Deloitte.

Top 10 for 2014
Our outlook for financial markets regulation and supervision

Six years after the onset of the financial crisis and the global regulatory response is by no means complete. Boards and executives, shareholders and customers still do not know the final impact of changes to regulation and supervision on financial services firms' strategies, business models and operations. That said, there are ten key areas where we expect significant progress in 2014.

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

1. Structural reform of the banking sector
2. Restructuring the (rest of) the financial system
3. Capital and liquidity – back to the future?
4. Wholesale conduct risk
5. Banking Union
6. Operational risk
7. Putting customers first through better conduct and culture
8. Individual accountability
9. Competition – part of the solution?
10. Managing regulatory change in an extraterritorial world

We have approached these topics from a UK perspective, bringing in relevant EU and global developments where appropriate.

EMEA Centre for Regulatory Strategy

STRUCTURAL REFORM OF THE BANKING SECTOR

Measures to ensure the impact of failing banks is minimised are coming to fruition. Ring-fencing requirements and regulators' demands for individual banks to be made resolvable will drive unprecedented changes to legal and operational structures, and in turn to banks' capital structure and funding models. There will be more clarity over the course of 2014 as national and regional rule-writing progresses, and work to articulate the key attributes of resolvability continues at the international level under the aegis of the FSB. As a result, planning for operational and strategic change will pick up pace.

A number of regulatory initiatives will have a direct and significant impact on how banks structure themselves: the focus on credible resolution strategies for all banks, especially the global systemically important banks (G-SIBs); the ring-fencing of critical retail and SME banking functions within the largest UK banks and the prospect of additional reforms at the EU level; and the need to optimise OTC derivative booking models in the light of the European Market Infrastructure Regulation (EMIR) and Title VII of the Dodd-Frank Act in the US. Other regulations addressing prudential soundness will indirectly affect decisions on structure as firms look at how they can continue to deliver strong financial performance.

None of these initiatives is new. What will be different in 2014 is that banks and their supervisors will have to begin to make concrete choices as to how banks (re) structure themselves in the light of these developments. Inevitably, some of these decisions will have to be made while uncertainty remains on some of the key variables. Very careful analysis, impact assessment and scenario planning will be required as banks work their way through this complex process. There will also be a need for continuing engagement with policy-makers, as consultation on the more detailed requirements begins.

The Financial Stability Board (FSB) will assess the cross-border consistency and global financial stability implications of these measures by end-2014. Although this is another source of uncertainty, it's unlikely to change the direction of national or EU reforms.

RESTRUCTURING THE (REST OF THE) FINANCIAL SYSTEM

Banks are not the only businesses subject to major structural upheaval. Resolution regimes for non-banks are expected to progress in 2014, particularly for CCPs and insurers, with the latter also under pressure from moves to address global systemically important insurers. Market structure will not escape unscathed, with EMIR set to drive further structural and operational changes through central clearing, while MiFID II will continue to alter the forms of trading venues and market structure.

The political and regulatory drive to make banks more resolvable and eradicate the "too big to fail" dilemma is clear. But the "resolvability" agenda does not stop at banks. As a number of policymakers have noted, the impact of the reform of OTC derivatives markets, in particular the drive for more central clearing of derivative transactions, has elevated the systemic importance of central counterparties (CCPs). The subject of resolution frameworks for CCPs (and for other financial market infrastructures) is currently much less emotionally and politically charged, because there has been no need for any "bailout" using public funds. But the subject matter is technically very complex and has implications not only for CCPs, but also their clearing members, members' customers and the wider market. The UK has been one of the first countries to introduce new resolution legislation for CCPs and we expect the EU to bring forward a legislative proposal in this area during the course of next year.

Insurers, particularly the nine global systemically important insurers (G-SIIs), now find themselves in the resolvability spotlight. The FSB needs to finalise how its Key Attributes for Effective Resolution Regimes should be adapted to insurers and this will in turn inform the recovery and resolution plans (RRPs) the G-SIIs are obliged to complete by the end of 2014. There is also the prospect of structural change within G-SII groups, if they choose to isolate their non-traditional, non-insurance activities within a separate company.

