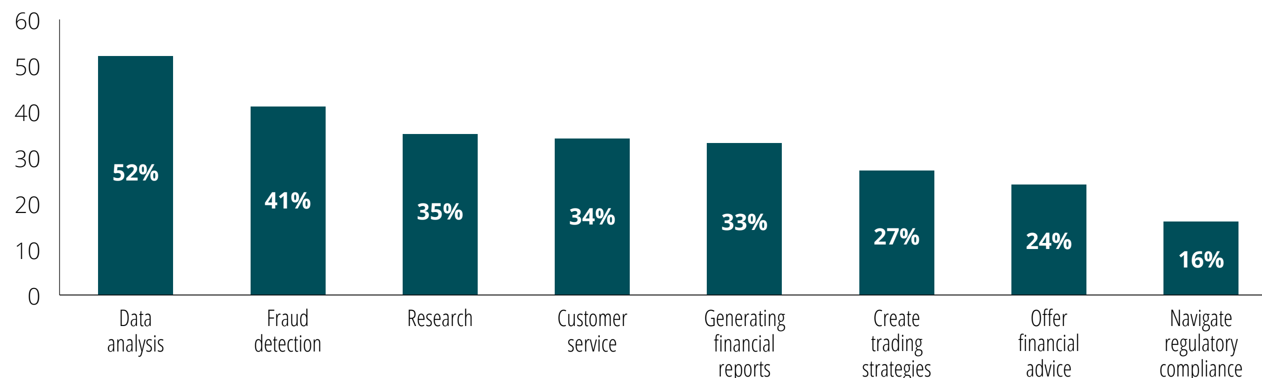
Artificial Intelligence

Regulation of AI is set to take centre stage in 2024, as firms seek to scale their AI capabilities. The EU has taken a bold step by establishing the first comprehensive AI legislative framework – the AIA - set to enter into force by H1 2024.

The EU is eager to establish the AIA as a global standard, and its extraterritorial impact on any AI system that affects EU residents may yet lend it some clout. However, regulatory divergence is more likely. Despite agreeing high-level principles for international cooperation, major jurisdictions are pushing ahead with their own national approaches.[54] The US, home to some of the largest AI companies, is a prime example, as illustrated by President Biden's recent Executive Order on AI.

The AIA has also received mixed responses, with some industry representatives and policymakers outside the EU questioning its ability to balance innovation and safety. The UK, for example, has proposed a principles-based, non-statutory framework that leverages existing regulatory structures and frameworks. This approach aims to avoid overregulation and mitigate the risk of requirements becoming outdated quickly due to the rapid pace of innovation.

Figure 9: Most common use cases for AI in Financial Services

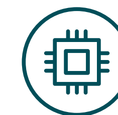


Source: Gilmore Centre for Financial Technology by Warwick Business School[55]

Nevertheless, as the AIA's implementation begins in 2024 firms must understand its requirements and implications, especially as they start scaling their AI solutions.

The AIA classifies and regulates AI models and systems based on their potential risk to society and individuals. FS firms using AI systems deemed high-risk – such as those of credit and life/health insurance risk assessments, staff monitoring, and recruitment – will face significant compliance demands. Similarly, use of General Purpose AI models and systems will also be subject to strict requirements. The decision to develop in-house or use off-the-shelf AI systems will be strategically important. AI providers – i.e., developers or commissioning firms – will have to comply with some of the AIA's strictest obligations. Firms will also need to manage grey areas, such as where material customisation of third-party AI systems may cause them to be considered developers.

Innovation, payments and digital assets



Regulation will (re)shape markets and digital transformation strategies

Multinational firms operating in both the EU and other jurisdictions must decide whether to embrace AIA standards globally or adopt EU-specific AI systems. Compliance costs and limits to innovation are among the downsides, while increased trust and reduced risks are potential upsides. Some FS firms – or their TPPs – may choose to scale back AI development or deployment in the EU to avoid the more comprehensive AIA requirements altogether. Some uncertainty will remain. AIA technical standards, against which firms must demonstrate compliance, will not be available until later in 2024 or 2025. Nevertheless, firms will possess sufficient information to assess their overall exposure, conduct a high-level gap analysis against key requirements, and devise an initial plan of action for product strategy and governance response.

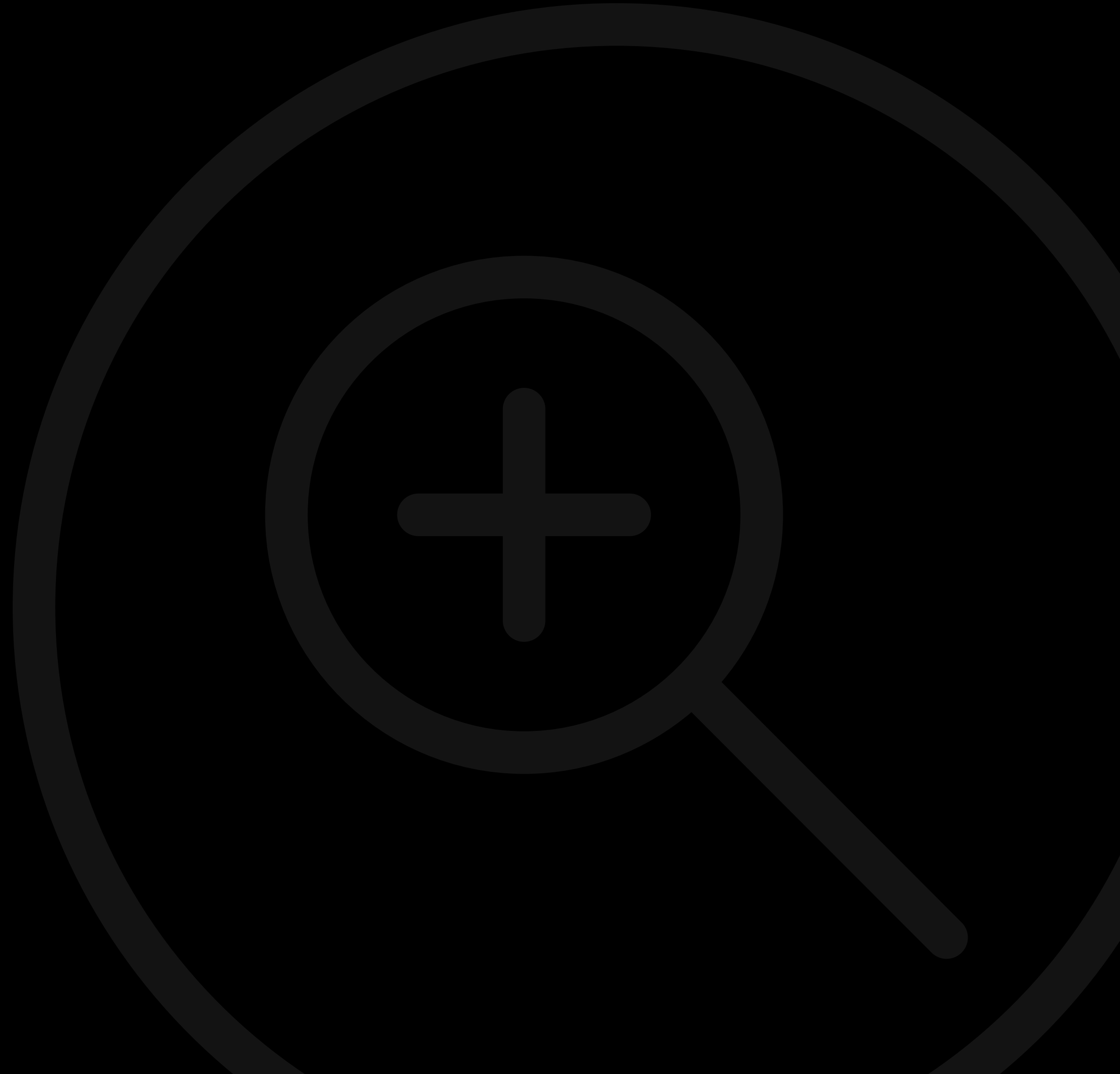
In addition, while AI-specific legislation is a critical component of AI regulation within FS, it is just one piece of a much larger puzzle. **Firms will also need to grapple with the existing and technology-neutral regulatory frameworks** – such as data and consumer protection, model risk management, and operational resilience – as they apply to their AI use cases.

