Hogan Lovells

FIS Horizons

2018

Scanning the horizon

2018 is likely to be another eventful year for the Financial Institutions sector. Across the world, we're facing change of every order; the question is how you deal with it?

Whether you're affected by regulatory changes or geopolitical uncertainty there will be a lot to watch and prepare for. All areas of the sector will have a long to-do list this year as we prepare our businesses for the future. Europe is leading the way with regulation, with MiFID II, PSD2 and GDPR all taking affect this year. Ensuring your systems and procedures are up-to-date and remain up-to-date is key. These regulatory changes also need to be considered under the guise of geopolitical upheaval. How will Brexit and the Trump administration affect the ecosystem around the FIS sector?

Technology and innovation also continue to shape the sector. Every business is impacted, including our own, and is considering how technology can drive efficiencies and deliver a better service for customers and clients. How well we all adapt to this innovation will certainly shape our futures.

Here we've collected a global snapshot of topics on the horizon, which we think you should be preparing for and will help shape your next 12 months. You will also find lawyers associated with each topic, please contact them if you want to discuss anything further.

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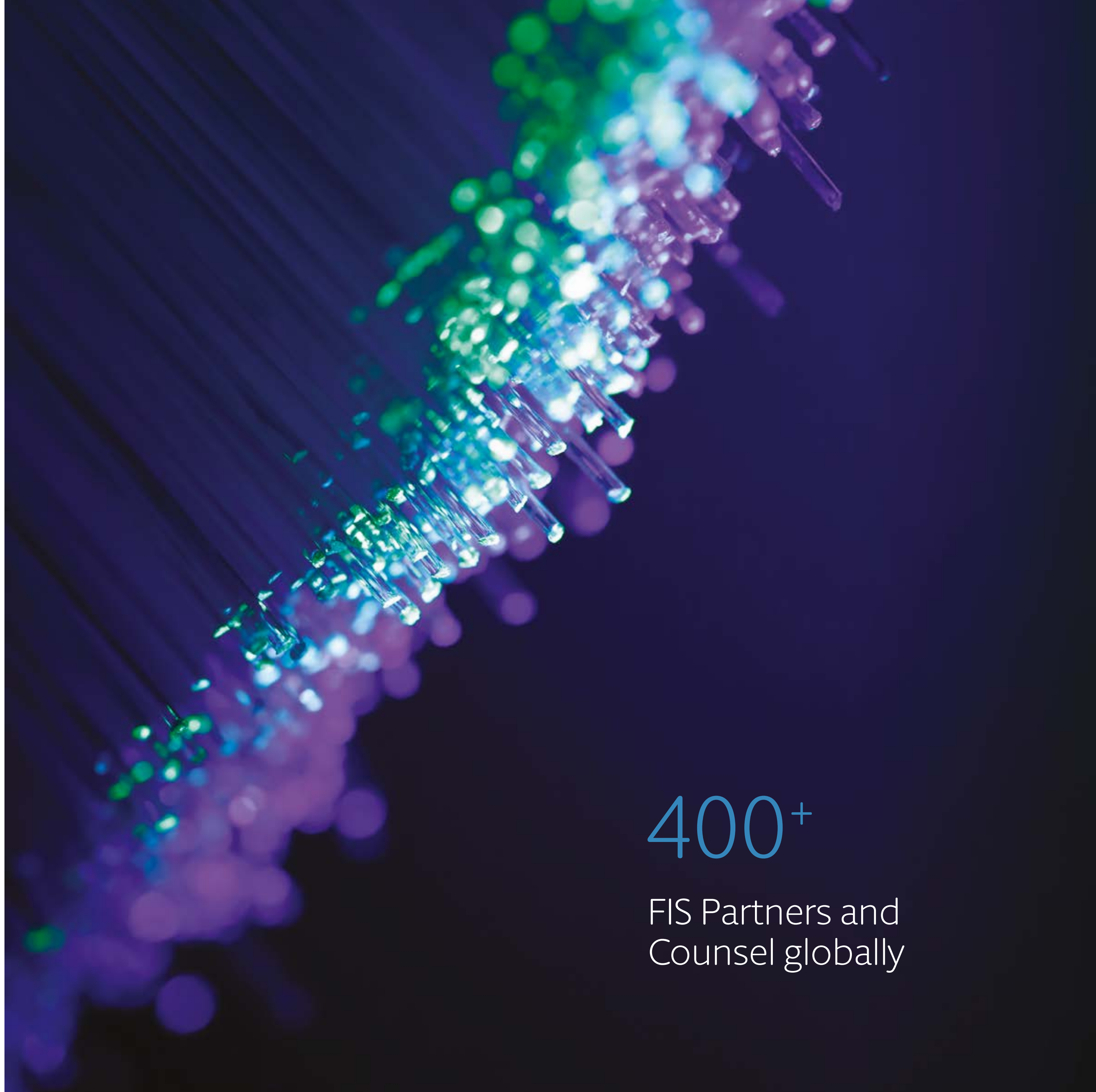
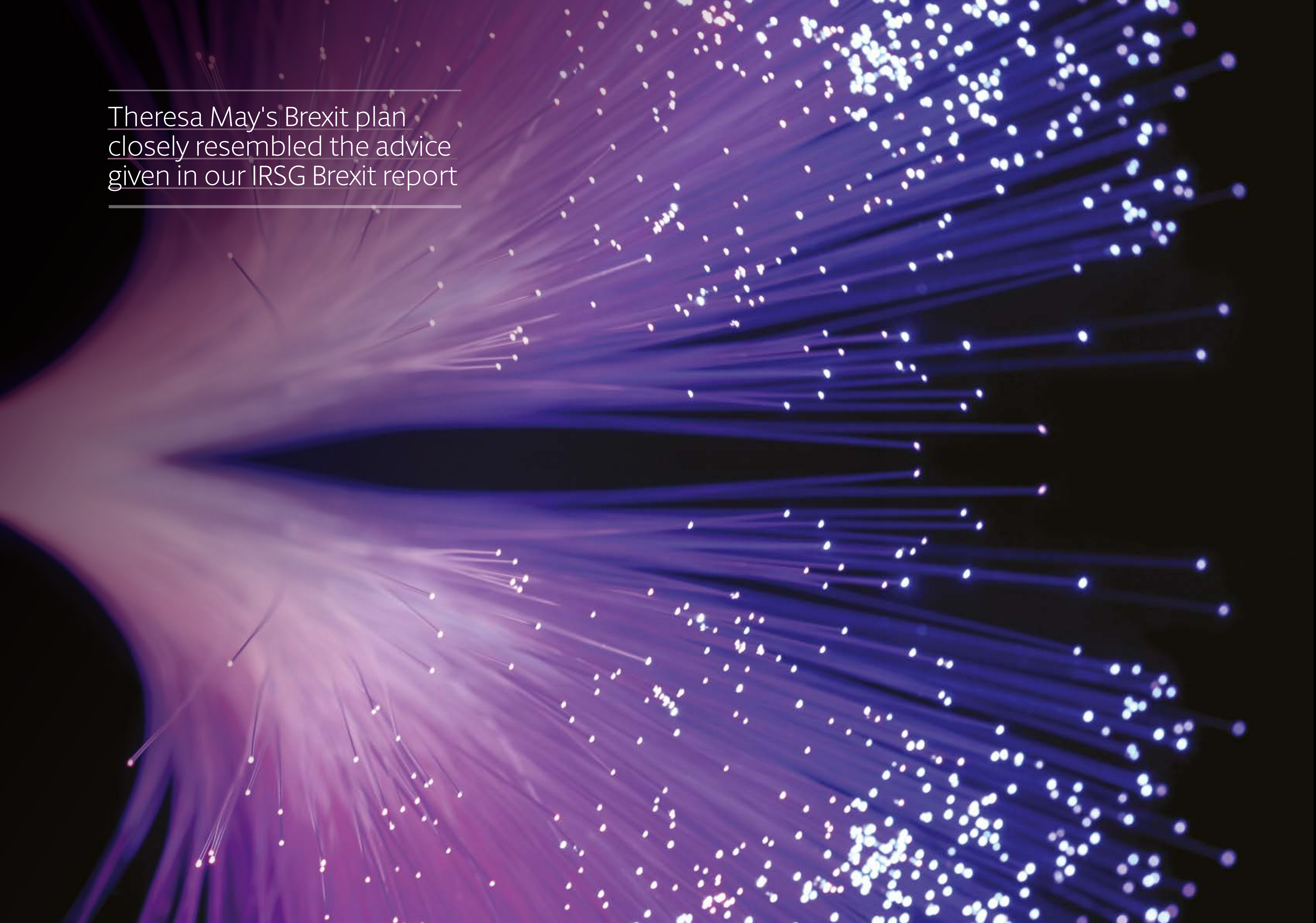
> "Whether you're affected by regulatory changes or geopolitical uncertainty there will be a lot to watch and prepare for."





