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Financial Markets

Interim Regulatory Outlook 2022

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Introduction

The first six months of 2022 have been characterised by a number of global shocks, most notably Russia's invasion of Ukraine, which have had a huge impact on the economic outlook and on financial markets. This has in turn required a rapid and far-reaching response from governments, central banks and regulators. We have structured this year's IRO to reflect these developments, dividing it into two sections.

The first examines the major market developments since our RO22 publication, their implications for financial services regulation and supervision and what this means for regulated firms. Here we consider: Russia's invasion of Ukraine and the resulting financial sanctions, the growing importance of energy security and how it interacts with the regulatory focus on sustainability, the dramatic increase in inflation, and the market volatility that we saw in March.

The second analyses the most important regulatory themes that have emerged in the first half of the year, themes that are distinct from those discussed in the RO22. They include the slower pace with which a number of regulatory changes are being delivered, the growing importance of competitiveness in shaping the future of financial services regulation, and finally how supervisory approaches are continuing to evolve.

Those wanting a fuller picture of the regulatory landscape for 2022 should read this document in conjunction with our RO22, whose themes and predictions remain valid midway through the year.

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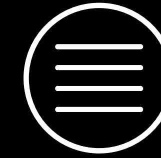
Executive summary

At a glance



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Market Developments

Russia's invasion of Ukraine

Russia's invasion of Ukraine has had and will continue to have a series of direct and indirect consequences for financial services firms. Firms have to adjust their operations, systems, assets and infrastructures to respond to sanctions, cyber threats and exposure to Russian and Belarusian markets and clients.

Balancing energy security with sustainability

Policymakers in the EU and the UK have to balance their net zero ambitions and the energy transformation of their economies with the disruption of oil and gas supplies due to Russia's invasion of Ukraine. In some countries this is likely to mean that use of coal and nuclear power will increase in the short term. Firms will have to consider their appetite for financing this increase and its impact on their own net zero commitments.

Inflationary pressure

Inflation and the cost of living have increased markedly and are now well above policymakers' targets. Central banks have begun to tighten monetary policy, increasing debt servicing costs for businesses and consumers and creating second and third round effects for firms.

Market volatility

Commodity, equity and crypto markets have all faced significant market volatility. Regulators are increasingly concerned with participants' ability to make payments, meet margin calls, and protect consumers.

Click here to view the Market Developments related actions and implications

Regulatory Themes

Moving, fast and slow

As policymakers have had to deal with various fast-moving market developments, the UK and EU have both been slower to implement and progress important aspects of their regulatory reforms than we anticipated. However in others the pace has picked up.

Click here to view the moving, fast and slow related actions and implications

Competing on competitiveness

Competitiveness concerns are becoming an important part of regulatory policy making. The UK's regulators look set to gain a secondary competitiveness objective, whilst the EU is adapting its reforms to respond to the UK's regulatory divergence. This approach may create tensions between governments and regulators.

Click here to view the competing on competitiveness related actions and implications

Evolving supervisory expectations

Supervisory approaches are evolving. The FCA ambition is to embed a data-driven supervisory strategy and to take a more assertive approach. The ECB has concerns about banks' booking models. The BoE's climate stress tests have identified general weaknesses in firms' capabilities and greenwashing has risen up the regulatory agenda.

Click here to view the evolving supervisory expectations related actions and implications

Market developments

Russia's invasion of Ukraine

Russia's invasion of Ukraine has dominated the political and economic news since February. While the greatest concern is the resulting war's tragic human consequences, it has also had important implications for financial markets and regulation. Russia's invasion prompted a raft of sanctions from the US, EU, UK, Switzerland and other nations. These have targeted not only Russian (and Belarusian) companies, but also their central bank assets, and high-profile individuals connected to these countries' political regimes.

Major Russian banks have been removed from Swift, the international payment system, while the US has barred Russia from using the reserves it holds in US banks to make debt payments. The UK and EU have also removed Russian firms from their financial systems, frozen the assets of all Russian banks, barred Russian firms from borrowing money, and placed limits on deposits Russians can make at UK and EU banks. The UK has also excluded Russian companies from its space/aviation insurance and reinsurance markets, and both the EU and UK have banned insuring any shipping cargo with Russian provenance.

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Russia's invasion of Ukraine

This means that all financial services firms will have had to consider whether these complex sanctions apply to them and, where they do, comply with them with little or no notice. Those with operations in Russia will have had (or chosen) to downsize or close them altogether. The fact that the sanctions are similar in intent but different in the detail across different countries has added to the compliance complexity, at a time when firms' arrangements were already under scrutiny from regulators in the UK and EU. The frequent and ongoing updates and changes to the sanctions, and the need to increase associated transaction, company and individual scrutiny significantly, have caused firms considerable resource challenges. Firms both large and small continue to recruit staff to bolster their operations, although there is a relative lack of expertise, which has necessitated rapid and extensive training. This has taken up a considerable amount of (already scarce) senior management bandwidth at many firms, and left others that had significant presences in Russia nursing losses as they withdraw from the country.

Both UK and Euro-area banks' direct exposure to Russia is relatively small (the UK's exposure is less than 1% of CET1 capital[1] and Euro-banks around 0.2% of total assets[2]) and is unlikely to present a direct risk to financial stability. Supervisors have expressed more concerns about the second-round effects arising from the war, as in the words of ECB Vice-President Luis de Guindos, the war has "increased financial stability risks through its impact on virtually all aspects of economic activity and financing conditions".

Valuation of some assets linked to Russia, Ukraine or Belarus has become challenging as they have become illiquid or untradeable. This has led to some fund managers having to suspend certain funds, although there are now signs of some funds reopening. ESMA released a public statement on the use of one particular liquidity management tool, referred to as a side pocket[3], which could enable some funds to reopen in due course. The UK's FCA, Luxembourg's CSSF and the Central Bank of Ireland, have all signalled their willingness to allow side pockets to be used in retail funds subject to certain conditions.

The conflict in Ukraine has also led to a higher worldwide state of alert to potential cyber threats, either as direct retaliation for Western sanctions placed on Russia, or as an unintended spillover of other cyber offensives between Russia and Ukraine. Many financial services firms and FMIs are viewed as critical infrastructures, and their exposure to attacks from state and state-backed cyber adversaries is likely to be heightened during this period of increasing geopolitical tension. While there is some evidence that malicious cyber activity has increased since the conflict began, a significant cyber-attack, on the scale of 2017's WannaCry ransomware or NotPetya malware attacks, has not yet occurred.

