



Still on track?







Interim Regulatory Outlook 2019

“The task is large, the window of opportunity is short, and the stakes are existential.”

**Mark Carney, Speech to the European Commission Conference:
A global approach to sustainable finance, March 2019**

Contents



	Contents	3		Supervisory constants	8		Sector specific developments	10
				Governance and culture				
	Foreword	4		Scrutiny of the resilience of firms' business models to the changing risk environment			Banking	
				Firms' protection and use of data			Capital Markets	
	Cross-sector themes	6		Access and vulnerable consumers			Insurance	
	Shift from implementing new regulations to ongoing supervision			Testing for cyber vulnerabilities			Investment Management	
	Preparing for Brexit			Model risk management				
	IBOR transition						Glossary	13
	Climate change and sustainability						Contacts	14
	Building resilience to operational disruptions							
	Value for money							

Contents

Foreword

Cross-sector themes

Supervisory constants

Sector specific developments

Glossary

Contacts

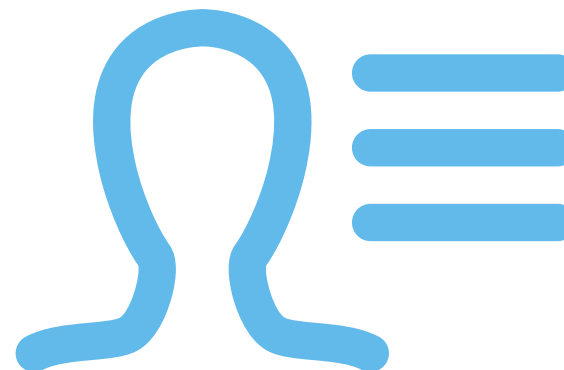


Our Regulatory Outlook was published last December. Then we saw a world where monetary policy would start to “normalise”, with interest rates slowly rising. Now rates are likely to remain lower for (even) longer, with long-term risk free rates below where they were at the end of 2018. Although this environment will support asset prices, it will also weigh on banks’ lending margins and insurers’ asset yields. This pressure on traditional sources of revenue will further incentivise firms to look for new ways of generating income, creating fresh business model and conduct risks and accompanying supervisory scrutiny.

This said, many of the “late cycle” macroeconomic risks we touched upon remain. Global debt levels are still higher than pre-crisis, non-bank lending continues to grow, as do levels of consumer credit. The FSB, ECB and BoE have continued to scrutinise the growth of leveraged loans, with Mark Carney remarking that *“The subprime analogy... isn’t perfect, but it’s on the road to ‘no doc’ underwriting which happened 11 years ago.”*¹ More generally, growth in the Eurozone and the UK has remained sluggish.

Concerns about the impact of the US-China trade dispute have periodically shaken markets, whilst there are also question marks over where the US and Chinese economies are in the economic cycle. Given this backdrop, we expect regulators will continue to test firms’ resilience to any economic downturn or market shock.

The outlook for global regulatory co-operation remains dim, notwithstanding the FSB’s very welcome mandate to tackle market fragmentation, and its commitment to continue work on this topic beyond the Japanese G20 Presidency. However, it seems likely that we will see increasing regulatory divergence between different regions and even, in some cases, within them. In Europe, the EU’s approach to Brexit suggests that in future, while the UK wants to take an open approach to financial services, the EU is much less comfortable with many important FS activities being provided from beyond its borders. This means that the UK may ultimately be faced with the unappetising choice of either being a “rule-taker” to maintain EU market access or accepting a loss of access in return for greater regulatory autonomy.