In the UK, in the absence of an AIA equivalent legislation, supervisors will rely on these frameworks to scrutinise firms' use of AI. The FCA, for example, has been particularly vocal about its plans to use the Consumer Duty to oversee AI conduct risks. Similarly, in the EU, regulations such as GDPR and DORA will intersect with the AIA, although the degree of interaction will only become clearer once AIA technical standards emerge.

Firms must balance innovation with risk mitigation and maintaining public trust. Ethical concerns will continue to be significant. This may lead to a shift away from use cases with significant impacts on privacy or financial outcomes towards back or middle office automation. Ultimately, regulatory compliance and the firm's own risk management and AI skillset will be crucial in determining which AI pilots firms can scale in 2024.

In summary, the regulatory changes surrounding retail payments, digital assets, and AI have created a complex and evolving landscape for FS firms. As firms adapt to this shifting regulatory environment and new digital financial markets, they must navigate a range of strategic opportunities and challenges.

Sector perspectives



Retail and commercial banking

A defining year ahead, for operational, financial and conduct reasons

The banking turmoil last March demonstrated how quickly, particularly in the age of social media and internet/mobile banking, negative sentiment about a bank's business model can precipitate deposit flight and close funding markets. Retail and commercial banks will therefore face scrutiny from supervisors, investors and the broader market of their business model viability and medium-term sustainability in 2024, especially given that NIM has likely peaked and credit impairments are rising. This will manifest through some common operational, financial resilience and conduct challenges, although the particular issues and responses will vary with the size and specific business model of the bank.

Operational challenges

The continuing volume of regulatory change means banks will have multiple, significant change programmes running concurrently including Basel, application of the Consumer Duty to closed products (in the UK), climate risk management and disclosures, as well as DORA and ongoing operational resilience implementation. For international banks the volume challenge is magnified by regulatory divergence (in both the substance and timing of new rules) between jurisdictions.

Faced with this resource challenge, many banks may end up with 'just-in-time' compliance – putting tactical solutions in place to achieve 'Day One' compliance. However, supervisors' patience for temporary solutions is finite, particularly if enduring solutions do not follow quickly. UK banks' experience with the Consumer Duty showed - from Day One - that supervisory latitude cannot be assumed. Similarly, the ECB's renewed focus on BCBS 239 and the UK regulators' tenacity on regulatory reporting show that banks cannot 'out-wait' supervisory scrutiny.

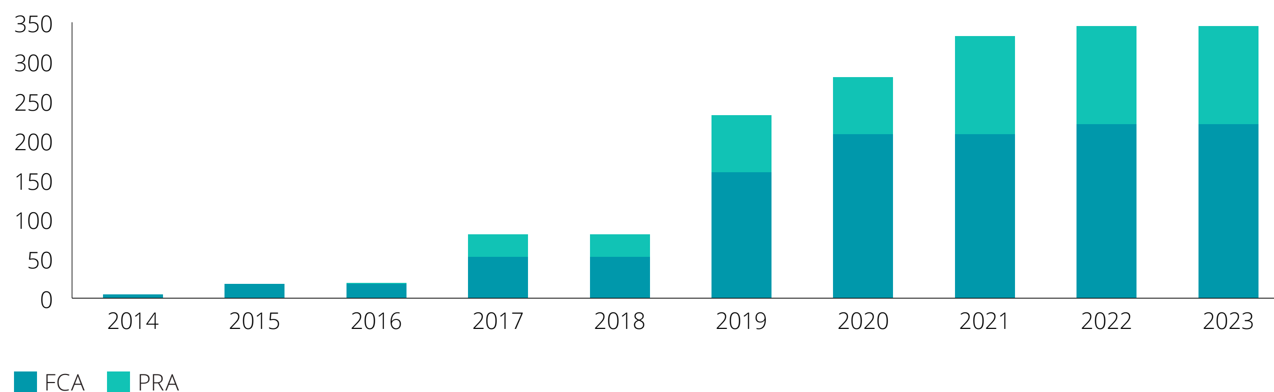
Retail and commercial banking

A defining year ahead, for operational, financial and conduct reasons

Banks' failure to deliver these major regulatory programmes and/or reliance on tactical solutions will be costly. Not only will remediation costs be high, but they also face capital add ons, including to reflect management and governance weakness. **Supervisors will likely be very robust in responding to failure by banks to remedy identified weaknesses,** given the prominence placed on timely action in the various lessons learned reports from the March 2023 turmoil. The ECB intends to go one step further in this regard, imposing "periodic penalty payments"[56] on SSM banks which fail to resolve supervisory findings on time – including those related to climate risk management, which is now firmly part of 'business as usual' supervision.

Following the bank failures in 2023, **banks should expect supervisors to re-assess resolution regimes**, and look at their appetite for branches relative to subsidiaries. The EBA has issued revised guidelines on resolvability[58] and CRD6 will re-draw the line – more tightly – for third country branch operations in the EU. Indications are that the PRA will review[59] its expectations and thresholds for when operations in the UK should be run in a subsidiary.

Figure 10: Cumulative value of regulatory reporting fines issued by UK regulators (in GBP million)



Source: PRA, FCA[57]

Supervisory capacity is just as constrained as banks'. The PRA and ECB's time to approve new capital models, or changes to existing ones, is one example, with both typically taking years, not months.

Banks must do what they can to make their interactions with regulators and supervisors more productive. Taking the model approval example: alongside governance, validation, business involvement and data quality, poor model documentation often leads to delayed approval. Regulators expect banks to produce clear, concise, intuitive and objective model documentation and have commented that this is an area of frequent weakness. Banks that comply closely with regulatory rules and guidelines (PRA's SS1/23 and the ECB's *Guide to Internal Models*) are likely to reap benefits in terms of quicker model approvals.

Financial resilience

Basel finalisation will be the key financial risk programme for most banks in 2024. Internationally active banks face significant challenges given divergence in the timing and substance of final rules in the EU, UK and US. Affected banks must understand the implications of divergence in timing, taking current timelines as the central case but developing contingency

Retail and commercial banking

A defining year ahead, for operational, financial and conduct reasons

plans for different scenarios of UK, US and EU implementation dates.

With the publication of near-final versions of the EU's CRD6 and CRR3,[60] and part one of the near-final UK policy,[61] differences in rules between jurisdictions are becoming clearer. Where rules differ, international banks need to decide whether to adopt a single version of a rule across all jurisdictions (accepting gold-plating where the capital impact is manageable) or to build capability to adopt different versions of rules in different jurisdictions (where justified by capital savings). Each bank's answer must be driven by cost/benefit analysis at portfolio, entity and group level. Producing such analysis may be easier said than done, but investment in calculation engines should deliver a commercial return.

Beyond immediate implementation challenges, many banks have made little progress addressing the strategy, product design and pricing impacts of Basel – for example, deciding how (or whether) to incorporate the Output Floor into pricing decisions, or reshaping balance sheets to account for portfolios that are less attractive under Basel 3.1 (e.g. buy-to-let mortgages under Standardised). Banks will gain competitive advantage by allocating more time and resource to this analysis in 2024 and taking necessary strategic actions.

