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From obligation to opportunity

An exploration into 2024 priorities

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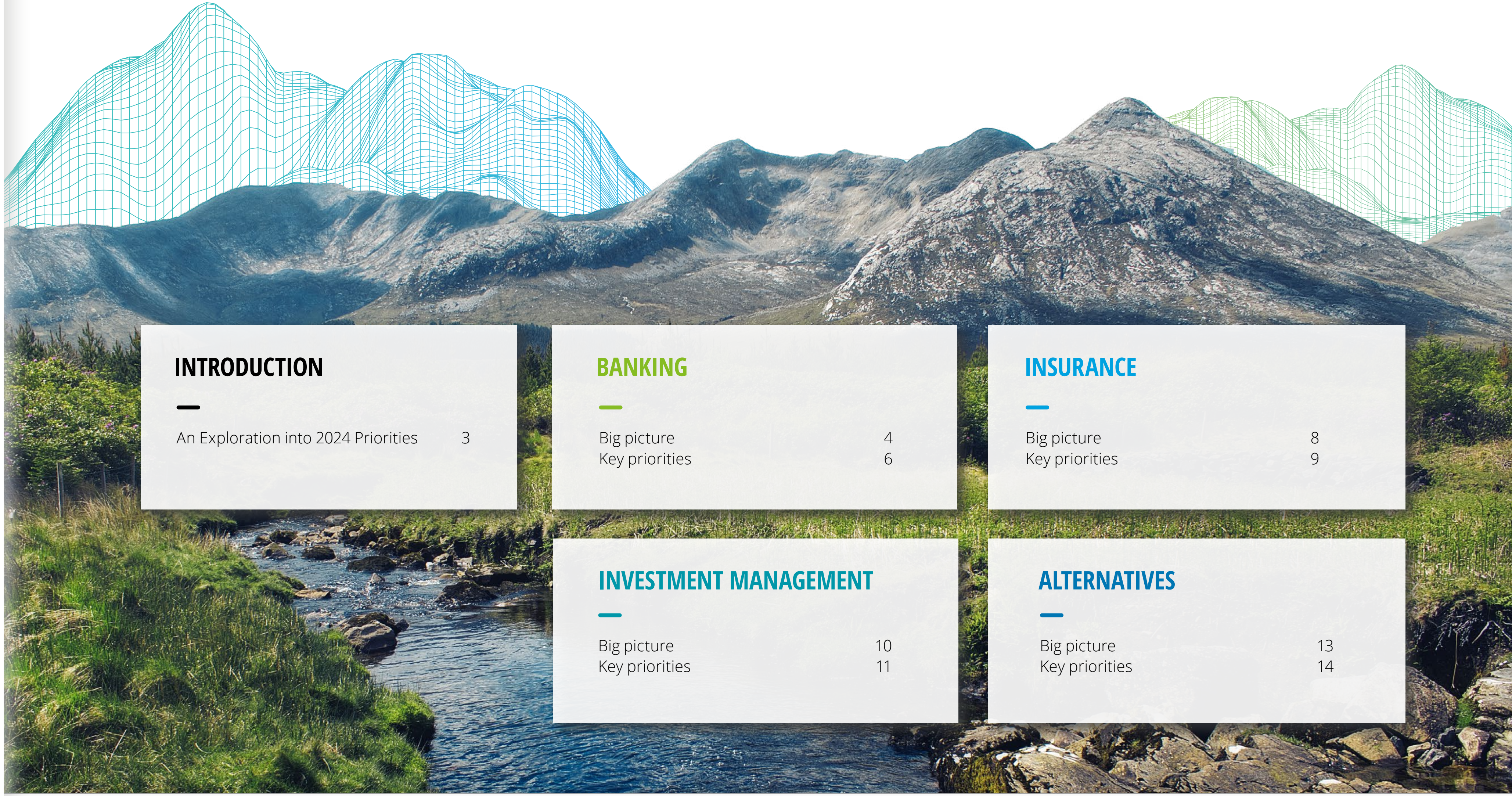

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An exploration into 2024 priorities

Get ready to embark on an expedition through Luxembourg’s 2024 regulatory landscape.

This guide provides invaluable insights and detailed information of key priorities, signaling paths through these complex, evolving regulations. As we navigate, we examine the key priorities and emerging trends, helping you plan your route to successful compliance and nimbly respond to changes.

It’s time to delve into the heart of Luxembourg’s regulatory landscape—no hiking boots required.

Begin your exploration now!

