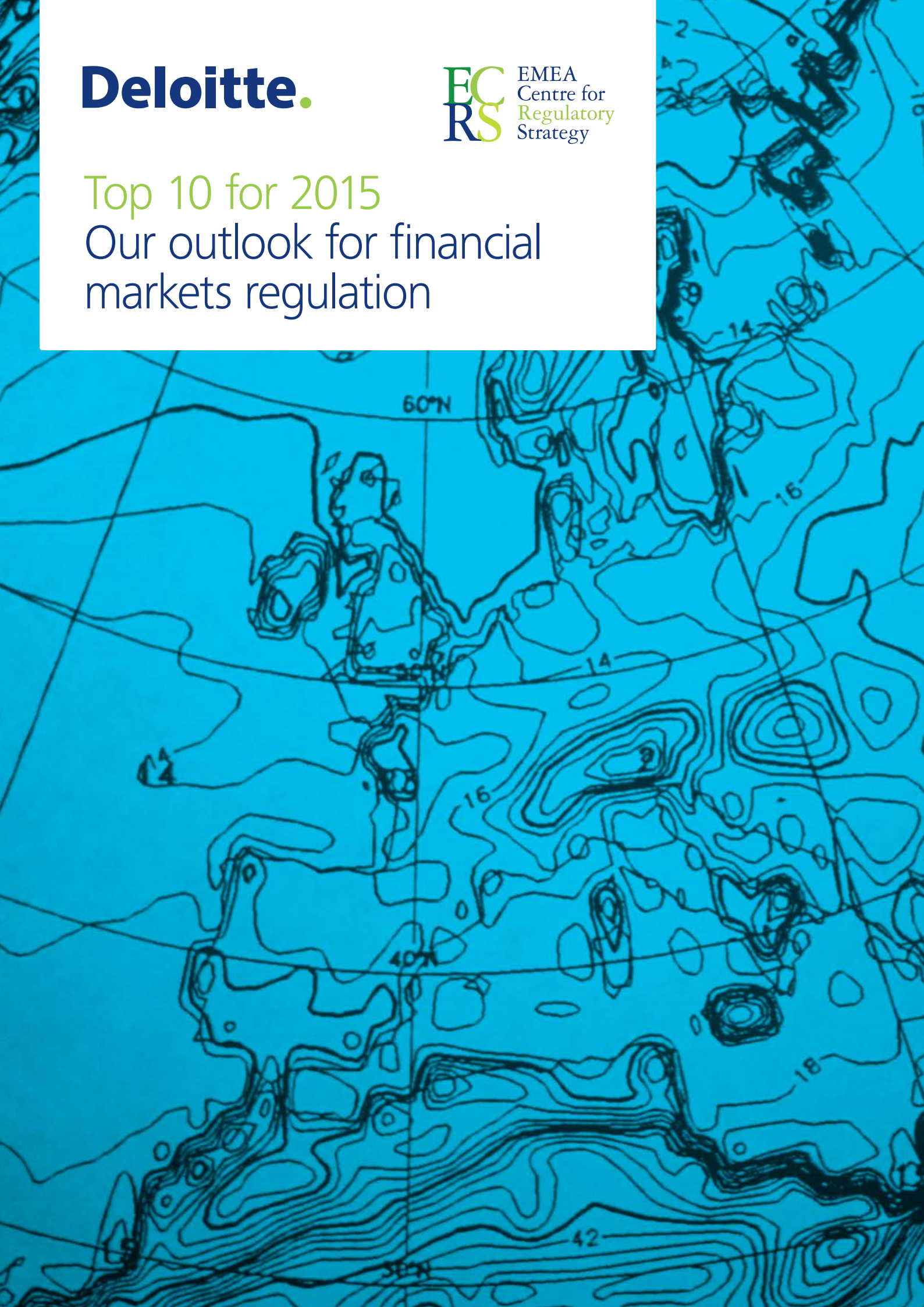












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Centre for  
Regulatory  
Strategy

Top 10 for 2015  
Our outlook for financial  
markets regulation



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# Foreword

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Will 2015 be the turning point in the post-crisis re-regulatory agenda, when the focus shifts from repairing balance sheets and reputations to the rôle of financial services in promoting jobs and growth? And from proposing new rules to implementing the multitude already agreed over the last few years?

There are grounds for cautious optimism. On the banking front, the vast majority of the new primary requirements are now in place (with the important exception of EU bank structural reform), although there are still reviews of various elements of the existing capital framework and a significant amount of implementing detail to come. After a very lengthy gestation, preparations for Solvency II will enter their final year. The new European Commission and Parliament will push ahead with work to decide what falls under the umbrella of the Capital Markets Union (CMU). Recognition of the need for capital markets and non-bank finance to contribute to the jobs and growth agenda could influence the approach that would otherwise have been taken to deal with concerns about shadow banking. Indeed, the Financial Stability Board (FSB) now speaks about “transforming shadow banking” into “resilient market-based finance.”

There will be new institutions making a fresh start, and they will be determined to make their presence felt. The European Central Bank (ECB) via the Single Supervisory Mechanism (SSM) has taken over as the prudential supervisor of eurozone banks. The new Single Resolution Board (SRB) will look at the resolvability of the cross-border eurozone banks, informed by the lessons learned from the FSB’s first set of resolvability assessments for Global Systemically Important Banks (G-SIBs). In the UK, the new Banking Standards Review Council (BSRC) will aim to draw a line under past misconduct and reset standards in banking, while the industry will also be looking ahead to the outcomes of the Fair and Effective Markets Review (FEMR). The UK parliamentary election in May will however inevitably add to uncertainty about the outlook for financial services regulation.

But there are clouds, some quite ominous, on the horizon. Standards and expectations have risen enormously across the board for all financial services firms – whether in terms of capital, liquidity, risk management or culture – and financial and other penalties for transgressions seem to be rising inexorably. The effects of this will continue to be felt, for instance through the “de-risking” which has been prompted by a number of anti-money laundering (AML) and sanctions-related enforcement cases, with some institutions reassessing their risk appetites and exiting certain markets.

Despite some aspects having been closed, residual enforcement actions by regulators, law enforcement agencies and competition authorities in relation to LIBOR and FX benchmarks appear to have some way yet to go, and some of the behaviour revealed has reignited concerns about governance, culture and the structure of remuneration. In this regard, supervisors will remain vigilant and intrusive in a year when the new Senior Managers Regime comes into effect in the UK. Further, even if the balance is shifting from policy formulation to action and implementation, regulation will continue to occupy significant resources and senior management time, including building relationships with the new institutions. In particular, although primary legislation is in place for most of the new EU Regulations and Directives initiated by the last European Commission and Parliament, the European Supervisory Authorities (ESAs) still have to publish a formidable amount of detailed implementing standards. There will be plenty of devils lurking in these details.

