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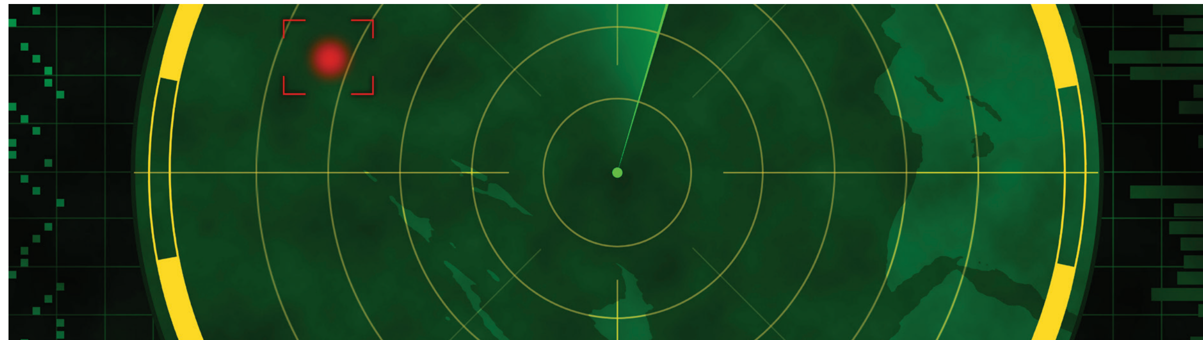
Top 10 for 2013
Our outlook for financial markets regulation and supervision



At the start of 2013, against the background of slippage in the timetable for some key initiatives in the post-crisis regulatory reform agenda, and growing concerns about the weakness of the economic recovery in Europe, we have set out our view of ten key regulatory and supervisory topics for the year ahead.

The ten key topics, in no particular order, are:

1. Making it easier to deal effectively with failing firms
2. Structural reform
3. Implementing the capital and liquidity regime
4. Reinventing wholesale markets
5. New supervisory bodies 'flexing their muscles'
6. Product intervention
7. Making governance effective
8. Competition and choice
9. Extraterritoriality
10. Rising standards on data

These have been approached from a UK perspective, drawing on relevant EU and global developments where appropriate.

EMEA Centre for Regulatory Strategy

1. Making it easier to deal effectively with failing firms: 2013 will see a sustained focus on improving the resolvability of both banks and non-banks, to allow firms to be wound down while safeguarding financial stability, continuity of essential services and consumer protection.

Measures to enable the orderly failure of global systemically important financial institutions (G-SIFIs) and thereby reduce the 'too big to fail' problem will continue to form a core element of the financial stability agenda in the UK and elsewhere. As part of this, the issue of resolution authorities having a 'bail-in' power to recapitalise failing banks has emerged as a key focus of discussion. The EU's Recovery and Resolution Directive, which should be agreed in 2013, will lay the foundations for such a power across the EU. In addition, countries that will participate in the Single Supervisory Mechanism (SSM) should expect proposals for a single resolution mechanism, one of the two missing pieces of the banking union puzzle (the other being the deposit protection arrangements).

At the same time, the debate about resolvability is extending well beyond banks and, in some respects, beyond financial stability considerations. In 2013 we expect to see significant progress made on resolution arrangements for central counterparties, an increasingly important member of the G-SIFI family. And there may also be developments on resolution frameworks for insurers, where the UK authorities seem to be concerned about continuity of essential insurance cover as well as financial stability.

2. Structural reform: Steps are in progress in a number of jurisdictions, including the UK and US and perhaps now the EU following the recommendations of the High Level Expert Group, to prevent insured depositors from funding proprietary trading and/or investment banking.

Progress on implementing the recommendations of the Independent Commission on Banking has been measured, as the Government has until the end of this Parliament to enact the legislation. We anticipate the pace will pick up in 2013, with progress on both primary and secondary legislation, although the need to incorporate the recommendations of the Parliamentary Commission on Banking Standards could temper this.

The other unknown is how the EU will respond to the conclusions of the High Level Expert Group. We expect the European Commission (EC) to undertake an impact assessment in Q1 2013 with proposals following around the middle of the year. It is possible that the outcome of the EC's initiative constrains or changes the UK's approach – though we think it unlikely that it will do so in any significant way.