Recent supervisor led stress tests show that large banks are capitalised sufficiently to absorb a very significant credit shock while continuing to lend through any downturn[62]. However, we see a significant difference between banks' *ability* to keep lending and their *willingness* to do so, particularly in a scenario where impairments rise and RWAs inflate through increases in PDs, putting pressure on banks' management buffers. With the publication of near-final versions of the EU's CRD6 and CRR3[1], and part one of the near-final UK policy[1], differences in rules between jurisdictions are becoming clearer. The BCBS asked – but did not fully answer – the question about *usability* of capital buffers in the lessons learned from Covid. It may have to revisit it.

For banks not subject to supervisor-led stress testing, credit risk may be a greater concern. Here we expect even closer supervisory monitoring, especially of early credit warning indicators.

Banks should be challenging the assumptions in liquidity stress tests in light of the evidence[63] **from bank failures in 2023 and the increasing competition for retail deposits.** Deposit competition has seen substantial deposit volumes move out of big banks, some to challengers, some to other assets including government securities. All banks, particularly those with concentrated funding sources, should be undertaking a range of reverse stress tests (RST)[64] and taking action as a result, including diversifying funding sources. Banks that do not currently have a formal liquidity RST approach in place should implement one before their next ILAAP/SLRP round.

> "The BCBS asked – but did not fully answer – the question about *usability* of capital buffers in the lessons learned from Covid. It may have to revisit it."

Retail and commercial banking

A defining year ahead, for operational, financial and conduct reasons

Conduct

UK supervisors expect banks to support customers proactively through current macroeconomic stresses: to achieve this, banks need to understand the drivers of customer vulnerability – current *and* future – and ensure internal systems and controls can identify them. For large banks, one difficulty is scale – multiple portfolios and customer sets, all potentially requiring differentiated approaches. For smaller banks, access to deep subject expertise and resources will be a challenge.

Banks should use H1 2024 to analyse the impact of a fully phased-in Duty and understand its effect on the bank's business model sustainability. This includes identifying where bank profitability relies on products whose benefits to consumers are less clear cut, such as customers in persistent overdraft and back-book savings accounts whose interest rates have not kept pace with newer accounts. The FCA is clear that such products are in its sights. Boards and senior management need confidence these products satisfy the Duty's price and value expectations. If not, the pricing and/or target market of the product will need to be changed, and the effect on business sustainability assessed. This analysis will be a key input into the Board report on Duty compliance that banks have to complete by July 2024.

Supervisory attention on how banks reflect base rate changes in customer rates will continue, focussing on both the speed and proportion of pass-through. If predicted downward base rate movements occur in 2024, regulators will compare downward changes with upward ones, and scrutinise *relative* changes – how quickly deposit rates change relative to lending rates.

Conclusion

2024 is a turning point for several major regulatory programmes, with implementation complicated by ongoing geopolitical risks, macroeconomic stress and associated pressure on banks' costs. Executing these programmes well has two broad benefits - positioning banks to capitalise on commercial opportunities emerging from the changing regulatory landscape and avoiding supervisory interventions and remediation costs arising from flawed delivery of regulatory programmes.

Investment banking

No let up in supervisory scrutiny

In 2024 the regulatory horizon for IBs will become clearer as some key capital markets initiatives in the UK and EU are finalised. On balance, the EU looks set to impose fewer restrictions on third-country firms providing cross-border investment services into the EU, and on third-country clearing, than once seemed likely. That said, IBs still face a significant programme of regulatory change management and implementation, with the FRTB standing out in this regard. We see no let-up in supervisory scrutiny of IBs by the PRA and ECB, particularly in relation to CCR management and booking model governance and controls. IBs' exposures to NBFIs will remain a supervisory priority.

Change, change and more change...

As policymaking has progressed, particularly in the EU, the answers to some of the major post-Brexit EU market access questions have become clearer. It now looks certain likely that third-country IBs will be able to continue to provide cross-border investment services into the EU under CRD6. EU legislators are still debating the details of the 'active' account that EU-based firms subject to the clearing obligation will need to maintain at an EU Central Counterparty (CCP). The emerging consensus suggests that the active account will have some operational and activity requirements in a first phase with further additional requirements under discussion. We judge the likelihood of an eventual extension of equivalence for UK CCPs beyond June 2025 to be high.

All that said, IBs still face a significant volume of regulatory change in 2024. Many reforms developed over the past few years, including the latest iterations of MIFIR, EMIR and CSDR, are close to implementation. Although the EU and UK have each gone their separate ways, the extent of divergence is not as great as initially expected. However, there are important differences in detail and implementation timelines. These will require IBs to sharpen their

Investment banking

No let up in supervisory scrutiny

regulatory mapping capabilities to derive potential synergies from implementation of regulatory change programmes and to anticipate peak demands on key resources, especially IT staff.

FRTB: implementation of SA and decision time for IMA

The final deadline for FRTB implementation is very close and IBs face the prospect of higher market risk RWAs under both the revised SA and IMA. All IBs will have to report SA capital calculations by January 2025 in the EU and July 2025 in the UK and the US.

Success in implementing FRTB SA will be based on having a scalable and robust calculation engine which supports increasingly granular regulatory reporting and the requirement for daily capital monitoring. Many banks continue to struggle with the availability and quality of sufficiently granular data and being able to calculate the SA daily. EU banks have a head start, needing to report FRTB SA as part of CRR2, but their existing solution is unlikely to be sufficiently scalable to satisfy global FRTB reporting requirements.

IMA will take FRTB implementation a step further. IBs will need to apply for approval for individual desks resulting, on some estimates, in 20–50 times more data generated daily. The accuracy and timeliness of data and alignment between 1LoD and 2LoD will also be a challenge. To generate material benefits from IMA, IBs will need to optimise the number of risk factors they can model and identify non-modellable risk factors in a way which is quite different to how IBs currently manage their trading book risks.

Many IBs are still assessing the capital benefits of IMA, and some may conclude that they are outweighed by the cost of seeking and maintaining approval. However, before making the final decision, IBs must consider the possibility that even if they do not apply for IMA, supervisors may still require IMA-equivalent granularity of information, to satisfy their financial soundness and stability needs, with no resulting capital benefit for IBs. A supervisory 'Catch 22'.

Focus on counterparty credit risk management

Recent instances of extreme, but so far relatively short-lived, market dislocation have increased supervisory scrutiny of IBs' preparedness for and resilience to severe market shocks, including through their exposures to non-bank financial institutions (NBFIs). This focus on NBFIs reflects both their increasing role in providing market-based finance, (c£740 billion[65] (around 55%) of all lending to UK businesses as of early 2023), and lack of an agreement on a global regulatory framework to mitigate the risks NBFIs pose. In the absence of such a framework, we expect supervisors to ratchet up their demands of IBs as a means of indirectly regulating the broader financial system, even though senior supervisors[66] question the ongoing effectiveness of such an approach.

> "We expect supervisors to ratchet up their demands of IBs as a means of indirectly regulating the broader financial system."

Investment banking

No let up in supervisory scrutiny

As a result, we expect supervisors to continue to use all the tools available to them in respect of IBs, with a particular focus on their CCR management practices. In October 2023, the ECB published the outcome of its review of sound practices in CCR governance and management,[67] specifically focusing on exposure to NBFIs. **The PRA also identified shortcomings in CCR management process,[68] while the FCA found poor management of client relationships and inadequate knowledge of clients' business profiles.[69]**

Even though there are differences in the detail between the ECB, PRA and FCA they share common priorities that IBs need to be ready for in 2024. These include the need for:

- improved customer due diligence procedures;
- enhancements of stress testing frameworks to consider the impact of tail risks on counterparties and own balance sheet and to adapt quickly to rapidly changing risks and;
- consideration of material and complex CCR exposures in risk appetite statements.

Although supervisors' focus will be on IBs' financial resilience, they will also scrutinise their **operational resilience**, particularly that their operational processes are sufficiently robust and scalable to withstand extended periods of increased volatility.

