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Risk and Regulation Monthly

This month a number of large **fines** were imposed by the Financial Conduct Authority (FCA), for benchmark manipulation, PPI complaints-handling and breaches of custody rules. Elsewhere the resilience of **central counterparties** (CCPs) continues to move up the regulatory agenda, and the European Central Bank (ECB) reported on the first six months of the **Single Supervisory Mechanism** (SSM).

Capital (including stress testing)

The Basel Committee on Banking Supervision (BCBS) *published* a progress report on adoption of the various **Basel** regulations by Committee members as of end-March 2015. Russia had made least progress: of the 27 member jurisdictions, 23 had completed adoption of Basel II and 2.5, while Australia, Brazil and Japan had met only two of the four Basel III sets of requirements (risk-based capital, systemically important surcharge, liquidity and leverage requirements). Progress across these elements was much more varied across countries. The BCBS also *published* a revised set of Frequently Asked Questions (FAQs) on Basel III monitoring.

In order to improve comparability between banks, the BCBS *removed* six **national discretions** from Basel II, including provisions on the treatment of past-due loans, the definition of retail exposures, and transitional arrangements for corporate, sovereign, bank and retail exposures. It added that banks should continue to derecognise their debit valuation adjustments in full, whether or not they adopted a funding valuation-type adjustment.

The European Banking Authority (EBA) *proposed* updates to the identification methodology for **global systemically important institutions (G-SIIs);** the format and dates for disclosure by G-SIIs; and the indicators of global systemic importance and their disclosure. The updates seek to re-align the EBA's methodology with the BCBS approach, which was revised earlier this year, in part to incorporate a new data template.

The Prudential Regulation Authority (PRA) *published* a supervisory statement setting out its expectations of firms in relation to set 1 of the European Insurance and Occupational Pension Authority (EIOPA) **Solvency II** guidelines. The PRA intends to comply with all Set 1 Guidelines in a proportionate manner as outlined in the consultation paper. The paper provided additional commentary on specific areas, such as ancillary own-funds, group solvency calculation and classification of own-funds.

EIOPA provided an *opinion* on preparation for internal model applications under **Solvency II**. It identified three areas where diverging approaches would lead to inconsistent results, and recommended to the national competent authorities its preferred approach. These areas covered modelling of sovereign exposures; absence of certain formal decisions at EU level (e.g. third country equivalence); and use of comparative studies in analysing internal models. EIOPA also published responses to questions received in relation to the guidelines on *group solvency* and on the classification of *own funds*.

ECRS EMEA Centre for Regulatory Strategy

Gabriel Bernardino, Chairman of EIOPA, *spoke* at the Central Bank of Ireland **Solvency II** forum. Key issues addressed were EIOPA's expectations of the own risk and solvency assessment (ORSA), internal models and reporting; and EIOPA's future role and strategy in developing a harmonised European supervisory culture. At the same event, Cyril Roux, Deputy Governor at the Central Bank of Ireland, *spoke* on "the good, the bad and the ugly of Solvency II". He commented on the "complex" nature of the capital requirements, that the Solvency Capital Requirement (SCR) is an "unreliable" tool to manage capital, and noted that the conditions for authorisation have not been revised from Solvency I.

Liquidity

No new developments.

Governance and risk management (including remuneration)

The PRA *published* a policy statement containing final rules, supervisory statements and a statement of policy on Part 2 of the **PRA Rulebook**. The Rulebook website is due to be launched in Summer 2015. Appended to the policy statement is a table mapping the PRA Handbook provisions to those in the Rulebook, and a *supervisory statement* on internal governance that sets out how firms should comply with the rules in the General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit, Risk Control, Outsourcing and Record Keeping Parts of the Rulebook. The PRA then *consulted* on Part 3 of the Rulebook. The proposed changes are designed to be more concise and stand alongside other PRA published guidance and the Capital Requirements Regulation (CRR), but in general do not represent policy changes.

The Lending Standards Board (LSB) *reviewed* the **Lending Code Governance and Control Framework**. Based on a survey of nine firms, it recommended the Code be updated to provide guidance on the role of Chief Compliance Officers and on firms' expectations for monitoring compliance with the Code. Subscribers should reflect on how their internal assurance framework ensured effective oversight of compliance. The Code should also be strengthened with regard to outsourcing, including provisions covering supplier selection and due diligence requirements, and oversight requirements such as monitoring (quality assurance) by the firm.