Against this background, firms will have to take some key strategic and business model decisions about which activities and products remain viable in a world of new, and in the case of banks, multiple regulatory constraints on balance sheets – in many cases, the finalisation of requirements will crystallise the need for action. Banks will be most affected, but Solvency II will raise similar questions for some insurers.

This new regulatory environment will create opportunities and challenges both for incumbents and newcomers. Set against that, digital innovation will be a potent force, with the potential to transform the financial services landscape – and who the winners and losers are – beyond any regulatory effect. Accompanying this opportunity is a threat – that of cyber-attack. For the Board and senior management teams all this puts an ever greater premium on the clarity and rigour of their scenario analysis and contingency planning, underpinned by high quality data, and timely decision-taking. In a world where firms may more readily be allowed to fail, and with “challengers” knocking at many doors, agility and forward-thinking will be key.



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Supervisors will expect banks to demonstrate a thorough understanding of their objectives and requirements and a credible strategy

# 1. Structural reform and resolution in the banking sector



Sector impact: Banking, Capital Markets and Insurance

Requirements for banks to ring-fence some of their activities have been debated for several years, but relatively little progress on implementation has been demanded. In 2015 this will change. In the UK, the largest banks must in January submit preliminary plans for how they will implement ring fencing. The largest foreign banks operating in the US are required to submit plans for the implementation of Intermediate Holding Company structures.

Banks in scope of domestic structural reform requirements in France and Belgium also face important deadlines. Planning is not easy; supervisors will expect banks to demonstrate a thorough understanding of their objectives and requirements, and a credible strategy. But lack of planning will not be judged acceptable.

Restructuring to meet authorities' expectations of resolvability will also be important. The initial results of the FSB's Resolvability Assessment Process (RAP) were published at the end of 2014, providing the first assessment of the progress that has been made to date by 10 out of the 30 G-SIBs (the remainder will be reviewed by mid 2015). The FSB notes that although some G-SIBs are making their legal entity structures less complex, further structural and operational changes may be needed. We expect that booking models will need to adjust and there will be a continuing focus on operational continuity for functions judged to be critical. There is also important unfinished business for some Governments in terms of putting new resolution legislation in place. Next year will also see a second wave of filings of recovery and resolution plans (RRPs) by banks in the US, where regulators took a tough line in 2014. Resolvability planning will also get underway in the EU as the Bank Recovery and Resolution Directive (BRRD) takes effect and the SRB starts to operate. Combining ring-fencing and resolvability considerations will add a layer of complexity to the strategic challenge for banks. Banks will also need to consider how other rules (including OTC derivatives reform) and supervisory policies (such as increasing scrutiny of intra group transactions) play into their analysis.

Against this background, significant uncertainty hangs over EU requirements for bank structural reform. Proposals unveiled in January 2014 are proving contentious and are expected to remain so as the European parliamentary process continues. Fundamental questions remain unresolved and some will (continue to) argue that the proposal is unnecessary for structures that are indeed resolvable, but it would be unusual for the proposal to be withdrawn. The derogation for national frameworks looks under threat, and it is unclear whether a workable compromise can be reached.

All this makes planning very difficult, yet domestic legislative timetables in some countries will force banks to take some decisions now. The key will be to do so in a way that retains some flexibility to make future adjustments.

Structural reform also applies on a geographic basis. Although the UK's Prudential Regulation Authority (PRA) has taken steps to clarify its risk appetite for non-EEA banks operating as branches in the UK, some uncertainty remains because application of the policy will be on a case-by-case basis. We expect the PRA's first priority to be those branches of non-EEA banks which accept significant amounts of retail deposits. Those banks which find themselves outside the PRA's risk appetite will either need to reduce their activities or convert their branch into a subsidiary. Similar themes can be observed in some other jurisdictions.

It is not only banks facing resolution requirements. Financial Market Infrastructures and some insurers also face similar questions. The European Commission continues to work on its framework for central counterparty (CCP) resolution, which the new Commissioner for financial services has said will be "one of [his] first priorities". CCPs will also be faced with a new international disclosure standard, and it has even been suggested that a new loss-absorbency requirement could be looked at, although it is unclear how such a requirement would be translated from banks to CCPs. At the international level, Global Systemically Important Insurers (G-SIIs) were originally expected to have RRPs in place by end-2014, although the FSB's RAP report makes it clear that this timetable has been extended. The FSB has set out an ambitious work programme on insurance resolution for 2015, although it is still far from clear how much effort national authorities will put into this and, eventually, how much structural change emerges. One acid test will be the speed with which national authorities look to incorporate the FSB's Key Attributes for the effective resolution of insurers into their domestic legislation.

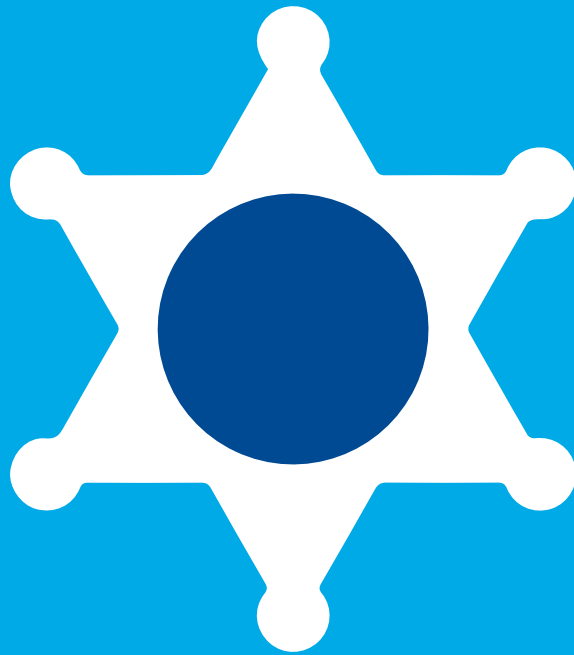
## Find out more

### Point of View

- **Structural Reform of EU banking: Re-arranging the pieces**

### Blogs

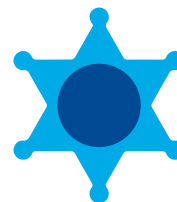
- **Loss-absorbing capacity for banks: EBA consults on EU requirements – 'MREL'**
- **PRA puts ring-fencing in industry's court**
- **Resolvability: breaking down the barriers**
- **Insurance resolution: Under the supervisory spotlight**
- **Single Resolution Mechanism: Great resolve; still some questions**



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We expect the first half of 2015 to be dominated by dealing with issues highlighted by the Comprehensive Assessment, with some of the more difficult or complex aspects informing longer-term supervisory actions

## 2. New institutions in action



Sector impact: Banking, Capital Markets, Insurance and Investment Management

2014 saw important institutional changes in the EU. In 2015 the implications for financial services will begin to play out. A new guard in the European Commission and Parliament, for the first time since the financial crisis, may dedicate a larger share of the financial services agenda to promoting growth through alternatives to bank financing than to the “safety and soundness” considerations that dominated their predecessors’ work. A similar change in emphasis was signalled by Mark Carney, chair of the FSB, after the recent G20 meeting.