3. Implementing the capital and liquidity regime: Implementation of Basel III capital and liquidity rules and Solvency II requirements will remain high on firms' agendas despite legislative delay. However, regulators face pressure both to safeguard firms' stability and encourage lending to the economy: a challenge in deciding the final liquidity rules, for instance. There will also be pressure to simplify the rules.

Neither the EU nor the US succeeded in implementing Basel III by the G20 deadline of 1 January 2013. And in the EU, agreement of the Capital Requirements Regulation and the related Directive is only the beginning of the process. The detail will be in the technical standards (of which there are around thirty) to be written by the European Banking Authority (EBA) in 2013. But the lack of legislation will not prevent supervisors from pressing ahead, using existing powers to incorporate elements of Basel III into stress tests (as the UK, EU and US have all done to some extent) and Pillar 2 judgements.

We expect the short-term tension between the desire for higher capital and liquidity on the one hand and a wish to foster the faltering recovery on the other to continue. In the UK the crunch point may come as early as March when the Financial Services Authority (FSA) is obliged to respond to the Financial Policy Committee's (FPC) concerns that UK banks' capital may be overstated. If the FSA's work validates these concerns and UK banks find it difficult to raise fresh capital or dispose of non-core assets, then it will be harder for banks to maintain new lending. The debate around 'simplification' of Basel III will continue, but without much traction in the EU whose appetite for the 'simple' element currently within Basel III (i.e the leverage ratio) is limited as it is. That said, the review of models implied by the risk-weighted-asset exercise in Basel could lead to change, perhaps underpinned by revisions resulting from the fundamental review of the trading book.

4. Reinventing wholesale markets: The raft of reforms in wholesale markets, including in the areas of resolvability, collateralisation and conduct, will drive an unprecedented amount of change. Will 'caveat emptor' survive?

The Libor scandal and, in the UK, problems around mis-selling of interest rate derivatives to small and medium sized enterprises will keep the spotlight on standards in the wholesale markets throughout 2013 and beyond. We expect to see the Financial Conduct Authority (FCA) put much greater emphasis on its wholesale conduct work, building on the clear signal in 'The Journey to the FCA' that certain types of customers currently treated as 'wholesale' may – in some respects – be given more of the safeguards previously reserved for retail customers.

2013 will see the process for identifying which derivative products are eligible for central clearing begin. This, together with new requirements for posting initial and variation margin on remaining OTC derivatives, will generate increasing demand for collateral. Efficient collateral management will therefore remain a priority. One risk, which might crystallise in 2013, is that the Financial Stability Board's (FSB) proposed new regulations for the repo market inhibit the recycling of collateral via that market.

5. New supervisory bodies 'flexing their muscles': 2012 was a year when new supervisory bodies, such as the Single Supervisory Mechanism in the euro area, were proposed, and recently established bodies, such as the European Supervisory Authorities, began settling in. In 2013 we will see them establish their supervisory style more clearly. A similar process will happen with the 'twin peak' structure in the UK.

In the UK, 2013 will be the year in which the Prudential Regulation Authority (PRA), FCA and FPC are formally established. But we already have a very clear sense of how they will operate, with each body anticipating its new objectives, philosophy and powers as much as it can under current legislation.

The EU institutions, in contrast, have made much slower progress. The European Systemic Risk Board (ESRB) will have to become much more active in 2013 if it is to emulate the more muscular FPC. The agenda of the European Supervisory Authorities (ESAs) will continue to be dominated by the need to write technical standards in respect of the new legislation. But the prospect of the EC's review of the ESAs in 2014 may prompt them to show more of their true supervisory colours. Finally, 2013 will be the year when the SSM is established. But there is a world of difference between legislating for the SSM and making it effective in practice, a process which will necessarily take years rather than months.

6. Product intervention: Conduct regulation is becoming increasingly intrusive and judgement-based, with regulators demonstrating readiness to intervene in all stages of a product lifecycle. This trend will affect a growing number of retail business lines, with implications for profitability.