The PRA published two supervisory statements on building societies, covering *treasury and lending* activities and the exercise of certain *functions* under the Building Societies Act 1986. The statements set out the PRA's approach and expectations, including on mitigation of risks related to mortgage lending, board and management responsibilities, lending policy, treasury investments and liquidity risk management, and merger and transfer procedures.

Conduct of Business (including MiFID)

The FCA *fined* Deutsche Bank £226.8mn for **manipulation of LIBOR and EURIBOR** (collectively IBOR), the largest fine it has imposed for IBOR misconduct. It found that at least 29 individuals on various trading desks had manipulated IBOR submissions across all major currencies. The breaches were aggravated by a failure to deal with the FCA in an open and cooperative way. The FCA also said that one of the bank's divisions "had a culture of generating profits without proper regard to the integrity of the market".

The FCA *fined* the Bank of New York Mellon £126mn for **failure to comply with FCA custody rules**. Among a number of breaches, the bank did not adequately record, reconcile and protect safe custody assets between November 2007 and August 2013. Specific failures included inadequate separation of safe custody assets from the firm's assets, and using safe custody assets held in omnibus accounts to settle other clients' transactions without the express prior consent of all clients whose assets were held in those accounts. The size of the fine took into account the seriousness of the failures, amplified by the systemically important nature of the firm.

The FCA *fined* Merrill Lynch International £13.2mn for incorrectly reporting about 35mn transactions and failing to report another 121,387 transactions between November 2007 and November 2014. This was the highest fine imposed by the FCA for **transaction reporting failures**. As an input into its calculation of the fine, the FCA used a figure of £1.50 per line of incorrect or non-reported data, rather than the £1.00 used in past cases, which it believed was not high enough to achieve credible deterrence.

The FCA *fined* Clydesdale Bank Plc £20.7mn for not having adequate **Payment Protection Insurance (PPI)** complaint-handling processes between May 2011 and July 2013: the largest ever PPI-related fine by the FCA. In addition the FCA said that "Clydesdale provided false information to the Financial Ombudsman Service [FOS] in requests for evidence for records it held on policies sold to individual customers".

The FCA *fined* Moorhouse Group, a general insurance broker, £159,300 for **failures in the oversight and control of its telephone sales**. The firm did not provide appropriate information on the limitations and exclusions of commercial vehicle add-on products to consumers, and failed to ensure a consistent and effective quality assurance process to monitor sales.

The FCA *finalised guidance* on **Multilateral Trading Facility** (MTF) rulebooks, detailing market conduct requirements and best practices relating to MTF operator rulebooks. The final guidance emphasised that a firm operating an MTF must have transparent and non-discretionary rules and procedures for orderly trading and included changes to rules on fees and incentive schemes, and guidance on publishing an instrument list alongside the instrument eligibility criteria. The guidance included a 'Dear CEO' letter to firms operating MTFs setting out good practice and stating the FCA's expectation that all MTF operators should be able to demonstrate that they had considered the good practice observations when determining their approach.

The FCA *answered* frequently asked questions concerning its implementation of the **Mortgage Credit Directive (MCD)**. The questions addressed the scope of the MCD and the impact it would have on the approved persons requirements, amongst other issues.

The European Securities and Markets Authority (ESMA) *consulted* on draft guidelines on criteria for the assessment of knowledge and competence of investment firms' staff providing investment advice or information to clients under the **Markets in Financial Instruments Directive II** (MiFID II). It considered an individual would need to attain an "appropriate qualification" and "appropriate experience" in order to comply with the requirements. This included an understanding of the key characteristics, complexity, and total costs of relevant products or services; how the market functions, the market structure, and the impact of economic data; how to use relevant data sources and valuation principles; and relevant regulatory requirements. National competent authorities should define the list of appropriate qualifications, or criteria to assess these qualifications.