CAPITAL AND LIQUIDITY – BACK TO THE FUTURE?

Will proposed changes to the capital framework take us towards Basel 3.5 or back to Basel 1.5? Legislation to implement Basel III is not the end of the story – supervisory attitudes will continue to shift in relation to models, with more challenge and less discretion, and increasing uniformity of practices in areas such as Pillar 2, stress testing and model approval. Implementation of the liquidity regime will continue to be in focus. What, if any, lessons can be learned from all of this – and from Solvency II – for the development of a global capital standard for insurers?

In 2013 the Basel Committee on Banking Supervision (BCBS) produced what is probably the "greenest" paper in its history: "The regulatory framework: balancing risk sensitivity, simplicity and comparability". It exposed the tensions between the proponents of a leverage ratio (simple, comparable) and the advocates of internal models for the measurement of credit and market risk (risk sensitive). It might be argued that there is room for both on the "dashboard" of capital and liquidity indicators. However, at any given time for any bank, only one out of the risk-based capital or leverage ratios will be the binding constraint. If the leverage ratio is the binding constraint, banks will make some risk-insensitive decisions. More generally, banks will have to rise to the challenge of managing their balance sheets in a way that simultaneously satisfies the demands of risk-based capital, leverage and the liquidity coverage ratio.

The FSB's work on loss absorbing capacity will also be important, in particular to what extent banks will be able to meet requirements with capital rather than debt, and to what degree supervisors will expect that banks can be recapitalised post-resolution. The issue is linked inextricably with bail-in requirements and the resolution agenda. If supervisors demand that firms hold some genuinely "gone-concern" capacity, it will need to be held as debt. That could in turn affect the amount of "going-concern" capital banks hold.

We expect the pace of progress on insurance capital to accelerate too. The transition period to Solvency II (SII) will start on 1 January 2014 and insurers should not be lulled into a false sense of security by the two years they have until full implementation, followed in some cases by as many as 16 years of transitionals. Much preparatory work remains to be completed. And at the global level the International Association of Insurance Supervisors (IAIS), having gone 20 years without putting in place a global capital standard, is now looking at three coming along in close proximity: a backstop capital requirement by end-2014; a "higher loss absorbency" requirement for G-SIIs by end-2015 and a fully-fledged global standard by 2016. This is a very ambitious timetable, from a standing start. Execution risk is high and insurers will need to engage with the process fully.

WHOLESALE CONDUCT RISK

The focus on wholesale conduct will intensify over the course of 2014. The issue is squarely in the sights of the FCA, and the results of a number of thematic reviews are due in 2014, while a recent series of high profile enforcement cases indicates the size of the stakes. Litigation in relation to interbank rate manipulation is set to continue, while investigations into the foreign exchange market are ongoing. Agreement on MiFID II will also bring algorithmic and high frequency trading under the spotlight.

As far as the Financial Conduct Authority (FCA) is concerned, wholesale conduct has two facets: customer protection and market integrity. Mis-selling of interest rate swaps to SMEs and LIBOR manipulation have harmed both. Concerns about potential manipulation of FX market benchmarks combined with on-going enforcement action and private litigation from the first two signal "more of the same" in 2014, with consequent reputational and financial damage for those who crossed the line.

In our view, all firms need to increase their focus on wholesale conduct risk and consider it in its widest form. Regulators increasingly care about the risk trickling down from wholesale to retail markets. This will mean asking searching questions about how sophisticated wholesale customers really are, the complexity of the product range, the conflicts of interest firms may face and the transparency of charging structures. In short, this is about ensuring good outcomes for wholesale customers and maintaining market integrity.