Theresa May's Brexit plan closely resembled the advice given in our IRSG Brexit report

Prepare for Brexit uncertainty

The challenges that Brexit will bring to the banking sector evidently depend on a multitude of factors, but passporting is key to the free flow of Financial Services and the current structures of banks. The EU and the government have not yet committed to retaining this position, but we have lobbying hard to impress upon them the benefit this will have particularly to EU consumers. Should we be unsuccessful in retaining this position, it is unlikely there will be significant change to regulations and law related to financial services. However, if not successful, banks will need to transfer existing business to a subsidiary (absent specific agreement on branches) in the EU and there may be more divergence from the current EU legislation.

Whilst navigating through the unknown landscape of Brexit and pending agreement of a transition deal, the priority for banks is to have and continue to implement a contingency plan so that in a worst case scenario of no deal, the bank can continue its operations to service its consumers and customers without breaking any laws.

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Large banks should be aware that the asset threshold for designation as a systemically important financial institution (SIFI) will be raised from $50bn to $250bn.

U.S. changes from the top

On Tuesday, March 6, the Senate voted 67 to 32 to move Senate Bill 2155, the Economic Growth, Regulatory Relief & Consumer Protection Act (the “Senate Bill”) toward debate. While the vote does not guarantee the passage of the Senate Bill, it looks very likely that the Senate will approve the bill.

Even though the Senate Bill is not yet law and is still subject to change, there are several provisions that banks should be aware of, depending on their status.

Large banks should be aware that the asset threshold for designation as a systemically important financial institution (SIFI) will be raised from $50bn to $250bn. Additionally, the Federal Reserve will develop separate prudential standards for those institutions with between $100bn and $250bn in total assets, which can be individually tailored to the institution.

Smaller banks, with $10bn or less in total assets, should be aware of a potential “regulatory off-ramp” that exempts institutions from certain federal laws, rules and regulations regarding capital and liquidity requirements if the institution maintains a certain capital threshold. However, the institution’s primary federal regulator may determine it cannot utilize this off-ramp due to its risk profile, especially the institution’s off-balance sheet exposures.

Smaller banks should also be aware that the Volcker Rule will not be applied to institutions with $10bn or less in total asses whose total trading assets and liabilities do not exceed 5% of their total assets. There will also be relief from the Qualified Mortgage requirements for institutions that hold the mortgages on their books rather than those that securitize and sell them. Furthermore, the asset threshold for the Federal Reserve’s Small Bank Holding Company Policy Statement will be raised from $1bn to $3bn.

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2018

Leading Firm for Government Relations and Public Affairs, *Chambers US and UK*

Keeping up with FinTech

As consumers are becoming increasingly accustomed to digital applications streamlining most aspects of their daily life, they no longer see digitised financial services as simply an added bonus, but now expect to enjoy the same streamlined delivery from their financial services providers as a given.

Meeting this expectation will be a key challenge for financial services providers in 2018. Now, more than ever, providers will need to re-consider how they deliver products and services to customers, and will need to think creatively in order to keep up with the shifting demand for digital services.

This does not apply exclusively to user-facing applications, but also to the technology underpinning financial services and those facing corporate clients. Many banks, for example, are considering how they might use distributed ledger or blockchain technology to improve processes and deliver different products to clients. Use cases range from securities and derivatives settlement; trade finance and supply chain; and securitisation asset tagging and reporting.