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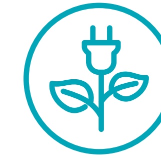
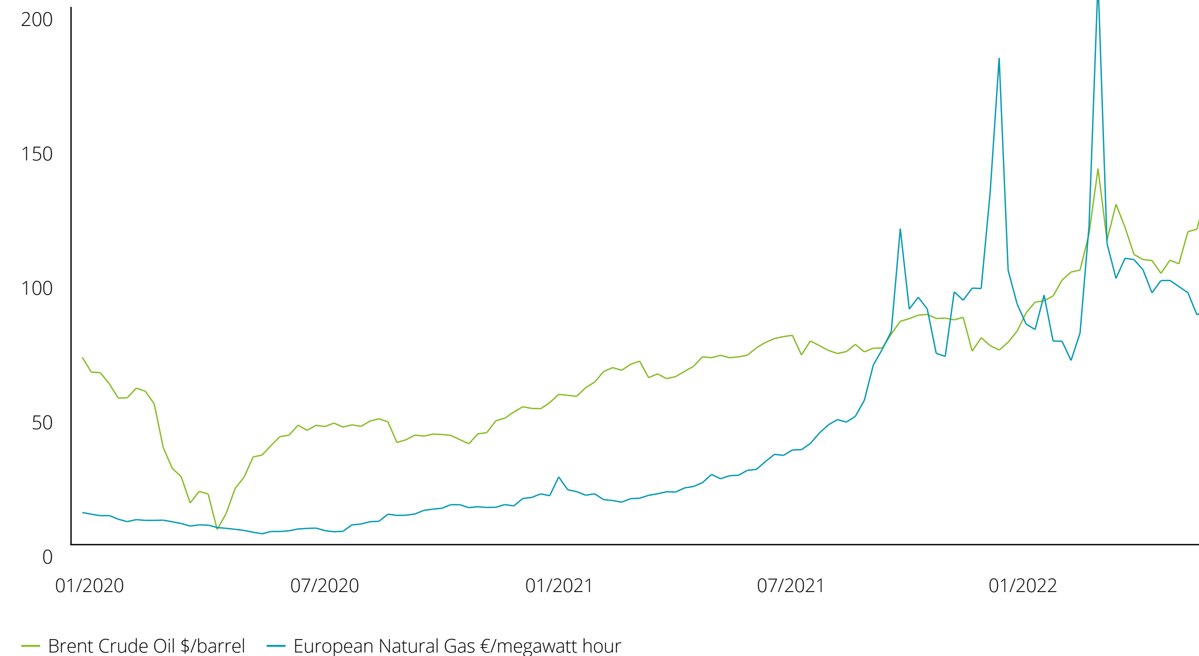
Balancing energy security with sustainability



Russia's invasion of Ukraine has disrupted oil and gas supplies to European countries, raising concern amongst UK and EU governments about energy security. Resulting higher energy prices have compounded a cost-of-living crisis, providing an additional driver for government action.

Such action will likely necessitate trade-offs against pre-existing commitments to transition to lower-carbon sources of energy, complicating government and individual firm transition strategies. For example, in the UK, in his letter to the FPC in April, the Chancellor underlined that while the UK government remains committed to the transition to net zero, energy security needs to be maintained in the interim. The British government also appears to be willing to keep some coal-fired power stations open for longer to maintain energy security over the short term, with Germany also taking a similar approach.

Chart 1. Energy prices



Source: Refinitiv Datastream.

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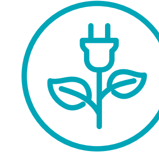

If countries are to reduce their dependency on Russian energy supply, this is likely to have two sets of consequences in the short term. First, use of coal – a more-polluting hydrocarbon – and nuclear power may increase. Decisions to stop mining – or not to exploit at all – alternative (non-Russian) sources of oil and gas may also be reversed. Second, some countries will seek to accelerate investment in low/zero carbon technologies. Countries may also be successful in promoting reduction in energy consumption and investment in energy efficiency.

We have seen both of these factors play out, for example, in the EU. EU President Ursula von der Leyen committed the EU to "doubling-down" on renewables to increase energy security, but in the nearer term some Member States are considering taking steps such as increasing use of coal or nuclear power.

Financial services regulators will regard firms funding companies' transition to lower-carbon technologies as a positive step, consistent with their objective to reduce the financial system's vulnerability to climate risk. Regulators will, though, also be alert to the heightened risk: for example, an acceleration of investment may lead to pressure to fund less-proven projects or technologies.

By contrast, an increase in coal mining is clearly very bad for the transition to a lower-carbon economy. Regulators are likely to accept the need for a short-term increase in exposures to these investments, but firms' strategies for managing the exposures will be closely scrutinised. The disruption to energy transition strategies across the economy will also affect financial services firms' calculations on the risk of stranded assets.

A related question is whether these developments will affect policy more generally, such as leading to a broadening of the definition of green energy as captured through green taxonomies.

This shift towards putting greater emphasis on the importance of energy security also reflects a wider question about the respective components of E (environmental), S (social) and G (governance) related approaches to financial activity, investing and regulation. In this case, wider social policy concerns are being weighed against environmental ones, but firms will also have to consider how they balance other competing and changing parts of the ESG agenda.

For example, the war in Ukraine has led some to question whether arms manufacturers – traditionally excluded from ESG-related indexes or funds – should now be included if they are creating weapons that may help Ukraine (or any other country subject to unprovoked attack) defend itself. It is for firms manufacturing such funds or indexes to reach such ethical judgements themselves (rather than outsourcing the decision to third parties) and be transparent about the conclusions they have reached.

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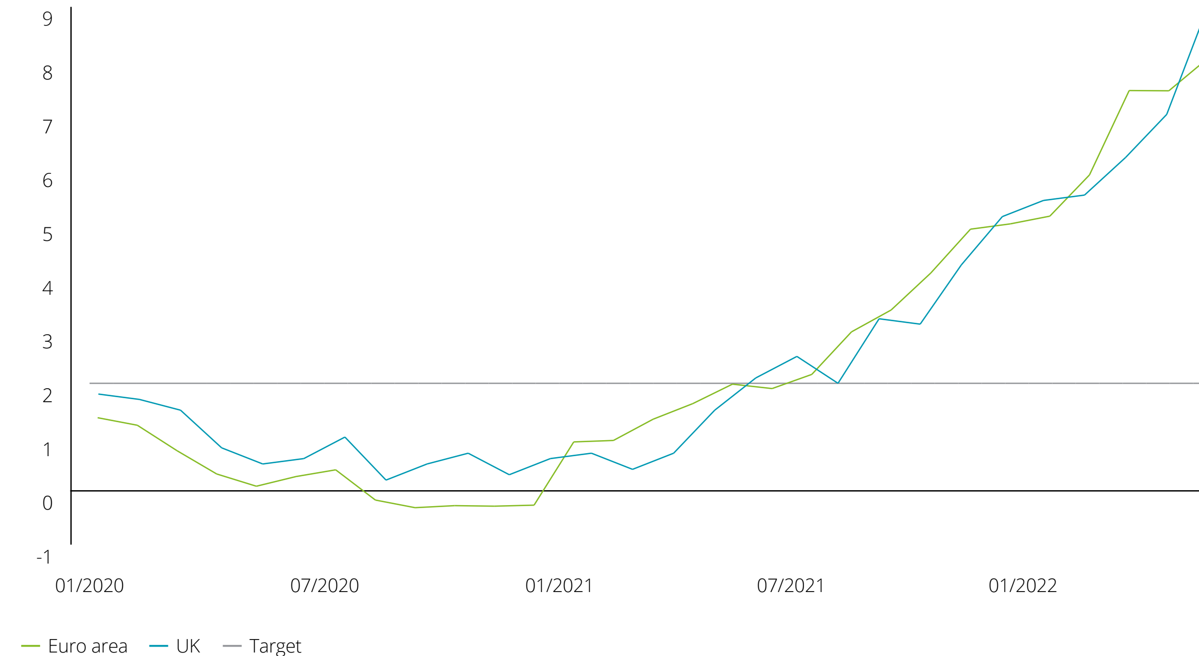
Inflationary pressure

Since January, inflation and the cost of living have increased markedly and have quickly risen to the top of policymakers' agendas.