BANKING UNION

With the SSM set to become operational in late 2014, there is an immense amount of preparatory work to be done. The ECB's comprehensive assessment exercise, including the asset quality review, will seek to ensure banks are financially sound before the ECB takes over responsibility for direct supervision of the largest banks. Of course, Banking Union is not just about the SSM, with proposals for a Single Resolution Mechanism, including a Eurozone-wide resolution fund also set to attract increasing attention over the next year. All these elements will create change, and new requirements and supervisory expectations for banks to manage.

The creation of the Single Supervisory Mechanism (SSM) as a key component of the much bigger Banking Union is a massive undertaking. By this time next year, the European Central Bank (ECB) will have put in place its top management team, recruited around 1000 staff, agreed a modus operandi with national supervisors and set out its supervisory approach. As a prudential supervisor, the ECB will establish a change in culture and introduce new supervisory expectations. Over time, it is likely to demand new and more data to support its supervisory approach; in the near-term firms will need to marshal significant resources to respond to the ECB and national supervisors in the set-up process.

At the same time, the ECB will run its comprehensive assessment of the 124 largest bank groups that it will directly supervise. The assessment comprises a business model assessment, asset quality review and stress test. As well as being technically complex to run, there are important political expectations that need to be fulfilled. It needs to be of the Goldilocks variety – tough enough to be credible but not so tough as to exacerbate the link between banks and their sovereign states that Banking Union is intended to dilute. The provision of extensive data to the ECB and the national supervisors will once again put the spotlight on data integrity and risk data aggregation at banks, adding impetus to pressure on the G-SIBs to comply with the BCBS principles for effective risk data aggregation and reporting by 2016.

OPERATIONAL RISK

Following a recent series of high profile incidents exposing serious shortcomings in operational risk controls, supervisors are turning up the heat in this area. Heightened supervisory expectations will see more banks subject to sizeable Pillar 2 add-ons for operational risk issues, while the Basel Committee is set to complete work in this area in 2014. Cyber security is one such risk in focus, with firms now subject to 'cyber stress tests'. Much tougher supervisory expectations on risk data aggregation is another. Integrating all of this within a coherent risk appetite and risk management framework remains a challenge.

In the years since the crisis the BCBS has scrutinised the definition of capital, risk weights and its approaches to capital for credit, market and, most recently, trading risks. However, so far it has paid relatively little attention to operational risk. This is set to change in 2014, with the BCBS scheduled to complete two reviews at the behest of the FSB, including an update of the relevant capital requirements by the end of the year, and a peer review on the implementation of its Principles on operational risk by June. Given the scepticism with which some members of the BCBS now regard model based approaches to calculating capital, it is likely that the Advanced Measurement Approach (AMA) on operational risk will come under particular scrutiny. But there are broader questions as to whether the hierarchy of the Basic Indicator Approach, the Standardised Approach and the AMA provides the right incentive structure and why, notwithstanding the focus on operational risk management for many years, so many operational risks are currently crystallising. Although banks may be most directly affected, we expect supervisors' interest in operational risk to extend across all the sectors, and to require changes to conduct and culture. Notably, the FSB has called on the IAIS to ensure its peer review of the Insurance Core Principles goes ahead as scheduled in 2014, with several principles covering operational risk issues.

Culture will increasingly be seen as the key to unlocking good outcomes for customers and firms should expect their supervisors to continue to focus on this area, posing challenging questions to Boards and senior management about how they can satisfy themselves that the positive culture they seek does, in fact, permeate their organisations.

The FCA's focus on product design and governance also looks set to continue, supplemented by further analysis of business models to determine whether the underlying economics of a firm's business are consistent with delivering good customer outcomes. In this regard, we expect particular scrutiny of whether firms are safeguarding the interests of existing customers while competing to attract new ones. Drawing on insights from behavioural economics, the FCA can be expected to be particularly vigilant for signs of firms taking advantage of customer inertia, or otherwise exploiting behavioural biases. The conclusions of the FCA's thematic review of annuities will be an interesting example here given its concern that customers are not shopping around. We expect the FCA will be delving even further into any grey areas, setting out increasing expectations on what firms should be doing, beyond what they need to do to remain compliant. Many consumer credit firms will be playing regulatory catch-up as the FCA takes over responsibility for their regulation from the Office of Fair Trading in April next year, with payday lenders likely to be first in the firing line.