Digitising financial products and services presents a number of challenges, and there is a complex web of regulatory hurdles that must first be untangled in order to deliver these new services to consumers. FinTech lawyers therefore have to keep a finger on the pulse of the rapidly evolving regulatory framework, so that they can best assist providers navigate the law, implement their new services and work with wider teams who have deep product knowledge.

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Band 1 for FinTech, *Chambers Professional Advisers, 2018*

Changing your payments

The implementation of PSD2 heralds the arrival of the open banking era. This has the potential to be the single most transformative change to payments and banking. It is often portrayed as a serious threat to existing business models but it also opens up significant opportunities for both banks and new entrants, including new business lines and new routes to market.

While the EBA's Regulatory Technical Standards are still to be implemented and will be important in finalising the detail, perhaps of most importance is how the market reacts to the changes. It is extremely rare for legislation to seek to disrupt markets and boost competition in the way that PSD2 has done. Whether it succeeds in revolutionising banking or merely tinkers with some niche practices around the edges will depend on how the market reacts.

What is clear is that banks will have to make access available to their payment accounts and that a number of Fintechs are interested in providing new services, piggybacking off bank infrastructure. What is less clear is whether there is a significant consumer demand for these types of services and whether businesses can develop sustainable business models to provide them.

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“It is extremely rare for legislation to seek to disrupt markets and boost competition in the way that PSD2 has done.”

Taking Blockchain mainstream

Over the course of 2018-19, we expect to see blockchain solutions begin to move out of the research lab and into the mainstream financial services eco-system. Blockchain has the potential to make profound and lasting changes to the financial services industry, with many advocates arguing that much of the existing centralised / siloed architecture that underpins financial services is capable of being disrupted by decentralised ledgers.

At the same time the convergence of blockchain with other technologies and concepts such as digital identity and open APIs opens up new opportunities for both financial institutions and their clients, whether retail or wholesale. This, coupled with AI and analytics, will also open up new opportunities for financial institutions (of all shapes and sizes) to provide much more bespoke, personalised products and services. Financial institutions will be able to maintain a competitive advantage by developing new products and services that leverage these new technologies and improve the customer experience.

Similarly, given the explosion of interest in crypto-currencies in 2017 we expect to see more infrastructure being built to support the continued evolution of the crypto-markets. As this matures and these assets become more widespread and accessible, customers will demand the ability to move in and out of crypto with significantly less friction than they enjoy today. We also expect that we will see regulators in traditional financial services centres such as the U.S. and the UK begin to develop regulatory frameworks for purely digital-assets classes which are designed to provide both issuers and investors with the appropriate levels of certainty and protection. In the US, we have already started to see significant enforcement actions by the CFTC, the SEC and FinCEN involving cryptocurrencies – and the recently-commenced trading of Bitcoin futures contracts is being closely watched by the CFTC.

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> "Blockchain has the potential to make profound and lasting changes to the financial services industry..."

Toolkit

Access our Blockchain Toolkit and the latest Blockchain news at hlengage.com

> Failure to comply to GDPR, for example, could lead to fines of up to 4% of the company's global annual turnover of the previous year.

Future-proofing cybersecurity and data privacy

With increasingly strict data protection regulations imminent and recent ransomware attacks bringing cybersecurity and data protection to the forefront, banks will need to do everything they can to prepare for 2018.

Banks will need to ensure that their legal teams are thinking and acting in an international context. They will need to formulate a forward-thinking plan to balance domestic or local compliance with international compliance. Legal teams need to be aware of all of the international aspects of privacy, especially with regards to upcoming EU General Data Protection Regulation (GDPR), or potential cybersecurity regulations in New York. Banks should dedicate extra resources to deal with the increasing amounts of data protection regulation, to help avoid substantial fines. Failure to comply to GDPR, for example, could lead to fines of up to 4% of the company's global annual turnover of the previous year.

Banks also need to be forward thinking in order to remain vigilant against the threat of cyber-attacks, including data breach and data manipulation. Data protection best practice is constantly changing, and banks will need to constantly ensure that they are following up-to-date advice, and that the procedures they have in place are still correct. Banks need to guarantee that they are doing enough to safeguard their client's data, as they can be held responsible if client's data is hacked.

