

**Deloitte.**



**Navigating the year ahead**  
Financial Markets Regulatory  
Outlook 2017

**CENTRE** *for*  
**REGULATORY**  
**STRATEGY**  
**EMEA**

Firms need to refresh their strategies for how they respond to regulation and how they do business in a regulatory, economic and political environment that could be fundamentally more constraining. Not all firms will succeed in doing this in the year ahead. Those that do will be those that find ways of making this new environment work for them, capitalising on their inherent resilience, agility and efficiency.

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# Foreword

2016 has been another difficult year for the financial sector, with economic and political uncertainty complicating the completion of the post-crisis regulatory repair agenda.

A prolonged period of tepid economic growth and persistently low and volatile interest rates has squeezed profitability in some sectors and put significant pressure on longstanding business models and balance sheet management. Firms are further challenged by continuing uncertainty over the final shape of post-crisis financial regulation. While regulators are keen to preserve the hard won reforms of recent years, rising political uncertainty in developed economies (as demonstrated by the UK's referendum decision to leave the EU and the US Presidential election results) has increased the volatility and hence unpredictability of the macro-policy environment. This has caused some to go as far as questioning the sustainability of free trade and open markets.

At the same time, the introduction of new technologies and digital distribution platforms in the financial sector is unleashing disruptive forces, promising benefits to consumers and markets and posing further challenges to the strategies (and margins) of established firms. New technologies also stand to multiply the cyber and IT risks the industry currently faces. Nevertheless, if properly harnessed, these technologies also present opportunities for incumbents which move quickly and wisely to revitalise their business models.

2017 starts with a range of highly anticipated regulatory developments at or near their finalisation. The Basel Committee on Banking Supervision (BCBS) is expected to conclude most of its banking framework; recovery and resolution planning is expected to move closer to being implemented for most large banks and increasingly clarified for non-banks; and markets are expected to continue to shift towards central clearing and higher standards for transparency. How these reforms and new regimes are implemented in national jurisdictions will, however, be more sensitive to concerns about going too far and potentially harming an already weak economic recovery. The risk of the fragmentation of global regulatory approaches.

From a supervisory perspective, compliance with these new requirements is the bare minimum; as important will be firms' preparedness for the unexpected. Supervisors will, more than ever, want to see that firms have in place robust plans for scenarios that could threaten their own stability, or the interests of their customers.

Despite the uncertainty that characterises 2017, one fact is becoming increasingly clear: financial services firms will not be able to wait out this current period of difficulty without taking decisive and, in some cases, bold actions in response.

**Strategies for a more constraining regulatory environment**

Despite the uncertainty that characterises 2017, one fact is becoming increasingly clear: financial services firms will not be able to wait out this current period of difficulty without taking decisive and, in some cases, bold actions in response. 2017 marks nearly a decade since the circumstances surrounding the Financial Crisis began, and many of the problems the industry has faced over the past decade are now starting to look more structural than cyclical. Despite a view in some quarters that the “regulatory pendulum” has swung too far, given the tastes of many politicians worldwide (if not those of supervisors as well), the regulations that have already been implemented to date are unlikely to be materially watered down, at least not soon. If interest rates stay lower for longer in major markets, many bank and insurance business models will need to be rethought. Yet rising interest rates would not be a panacea either, given the pressure it would put on (household) borrowers and counterparties with fragile balance sheets.

As a result, firms need to refresh their strategies for how they respond to regulation and how they do business in a regulatory, economic and political environment that could be fundamentally more constraining. Not all firms will succeed in doing this in the year ahead. Those that do will be those that find ways of making this new environment work for them, capitalising on their inherent resilience, agility and efficiency.

It is in this fluid context that we<sup>1</sup> present the Deloitte Centre for Regulatory Strategy’s EMEA regulatory outlook. This gives our view on how regulatory themes will shape the financial industry in the year ahead and how firms can respond to the challenges they will face.



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# Executive Summary

## Why the problems of the last decade need solutions in 2017

Compared to international peers, European financial services firms have faced a more challenging set of circumstances than most. The largest European firms, particularly banks, have struggled to adjust to the new post-crisis political economy in Europe – characterised by slower growth, lower interest rates and more regulatory uncertainty than in some other jurisdictions. Nearly a decade on from the beginning of the crisis, firms are still grappling with the task of demonstrating sustainable models for achieving both compliance and profitability. These challenges are exacerbated by Brexit and its resulting uncertainty.

There is growing recognition that the challenges faced by many European financial services firms are not cyclical, but are instead, deep, unresolved and structural in nature. Looking at the banking sector in late 2016, the International Monetary Fund (IMF) estimated that even in a cyclical upturn scenario, one third of Europe's banks, accounting for \$8.5 trillion in assets, would remain weak and incapable of generating a return on equity above 7%.<sup>2</sup>

This underlines a renewed impetus in 2017 for firms to develop comprehensive responses to the regulatory and economic headwinds they have faced in the decade since the crisis began.

There is growing recognition that the challenges faced by many European financial services firms are not cyclical, but are instead, deep, unresolved and structural in nature.

### How we see financial regulation in 2017

We have identified three major questions for management and boards in the year ahead:



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**Whether, or how far, the “regulatory pendulum” will swing** – given the subdued economic outlook, especially in the EU, and the associated low interest rate environment challenging the profitability of many firms, will regulators be inclined, or encouraged, to ease the introduction of new rules or soften existing ones? Will this exacerbate international regulatory fragmentation?

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**How to develop sustainable business models** – with economic and regulatory pressures undermining profitability, how can firms re-shape their business models and structures to be more competitive in this new environment while still managing to embed the right culture and practices in their organisations?

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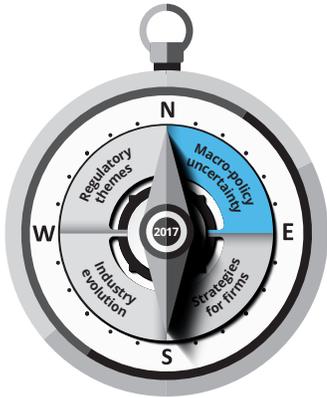
**How new technology will change the financial sector** – how can firms understand the widespread technology-driven change the industry is facing and appropriately harness its opportunities, while also guarding against the risks that will inevitably arise from it?

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None of these questions has simple answers, but the trends that underlie them stand to shape the performance of the European financial sector in 2017 and beyond. Our 2017 Outlook presents what we see as the 11 most pressing issues resulting from these trends. At the core of our Outlook is the belief that to succeed in this challenging environment firms must accelerate strategic choices aimed at improving the way they integrate regulatory and commercial thinking. This is crucial not just for how firms approach their compliance activities, but also for how they design their future business models and strategies.

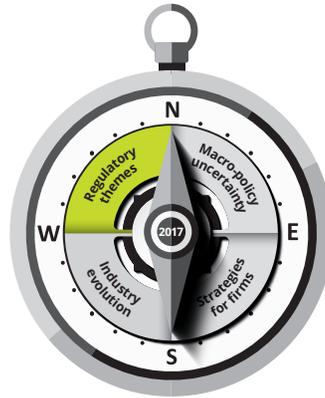
At the core of our outlook is the belief that to succeed in this challenging environment, firms must accelerate strategic choices aimed at improving the way they integrate regulatory and commercial thinking.

The four quadrants illustrated overleaf show how we group the key challenges for financial services firms in 2017, and how we have organised the 11 topics in this publication.



### Macro-policy uncertainty

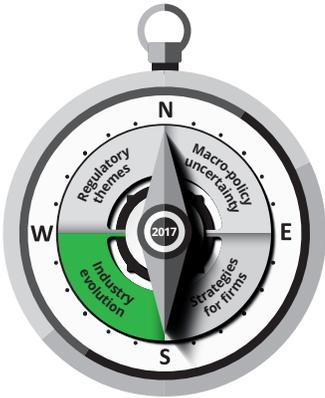
While regulators have increasingly signalled that post-crisis regulation should bed down in the coming years, heightened political risk in developed economies, potentially leading to tectonic shifts such as **Brexit**, challenges the certainty of the regulatory framework and open the door to future divergences between rules set in the UK and EU. We do not expect UK regulatory policy challenges in 2017 as the UK government begins exit negotiations with the EU, but supervisors will closely monitor how firms are preparing to deal with an extended period of uncertainty and the unpredictability of Brexit's eventual outcome.



### Regulatory themes

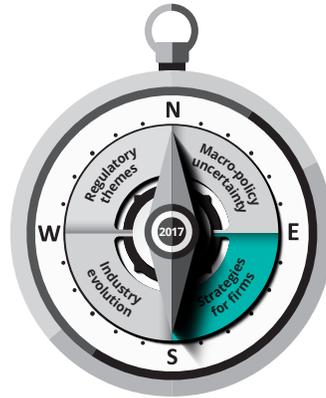
We have identified five regulatory themes for 2017. We see **resolvability** as the main driver of structural reform (at least outside of the UK), as the Single Resolution Board (SRB) starts to ask Eurozone banks to make changes to address practical impediments in this area and central counterparty (CCP) recovery and resolution rulemaking gets underway in earnest in the EU. When the BCBS completes its final package of rules on capital and risk measurement, the **financial resilience** agenda will be largely concluded at the international policy-setting level. But the EU will consider carefully which elements of the package to adopt as it takes into account its own priorities. Efforts to design methods that adequately address **conduct and culture** in firms will continue, and prudential supervisors will increasingly hold firms accountable for the risk of conduct failures. In particular, supervisors will not let up on their pressure on boards to promote an appropriate culture through setting the right tone and example “from the top”.

On the frontier of **new technologies**, EU regulators will take a more active role in supporting innovation and FinTech entrants, but will also begin to consider risks arising from new technologies and distribution platforms and how they should respond. Expectations for **cyber and IT resilience** will become clearer as UK and EU supervisors begin to articulate increasingly detailed expectations for how firms assess and respond to cyber and IT risk.



### Industry evolution

The adoption of post-crisis regulation is not simply challenging individual firms, but is increasingly changing the structure of the market for financial services itself. With a new payments landscape prompted by the implementation of the second EU Payment Services Directive (PSD2) and greater transparency around the pricing of products, new rules are **opening up markets** and sharpening the competitive environment that firms face. The entry into force of the central clearing and margining requirements will reach an inflection point in 2017 and the **evolution of the trading landscape** will pressure market participants to restructure their product offerings.

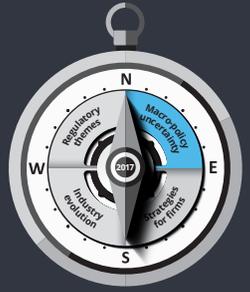


### Strategies for firms

Almost ten years since the beginning of the financial crisis, a top theme for 2017 must now be how firms are designing strategies for the medium-to-long term. Firms will have to consider how they employ RegTech solutions to improve the **efficiency of their regulatory controls**. They will equally have to think more carefully about how they join up regulatory and commercial considerations in the **sustainability of their business models**. As supervisors are looking more closely at intra-group relationships and for subsidiaries to demonstrate their ability to act independently of their parents, a new focus is required on **governance strategies**, enhancing effective challenge and simplifying organisational complexities, is required.

Well considered strategies across these three areas will form the basis of how the most successful firms adapt to the challenging regulatory and commercial environment they face as the post-crisis era enters its second decade.

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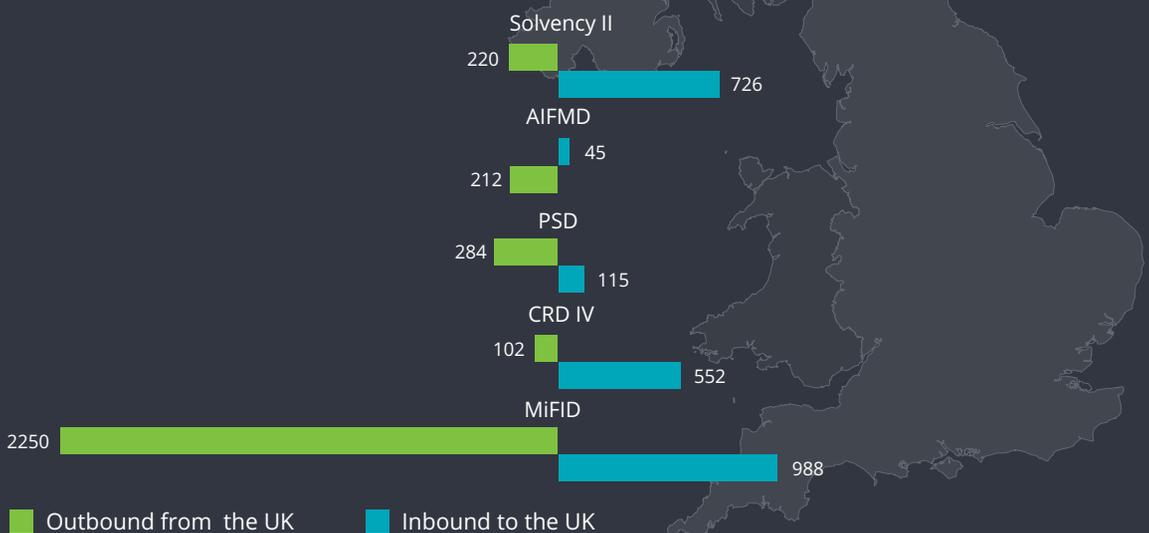


# Brexit

Prolonged uncertainty is here to stay

- Even if Article 50 is triggered by March 2017, exit negotiations are likely to be influenced by the newly elected leaders in France and Germany.
- The UK's status on leaving the EU and the existence of any transitional period will only become clear towards the end of negotiations.
- Persisting uncertainty on EU market access will pressure some firms to start implementing their contingency plans in the course of 2017.
- Supervisors around the world will continue to monitor closely the Brexit contingency plans of the firms for which they are responsible.