In the EU, a new focus on non-bank forms of finance to promote jobs and growth, as part of this the CMU, may influence proposals for dealing with shadow banking. What happens on the proposed Money Market Funds (MMF) Regulation will give one early indication of how this balance will be struck.

In the eurozone, the start of the SSM initiates a journey that will test banks and supervisors. The ECB will work hard to instil a new supervisory culture and good practice across the region. It will be important for banks to engender dialogue, trust and a strong understanding of their business with supervisors. New supervisory expectations will be important drivers of business strategy. We expect the first half of 2015 to be dominated by dealing with issues highlighted by the Comprehensive Assessment, with some of the more difficult or complex aspects informing longer-term supervisory actions. Consistency of risk-weighted assets, and model validation, will be important topics for thematic work by SSM supervisors in the coming year. More broadly, harmonising the discretions available to supervisory authorities across the Eurozone is high on the ECB to-do list. The Supervisory Risk Evaluation Process (SREP) will become an increasingly important part of the dialogue between banks and supervisors.

The SRB, part of the Single Resolution Mechanism (SRM) within the Banking Union, remains an unknown quantity but will wield significant power. From January 2015, it will begin working with national authorities on resolution planning, resolvability assessments and the setting of loss absorbency. This new institution has received relatively little attention to date – given the significance of its influence this needs to change in 2015.

In the UK, the Payments Systems Regulator (PSR), a subsidiary of the Financial Conduct Authority (FCA), will begin regulating in 2015. It has been established to address concerns that have been raised about a number of issues in the payments industry, including access to the UK payments systems, the terms offered for access, and the industry’s pace of innovation.

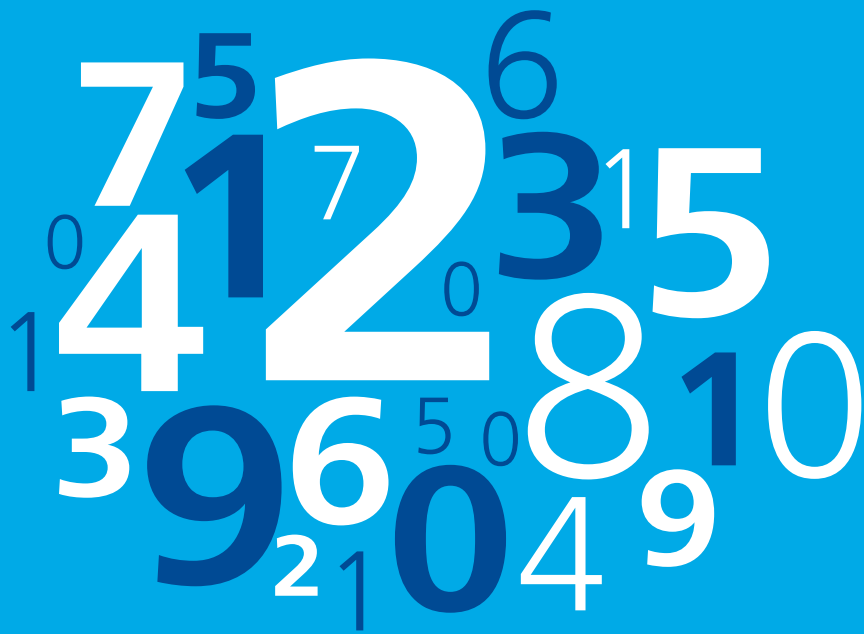
### Find out more

#### Point of View

- Meeting the challenge of the SSM | How banks should get ready for the new regime

#### Blogs

- Results of the ECB’s Comprehensive Assessment
- Eurozone banks wake up to a new supervisor. What’s next?
- A “watershed” moment for financial regulation, and “the next phase of reform”



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Many banks experienced difficulties providing accurate data in the form that supervisors wanted on a timely basis



# 3. Data and regulatory reporting



Sector impact: Banking, Capital Markets and Insurance

Appetite from supervisors for more, and more granular data, has been growing since the start of the financial crisis, but in the coming year several initiatives will combine to make data and reporting once again critical for firms. Although in the near term cost and time pressures may force firms to adopt tactical solutions, in the longer run it could be more effective to take a view on more fundamental, strategic, changes. And in some cases supervisors may insist on a strategic solution.

Foremost in the minds of the largest Eurozone banks will be the follow-up to the asset quality review (AQR) completed as part of the ECB's Comprehensive Assessment. Many banks experienced difficulties providing accurate data in the form that supervisors wanted on a timely basis. The ECB will also introduce regulation on reporting of supervisory financial information.

Supervisors also expect banks to improve their risk data capabilities. Although the Basel Committee on Banking Supervision (BCBS)'s Principles for effective risk data aggregation and risk reporting currently only apply to G-SIBs, the indications are that supervisors will expect the principles to be adopted more widely. The G-SIBs have until 1 January 2016 to comply with the BCBS's principles and we expect 2015 to be a year of significant activity, with some banks finding it a challenge to make progress.

The challenge extends beyond risk and prudential data. The FSB recently observed that G-SIBs' management information systems may still not be capable of providing accurate or relevant information required in resolution in the right timeframe. In the EU, the European Banking Authority (EBA) is consulting on technical standards for the independent valuation that will be carried out in the event a bank is resolved.

Important changes are being made in accounting standards which, with time, are expected to affect prudential reporting and capital. For example, IFRS 9 provides new guidance on the classification and measurement of financial assets and introduces a new expected credit loss model for calculating impairment. During 2015, banks will begin programmes of work expected to last at least two years, although the earliest reported financial impacts are expected to be in 2015 and 2016 ICAAPs.

Insurers face more stringent data and reporting requirements as well, to a significant degree driven by Solvency II transposition timelines. 2015 is the first year in which preparatory Pillar III reporting disclosures are expected, prior to Solvency II implementation on 1 January 2016. Furthermore, Solvency II continues to present insurers with the significant challenge to generate data to the right level of granularity, for example related to "look-through" asset data. Ensuring rapid access to the required data remains an industry issue. Building-in known elements of other upcoming data and reporting requirements (for example IFRS 4 Phase II or resolvability assessments) will minimise the need to 'dig up the road twice' when the new requirements come into play.