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2017

Privacy and Data Security team of the year, *Chambers*

Getting to grips with MiFID II

MiFID II has introduced significant changes to the way in which investment business will be undertaken in the EU. It will affect wholesale investment activity and retail investment activity in multiple ways, including through the introduction of more transparency and through an increased focus on investor protection arrangements.

Banks will have already spent much of 2017 getting ready for MiFID II implementation. However, now that it is here, there are a number of issues that they will still need to grapple with.

Banks will need to ensure that their MiFID II processes are operating in a compliant manner. MiFID II is a very detailed regulation. There is significant scope for varying interpretations in a number of areas. We should see clarifications from the regulators over time, but in the meantime, banks will need to come to sensible decisions when faced with areas of ambiguity.

Banks will also need to deal with counterparties or clients who may not themselves have fully implemented MiFID II. The degree of MiFID II compliance across the industry is varied. Some firms have either not been able to get ready in time, or are only just waking up to the fact that MiFID II might affect them. Dealing with non-compliant counterparties will be a challenge for banks in 2018.

Legal teams should ensure that they understand to what extent there may be more work to do to get their businesses MiFID II compliant. The FCA has indicated that it will take a proportionate approach to MiFID II compliance in the initial stages of 2018, but to do nothing will not be looked at favourably.

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Banks will need to ensure that their MiFID II processes are operating in a compliant manner

Our MiFID II Toolkit on HL Engage brings together everything you need in one place to help you navigate the regulation

Financial crime awareness in the UK

Market manipulation and AML remain key focus areas for the FCA's Enforcement and Markets Oversight Division (EMO). Against the background of the mutual evaluation of the UK's AML and CTF framework by FATF there has been much closer liaison between the FCA and other agencies, including the SFO and NCA – and even some joint development of money laundering cases. The FCA's evolving approach to investigations means that while the past year has seen a dearth of public outcomes, there has been a huge increase, both in the number of investigations opened and individuals being interviewed under caution, many in relation to distinctly non-egregious behaviour. This approach reflects the fact that EMO is no longer focused on cherry-picking cases designed to send new messages to the industry, but instead wants to make its presence felt, patrolling the waterfront, with a zero-tolerance approach to breaches of any kind. Unfortunately, more investigations without more resources means that progress is often extremely slow.

HMRC has also flexed its muscles in championing a new corporate 'failure to prevent' offence. Introduced in September last year, this is designed to punish firms that do not have procedures in place to prevent the facilitation of tax evasion by associated persons. The proposal to extend this model of corporate liability to failures to prevent fraud, false accounting and market abuse, among others, has not gone away despite the apparent tussling between Government departments. So watch this space.

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“... there has been a huge increase, both in the number of investigations opened and individuals being interviewed under caution, many in relation to distinctly non-egregious behaviour.”

US$350tn

Instruments with an estimated aggregate notional value of US$350tn incorporate LIBOR.

Life after LIBOR

Last year, the FCA announced that it will neither compel nor seek to persuade banks to make LIBOR submissions beyond 2021 – and warned that market participants "must take responsibility for their individual transition plans" over the next 4 years.

That will be no small task. Instruments with an estimated aggregate notional value of US$350tn incorporate LIBOR. These include swaps and other OTC derivatives, exchange-traded derivatives, all manner of bonds and other securities, bilateral and syndicated commercial loans, consumer loans and mortgages.

2018 will be a busy year as the transition away from LIBOR gets underway. "Risk-free" overnight rates – the reformed SONIA and the new SOFR – are being launched by the Bank of England and the Federal Reserve, respectively. But these will differ significantly from LIBOR, as they do not reflect term or credit risk. Industry groups are already working on developing robust fall-backs and substitutes for use after LIBOR is no longer available. In the interim new transactions will need to include fallback language to deal with discontinuance and, particularly with traded securities, provisions to allow an expedited approval process for substitution of LIBOR references in due course.