At the EU level, the revision to the Markets in Financial Instruments Directive/ Regulation (MiFID II / MiFIR) remains a priority and, while negotiations have been slow-going, agreement may be reached before the EU process is interrupted by the Parliamentary elections and the appointment of a new Commission. However, it remains to be seen whether sufficient progress on negotiations will be made on the revision to the Insurance Mediation Directive (IMD II) and the Packaged Retail Investment Products (PRIPs) initiative ahead of this effective cut-off date. Each of the European Supervisory Authorities (ESAs) has included consumer protection initiatives in its work plan for 2014 and will also continue to collect and analyse data on consumer trends. However, given the limited resources at the ESAs and the fact that consumer protection activities will need to compete against the large number of technical standards that the ESAs have to complete in 2014, we expect that national supervisors and their consumer protection priorities will set the agenda for firms.

PUTTING CUSTOMERS FIRST THROUGH BETTER CONDUCT AND CULTURE

Fairness and the 'ethics of care' will take precedence over narrow compliance with rules as supervisors look to exercise more judgment and encourage more customer-centric cultures. All areas of firms and all levels of staff will be under scrutiny, as supervisors assess how practices at all stages of the product life cycle contribute to good consumer outcomes, while product intervention powers will be developed further. It will be instructive to see how the FCA uses its new powers over consumer credit.

INDIVIDUAL ACCOUNTABILITY

Governance and corporate culture will remain in the spotlight, but it is clear that firms will need to focus on more than structures alone, as regulators consider how high level policies are cascaded through firms. Senior individuals will be under the spotlight, with new legislation and supervisory approaches looking to make individuals more accountable and find ways to 'focus minds'. The increasing use of "attestations" by supervisors will be one way of achieving this end.

The focus on individual accountability will increase in 2014 as the Banking Reform Bill becomes law and the Prudential Regulation Authority (PRA) and FCA put in place the detail of the new Senior Persons regime and the associated licensing regime. As part of this both regulators will ask firms to identify which of their senior management team is individually accountable for which key risks. This will build on the foundation of individual accountability and responsibility that has been reinforced this year through the increasing use by the PRA and FCA of senior management attestations. This will in turn heighten the focus on risk, the robustness of associated controls and the testing of the quality of outcomes that the controls deliver.

These developments are clearly part of a broader agenda which is the regulatory focus on culture. In this regard, the FSB's recent paper on risk culture, which complements its previous work on risk appetite, is instructive. The FSB's focus is on four indicators of risk culture: tone from the top, accountability, challenge and incentives. These are sensible places to start, but in reality Boards and senior management teams will need to develop these considerably, both to be clear about what sort of culture they want and to have clear yardsticks with which to measure it.

COMPETITION – PART OF THE SOLUTION?

The UK's FCA will continue to pursue its competition objective, while the new Competition and Markets Authority will assume its full responsibilities in April 2014. The seven day current account switching service is now live, but work to set up a new payments regulator is on-going, and account portability will continue to be an issue. Wholesale markets are also under scrutiny, and the results of the FCA's Wholesale Strategic Review will determine whether a full-blown market study will be undertaken on competition in wholesale markets, and its effect on retail products.

In 2014 we expect to learn more about the practical consequences of the FCA's focus on competition as a means of securing positive outcomes for consumers and for market integrity. So far "market studies" have been launched in relation to the cash savings market and to add-on products in the general insurance market. If these studies identify a need for intervention, what will be the balance between the FCA deploying its own rule-making powers to improve competition and using the accelerated procedure for referring issues to the new Competition and Markets Authority? Time will tell.