## Number of firms with at least one market access passport under each EU Directive<sup>3</sup>





For firms considering the strategic and regulatory implications of Brexit, the picture will remain unclear. The decision of the Supreme Court in the UK on whether the government has to involve Parliament in the decision to trigger Article 50 may complicate its intention to do so by the end of March 2017. Even if there is no delay, we expect that the forthcoming elections in France and Germany will mean that negotiations may need to be “reset” to reflect the views of elected leaders. Even at that point, however, uncertainty over the outcome of the talks is likely to persist until very near their conclusion. In the absence of meaningful clarity about the UK’s future relationship with the rest of the EU in 2017, many firms will feel significant pressure to start implementing their contingency plans.

To understand the strategic and operational implications of a “hard Brexit”, firms must consider a radical scenario in which no two-way market access is available at the end of the two-year negotiation period. This scenario can then be flexed for more favourable market access arrangements if and when they emerge. Contingency plans of other players in the financial ecosystem, and of the customer, also need to be taken into account.

While we do not expect UK regulators to make policy changes in response to Brexit, they will continue to have regular conversations with firms to understand their Brexit contingency plans and the possible resulting shape of the future financial services industry in the UK. Elsewhere in the EU, finance ministers and supervisors will have to determine their risk appetite to accept firms, products and activities onto their “national balance sheet”, which, in turn, will be heavily influenced by the resolvability agenda. Some supervisors will need to expand and upskill their workforce to enable them to deal with new entrants. Lead times on authorisations, model approvals, senior management hires and leases of suitable premises in EU relocation destinations will be material considerations.

However, even if there are no immediate changes to the UK’s regulatory policy, 2017 may give some indication of the stance the UK will adopt once it has left the EU. The European Commission’s Capital Requirements Directive (CRD) V / Capital Requirements Regulation (CRR) II package will only start to be negotiated in earnest in 2017, and is unlikely to enter into force until after the UK has left the EU. The same applies in even greater measure to the unfinished business on the BCBS’s agenda. Any pointers from HM Treasury or the Bank of England (BoE) as to how they intend to implement the new requirements (e.g. by introducing greater proportionality and flexibility in the use of internal models and to facilitate their adoption by challenger banks) will be an important indication of the UK’s approach to regulatory policymaking as a non-EU state.

# Brexit

## Sector impacts



### Banking and Capital Markets

In the event of a “hard Brexit”, banks will lose their market access rights under the EU’s CRD IV to offer core banking services or establish a branch in any EU country. This will affect UK-based banks accessing the EU market, and vice versa. While equivalence under the Markets in Financial Instruments Directive (MiFID) II might allow some wholesale services on a cross-border basis, a number of core banking activities, including deposit-taking, lending and payments, are uniquely covered by the CRD IV passport and stand to be most affected.

A significant number of non-European Economic Area (EEA) headquartered firms use London as their base to access the rest of the EU. Indeed, many EEA headquartered firms also use London as a base to serve EEA clients, particularly for certain wholesale services. These firms face tough strategic decisions regarding possible relocation of activities, legal entity structures and future business model. The prospect of further fragmentation of capital and liquidity will undoubtedly raise questions regarding the future viability of some products and services. There may also be some relocation of activities to non-EEA financial centres where the nature of the activity does not strictly require it to be carried out or booked within the EEA.

In addition, if firms decide to establish new entities as part of their post-Brexit market access arrangements, they will need to be mindful of the resulting impact on their resolvability. Many firms, particularly the globally systemically important banks (G-SIBs) have been pushed to simplify their structures to improve resolvability. It will be essential for firms to design and implement their post-Brexit structures in a way that does not undermine this progress.



### Investment Management

The impact of Brexit will be greatest for UK firms providing services to EU retail clients because there is no third country passport available for such business. Some UK firms may need to set up Undertakings for Collective Investment in Transferable Securities (UCITS) funds, an UCITS management company and an EU-based distributor. In most cases portfolio management could still be delegated to a UK entity. For non-retail business, the impact of Brexit will be partly mitigated if the UK is granted equivalence under MiFID II and the Alternative Investment Fund Managers Directive. EU firms would also lose their passports to access the UK and may need to establish a greater UK presence, although the UK’s national regime for third country firms is comparatively open.

Brexit contingency planning should consider the wider changes in the financial ecosystem, which might affect how investment managers access trading, clearing and custody services.



### Insurance

The impact of the loss of passporting under Solvency II will depend on each firm's business model. Typically, life insurers tend to carry out their business in overseas markets through locally incorporated subsidiaries, while general insurers are more likely to use their EU market access freedom to establish branches in other countries. Solvency II also allows branches of third country insurers to do cross-border business in the EU if they meet certain conditions. This means that UK insurers doing business across the EU may need to consider where best to locate such a branch. If the UK is granted equivalence under Solvency II, this will have a number of benefits relating to reinsurance, group capital calculations and group supervision.

Brexit may influence current efforts to reduce the interest rate sensitivity of the Solvency II risk margin, which the UK authorities have publicly stated to be an important policy objective. The European Insurance and Occupational Pensions Authority (EIOPA) will continue to consider this issue, but the UK's impending exit may limit the momentum of what is a key workstream for the UK life sector.

To understand the strategic and operational implications of a “hard Brexit”, firms must consider a radical scenario in which no two-way market access is available at the end of the two-year negotiation period.

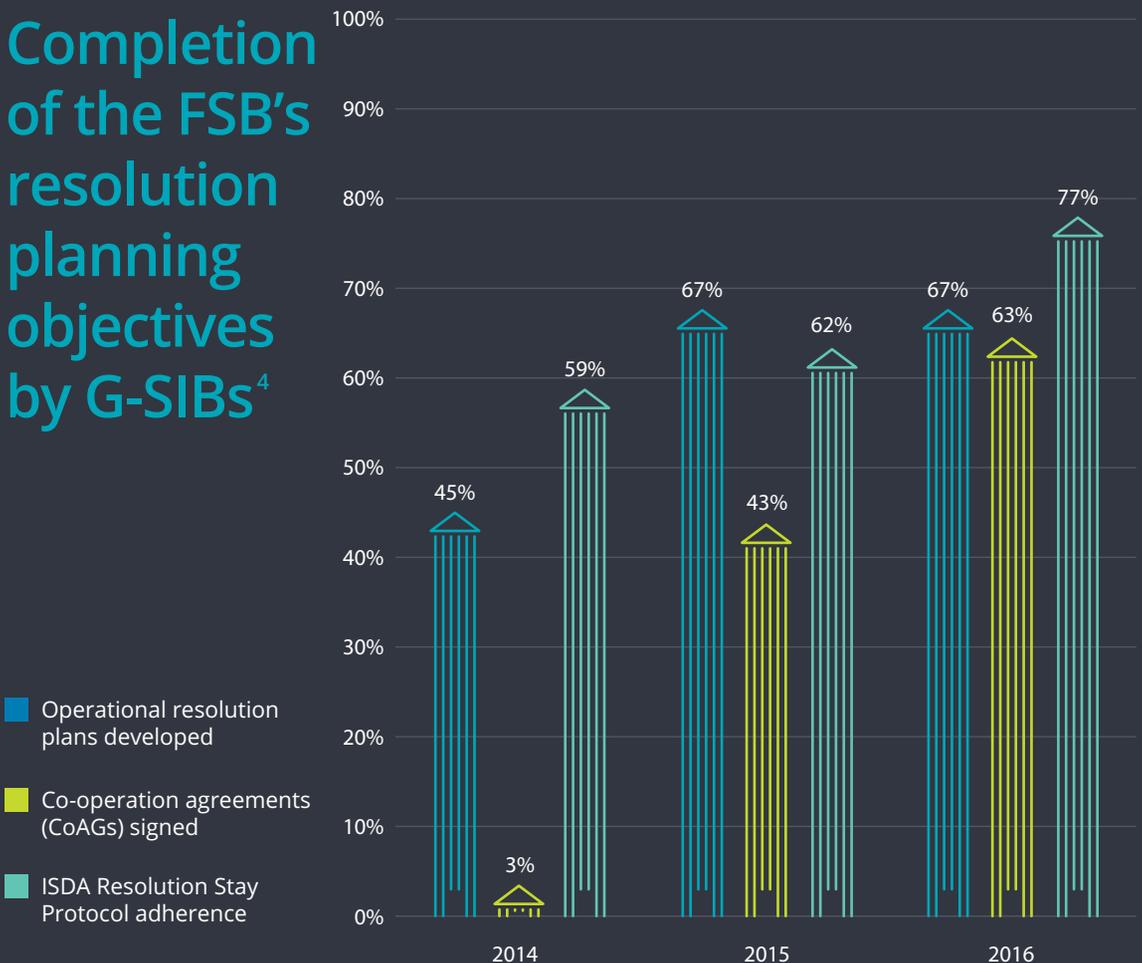


# Resolvability

## Europe test-drives bank resolvability

- The EU’s BSR proposal will remain stuck and regulators will instead focus on resilience and resolvability.
- The SRB will start to press Eurozone banks to become more resolvable and meet interim MREL targets.
- Banks will have to show they can overcome practical obstacles to resolvability.
- CCP resolution will come into focus with EU and FSB level rule development.
- Insurance resolvability will continue to lag significantly behind that of banks and CCPs.

## Completion of the FSB’s resolution planning objectives by G-SIBs<sup>4</sup>





While the focus of new regulation has been on making institutions less likely to fail, failure will not always be avoided. Indeed, regulators are not trying to run a “zero failure” regime. Rather, the ambition is to build a framework in which firms can fail without an excessive destabilising effect on the wider system, through the process of resolution. The importance of efforts to make institutions resolvable is underlined by the continuing fragility of the banking sector in Europe; recent banking failures elsewhere in the world, such as in Kenya, also serve to highlight the relevance of resolvability beyond the EU and US.

Despite several years of work to build new resolution regimes, resolvability still has a long way left to run, and the real structural implications for firms have not yet played through. At least for banks, this should begin to change in 2017. In the Banking Union, the SRB will provide the largest banks with the findings of its first resolvability assessments, including statements of any “material impediments”, which those banks will then need to address. Similar conversations will continue in the UK, where the BoE has been engaged with the largest banks bilaterally for some time now. But the US will remain further ahead, driven by its more challenging hurdle of Title I resolution. The US process will also remain more public than elsewhere. However, if economic circumstances in the Eurozone do not improve, the SRB may be the first to gain practical experience of resolving a bank, providing a major test of its operational capabilities.

Attention is turning to the practical side of resolvability: this goes beyond having a plan on paper. Banks will have to demonstrate that they are able to provide the relevant data in short periods of time, carry out the necessary valuation exercises, clearly articulate booking models and related processes, convene the right governance processes, and more.

As a result, resolvability will start to become more tangible under “business-as-usual” circumstances, as banks engage in testing, and work to embed resolvability drivers into risk management practices. Resolvability also needs to be fully incorporated into business models, along with the ongoing costs it will entail.

With this in mind, resolvability is set to overtake ring-fencing as the main driver of structural reform for banks in the EU. After 18 months of stalled negotiations, the EU’s Bank Structural Reform (BSR) Regulation (“Liikanen”) will continue to drift and its objectives will likely be pursued through resolvability powers in combination with the existing prudential regime. UK regulators, however, will continue to push for the timely implementation of ring-fencing for the largest UK banks, and will be watching closely for any signs of slippage or heightened execution risk.

# Resolvability

## Sector impacts



### Banking and Capital Markets

Banks are most immediately affected by resolvability, as we expect resolution authorities to start pushing them to improve their capabilities and preparedness following resolvability assessments carried out in 2016. We expect the agenda to be dominated by six drivers of resolvability: legal entity structures, operational complexity, loss-absorbing capacity, liquidity management, booking models and data, reporting and valuation capabilities.<sup>5</sup> Banks' long wait for target levels for the minimum requirement for own funds and eligible liabilities (MREL) will come to an end, although the picture will be complicated by the EU's efforts to incorporate the international Total Loss-Absorbing Capacity (TLAC) standard into EU legislation. In addition, the EU's recent proposal to require most foreign banks to house their EU operations under a local intermediate parent undertaking adds a further layer of uncertainty over the structural changes banks will need to make in order to be considered "resolvable".

CCPs are the next priority, with significant policy development expected in 2017 at the international level, but also in the EU as negotiations get under way on its recent legislative proposal on recovery and resolution for CCPs. CCPs and their members will need to adapt to the prospect of resolution authorities retaining a significant degree of discretion to intervene, including regulatory powers to amend the terms of derivatives contracts.



### Investment Management

Investment managers are not subject to the same intense scrutiny of their resolvability as banks. However, the Financial Stability Board (FSB) has suggested that national authorities should introduce requirements (or guidance) for investment managers that are large and complex or are providers of critical services to have robust contingency plans to enable the orderly transfer of their investment mandates in stressed conditions – an area of increasing supervisory focus. In the EU, some investment managers are already required to produce recovery plans under the Bank Recovery and Resolution Directive. The FSB is also conducting work on assessment methodologies for non-bank non-insurer (NBNI) global systemically important financial institutions, which may yet capture larger investment managers.