Financial institutions have begun to review legacy contracts, and will seek to amend them where necessary. That is important: legacy contracts lacking workable fall-back provisions may not be enforceable after LIBOR's demise, and it would be a mistake to assume that courts will salvage them.

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> ... market participants 'must take responsibility for their individual transition plans' over the next 4 years.

Changes for loan portfolios

Although European lenders have been deleveraging both their non-performing loan (NPLs) and non-core loan portfolios since the financial crisis, regulators remain concerned about the overhang of NPLs in Europe. Last year the ECB issued guidance to banks on NPLs and launched a consultation in respect of additional provisioning requirements for new NPLs.

In addition, IFRS 9 (which provides for forward looking loss provisioning) came into force at the start of the year and raises questions about whether banks will be forced to raise additional capital to offset its impact, and is likely to result in more loans being designated as non-core.

Given these changes, there are likely to be more portfolio sales in the coming years in respect of an increasing range of asset classes, such as secured consumer and SME loans.

Some banks will be sellers but others may be buyers, either independently or in joint ventures with debt funds (which have raised significant amounts of capital which is yet to be deployed).

Most buyers will seek to leverage their investments, which they will generally buy at a discount.

Leverage often takes the form of warehousing loan facilities (so-called loan-on-loans) and, more recently, securitisation transactions involving both performing loan and NPL portfolios.

When lending against such portfolios, legal teams need to consider (amongst other things) due diligence on the relevant portfolio, balancing discretions retained by the buyers with protecting the senior debt and, on NPL portfolios in particular, the availability of servicing and the timing and cost of enforcement in any given jurisdiction.

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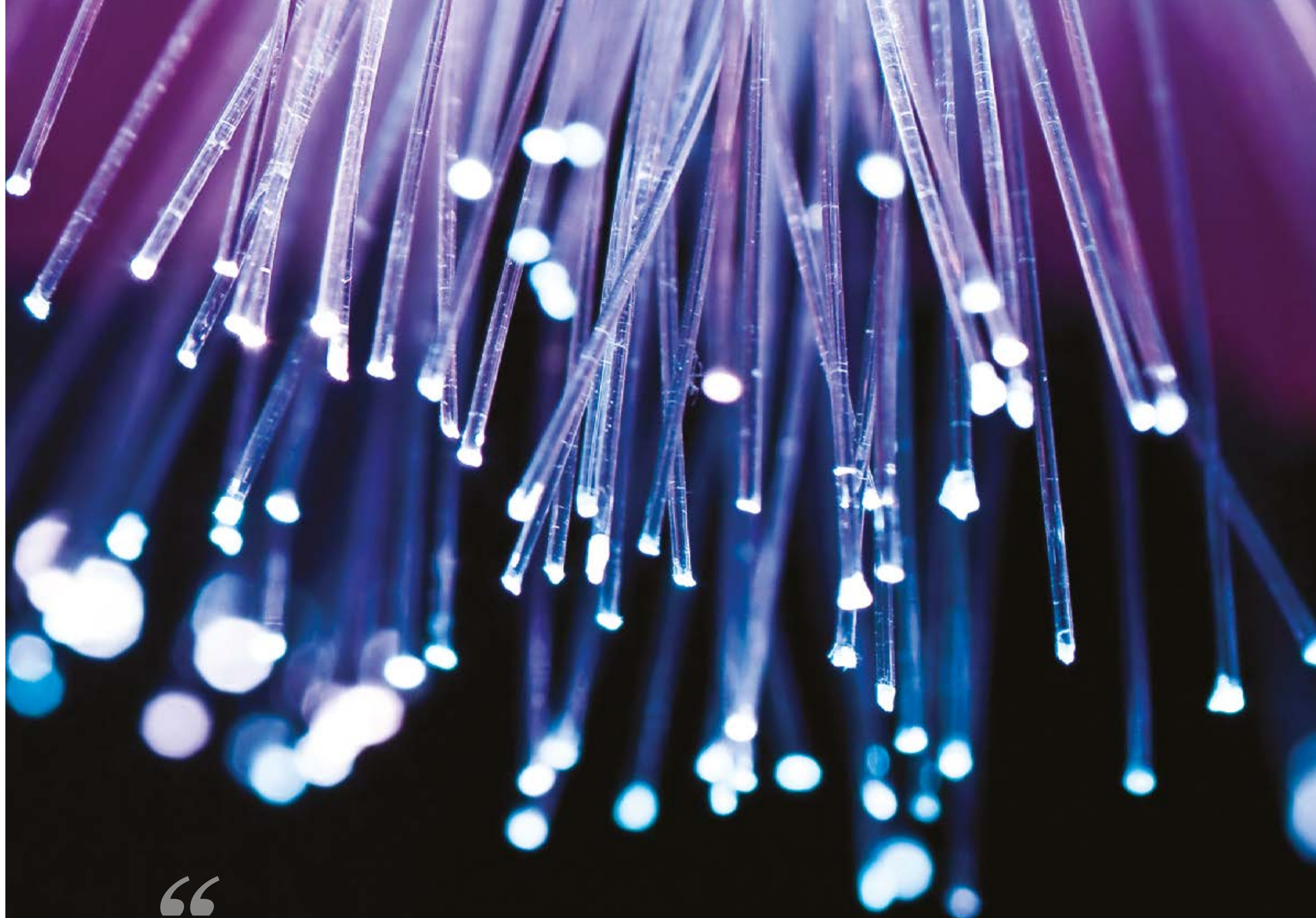