Inflation has exceeded central bank targets across the EU, US and the UK, with the US and UK seeing the highest rates of inflation for 40 years. Russia's invasion of Ukraine has exacerbated inflationary pressures, especially with respect to energy prices and agricultural commodities such as wheat. There are also fears that stagflation may soon follow from inflation, with many countries also facing challenging growth outlooks. Rising prices are likely to create strong commercial headwinds, and many consumers may be forced to reconsider whether they can continue to afford certain financial products in the face of significant cost of living increases. Poorer households are likely to face greater pressure, with the UK-based Institute for Fiscal Studies estimating that they may face average inflation rates of 14%, compared to 8% for the richest households. Firms will find it challenging to balance the need to reach commercial targets whilst also ensuring they deliver good customer outcomes.

Chart 2. Consumer price inflation



Source: Refinitiv Datastream.

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Inflationary pressure

Central banks have begun to tighten monetary policy in response, raising interest rates and starting to unwind quantitative easing programmes, while also setting out a path for further tightening should the rate of inflation continue to increase. While rising interest rates mean banks will benefit from improved net interest margins, they will also drive up the cost of debt for both companies and consumers. Certain sectors and types of counterparties could be particularly vulnerable, such as corporates with high energy consumption that are not able to pass on higher prices easily to end customers; and corporates that borrow at variable rates and whose balance sheets have been weakened by the pandemic. The ECB and the BoE took the slightly unusual step of issuing a joint statement expressing concern about declining credit standards in, and firms' increasing levels of exposure to, leveraged and highly leveraged lending. The ECB followed up with a Dear CEO letter.

The factors above point to an increase in banks' impairments and loan loss provisions in the second half of 2022, although this may be mitigated by the general strength of corporations' balance sheets and high household savings levels. Given current capital levels, banks are well placed to absorb the capital impact of further credit losses. Nevertheless, bank supervisors will continue to emphasise the importance of robust credit risk management practices. The ECB's longstanding concerns around timely recognition of increases in credit risk, and adequate coverage through impairment or collateral, will remain high on its agenda.

In the insurance industry, inflationary pressure is likely to affect commercial performance with many customers in financial difficulty potentially cancelling or missing their premium payments, plus rising claims inflation increasing loss ratios. Lines such as home and private medical insurance are likely to be particularly affected. We expect expense costs to increase across all product lines.

An increase in defaults will also have implications for firms' treatment of consumers. Lenders will need to have processes in place to identify borrowers in financial difficulty; and enable consistent good outcomes by tailoring forbearance and support to their individual circumstances. Supervisors will expect early engagement and communication with consumers struggling with rising living costs, ensuring that they are aware of where they can get help including debt advice. Consumer credit firms will need to check their financial promotions do not exploit the cost-of-living crisis through misleading claims about the ease and consequences of taking on debt. Several EU countries are bringing, or looking to bring, BNPL products within the regulatory perimeter. The UK is also planning to regulate BNPL, although detailed rules are now not expected until mid-2023. Whatever the timeline, as they design the regulatory framework, regulators will need to balance consumers' access to affordable credit with protecting them from the build-up of unsustainable debt.

Value for money will also come into sharper focus, as firms begin the value assessments required under the FCA's new Consumer Duty. This will be an extensive exercise and, with less than a year until the 30 April 2023 deadline, firms which have not begun developing their assessment frameworks may struggle to complete their reviews in time. Moreover, the FCA has been clear that it is not waiting for the Duty to come in before it acts to improve consumer outcomes and it will expect firms to start thinking now about how they support customers experiencing pressure from the rising cost of living.

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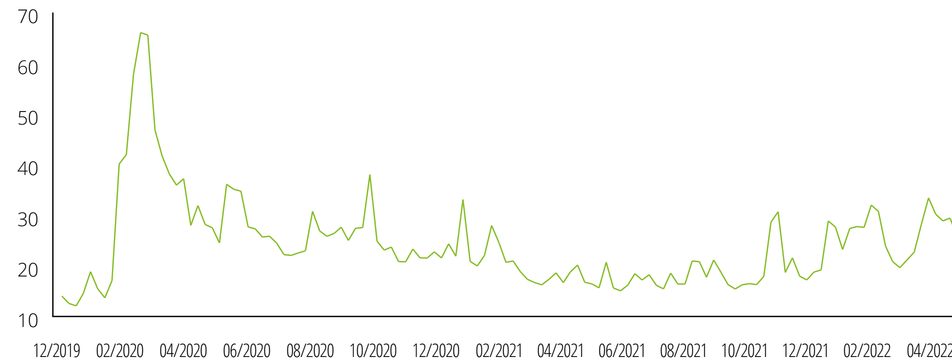
Russia's invasion of Ukraine also triggered a bout of market volatility, most notably with respect to commodity prices, particularly nickel. The LME suspended trading in nickel on 8 March and cancelled trades that had taken place earlier that day. The LME will now carry out its own independent review and there will also be reviews by the UK regulators.

The immediate concern in the first weeks of March was market participants' ability to meet margin payments on commodities contracts. Some were late in making payments, but the market found a way through. There is no doubt that regulators are continuing to watch developments in commodity markets, well beyond the LME and nickel. Regulators are particularly concerned about market participants' ability to manage and meet their margin calls, because of the effect this may have on their creditworthiness and the functioning of markets themselves, as well as the impact on the clearing houses that underpin these markets. We expect regulators in the UK and the EU to continue their work on margining practices, including firms' testing of their own and their counterparties' ability to meet margin payments under stress. ESMA Chair, Verena Ross, said ESMA would be looking "at measures that would improve the transparency in these [commodity] markets and would enable market participants and regulators to identify risks and maintain orderly markets."