Stepping up engagement on wholesale conduct

In a period of ongoing macroeconomic uncertainty and market volatility, supervisors are increasingly concerned that new conflicts of interest may emerge, or firms may prioritise commercial interests over regulatory obligations, undermining controls' effectiveness. Supervisors might challenge IBs to demonstrate that their culture and controls remain sufficiently robust despite revenue headwinds. In particular, the FCA will focus on new conflicts arising from market environment changes. For example, when an IB develops new products that align with the UK Government's agenda of increasing retail participation in capital markets but allows its pursuit of higher volumes and/or margins to override its obligations under the Consumer Duty.

In addition, we expect a focus on conduct and culture to continue to drive supervisory activity in some EU jurisdictions, particularly those where wholesale trading has increased as a result of IBs relocating activity following Brexit. IBs need to do more to ensure that they embed a conduct-focused culture effectively into their day-to-day operations. Supervisors will be scrutinising IBs' 'speak-up' culture policies, in particular in areas of improper behaviour and non-financial misconduct.

Consumer Duty – eliminating the tail risk

IBs in the UK will, where relevant to their product set, be working towards compiling the evidence and engaging with the Board to deliver their first Consumer Duty compliance report before 31 July 2024. Although IBs may feel that they are not at the top of the FCA's priority list for Duty compliance, the FCA requires all firms to put their customers' needs first in particular if they have a direct relationship with retail clients or manufacture products that can ultimately reach retail clients. We expect the FCA to scrutinise and challenge IBs' reports.

Investment banking

No let up in supervisory scrutiny

IBs should review their current data and MI on distribution and ultimate destination of their products to determine if they are sufficient to evidence compliance with the Duty and establish the right 'tone from the top' to foster an environment where staff are focused on delivering good consumer outcomes.

Conclusion

As visibility for some key capital markets regulations improves in 2024 and many regulatory initiatives enter the implementation stage, IBs will need to step up, once again, their regulatory change management programmes. IBs will have to implement the changes whilst keeping up with ongoing supervisory engagement in traditional areas such as risk management and newly emerging ones such as Consumer Duty.

General insurance

Carving opportunities out of change and challenges

Following sustained market and economic pressures, including high inflation, ongoing cost-of-living pressures, mounting catastrophe losses and continued geopolitical turmoil, the outlook for the GI sector across the EU and the UK remains challenging. Although most firms are weathering the storm well - often due to higher yields on investments compensating for higher claims inflation - they now face the difficult task of staying on course in 2024. At the same time, several ongoing regulatory initiatives will require GI firms' close attention, such as the SUK reforms.[70] From a conduct point of view, GI firms need to focus on embedding the Duty and responding to intense regulatory scrutiny on their delivery of good customer outcomes.

GI firms will continue to face significant pressures in 2024, but our view is that the economic and regulatory environment could also present certain opportunities for firms.
To succeed, GI firms must:

- innovate to meet their customers' changing needs;
- maintain robust underwriting discipline with effective feedback loops across all three lines of defence and relevant functions (i.e., pricing, reserving, risks, and the Board); and
- assess how to benefit from the potential advantages brought about by changing regulation.

General insurance

Carving opportunities out of change and challenges

SUK presents one such opportunity. The UK Government has signalled a full de-coupling from the EU and is in the process of implementing its new prudential regime aimed at making the UK insurance market more attractive. Although the SUK-driven capital release will be smaller for GI firms than for life insurers, some of the reforms could, in aggregate, allow GI firms to free up some resources. For example, by the end of this year, GI firms will be able to take advantage of a more streamlined IM approach as well as a reduction in the reporting burden.

The new streamlined IM process reduces the number of tests and standards for new IM applications and introduces more flexibility for the PRA to grant permission for a model subject to residual limitations. This is likely to reduce upfront costs for GI firms to use an IM and would result in a more tailored and risk sensitive capital requirement. Applying for an IM of partial IM could be particularly attractive for GI firms that have started to underwrite specialty products that require a more nuanced and risk-sensitive approach, or those that are highly diversified and could benefit from better use of diversification models. GI firms should also consider other external factors including the fact that IMs are now better understood and third-party model validation more widely available than before.

Some of the SUK reforms could impact the make-up of the sector by introducing a new insurance mobilisation regime and removing TCB capital requirements. This could reduce the operational burden for groups seeking to establish and maintain a commercial lines TCB in the UK. Groups with a UK subsidiary should explore ways in which they, too, can benefit from the TCB reforms. For example, groups that currently operate in the UK through a subsidiary should re-visit the benefits of operating through a branch instead of, or alongside their subsidiary. Potential benefits of a branch structure include no localisation of assets or branch capital requirements as well as less onerous governance and reporting requirements and compliance with a single regulatory capital regime (that of the home country). Potential costs include the need to open the home insurer to the PRA's potentially intense supervisory scrutiny and limits on the volume of FSCS-covered liabilities that can be underwritten by a branch (£500m, subject to PRA approval).[71] Going forward, we also expect more supervisory scrutiny around TCB reinsurance arrangements by both EU and UK supervisors.

> "Low-value (to the customer) products such as GAP and legal expenses insurance, as well as other add-on products, will become a significant test case for the Duty's effectiveness following years of warnings and little tangible action by firms."

In an increasingly competitive environment firms will need to consider the best ways of winning new business and retaining customers while ensuring compliance with the Duty. Personal lines insurers have been on the receiving end of supervisory scrutiny around product governance and value for several years – we expect no let-up under the Duty. Low-value (to the customer) products such as GAP and legal expenses insurance, as well as other add-on products,

General insurance

Carving opportunities out of change and challenges

will become a significant test case for the Duty's effectiveness following years of warnings and little tangible action by firms. Insurers should assess to what extent their business models and profitability rely on these products, and the potential impact of reducing such reliance over time. Some insurers may need to consider rebalancing their portfolios and/or review their pricing strategies. This exercise could be made even more challenging by the changing needs of customers in a difficult economic environment, where the number of policyholders in financial difficulty could continue to increase. Moreover, we expect scrutiny around GI pricing practices to continue through the FCA's evaluation of GI pricing rules implementation to run in 2024.

The new rules on **MOBI**[72] **that came into effect at the end of 2023 also illustrate the increasing regulatory expectations on consumer protection**. Firms underwriting MOBI products will be well acquainted with the need to ensure good outcomes for policy stakeholders but firms that underwrite other types of group policies will need to ensure they identify policy stakeholders in their books and put in place the right controls and processes. In the year ahead, firms should expect continued FCA scrutiny in this area.

Overall, delivering good outcomes for customers while retaining the best risks and staying competitive in the process will require significant ingenuity, including being on the forefront of product innovation to meet the changing customer needs and regulations.

Ingenuity and better decision-making are some of the objectives of a different regulatory initiative that GI insurers will need to respond to in 2024. The PRA and FCA will publish their final rules on D&I later this year. If the regulators stick to their original proposals, most insurers will be required to develop, maintain, and publicly disclose their D&I strategies, set targets against key demographics and report data across a range of metrics on an annual basis. We expect this to be particularly challenging to the wholesale insurance market, given the FCA recently mentioned that it has a long way to go to develop an inclusive culture.[73] Wholesale GI firms needs to identify the root causes of their lack of progress and deal with any residual obstacles, not only because of regulatory pressure but also to meet the expectations of a range of stakeholders. The new proposals will require significant disclosures and firms might find themselves in a difficult position explaining why their D&I metrics look worse than their peers'. Moving the dial on D&I takes time, so the earlier firms start acting on the root causes of this challenge, the easier it will be to get on the right track.

"Although GI firms have been proactive in terms of climate stress testing and scenario analysis, particularly for physical and transition risk, one area where they fall short is around integrating scenario analysis into their overall strategies."