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In 2024, banks will face a unique mix of macroeconomic challenges that will impact their ability to generate income and manage costs (both interest costs and operational expenses). Higher interest rates have been a boon to the banking industry, leading to a significant increase in net interest income. However, elevated rates will continue to push funding costs higher and squeeze margins.

Going forward, the global banking industry may be hard-pressed to bring down high deposit costs (and lower deposit betas) even as interest rates drop. Customer expectations of higher rates, coupled with increased market competition, will force many banks to offer higher deposit rates to retain customers and shore up liquidity.

In this context, we expect demand for loans to be modest, given the high borrowing costs and banks' restrictive lending policies. Additionally, climate change will play an important role in loan demand and credit availability since environmental risks and the taxonomy alignment obligation will tighten the credit standards for loans to "brown" firms. At the same time, a net easing impact is expected for green firms and firms transitioning to decarbonization.

Banks should prioritize noninterest income in 2024 to make up for the shortfall in net interest income. Noninterest income is expected to grow meaningfully in the next few years through a variety of channels (e.g., consumer-focused fees, such as overdraft fees, insufficient funds fees, and credit card late fees). However, they may face some constraints in doing so, as these channels could attract regulatory scrutiny. In any case, banks with stronger advisory, underwriting, and corporate banking franchises should have more room to grow their fee income.

In addition to the factors highlighted above, the banking industry will have to contend with several disrupting forces that will challenge incumbent business models, namely:

- Increasing competition from digital banks and wallets, account-to-account payments, and private and hedge funds;
- Paradigm shift in how to approach risk, propelled forward by changes to asset liability management (ALM) rules, interest rate risk, and liquidity, credit and counterparty risks, due to an expected push from regulators to strengthen resilience to macro-financial and geopolitical shocks; and
- Continuous push for the remediation of current governance shortcomings, which will require changes to the functioning of banks' management bodies and their steering capabilities.

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BANKING PACKAGE

The EU's Banking package will require banks to review their capital requirements calculations to ensure transactions are properly captured and adjust their data management and reporting abilities. Their risk management frameworks will need to incorporate new focus areas like environmental, social and governance (ESG), cryptocurrency and cyber risks. Finally, they will need to assess the new rules' strategic and business impacts from a product design, pricing or market positioning standpoint.

SUSTAINABILITY

Sustainability will remain a prominent focus in 2024 and beyond. Regarding disclosure regimes, the Sustainable Finance Disclosure Regulation (SFDR) mandates pre-contractual disclosures from financial market actors and advisors. While the Corporate Sustainability Reporting Directive (CSRD), effective since 5 January 2023, enhances ESG reporting standards for institutions of a certain size or revenue.

Other ESG requirements are pushing companies to reconsider their business strategies and operating models. The EU Taxonomy, in force since 1 January 2024, assesses companies' environmental impact, with Article 8 disclosures effective from June 2024 and requiring banks to deploy transition strategies with their clients and guide them towards taxonomy-aligned operations.

Banks will also need to integrate ESG factors in their investment decision process (as per the revised Markets in Financial Instruments Directive or MiFID) and the product definition stage, incorporate climate and environmental risk into their risk frameworks, and follow the European Supervisory Authorities' (ESA) guidelines to combat greenwashing, effective as of May 2024.

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OPERATIONAL RESILIENCE

Cybersecurity and digital resilience are at the forefront, with the European Central Bank (ECB) planning its first cyber stress test in 2024 and the European Securities and Markets Authority (ESMA) making cyber risk an EU supervisory priority for 2025. Supervisors will focus on strengthening firms' information and communication technology (ICT) risk management to tackle major outage disruptions and adapt to market and technological changes.

Financial institutions will need to intensify their efforts to ensure compliance with the Digital Operational Resilience Act (DORA) and its regulatory technical standards from January 2025. These new rules cover identifying and managing ICT and cyber risks, reporting major ICT incidents, testing cyber defenses, managing ICT third-party risk, and sharing threat intelligence.

DATA AND PRIVACY

While the EU is investing in fostering innovation and developing new technologies, their impact is dependent on data quality. Therefore, the EU's initial focus is on assessing how data-driven transformations can enhance banks' business models, customer service, and competitiveness.

The Data Act establishes a data-sharing framework that will benefit financial institutions as data receivers. The Instant Payment Regulation and Financial Data Access framework will transform payment processing and widen financial data access, while the AI Act and the electronic Identification, Authentication and Trust Services (eIDAS) Regulation will provide frameworks for AI data processing and digital identities, respectively.