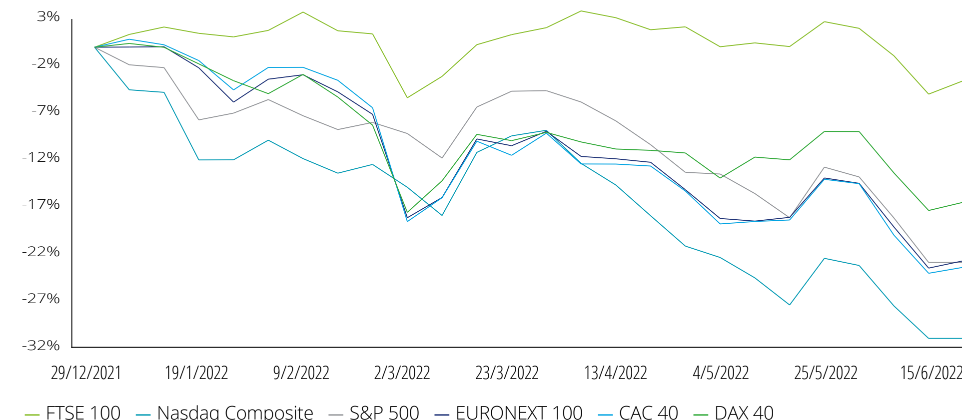
Equity markets have also suffered a sharp downturn since the beginning of the year. This has also coincided with a large fall in value of various crypto-assets and some stablecoins being unable to maintain their price pegs. TerraUSD[4] lost nearly all its value, while Tether[5] lost its peg to the US dollar.

Chart 3. VIX market volatility index



Source: Refinitiv Datastream.

Chart 4. Major equity market performance YTD



— FTSE 100 — Nasdaq Composite — S&P 500 — EURONEXT 100 — CAC 40 — DAX 40

Source: Refinitiv Datastream.

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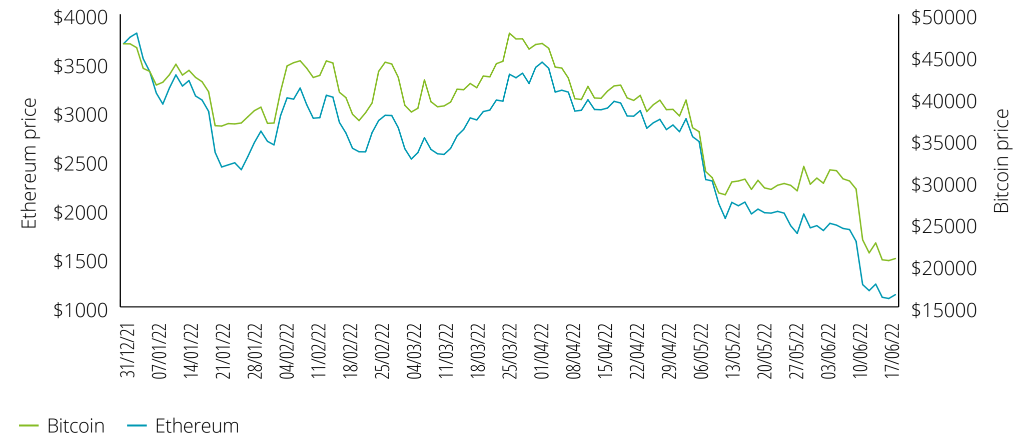
Unsurprisingly policymakers worldwide have refocussed their attention on stablecoins with a view to setting out requirements to make them more "stable". Policymakers will continue to shape these long-term crypto frameworks in the second half of 2022, but they will not start to apply until at least 2023/2024. In the interim, this means that regulators will have limited tools to oversee the risks posed by stablecoin issuers and other key crypto natives i.e. businesses based on a decentralised protocol that enables a function currently carried out centrally, such as exchanges.

Although market volatility in 2022 has not reached the highs experienced in March 2020, heightened market stress caused some banks to experience increased levels of VaR model backtesting overshoots, leading to market risk capital add-ons for those banks. This raises the possibility that supervisors in some jurisdictions could reintroduce exemptions from capital add-ons, as they did during the early onset of COVID-19. However, this appears unlikely, particularly in the EU, given that it would require level 1 legislative changes and that banks currently have strong capital positions.

For most insurers, the impact of market volatility is likely to be marginal given the long-term and conservative nature of their investment portfolios and, for life insurers, the smoothing impact of the Matching and Volatility Adjustment. Some insurers, particularly some smaller general insurers that are less diversified and that are exposed to more short-term assets, should monitor market movements closely and take action where necessary.

Chart 5. Major cryptoasset prices



Source: Refinitiv Datastream.

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Actions and implications for firms

Sanctions: firms should look to bolster their sanctions teams' capabilities, either by bringing in new permanent staff to replace temporary staff taken on to manage the rapid ramp-up in activity, or by investing in enhanced client management systems, to allow them to identify affected clients more easily and take appropriate action. In order to provide comfort to senior management, the Board and supervisors, firms may choose to commission Internal Audit reviews of compliance with sanctions requirements, if they have not already.

Credit risk: firms should focus their attention on the second-round effects from Russia's invasion of Ukraine, including how borrowers will be affected by the recent surge in inflation and consequent monetary tightening. We expect supervisors to focus on firms' credit exposures to borrowers whose business models are directly or indirectly affected (e.g., through complex supply chains) by Russia's invasion of Ukraine; and on banks' exposures to commercial and residential real estate and leveraged and/or highly leveraged loans. Lenders will also need to understand the additional impact of the ending or withdrawal of any pandemic-related government support measures.

Banks will also need to ensure they have a robust understanding of their counterparties' CO2 emissions and sensitivity to changes in carbon prices – a key factor in the identification and measurement of climate change transition risks.

Fund managers: side pockets can be challenging to set up and administer, especially for funds which have retail investors. Consequently, fund managers which have identified the need to establish a side pocket should act quickly and engage in a proactive dialogue with their regulator (to ensure compliance) and their customers (to explain how the side pocket works and the timelines involved).

Cyber: firms need to remain alert as the Ukraine conflict continues, and when it is over, given the long lead times required to plan and launch sophisticated cyber-attacks. Firms should ensure that incident response and recovery plans are in order and that the work that has been done so far on implementing operational resilience requirements, focused on identifying important business services and potential harm done by their disruption, can be leveraged in the event of a successful attack.

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Energy security: firms will need to reflect on the balance between energy security and a sustainable transition to net zero. If firms revise their near-term transition strategies, they should ensure that their rationale for doing so is clearly articulated and fully consider the longer-term risk implications, including in terms of stranded assets and reputational risk.

Insurers: insurers will be monitoring the impact of rising inflation on their claims and expense base to ensure their pricing reflects this new reality. However, further premium increases should be considered carefully to avoid exacerbating the number of customers struggling to afford premiums. Some insurers may want to go even further and perform a detailed claims review to understand the full impact on pricing for various products.

Fair treatment of customers in financial difficulty: firms need to build on the progress made during COVID to support customers experiencing financial difficulty. They should continue to offer appropriate support and forbearance, tailored to customers' individual circumstances, and ensure that staff are adequately trained to identify the characteristics of vulnerability. Supervisors will look for evidence that all firms have embedded quality assurance around customer outcomes, including end-to-end outcome testing, and are addressing any issues identified.