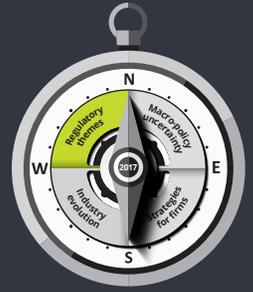
### Insurance

From a structural reform and resolution perspective, insurers have been a lower priority in the last five years than either banks or CCPs. Nevertheless, insurance supervisors are likely to have learned valuable lessons from the roll out of the Global Systemically Important Insurers (G-SII) initiative, as well as from the implementation of bank resolution regimes in recent years. We expect to see these influence their practical approach and requirements in their day-to-day supervision of non-GSIs with large domestic footprints. In particular, this is likely to be felt most keenly in supervisory dialogue in the areas of outsourcing, intra-group financial flows and recovery/run off planning.

Attention is turning to the practical side of resolvability: this goes beyond having a plan on paper. Banks will have to demonstrate that they are able to provide the relevant data in short periods of time, carry out the necessary valuation exercises, clearly articulate booking models and related processes, convene the right governance processes, and more.

# Financial resilience

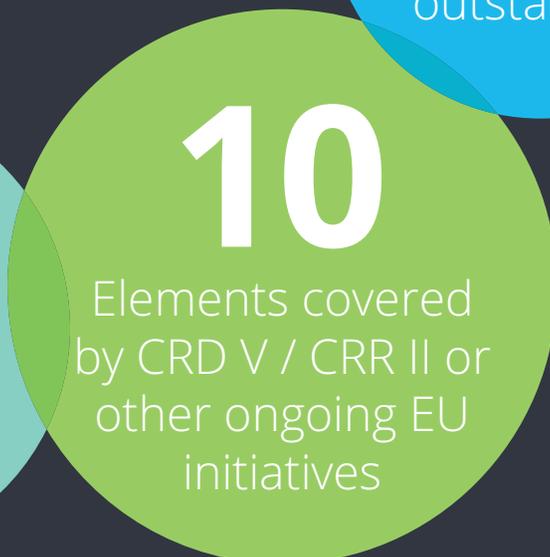
Significant implementation challenges ahead



- The BCBS will finish most of its work on measuring risk weighted assets.
- The EU will consider carefully its adoption of the BCBS standards as it takes into account its own economic priorities.
- Uncertainty over the final shape of EU capital rules will make it harder for institutions to model their impact.
- Adoption of TLAC, MREL and IFRS 9 will require greatly enhanced balance sheet management capabilities.
- In the EU, comparability of internal credit risk models and enhancement of the Pillar II framework will remain high on the agenda.

## Status of the EU's adoption of elements of the Basel III framework<sup>6</sup>

As at December 2016





Even though regulators are clear that overall bank capital requirements have reached their steady state levels, financial resilience remains a priority and significant policy development at the EU and national levels is still due to occur in the coming years.

In 2017, we expect the BCBS to finish most of its work on the post-crisis capital agenda, with its standards on the revised approaches for credit, market and operational risks and capital floors likely finalised by early 2017. However, uncertainty will persist around implementation of the Basel standards in the EU. The European Commission's CRD V / CRR II proposal makes a meaningful step forward in terms of implementing measures such as the Net Stable Funding Ratio, TLAC, the BCBS's Fundamental Review of the Trading Book (FRTB) and a binding leverage ratio. The omission, however, of the BCBS's aforementioned work from this proposal will inevitably raise questions about the EU's approach to the final phase of the bank capital agenda. Ultimately, we expect that the EU will implement most BCBS standards, but it will likely do so more slowly than expected and with exceptions where EU economic priorities are at stake.

A further challenge for EU banks' resilience comes in the form of the legacy of non-performing loans (NPLs). The European Central Bank (ECB) estimated that at the end of 2015, the 130 largest Euro area banks held around €1 trillion of impaired assets.<sup>7</sup> Following its consultation on NPLs, which closed in September 2016, the ECB will expect banks to apply its guidance in line with the scale and severity they face and put in place appropriate governance and operations structures to deliver effective NPL solutions. At the same time, the implementation of International Financial Reporting Standard (IFRS) 9, the International Accounting Standards Board's (IASB) response to the financial crisis, will have to be completed and applied consistently across countries and type of firm. Given the judgment involved, it will inevitably take time for the new approach to bed down and meet the expectation of all stakeholders, including regulators.

Solvency II will enter its second year of implementation, and its effects will continue to be scrutinised, both within the EU and elsewhere. In the UK, the Treasury Committee's review of Solvency II will give rise to a report in 2017. The review's Terms of Reference place particular emphasis on the impact of Solvency II on the competitiveness of the UK insurance industry. The findings are likely to address the design of the risk margin, which has caused concerns shared by the Association of British Insurers and the Prudential Regulation Authority (PRA), and reporting requirements.

Ultimately, we expect that the EU will implement most BCBS standards, but it will likely do so more slowly than expected and with exceptions where EU economic priorities are at stake.

# Financial resilience

## Sector impacts



### Banking and Capital Markets

As noted earlier, there will be a delay between the completion of the final phase of BCBS's work on bank capital standards and their implementation in the EU. Despite this, any relief for EU banks may be limited. Experience with the first phase of Basel III indicates that investors will watch closely the convergence of banks towards the fully loaded Basel standards, and are likely to require, at least for the largest globally active banks, significant frontloading, in effect reducing or eliminating the benefit of any transition period.

As a result, EU banks need to be ready to calculate capital requirements using the new standardised approaches (a significant challenge for some) and for new rules constraining the use of internal models. The work to inform this should feed into early decisions around whether or not advanced approaches, with all their risk management benefits, look sufficiently attractive for banks to maintain given the burdensome approval processes. For banks in the Eurozone, this will coincide with the ECB's Targeted Review of Internal Models (TRIM) exercise. This will be a significant drain on resources for banks and supervisors in 2017, although the consequences of TRIM – revisions to models and possible re-assessment of approvals – may not bite until the following year. All this comes at a time when IFRS9, preparation for implementation of the FRTB and stress testing will also demand model developments.

2017 will see a further development in stress testing as the BoE introduces its first "exploratory scenario" for the largest UK banks. We expect this to challenge the banks around modelling, resources and data. Although the read-across from the scenario to other banks is limited, we see this as part of a general trend of supervisors, including the ECB, to "raise the bar" in terms of their expectations for stress testing. The ECB is currently making a significant investment in its capacity and capabilities to run stress testing exercises, ahead of the next EU-wide exercise in 2018. The BoE will publish a further iteration of its stress testing approach document in 2017, which we expect to tackle systemic risk and risks beyond the banking sector for the first time. More immediately, greater attention will be paid by supervisors to the internal liquidity adequacy assessment process (ILAAP) in the next supervisory review and evaluation process (SREP) round, driving increased focus on liquidity stress testing.

With an implementation date of 1 January 2018, banks will be looking to embed their IFRS 9 models into business as usual, increasingly using the output from these models to inform forecasting and stress testing (within the internal capital adequacy assessment process (ICAAP)), and for management purposes to better understand the expected increase in volatility of impairment provisions and manage the higher impairment provisions after transition.



### Investment Management

European investment firms that are subject to the CRR and are struggling with the same implementation issues as banks may see some respite on the horizon. The European Commission will spend the early part of 2017 investigating options to create a separate prudential framework for non-systemic investment firms that could significantly lessen the financial and operational burdens they currently face under the CRR. Legislation will take longer to materialise, but a proposal could come before the end of the year. Non-systemic investment firms have already won some respite, as the Commission's recent CRD V / CRR II proposal scopes them out from applying any of the new requirements.

Regulators are also continuing to focus on risks associated with liquidity in investment funds. The FSB has asked the International Organization of Securities Commissions (IOSCO) to review its fund liquidity stress testing guidance in 2017. It also recommended that authorities should widen the availability of liquidity management tools such as swing pricing, redemption fees, gates and suspensions, and ensure that funds' assets and investment strategies are consistent with redemption terms. The Financial Conduct Authority (FCA) has indicated that it may propose new rules relating to liquidity mismatch in commercial property funds in 2017. The new rules could potentially include restrictions on the circumstances in which these funds can offer daily redemptions.



### Insurance

The UK has by far the most model-intensive insurance market of the Solvency II jurisdictions. The approval last year of 19 internal models, together with the matching adjustment approval process, is likely to have two distinct practical consequences. First, supervisors will be scrutinising model change applications to ensure that they are not leading to systematic model drift. Second, the introduction of the matching adjustment regime has significantly curtailed the degree of liquidity premium that certain illiquid assets, most notably Equity Release Mortgages (ERMs), can attract in the solvency calculation. This has, in turn, shone a spotlight on the stressed capital modelling assumptions to be applied in cases where there are thin markets and hence limited market price valuation bases.

The UK's PRA has initiated a discussion process which is likely to lead to a formal consultation exercise on future valuation approaches. This could lead to a strengthening of capital and valuation requirements, although given the significance of these asset classes, and the wider macroeconomic desirability of promoting insurer investment in infrastructure assets, some transitional arrangements may also be considered.

2017 will also see Internationally Active Insurance Groups (IAIGs) starting to report private data relating to the Insurance Capital Standard ("ICS") that the FSB has asked the International Association of Insurance Supervisors (IAIS) to develop and will also see a comprehensive consultation initiated on the shape of a common supervisory framework ("ComFrame") for international insurers, with adoption planned for 2019. In the meantime, the debate will continue as to the eventual standard's approach to valuation and economic capital modelling, creating uncertainty for insurers in the interim as to whether, or how far, the final standard will replicate Solvency II and hence align risk management approaches and incentives between the two regimes.

# Conduct and culture

Firms have yet to put misconduct truly behind them



- Firms will need to articulate clearly their conduct risk appetite and embed this into their culture and processes.
- Firms will need to improve systems and controls for managing conduct risk, despite practical challenges.
- Prudential regulators will increasingly hold senior management accountable for ensuring the right culture and controls are in place in respect of conduct risk.

Assessed  
conduct risk  
losses for  
EU banks in  
the EBA's  
2016 stress  
tests<sup>8</sup>

€71  
Billion



Improving conduct in financial services firms remains a top priority for supervisors. The potential for the consequences of misconduct (in the form of fines, redress payments and erosion of franchise) to create systemic risks has been prominently highlighted, particularly by the FSB. Firms across jurisdictions must reinforce efforts to tackle poor culture, lack of accountability and misaligned incentive policies or face further intervention. Initiatives to improve conduct and culture have grown globally and greater convergence of approaches may occur. The 2017 workplans of the FSB and IOSCO will introduce measures to maintain the momentum in terms of establishing cultural change and better aligned incentive structures. EIOPA has signalled that a European supervisory culture that promotes consumer protection and enhances stability will be important in the coming years, and the EBA has revised guidelines on internal governance, placing more emphasis on conduct, culture and conflicts of interest.

In wholesale markets, the spotlight will remain on fixed income, currency and commodity markets, with the Global FX Code prepared under the auspices of the Bank for International Settlements (BIS) coming into effect. It remains to be seen whether products and markets other than FX will lend themselves quite so readily to global codes, given that most countries already have (often very different) statutory regimes for fixed income and some aspects of commodity markets. Nonetheless, the BoE has emphasised the importance of market participants creating industry standards and codes that go beyond the regulatory minimum and encourage behavioural and cultural change. The Banking Standards Board (BSB), founded on the participation of leading UK banks and building societies, has also said that its work in developing voluntary standards needs to be differentiated from minimum regulatory standards. This will be a key theme throughout 2017 and will require firms to ensure that good practices are not only promulgated on paper, but are also put into practice. Should firms fail to do so, the FSB has highlighted that the official sector will introduce stricter regulation.

Consistent with this, firms need to continue to step up efforts in terms of establishing their overall conduct frameworks. To drive change, they should articulate conduct risk appetite more clearly and embed it into their processes, management information (MI) and decision-making, providing sufficient granularity for staff to understand its application.

In its draft Mission Statement, the UK's FCA has also proposed a greater focus on vulnerable retail consumers. While certainly not a new consideration, firms in the UK will have to embed the identification of vulnerable customers into their approaches and processes which in some cases may require significant investment in improving data quality, analytics and staff training.

# Conduct and culture

## Sector impacts



### Banking and Capital Markets

Regulators are showing willingness to draw a line under previous episodes of misconduct, provided that this can be done in a way that is fair to affected customers. The FCA has proposed a deadline for redress for payment protection insurance (PPI) mis-selling. But in some other areas, banks will have to establish remediation programmes, for example for the treatment of some cases of mortgage payment shortfalls in the UK and the mis-selling of interest-rate derivatives in the Netherlands. And it is likely that new areas of misconduct will emerge in 2017. For example, investigations into investment banks' trading and clearing of interest rate swaps may give rise to enforcement actions in 2017.

In the UK, the FCA has made it clear that firms should ensure lessons learned from the FX remediation programme are applied right across their organisations. Included in the requirements are assessments of front office culture and financial incentives. For large and complex firms, this will be a significant programme of work, but it signals the importance that firms should attach to learning lessons both from what has gone wrong in the past and "near misses" to avoid recurrence.

Banks must continue to consider conduct and operational risk in ICAAP assessments and supervisory stress tests. Given the difficulty of measuring these risks – and differences of approach – there may continue to be divergence between banks' and supervisors' assessments. For example the EBA's 2016 stress tests resulted in an additional €71bn in assessed losses under the adverse conduct risk scenario for the participating banks, whilst the BoE's stressed tests identified £40bn of additional conduct costs for the seven banks participating in its exercise.



### Investment Management

As the deadline for MiFID II draws closer, investment management firms will be accelerating their implementation plans. For example, firms will need to enhance their product governance processes, upgrade their systems to disclose more detail on their costs and charges and upgrade their best execution policies and monitoring processes.

The UK Senior Managers and Certification Regime (SM&CR) will be extended to investment managers in 2018, with consultation likely in early 2017. Firms which seek to be well prepared will start to review their organisational structures and identify who will be a Senior Manager and how key responsibilities will be allocated.