The Investment Association *published* a statement of **principles for investment managers** setting out what the responsibility of managing other people's money means in practice for corporate culture and individual mind-set. The ten principles included commitments to putting the clients' interests first, ahead of the investment manager's own interests, ensuring services add value for clients or achieve their financial goals, and transparency over all costs and charges. Signatories to the statement will publicly set out their approach to applying the Principles, and confirm annually that processes are in place to ensure compliance.

Crisis management (including special resolution, systemically important firms, and business continuity)

The PRA *set out* rules on **depositor and dormant account protection;** the rules implement the recast Deposit Guarantee Schemes Directive (DGSD). The final rules include a number of changes from the consultation, including additional guidance on the PRA's expectation of how firms meet the disclosure requirements, a new rule to provide a list to depositors of exclusions from eligibility, and an extension to the implementation timeline for the single customer view and continuity of access rules. Most rules take effect from 3 July 2015. The PRA subsequently *consulted* on material changes in the policy proposed, including extending deposit protection to deposits held by local authorities with an annual budget of up to €500,000, and a new requirement for firms to inform depositors of deposits, categories of deposit and instruments no longer covered.

The PRA *finalised* rules on policyholder protection, aiming to align the existing insurance compensation rules more closely with the PRA's statutory objectives and assist the Financial Services Compensation Scheme (FSCS) in providing continuity of cover, payment of benefits falling due and compensation in the event of the failure of an insurer. Changes included extending compensation for all long-term insurance products to 100%. The PRA confirmed it is not introducing a cap on large claims. The rules take effect from 3 July 2015.

The Financial Stability Board (FSB) *launched* the second peer review on bank **resolution regimes** in FSB jurisdictions, in order to understand better the powers that are available to FSB members. It requested comments on the scope and design of guidance by the authorities for entry into resolution and for the exercise of bank resolution powers; and factors that may affect how resolution powers are exercised in different regimes.

The International Organisation of Securities Commissions (IOSCO) consulted on business continuity plans for *trading venues* and *intermediaries*. IOSCO provided an overview of risks related to technology and disruption of critical systems faced by trading venues, and outlined ways to mitigate these risks. The reports proposed recommendations, standards and sound practices that regulators could consider as part of their oversight of business continuity and recovery planning by trading venues and market intermediaries.

Benoît Cœuré, Member of the Executive Board of the ECB, *spoke* about the loss-absorbing capacity of **CCPs**. He asked whether this could be achieved through CCPs observing existing international standards, or whether new, more onerous and specific requirements were necessary. International standards have been "significantly strengthened", but given the role of CCPs "regulators need to think the unthinkable". Global CCP risk-management practices are being reviewed with a view to identifying any areas where greater consistency or granularity is needed. Any further loss-absorption requirements should provide the right incentives for CCPs and their members, offer authorities flexibility, and not create disincentives for central clearing.

The FSB *published* a letter written by Mark Carney, FSB Chairman, which summarised the **progress the FSB** had made on its work plan for the November G20 summit. Among other developments, it had agreed an outline of its first annual report on the implementation of regulatory reforms and their effects. The international standard on Total Loss Absorbing Capacity (TLAC) should be finalised by the Antalya Summit in November. The FSB is coordinating a workstream to promote resilience, recovery and resolvability of CCPs. To address emerging risks, the FSB is prioritising work to understand and address vulnerabilities in capital market and asset management activities, and has agreed a work plan to address misconduct risks.

The G20 *published* a communiqué following a meeting of finance ministers and central bank governors. It supported the appropriate use of macro-prudential measures to address financial stability risks from large and volatile capital flows, and asked the IAIS, the International Association of Insurance Supervisors, to finalize higher loss absorbency requirements for global systemically important insurers by November.

Regulatory perimeter

The UK Government *responded* to the **Capital Markets Union (CMU)** Green paper. It noted that significant sections of the framework to support cross-border flows of capital are already in place, predominantly through the post-crisis reforms, but some barriers remain and that legislation alone will be insufficient to address them. The response was based on three principles; every initiative should aim to contribute to sustainable growth and competitiveness; initiatives must be prioritised on feasibility and impact; and a high burden of proof should be required to create new infrastructure or employ institutional change. The UK priorities broadly overlap with the short and medium term goals of the Commission, but set out several areas where work should not be progressed: namely tax, insolvency, a 29th regime for personal pensions, and the creation of a single supervisor.