UK firms must also continue preparing for the introduction of the Consumer Duty by end April 2023. Immediate actions for firms include completing their gap analysis of the requirements of the Duty against product lifecycles and customer journeys; and developing and testing the value assessment framework.

Crypto: as a no-regrets action, while we wait for finalised long-term EU/UK crypto frameworks and UK crypto promotions rules, crypto exchanges should review the level of due diligence they do when deciding whether and how to market tokens on their platform. When assessing a stablecoin, they should pay attention to the arrangement's stabilisation mechanism and governance arrangements.

ESG funds: regulators will expect firms to have clear explanations for the inclusion and exclusion of particular assets or securities when marketing any ESG related funds to investors.

Margining: firms should expect supervisory scrutiny of their and their counterparties' ability to meet margin payments under stress, and will consequently want to ensure they have suitably resilient margining policies and practices in place.

Back testing: banks should ensure that they understand the reasons for any overshoots and are able to explain them to their supervisors.

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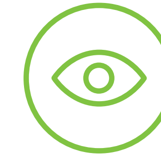

Alongside the broader market developments discussed above, several new regulatory themes have emerged since the publication of the RO22. Below, we set out these new themes and explore their implications for firms and markets.

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Moving, fast and slow

While firms still face a demanding schedule of ongoing and forthcoming regulatory changes to implement, there has been an observable slowdown in the pace of certain elements of regulatory reform. Finite resources and an immediate need to deal with the fast developing high-priority issues discussed above have reduced UK and EU policymakers' capacity to make progress on some other initiatives. Moreover, where regulatory change requires legislation, it is having to compete for a limited amount of legislative bandwidth with measures to deal with these high-priority issues, including energy security and the cost-of-living crisis. As a result, regulatory reform may slip down the agenda. Nonetheless, as is clear from the analysis that follows, the picture is mixed – some initiatives are still on track, others are delayed, and some have accelerated. It is a complex picture and that, in itself, introduces challenges for financial services firms.

Regulatory reform in the UK

In general, the regulatory reform process in the UK is proceeding more slowly than expected. The UK has only just begun consulting on the specifics of its revised approach to Solvency II (more detail can be found later in the document); and its various capital market related changes, in the wholesale market review and elsewhere, still need legislation and further regulatory consultations before they can take effect.

This said, the UK's forthcoming future regulatory framework reforms, to be legislated for in an upcoming financial services bill, will see many statutory pieces of regulation transferred to the regulators' rulebooks, allowing them to be revised and reformed without the need for further legislation. In principle, this should speed up the pace at which the UK regulators are able to introduce regulatory change, although elements of the bill (such as the proposal to give the regulators a secondary competitiveness objective) will be controversial and may in turn slow down its passage into law.

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Moving, fast and slow

Beyond financial services, some momentum is also building around the UK's plan to reform its data rights and protection regimes, a crucial element of the government's newly launched Digital Strategy. As part of this, the government committed to introducing "Smart Data"[6] legislation in this Parliamentary session. While it will take time for the final regulatory framework to emerge, Smart Data will create the legislative footing for regulators to expand Open Banking into Open Finance.

Regulatory reform in the EU

In contrast, most of the EU's wider regulatory policy initiatives remain on schedule, with, at present, no significant changes or delays to the banking package (CRD6), Solvency II, CSRD, or MiFIR reforms.

Nonetheless, the relative importance of Russia and Ukraine related legislation, in addition to the time and operational bandwidth DG FSMA is spending on sanctions, could mean that delays start to emerge later in the year.

There are also some more general exceptions to the EU's currently on track timetable. Despite signaling its strong desire to "onshore" all euro clearing activity by June 2025, when the UK's temporary clearing equivalence is due to expire, the EU has been slow to put together a concrete package of legislative measures to incentivise (or require) market participants to shift this activity to EU-based CCPs. Many of the changes discussed in the Commission's February consultation on clearing would, if pursued, require level one changes to both EMIR and CRR and could take months, possibly years to become law. Although in theory three years should be more than sufficient for firms and their clients to shift clearing activities, in practice the operational complexities involved mean that it will be not be long before the June 2025 "cliff edge" starts to come into view.

Sustainable finance

Through the course of the pandemic in 2020 and 2021, regulators postponed and, in some cases, even abandoned certain regulatory initiatives. The notable exception was sustainability, on which work continued uninterrupted. This has not been the case in the first half of 2022.

In the UK, the Queen's Speech in May was expected to include legislative measures to implement a UK taxonomy, and to require the FCA to develop a SDR. It did not. The FCA has indicated that it still expects to consult on the SDR in July, but it may take longer to get the regime and labelling classifications right. This reflects the complexity of these changes and the teething problems which firms have had in the EU with the SFDR and the Taxonomy. In the EU, the Taxonomy complementary Delegated Act on gas and nuclear has been significantly disrupted and faces possible objections in the European Parliament. Two European Parliament environment and economy committees have voted against gas and nuclear being included within the EU list of sustainable investments, despite calls from industry for pragmatism and for both to be included within the Taxonomy.

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Moving, fast and slow

In contrast, other measures have continued apace. In particular, the ISSB has consulted on its first two proposed standards, on general sustainability-related disclosure requirements and climate-related disclosure requirements, much quicker than we originally anticipated. This could accelerate the implementation of recommendations from the TNFD, which published its prototype risk management and opportunity disclosure framework in March 2022. In addition, the increased focus on ESG ratings providers continues. In June, ESMA published the results from its call for evidence on the market structure for ESG ratings providers which showed a lack of transparency and granularity around ESG ratings. As a result, ESMA continues to support the European Commission's intentions to introduce regulatory safeguards. The FCA also expects ESG ratings providers to be brought within the UK regulatory perimeter in the near future. Ultimately, regulation should help to resolve some of the inconsistencies in ESG ratings and provide greater transparency for the data that sits behind them.

Digital assets

The timeline to develop the UK's future crypto regulatory framework is longer than we anticipated. The UK's forthcoming Financial Services Bill is expected to amend the regulatory perimeter to capture stablecoins used as a means of payment. Still, detailed regulatory requirements will take longer to emerge. For example, UK will not consult on detailed rules for systemic stablecoins and wallets until 2023. Meanwhile, a consultation on the UK approach to broader unregulated cryptoassets activities – such as trading and investing in unbacked cryptoassets – is not expected until later in 2022. In contrast, the EU expects to finalise its comprehensive MiCA framework by end-2022.

UK prudential framework for smaller banks

The PRA's "strong and simple" prudential framework for smaller banks is also progressing slowly. Whilst work to develop the framework has started, the PRA is not planning to consult on the framework for firms in the regime until 2023 and 2024, suggesting the regime's implementation is at least several years away.

Overall assessment

Some firms may welcome this deceleration in some aspects of regulatory reform given the sheer volume of regulatory change currently taking place. Nonetheless, others may be disappointed that important reforms are taking longer than expected. Firms may find that the uncertainty over when and how these reforms will be delivered complicates their strategic planning and in some cases limits their opportunities to access new markets (such as digital assets or green finance).