In 2017, under the Financial Advice Markets Review (FAMR) there will be more work to support firms offering more affordable advice and guidance services.

The prevailing low or negative interest rate environment will see continued heightened demand from investors as they "hunt for yield", sometimes through higher risk products. Investment managers and distributors should ensure that promotional material is clear about the risks investors are taking to avoid potential vulnerability to mis-selling claims.



### Insurance

Sales practices will remain high on EU supervisors' agendas. Firms will need to prepare for the implementation of the Insurance Distribution Directive standards on product governance, disclosures and conflicts of interest. EIOPA is bolstering its efforts on consumer protection and has made this a strategic priority for 2017. This will mean senior management taking responsibility for ensuring adequate product oversight and governance arrangements throughout the life of a product.

In the UK, the FCA's focus on the oversight of delegated authorities and appointed representatives will also result in Managing General Agents (MGAs) and brokers needing to enhance controls to oversee their delegation arrangements.

Pensions and long-term retirement savings are key regulatory priorities and the UK FCA has confirmed that they are top of the list in terms of their importance to society. In 2017, it will launch a strategy on the ageing population aimed at securing improved outcomes for older people. Firms may see further regulatory scrutiny of products and services offered to older consumers.

Pension freedoms may increase the risk that consumers will not understand the different options available to them and the associated costs and benefits, creating more risks that firms will have to manage in their sales.

EIOPA is bolstering its efforts on consumer protection and has made this a strategic priority for 2017. This will mean senior management taking responsibility for ensuring adequate product oversight and governance arrangements throughout the life of a product.

# Regulation of new technologies

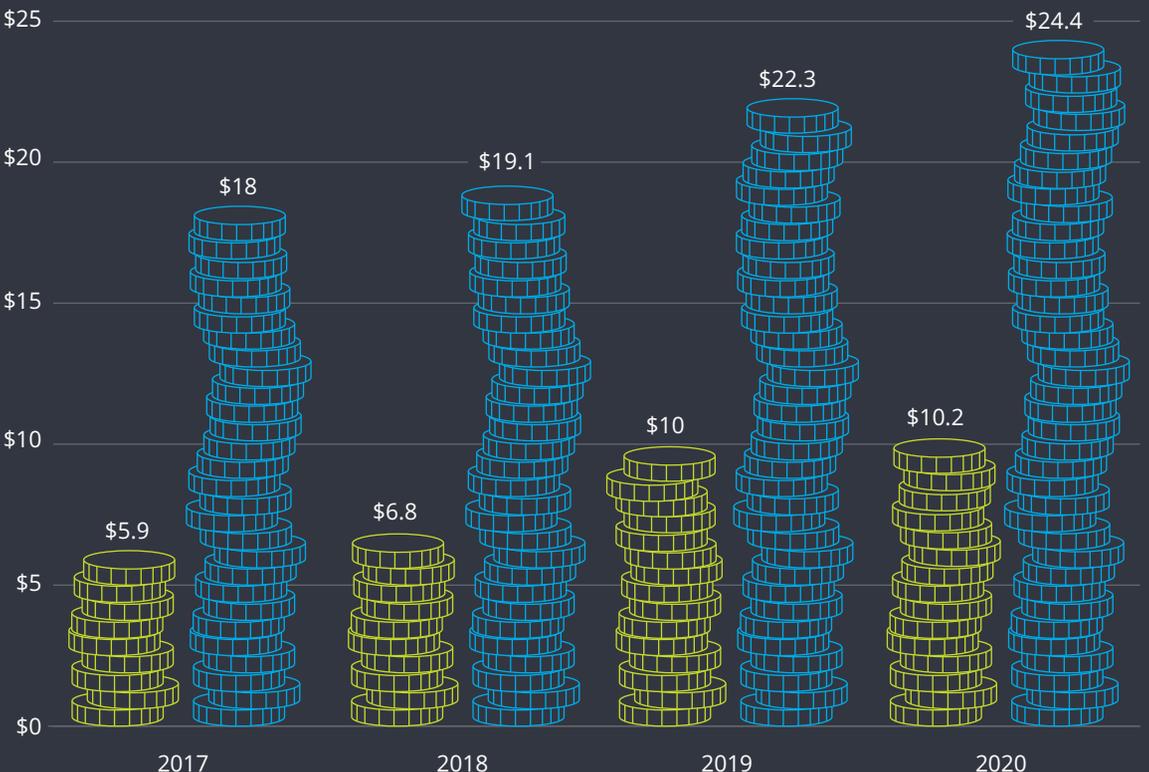
## The tricky business of keeping up with the times



- National regulators in Europe will take a much more active and engaging role to understand emerging inherent risks and regulate as necessary.
- Industry standards of communication for third party access will be crucial for both FinTech firms and banks if they are to succeed in exploiting the opportunities presented by PSD2.
- As firms harness AI and data analytics to offer tailored customer experiences, supervisors will focus on the unintended consequences these may bring.

## Total projected value of FinTech investments (in USD \$ billions)<sup>9</sup>

EU countries   
United States 





Regulatory and political support for innovation and competition will remain very high, and regulators in continental Europe, which have so far taken a less active approach than the UK, will become much more engaged. French and German regulators recently established dedicated FinTech units, and Switzerland is considering a special licence and a tailored regulatory regime for providers of innovative financial technologies. Similar initiatives in other countries are likely to follow as they seek to stay in step with disruption.

Regulators will adopt a proportional approach in their oversight of financial innovation, with a view to stepping up regulatory engagement as technologies approach, as the European Securities and Markets Authority (ESMA) said recently, a “tipping point”, such as gaining the potential to pose systemic risk. This will not materialise in 2017, but the implications of a widespread adoption of new technologies will feature more prominently on the regulatory radar, and monitoring will intensify, both at micro and macro level. This means that the boards and senior management of large FinTech firms need to prepare for this increased scrutiny.

The FSB is closely monitoring FinTech’s potential risks and benefits to financial stability, with a particular focus on Distributed Ledger Technologies (DLTs, including “blockchain”), peer-to-peer lending and Artificial Intelligence (AI). The European Commission will set out its initial views on the impact of FinTech on the financial services industry, as well as possible policy measures. As part of this, regulators will also start to express clearer positions on whether specific uses of DLTs warrant a regulatory response. Firms developing Proofs of Concept should focus on engaging closely with regulators to discuss challenges, solutions and what an adequate, and internationally consistent, regulatory approach could look like.

The European Supervisory Authorities (ESAs) are working to assess the implications of AI and the use of Big Data, paying particular attention to the lack of transparency around how data are processed and used, the impact on customers’ ability to access products and security and privacy concerns.

In the UK, the FCA launched a Call for Input on crowdfunding, signalling its intention to consult on rule changes to reflect the growth of the sector and the associated risks, including the mismatch between the maturity of the loans and the promises of liquidity made to investors.

Innovators will have to prove to supervisors that they understand the risks inherent in their business model and technology, and that their culture, systems and controls take into account the interests of their customers and market integrity. FinTech start-ups in particular will quickly have to learn how to determine, to their supervisors’ satisfaction, the right balance between risk and reward.

# Regulation of new technologies

## Sector impacts



### Banking and Capital Markets

PSD2 implementation will be a challenge for both retail banks and FinTech firms. A key issue will be the lack of detailed requirements in the EBA draft Regulatory Technical Standard (RTS) on authentication and communication. To avoid introducing unintended obstacles to future technological innovation, the EBA has eschewed prescriptive requirements around communication interfaces between banks and Third Party Providers (TPPs). The absence of detail could, however, lead to fragmentation and a lack of interoperability between TPPs and banks, to the detriment of all stakeholders, including consumers. If this approach is upheld in the final RTS, we will see a strong push from banks, which need to build the interfaces and face the strategic decision of whether or not to act as a TPP themselves, to develop industry standards to address this concern. In the UK, the Open Banking Standard initiative will lead the way.

In capital markets, ESMA will take a view on whether a regulatory response may be needed in relation to the use of DLTs in securities markets. Regulators in one sector should avoid a “siloeed” approach, and instead work with counterparts across other sectors and jurisdictions to develop a common framework within which the technology can safely evolve and thrive.



### Investment Management

Regulators' support for automated advice is spurred by the belief that a level of automation can make financial advice more accessible to consumers currently excluded from it. But questions about how the current regulatory framework applies, in practice, to automated models and whether it is fit to deal with the risks introduced by technology (e.g. the possibility of mis-selling on a wide scale due to the level of automation) need to be answered, to enable the sector to grow and expand.

The Joint Committee of the three ESAs is currently analysing the responses to its Discussion Paper on automation in financial advice and will take a view on whether cross-sectoral action is needed at this stage. In the UK, the FCA's Advice Unit will give regulatory guidance and feedback on the automated advice model of nine selected firms and will also share any insights gained publicly. By the end of 2017 therefore, firms should have greater clarity about regulators' expectations for “robo-advice”, and this may help significantly increase investment in this distribution channel.



### Insurance

New technologies, such as driverless cars, and the Internet of Things will increasingly bear on insurance business models. Applications of DLTs to insurance will also be in focus as insurers explore their potential to bring efficiency and savings, especially through the use of smart contracts.<sup>10</sup> The debate on the regulatory implications of these technologies will intensify, and regulators will have to judge whether their adoption in 2017 is on a scale that warrants a significant change of approach. Our view is that, on balance, this is unlikely.

Although comfortable with the general concept, regulators will also seek to understand better the underlying risks of telematics and the increasing use of Big Data in underwriting, pricing and distribution, including possible unfair price discrimination and the negative effects of increased risk segmentation on customers' ability to access insurance. Insurers will therefore need to understand the implications of these developments for their customers and ensure that all aspects of their conduct practices are transparent and fair

In this regard, EIOPA announced for 2017 a series of roundtables on InsurTech to discuss its benefits and risks to consumers and obstacles to "good" innovation, with the aim of assisting EIOPA's design of an appropriate regulatory framework.

Innovators will have to prove to supervisors that they understand the risks inherent in their business model and technology, and that their culture, systems and controls take into account the best interests of their customers and market integrity.



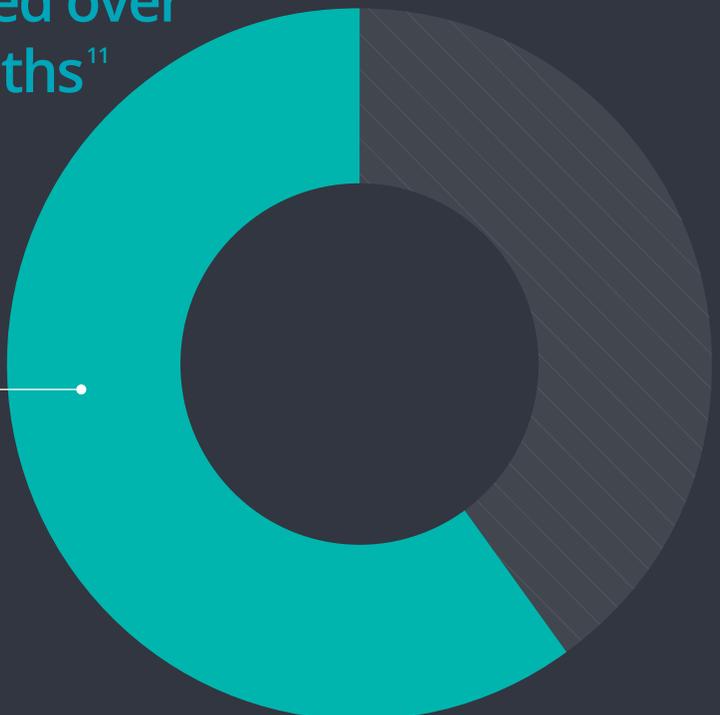
# Cyber and IT resilience

## More specific and more demanding

- The focus of supervisors on cyber resilience will continue to increase.
- Supervisors will begin to articulate more detailed expectations of firms.
- Testing, war-gaming and red-team exercises will be used to show whether resilience plans work.
- Real-time cross-industry information-sharing on cyber threats will become more important.
- Large-scale improvements in IT infrastructure remain costly and will make little progress in 2017.

Proportion of FS EMEA IT risk professionals surveyed that felt their exposure to IT risk had increased over the past 12 months<sup>11</sup>

Over  
60%





Heightened interest in the ability of firms to cope with rising cyber risks and obsolete IT infrastructure set the scene for a more active supervisory approach to these issues in 2017. The \$81 million theft from the Central Bank of Bangladesh using the SWIFT network last year, in particular, will spur supervisors to work more closely together to identify ways in which firms and the financial networks they rely on can become less susceptible to technological failures, cyber-crime and data breaches. These efforts will lead to high-level statements from bodies such as the BIS and IOSCO, while more detailed expectations will begin to emerge from national supervisors who will look to integrate this work into their routine supervision of firms and to identify tangible signs of improvement.

Supervisors expect firms to demonstrate that they have put in place effective threat detection systems, robust plans (including communication plans) to respond to cyber breaches, third party provider risk, internal threats and technological failures and have designed a governance structure that creates appropriate degrees of responsibility and independence among senior management. These plans can be put through organisation-wide tests and red-team exercises, potentially generating rich data to demonstrate the actual resilience of an institution to a hypothetical event. Some firms may choose to integrate this planning into their broader recovery and resolution war gaming. For institutions where a technological failure could pose serious systemic risks (e.g. large banks, exchanges or other financial market infrastructures (FMIs)) supervisors may, building on approaches already taken by IOSCO and US agencies, look for these tests to demonstrate sufficiently short downtimes of less than two hours and high levels of redundancy in systems.

In the UK, the PRA has proposed to designate a “Chief Operations” Senior Management Function under the SM&CR and Senior Insurance Managers Regime (SIMR) responsible for operational resilience and technology security.