Regulators are also seeking to increase transparency in capital markets and shadow banking. Further detail will emerge next year from the European Securities and Markets Authority (ESMA) on the expanded post-trade reporting, transaction reporting and commodities derivatives position reporting requirements under the Markets in Financial Instruments Regulation (MiFIR). The Regulation on reporting and transparency of securities financing transactions is also likely to enter into force next year.

Data protection reform in the EU, likely to be concluded in 2015, will be another important consideration in reforming data systems.

## Find out more

### Points of View

- Risk data and the Supervisor
- Going up? The impact of impairment proposals on regulatory capital
- Fourth Global IFRS Banking Survey

### Blog

- Results of the ECB's Comprehensive Assessment



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Industry needs to focus on how senior management can best oversee culture and conduct risk, putting conduct risk MI high on the agenda

# 4. Culture and treatment of customers



Sector impact: Banking, Capital Markets, Insurance and Investment Management

Culture and the treatment of customers will remain at the forefront of the financial services debate. Banking and capital markets activities are in focus following well-publicised transgressions, but the principles have broader relevance for all financial services sectors.

There is no doubt about the seriousness of the crackdown on activities perceived to have the potential to lead to consumer detriment, whether retail or wholesale, or harm market integrity. Everyone in financial services can now talk culture, but the real challenge is to “do” culture – identify it, articulate it and embed it at all levels of the organisation. This is where supervisors will expect to see hard evidence of significant progress in 2015.

In the UK, new Senior Managers Regimes are being introduced in both banking and insurance. This will result in more supervisory scrutiny of individuals in scope and (especially in banking) potentially significant individual liability if things go wrong. The PRA explicitly prescribed two responsibilities linked to culture (one for developing, the other for embedding culture), which should concentrate minds on this, as will recent enforcement action by the FCA. To prepare, the industry needs to focus on how senior management can best oversee culture and conduct risks, putting conduct risk MI high on the agenda. In 2015 the UK’s BRSC will launch, with measuring improvements in banking culture and consumer outcomes high on its agenda.

In the EU the ESAs have been encouraged to up their game on consumer protection across the EU, although it remains to be seen whether they can secure the additional budget and resources to make this a reality, with everything else they have on their plate. One area where they will be very busy, with respect to investor protection, will be in developing level two measures, in particular for the Markets in Financial Instruments Directive (MiFID II) and for the Regulation on Key Information Documents (KIDs) for Packaged Retail and Insurance-based Investment Products (PRIIPs).

Wholesale conduct issues will run well into 2015, and possibly beyond. The UK’s FEMR will report in mid-2015, with its focus being on fixed-income, currency and commodity markets, and their associated derivatives and benchmarks. The review entrenches the idea that regulators will no longer wait for misconduct to materialise before taking action – the focus is on the susceptibility of markets to abuse, and taking preventative action. This means action on systems and controls, but also behavioural practices, and the incentive systems which drive that behaviour. In our view it would be short-sighted to regard the outcome of the FEMR as only affecting the UK. Given the UK’s role in global markets, what starts there is bound to have ramifications for other major financial centres.

## Find out more

### Point of View

- **Transition to the Senior Managers and Certification Regimes – Strengthening accountability in banking**

### Blogs

- **Driving change in FICC markets**
- **The FCA Risk Outlook and Business Plan 2014-15**



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The competition powers raise questions relevant across all financial services – from cash savings accounts to retirement income products, from consumer credit activities to wholesale market activities

# 5. Competition and innovation



Sector impact: Banking, Capital Markets, Insurance and Investment Management

From April 2015, in the UK the FCA and CMA will be “concurrent” competition regulators for financial services. What this means in practice remains to be seen, and it may be some time before it is clear which authority takes the lead on what. At present, there are ongoing competition reviews by the FCA in a number of areas, while the CMA has recently launched a market investigation into personal current accounts and SME banking, due to report its provisional findings and possible remedies in September 2015.

The new PSR (which will have a competition objective) will also take on its full responsibilities in April 2015, by when HM Treasury will have concluded its consultation on which systemically important payment systems come within its scope. With payments services at the forefront of digital innovation in banking the work of the PSR will be all the more important. The PRA also now has a secondary objective to facilitate competition. While we do not expect the PRA to be as active in relation to competition issues as the FCA, competition considerations will be more prominent in its work than has previously been the case.

Under the new competition framework, the FCA will be obliged to consider whether its competition law powers should be used before taking action in line with its regulatory powers. The competition powers raise questions relevant across all financial services – from cash savings accounts to retirement income products, from consumer credit activities to wholesale market activities. Over the course of 2015, the FCA will continue its programme of thematic reviews and market studies. The questions it is posing to industry are granular and challenging, with supervisors delving into details of business lines to identify potential competition issues. The regulatory treatment of challenger banks and challenger products (such as potential successors to annuities) will bear watching closely, as regulators hope to spur innovation through the elimination of competitive distortions. As a measure of progress to date, the PRA and FCA authorised five new banks between March 2013 and 2014 and have seen an increase in the number of firms discussing the possibility of becoming a bank.

UK authorities are not alone in their competition focus. The new Commissioner for Financial Stability, Financial Services and Capital Markets Union, Lord Hill, seems to have taken a leaf out of Martin Wheatley’s book by signalling that he will seek to put consumers at the centre of financial services policies through promoting competition, transparency, choice and innovation. Competition is also a significant motivation for revisions to EU payments legislation and for rules on non-discriminatory access to trading venues and CCPs contained in MiFIR.

Much of the regulators’ competition-related work is likely to have implications for strategy and business models. While the impact may not be as stark as in the payday lending industry, where charge caps will apply from the start of next year, there is a threat to profitability for some business activities for incumbents. At the same time, increased competition will open up opportunities. In practice this means that all types of financial services firms will need to become more attuned to regulators in the widest sense looking at their activities through the lens of competition. And while many organisations will bring these skills and perspectives to bear when dealing with competition authorities, they will be less prevalent in compliance and risk management functions when they are dealing with “traditional” financial services regulators. This needs to change.

## Find out more

### Point of View

- **Banking Disrupted**  
– How technology is threatening the traditional European retail banking model



### 1. Structural reform and resolution in the banking sector

Requirements for banks to ring-fence some of their activities have been debated for several years, but relatively little progress on implementation has been demanded. In 2015 this will change. Further progress on restructuring to meet authorities' expectations of resolvability will also be important. Activity will not though be limited to moving forward work already in train. Significant uncertainty hangs over new EU requirements for bank structural reform, first proposed in January 2014. In the eurozone, the SRB will begin operation. In the UK, banks will also be looking for further clarity on the PRA approach to non-EEA banks operating branches in the UK. And it is not only banks facing resolution requirements. Financial Market Infrastructures and some insurers face similar questions.