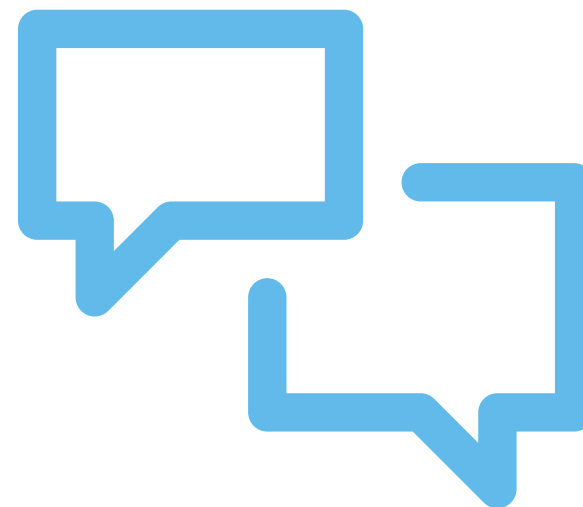




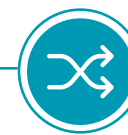
Either way, unless the UK and EU can agree to a strong system of regulatory co-operation post Brexit, we could see European markets fragment, with less competition and cross-border investment, potentially driving activity to other global financial centres.

2019 has also seen continued political instability and emerging realignments which, longer term, could lead to different political perspectives on regulatory priorities and approaches. For example, strong performances from Green and environmental parties may well lead to greater regulatory focus on climate change and the scope to use the regulatory system to achieve wider environmental goals. In the European Parliament, the Green grouping has previously pushed for environmental risks to factor into firms' capital requirements, an issue that could be raised again in future.

The boundaries of the regulatory perimeter continued to attract much attention in the first half of 2019. Many jurisdictions have started to have serious discussions about regulating cryptoassets, not only from a financial crime and AML perspective, but also as financial instruments in their own right, with the EU looking at how cryptoassets should be considered under capital markets legislation such as MiFID II and CSDR. The BCBS has also set out its prudential expectations of banks' holdings of cryptoassets, while conduct regulators such as the FCA have raised concerns over consumers falling for crypto-related investment scams. Consequently, it now looks likely that cryptoassets will be brought into the scope of a number of countries' regulatory regimes in the not too distant future.



¹ Mark Carney, Oral evidence to the Treasury Committee, 16.01.2019



Our Regulatory Outlook for 2019 identified six cross-sector themes with strategic significance for the FS industry.



The first of these was a **shift from regulation to supervision**. Notably, in his foreword to the PRA's business plan for 2019/20, the Chief Executive, Sam Woods, observed that this shift is already taking place and will be a priority. Notwithstanding a burst of pre-election activity from the EU, new regulation has slowed while on the supervisory front, as predicted, a number of jurisdictions have begun to look at firms' MiFID II implementation. However, in our view, this shift towards more intensive supervisory scrutiny has been measured and fairly gradual so far.



Brexit was another of our themes, and as expected uncertainty continues to prevail. While the delay to the UK's departure has given newly established firms in the EU27 a welcome breathing space, including for systems

testing, they need to be ready for the SSM and the EU27 NCAs to begin scrutinising the issues that concern them most – governance, booking models, outsourcing and delegation arrangements. We said in the Outlook that “we expect the EU to choose emergency fixes over disorder”, and this has proven to be the case. Where a no-deal Brexit scenario would pose an immediate risk to financial stability, the EU has been prepared to put in place contingency measures. However, in other areas, such as the trading obligation, the EU has taken a stronger line and has refused to recognise UK trading venues even though they could provide better pricing and liquidity for EU traders and their customers. That said, where the EU has left gaps in its contingency planning, individual Member States have shown that they are ready to close them.

IBOR

The pressure to transition away from **IBORs** has increased, with regulators directly scrutinising firms' transition plans. Different jurisdictions are taking different approaches; the UK and US have been pushing firms to

switch to new RFRs, but are now starting to show more willingness for other rates – for example, those that reflect credit risk – to be considered. Other countries have taken a “dual track” approach where both IBORs and RFRs will co-exist. However, while the issuance of products linked to new RFRs has grown, many firms continue to take a “wait and see” approach. The deadline for critical and third country benchmarks to comply with the EU BMR has been extended to December 2021, giving administrators longer to seek authorisation. Both reformed Euribor and EONIA are now expected to become compliant. The administrator of EONIA has also published proposals to administer a recalibrated EONIA rate, which will track the euro short-term rate, as a temporary solution to facilitate and ultimately ensure transition to €STR. These developments demonstrate that the post-LIBOR and wider benchmark landscape is not fixed. While some firms, particularly those using EONIA, may now feel like they have more breathing space to manage the transition, we continue to expect regulators to become still more vocal as we head into 2020.