This can only serve to increase scrutiny by firms of these areas, in particular to determine what are “reasonable” steps for a Senior Manager to take in relation to operational resilience.

Supervisors will also look for firms to more routinely share real-time information with their peers on cyber-threats as they arise. Jurisdictions that establish cross-industry fora that successfully facilitate this will be quickly copied, and firms that hold back vital information will come under increasing pressure.

More structural threats to the technological resilience of financial services firms, including the obsolescence of their data management, potentially impeding their adaptability in an extraordinary event (including resolution), will be more challenging to address in 2017. Despite the cost of operational failures to the financial services industry, the investment needed to make major upgrades to technical capabilities has been challenging for firms to justify in an environment of weak profitability. Although many firms will commit to significant improvements in this area, large-scale progress by the industry as a whole will not be made before the year is out.

# Cyber and IT resilience

## Sector impacts



### Banking and Capital Markets

Supervisors are likely to scale up their cyber activity at different paces, but banks and FMI should be the first to expect increased scrutiny. The late-2016 consultation by US regulatory agencies on Enhanced Cyber Risk Management Standards cleared a path for more detailed expectations that we expect to see EU regulators follow in the coming year. Most of this activity will likely occur through the normal supervisory process, but could also result in special investigations if certain breaches or deficiencies are identified. The EBA's Guidelines on assessing Information and Communications Technology (ICT) risk as part of SREP is an early example of this trend crystallising.

Besides the scrutiny of plans, routine testing and new internal governance structures that this will bring, banks and FMIs will also feel increasing pressure to appoint someone with practical cyber and IT experience to their board. At a minimum, we expect that boards will be asked to demonstrate that they have access to sufficient cyber and IT expertise to allow them to challenge management in this area.



### Investment Management

Although supervisory pressure, at least initially, will be most focused on banks and FMIs where cyber threats can pose serious financial stability concerns, investment managers should carefully consider the spillover of supervisory expectations into their sector as well. Cyber and IT concerns for investment managers are more likely to materialise around the security of critical client data, and its potential leakage following unintentional or deliberate acts. Third-party providers working with investment managers could also be a source of exposure to cyber risks, and managers may have to increasingly assess whether their vendors have adequate security controls and incident response plans in place.

Supervisors will also look for firms to more routinely share real-time information with their peers on cyber-threats as they arise. Jurisdictions that establish cross-industry fora that successfully facilitate this will be quickly copied, and firms that hold back vital information will come under increasing pressure.



### Insurance

The increasing digitisation of insurance business and more online interaction with customers will open the sector to new sources of cyber and IT systems risks. In keeping with their banking counterparts, insurance supervisors will assess board understanding, oversight and readiness in this area and will look to ensure that insurance firms have appropriate plans in place to protect data as digitisation gathers pace.

From a different perspective, cyber security concerns in the financial and non-financial sectors present a growing opportunity for general insurers and reinsurers as companies increasingly look to insure against their exposure to cyber risk. The PRA, however, has already indicated that it expects insurers to be able to adequately identify, quantify and manage their cyber insurance underwriting risk.

At a minimum, we expect that boards will be asked to demonstrate that they have access to sufficient cyber and IT expertise to allow them to challenge management in this area.

# Financial markets regulatory outlook



## Resolvability

### Europe test-drives bank resolvability

In 2017, resolvability will become the driving force behind structural reform in the EU. The SRB will push Eurozone banks to demonstrate their practical preparedness for resolution as EU and international regulators step up their work on CCP resolution. Resolution regimes for insurers, however, will be less of a priority.



## Financial resilience

### Significant implementation challenges ahead

Following the BCBS's conclusion of most of its work on the risk framework early in 2017, the EU will deliberate how to adopt the new capital standards, while protecting the region's economic priorities. Banks will have to deal with uncertainty over the final shape of the rules as well as enhance balance sheet management capabilities for TLAC, MREL and IFRS 9 implementation.



## Conduct and culture

### Firms have yet to put misconduct truly behind them

The work of the FSB and IOSCO will introduce measures to tackle poor culture, lack of accountability and misaligned incentive policies. A key theme in 2017, however, will be on market participants creating industry standards that go beyond the regulatory minimum and encourage tangible behavioural and cultural change. In addition, conduct risk will increasingly be monitored by prudential regulators as part of ICAAP assessments and stress tests.



## Regulation of new technologies

### The tricky business of keeping up with the times

FinTech will continue to change the industry, along with Artificial Intelligence and data analytics. Innovative entrants will find more support from European national regulators, who will also be vigilant about the risks they pose. While PSD2 presents many business opportunities, both FinTech firms and retail banks will find its implementation challenging, in part because of the lack of specificity in some of its provisions.



## Cyber and IT resilience

### More specific and more demanding

Spurred by a number of high-profile attacks on firms, supervisors will increase their focus on cyber resilience. Supervisory expectations will include more detailed planning for responses to scenarios such as cyber breaches and technological failures. Firms will increasingly use testing, war-gaming and red-team exercises to demonstrate the robustness of their resilience plans.



## Opening up markets

### Vulnerable incumbents

Increased competition and the higher degree of transparency and disclosure on products and pricing under MiFID II and PRIIPS will shift the ground for all firms providing investment products. In the UK, the introduction of pension freedoms will intensify competition between life insurers and investment managers in the retirement market. Banks will need to determine their strategic positioning following strengthened competition in the payments market.



## Evolution of the trading landscape

### Decision time for trading strategies

The introduction of new trading venues and the entry into force of the clearing and margining requirements will reshape how firms develop and execute their trading strategies. The authorisations and registrations for trading venues in preparation for the implementation of MiFID II will further play a crucial role. Firms will also choose to clear an increasing volume of OTC derivatives centrally.



# 2017 Navigating the year ahead



## Brexit

### Prolonged uncertainty is here to stay

The picture for EU market access remains unclear for firms assessing the impact of Brexit on their business model and strategy. This is also the case for EU firms' access to the UK market. While supervisors in the UK and EU will be watching firms' preparations and actions closely, we do not expect regulatory changes while the UK remains a member of the EU. In the light of continuing uncertainty, firms may decide to start implementing their contingency plans during 2017.

### Other drivers of macro-policy uncertainty:

- Low growth and subdued interest rates
- Political risk and policy volatility in developed markets
- Rising challenges to the free movement of capital and services across borders



## Controls efficiency

### The rise of RegTech

RegTech promises to enable firms to push down costs, rein in compliance risk and improve controls. However, the effective implementation of RegTech solutions will require up-front investment that may be hard to justify in the difficult commercial conditions that will prevail in 2017. For this reason we expect the adoption of RegTech to be gradual as firms seek to demonstrate how such investment will add value to the business.



## Governance strategy

### Too big to manage?

Boards and senior management teams will come under increasing pressure to show supervisors that they can effectively manage groups comprising a multitude of legal entities and activities spanning numerous countries. Questions related to organisational complexity will be raised, whether on the functioning of intra-group relationships or the ability of subsidiaries to operate independently of their parent company if the need arises. This, however, will be an opportunity for firms to reduce their complexity and, in so doing, become more manageable organisations.



## Business model sustainability

### Accelerating strategic change

In re-shaping their business models firms hold the key to managing costs and restoring returns. As firms respond to the need to address new regulations and tackle increased macro-policy uncertainty, they will need to re-shape their financial resources to allow for strategic flexibility and efficiency. Supervisory and resolution authority discussions will add further pressure to integrate regulatory compliance, stress testing and resolution planning more comprehensively into business strategy and strategic planning.

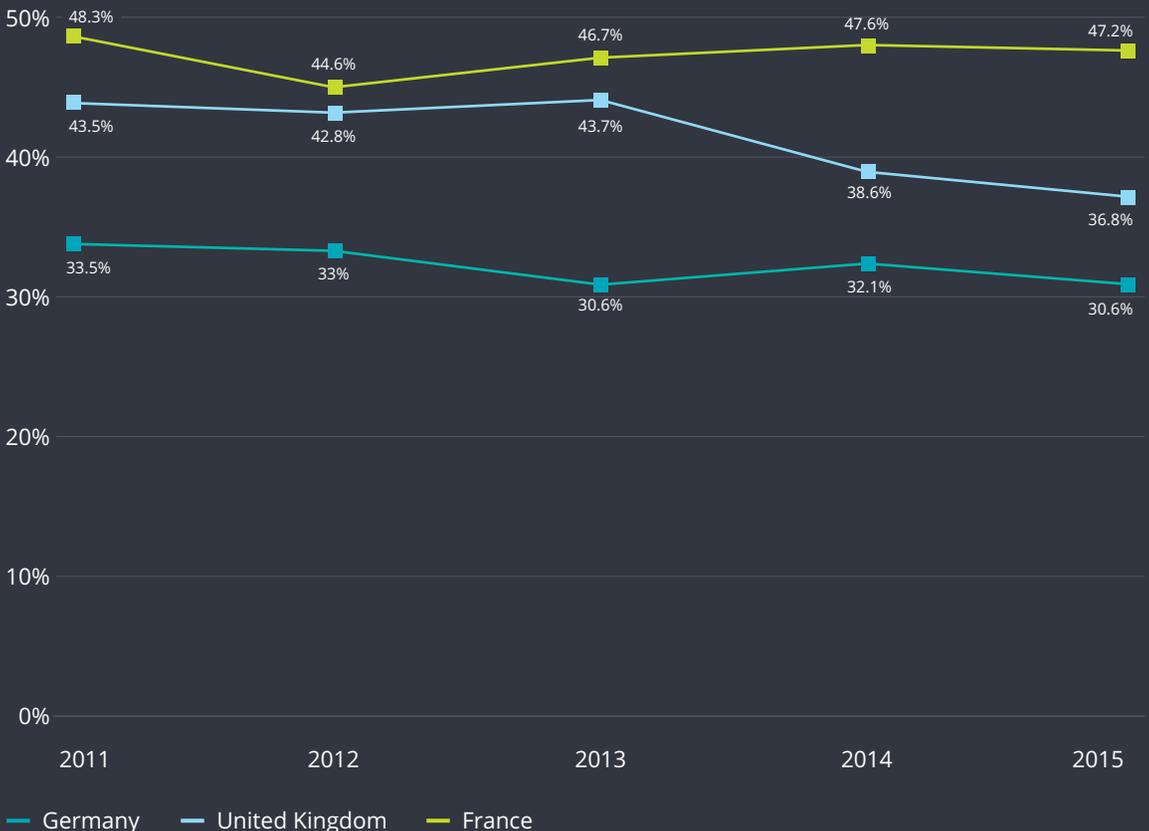


# Opening up markets

## Vulnerable incumbents

- Banks will need to choose their strategic positioning following increased competition in the payments market.
- Firms across the financial services industry will need to be more transparent about the nature and costs of their products and services.
- In the UK, life insurers will continue to face strong competition from investment managers in the retirement market following the introduction of pension freedoms.

## Share of total assets of five largest credit institutions<sup>12</sup>





In 2017 competition will remain high on the agenda of regulators in the EU and the UK. The most significant change will be for banks, which will be forced by PSD2 to share customer transaction data with third parties, following customer consent. This will allow non-bank providers such as payment “apps” to compete for the direct customer relationships, which could allow them to offer additional services, including lending to customers.

Transparency of disclosures on products and services, especially on costs and charges, is a key regulatory theme across the financial services industry. Firms providing investment products will need to prepare for MiFID II and the regulation on packaged retail and insurance-based investment products (PRIIPs) disclosures. The application date for the PRIIPs disclosure requirements (which also apply to insurers providing investment products) has been delayed by 12 months until 1 January 2018. In 2017, firms will need to put in place processes to collate the data required and ensure that information is exchanged between manufacturers and distributors. Firms will also need to move beyond focusing on implementation and assess how their product and service costs and charges compare to competitors. With more costs and charges information going into the headline figures, investors will likely see an increase in headline costs and charges, even if there is no substantive change. This will put pressure on charges and lead distributors to scrutinise product value for money and continue to look for innovative ways to distribute cost-effectively.

In the UK, as restated in the consultation on its Mission Statement, the FCA is promoting transparency through its competition work across investment and corporate banking, investment management, retirement products and general insurance. The FCA has also signalled in its Mission Statement that it is willing to consider price interventions, such as standardising pricing structures or intervening on exit charges, where other options are ineffective. Firms should prepare for increased regulatory and customer scrutiny of the value for money of their products and services.

The FCA will continue to support innovation through its regulatory sandbox and Advice Unit. The potential for new technologies to disrupt markets is discussed in the section on the regulation of new technologies.

The FCA signalled in its Mission Statement that it is willing to consider price interventions, such as standardising price structures or intervening on exit charges, where other options are ineffective.

# Opening up markets

## Sector impacts



### Banking and Capital Markets

Retail banks will start the complex task of implementing PSD2, but the real challenge will be to understand the risks it poses to their business model. TPP access means competitors (both banks and non-banks) will be able to intermedate between a bank and its customers. This will not only erode profits from payments services, but will also fundamentally change the dynamics of the relationships. Competitors will be able to leverage banks' access to customers, and their data, to offer them additional services over time, including lending. Banks must decide what role they want to play in the new value chain, and what new products and services to offer customers and/or TPPs as a result of PSD2.



### Investment Management

MiFID II and PRIIPs will require investment managers to disclose more information on costs and charges. Under MiFID II, firms will need to decide whether to introduce an up-front investor charge for research or to absorb research costs within their overheads. The new regime is likely to create opportunities for independent research providers as the pricing of research will become more transparent. Stricter rules on inducements under MiFID II will also make investment managers more reliant on up-front investor charges.