The Council of the EU *adopted* the **European Long-term Investment Funds Regulation** (ELTIF), aimed at increasing the pool of capital available for long-term investment in the EU by creating a new form of fund vehicle. ELTIFs will focus only on alternative investments that fall within a defined category of long-term asset classes whose successful development requires a long-term commitment from investors.

The **International Swaps and Derivatives Association** (ISDA) *published* a set of principles to promote consistency in the development and application of centralised trading rules for derivatives, amid concerns that regulatory divergence could lead to market fragmentation, low trading liquidity and overlapping compliance requirements. The principles include that the process for determining the trading liquidity of a derivatives contract should be by reference to specific objective criteria, and derivatives contracts subject to the trading obligation should be able to trade on a number of different types of centralised venue. ISDA also highlighted the issue at its AGM, where it *expressed* the need for cross-border harmonisation in financial regulation, and considered ways of addressing the fragmentation in liquidity pools.

ESMA provided two updates to its questions and answers on **European Market Infrastructure Regulation** (EMIR) implementation. The *first* provided clarification on the clearing obligation and the Regulatory Technical Standards on direct, substantial and foreseeable effect of contracts within the EU. The *second* introduced an additional layer of validation requirements for registered trade repositories under EMIR.

The High Court *authorised* ESMA under **EMIR** to carry out an inspection at the premises of DTCC Derivatives Repository Limited, a trade repository, in England. DTCC had already consented to the inspection. As this was the first such application Mrs Justice Rose set out the principles that apply to this exercise of power, which is part of ESMA's general supervisory functions.

ESMA *recognised* ten **third-country CCPs** established in Australia, Hong Kong, Japan and Singapore. As a result, these can provide clearing services to clearing members or trading venues established in the EU. This is the first time ESMA has recognised third-country CCPs under EMIR.

ESMA *launched* two centralised data projects relating to the **Markets in Financial Instruments Regulation** (MiFIR) and **EMIR**. The Instrument Reference Data Project, which will collect data directly from approximately 300 trading venues across the EU, will provide (from 2017) a central facility for instrument and trading data and the calculation of the MiFIR transparency and liquidity thresholds. From 2016, the Trade Repositories Project will provide a single access point to trade repository data under EMIR.

The **Financial Markets Law Committee** (FMLC) *wrote* to HM Treasury about uncertainty over a number of definitions ("possession", "control" and "excess financial collateral") under the Financial Collateral Arrangements (No. 2) Regulations 2003 and the cumulative impact on the operation of the wholesale financial markets and systemic stability. The legal uncertainty would be exacerbated if – as the FMLC expected – changes brought about by EU financial regulation resulted in an increased use of security financial collateral arrangements.

Hannah Nixon, Managing Director of the **Payment Systems Regulator** (PSR), *spoke* about the regulator's policy approach and key workstreams over the next twelve months, reflecting the policy statement and work programme published in March. These included setting up a Payments Strategy Forum, reviewing control and governance of payment systems, and improving how businesses and individuals access payment systems. 2015 included market reviews on the supply of indirect access to payment systems and on the ownership and competitiveness of infrastructure provision, and on changes to card payment systems related to the introduction of the new Interchange Fee Regulation at the European level.

ESMA *published* a call for evidence on **virtual currency** and distributed ledger technology. ESMA is requesting information on three topics: virtual currency investment products; virtual currency based assets, securities and asset transfers; and the application of distributed ledger technology to securities and investments.

The European Council *issued* a mandate to the European Commission to negotiate an agreement with the US on **reinsurance**. An agreement will be concluded by the Council with the consent of the European Parliament.

Rethinking the domestic and international architecture for regulation

The EBA *reported* on the **convergence of supervisory practices** under the Capital Requirements Directive (CRD IV), the assessment primarily focussed on the Supervisory Review and Evaluation Process (SREP), supervisory stress testing and the ongoing review of permissions to use internal approaches to capital adequacy. EBA observed "significant progress": however, some differences remain in methodologies, practices and supervisory measures. A lack of cooperation, often caused by misunderstandings based on divergent supervisory methodologies, continued to pose challenges in e.g. reaching joint decisions on capital.