[Contents](#)[Foreword](#)[Cross-sector themes](#)[Supervisory constants](#)[Sector specific developments](#)[Glossary](#)[Contacts](#)



On **climate change and sustainability**, the UK is setting the pace in terms of expecting banks and insurers to manage the financial risks associated with climate change. At the EU level, two climate change benchmarks have now been adopted, while there has also been final agreement on new sustainability disclosure requirements. However, measures to adopt a common taxonomy are still to be agreed. ESMA and EIOPA have also published their technical advice to the Commission on integrating sustainability risks in to MiFID II, UCITS/AIFMD, IDD and Solvency II, although it is uncertain when these new rules will come into force. The ECB is also increasing its focus on climate issues. The NGFS published its first report, issuing a call for action for central banks to integrate climate related financial risks into their financial stability monitoring and firm supervision. All of this points to climate change rising up the regulatory agenda, but it may be the case that investor and other outside pressure will force firms to move further and faster than any regulatory requirements.



Operational resilience was flagged as a priority in both the PRA and FCA's 2019/20 Business Plans, although progress at the policy level has been slower than we expected, with the PRA and FCA's proposals for their impact tolerance framework unlikely to be published until later in the year. This said, many firms are being subjected to increasing supervision of their idiosyncratic operational risks, with firms' boards often struggling to set a meaningful risk appetite. At the EU level, the ECB is yet to extend its cyber resilience expectations to a larger number of firms, despite stating its intention to do so. However, there has been heightened scrutiny of firms' use of cloud computing, with the ESAs pushing for additional powers to look at CSPs, given the potential macroprudential risks that concentration among them may pose.



Value for money is a theme which has attracted a higher profile and wider practical focus in the UK than in the rest of EMEA. The FCA has put pressure on asset managers' value and pricing, with AFMs being given a new prescribed responsibility for value assessments under the SM&CR – importantly, the first time an EMEA regulator, has, within a statutory accountability regime, made an individual accountable for a firm assessing value for money. Insurers' pricing practices are also being scrutinised closely as part of an ongoing review whose conclusions will provide important pointers as to how the FCA is likely to approach price discrimination issues across sectors. As expected, UK regulators have intervened decisively to correct perceived poor value, with the FCA having now adopted a price cap on rent-to-own products. At the EU level, ESMA produced a report on costs and past performance in retail investment products which found that, on average, UCITS fund charges reduce returns by 25% and retail investors in UCITS funds pay twice as much as institutional investors. However, to date ESMA has not proposed any direct regulatory intervention in response to these findings.

Supervisory constants

Alongside our six cross-sector themes our Regulatory Outlook also identified six supervisory constants – issues that, although not new, would nonetheless be important areas of focus in 2019 as supervisors pursue risk-based approaches.



The importance that supervisors place on **culture and governance** has been reaffirmed by the PRA and FCA, both of which list them as a priority in their 2019/20 Business Plans. The South African Reserve Bank has also focused on culture as its 2019 “flavour-of-the-year” topic for discussion with bank boards. Scrutiny of senior individuals has increased, with 58 directors now under regulatory investigation by the FCA, up from 24 in 2016. Of these 58 cases, roughly half (27) relate to failings in culture and governance.² As expected, the FCA has also continued to stress the importance of diversity and inclusion to firms’ culture, a message echoed by supervisors in Ireland and the Netherlands. Nevertheless, this emphasis on culture does not yet appear to have emerged in other EMEA countries, where more traditional governance issues continue to be the focus of supervisors’ attention.



There has also been a gradual shift towards more **scrutiny of the resilience of firms’ business models**, but no “big bang” changes or major new supervisory initiatives. There is an increasing gap between the perceived need for cross-border banking consolidation in the EU, especially the Eurozone, and the ability for policymakers to put in place the right framework to enable it. We expect to see growing political interest in creating national or regional champions.



FS **firms’ protection and use of data** have continued to grow in importance for mainstream FS regulators. However, EU data protection authorities have yet to probe the financial sector’s data practices. As we predicted, they are still building capability post-GDPR, and bar any surprise event, it will take them a little longer to look at the FS sector more closely and at scale. We anticipated that data ethics would become a topic of growing regulatory interest, and progress has been faster than we expected, with the EU having issued its guidelines for “Trustworthy AI” in April and the FCA now including data ethics in its priorities for 2019/20.