In the UK, the FCA has found weak price competition in the investment management industry. Its proposed remedies are likely to increase industry scrutiny of fund charges and investment performance, which may put pressure on revenues and accelerate the existing trend towards passive investment strategies. In response to increased margin pressure, firms may rationalise their product range to focus on larger funds in order to benefit from economies of scale.

Firms should prepare for increased regulatory and customer scrutiny of the value for money of their products and services.



### Insurance

In the UK, life insurers will face increasing competitive pressures from asset managers due to pension freedoms. At the same time the FCA is scrutinising consumer outcomes in the retirement market. Annuity sales fell by around three quarters following pension freedom implementation<sup>13</sup>, with drawdown becoming more popular. The FCA will continue to review the extent to which consumers shop around for retirement products and explore whether they understand the different options open to them. Life insurers are competing directly with investment managers in the drawdown market. However, their unique ability to provide longevity protection remains an important source of competitive differentiation and is likely to inform product design. In addition, insurers are also looking to compete with investment firms and platforms by entering the Individual Savings Account (ISA) market and building up their own platform technology.

The FCA will require general insurers to give consumers who have renewed with them four consecutive times a prescribed message encouraging them to shop around, which is likely to put further pressure on insurers to offer competitive products.

The FCA will continue to review the extent to which consumers shop around for retirement products and explore whether they understand the different options open to them.

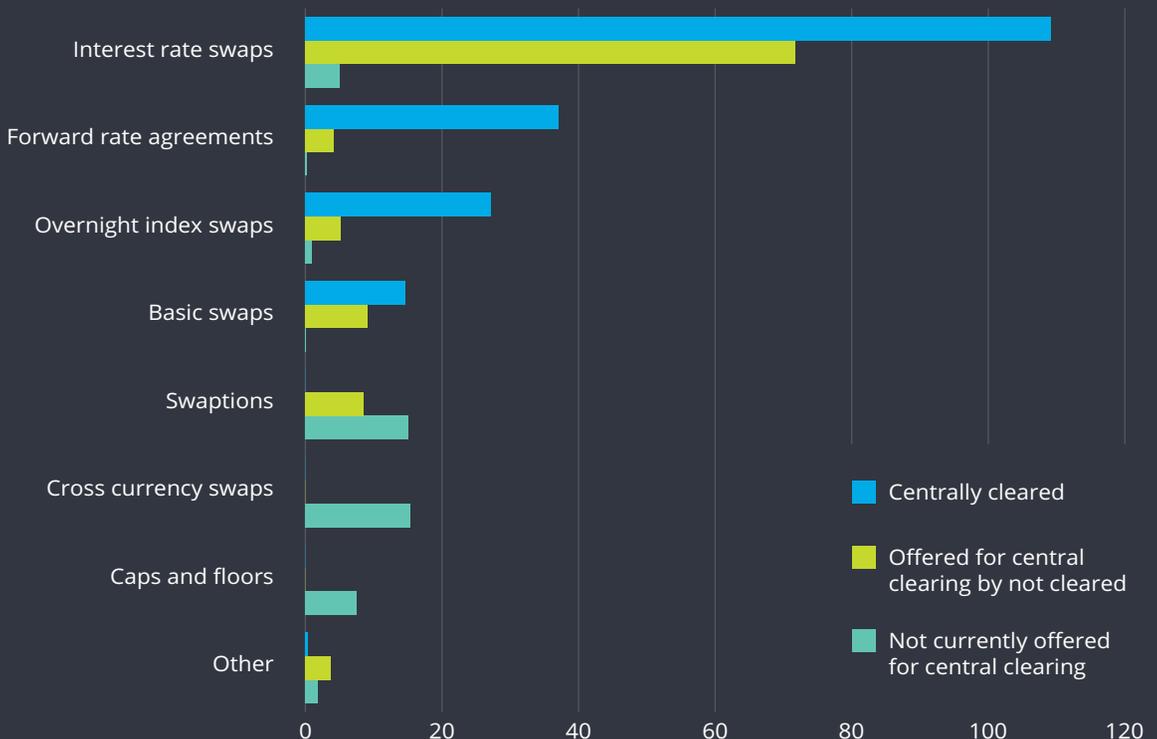
# Evolution of the trading landscape



## Decision time for trading strategies

- There will be little change to the trading landscape in 2017, but the relevant authorisations and registrations for new MTFs, OTFs and SIs and decisions on trading strategies will need to be taken ahead of January 2018.
- More OTC derivatives will move to central clearing, not only as part of the mandatory clearing obligation but also on a voluntary basis.
- The entry into force of the clearing and margining requirements in the EU will add pressure on market participants to restructure their product offerings, such as moving from non-standardised to standardised derivative products.

## Central clearing of OTC derivatives by product type in USD \$ trillions in 2016<sup>14</sup>





The upcoming regulatory requirements around trading and post-trading activities in MiFID II, the European Market Infrastructure Regulation (EMIR) and the Central Securities Depositories Regulation (CSDR) will drive commercial considerations for market participants and prompt them to start revisiting their existing operations, systems and procedures to meet the new standards and to adjust their business models to the new regulatory and market constraints.

From 2018, MiFID II will bring more OTC bilateral trading under the Systematic Internaliser (SI) regime and increase the number of Multilateral Trading Facilities (MTFs), particularly in bond markets. The trend of increased electronic trading will continue. Firms will also have the option of operating a new type of trading venue for non-equities, the Organised Trading Facility (OTF), which will most likely be taken up by brokers. These changes come coupled with profitability concerns stemming from tougher capital requirements and market liquidity issues and will cause firms to make strategic decisions regarding their trading activities ahead of the MiFID II application date of January 2018. The decisions will include the choice of venues, the costs of reclassification and infrastructure investment to ensure connectivity. Firms authorising new venues or registering SIs will also need to meet organisational and transparency requirements before January 2018. Market participants will also need to start getting ready for the implementation of the derivative trading obligation, which is expected to come into effect as early as January 2018.

In the post-trading landscape, more OTC derivatives are likely to be centrally cleared as a result of the implementation of the clearing obligation for interest rate derivatives and CDS for certain market participants. According to the BIS, 62% of the \$544 trillion in notional amounts outstanding reported by dealers was centrally cleared as of end-June 2016, with 75% of interest rates and 37% of CDS being booked with CCPs. We expect this trend to continue in 2017. The increased cost of trading associated with the implementation of margin requirements for non-cleared derivatives, which is expected to take effect in the first quarter of the year for the largest market participants, will push more derivatives into central clearing and also incentivise firms to restructure their product offerings, such that they cease to offer some non-standardised derivative products altogether.

The introduction of margin requirements will also make collateral management more challenging, with firms increasingly outsourcing aspects of their collateral management function to a third party (e.g. collateral management utility) to increase efficiency. Regarding settlement, we expect the first central securities depositories (CSDs) to become authorised under the CSDR in 2017, while CSD members should start getting ready for the implementation of settlement discipline measures (expected to be in place in 2018).

# Evolution of the trading landscape

## Sector impacts



### Banking and Capital Markets

Almost a year in advance of the implementation of MiFID II, banks and brokers will need to determine where they need to be authorised as MTFs or OTFs, or register as SIs, taking into account Brexit scenario planning. Where banks determine that the increased transparency under the SI regime is a disadvantage to their business, they could undertake dynamic monitoring of their trading activity to ensure they take action to remain below the SI threshold. Such actions could include reducing trading activity, moving trading on to a trading venue (e.g. a regulated market or MTF), or moving activity to a different legal entity. The expected implementation of margin requirements in the first quarter of 2017 will increase demand for collateral and incentivise firms with large derivatives portfolios to move some of their collateral management functions, such as collateral valuation and negotiation, to market utilities.



### Investment Management

In light of the changing trading landscape and increased transparency being introduced into the market under MiFID II in 2018, potentially affecting both pricing and liquidity, investment managers will need to consider their optimal trading strategies. This is likely to include consideration of how they can use the new data that will be available in 2018 from the MiFID II transparency and best execution rules. We expect investment managers to put in place their clearing arrangements depending on their chosen clearing model – direct or indirect. Besides the traditional client clearing model, emerging industry solutions are designed to allow financial market participants to become direct members of a CCP. Given banks' reduced appetite to offer client clearing services, mainly because of the implications for their capital requirements, several CCPs are considering offering sponsored direct access to buy-side firms that would allow them have separate margin and asset accounts with the CCP provided that these firms have a sponsor to contribute to the CCP's default fund. In the area of collateral management, investment managers might consider outsourcing their overall function or some parts of it to a third party.



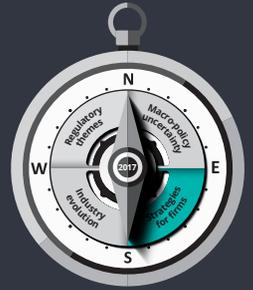
### Insurance

Insurers, where they are not trading through an investment manager, will need to get ready for clearing and margining by putting in place clearing arrangements and updating their IT systems and documentation before they start exchanging margin. Insurers will face similar concerns to investment managers in terms of trading strategy and clearing and they might need to explore the alternative models for accessing CCPs as discussed above. In terms of managing their collateral, insurers – specifically those with large derivatives portfolios – should explore outsourcing some of the collateral management functions to third parties, including collateral management utilities, to reduce their costs and make collateral management more efficient.

The increased cost of trading associated with the implementation of margin requirements for non-cleared derivatives will push more derivatives into central clearing and also incentivise firms to restructure their product offerings, such that they cease to offer some non-standardised derivative products altogether.

# Controls efficiency

## The rise of RegTech



- The imperative to reduce compliance costs will make it essential for firms to turn to new technologies to achieve efficient controls and value for money.
- New RegTech solutions will proliferate, although their adoption will be gradual as firms seek comprehensive solutions that add value beyond compliance.
- The largest banks will struggle to reap the full benefits of RegTech due to their current IT infrastructure. Smaller banks are well positioned to be RegTech pioneers.

Proportion of financial services respondents who expect an increase in their compliance budget over the next 12 months<sup>15</sup>

69%



The post-crisis increase in both regulatory requirements and supervisory scrutiny means financial services firms are spending ever increasing amounts of money and resources to manage their compliance risk. This cost, especially in the current low profitability environment, has now reached unjustifiable levels in the eyes of some investors.

Some of the main cost drivers for compliance stem from inefficient IT systems, manual processes and reliance on post-event detective controls. Firms will continue to search for new technologically innovative solutions, including RegTech, to automate and modernize their compliance, risk management and internal controls frameworks, to enable them to manage risks proactively.

Regulators, who continue to focus on the effectiveness of systems and controls, are supportive of RegTech, with the FCA leading the way with its pledge to “act as a catalyst” to unlock the potential benefits of technology innovation. But in practice, it is for firms to take the lead.

We will see RegTech gain significant momentum in 2017, but its adoption will be gradual. Robotics Process Automation (RPA), Big Data and analytics, together with regulatory reporting solutions, are some of the RegTech offerings which will see the greatest degree of adoption in the shorter term. In the longer term, cognitive and AI solutions could revolutionise and automate much of firms' regulatory change management programmes.

RegTech solutions will not be a panacea, and their implementation will require an upfront investment which, in an environment of low shareholder returns, will be hard to justify. For investment to be unlocked, it will need to add value beyond compliance and provide management with strategic business insights and the control to make better and timelier choices, help gain competitive advantage, as well as quantifiably reduce costs.

To deliver, solutions need to be chosen strategically and implemented effectively. Firms should reflect on their medium to long-term strategy, conduct a thorough risk assessment, rationalise their internal processes and then identify the areas that would benefit most from investment in RegTech. They should also commit adequate time and resources to the implementation of the chosen solutions, including undertaking the necessary cultural change programmes, and carefully calibrate and integrate solutions with existing systems to fit each firm's unique needs.

Although RegTech promises to be able to interact more easily with existing IT infrastructure, the complexity of many firms' legacy systems means that in many cases major investment in and rationalisation of existing data structures will still be required. This may tempt firms to shy away from strategic RegTech programmes and look for tactical fixes instead. In our view, such an approach will not deliver the same value for money and risks adding complexity to an often already heavily fragmented IT infrastructure.

# Controls efficiency

## Sector impacts



### Banking and Capital Markets

As banks reflect on how to upgrade their legacy systems, they may be reluctant to add a multitude of “point” solutions to an already fragmented infrastructure. Smaller banks, which may be tempted to wait until best in class solutions emerge, should instead take their own view of whether RegTech is the most efficient way to respond to the regulators’ expectations, and take the lead.

In the short term, the implementation of the fourth EU Anti-Money Laundering (AML) Directive, which will enter into force in July 2017, will impel banks to look for solutions to minimise compliance costs resulting from the increased emphasis on a risk-based approach to Customer Due Diligence requirements and more widely on the identification and management of financial crime risk.

Capital markets firms will be increasingly looking to RegTech innovations to achieve compliance with new regulations such as reporting requirements under MiFID II, EMIR and the Securities Financing Transactions Regulation, as well as to meet MiFID II investor protections rules, such as on suitability.

Market infrastructure players are not lagging behind, with the Financial Industry Regulatory Authority and the London Stock Exchange planning to use AI for market surveillance in the near term.



### Investment Management

Investment managers will be actively looking for RegTech solutions that help them fulfil regulatory compliance. Particular areas that could most benefit from technological innovation will be around new MiFID II requirements on transaction reporting, customer charges disclosure, and product governance.

Market infrastructure players are not lagging behind, with the Financial Industry Regulatory Authority and the London Stock Exchange planning to use AI for market surveillance in the near term.



## Insurance

One of the areas where RegTech solutions may bring the most added value to insurers, MGAs and insurance brokers is around the management of delegated authorities (DA).