### 2. New institutions in action

The ECB is the newest supervisor in town, and 2015 will see banks continue to ride a sharp learning curve as the ECB overhauls the culture of supervision and good practice across the eurozone. The SRB will also start to get up and running, with the centralised resolution authority set to have significant influence over the direction of resolution actions for eurozone banks. We will also begin to see where the new guard at the European Commission and Parliament stands on developing financial services legislation. An emphasis on promoting growth as well as "safety and soundness" considerations is already evident.



### 3. Data and regulatory reporting

Appetite from supervisors for more, and more granular data, has been growing since the start of the financial crisis, but in the coming year several initiatives will combine to make data and reporting once again critical for firms. Although in the near term cost and time pressures may force firms to adopt tactical solutions, in the longer run it could be more effective to take a view on more fundamental, strategic, changes. The challenges apply across financial services. Foremost in the minds of many banks will be the follow-up to the AQR, but the issues extend much further, including to resolution planning and meeting principles for effective risk data aggregation. More stringent requirements for insurers will be driven primarily by Solvency II. Regulators are also seeking to increase transparency in capital markets and shadow banking.



### 4. Culture and treatment of customers

Culture and the treatment of customers will remain to the fore. Everyone in financial services can now talk culture, but the real challenge is to "do" culture. This is where supervisors will expect to see hard evidence of significant further progress in 2015. For firms in scope, the UK's new Senior Manager Regime should concentrate minds. The UK Banking Standards Review Council, which will begin its operations in 2015, has measuring improvements in banks' cultures and consumer outcomes high on its agenda. The ESAs have also been encouraged to up their game on consumer protection across the EU. Wholesale activities will remain in the spotlight, with the FEMR final recommendations expected in June 2015. The review entrenches the idea that regulators should take preventative action in areas susceptible to market abuse, rather than wait for misconduct to materialise. Overall, it will be increasingly important for firms to produce reliable and meaningful conduct risk "data".



### 5. Competition and innovation

From April 2015, in the UK the FCA and CMA will be "concurrent" competition regulators for financial services. Both have ongoing reviews and the new year will bring clarity around their other areas of focus. The treatment of challenger banks and challenger products will bear watching closely. The new PSR, which will have a competition objective, will take on its full responsibilities from the same date. With payments services at the forefront of the digital innovation in banking, the work of the PSR will be all the more important. The PRA now also has a secondary objective to facilitate competition. Initiatives motivated by competition considerations are also prominent at the EU level. Much of regulators' competition-related work is likely to have implications for strategy and business models.



## 6. Stress testing and risk management

The highest-profile stress testing exercise in the shape of the ECB's Comprehensive Assessment may be over, but stress testing does not end there – stress tests will continue to develop in the UK, eurozone and US, and will become an increasingly important supervisory tool. Murmurings about cross-border coordination will get louder once authorities become more comfortable with the rôle their own tests play in their respective jurisdictions. Firms will need to begin thinking about how to join up their risk management and stress testing responses, to provide 'one firm' capability across countries. G-SIBs also face a significant challenge in meeting the BCBS' deadline of January 2016 to achieve the risk data aggregation capabilities set out in its international principles.



## 9. Solvency II and insurance capital

Preparations for Solvency II implementation will enter their final year in 2015, with the long term guarantee package having been agreed in 2014. The main developments for 2015 will be the approval of the Delegated Acts which will be transposed into national law by all EU Member States. Guidelines for supervisors have been issued on systems of governance, Own Risk and Solvency Assessments, reporting, and pre-applications for internal model approval to prepare firms for the implementation of the regime. Solvency II will raise questions for insurers in terms of business mix. New capital requirements will affect optimal asset allocation. Meanwhile, at the international level work is gaining steam to develop a global Insurance Capital Standard (ICS) for G-SIBs and Internationally Active Insurance Groups. It remains to be seen how much impact the global capital standards will have. The bigger impact may come from the increased intensity of supervision insurers attract.



## 7. Capital Markets Union

CMU is a flagship initiative of the new European Commission. The primary motivations are to increase jobs and economic growth, and to develop a more resilient financial system. In contrast to the Banking Union, it will apply to the whole of the EU and seeks to facilitate the growth of new markets. That will be achieved by increasing market-based funding, lowering the costs of raising capital, and eliminating barriers to the cross-border provision of financing, particularly for SMEs and infrastructure projects. Transparent and simple securitisation markets and the development of EU private placements markets are seen as key. Important questions remain though about what CMU will entail, including how it will interact with existing initiatives, and how ambitious plans will be. This new and important agenda will be particularly well debated as different stakeholders vie to influence the emerging agenda.



## 10. The interaction of market structures in different countries

Financial market structures are being radically altered by multiple regulatory requirements, and the way in which users of those markets interact with them is set to change as a result. Old issues of extraterritoriality have not yet gone away, and appear unlikely to any time soon. 2015 will likely see a key equivalence decision in relation to the US derivatives rules, with implications for the geography of derivatives trading. MiFID II/MiFIR will affect all stages of the life-cycle of a trade, from venue access, through to execution, and ultimately reporting and other post-trade requirements. We can expect wrangling over the all-important technical details of the MiFID framework in the next two years. The politics of the Transatlantic Trade and Investment Pact are tricky, but TTIP also remains one to watch.



## 8. Business model mix in a world of multiple constraints

As banks roll out changes to meet the requirements of Basel III, the strategic challenge will shift to managing the implications. High amongst those is what business model – and mix of activities – banks will pursue once capital, liquidity and leverage ratios, stress testing and loss-absorbing capacity requirements are taken into account. Although some uncertainties remain, there is no reason for banks to delay in building capabilities they need to manage their balance sheets in this more complicated regulatory environment.



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Ultimately banks should recognise that, in the context of a forward looking, judgement-led approach to supervision, scenario analysis – and stress testing – is a key supervisory tool



# 6. Stress testing and risk management



Sector impact: Banking, Capital Markets and Insurance

For banks, 2014 saw unprecedented activity in stress testing, underscoring the importance supervisors now give to it as a diagnostic and risk management tool. Stress testing is becoming more frequent, more invasive and more demanding. And it is not just a concern for the largest banks; the same principles are likely to be applied (proportionately) to others.

Some banks involved in the ECB's Comprehensive Assessment, which incorporated the EBA's stress test, will have significant remediation work to do as a result of identified shortcomings in data and processes. Although the ECB has indicated it is unlikely there will be a repeat of the EBA exercise in 2015, it is equally likely there will be one in 2016. At least as important will be the role of stress testing in the ECB's individual capital and liquidity assessment processes. We expect over time the approach to look more similar in style to the Bank of England's (BoE) framework for Pillar 2 stress testing.

At the same time as stress testing exercises become more challenging from a risk perspective, supervisors will also place greater emphasis on banks' stress testing processes and governance. There will be marks for the showing your workings as well as for the final result.

