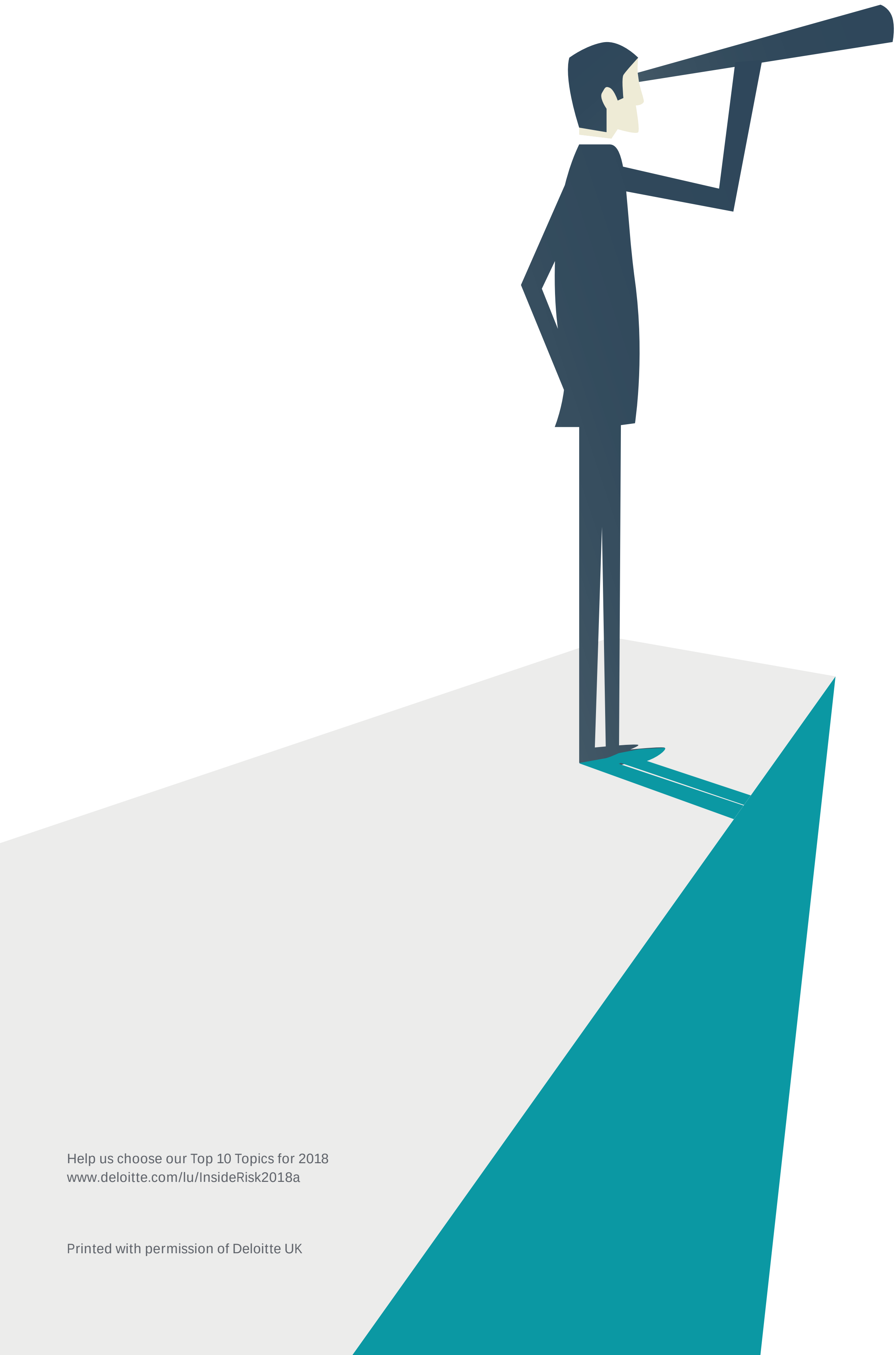

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Bringing it all together

Financial Markets Regulatory Outlook 2018

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The year 2018 heralds numerous challenges for European financial services, particularly in the arena of regulatory reform. The industry must grapple with the implementation of multiple new EU directives and regulations, while simultaneously preparing for Brexit, and guarding against the ever-increasing competitive and operational challenges posed by the development of new technology. This article provides a whistle-stop tour of these and a number of other themes that we identified in our 2018 Financial Markets Regulatory Outlook as strategically important for all sectors of the financial services industry in the year ahead.

This time last year, we expected 2017 to be a period of uncertainty for the financial services industry—among other things, there was a lack of clarity over the final shape of post-crisis reforms, and the implications of Brexit to deal with. We also saw pressures on the industry from sluggish economic growth and low interest rates, as well as competition from new entrants. Looking ahead to 2018, it seems fair to say that most of these challenges and uncertainties remain.