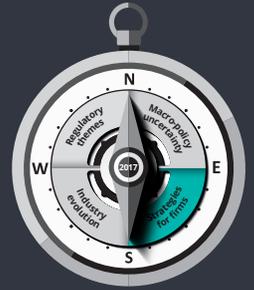
Insurers, MGAs and insurance brokers use significant populations of DA to distribute their products, as well as handle their claims and complaints. These populations can span from hundreds to thousands of agency relationships. Although regulatory expectations about the control and oversight of these relationships have increased significantly over the last few years, firms are still using manual processes that are not fully or adequately risk-based. This issue applies equally to the oversight of Appointed Representatives.

RegTech solutions could help to streamline, automate and enable the workflow of an end-to-end DA framework, including risk assessing each DA and automatically determining the appropriate take-on due diligence and oversight and audit processes. Among the added benefits, firms will have an accurate audit trail, for reporting and supervisory purposes.

Regulators, who continue to focus on the effectiveness of systems and controls, are supportive of RegTech, with the FCA leading the way with its pledge to “act as a catalyst” to unlock the potential benefits of technology innovation. But in practice, it is for firms to take the lead.

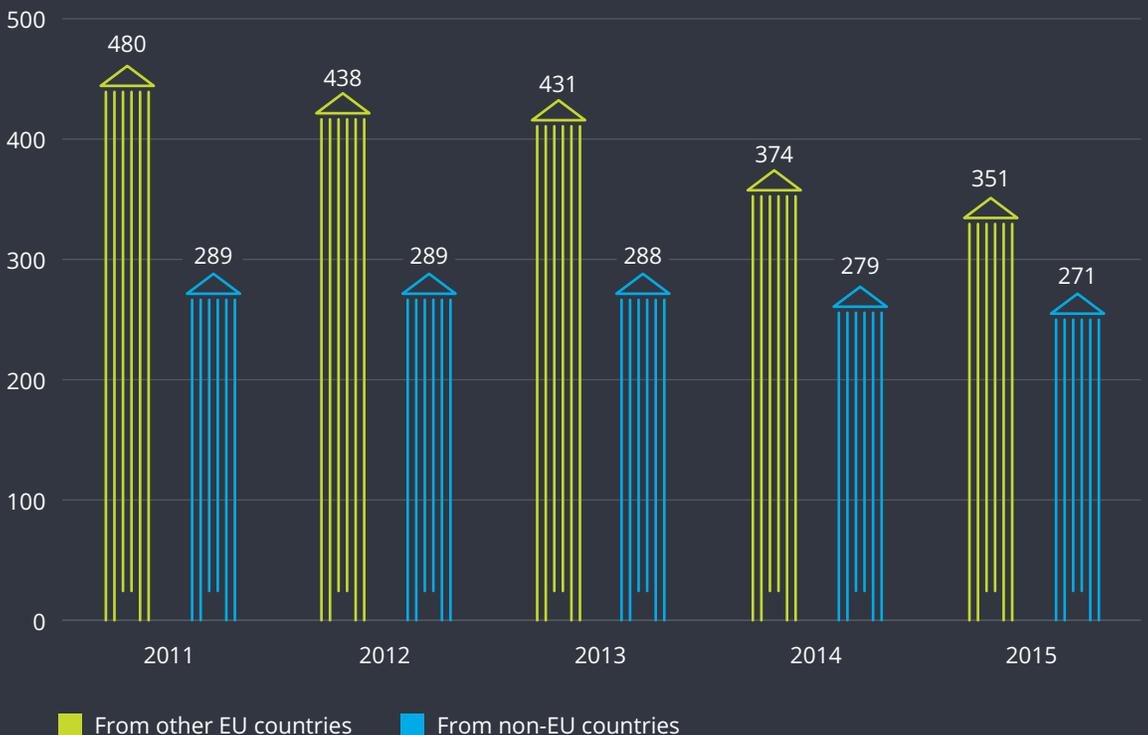
# Governance strategy

## Too big to manage?



- Supervisors will increasingly look at the functioning of intra-group relationships.
- Subsidiaries will have to demonstrate their ability to operate independently of their parent company.
- Governance inadequacies will come under heightened scrutiny in business-as-usual times, including through supervisory stress-testing and resolvability assessments.
- Firms will have reduced flexibility to deploy capital and liquidity around their group.

## Number of foreign subsidiaries authorised in EU countries<sup>16</sup>





Organisational complexity within financial services firms has led many to struggle in an environment of increased regulatory and supervisory scrutiny. The breadth and complexity of some organisations are creating real impediments to compliance, and to a complete understanding of the business impacts of far-reaching regulatory change. These impediments have been exposed by some firms' inability to identify potential sources of misconduct, or to track the location and value of capital, liquidity and collateral, or to determine how resolvable they are perceived to be by resolution authorities. A more interventionist supervisory environment means that there are new ways for inadequate governance arrangements to be exposed in the normal course of business.

Complex group structures are gradually being prised open by regulatory change: resolvability requires legal entity rationalisation; supervisory work on booking models is tracing complex networks of intragroup relationships; intermediate holding company (IHC) requirements for foreign banks in the US are shining light on previously opaque regional operations; and the UK's SM&CR and SIMR (which is in the process of being extended beyond banking and insurance) are providing supervisors with a "map" of clearly allocated management responsibilities. In general, regulators expect more of senior management members in terms of their understanding of group structures, business models and operating models: "know your structure" is the watchword. And these expectations are not limited to executives – non-executives have their work cut out too, with the line between executive and non-executive roles on occasion being blurred by the growing need for non-executive directors (NEDs) to dive deep into the business.

Changes to governance structures and processes have accompanied broader organisational change in the sector, but sometimes with the appearance of having been "retro-fitted". As a result, management structures are calibrated to cope, rather than to facilitate efficient decision-making. This will need to change if firms are to deal with the challenging new environment, in which multiple new regulatory requirements are pointing in the same direction: simplification and transparency of group structures, and an expectation of a deepening of senior management understanding of those structures. FS firms need to respond by developing more complete governance strategies: for group boards to evidence the necessary understanding of their wider group, for subsidiary operations to meet the nuances of local requirements, and for parent companies and their subsidiaries to join global and local perspectives. In some cases this will result in groups asking themselves how many governance lenses they really need. Given the importance placed on group governance and individual legal entity governance, it will be essential to be clear about the value which the regional lens adds.

# Governance strategy

## Sector impacts



### Banking and Capital Markets

The complexity that banks, particularly large groups with global operations, have accumulated over time is being challenged by the confluence of structural reform and tougher governance regimes. Further, the current round of regulatory changes has yet to be finished in some significant areas – UK bank ring-fencing contains a highly prescriptive set of governance requirements, for instance, and this will not play through into changing group structures until 2018.

Banks are also challenged by the development of tougher governance requirements which are being applied to their foreign subsidiaries – non-US banks with US IHCs, for instance, are in the early days of operating with their new structures, which for some means a newly strengthened US-specific risk oversight function. The resolvability imperative also impinges on governance arrangements: host supervisors are in some cases looking to local operations to be able to demonstrate a capacity to operate independently of parent companies, lest the need arise in a resolution scenario.

Banks have more to do to document their current structures clearly and comprehensively. They will need to join the pieces between structural change, supervisory priorities, and the needs of day-to-day group management. They also need to bring transparency to intragroup relationships, particularly on a cross-border basis. The UK PRA has been focusing on these issues for some time now, but the recent publication of revised guidelines on “internal governance” by the EBA makes clear that this is firmly on the supervisory agenda elsewhere.

IFRS 9 further increases the governance requirements for banks. Boards are expected to attest to the adequacy of impairment provisions. This will be more difficult than under the old International Accounting Standard 39 regime due to new requirements, including the use of forward looking information and macroeconomics factors, along with the assessment of significant deterioration in credit risk using both backward and forward-looking information.



### Investment Management

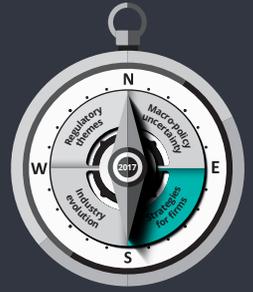
Investment firms are subject to many of the same regulatory requirements and supervisory expectations as banks via CRD IV – a situation that will continue until the EU's ongoing investment firm review is complete. Furthermore, in the UK, the extension of the SM&CR means that investment managers need to gear up for the 2018 implementation deadline. Standalone investment managers may in general be less complex than large banking groups, but still need to ensure they have effective governance both at group and subsidiary levels, as well as independent fund governance structures. Experience in the banking and insurance sectors suggests that there will be a considerable amount of work to carry out in order to identify Senior Managers, document responsibilities, and train all relevant staff. In its asset management market study, the FCA proposes to strengthen governance standards for UK authorised funds, potentially through requiring more independent board members and creating a stronger duty to act in investors' best interests and consider value for money. This would place a greater onus on boards of authorised fund managers to demonstrate that they provide effective challenge to portfolio managers.



### Insurance

In the UK and more broadly across the EU, insurers will need to manage a supervisory drive to bring subsidiary governance into line with banking best practice, particularly with respect to the appointment of independent board members. Subsidiary operations of insurance groups will need an independent Chair (albeit that the appointee may also be a Group independent non-executive director (INED)), and subsidiary boards will need to comprise a majority of INEDs. They will also need to ensure the presence of sufficient technical understanding and demonstrate to supervisors their ability to provide robust challenge to the executive. Subsidiaries will be pushed to demonstrate how their reformed governance structures will operate within, and ensure compliance with, group risk appetite and control parameters.

A more interventionist supervisory environment means that there are new ways for inadequate governance arrangements to be exposed in the normal course of business.



# Business model sustainability

Accelerating strategic change

- Business model sustainability will come to the fore as a key consideration in managing (regulatory) costs and restoring returns.
- There will be more scrutiny in supervisory and resolution authority discussions, in particular for banks, of the coherence of the business strategy and the integration between strategic planning, stress testing and recovery planning.

Return on Equity (RoE) for EU banks from 2005 to 2015<sup>17</sup>

**RoE**  
**17%**  
2005

**RoE**  
**5%**  
2015



Financial services firms face challenges to their business models from a potent mix of low interest rates and low economic growth, higher operating costs and complexity, and heightened competition including as the result of technological innovation. In Europe in particular, some banks face the additional problem of working through large portfolios of NPLs. The challenges are most acute for banks and insurers, but are still important for investment managers to assess. A result has been persistently lower profitability, downward revisions in profitability targets and, in some cases, clearly dissatisfied shareholders.

Amongst the factors driving these challenges is the wave of new and proposed regulations, which has increased regulatory complexity and uncertainty. Left unchecked, the changes will reduce strategic flexibility and lower efficiency. Despite the importance of the changes though, few firms have adapted their financial resources – and business strategy – to reflect the new constraints. Instead, many firms have focused on the near-term compliance challenge and hence have yet to take a strategic view. Firms are still grappling with the task of demonstrating a business strategy that delivers sustainable future returns.

Regulators have taken note of this. Sam Woods, CEO of the UK's PRA, observed recently that it was “too early to say how business models will shape up in the future ... many banks have simply not yet adapted to the new prudential constraints or the lower-rate environment”. Moreover, business models of financial services firms are under ever-increasing supervisory scrutiny. Firms will be expected to develop and integrate a stronger understanding and analysis of business strategy in the new operating environment, and how their business compares to that of peers. After hinting at this in the past, supervisors will take more concrete action in 2017 to ensure it becomes a reality.

In the UK, for example, banks that take part in the annual supervisory stress test will next year apply an additional scenario to explore how their business models are responding to the challenging environment they face, and the implications for their viability and future resilience over a seven year horizon.

To plan what further investment to make, firms should begin by benchmarking their current capabilities and requirements – across modelling, stress testing, financial planning and, perhaps most importantly, data. Firms need to transition to an approach that is comprehensive, forward-looking, and analysis-driven, integrating an assessment of the impact of regulatory and accounting changes (particularly IFRS 9). This could ultimately require significant resources to be deployed. The benefits should extend beyond business model sustainability, including through increased effectiveness of decision making. Some of the savings made could be used to fund more effective and efficient controls, as set out in the section on controls efficiency.

# Business model sustainability

## Sector impacts



### Banking and Capital Markets

The further clarity on the future level of capital requirements that will emerge in 2017, at least at the level of the Basel framework, and progress towards the implementation of IFRS 9, present an opportunity for banks to develop a clearer understanding of the economics of doing business under the new regulatory regime and assess their strategic options. We expect more decisive action from banks on business models as a result. As an example, the cumulative effect of prudential rules and post-trading requirements will change the trading landscape for banks, with fewer non-standardised derivatives traded overall. While we see some banks prepared to exit this segment completely, other banks will rethink their strategy to benefit from the retrenchment of rivals. We also expect an acceleration of efforts to achieve simplification and cost reduction. Consolidation in the sector will accelerate as efficiencies are exploited and competition with non-banks intensifies. Separately, but related, supervisors will increasingly consider the coherence and integration of business strategy as pivotal to their assessment of banks' stress testing and recovery and resolution plans, as the frameworks for both these aspects of banking regulation mature.

This transformation of banking business models will not be completed in 2017. But we expect shareholders to become increasingly demanding of banks to demonstrate that they can deliver maximum value while satisfying regulatory requirements and supervisory expectations.



### Investment Management

The business models of investment managers are under less extensive regulatory pressure relative to banks. However, there is increased regulatory and supervisory focus on ensuring customer value for money across the product value chain. In addition, increased transparency on costs and charges, strengthened inducement rules, and rules on unbundling of dealing commission will mean investment research costs, fund management charges, and distribution costs will all be under pressure. Investment managers will be seeking more cost-effective and direct distribution channels, including the increased use of automated financial advice.