Between them, the ECB, BoE and US Federal Reserve (which also has its own stress testing framework) are responsible for the supervision of 21 out of 30 G-SIBs.

Several G-SIBs will be subject to two sets of stress tests and a handful to all three. These banks need to identify what synergies exist.

Supervisors will look at the consistency between a bank's internal stress testing, assumptions made in recovery and contingency planning, and (if separate) in the SREP. Strong controls and oversight will be required to achieve that consistency. This means that tactical approaches to supervisory stress testing, often divergent from banks' own stress testing exercises, will ultimately not be sustainable (nor permitted by supervisors). It is much too early to talk of an international consensus on an approach to stress testing, but there may be scope to identify areas of alignment, especially as authorities become more comfortable with their own tests.

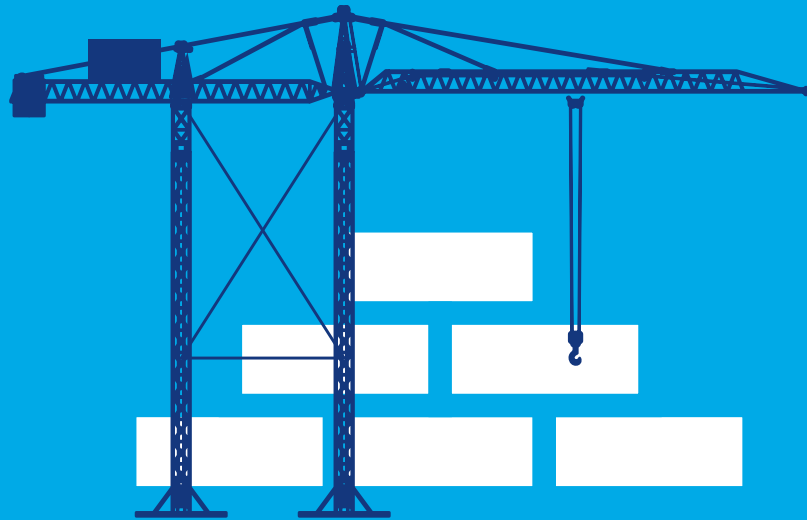
Ultimately banks should recognise that, in the context of a forward looking, judgement-led approach to supervision, scenario analysis – and stress testing – is a key supervisory tool. It won't just be the marginal determinant of capital in future, but also an important driver of the whole supervisory dialogue.

Supervisory stress testing is not limited to banking. During 2014, EIOPA carried out a stress testing exercise for insurers in the EU, assessing risks through the lens of requirements for Solvency II. In the US, regulators recently indicated that clearing houses may be required to undertake standardised stress tests as a part of the risk management process around these increasingly important parts of the financial market infrastructure.

## Find out more

### Blogs

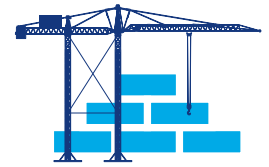
- [Results of the ECB's Comprehensive Assessment](#)
- [EU banking stress test | EBA fires the starting gun](#)



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There is an opportunity for market practitioners, with direct experience of what does and does not work in the EU's capital markets today, to shape this agenda

# 7. Capital Markets Union



Sector impact: Banking, Capital Markets, Insurance and Investment Management

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CMU is a flagship initiative for the new European Commission with a rapidly developing agenda and potentially a very broad scope. The primary motivations are to increase jobs and economic growth, and to develop a more resilient financial system. In contrast to the Banking Union, it will apply to the whole of the EU and seeks to facilitate the growth of new markets. That will be achieved by increasing market-based funding, lowering the cost of raising capital and eliminating barriers to the cross-border provision of financing, particularly for small and medium-sized enterprises (SMEs).

The revival of transparent and simple securitisation markets and the development of EU private placements markets are seen as key. More broadly, CMU has in scope the various initiatives that have previously been pursued as part of the shadow banking agenda. However, its scope is potentially very wide and expands beyond regulation to areas such as financial reporting, insolvency law and tax. The CMU agenda will need to maintain a balance between policy seeking to facilitate growth, and regulation to ensure financial stability and investor protection.

Important questions remain about what progress on the CMU will entail, including the implications for the remit of ESMA and for the Level 2 development of key capital market regulations such as MiFID II/MiFIR, and existing regulations such as the Prospectus Directive, Market Abuse Directive (MAD II) and the Transparency Directive. Integration of the CMU action plan with current initiatives will be a key to the success of the development of a CMU.

Although Lord Hill, the recently appointed Commissioner for Financial Stability, Financial Services and Capital Markets Union, has made it clear that he expects new legislative proposals only to be produced after careful analysis of the current impediments to CMU, history suggests that there will be no shortage of ideas for bold new initiatives. Indeed, some of the debate echoes discussions which took place decades ago. That said, there is an opportunity for market practitioners, with direct experience of what does and does not work in the EU's capital markets today, to shape this agenda. If they do not, others are likely to.



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Divining an optimal strategy that considers all metrics simultaneously and at different points of the economic cycle (when different constraints may bind) will present a significant challenge

# 8. Business model mix in a world of multiple constraints



Sector impact: Banking and Capital Markets

As banks roll out changes to meet the requirements of Basel III, the strategic challenge will turn to managing the implications. High amongst those is what business model – and mix of activities – banks will pursue once the regulatory constraints now in place (capital, liquidity and leverage ratios, stress testing, and loss absorbency requirements) are taken into account. Determining which business lines are most profitable and in what combination is increasingly complex.

Some of these requirements are now set, although there remains uncertainty about others, for example, in the case of the FSB's recent consultation on Total Loss-Absorbing Capacity (TLAC) – the minimum calibration, the use of Pillar 2 and the ability of host authorities to call for additional TLAC to be held in subsidiaries (as well as how requirements will be implemented in the EU). There is also uncertainty on the outcomes of the BCBS's proposals on the Fundamental Review of the Trading Book and its reviews of the standardised approach to credit risk, interest rate risk in the banking book and capital requirements for operational risk. Although a standard has been agreed internationally for the leverage ratio, the calibration of a minimum requirement remains to be decided.

Notwithstanding these uncertainties there is no reason for banks to delay in building the capabilities they need to manage their balance sheets in this much more complicated regulatory environment and to take decisions on the right business model mix. Divining an optimal strategy that considers all metrics simultaneously and at different points of the economic cycle (when different constraints may bind) will present a significant challenge.

The need for individual banks to invest in this capability will depend significantly on their business models, with the G-SIBs likely to be most significantly affected – not only because of the nature of their activities, but also because of the trend by many supervisors across the world to require the localisation of financial resources. This complicates capital and liquidity management by reducing the flexibility and fungibility of financial resources.

[Find out more](#)

**Blog**

- UK leverage ratio requirement: a cornucopia of capital complexity?