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Existential threats, such as catastrophic climate change, the explosion in cybercrime, and concern over vast uninsured and underinsured populations, are driving many insurers to reimagine how to confront disruptions caused by the changing environment. This is to help consumers across all segments prevent or mitigate risks before they occur, rather than merely paying to rebuild and recover after the fact.

Even when the most extreme events may appear unavoidable, insurance combined with proactive risk management can still help minimize the degree of their impact on affected individuals and communities. Next to this, the inflation and interest rate increases are creating additional economic challenges for the industry.

To achieve this level of transformation, insurance companies may need to adopt new technology, including generative AI, to harvest actionable insights from any new data at the industry's disposal. Industry convergence for access to more information sources, products and services, as well as talent with the skill sets and know-how of emerging capabilities, are becoming table stakes.

From a macroeconomic standpoint, the economic and geopolitical uncertainty remains challenging and leads to significant market volatility, high inflation and uncertainties that threaten the stability of the industry and negatively impact consumer confidence. This call for a continued and forward-looking identification of risks should leverage risk assessment methodologies and forward-looking tools, such as stress tests and consumer and behavioral research, as well as the enhanced collection of data to capture traditional and emerging risks.

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SUSTAINABILITY

The industry must continue to tackle climate change risk and address protection gaps by improving awareness of consumer risk and risk-based prevention measures, while aligning public and private initiatives to reduce losses. Insurers should consider macro-prudential elements when analyzing protection gaps, as well as solutions addressing demand-side issues to ensure consumers take up affordable products, when available. In addition, firms should also focus on identifying, monitoring and addressing greenwashing cases.

OPERATIONAL RESILIENCE

The role and impact of digitalization and financial innovation continue to evolve and consolidate, influencing business models, products, services and distribution channels. This generates new challenges and increases digital, operational and cyber risk exposures for both undertakings and consumers. Insurers must have the necessary safeguards to mitigate cyberattacks and address broader ICT and resilience risks.

CONSUMER PROTECTION

Consumer protection will continue to be fundamental, especially for emerging risks that could affect consumers' financial health, such as those relating to high inflationary trends. Undertakings will need to ensure products still offer good value for money, that digitalization helps consumers and creates good outcomes, and that ESG risks are managed.

DATA AND PRIVACY

The industry will need to prepare for EU initiatives aiming to improve public access to entities' financial and non-financial information (the European Single Access Point, or ESAP), share customer data across the financial sector while meeting their customer data protection obligations (the Financial Data Access framework, or FIDA), and leverage AI solutions in a sound way.

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Investment management companies face new threats and unique opportunities in the post-pandemic business world. While some asset classes have outperformed others, industry performance has remained subdued overall due to various economic and industry pressures.

Product innovation and impactful customer experience will likely remain the leading growth drivers. Fresh challenges are impacting talent models, company purposes, workplace settings, and ESG mandates, highlighting the importance of strong governance and high-quality management information (MI).

We expect fund liquidity to be a key supervisory priority given the new liquidity management rules in the EU's revised Undertaking for the Collective Investment in Transferrable Securities (UCITS) and Alternative Investment Fund Managers Directive (AIFMD) frameworks.

This will require many firms to change how their boards and governance committees engage. Good practice includes a dedicated liquidity risk management committee, which is a sub-committee of their product governance or investment risk committee, with MI sent to the board risk committee. Firms should focus on model governance and validation, including stress testing, swing pricing and asset valuation models, and provide enhanced governance in times of market stress.

Finally, the industry will need to finalize its framework changes to meet the new European Market Infrastructure Regulation (EMIR) Refit reporting obligations, or shorten its settlement cycle for many US securities trades from two business days after the trade date (T+2) to one business day after the trade date (T+1). The revised European Long-Term Investment Fund structure (ELTIF II) and liquidity management best practices should also be closely monitored to ensure ELTIFs' attractiveness for investors and asset managers.

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LIQUIDITY

Firms should implement robust liquidity risk stress tests with sufficiently severe scenarios that consider forward-looking risks. Conservative assumptions should also be used where appropriate, such as the "prorata" approach, where a proportionate "slice" of the portfolio's assets is sold to accommodate the redemption. Firms may need to adjust their funds' liquidity profiles as a result.

To monitor liquidity risk effectively, metrics, escalation triggers and processes (including anti-dilution tools), tailored to each asset class and fund's risk profile, are a must. Implementing these arrangements will require significant work and senior management time for most firms.