The EBA *published* its annual assessment of **EU colleges of supervisors**, responsible for the oversight of cross border banks. These had been important for effective coordination between national supervisors during the 2014 Asset Quality Review and the EU-wide stress test. In 2015, close monitoring of capital plans will be vital as a follow up to last year's stress tests. In addition, supervisors will closely monitor credit risk management and undertake benchmarking of internal model outcomes. The 2015 work programme will also be marked by the new Bank Recovery and Resolution Directive (BRRD) which requires colleges to reach a joint decision on the assessment of recovery plans of cross-border groups. Among the areas for supervisory attention in 2015 were conduct risk, Information Technology risks and effective decisions on recovery plans.

The PRA *published* a policy statement on the **Branch Return**, a twice-yearly exercise aimed at gathering information about the UK activities of such firms. It provided an update on the development of the Return and a final implementing rule.

Ignazio Angeloni, Member of the Supervisory Board of the ECB, *spoke* about the **SSM** and its contribution to international supervisory cooperation. It had already "made decisive steps" towards organisational and operational "singleness" simplifying cross border supervision and bringing together "the expertise and vision of the ECB with the specific experience and knowledge of the national supervisors". Work was still under way on cross-border cooperation agreements among supervisory authorities, including finalising a standard template to be negotiated with non-SSM partners, and the international representation of the SSM.

The ECB *published* its annual report on its supervisory activities in 2014. This reviewed the establishment and progress of the **SSM** and set out its priorities for 2015, which build on the findings of the Comprehensive Assessment, particularly regarding credit risk. Key areas of focus included non-performing exposures, leveraged lending, the effectiveness and robustness of banks' credit risk management functions, viability of business models and profitability drivers, governance at the institutional level and quality of management information. For the "horizontal" activities, a priority will be to foster greater harmonisation of supervisory approaches across the SSM. For further analysis of the SSM's first six months see our paper on *getting to grips with the new regime*.

Sabine Lautenschläger, Vice-Chair of the Supervisory Board of the SSM, *spoke* about the **European banking sector**, stating that “comprehensive regulation and energetic supervision” was needed to ensure stability and functionality of the sector. At the same time, the rules had to be “adaptable” and to allow “room for discretion and provide leeway for a clever supervisor with good judgement skills”. Banking supervision “should take tough but fair action” and create a level playing field. Further work was needed on, amongst others, internal bank models and analysis of the overall effect of regulatory measures.

Vítor Constâncio, Vice-President of the ECB, *spoke* about **financial integration and macro-prudential policy**. He stressed the need for the co-ordination of macro-prudential policies, since inconsistent application could cause negative spillovers and counteract the intended objective to promote financial stability. A framework for analysing cross-country spillovers and the application of reciprocity was under development by the European Systemic Risk Board (ESRB). As the CMU agenda progressed, the macro-prudential toolkit should be extended to the non-banking sector and to market-based instruments to strengthen the overall framework further.

The ECB *announced* its **supervisory fees** for the prudential supervision of SSM-banks in 2014-15, at €326m. €290m, or 89% of the total, was to be recovered from the 123 significant banks directly supervised by the ECB, with the remainder paid by the approximately 3,500 less significant banks. Invoices will be sent in late 2015.

The House of Commons Treasury Committee *published* a letter from Martin Wheatley, FCA CEO, on the risk of conflicts of interest for regulated firms that have taken on **secondees** from advisers and accountancy firms for free or a materially low cost. Mr Wheatley said that the use of “free secondees does not appear to be widespread” and they have not found any evidence that there is a direct link to “customer detriment”.

EIOPA *revised* its **2015 work programme** due to a 7.6% reduction in its budget. It confirmed that Solvency II work will remain at the top of its agenda, but will also be affected. EIOPA noted that 31 projects had been reduced in scope, 12 downgraded and 27 eliminated.

The EBA *revised* its **2015 work programme** due to a 15% decrease in its budget and the receipt of new mandates. The revised work programme added 30 new deliverables, stemming predominantly from the new Multilateral Interchange Fee Regulation and updated technical standards on the liquidity coverage and leverage ratios; delayed 39 deliverables, largely related to CRD IV but also covering BRRD and EMIR; and removed two, including an annual report on the impact of the liquidity coverage ratio.