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We expect those insurers applying for internal model approval to be subject to continuous scrutiny as applications are filed for approval, especially those regulated by the PRA

# 9. Solvency II and insurance capital



Sector impact: Insurance and Investment Management

Preparations for Solvency II implementation will enter their final year in 2015, with the expected approval of the Delegated Acts in June 2015 being a key date in the finalisation of the regime. Completion of the asset data templates in the preparatory period and under the full regime remains a challenge for insurers.

Solvency II will also raise some questions for insurers in terms of business model mix, although the challenges will not be as acute as for banks. New capital requirements will affect the optimal asset allocation for insurers, and they will also have some important choices to make in relation to the various transitional provisions open to them. Again this will require careful scenario analysis to inform the initial decision, followed by careful monitoring to ensure that the firm is operating within the constraints of the option(s) chosen.

We expect those insurers applying for internal model approval to be subject to continuous scrutiny as applications are filed for approval, especially those regulated by the PRA. It is inevitable that some of the scepticism that the UK's banking supervisors are showing towards banks' internal models will rub off on their insurance counterparts. As part of this, model governance arrangements, including the role and responsibility of non-executive directors, will be tested.

While Solvency II is a maximum harmonising Directive, concerns over a level playing field for EU insurers are unlikely to be addressed with the transposition of the Directive in 2015. Much will depend on how the transposed rules are applied by local supervisors, and convergence of supervisory approaches will be a much longer process.

Meanwhile, at the international level, work is gaining steam to develop a global Insurance Capital Standard (ICS) for G-SIIs and for Internationally Active Insurance Groups (IAIGs) as the insurance capital and resolution debate increasingly follows that in the banking industry. As a first step the International Association of Insurance Supervisors (IAIS) completed its work on the Basic Capital Requirement (BCR) in the autumn of 2014 and this will be used as the foundation for calculating Higher Loss Absorbency (HLA) for G-SIIs. It remains to be seen how much impact the global capital standards will have on G-SIIs and the wider insurance industry and the extent to which any G-SIIs will have to change their business mix or raise capital as a consequence. For the G-SIIs, the bigger impact may in fact come from the increased intensity of supervision they attract and the extent to which this requires them to change their risk and capital management approaches.

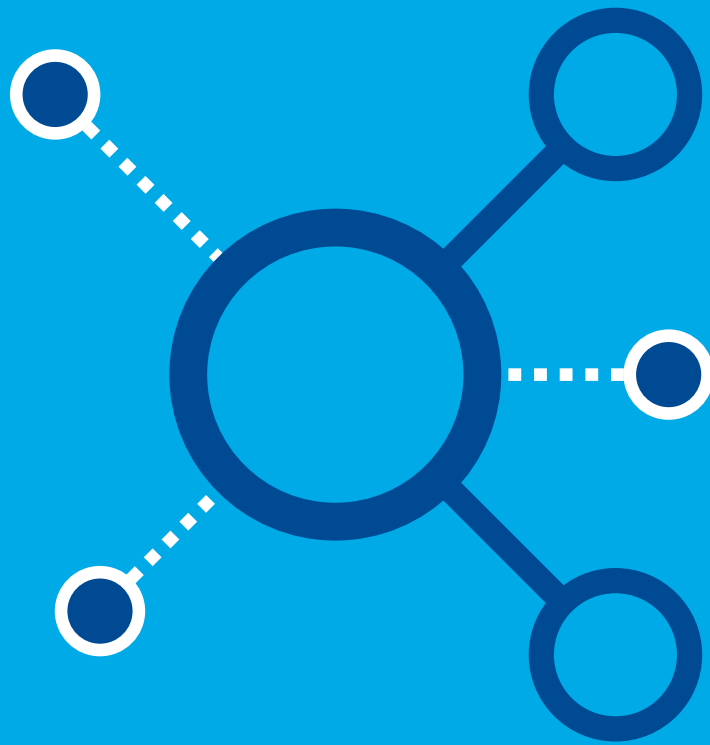
## Find out more

### Point of View

- Solvency II: preparing for EIOPA's interim guidelines

### Blog

- European Trialogue agreement provides green light for Solvency II implementation

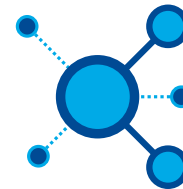


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There will be significant decisions made in relation to which categories of derivatives will face mandatory central clearing, with any inconsistencies between regions likely to spur banks to reassess where they book segments of their business



# 10. The interaction of market structures in different countries



Sector impact: Banking, Capital Markets, Insurance and Investment Management

Financial market structures are being radically altered by multiple regulatory requirements, and the way in which users of those markets interact with them is set to change as a result. Old issues of extraterritoriality have not yet gone away, and appear unlikely to any time soon, despite efforts at the international level to focus on equivalence of outcomes and deference to local rules.

2015 will likely see a key EU equivalence decision on US derivatives rules and continued coordination to resolve cross border issues in the implementation of the derivatives reform agenda, with implications for the geography of derivatives trading. There will also be significant decisions made in relation to which categories of derivatives will face mandatory central clearing, with any inconsistencies between regions likely to spur banks to reassess where they book segments of their business. Supervisory scrutiny of booking models, including of remote booking and back to back intra group transactions for risk management purposes, looks set to continue. Overall we expect to see more regionalisation of booking practices.

Meanwhile, the implementation of MiFID II/MiFIR will affect all stages of the life-cycle of a trade, from pre-trade transparency, through to execution, and ultimately reporting and other post-trade requirements. We can expect wrangling over the all-important technical details of the MiFID framework in the next two years, particularly as non-EEA investment firms face the prospect of enhanced wholesale market access if favourable equivalence decisions are made.

The intended effect of these regulatory changes is to bolster financial stability, including through increased transparency. Mandatory clearing, rigorous risk management standards for non-cleared derivatives and greater use of trading venues will all contribute to this. However, the impact on liquidity and on the choice of derivatives available to end users is less clear, with the cost of non-cleared derivatives set to increase significantly and the number of banks offering a full suite of such products reducing. Market liquidity more generally is under pressure as various new regulatory requirements are causing dealers to re-assess their ability to hold inventory and provide liquidity. In addition, the role of CCPs will become increasingly important, attracting attention not only from regulators and resolution authorities but also from CCP members and end users.

The politics of the Transatlantic Trade and Investment Pact (TTIP) are tricky, but TTIP also remains one to watch, with EU officials continuing to push for financial regulation to be included, while US authorities resist. Regulators in each jurisdiction may watch nervously for any signs of post-crisis regulatory reforms being unpicked as part of the wider negotiations.

We do not expect a fully evolved global market structure to emerge by the end of 2015, but the way that these forces are shaping market outcomes should be much clearer by then.