However, what is clear already is the FCA's interest in transparency of pricing and charging in both retail and wholesale products and markets. This is most recently evident in a review that the FCA has announced of price comparison websites in the general insurance market. But such considerations also underpin the FCA's interest in charging structures in asset management and in the use of broker commissions. Firms need to ask themselves which – if any – aspects of their current business practices and model are likely to be subject to similar scrutiny.

2014 will mark 12 months since the introduction by the PRA and the FCA of their new framework to ease the path of new entrants into the (retail) banking market. Although a number of applicants are understood to be in the pipeline, from March to October 2013 only six new banks have been authorised, including three branches of overseas banks. If new entrants remain more of a trickle than a flood and the incidence of current account switching does not increase markedly, there remains the likelihood of further Government and/or FCA intervention into the retail banking market.

At the same time focus will be on the Government's proposal, following a recommendation from the Parliamentary Commission on Banking Standards, to give the PRA a secondary objective to promote competition. While this secondary objective would be subordinate to its general objective to ensure the safety and soundness of the firms that it regulates, it would require the PRA to take a more proactive approach to competition.

Consistent with our opening comment about the re-regulatory process being far from complete, the need for financial services firms to invest in regulatory change management capabilities is undiminished. Doing this well – from identifying emerging regulatory issues and risks early, engaging with policymakers and other stakeholders, working with the business to assess impact and finally to implementation – will reap benefits. It requires very senior sponsorship and investment, both scarce commodities, but justified in this case by the need to respond nimbly to regulatory change and minimise damage to franchises and business models.

As implementation plans bed down we expect firms to move away from tactical to strategic decision making, but the extraterritorial world of global regulation adds another layer of complexity. 2013 saw mixed messages on the willingness of regulators to achieve pragmatic solutions to the extraterritorial effects of national and regional legislation, with the lack of anything other than agreed high level principles between the US and EU on the difficult interaction between EMIR and Dodd-Frank. In the absence of more concrete progress the consequences for booking models and bank structures could be significant.

On the other hand, SII is reported as having reached a more accommodating conclusion on assessing the "equivalence" of non-EU countries' insurance capital frameworks. This could set a more positive and pragmatic tone for 2014, at least from the EU, but progress certainly cannot be taken for granted.

MANAGING REGULATORY CHANGE IN AN EXTRATERRITORIAL WORLD

Regulatory change management has three elements – dealing with new regulatory authorities; new regulations; and new supervisory attitudes and expectations. This in itself is a mammoth task, particularly for global organisations. But its complexity is compounded by extraterritorial effects, with rules applying outside the national environment, creating conflicts and overlaps. EMIR, MiFID II and Dodd-Frank will crystallise some of these conflicts in 2014.

Top 10 for 2013
How did our predictions fare?