General insurance

Carving opportunities out of change and challenges

ESG issues continue to dominate both the prudential and conduct regulatory agendas across EMEA. GI firms have a lot more work to do in this area – particularly when it comes to embedding climate risk into their risk management frameworks. Although GI firms have been proactive in terms of climate stress testing and scenario analysis, particularly for physical and transition risk, one area where they fall short is around integrating scenario analysis into their overall strategies.
In 2024, we expect this to become increasingly important, especially as the impact of climate risk on GI products and customers becomes more tangible. Firms should ensure the Board gets the appropriate MI to inform strategy and pricing, including results of climate stress and scenario analysis, and how this compares to risk appetite.

More broadly, both commercial and retail GI firms are exposed to all types of climate risk through their insurance products. As catastrophes become more severe and frequent, and the risks associated with the green transition (e.g. through restricting insurance coverage to certain high-emitting industries) materialise over time, GI firms are at a crossroads in terms of how to deal with the changing nature of the underlying risk in their products. Commercial insurers also face the growing threat of increasing climate-related litigation through their liability products (especially Directors' and Officers' insurance). GI firms that innovate and adapt products in line with the changing demands of customers and the environment, while maintaining a robust underwriting discipline, will be at a clear advantage going forward. This is why supervisors continue to advocate 'impact underwriting'[74] as a way for insurers to working innovatively with policyholders to reduce the level of risk.

In conclusion, GI firms face several challenges, brought about by a continuation of the difficult economic environment, changing regulation and evolving risks such as climate change on the horizon. **In 2024, GI firms need to navigate these challenges safely while also making the most of potential opportunities along the way.**

Life insurance

Once-in-a-generation opportunities and challenges ahead

The life and pensions sector faces once-in-a-generation opportunities and challenges. This is driven by a heady mix of higher interest rates and inflation alongside **significant changes to the prudential regulatory regimes** (Solvency UK and Solvency II) and **conduct regulation** in the UK. The higher interest rate environment is increasing consumers' appetite for long-term guaranteed products such as annuities at a time when changes in regulation could reduce the capital required for this business. The pace of DB pensions scheme transfers to insurers is also set to accelerate over the next few years. These trends can lead to opportunities for growth while providing customers with products that better meet their needs and result in better outcomes , provided insurers have the appropriate risk controls in place.

The new SUK regime will result in a reduction of the risk margin and give insurers more flexibility to invest in new asset categories. However, those benefits have strings attached. Under the proposals, insurers will need to attest annually to the sufficiency and quality of their Fundamental Spread and Matching Adjustment (MA).[75] This means that, on the one hand, insurers might be allowed to invest in a wider range of assets, but on the other, will be made to prove they are not taking more benefit than they should by holding them. At the heart of this tension sits the fact that the UK Government intends the SUK reforms to result in more insurance investment in productive UK assets while the PRA needs to ensure that any increased flexibility and risk taking are not done at the expense of policyholder protection.

Life insurance

Once-in-a-generation opportunities and challenges ahead

The PRA is also proposing to increase risk management expectations over life insurers' use of funded reinsurance. Proposals include the need for insurers to demonstrate they would remain solvent if they had to recapture the ceded risks in the event of the reinsurer's failure, and to assess the quality, liquidity and liability duration matching of reinsurance collateral as well as its MA eligibility. This is likely to result in an increased cost of capital for those seeking to fund long-term business with reinsurance capacity since the level of capital firms will have to retain in the UK in relation to funded reinsurance exposures is likely to rise.

Our view is that for insurers to navigate these waters successfully they will need to invest in the expertise and capabilities necessary to explore the benefits of investment flexibility, including asset origination, valuation and modelling. We believe the benefits will be gradual and modest at first but those entering this market early will gain the knowledge and understanding necessary to demonstrate a credible track-record to the PRA and make the most of the opportunity in the years ahead.

Insurers should engage as soon as possible with the attestation process, in particular those that have a range of assets other than corporate and government bonds in their MA portfolios. The building blocks of a successful attestation include assessing the current asset portfolio to identify higher risk categories of assets, creating the methodology for calculating the Fundamental Spread which will include identification of risks not currently in valuations or emerging risks, developing models to calculate the impact of new risks identified on the Fundamental Spread, and developing the necessary governance and controls that need to be put in place to allow for the attestation process to run smoothly. In our view, the SUK proposals mark the beginning of a journey where firms and the PRA will learn through the process and fine tune the regime further. Insurers should use the next few years to test the benefits of investment flexibility and demonstrate proficiency to the PRA. This will put them in the best position to make good use of the regime as more eligible assets become available and the regime beds down.

"Our view is that for insurers to navigate these waters successfully they will need to invest in the expertise and capabilities necessary to explore the benefits of investment flexibility, including asset origination, valuation and modelling."

Life insurance

Once-in-a-generation opportunities and challenges ahead

The prudential regime does not have a monopoly on regulatory tensions. The implementation of the Duty in the UK has been onerous, to say the least, and the FCA's expectations around it are still evolving. It is widely recognised that the Duty will be a significant challenge for life firms in dealing with their portfolios of **closed products**. Many life insurers have grown over the years through mergers and acquisitions resulting in complex portfolios with many products managed under different legacy systems. Many of those products include features or fee structures that may not be considered fair value if they were sold today. Some of the contractual terms in closed products (e.g. fees and charges) will be considered vested rights. Firms will not be expected to amend charges where they fall under the vested rights category, although they would be welcome to choose to do so if this resulted in improved outcomes for customers.

However, firms will need to assess carefully if certain products exploit customers' lack of knowledge and if complex pricing structures may make it more difficult for customers to switch or terminate a contract. Firms should also consider how their Duty work on customer understanding and support can help ensure closed products remain fair value to customers – looking at "value in the round" in the words of the FCA. In our view, firms will need to consider if the value differential between open and closed products can be justified in the medium term. They might want to develop a path towards reducing gaps over time where justifying the differential is likely to be challenging.

"Firms should assess the effectiveness of guidance and support services at retirement and develop an action plan to demonstrate they are delivering good retirement outcomes."

The Duty also raises difficult questions for firms when it comes to delivering good retirement outcomes and enabling customers to pursue their financial objectives. At retirement, decisions are notoriously difficult for customers, because of their complexity, and life insurers which do not have advice permissions are wary of being perceived as crossing the boundary from guidance to advice. This has resulted in a reluctance by firms to take a broader view of what they provide by way of guidance, thereby constraining their support for customers at retirement. The key question is for how long this reluctance will be a risk-free choice for life insurers. The FCA is aware of this dilemma and plans to review the advice/guidance boundary in 2024.[76] Firms should assess the effectiveness of guidance and support services at retirement and develop an action plan to demonstrate they are delivering good retirement outcomes.

Life insurance

Once-in-a-generation opportunities and challenges ahead

Climate-related risks are another source of potential poor customer outcomes in the life insurance sector, especially for unit-linked pensions where policyholders bear all investment risks. Insurers need to consider actions to help customers understand and manage climate risk in their portfolios, for example the risk of stranded assets, while also being alert to potential greenwashing risks when offering unit-linked funds that include sustainability claims. In our view, insurers should consider applying the tools and expertise they deploy to manage their own climate-related risks to their customers' exposures. Insurers could then provide customers with information and options about the level of risk they bear and ways to manage it. Life insurers might want to harness their work to comply with the ever-expanding climate disclosure requirements to ensure customers are well informed, understand the risks in their exposures and are offered a range of products that meet their appetite for sustainable investments.

Conclusion

A key feature of the regulatory landscape for life insurers is the inter-dependence of risks and opportunities. Leaving prudential reform to actuarial teams, Consumer Duty to compliance, and climate-related risks to sustainability teams will not result in the best outcome. Firms need to consider a multi-disciplinary approach to tackle these challenges to ensure they can make the most of the opportunities they present while managing and mitigating emerging risks. Firms should engage the Board early on in assessing the strategic impact of some of the key regulatory initiatives described above and setting up working groups that bring together expertise from different areas of the business to ensure opportunities and risks are identified and addressed promptly. In our view, those who can best put the different pieces of the jigsaw together and see the whole picture in the process will be the most successful in adapting to the new regulatory landscape.