Many firms have focused on the near-term compliance challenge and hence have yet to take a strategic view. Firms are still grappling with the task of demonstrating a business strategy that delivers sustainable future returns.



### Insurance

For insurers, the low interest rate environment and its transmission through the Solvency II regime is exerting an increasingly powerful influence on business models. The current design of the Solvency II risk margin is amplifying the balance sheet volatility effect of low interest rates and incentivising insurers increasingly to reinsure longevity business that is not covered by transitional Solvency II arrangements. The longer term regulatory reaction to this trend is uncertain, but amongst other responses, it is likely to lead to greater supervisory scrutiny of insurers' risk appetites, governance and controls in the reinsurance area. As low bond yields incentivise shifts in the portfolio mix of investments, supervisors are also likely to sharpen their focus on board oversight and understanding, and the quality of credit underwriting controls and monitoring.

To plan what further investment to make, firms should begin by benchmarking their current capabilities and requirements – across modelling, stress testing, financial planning and, perhaps most importantly, data.

# Top 10 for 2016

How did our predictions fare?

Topic	What we said	What happened	Score out of 10
<p><b>Culture</b></p>	<ul style="list-style-type: none"> <li>• Larger firms will continue to grapple with defining and embedding a common culture, specifically one that resonates from the board and the top of the firm across all business areas and jurisdictions.</li> <li>• The ECB will issue new regulations to make fit and proper assessments of board members consistent across the SSM.</li> <li>• The key challenges will be to determine the levers that will encourage the right behaviours and to measure their effectiveness in facilitating cultural change. Continuing regulatory focus on the role of boards and remuneration will be used as a key lever to influence culture.</li> </ul>	<ul style="list-style-type: none"> <li>• The EBA launched a consultation on draft guidelines aimed at further harmonising institutions' internal governance arrangements, in line with the new requirements in this area introduced in CRD IV.</li> <li>• In late 2016, the ECB published guidelines regarding fit and proper assessments.</li> <li>• Supervisory developments on remuneration included the recommendation from the Fair and Effective Markets Review (FEMR) for the FSB to improve the alignment between remuneration, the FSB progress report on measures to reduce conduct risk and the PRA remuneration policies.</li> <li>• Findings from the BSB report and the emphasis that the ECB and FCA placed on culture in 2016 confirmed the supervisory focus on culture as predicted.</li> </ul>	<p>9</p>
<p><b>Conduct risk</b></p>	<ul style="list-style-type: none"> <li>• In the UK, work will continue on flagship initiatives such as the FEMR, SM&amp;CR and SIMR and FAMR.</li> <li>• At EU level, all hands will be on deck to implement MiFID II, Market Abuse Regulation (MAR) and PRIIPS.</li> <li>• Conduct risk will be taken up by global institutions to an extent not previously seen, with a particular focus on integrating conduct risk into prudential frameworks, benchmark reform and the alignment of remuneration and conduct risk.</li> </ul>	<ul style="list-style-type: none"> <li>• The SM&amp;CR and SIMR were implemented in 2016, and the FCA's Mission Statement emphasised the importance of senior management accountability under these regimes in its supervisory approach. Progress in implementing the FEMR and FAMR recommendations continued.</li> <li>• Significant work has gone into implementing MiFID II and PRIIPS despite the 1-year delay in MiFID II implementation and the likely delay in PRIIPS implementation. MAR was implemented as expected in July 2016.</li> <li>• In 2016, the EBA included conduct risk in its EU-wide stress test for the first time. The FSB reported that banks have made good progress in linking remuneration and conduct risk. Work continued on benchmark reform, albeit at a slower pace than expected.</li> </ul>	<p>8</p>

Topic	What we said	What happened	Score out of 10
<b>Competition</b>	<ul style="list-style-type: none"> <li>• The FCA will look to improve competition through facilitating innovation.</li> <li>• Regulation will not focus on structural change or price regulation.</li> <li>• UK and EU regulators will focus on costs and product disclosure.</li> </ul>	<ul style="list-style-type: none"> <li>• FCA's regulatory sandbox, part of Project Innovate, accepted 24 applications towards development of RegTech and FinTech applications.</li> <li>• FCA's remedies for investment and corporate banking market study were not as wide-ranging as expected.</li> <li>• The Big Data Call for Input in general insurance did not result in a market study as the findings found it improved customer outcomes. However, there were concerns regarding pricing practices and inappropriate use of risk segmentation by firms.</li> <li>• The European Commission issued its Green Paper on Retail Financial Services, but concrete plans to develop a genuine Single Market have yet to be seen.</li> <li>• The FCA published an interim report on its Asset Management market study.</li> </ul>	8
<b>Structural reform</b>	<ul style="list-style-type: none"> <li>• In 2016 resolvability will increasingly drive regulatory interventions, with operational continuity to the fore.</li> <li>• SRB more likely to be in information gathering mode than intervention mode.</li> <li>• BSR will progress slowly.</li> <li>• UK banks will press ahead with ring-fencing implementation.</li> </ul>	<ul style="list-style-type: none"> <li>• 2016 saw very few interventions on resolvability across EMEA, but significant regulatory and supervisory interest in operational continuity. The PRA proposed a new SMF for operations, including responsibility for ensuring operational continuity and resilience.</li> <li>• The SRB was clearly still in information gathering mode without public interventions of any kind.</li> <li>• There was no progress on BSR.</li> <li>• UK banks have clearly been pushing on with ring-fencing and have set out considerably more detail this year.</li> </ul>	7

Topic	What we said	What happened	Score out of 10
<b>Measuring risk exposures</b>	<ul style="list-style-type: none"> <li>• Potential for misalignment between the regulatory capital agenda and broader political interests in promoting the economy and reducing barriers to entry.</li> <li>• The European Commission's consultation on bank financing of the economy, and call for evidence into the EU financial services framework, will be instrumental in setting the policy direction.</li> <li>• Greater emphasis on NPLs will compound the effects of regulatory capital initiatives.</li> <li>• Insurers' and regulators' work on Solvency II internal models will continue, with refinements to existing models and new models to approve.</li> </ul>	<ul style="list-style-type: none"> <li>• Political concerns around the (unintended) consequences of increasing capital requirements intensified, and look set to influence the final design of the proposals.</li> <li>• Responses by the European Commission to their consultation and call for evidence have been delayed.</li> <li>• The ECB made NPLs one of its supervisory priorities. It published draft guidance for banks and undertook a stocktake on national practices.</li> <li>• The PRA approved full or partial internal models for 19 insurers and set out expectations and changes in relation to existing models.</li> </ul>	7.5
<b>Capital calibration</b>	<ul style="list-style-type: none"> <li>• Supervisors will move to limit the increase in overall capital requirements for banks.</li> <li>• Pillar II will become an increasingly important part of determining banks' capital requirements.</li> <li>• Regulators will assess the appropriateness of CRD IV for investment firms.</li> </ul>	<ul style="list-style-type: none"> <li>• The BoE maintained its target of 11% Tier 1 capital for banks despite criticism from some observers.</li> <li>• The European Commission's CRD V / CRR II proposal included a number of phase-in provisions designed to limit the capital and liquidity increases associated with new requirements.</li> <li>• Volatility in the AT1 market earlier in the year prompted the EBA and the ECB to clarify the EU's Pillar II framework to more consistently use Pillar II guidance for banks.</li> <li>• The EBA's assessment of the impact of CRD IV for investment firms led it to recommend the creation of a new EU prudential regime for non-systemic investment firms.</li> </ul>	8

Topic	What we said	What happened	Score out of 10
<b>Data and regulatory reporting</b>	<ul style="list-style-type: none"> <li>• Firms can deal with data by investing heavily to realise the long-term benefits. The ultimate winners will be firms that bite this bullet soon.</li> <li>• In 2016 the number and overall complexity of demands on firms will increase further.</li> <li>• Supervisors will spend more time assessing firms' capabilities.</li> </ul>	<ul style="list-style-type: none"> <li>• Firms have invested in data and analytics capabilities, but more remains to be done</li> <li>• While large infrastructure projects were set up at a large number of banks, progress was still dictated by the imperative to keep up with regulatory change.</li> <li>• Further proposed amendments to Pillar III continued to increase regulatory pressure on banks to improve their reporting of regulatory data.</li> <li>• Supervisors and banks still have not fully grasped the issues that BCBS 239 was intended to address.</li> </ul>	6
<b>Technology and innovation</b>	<ul style="list-style-type: none"> <li>• Blockchain will remain a hot topic, but neither the technology nor regulators nor the industry are ready for mass adoption.</li> <li>• Regulators will need to develop the capabilities to understand, respond and leverage new technological developments.</li> <li>• Insurers can expect more regulatory pressure for transparency about the data they collect, why it is collected and how it is used and shared.</li> </ul>	<ul style="list-style-type: none"> <li>• Firms continued to invest heavily in the development of Proofs of Concept to unlock the potential of DLTs. Regulators started to consider their implications in more detail and are contemplating the right approach and timing for regulatory intervention.</li> <li>• FinTech units and regulatory sandboxes sprang up across Europe, and elsewhere, as regulators sought to support innovation and competition, while furthering their understanding of the risk and opportunities these present for consumers and market integrity.</li> <li>• The FCA found the overall impact of Big Data on consumers to be largely positive, but it said it will "remain alert" to potential issues. Beyond insurance, the EBA started considering the implications of innovative uses of consumer data by financial institutions, and the World Economic Forum recommended a debate on the ethical use of data.</li> </ul>	9

Topic	What we said	What happened	Score out of 10
<b>Operational resilience</b>	<ul style="list-style-type: none"> <li>• The threats arising from cyber risks will heighten for financial services firms in 2016.</li> <li>• Supervisors will become increasingly interested in the operational resilience of banks and market infrastructures and the plans they put in place to deal with breaches.</li> <li>• Other event risks like Brexit will test the operational resilience of firms and the markets they operate in.</li> </ul>	<ul style="list-style-type: none"> <li>• A number of high-profile cyber breaches and IT failures served to sharpen the financial sector's focus on better managing their operational resilience.</li> <li>• Supervisors, including the UK PRA, began to refine their operational resilience expectations of firms and integrate them into their routine supervisory work.</li> <li>• US regulatory agencies consulted on the creation of detailed cyber resilience standards for banks and FMI's.</li> <li>• The Brexit vote honed the focus of firms on their operational preparedness for significantly changing and unpredictable circumstances.</li> </ul>	9
<b>Market participants adjusting to a new order</b>	<ul style="list-style-type: none"> <li>• Firms will be gearing up their MiFID II implementation programmes for the 2017 go-live date.</li> <li>• The number of new trading venues will increase before the end of 2016.</li> <li>• EMIR costs will start to bite as the final and most onerous provisions come into effect.</li> <li>• The FSB and IOSCO are set to publish recommendations on mitigating risks around market liquidity and asset management activities. The NBNI SIFI debate will remain on hold.</li> </ul>	<ul style="list-style-type: none"> <li>• The MiFID II application date has been delayed until January 2018.</li> <li>• There was little clarity on the number of new trading venues and SIs, as firms are in no hurry to take these up in advance of the go-live date.</li> <li>• The impact of margin requirements has yet to be fully assessed as implementation has been delayed to Q1 2017. Since July 2016 the clearing obligation has started to be phased in.</li> <li>• The FSB consulted on its policy recommendations on addressing structural vulnerabilities from activities of asset managers; the NBNI SIFI work remained on hold until these recommendations are finalised. In the EU, the proposal for a Money Market Funds Regulation (MMFR) was agreed.</li> </ul>	7

# Endnotes

<sup>1</sup> Deloitte LLP.

<sup>2</sup> International Monetary Fund, Global financial stability report 2016.

<sup>3</sup> FCA, Letter from Andrew Bailey to Andrew Tyrie, August 2016.

<sup>4</sup> FSB, Resilience through resolvability moving from policy design to implementation, 5th Report to the G20 on progress in resolution, August 2016.

<sup>5</sup> For more details, see the recent paper from Deloitte Centre for Regulatory Strategy, EMEA: "Tackling too-big-to-fail | The resolvability challenge for banks".

<sup>6</sup> BIS, Eleventh progress report on adoption of the Basel regulatory framework, October 2016, in addition to Deloitte analysis.

<sup>7</sup> ECB, Financial Stability Review November 2016.

<sup>8</sup> EBA, 2016 EU-wide stress test results, July 2016.

<sup>9</sup> Market Research, Five banking innovations from five continents: USA, Europe, Asia, Africa, Australia, February 2015.

<sup>10</sup> "The concept of smart contract had emerged before the development of the DLT but the technology could accelerate its development. Smart contracts are self-executing codes meant to replicate the terms of a given contract. They effectively translate contractual terms (e.g., payment terms and conditions, confidentiality agreements) into computational material." From ESMA Discussion Paper on Distribution Ledger Technology Applied to Securities Markets 2016.

<sup>11</sup> Deloitte, EMEA Financial Services IT Risk Management Survey, 2016.

<sup>12</sup> ECB, EU structural financial indicators annex, July 2016.

<sup>13</sup> An FCA study found that annuity sales in July to September 2015 were 74% lower than in January to March 2013. FCA, Pension freedoms data collection exercise: analysis and findings, 2015, and FCA, Retirement Income Market Data, 2016.

<sup>14</sup> FSB, OTC Derivatives Market Reforms, Eleventh Progress Report on Implementation, August 2016.

<sup>15</sup> Thomson Reuters, Cost of Compliance 2016.

<sup>16</sup> ECB, EU structural financial indicators annex, July 2016.

<sup>17</sup> ECB, Challenges for the European banking industry, 2016.



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