The importance of **access and vulnerable customers** is now well embedded in the UK, with almost every FCA market study and thematic review making extensive reference to vulnerability. Consequently, the treatment of vulnerable customers must now form a core part of UK boards’ and senior managers’ responsibilities. Vulnerability has also been given attention by the ESAs, with EIOPA publishing a new conduct risk framework which discusses the importance of protecting “vulnerable target groups”. Beyond the UK and Ireland, access and vulnerability are yet to gain as much traction. Nevertheless, given the continued attention vulnerability has received from Anglo-Irish regulators and the ESAs, it seems likely that other jurisdictions will respond to this trend in time.



Contents

Foreword

Cross-sector themes

Supervisory constants

Sector specific developments

Glossary

Contacts

Supervisory constants



Supervisors have continued to step up their efforts in testing for **cyber vulnerabilities**. As predicted, the FPC is moving forward with a series of scenario-based cyber stress tests, while the PRA and FCA have also confirmed their intention to extend CBEST testing to a larger group of firms later in the year. The roll out of TIBER-EU framework testing has been slower than expected, with most countries likely to roll it out from 2020 onwards. At the international level, the G7 took a more ambitious approach than we initially expected and conducted the largest cross-border cyber incident exercise among its members to date. This test involved over 24 public authorities and a range of private firms simulating their responses to a significant cyber-attack with systemic spillovers.



Given the substantial portions of banking and insurance sector capital that are now determined by approved capital models, **model risk management** has, unsurprisingly, remained a supervisory priority. Supervisors of both banks and insurers appear determined to avoid a repeat of the secular decline in banking capital that occurred in the run-up to the financial crisis. In this regard, the PRA's Executive Director of Insurance, David Rule gave a speech in May on "model use and misuse", highlighting the PRA's ongoing concerns around model drift. The ECB's TRIM programme also continues, with the ECB highlighting this ongoing work as part of its 2019 work programme. EIOPA continues to prioritise convergence in the supervision of internal models, highlighting the risks posed by model drift to the internal market and level playing field. Supervisors have also shown growing interest in firms' governance and controls over their algorithmic and AI driven internal models, a trend we expect to continue.

[Contents](#)[Foreword](#)[Cross-sector themes](#)[Supervisory constants](#)[Sector specific developments](#)[Glossary](#)[Contacts](#)

² FCA investigations into City directors rise sharply, Financial Times, 19.05.2019



Banking



Following the completion of the Risk Reduction Measures package (CRD5/CRR2), the Commission has turned its attention to the forthcoming CRD6/CRR3 package to implement the remaining elements of Basel III. Given the EBA's initial impact analysis, which predicts a 28.4% increase in the minimum capital requirements for EU G-SIBs stemming from Basel III, it seems increasingly likely that the EU will diverge from the Basel standards, as we predicted in our Regulatory Outlook. So far, there is no certainty over where this divergence will be most evident. However, with the EBA impact report indicating that the output floor will be the largest driver of the capital increase for most EU banks, it seems likely that this is where the Commission and EU legislators will be at their most creative.

Whist the themes we called out in the Regulatory Outlook on ICAAP, ILAAP and stress testing still hold true, the impact on banks now looks more likely to be evolution than revolution. However, Andrea Enria's appointment as Chair of the ECB SSM

Supervisory Board has catalysed a renewed focus on Pillar 2. Enria has advocated publication of Pillar 2 Requirements, due to the price-sensitive information that they contain for investors, as well as harmonised disclosure of Pillar 2 Guidance across the EU.

On the subject of financial crime, we highlighted the Commission's legislative proposals to entrust AML/CFT responsibilities to the EBA, with the caveat that we did not expect the measures to be adopted quickly. In contrast, perhaps as a result of recent money-laundering problems in certain EU banks, the ESA Review legislative package, which includes the EBA's new AML/CFT responsibilities, was ratified by the EP in the last plenary meeting before the elections. Viewed alongside provisions in CRD5 compelling supervisors consistently to consider AML/CFT in their work, and the EBA calling on supervisory colleges to join the ECB in including AML/CFT in Pillar 2 assessments, it is clear that these changes to the EBA's powers form part of a wider effort to crack down on financial crime in the EU.