The FSA is already consulting on the circumstances in which the FCA may use its temporary product intervention powers, a clear statement of intent that it expects the FCA to be ready to use these powers from the moment the new legislation takes effect in spring 2013. This will keep the spotlight on product design and approval processes within firms.

This in turn may also add impetus to the Government's simple financial products initiative, with Carol Sergeant's final report due in February 2013. At the EU level, assuming the relevant provisions in the proposed Markets in Financial Instruments Regulation on product intervention are agreed in 2013, both the ESAs and national supervisors will have extended product intervention powers. So we may see some of the FCA's attitudes and practices in this area exported to the rest of the EU.

7. Making governance effective: The focus on establishing effective risk controls, a sound corporate culture and appropriate reward systems is here to stay. We expect to see developments in the area of sales incentives as well as more explicit requirements for risk appetite frameworks.

The supervisory interest in the culture that exists within firms is set to intensify, recognising that even strong controls cannot cure poor culture and/or remuneration and incentive structures that cause individuals to put their personal interests ahead of the firm's and its customers. Conversely, a healthy culture will tend to amplify the positive effect of systems and controls. However, translating the 'tone from the top' into concrete actions at all levels throughout the organisation and 'proving the positive' in terms of culture is always going to be difficult. We expect Boards and supervisors to spend time and effort on finding ways to assess and satisfy themselves that a firm's culture is as it should be. This will be a challenge, but one with real potential to yield significant benefits.

8. Competition and choice: Competition will be an objective of the FCA, although some elements of regulatory reform could reduce consumer choice by increasing barriers to entry for new business or by causing providers to abandon existing product lines. As a result, there may be pressure on the FCA to act as 'economic regulator' and, for example, take a view on pricing.

The competition and choice agenda will be at the centre of the UK stage in 2013, given the FCA's new competition objective, but seems less of a regulatory concern elsewhere. In the UK the FSA has already recognised the scope for tension between the FCA's need to promote competition and choice on the one hand and other elements of its approach, particularly its scrutiny of more complex products, and any effect this has on product innovation. We expect the FCA to take a close interest in the pricing of products and services, especially where high margin products and inappropriately structured incentives for sales staff combine to create a high risk of mis-selling.

This combination of promotion of competition, scrutiny of high margin products and focus on pricing will increase downward pressure on return on equity.

9. Extraterritoriality: As regulatory reform remains in the public focus and high on the political agenda, we expect to see rules increasingly take effect outside domestic jurisdictions. It is also likely that the implementation of reforms across the globe gives rise to regulatory overlaps.

Unsurprisingly given that Over-the-Counter (OTC) derivatives represent a genuinely global market, concerns about extraterritoriality have been greatest in relation to Title VII of the Dodd Frank Act, particularly how it interacts with the European Market Infrastructure Regulation. Despite some signs of progress, we see extraterritoriality remaining on the agenda in 2013, and this being no longer confined to the US.

Increasingly, EU directives and regulations have both an equivalence test and a reciprocity test which have to be met before a non-EU firm can operate via a branch in the EU. The existence of these provisions only serves to raise the political stakes in what would otherwise be purely regulatory matters. Almost inevitably, given concerns about underlaps in regulation, regulators will regard overlaps in regulation as the lesser of two evils. This will in turn significantly increase the compliance burden for firms, especially those with global operations.

10. Rising standards on data: Firms need to provide regulators with timely, high quality and accurate data. Data reporting requirements such as those agreed in Europe and the common data template for global systemically important banks will begin to kick in. Data governance and infrastructure processes in firms will move to centre stage with a particular emphasis on risk data aggregation capabilities.

2013 will see the first concrete step in the introduction of the FSB's legal entity identifier initiative and of the common data template for global systemically important banks. In addition, we expect the Basel Committee on Banking Supervision to finalise some exacting standards concerning banks' risk data aggregation capabilities. Closer to home, the PRA is already signalling a strong interest in the quality and timeliness of banks' and insurers' data reporting, with the prospect of increasing use of reports by skilled persons to verify regulatory returns submitted by firms. The direction is therefore clear. The choice for firms is whether to invest significantly in improving their data management capabilities at a time when costs are under severe pressure, or to tackle each separate data initiative piecemeal. The former course promises greater benefits and fewer risks.

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