## Find out more

### Points of View

- [OTC Derivatives – The new cost of trading](#)
- [CFTC and EU OTC Derivatives Regulation- An Outcomes-based Comparison](#)

### Blogs

- [Countdown to MiFID II go-live date begins](#)
- [Political agreement reached on MiFID II / MiFIR | A new landscape for EU capital markets](#)

# Top 10 for 2014

## How did our predictions fare?

THEME	COMMENTS	GRADE
<b>STRUCTURAL REFORM OF THE BANKING SECTOR</b> Measures to ensure the impact of failing banks is minimised are coming to fruition.	<ul style="list-style-type: none"> <li>Discussion of structural reform dominated 2014, and industry has been working hard to consider the consequences, but in general implementation is yet to come. We gained more clarity on UK ring-fencing, but significant uncertainty persists over proposed EU legislation. Little evidence so far of resolvability driving structural reforms. 2015 looks set to mark the start of this process. It may well be far-reaching.</li> </ul>	8/10
<b>RESTRUCTURING THE (REST OF) THE FINANCIAL SYSTEM</b> Resolution regimes for non-banks are expected to progress in 2014, particularly for CCPs and insurers.	<ul style="list-style-type: none"> <li>Supervisors, in the UK and at an international level, kept their foot on the pedal when it came to non-bank resolution in 2014, but there was hardly a need to shift to a higher gear (requirements for G-SIIs notwithstanding). Milestones were reached in market infrastructure regulation and implementing measures, under both MIFID II and EMIR, but resolvability is not yet centre stage.</li> </ul>	7/10
<b>CAPITAL AND LIQUIDITY – BACK TO THE FUTURE</b> Supervisory attitudes will continue to shift in relation to models, and increasing uniformity of practices in areas such as Pillar 2, stress testing and model approval.	<ul style="list-style-type: none"> <li>Supervisory attitudes and scepticism towards models – most notably through a revised SREP process and stress testing – increased in importance as expected. Progress was made at national, EU and global level on defining the leverage ratio, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) and loss-absorbing capacity, and globally on high-level capital standards for insurers. In Basel the debate between risk-sensitivity and complexity continued, although confirmation from the BCBS that it will look to introduce a permanent capital floor, based on the revised Standardised Approach, suggests that “simplicity” is gaining traction.</li> </ul>	9/10
<b>WHOLESALE CONDUCT RISK</b> The focus on wholesale conduct will intensify over the course of 2014.	<ul style="list-style-type: none"> <li>The focus on wholesale conduct has intensified significantly over the course of 2014. In the UK, a number of thematic reviews are underway, including Competition, Conflict of Interest Management, and the Fair and Effective Markets Review. Wholesale conduct risk featured in both the FCA’s Risk Outlook and Business Plan, as one of the conduct regulator’s ‘forward looking areas of focus’ for 2014-15, specifically asset management, investment banking, corporate banking and markets and infrastructure.</li> </ul>	8/10
<b>BANKING UNION</b> With the SSM set to become operational in late 2014, there is an immense amount of preparatory work to be done.	<ul style="list-style-type: none"> <li>The SSM took effect on 4 November, with preparations for this, including the Comprehensive Assessment, having dominated the agenda of eurozone banks and national authorities throughout 2014. All indications are that the ECB is still equipping itself to be a rigorous supervisor, albeit one which will be calibrating its approach and culture for a few years to come. Legislation was finalised on the other two pillars of the Banking Union, the SRM and the Deposit Guarantee Schemes Directive, with signs of action on both fronts.</li> </ul>	10/10
<b>OPERATIONAL RISK</b> Following high profile incidents exposing serious shortcomings in operational risk controls, supervisors are turning up the heat in this area.	<ul style="list-style-type: none"> <li>2014 saw greater focus on capital add-ons for operational risk in Pillar 2. BCBS 239 has driven implementation activity in relation to data aggregation. In addition, the BCBS is consulting on a revised Standardised Approach for operational risk. Further regulatory consultations in relation to operational risk models and Pillar 2A methodologies are expected by end of 2014 and 2015. Cyber security moved towards the top of the agenda, following some high-profile (attempted) attacks.</li> </ul>	7/10
<b>PUTTING CUSTOMERS FIRST THROUGH BETTER CONDUCT AND CULTURE</b> 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.	<ul style="list-style-type: none"> <li>The FCA emphasised “judgement-based supervision” and looking at behaviours that underpin conduct risk culture. The new Senior Managers and Certification Regimes outlined conduct rules in relation to all levels of firm staff, so that practices at every stage of the product lifecycle contribute to good customer outcomes. At the EU level, ESMA has been given powers to ban harmful products directly. Findings of the review into the European System of Financial Supervision found that the ESAs have performed well during their first three years but need stronger powers to assert themselves, particularly in the fields of consumer and investor protection.</li> </ul>	9/10
<b>INDIVIDUAL ACCOUNTABILITY</b> 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’.	<ul style="list-style-type: none"> <li>The PRA and FCA consulted on the new Senior Managers and Certification Regimes in banking and insurance, putting the accountability of senior individuals front and centre of the UK approach. In addition, there is now a wider debate about the possible unintended consequences of the new regime. 2014 also saw the FCA confirm that attestations, usually signed by senior individuals, are a formal part of its supervisory toolkit, and the FCA committed to publish quarterly data on continuing use.</li> </ul>	9/10
<b>COMPETITION – PART OF THE SOLUTION?</b> 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.	<ul style="list-style-type: none"> <li>The FCA launched competition reviews and market studies for various markets: annuities, credit cards, cash savings and the wholesale sector. The PRA announced that it is going to take a more proactive approach on competition to meet its secondary objective to facilitate competition. However, neither the FCA nor the PRA has yet put forward policy proposals or other interventions with explicit reference to advancing competition. In April 2014 the new CMA became operational and has, since then, reviewed various financial services markets. Towards the end of the year the CMA announced an investigation into the supply of personal current accounts and of banking services to SMEs.</li> </ul>	8/10
<b>MANAGING REGULATORY CHANGE IN AN EXTRATERRITORIAL WORLD</b> Regulatory management complexity is compounded by extraterritorial effects, with rules applying outside the national environment, creating conflicts and overlaps.	<ul style="list-style-type: none"> <li>OTC derivatives rules are still high on the agenda, as a key decision on the equivalence of the US regime under EMIR continues to be negotiated. However, Australia, Japan, Hong Kong and Singapore did get the green light from the European Commission. Among other items on the extraterritoriality watch are persisting uncertainties around Financial Transaction Tax (FTT) (in April the European Court of Justice (ECJ) dismissed the UK challenge against the tax as premature) and application of exemptions under the US Volcker Rule. There was more clarity on supervision of branches and subsidiaries in the UK as the PRA’s non-EEA branch risk-appetite became better defined.</li> </ul>	7/10



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