Capital markets



A surprising number of CMU legislative initiatives were agreed ahead of the European Parliament elections. While only 17% of CMU-related legislative initiatives had been agreed and were in force at the time of writing the Outlook, now 85% of CMU initiatives have at least been agreed, even if some will not enter into force until later in the year. A key question for 2020 will be how the new European Commission decides to take forward the CMU.

Firms have continued grappling with MiFID II compliance. Many EU supervisors have pursued wide-ranging MiFID II supervisory programmes and implementation reviews, focusing mainly on investor protection topics. Particular focus areas have been on costs and charges, distribution and inducements, and product governance. Impact assessments and market studies are also underway, in particular on the payment for research rules, and the German Ministry of Finance MiFID II consultation has already provided the opportunity for industry to air its views on what might be in a future MiFID Review. While the timeline for

Contents
Foreword
Cross-sector themes
Supervisory constants

Sector specific developments

Glossary
Contacts



proposed revisions may well vary, likely targets include market data and consolidated tape providers, the transparency regime and Brexit recalibrations, transaction reporting, payment for research, costs and charges, third country rules, cryptoassets, and sustainable finance.

Insurance



In the insurance sector, we continue to see regulators respond to and challenge long-term trends in the insurance business model and economic environment.

In the UK, the PRA has long been concerned about rate adequacy and underwriting discipline in the soft market environment. Its 2019 insurance stress will assess the industry's resilience to, inter alia, a further downward shift in long-term interest rates, credit spread stresses and reserve deterioration, a systemic cyber event (for general insurers), and will analyse the financial impact of climate change. While general insurance pricing has lately followed an upward trend following significant catastrophe losses and increasing recognition of climate risks, the continuing abundance of

capital in the market may well limit the scale of any upswing in pricing compared to historical hardenings of the market.

Insurance business models have also come under thematic regulatory focus. For general insurers, the UK's FCA has identified a number of concerns about how pricing and distribution may contribute to poor consumer outcomes across the general insurance market, for example through differential pricing, and opaque broker commissions and incentives. It is implausible that such concerns are unique to the UK market, and EIOPA has already drawn attention to a number of these issues in the conduct risk framework it published in March.

We have also seen the PRA take an increasingly banking-like, credit-risk driven approach to business model shifts that see insurers, in particular life firms, take on more banking-like risks. For example, the PRA's revised policy on equity release mortgage lending borrows heavily from banking supervision in its focus on credit modelling, and is an example of the insurance regime tightening in response to business model and macroeconomic changes.

The PRA also advocated strongly in February for the Department for Work and Pensions to apply an insurance-like regulatory framework to defined benefit pension scheme "superfund" consolidators – a not dissimilar example of the PRA seeking to head off risks of regulatory arbitrage across sectors in the context of business model innovation.

Renewed international debate on macro-prudential policy for the insurance sector has also pointed to consideration of whether banking-type measures may be appropriate for the sector. The European Commission is considering a small number of targeted macro-prudential changes for the Solvency II review. However, it is possible that this position may shift in the future as the FSB's position develops through the IAIS's work on its Holistic Framework for Systemic Risk in the Insurance Sector.

Investment Management



Investment managers face close ongoing scrutiny on value for money, as explained in our cross-sector themes section above. In

- Contents
- Foreword
- Cross-sector themes
- Supervisory constants

Sector specific developments

- Glossary
- Contacts



the UK, this is given further weight by the new prescribed responsibility on value assessments being introduced under the SM&CR.

In many areas we have seen strong rhetoric from regulators but concrete change has so far been incremental. For example, on costs and charges disclosures the EU has been progressing its review of PRIIPs and the FCA has conducted a supervisory review across MiFID II, UCITS and PRIIPs. However, we are still some way from the goal of having a consistent regime across fund types. On fund liquidity, ESMA has consulted on principles-based stress testing guidance, but we have not yet seen an EU-wide or UK ban on open-ended retail funds investing in illiquid assets. The recent suspension of a UK equity UCITS fund will surely increase scrutiny of liquidity risk management in retail funds. On fund governance, the FCA has taken a significant step in requiring independent directors on boards of AFMs, but, and in contrast to approaches in other sectors, has so far has stopped short of requiring them to be in the majority.