OPERATIONAL RESILIENCE

Some financial sector actors, such as high-maturity firms and large cross-border groups, have likely made significant inroads towards DORA compliance. However, regulators are expected to require better-developed capabilities from larger entities, and market-leading capabilities from entities with critical systems. Therefore, entities across the board could face a challenging implementation period up to DORA's January 2025 deadline.

Given DORA's breadth of topics, in-scope entities are expected to launch coordinated projects to cover all DORA requirements while capitalizing on their existing digital security and resilience measures.

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GREENWASHING

In the EU, a fundamental review of the SFDR is underway—and with several firms having already changed SFDR categories, further adaptations may erode investor trust. With ESMA's expected restrictions on using ESG terms in fund names, EU firms may be driven to re-think their sustainability ambitions. There are clear commercial implications if firms cannot participate in the sustainable funds market, potentially undermining their reputation.

Instead of viewing transition planning as a mere disclosure exercise with siloed pockets of activity, firms will need to embed sustainability strategies across their organizations. The required steps and KPIs to achieve targets must also be clearly defined, as well as the interplay between firm-level commitments and product-level ESG performance.

OTHER EU INITIATIVES

The industry will need to finalize its ongoing initiatives, such as the EMIR Refit or the T+1 settlement cycle. The EMIR Refit calls for substantial changes to firms' reporting frameworks, processes and tools, including new reporting template fields, reports and written procedures, while ensuring effective oversight of reporting quality. While the T+1 settlement cycle will indirectly but profoundly impact investment managers' operations, risk management and liquidity planning, requiring firms to analyze and anticipate any gaps caused by settlement mismatches.

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Growth in private market investments has mushroomed over the last decade, attracting the attention of governments and regulators alike. Governments have implemented a range of measures to stimulate investment in long-term, productive assets, including ELTIF II and a new loan origination fund regime 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. The International Organization of Securities Commissions (IOSCO) has warned higher interest rates could increase defaults and threaten valuations in this relatively opaque market. Regulators are also calling for more transparency in private markets.

ESMA's recent Common Supervisory Action (CSA) on valuations highlighted specific risks for private equity and real estate assets. Key concerns include subjectivity and potential conflicts of interest in the valuation process, along with misalignments between the frequency of the net asset value (NAV) calculation, the asset valuation, and the availability of up-to-date data. Accurate valuations are especially essential if investors can exit the product early or trade it in the secondary market.

In this context, we expect the sector's level of supervisory scrutiny to ramp up in 2024. The industry will need to invest significantly to ensure its risk and compliance functions are appropriately resourced and have robust control frameworks and operational processes.

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VALUATION

Valuations are in the supervisory spotlight. Governance will be a particular challenge in key stages of the valuation process, from the methodology used to the reasonableness of material judgments to determine valuations. As this challenge must be tackled independently with the right level of seniority and expertise, some firms are considering increasing their use of third-party valuers.

PRIVATE CREDIT

EU managers of private credit funds will need to consider their business strategy given the AIFMD's new harmonized regime for loan origination funds. Funds will have new opportunities to lend cross-border across the EU, helping managers scale their operations. However, the new regime's requirements will also reduce flexibility, including leverage caps and risk retention rules, and limit open-ended structures unless appropriate liquidity management practices are demonstrated. Funds not currently meeting these requirements will need to review their investment strategy and/or structure to ensure they remain attractive to investors.

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RETAIL INVESTMENT

With more managers courting retail investors, supervisors are zeroing in on conduct risks—such as wealth managers exposing consumers to inappropriately high-risk investments, stockbrokers promoting products too complex to understand, and consumers unaware of high fees shrinking their investment returns. Firms require strong controls of their marketing, distribution and product functions to mitigate these risks.

Similarly, defined contribution (DC) pension schemes ramping up their unlisted asset investments must ensure their members understand the risks and that their investments deliver value net of fees, while revisiting their asset allocation rationale periodically. These conduct considerations will likely slow the uptake of increased private market allocations in 2024.

ESG

Prescriptive requirements for sustainable investment labels and marketing restrictions may see firms reconsidering their ESG goals, given the increased regulatory and reputational risk. Private market firms may struggle with their reporting duties due to private companies' lack of ESG data, a key source of greenwashing risk. Therefore, firms must ensure private companies can produce high-quality ESG data, identify gaps to manage their own reputational and liability risks, and produce accurate disclosures.

Firms should also proactively document how they identify and manage climate risks and opportunities in their portfolios, as requesting private companies' climate-related data on short notice will likely be challenging.

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