Meeting multiple regulatory deadlines

2018 has a concentration of regulatory deadlines, which in combination touch all sectors of financial services. There is MiFID II, PRIIPs, the EU Benchmarks Regulation, the Insurance Distribution Directive, the revised Payment Services Directive, and the General Data Protection Regulation.

The focus on meeting these in such a short space of time will come with a significant opportunity cost. Firms will not have been able to exploit the potential synergies that exist between several of these regulations, and have had to divert resources from other strategic priorities. In a number of areas, we are expecting some firms to have to undertake significant remediation work after the deadline to make compliance more efficient and effective.

Some implementation work will inevitably overrun regulatory deadlines. Firms need to act swiftly to identify areas where they may be at risk of not being fully compliant and plan accordingly. Moreover, although some regulatory authorities have publicly recognized the challenges of getting over the line in time, there is no room for industries to relax.

Many firms will have to make ongoing changes to implementation plans throughout 2018 to ensure that they are working toward strategic solutions that will deliver optimal operating models. This means that controls optimization is likely to be a multi-year program.

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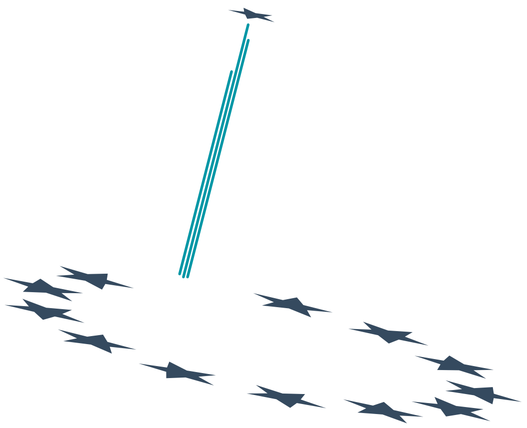

Brexit

as part of their Brexit preparations, we expect firms operating in the UK to start building their presence in EU27 countries on a sliding scale of intensity throughout 2018. We are yet to see whether a transitional period might be agreed, or what shape it might have. We expect some firms to press ahead with certain parts of their plans, including new authorizations and model approvals, even if a transitional agreement is reached.

With respect to two of the fundamental industry-wide issues in need of early resolution, namely the treatment of derivative contracts and of cross-border insurance contracts with durations beyond the UK's exit date, we expect legislative (or equivalent) solutions, especially given the risk of customer and counterparty detriment. These issues are clearly on regulators' radars.

We expect a degree of supervisory "learning by doing"—supervisors' expectations may well evolve over time as they better understand the specific challenges in relation to restructuring work brought on by Brexit. In the EU27, industry can expect to see a strong drive for consistent treatment of restructuring firms, led by the European Supervisory Authorities (the EBA, ESMA, and EIOPA) and the ECB.

For incoming firms to the UK, the FCA has said that it will set out more details in the new year of its approach to a potential temporary permissions regime, for which the UK Government will legislate if necessary. The PRA meanwhile has clarified its stance on the post-Brexit treatment of UK branches of EU firms, most notably for systemic wholesale bank and investment bank branches, for which the PRA will expect to have a degree of influence and visibility over the supervisory outcomes for the relevant firm as a whole. The PRA also made clear that it will retain the option of requiring subsidiarization of such branches where it cannot meet its objectives through other regulatory measures. With respect to insurance, the PRA has said it is likely to press insurers to subsidiarize if they are servicing material volumes of retail insurance business, with £200 million of FSCS-protected liabilities given as a benchmark for this assessment.

Data protection and innovation

We are in an increasingly data-heavy world, with more and more tools at our disposal to analyze that data in novel ways. For financial services firms, this creates opportunities, but also risks. In particular, we see increasing concerns about the use of personal data and data privacy, and as a result, the industry can expect greater supervisory scrutiny of the way in which it uses and controls personal data. This is particularly true of those firms whose business models rely on wholesale processing of customers' personal data.

Most significantly this year, the EU's General Data Protection Regulation will come online in May. This will give consumers additional rights to understand and take control of how firms are using their personal data. Firms will have to carry out Data Protection Impact Assessments, not only to satisfy supervisors, but also to enable them to respond to customers' enquiries in a meaningful, transparent, and understandable way.

Still, GDPR compliance is not the end of the story. Conduct supervisors will be paying attention to any unintended consequences of the automated processing of large data sets—for instance, the potential for financial exclusion and discrimination, and what this means for customers who might be considered vulnerable.

Business model sustainability

The macro-economic environment, competitive forces, and regulatory and technological change continue to put pressure on traditional business models across the financial services industry, and in some cases are driving significant changes to business models, risk appetite, and strategic positioning.