Stewardship is an increasing area of focus. The EU Shareholder Rights Directive introduces new disclosure requirements from June 2019. The FCA has published a discussion paper on effective stewardship, and the FRC has proposed revisions to the UK Stewardship Code. We expect increasing scrutiny in the political sphere on whether institutional investors hold firms to account on social issues such as climate change and the gender pay gap, and regulators to reinforce this by encouraging a long-term approach to investing.

Investment managers are continuing to face cost pressures, in part due to the cost of compliance with regulations and increased transparency on pricing. This is likely to accelerate further the already pronounced trend of market consolidation, with 253 deals announced globally in 2018, an 11-year high.³



³ M&A activity in fund sector breaks 11-year record, Financial Times, 16.02.2019



AFMs
Authorised Fund Managers

AI
Artificial Intelligence

AiFMD
Alternative Investment Fund Managers Directive

AML
Anti-Money Laundering

BCBS
Basel Committee on Banking Supervision

BMR
Benchmarks Regulation

BoE
Bank of England

CBEST
Bank of England cyber red team test

CFT
Counter Financing of Terrorism

CMU
Capital Markets Union

CRD
Capital Requirements Directive

CRR
Capital Requirements Regulation

CSDR
Central Securities Depositories Regulation

CSPs
Cloud Service Providers

EBA
European Banking Authority

ECB
European Central Bank

EIOPA
European Insurance & Occupational Pensions Authority

EMEA
Europe, Middle East and Africa

EONIA
Euro OverNight Index Average

EP
European Parliament

ESAs
European Supervisory Authorities (the EBA, ESMA and EIOPA)

ESMA
European Securities & Markets Authority

€STR
Euro Short-Term Rate

EU
European Union

Euribor
Euro Interbank Offered Rate

FCA
Financial Conduct Authority

FPC
Financial Policy Committee (part of the Bank of England) Financial Services

FRC
Financial Reporting Council

FSB
Financial Stability Board

GDPR
General Data Protection Regulation

G-SIB
Global-Systemically Important Bank

IAIS
International Association of Insurance Supervisors

IBOR
Interbank Offered Rate (for the purposes of this paper, the term “IBOR” is used to describe LIBOR, Euribor and EONIA)

ICAAP
Internal Capital Adequacy Assessment Process

IDD
Insurance Distribution Directive

ILAAP
Internal Liquidity Adequacy Assessment Process

LIBOR
London Interbank Offered Rate

M&A
Mergers and Acquisitions

MiFID
Markets in Financial Instruments Directive

NGFS
Network for Greening the Financial System

PRA
Prudential Regulation Authority

PRIIPs
Packaged Retail Investment and Insurance Products (Regulation)

RFR
Risk-Free Rate

SM&CR
Senior Managers and Certification Regime

SSM
Single Supervisory Mechanism

TIBER
Threat Intelligence-based Ethical Red Teaming

TRIM
Targeted Review of Internal Models

UCITS
Undertakings for Collective Investments in Transferable Securities

Contents
Foreword
Cross-sector themes
Supervisory constants
Sector specific developments

Glossary
Contacts



Andrew Bulley
Partner, Centre for
Regulatory Strategy, EMEA
abulley@deloitte.co.uk
+44 20 7303 8760



David Strachan
Partner, Head of Centre for
Regulatory Strategy, EMEA
dastrachan@deloitte.co.uk
+44 20 7303 4791

Contents
Foreword
Cross-sector themes
Supervisory constants
Sector specific developments
Glossary
Contacts



Important notice

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NSE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”).

DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NSE LLP do not provide services to clients. Please see www.deloitte.com/ about to learn more about our global network of member firms.

© 2019 Deloitte LLP. All rights reserved.

Designed and produced by The CoRe Creative Services, Rzeszow 269859