Our assessment is that this is not necessarily a temporary phenomenon, caused solely by legislators and regulators having to respond to events in the first half of this year. Regulators are due to take on an ever-growing number of responsibilities, including a comprehensive sustainable finance agenda, regulation of crypto-assets, AI and cloud technologies, and more. In the absence of a significant increase in resources, and at a time when they are finding it difficult to retain or replace existing staff, it looks as if regulators will continue to be stretched in the years ahead. This will mean that they will face increasingly tough choices over what to prioritise.

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Moving, fast and slow

In our view, there has been an observable slowdown in the pace of certain elements of regulatory reform across the EU and UK. In this chart, we highlight the initiatives that are being delivered at a slower pace, as expected, or faster than expected in our RO22.

Regulatory Initiatives	Speed of Delivery		
	Slow	As expected	Fast
Future Crypto Regulatory Framework (UK)/ MiCA (EU)	UK reforms	EU reforms	
SDR/SFDR	UK reforms	EU reforms	
Taxonomies	UK reforms, EU reforms		
Solvency II	UK reforms	EU reforms	
EMIR and CRR changes to clearing activity	EU reforms		
“Strong and Simple” Prudential Framework	UK reforms		
FRFR		UK reforms	
Overseas Framework (Including OPE)	UK reforms		
MiFID/MiFIR	UK reforms	EU reforms	
Taskforce on Nature Related Financial Disclosures			Global reforms
ISSB sustainability-related disclosure/climate-related disclosures			Global reforms

Key: UK reforms, EU reforms, Global reforms

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Actions and implications for firms

- Historically, the UK has often been one of the first to develop regulation in response to financial innovation or new risks, and this has often influenced the regulatory approach adopted by other countries. It may do so again in areas such as Smart Data and Open Finance. Nonetheless, in several other areas mentioned above, it now looks as if the UK will be slower to deliver its frameworks, which may mean regulators and firms in the UK are able to learn from the regulatory experiences of other countries, for example with respect to sustainable disclosures or cryptoassets. The MiCA framework is a good case in point. Firms with a footprint in the EU and UK should start to think about their cross-border approach to governance, risk management and compliance. This is true both for crypto natives and traditional regulated firms. They could consider deploying policies and procedures developed to MiCA standards in their UK business. This will serve as a baseline threshold for compliance which firms can adjust once the UK's regulatory approach becomes clearer. The reputational risk management benefits will likely outweigh the additional compliance costs.

- More generally, financial services firms will need to monitor the changing regulatory timelines closely, from both a business and operational perspective. Delays may introduce business benefits, in the form of reduced compliance costs, but may also deny firms opportunities to provide more products and services, for example in relation to digital assets. Boards and senior management will need to incorporate these considerations into their forward planning. Operationally, changes to regulatory timetables complicate resource planning, especially across change implementation and IT teams, with the associated risk of bottlenecks or, less likely, teams having to be stood down.

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Competing on competitiveness

The UK's financial services regulators will soon be subject to the first set of significant changes to how they approach regulation since the introduction of the "twin peak" structure in 2013. The UK government's FRFR will not only give the UK regulators responsibility for setting many of the direct regulatory requirements which are currently set out in retained EU law, but will also propose a new secondary competitiveness objective for them.

What will a secondary objective focusing on competitiveness mean in practice? In a recent speech, the FCA's then Chairman, Charles Randell, set out his perspective on competitiveness, in particular the need to avoid any compromises with the FCA's primary objectives and any loss of regulatory independence or agility.

Solvency II

This tension between the differing priorities of the Government and the regulators is already evident from the recent papers published on Solvency II reform by HMT and the PRA respectively. HMT is proposing to reduce the size of the risk margin and expand the eligibility criteria for the MA (which benefits insurers that hold long-term assets which match the cash flows of similarly long-term insurance liabilities). On the whole HMT expects the reforms to reduce required regulatory capital by 10 to 15%.

However, there seems to be a difference of view between HMT and PRA on how to calibrate the Fundamental Spread within the MA – the particular calibration chosen could negate some of the capital benefit from a reduction in the RM. HMT is considering a wider set of calibrations for the Fundamental Spread, whereas the PRA proposes to be more restrictive to ensure policyholder protection. This issue is likely to be material to the degree of capital release that could be achieved by the reforms and, therefore, it will be an area of focus for both industry and regulator. In addition, the UK's reforms aim to make it easier for third-country insurers to establish branches (in particular for wholesale/commercial lines insurance businesses) in the UK and propose a relatively accommodating approach to regulation with no localisation of assets or requirement to maintain branch capital. Unless branches are subject to a home-country capital regime at least as robust as the UK's, UK-based insurers could be disadvantaged.

Basel 3.1

The Solvency II reforms are also intended to make the UK's insurance market more competitive now that the UK has left the EU, a consideration that will also be of importance in the context of the UK and the EU's approaches to implementing Basel 3.1, which is also sometimes termed "Basel IV". In the EU this will mean substantial divergence from the BCBS standards in the substance of the rules, particularly through the use of long transitional periods for the standardised Output Floor (which sets a minimum capital requirement derived from banks' internal models), and in the capital treatment of unrated corporate exposures. In the UK, the primary legislation enabling the implementation of Basel 3.1 requires the PRA to do so with due regard to its impact on the medium-to-long-term financing of economic activity, and the UK's standing relative to other jurisdictions as a centre for financial services among internationally active banks. While the PRA is typically very clear about its desire to stay close to the BCBS standards (as recently evidenced by Sam Woods' speech on bank capital buffers), areas where the EU will diverge will put pressure on it to follow suit if not doing so is seen as inimical to the competitiveness of UK-based banks.

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Crypto regulation

There are also signs of a tension between the priorities of the Government and regulators in the UK's emerging approach to crypto regulation. In April 2022, HMT announced its ambition to make the UK a "global hub" for crypto technology and investment. It also announced a series of measures to help achieve this ambition, including bringing stablecoins used as a means of payment into the scope of regulation.

The FCA, on the other hand, is more focussed on tackling the consumer protection and financial crime challenges posed by crypto. The obligation for crypto firms providing certain services to comply with the MLRs and register with the FCA was implemented on the 10th January 2020. However, a Treasury Committee report criticised the registration process for being "too slow" and Lisa Cameron MP, Chair of the UK APPG on crypto and digital assets, argued that crypto firms had experienced "significant delays" in FCA registrations, and that this would "cost the UK in terms of jobs, talent, and revenue". This demonstrates the tension the FCA faces in meeting its statutory objective to protect consumers, whilst also facilitating the Government's ambitions to make the UK a "crypto hub".