From supervisors' perspectives, deeper analysis of regulated firms' business models enables them to think more broadly about their approach to supervision. Supervisory business model analysis played a more prominent role in supervisory activity in 2017, and will only intensify this year. The result is that business model analysis will increasingly provide a lens through which supervisors will view the competence and effectiveness of the board and senior management.

Firms need to be ready for this, and they may find themselves under scrutiny from two polar opposite ends: on one hand, they may ask themselves whether they are making sufficient and sustainable returns. On the other, they wonder where they are making good returns, and if they have considered the competition and conduct issues around pricing, fees, customer suitability, transparency, and so on. Either way, firms will need to develop their own internal capacity to analyze their business models and their vulnerabilities.

Customer vulnerability

Regulators are increasingly recognizing that legislation, products, and services are often built for the "average" consumer. While that means that things work well enough for many, supervisors have a responsibility to consider customers whose situational vulnerability may mean that they are less able to look after their own interests and hence are at greater risk of suffering harm.

As a result, we are seeing a general shift in conduct supervision strategy. The starting point remains firms' responsibilities to treat all customers fairly, but conduct supervisors will increasingly look to focus their resources on groups of customers at greatest risk of potential detriment or harm. At the same time, those supervisors are broadening their understanding of what it means for a customer to be vulnerable.

Essentially, regulators are recognizing that an individual's vulnerability is dynamic and a function of many variables—it is not just a case of someone's income, but will be based on health, age, life events, and other factors that may change over time. The industry will need to adapt to this broader definition of vulnerability, and factor it into their governance and interactions with customers. Building the capability to monitor vulnerability factors over time will be crucial and will need to be supported by strong board and senior executive engagement and enhanced data analytics.

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Cyber resilience

Clearly, the regulatory focus on cyber risks is not new, particularly in light of technological change and increasingly digital business models. Nevertheless, in 2018 we are likely to start to see regulators articulating clearer priorities for what firms need do to prepare for the inevitable cyber threats they face.

One shift of emphasis we expect in 2018 is driven by the heightened risk of cyber attacks with the potential to threaten financial stability. The increasing interconnections between financial services firms and their outsourcing partners—particularly technology partners—add to the challenge of dealing with what are increasingly becoming jointly owned systemic cyber risks, especially when you consider the cross-border element to many firms' arrangements.

In the insurance industry in particular, prudential supervisors will take a close interest in stress testing and reserving practices, with EIOPA having indicated that it will look to incorporate qualitative elements relating to cyber risk in its 2018 stress test. Conduct supervisors, on the other hand, will be alert for signs about whether policyholders have concerns about the coverage of policies they have already bought, and whether they provided adequate cover any for cyber events they experienced.

Model risk management

It seems clear that regulators in Europe continue to see value in modelling as a part of the regulatory framework, even if they do so with differing levels of enthusiasm. However, there remain general concerns in some quarters as to whether models are fulfilling their intended role in adequately capturing and calibrating risks. There are also concerns as to whether model risks are well understood and managed by boards and senior executives.

In the light of this, firms need to demonstrate that they have considered the inherent limitations of their models, and that they understand the circumstances in which key model assumptions and dependencies might break down.

There are two immediate drivers for supervisory interest in models. The first is the ECB's fieldwork for its Targeted Review of Internal Models, which will be substantially complete by the end of 2018, and as a result, some banks can expect to be asked to carry out remedial work. The second is forthcoming guidance from EIOPA on internal model convergence for insurers.

These things all point to the importance of model risk management frameworks—that is, the governance and oversight of the deployment of models, and the management of risks that arise from their use. We expect supervisors to scrutinize firms in this area; firms will need to demonstrate that they have identified all models generating material risk, and that they have a clear understanding of risks posed by their models, including those outside the scope of regulatory approval. Supervisors will be particularly interested in the information provided to boards and risk committees that lead them to their decisions over how and where to use models.

Conclusion

We titled this year's Financial Markets Regulatory Outlook "bringing it all together." So what are some of the common threads in our analysis?

First, it is clear that the industry is under significant resource constraints, with numerous competing priorities. With business models under pressure, it can be difficult for regulated firms to do the bare minimum, let alone become the best in class.

Second, this is not helped by considerable uncertainty about the future regulatory environment. Irrespective of this, firms will have to act on several fronts in 2018.

Third, the ecosystem of financial services is clearly changing. The capital markets landscape is being changed by MiFID, but we are also seeing old and new players forge new connections, particularly through technology.

Fourth, these new technologies create opportunities, but also risks, particularly for firms whose business models may be challenged, and risks for consumers where the use of technology is not well understood or controlled.

Last, but not least, and on the subject of customers – their relationships with the financial services sector are changing. Firms are looking to use technology and data in new ways, but customers are also set to gain stronger rights over how their data is used.

All in all, the financial services industry faces a complex landscape as it enters into 2018.