> “IFRS 9 came into force at the start of the year and raises questions about whether banks will be forced to raise additional capital to offset its impact, and is likely to result in more loans being designated as non-core.”

Alternative finance: a fresh approach

Following the financial crisis, the global financial landscape has shifted with commercial banks now subject to increased regulation and higher capital adequacy requirements. This in turn has led to the rise of alternative lenders who are not shackled by the same constraints. Private debt and equity funds, as well as pension funds and other asset managers, have a huge global pool of capital that needs to be invested and are actively looking for new and innovative ways of deploying that capital with the quantum of their debt offerings to borrowers constantly increasing.

These institutions are contributing to the continued development and evolution of financing structures, such as unitranche facilities and first out/last out loans. Alternative lenders can provide non-amortising structures, more flexible, bespoke terms and longer tenors, which are attractive to borrowers but these funds are likely also to have higher return thresholds than the banks. In addition, alternative lenders may not be able to provide a borrower with all the funding required – for example, they generally do not offer working capital facilities, transactional facilities or swaps. Over 2018, we expect to see financing structures becoming more refined, with commercial banks and alternative lenders continuing to find ways to collaborate to provide tailored financing solutions to borrowers such as the use of asset backed loans to provide working capital liquidity alongside a term loan. We also believe that the alternative lenders are likely to look to new markets for investment opportunities as they continue their expansion into the Asia Pacific region and explore geographies such as Eastern Europe.

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> “2018 will bring continued disintermediation, with alternative lending becoming increasingly more mainstream.”

Internationalization of the Renminbi

Over the past 10-15 years China has progressively introduced a series of regulatory-driven reforms as well as more ambitious schemes like the Belt & Road Initiative to facilitate the internationalization of the Renminbi ("RMB") – the process whereby the RMB assumes the functions of a global currency.

Successful internationalization of the RMB would manifest itself in many ways, perhaps most obviously when the RMB becomes a major pricing and settlement currency in trade, a preferred financial transaction currency, and an international reserve currency. However, China still maintains strict capital controls, including on outbound direct investments by Chinese companies.

Major financial hubs like the City of London have been making huge efforts to establish themselves as offshore RMB centers – something that would have been unthinkable 10 years ago – however it remains challenging to convince the world to use the RMB as its preferred trading and reserve currency whilst it is still not free floating on global markets.

China wants the status of the RMB to mirror its position as the world's second largest economy, but is proceeding cautiously, taking a step-by-step approach, wary of exposing itself to a meltdown like in the 1997 Asian Financial Crisis or an attack on the RMB by speculators, and has not forgotten the events in September 1992 when the Bank of England was 'broken' on so-called Black Wednesday.

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> "Major financial hubs have been making huge efforts to establish themselves as offshore RMB centers..."

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