Investment management and wealth

Supervisors demand strong governance and MI to demonstrate good outcomes

Key focus areas for asset and wealth managers in 2024 will include embedding the Consumer Duty ("the Duty"), mitigating greenwashing risk and strengthening fund liquidity management. Across these topics, a recurring theme is the importance of strong governance and high-quality MI. As the FCA becomes a data-led regulator, its expectations of firms' MI are increasing, including that Boards should use improved MI to challenge the business robustly.

Consumer Duty

With the first Board report due in July 2024, **firms need to focus on refining and embedding their frameworks for monitoring outcomes**. We think firms need to challenge themselves on whether they have sufficiently robust data to evidence good customer outcomes and consideration of foreseeable harm, and if not, what additional data they need. One challenge is poor information-sharing between manufacturers and distributors, especially along complex distribution chains. We would expect the FCA to intervene if lack of cooperation impedes effective information-sharing which is needed for product governance and value assessments.[77]

Value assessments will be a key focus in the FCA's 2024 review of Duty embeddedness.[78] The FCA expects firms to consider value holistically – for example, its 2023 review of AFMs' value assessments emphasised that firms should consider each assessment criterion rather than simply using comparable market rates to justify fees. More recently,[79, 80] it has highlighted that firms need to consider whether they are passing on a fair share of revenues (e.g. interest on cash balances, revenues from securities lending) as well as looking at charges. Wealth managers and other intermediaries assessing value for the first time under the Duty face challenges in assessing the value of a service -

Investment management and wealth

Supervisors demand strong governance and MI to demonstrate good outcomes

while this may be a qualitative exercise, we think it needs to be backed up by measurable evidence and data. Furthermore, where these firms are also manufacturers (e.g. when offering a model portfolio), they cannot simply rely on the fact that all of the underlying funds are assessed by the fund manager as providing value – they need to justify why they have chosen each fund and how it contributes to the portfolio's value.

"In our view, good practices for embedding a Duty-conscious culture include appointing Duty Advocates, and communicating to each individual what the Duty means for their role."

As the Duty moves into BAU, firms need to embed a culture and operating model that facilitates good customer outcomes. The FCA has signalled a greater willingness to intervene where it does not find evidence of this – for example it has been forthright about failings in the wealth management and stockbroking sector,[81] including its finding that 49% of portfolio managers and 69% of stockbrokers had identified no vulnerable consumers. In our view, good practices for embedding a Duty-conscious culture include appointing Duty Advocates, and communicating to each individual what the Duty means for their role. How proactive firms are at remedying poor value in closed products by July 2024 can also be an indicator of culture, as these often receive less attention.

In the EU, many firms are anticipating the retail investment strategy, which may include significant new requirements on value for money and inducements. While the details are unlikely to be finalised before 2025, firms can already start considering lessons from the UK's experience in these areas.

Sustainability

Greenwashing risk will be a key concern for investment and wealth managers across the UK and EU in 2024. Final rules under the FCA's SDR were published in late 2023 with the key objective of mitigating greenwashing. The SDR's sustainable investment label regime will help firms to communicate their sustainability goals more clearly and consistently to investors. However, challenges remain. For example, the SDR has not defined the term 'sustainability' - how firms define this will have an impact on all their disclosures and the way they procure and use ESG data. Firms need to be pro-active about ensuring a consistent understanding of what greenwashing means across functions, before establishing new or enhancing existing controls. Firms also need to carry out comprehensive risk reviews across their functions to determine the various sources of this risk. This will allow for smoother implementation and enable firms to demonstrate to the FCA that they have considered and mitigated multiple sources of the risk.

Investment management and wealth

Supervisors demand strong governance and MI to demonstrate good outcomes

In the EU, a fundamental review of the SFDR is underway. This may potentially change the way in which the Article 8 and 9 categories are used. Several firms have already changed SFDR categories previously and more changes may erode investor trust. This, in combination with expected restrictions from ESMA on the use of ESG terms in fund names and implementation challenges associated with SDR, may cause some firms across the UK and EU to re-think their sustainability ambitions. This will clearly have commercial implications if firms are not able to participate in the sustainable funds market – and it might also undermine firms' reputations.

Furthermore, stakeholders will expect firms to **step up their efforts in relation to transition planning** in advance of new detailed regulatory requirements that we anticipate coming in for many firms in the EU (from 2024) and UK (from 2025). Firms will need to move beyond viewing transition planning as a disclosure exercise with siloed pockets of activity. They will need to embed sustainability strategies across the organisation. They will also have to define the steps and KPIs needed to achieve targets and be clear about the interplay between firm-level commitments and product-level ESG performance.

Fund liquidity

We expect fund liquidity to be a key supervisory focus area in view of the significant shortcomings found in the FCA's recent review,[82] and the new rules on liquidity management in the EU's revised UCITS and AIFMD frameworks. Many firms will need to make a step change in how Boards and governance committees engage on this topic. In our view, good practice is for firms to have a dedicated liquidity risk management committee which is a sub-committee of their product governance committee or investment risk committee, with MI sent to the Board risk committee. We think firms should pay particular attention to model governance and validation (including on models for stress testing, swing pricing and asset valuation), and to providing enhanced governance in times of market stress. Although not applicable to investment managers, the PRA's principles for model risk management[83] provide a good starting point for model governance.

To monitor liquidity risk effectively, firms will need **metrics, escalation triggers and processes** (including the use of anti-dilution tools) that are **tailored to each asset class and calibrated for the risk profile of each fund**. For many firms, putting these arrangements in place will require significant work and senior management time.

Firms should ensure that they have **robust liquidity risk stress tests** with scenarios that are sufficiently severe and consider forward-looking risks. Firms should also use conservative assumptions, such as a 'pro-rata' approach (where a proportionate 'slice' of every asset comprising the portfolio is sold to accommodate the redemption) where appropriate. More stringent stress tests may result in firms needing to adjust their funds' liquidity profiles.

Investment management and wealth

Supervisors demand strong governance and MI to demonstrate good outcomes

Firms will need to **build a model to estimate market impact cost** for swing pricing and other anti-dilution tools – IOSCO's guidance says[84] that firms should analyse previous transactions under similar market conditions or use relevant market data/models. Since firms will need to apply judgement, their models should be subject to robust governance and back-testing.

In view of rules expected from the FCA on redemption notice periods for open-ended property funds, and the FSB's recommendation that funds investing significantly in illiquid assets should not have daily dealing,[85] firms will need to **review their redemption terms for funds holding illiquid assets** and consider how they can remain attractive to investors.

Conclusion

As investment and wealth managers work hard to comply with evolving regulatory expectations, they also need to understand the impacts on their business strategy. For example, as firms integrate value assessments into BAU processes, the assessments will need to become an integral part of product/service design, rather than solely a compliance exercise. Similarly, supervisory scrutiny on greenwashing and transition plans will prompt firms to consider the viability of their sustainable product offering. Finally, new requirements on fund liquidity may result in changes to product design.

Private market investments

Supervisors shine spotlight on controls in bid to uncover hidden risks

The last decade has seen rapid growth in private market investments (see figure 11), attracting the attention of governments and regulators. Governments are keen to facilitate greater investment in long-term, productive assets and have put in place a range of measures to do so, most notably increasing opportunities for investment by defined contribution[86] and defined benefits[87] pensions, the Mansion House Compact[88] and the LTAF[89] in the UK, and ELTIF II[90] and a new regime for loan origination funds[91] in the EU.