THEME	COMMENTS	GRADE
MAKING IT EASIER TO DEAL WITH FAILING FIRMS 2013 will see a focus on improving the resolvability of both banks and non-banks.	• 2013 saw a sustained focus on resolvability, of banks and also of CCPs, insurers and other non-bank financial institutions. • This very tough nut has not yet been cracked, but the main outstanding issues are understood and being addressed.	9/10
STRUCTURAL REFORM Steps are in progress in a number of jurisdictions to prevent insured depositors from funding proprietary trading and/or investment banking.	• There was progress, but it was slower than expected, reflecting the complexity of the issues. • In the UK, the amendments to the Banking Reform Bill slowed the Bill down through Parliament. The EU's timetable slipped significantly.	7/10
IMPLEMENTING THE CAPITAL AND LIQUIDITY REGIME Implementation of Basel III and Solvency II requirements will remain high on firms' agendas. However, regulators face pressure to balance safeguarding firms' stability and encouraging lending. There will also be pressure to simplify the rules.	• CRD IV was agreed and will come into force on 1 January 2014. • Late in the year Solvency II was kick-started (again) and the International Association of Insurance Supervisors announced its intention to put in place capital standards for both systemically important and internationally active insurers. • As we predicted, the final Basel III Liquidity Coverage Ratio was relaxed in a number of important respects. We also called correctly the intensification of the debate about "simplification" of the Basel III capital framework.	9/10
REINVENTING WHOLESALE MARKETS The raft of reforms in wholesale markets will drive an unprecedented amount of change. Will 'caveat emptor' survive?	• The spotlight shone on wholesale conduct: reform of benchmark regulation, concerns about the speed of redress to SMEs mis-sold interest swaps, and the recently announced investigation into possible misconduct in the foreign exchange market. • Progress in the EU on OTC derivatives reform was much slower.	8/10
NEW SUPERVISORY BODIES 'FLEXING THEIR MUSCLES' In 2012 new supervisory bodies were proposed, and recently established bodies began settling in. In 2013 we will see them establish their supervisory style more clearly.	• Whilst there is no doubt that in the UK the PRA and FCA showed their strength, there was much less evidence of the ESAs engaging with the supervisory (as opposed to regulatory) agenda. • The SSM was mostly about planning, although the launch of the Asset Quality Review in the last quarter saw activity move up several gears.	7/10
PRODUCT INTERVENTION Conduct regulation is becoming increasingly intrusive and judgement-based, with regulators demonstrating readiness to intervene. This trend will affect a growing number of retail business lines, with implications for profitability.	• Despite plenty of talk, relatively little overt action to date. This could, of course, be a sign that the FCA's tough talk (and action in relation to unregulated collective investment schemes) is having the desired effect, and that firms are carefully reviewing their product offerings to ensure that they stay on the right side of the line.	6/10
MAKING GOVERNANCE EFFECTIVE The focus on effective risk controls, a sound corporate culture and appropriate reward systems is here to stay. We expect to see developments in the area of sale incentives and more explicit requirements for risk appetite frameworks.	• The regulators' focus on culture continued, and was complemented by private-sector initiatives. • Sale incentives became front page news. • The FSB kept up the pressure on the need for financial services firms to have effective risk appetite frameworks.	9/10
COMPETITION AND CHOICE Competition will be an objective of the UK FCA. Elements of regulatory reform could reduce consumer choice by increasing barriers to entry or by causing providers to abandon existing product lines. There may be pressure on the FCA to act as "economic regulator".	• The FCA has certainly set out its stall in relation to competition, with significant market studies underway and more to come in 2014. • In addition, the FCA and PRA have streamlined significantly the process for authorising new banks and the requirements that initially apply to them. • While the FCA has not become a price regulator, its interest in pricing is clear.	7/10
EXTRATERRITORIALITY We expect to see rules increasingly take effect outside domestic jurisdictions. Implementation of reforms across the globe is also likely to give rise to regulatory overlaps.	• This difficult issue surfaced in a number of areas: in relation to OTC derivatives reform (the interaction between the EU's EMIR and Title VII of the Dodd Frank Act in the US) and in relation to the EU's proposed Financial Transaction Tax.	10/10
RISING STANDARDS ON DATA Firms need to provide regulators with timely, high quality and accurate data. Data reporting requirements will begin to kick in. Data governance and infrastructure processes in firms will move to centre stage.	• The BCBS finalised its Principles for Effective Risk Data Aggregation and Reporting. Despite appearing to some on first reading as "motherhood and apple pie", the deadline for implementation (January 2016 for the G-SIBs) and the force of some of the principles add up to a significant challenge.	9/10

Contacts

David Strachan
Partner
EMEA Centre for Regulatory Strategy
dastrachan@deloitte.co.uk

Clifford Smout
Partner
EMEA Centre for Regulatory Strategy
csmout@deloitte.co.uk

Karyn Daud
Partner
EMEA Centre for Regulatory Strategy
kdaud@deloitte.co.uk

Designed and produced by The Creative Studio at Deloitte, London. 31770A