Wholesale market review

Competitiveness has also been an important angle in the UK's wholesale market review reforms, set to be implemented through a combination of upcoming FCA consultations and a financial services bill for those changes that need primary legislation. HMT's original blueprint stressed that it wanted the UK to be "an open and global financial hub" and this review is intended "to cement the UK's position as a global hub for wholesale markets." What is interesting, is that it now appears that competitiveness-related concerns are influencing the EU's approach to its own set of MiFIR reforms which are currently being debated amongst EU member states. In particular, the EU is considering amendments to reference price waivers, and both pre- and post-trade transparency regimes to ensure that the EU does not become competitively disadvantaged in response to the UK's own reforms. We see the beginnings of a new dynamic in regulation, at least between the UK and EU.

Competing on competitiveness

Actions and implications for firms

Solvency II: international groups will want to consider how best to access the UK market, with branches becoming an easier pathway following the reforms. This will be particularly relevant for wholesale and commercial lines insurance businesses.

Basel 3.1: banks, particularly those with permission to use internal models, should not let the delay in implementation to 2025 lead to a loss of focus on the work needed to comply with the Basel framework. International banking groups will need to prepare for an increasingly divergent approach to Basel 3.1 adoption to become clearer in 2022 (particularly between the UK and EU) and consider how this will affect their internal impact assessments and planning for implementation.

Crypto regulation: crypto natives should engage proactively with policymakers as they shape the UK's regulatory approach to crypto. HMT is establishing an industry crypto regulatory engagement group and the FCA recently launched a crypto policy sprint, demonstrating policymakers' willingness to engage with firms, including on key issues.

Wholesale markets review: international firms with a presence in both the UK and EU will need to have clear governance and decision-making frameworks in place to enable them to decide whether it is both possible and cost effective to have a single, unified approach to compliance, or whether they will need to develop two (or more) approaches to deal with increasingly divergent sets of regulation, and the accompanying local particularities.

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Evolving supervisory expectations

In addition to the developments and trends described above, supervisors' expectations and approaches have also continued to evolve in the first half of the year.

The FCA's new supervisory strategy

In the UK, the FCA has recently adopted a three-year, outcome-based strategy. It promises to be a more assertive regulator, using its enforcement and intervention powers more proactively and to *"act faster, challenging [itself] and testing the limits of [its] powers."* This suggests that the FCA may take a less conservative approach to enforcement action than it has done previously, and firms may have to recalibrate their expectations accordingly. A key focus will be shutting down problem firms, which do not meet basic regulatory standards. The FCA is increasing headcount in its authorisations department to strengthen scrutiny of new firms and new powers will enable it to quickly cancel or vary permissions for firms who are no longer carrying out FCA regulated activities.

The FCA also promises to be tougher on its own performance and has, for the first time, published a set of detailed metrics against which it can be assessed and challenged. Demonstrating progress against these metrics will influence the FCA's priorities and approach to supervision. Firms need to be familiar with them and alert to the risk of any unintended consequences. For example, in line with its focus on problem firms, one of the FCA's metrics is increasing refusal/rejection rates for new firm authorisations. This may lead to higher standards in the quality of firms being authorised by the FCA but may also make it more challenging for new firms to enter the market, unintentionally affecting competition and innovation.

Cryptoassets

Notwithstanding the UK's relatively slow progress on crypto regulation (described above), the UK regulators have set out how they will use their existing frameworks and powers to probe regulated firms' activities and exposures. The PRA issued a Dear CEO Letter which set out a detailed account of how the prudential framework applies to banks' and designated investment firms' crypto activity. At the same time the FCA published a notice reminding firms of their existing obligations when interacting with crypto, guided by its consumer protection and market integrity objectives.

The publications provide a stopgap in the form of short to medium-term regulatory clarity for firms building their crypto strategy now. Nonetheless, applying traditional frameworks not designed with crypto in mind is sub optimal and firms need clarity on the UK's long-term approach to crypto regulation if they are to build a sustainable crypto strategy.

ECB desk-mapping review

The ECB published the findings of the first phase of its desk-mapping review, i.e. its review of booking and risk management practices across trading desks active in market-making activities, treasury and derivative valuation adjustments. The review's findings set out the ECB's "very real concern" about banks' use of empty shell structures, as well as their use of both remote booking and back-to-backs. The ECB is clearly concerned that its supervisory expectations are not being fully met.

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This is not the end of the ECB's supervisory work and investigations into credit risk-shifting techniques. The reliance on parent entities for liquidity and funding, and internal model approvals are still ongoing, although the ECB has not provided a timeline for when these might be concluded.

Model risk management

The PRA published a consultation paper with proposals for five principles for model risk management for banks, building societies and designated investment firms. The PRA is concerned that models are increasing in both complexity and importance to decision making in firms, but that the standard of MRM in firms is declining. The CP proposes a definition of a model that is likely to be considerably broader than most firms' existing internal definitions, so the principles may apply to a significantly larger population of models than that to which firms currently apply model standards and governance.

Funds' costs and charges

In May 2022, ESMA reported on its 2021 CSA on costs and fees in UCITS funds. Overall, the CSA found a satisfactory level of compliance with the requirement not to charge investors undue costs. It therefore appears that ESMA is not minded to push EU fund managers to carry out more detailed value assessments, such as those required in the UK.

Nonetheless, ESMA did highlight some issues that needed improvement. For example, a key finding was that firms with smaller amounts of AUM had less formalised and sophisticated pricing processes in place, with delayed involvement from senior management. In addition, there was evidence of portfolio managers to which investment management was delegated exercising significant influence and sometimes deciding the level of costs and fees charged by the fund, raising concerns about the authorised UCITS manager not retaining enough control over the process. Furthermore, many UCITS managers did not have adequate policies and procedures in place on efficient portfolio management techniques, and many managers only returned 50-65% of gross revenues from securities lending to the fund.

Climate stress testing

Sustainability related supervisory concerns have also continued to evolve. The BoE's CBES revealed that firms still have some way to go to understand and manage their climate risk exposures. The most pressing task for firms is to fill data gaps revealed by the exercise and engage with their counterparties to assess the quality and feasibility of their transition plans. Although the details differ, the sentiment that firms still have much work to do is consistent with the message from the ECB's feedback on eurozone banks' climate risk assessment and management capabilities.

In our view, the CBES marks a step-change in the BoE's tone on the issue of climate data. Gentle encouragement now appears to have given way to more robust direction for firms to adopt a more proactive approach to data gathering. We expect the ECB to strike a similar tone in its feedback from its own climate stress test for banks – as hinted at by Andrea Enria, Chair of the ECB's Supervisory Board.

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The BoE's exercise also revealed that many firms are highly (and in some case probably unduly) reliant on the use of third-party vendor models. Although the BoE stopped short of telling firms not to use third party models, it wants to ensure that the complexity of climate risk does not drive firms to adopt "black box" climate risk capabilities.

Stefan Claus, Head of Insurance, Analytics Division at the PRA, provided some additional insights on the CBES results for insurers specifically. One point that stood out for us was that while, overall, climate costs to insurers should be absorbable, this is partly because some losses are passed to life insurance policyholders through lower returns in savings and retirement products. We expect this finding to attract attention from conduct regulators.