At the same time, **supervisors are alert to the risk of inaccurate valuations, conflicts of interest, poor liquidity and leverage controls, mis-selling and greenwashing risks**. IOSCO has warned[92] that higher interest rates could increase defaults and threaten valuations in this relatively opaque market. Regulators are calling for more transparency in private markets[93] as part of the policy debate on NBFIs. Taken together, we expect this to result in a step change in the level of supervisory scrutiny of this sector in 2024. Private markets firms will need to invest significantly to ensure that risk and compliance functions are appropriately resourced and that they have robust control frameworks and operational processes.

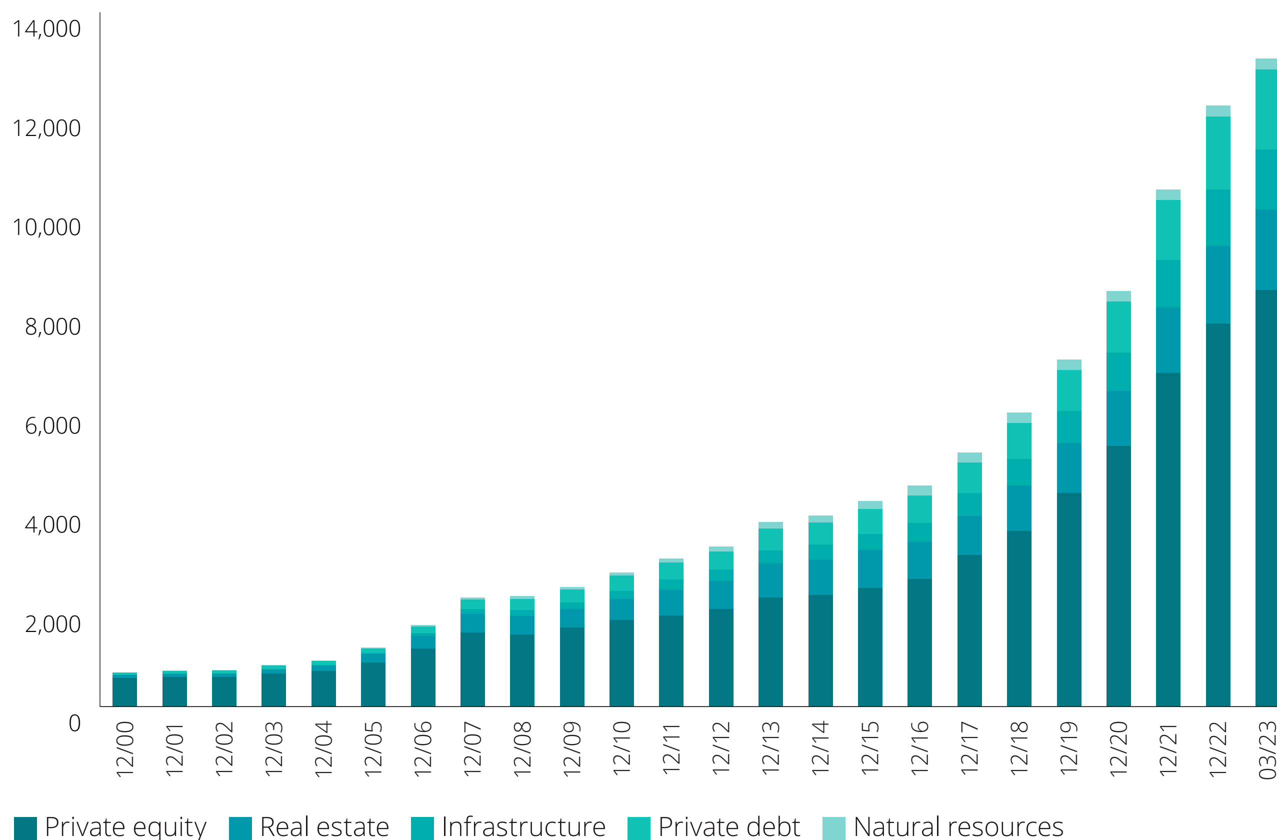
Valuation

Valuations are under the supervisory spotlight. In the UK, the FCA is conducting a review of valuation in private markets, while in the EU, ESMA's recent CSA on valuation[94] highlighted particular risks for private equity and real estate assets. Key concerns include subjectivity and potential conflicts of interest in in the valuation process, and misalignments between the frequency of the NAV calculation, the asset valuation, and the availability of up-to-date data. Accurate valuations are especially important if investors can exit the product early or trade it in the secondary market.

Private market investments

Supervisors shine spotlight on controls in bid to uncover hidden risks

Figure 11: Global private capital assets under management split by asset class (in USD billion)



Source: Preqin Ltd.

In our view, firms should particularly focus on governance, which should provide challenge at key stages of the valuation process, from the methodology used, to the validity of the inputs, and the reasonableness of material judgements used to determine valuations. This challenge needs to be independent and to have the right level of seniority and expertise. Some firms are considering greater use of third-party valuers – this can provide more independence but firms should be aware that it does not absolve them of responsibility.

We think that governance committees should ensure that the assumptions behind valuation models are robust and periodically back-tested and that firms use high quality data as inputs. It will also be important for the valuation process to be clearly documented, and for individual responsibilities to be set out clearly, including for senior managers subject to the Senior Managers and Certification Regime. Although not applicable to investment managers, the PRA's principles for model risk management[95] provide a good starting point for model governance.

Private market investments

Supervisors shine spotlight on controls in bid to uncover hidden risks

Private credit

Private credit markets – which globally grew from less than USD 60 billion in 2002 to over USD 1.3 trillion in H1 2022[96] – will face their first big test at their current size, as more challenging market conditions and higher interest rates are likely to lead to more borrowers in difficulty. Private credit managers will therefore need to ensure that they have sufficient arrangements for working with borrowers to enforce covenants and solve financing issues before they become more significant, particularly for loans that are not sponsored by a private equity firm. Rising defaults may also prompt supervisors to question firms on their liquidity and leverage controls, given the current focus on how hidden leverage can transmit risk across the financial system.

EU managers of private credit funds will need to consider their business strategy in light of **AIFMD II's new harmonised regime for loan origination funds**. This creates new opportunities for these funds to lend on a cross-border basis across the EU, which will make it easier for managers to scale their operations. Nevertheless, the new regime introduces some significant new requirements which will reduce flexibility for managers, including leverage limits, risk retention requirements and a requirement to have a closed-ended structure unless they can demonstrate appropriate liquidity management practices for an open-ended structure. Funds that do not currently meet these requirements will need to review their investment strategy and/or structure to ensure they remain attractive to investors.

> "Private credit markets – which globally grew from less than USD 60 billion in 2002 to over USD 1.3 trillion in H1 2022 – will face their first big test at their current size, as more challenging market conditions and higher interest rates are likely to lead to more borrowers in difficulty."

Retail investment

As more managers seek investment from retail investors (including DC pensions and wealth clients), supervisors are increasingly focusing on conduct risks. In the UK, we expect the Consumer Duty ("The Duty") to be a key area of supervisory focus. As part of its work on the Duty, the FCA recently raised[97] concerns that wealth managers have exposed consumers to inappropriately high-risk or complex investments, that execution-only stockbrokers have promoted products that are too complex to understand, and that consumers can be unaware of high fees that significantly reduce their investment returns. Firms will need strong controls across their marketing, distribution and product functions to mitigate these risks.

Similarly, DC pension schemes increasing their investment in unlisted assets under the Mansion House Compact will need to ensure their members understand the risks, that the investments deliver value net of fees, and that they revisit the rationale for their asset allocation periodically. We think that conduct considerations are likely to slow the uptake of increased private markets allocations in 2024 as DC pension schemes will need to consider each investment carefully. For example, the government's

Private market investments

Supervisors shine spotlight on controls in bid to uncover hidden risks

own analysis[98] shows that the value for investors depends significantly on the level of fee discounts that pension schemes can negotiate. In addition, the fact that global private equity dry powder reached a record USD 2.69 trillion in December 2023[99] suggests that good investment opportunities may take time to find.