Disclosure, valuation and accounting

The PRA *consulted* on the consistency of UK generally accepted accounting principles (GAAP) with **Solvency II**. It set out its expectations of firms that are considering applying the derogation in Solvency II that permits firms to value some assets and liabilities using local GAAP if certain criteria are fulfilled.

The EBA *reported* on compliance with its guidelines on disclosure requirements for **G-SIIs**. Eighteen competent authorities currently comply, two partially comply (the PRA and BaFin) and twelve did not respond.

Information security and data privacy

The Chartered Insurance Institute (CII) has released a new *guideline*, relating to requests made under the **Data Protection** Act (DPA). The document aims to improve the quality of data sharing under the DPA, which allows organisations to share data with a third party in order to prevent and detect crime. It is aimed at requests made in respect of claims, underwriting or financial crime within the insurance profession. The guideline has been produced with support from the Insurance Fraud Bureau (IFB).

The Commission *published* a new **European Security Agenda**. EU legislation covering fraud and counterfeiting activities relevant to non-cash payment instruments should be updated to reflect modern payment technologies. In an effort to address the rising threat of cybercrime and payment fraud, legislation originally enacted in 2001 could be broadened to cover a wider range of financial instruments, above and beyond the physical non-cash payment methods that are currently covered, such as credit cards and cheques.

Financial crime

The Council of the EU adopted the draft of the fourth *Anti Money Laundering Directive (MLD 4)* and the *Wire Transfer Regulation* at first reading. The proposals include tighter rules on customer due diligence; new traceability of fund transfer requirements; and higher sanctions, with a maximum fine of at least twice the amount of the benefit derived from the breach or at least €1m.

HM Treasury *published* a revised advisory notice on jurisdictions with strategic deficiencies in their **anti-money laundering** and **counter terrorist financing** regimes. It advised firms to consider Algeria, DPR Korea, Ecuador, Iran and Myanmar as high risk for the purposes of the Money Laundering Regulation 2007, and to apply enhanced due diligence measures.

The FCA *updated* its guidance on financial crime to include examples of good practice from two recent thematic reviews that considered small banks' anti-money laundering and financial sanctions, and small commercial insurance brokers' anti-bribery and corruption systems and controls. The update also clarified the FCA's expectations in some areas where significant weaknesses persist. The FCA subsequently *summarised* the responses it received to the changes to the guidance. Most of the twenty respondents welcomed the proposals, suggesting they would ensure firms approached financial crime compliance in a more proportionate and risk-based way, and implement more effective controls to identify, assess and mitigate financial crime risk.

The FCA *clarified* its expectations over banks' management of money-laundering risks and "derisking". Banks are required to have in place and maintain comprehensive policies and procedures to identify and manage these risks, but the risk-based approach does not require banks to (cease to) deal generically with whole categories of customers or potential customers: there should be relatively few cases where it is necessary to decline business relationships on such grounds. The FCA now considers whether firms' derisking strategies give rise to consumer protection and/or competition issues. The FCA encouraged banks to consult its financial crime guidance to help in adopting proportionate and effective anti-money laundering systems and controls.

Other

The Society of Lloyd's *published* its first **market oversight supervisory plan** to inform managing agents. A key priority includes ensuring that managing agents are prepared for Solvency II. It also intends to conduct thematic reviews during 2015 in certain areas such as reserve adequacy, and governance, risk and operations.

The FSCS *published* its **outlook newsletter** and *announced* its levy for 2015/16 at £319mn. The amount is £32mn more than forecast in the FSCS's Plan and Budget in January. The increase is primarily due to a rise in claims relating to self-invested personal pensions.

The FSB *appointed* the chairs of three of its Standing Committees (SC) as of 1 April 2015. Glenn Stevens, Governor of the Reserve Bank of Australia, was appointed Chair of the committee on Assessment of Vulnerabilities. Daniel Tarullo, Governor of the US Federal Reserve Board, was reappointed Chair of the SC on Supervisory and Regulatory Cooperation and Ravi Menon, MD of the Monetary Authority of Singapore, was reappointed Chair of the SC on Standards Implementation.

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