Greenwashing

Greenwashing has also become a top supervisory concern. In the UK, the FCA has said that it is actively monitoring markets for instances of greenwashing , whilst in the EU, ESMA demonstrated the importance it attaches to the issue by publishing a supervisory briefing which set out common criteria for NCAs to use for the effective supervision of the documentation and marketing materials of investment funds with sustainable features. We expect that this will drive a renewed focus on greenwashing amongst European regulators.

There has also been high profile regulatory activity related to greenwashing on both sides of the Atlantic. BaFin has launched a greenwashing related investigation, while in the US, the SEC issued a $1.5mn fine to a firm for providing misleading information on the way ESG screening was undertaken for its funds. This demonstrates that regulators are already stepping up their scrutiny of firms, with enforcement action to follow for those which are deemed to have made misleading claims.

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Actions and implications for firms

The FCA's new supervisory strategy: firms need to engage with the strategy and choice of metrics to understand the FCA's priorities and how it will measure progress against them.

Firms will need to review regulatory permissions regularly to ensure they are up to date and apply to remove those that are not needed.

Cryptoassets: firms should embed the PRA's and FCA's interim expectations into their crypto risk and compliance approaches. They are a clear indication that supervisors will probe firms to ensure they have considered the impact of their crypto activities and exposures on their prudential health and have set aside sufficient capital.

ECB desk-mapping review: all banks subject to ECB supervision (not only those that established new or expanded existing entities as a result of Brexit) will want to review their booking models to ensure they are aligned with the ECB's expectations. Many of the banks directly targeted by the ECB's review will have to appoint more senior staff to their EU entities and overhaul their booking model practices, adding to their costs. Banks will also want to ensure they consider the findings of the ECB's review alongside the EU's wider set of proposed reforms to third-country branches and cross-border market access.

Model risk management: the PRA's supervisory statement is not due until Q1 2023, however recent experience suggests that any changes from the consultation are likely to be minor. Firms with significant work to do may decide to start sooner rather than later in terms of identifying the set of models that meets the PRA's definition and initiating a gap analysis.

Evolving supervisory expectations

Actions and implications for firms

Funds' cost and charges: EU UCITS managers should ensure they have a robust structured pricing process with senior management involved early in the process, especially where firms have smaller AUM or delegate to external portfolio managers. External portfolio managers should expect more scrutiny on costs and fees from UCITS managers. EU UCITS managers should ensure that all net revenues from efficient portfolio management techniques are returned to the fund.

Climate stress-testing: firms need to engage directly with their clients to populate physical and transition risk data gaps identified by climate risk scenario analyses, and to evaluate the quality and feasibility of clients' transition plans. Firms using third-party models as part of their climate risk management framework should be able to scrutinise, challenge and customise those models. Ultimately, firms need to apply the same rigour to reviewing climate models as they do with any other model. Life insurers should investigate the extent to which policyholders will bear the brunt of climate losses, and explore potential actions they can take to limit this exposure, particularly where the customers may be vulnerable.

Greenwashing: firms should ensure they undertake full due diligence on any ESG related claims they are making, especially in required documentation (such as prospectuses) and marketing materials.

Firms should ensure that they properly scrutinise any third-party ESG related data and that any methodological gaps are assessed and, where appropriate, disclosed, as part of their own ESG related assessments.

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When we prepared our initial RO22 we saw a heavy regulatory and supervisory agenda ahead. Since then, Russia has invaded Ukraine and while financial markets and participants in them have been able to deal with the first-round effects, the second-round effects – especially the surge in inflation and monetary tightening, including higher interest rates – are likely to prove much more challenging. These challenges will be much greater in any economy that experiences stagflation.

Firms and regulators alike consequently face a number of acute demands on their management bandwidth and, as a result there may be a slowdown in the pace of regulatory reform. Nonetheless, given everything else on their agendas, this will not provide firms with much respite and may in fact complicate their strategic planning as new delays emerge. Firms will need to exercise continuing vigilance when it comes to their risk management processes and will need to ensure their strategic plans take into account the new and emerging regulatory risks on the landscape, including the potential for renewed regulatory divergence between the UK and EU.

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Glossary

AFM
Authorised Fund Managers

AI
Artificial Intelligence

AML
Anti-Money Laundering

AUM
Assets Under Management

BaFin
The German Federal Financial Supervisory Authority

BCBS
Basel Committee on Banking Supervision

BoE
Bank of England

BNPL
Buy Now Pay Later

CBES
Climate Biennial Exploratory Scenario

CCP
Central Counterparties

CET1
Common Equity Tier 1

CMU
Capital Markets Union

CRD6
Capital Requirements Directive 6

CRR
Capital Requirements Regulation

CSA
Common Supervisory Action

CSRD
Corporate Sustainability Reporting Directive

CSSF
The Commission de Surveillance du Secteur Financier

ECB
European Central Bank

EMIR
European Markets Infrastructure Regulation

ESG
Environmental, Social and Governance

ESMA
European Securities and Markets Authority

FCA
Financial Conduct Authority

FMI
Financial Market Intermediaries

FPC
Financial Policy Committee

FRFR
Future Regulatory Framework Review

HMT
Her Majesty's Treasury

ISSB
International Sustainability Standards Board

IRO
Interim Regulatory Outlook

LME
The London Metal Exchange

MA
Matching Adjustment

MiCA
Markets in Crypto Assets Regulation

MiFID
Markets in Financial Instruments Directive

MiFIR
Markets in Financial Instruments Regulation

MLRs
Money Laundering Regulations

MRM
Model Risk Management

NCAs
National Competent Authorities

OPE
Overseas Persons Exclusion

PRA
Prudential Regulation Authority

RM
Risk Margin

RO22
Regulatory Outlook 2022

SDR
Sustainable Disclosures Regime

SEC
Securities and Exchange Commission

SFDR
Sustainable Finance Disclosures Regulation

SWIFT
Society for Worldwide Interbank Financial Telecommunications

TNFD
Taskforce on Nature-Related Financial Disclosures

UCITS
Undertakings for the Collective Investment in Transferable Securities

VaR
Value at Risk

VIX
Chicago Board Options Exchange's Volatility Index

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1. Data taken from a speech by Sir Jon Cunliffe, Deputy Governor of the Bank of England, available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2022/april/monetary-and-financial-stability-and-the-invasion-of-ukraine-speech-by-jon-cunliffe.pdf?la=en&hash=4725B2F88EDD60D8305D2327D79E10B047B41847

2. Data taken from the ECB, *Financial Stability Review*, May 2022, available at: https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202205~f207f46ea0.en.pdf

3. Side pockets allow investors to redeem the part of their investment that is still tradeable, while retaining the right to any proceeds from the affected investments if they are sold at a future date.

4. A stablecoin backed by an algorithm linked to a partner cryptoasset (Luna)

5. A stablecoin backed by a reserve of traditional assets

6. Smart Data is the secure and consented sharing of customer data with authorised third-party providers. These providers then use this data to provide innovative services for the consumer or business, such as automatic switching and account management.

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