ESG

According to Deloitte's ESG in Private Capital Survey 2023,[100] **which sought insights from 69 individuals across 61 UK private asset investors (including both GPs and LPs), UK private asset investors are committed to integrating ESG factors into investment decisions, with 91% already having ESG policies in place.** The survey also found that the approach to ESG is currently largely driven by LPs' views rather than by regulators.

This dynamic is very likely to change in the UK with the FCA's SDR published at the end of 2023. Prescriptive requirements underpinning the use of sustainable investment labels alongside strict marketing restrictions mean that firms may need to consider the viability of their sustainability ambition in light of increased regulatory and reputational risk. SDR compliance will be a particular challenge for private market firms due to the lack of availability of ESG data from private companies. To mitigate greenwashing risk, firms will need to take the lead in ensuring that private companies have the right arrangements to produce high-quality ESG data – they can leverage regulations that require corporate disclosures i.e. the Corporate Sustainability Reporting Directive for EU (and some non-EU) companies, and the UK's upcoming Sustainability Disclosure Standards. Since ESG data is a key source of greenwashing risk, it is crucial for firms to identify gaps in ESG data in order to manage their own reputational and liability risk, and to produce accurate disclosures. Separately, firms subject to the TCFD reporting deadline of June 2024 should ensure that they pro-actively document how they identify and manage climate risks and opportunities in their portfolios – seeking climate related data from private companies at short notice is likely to be challenging.

Conclusion

While the expansion of private market investments creates significant new opportunities, firms will need to ensure that they have robust processes and controls and that their risk and compliance functions are appropriately resourced as they grow. In 2024, we expect a particular supervisory focus on valuation, private credit, protections for retail investors and greenwashing risk. EU managers of private credit funds will also need to make important decisions about their business model ahead of the implementation of AIFMD II.

Further reading

Sustainable finance	It's all in the planning: three key challenges to consider when designing a transition plan FCA's new "anti-greenwashing rule" - "clear, fair and not misleading" is complicated when it comes to sustainability-related claims	EU Corporate Sustainability Reporting Directive (CSRD) - Strategic and operational implications
Innovation, payments and digital assets	Stablecoins – how do you regulate an emerging ecosystem? | Deloitte UK Reviewing the EU payments regulatory framework: the new PSD3/ PSR1 package | Deloitte UK Regulating AI: can the UK's proposed approach achieve both flexibility and clarity? | Deloitte UK	The EU AI Act: the finish line is in sight | Deloitte UK Navigating the fragmented global digital assets regulatory landscape | Deloitte UK
Retail and commercial banking	Basel 3.1 near-final rules: the fog starts to clear | Deloitte UK The PRA delays Basel 3.1 – again. What should banks do now? | Deloitte UK	Countdown to compliance with SS1/23 Model Risk Management: Implications for Board members | Deloitte UK
Investment banking	FCA Wholesale Banks portfolio letter – a wider range of issues to dominate the supervisory agenda | Deloitte UK	Shining the light on the financial trade-offs of Accelerated Settlement | Deloitte UK
Life and general insurance	Solvency UK: Moving closer to reality | Deloitte UK Solvency UK Matching Adjustment: Another piece of the puzzle falls into place | Deloitte UK Preparing the Consumer Duty Board Report | Deloitte UK Enhancing consumer protection in general insurance: from multi-occupancy building insurance to group policies | Deloitte UK	Assessing climate litigation risk for insurers | Deloitte UK Tackling climate-related risks leading to poor customer outcomes in insurance | Deloitte UK Greenwashing for insurers | Deloitte UK
Investment management and wealth	Deloitte's IMW Consumer Duty Survey: The Results Are In | Deloitte UK FCA's new "anti-greenwashing rule" - "clear, fair and not misleading" is complicated when it comes to sustainability-related claims | Deloitte UK	FCA joins growing regulatory call to action on fund liquidity | Deloitte UK
Private market investments	ESG in Private Capital Survey 2023 | Deloitte UK	A focus on valuation governance | Deloitte UK

Glossary

1LoD
First Line of Defence

2LoD
Second Line of Defence

A2A
Account-to-Account

AFM
Authorised Fund Manager

AI
Artificial Intelligence

AIA
Artificial Intelligence Act

AIFMD
Alternative Investment Fund Managers Directive

AML
Anti-Money Laundering

APM
Alternative Payment Method

APRA
Australian Prudential Regulation Authority

BAU
Business as usual

BCBS
Basel Committee on Banking Supervision

BIS
Bank for International Settlements

BNPL
Buy Now, Pay Later

BoE
Bank of England

CBDC
Central Bank Digital Currency

CCP
Central Counterparty

CCR
Counterparty Credit Risk

CMA
Competition and Markets Authority

CRD6
Capital Requirements Directive 6

CRR2
Capital Requirements Regulation 2

CRR3
Capital Requirements Regulation 3

CSA
Common Supervisory Action

CSDDD
Corporate Sustainability Due Diligence Directive

CSDR
Central Securities Depositories Regulation

CSRD
Corporate Sustainability Reporting Directive

D&I
Diversity and Inclusion

DC
Defined Contribution

DLT
Distributed Ledger Technology

DORA
Digital Operational Resilience Act

Duty
Consumer Duty

EBA
European Banking Authority

ECB
European Central Bank

EIOPA
European Insurance and Occupational Pensions Authority

ELTIF
European Long-term Investment Fund

EMEA
Europe, Middle East and Africa

EMIR
European Market Infrastructure Regulation

ESG
Environmental, Social and Governance

ESMA
European Securities and Markets Authority

EUR
Euro

FCA
Financial Conduct Authority

FMI
Financial Market Infrastructure

FRTB
Fundamental Review of the Trading Book

FS
Financial Services

FSB
Financial Stability Board

FSCS
Financial Services Compensation Scheme

G-SIB
Global Systemically Important Bank

GAP
Guaranteed Asset Protection

Glossary

GBP
Pound Sterling

GDPR
General Data Protection Regulation

GI
General Insurance

GP
General Partner

IB
Investment Bank

ID
Identification

ILAAP
Internal liquidity assessment process

IM
Internal Model

IMA
Internal Model Approach

IMF
International Monetary Fund

IOSCO
International Organization of Securities Commissions

IRB
Internal Ratings-Based

LDI
Liability Driven Investment

LP
Limited Partner

LTAF
Long Term Asset Fund

MA
Matching Adjustment

MI
Management Information

MiCAR
Markets in Crypto-Assets Regulation

MiFID
Markets in Financial Instruments Directive

MiFIR
Markets in Financial Instruments Regulation

MMF
Money Market Fund

MOBI
Multi-Occupancy Building Insurance

MS
Member State(s)

NAV
Net Asset Value

NBFI
Non-Bank Financial Institutions

NIM
Net Interest Margin

NPA
New Payments Architecture

PD
Probability of Default

PRA
Prudential Regulation Authority

PSD3/PSR
Third Payment Services Directive / Payment Services Regulation

PSP
Payment Service Provider

RWA
Risk-Weighted Asset

SA
Standardised Approach

SDR
Sustainability Disclosure Requirements

SDS
Sustainability Disclosure Standards

SEC
U.S. Securities and Exchange Commission

SFD
Settlement Finality Directive

SFDR
Sustainable Finance Disclosures Regulation

SME
Small- and Medium-sized Enterprises

SLRP
Supervisory Liquidity Review Process

SUK
Solvency UK

SWES
System-Wide Exploratory Scenario

TCB
Third-Country Branch

TCFD
Task Force on Climate-related Financial Disclosures

TNFD
Taskforce on Nature-related Financial Disclosures

TPP
Third-Party Provider

UCITS
Undertaking for the Collective Investment in Transferrable Securities

USD
US Dollar

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