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EMEA Centre for Regulatory Strategy

Top 10 for 2016
Our outlook for financial markets regulation

Contents

Foreword

Last year we[1] asked if in 2015 financial services firms would see the authorities shift towards promoting growth and implementing already agreed rules, and away from proposing new ones. As 2015 draws to a close, there is evidence of such a shift, especially within the European Union (EU). However, more generally, it has been post-crisis "business as usual": daunting implementation challenges in respect of multiple regulations that affect financial services firms' (particularly banks') business models and strategies, significant unfinished business, especially in relation to bank capital, and an intensive supervisory and enforcement agenda.

Looking back

In 2015 three broad themes stood out. First, the political mood changed. The emphasis in the EU is now on the jobs and growth agenda; the flagship Capital Markets Union (CMU) initiative is more about deregulation than re-regulation. The shift in sentiment is even clearer in the UK, where the "tone from the top" from HM Treasury (HMT), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) has changed significantly. Some would see concrete evidence of the "new settlement" between authorities and banks in the proposed removal of the "presumption of responsibility" from the accountability arrangements set out in the Senior Managers Regime (SMR), although both regulators are at pains to point out that, in reality, little has changed. And what HMT took away with one hand (the presumption of responsibility), it gave back with the other, by proposing to extend the SMR to all financial services firms.

Moreover, even if the high level messages in the EU and the UK did change, on the ground the scale, scope and pace of regulatory, supervisory and, in some cases, enforcement activity were undiminished. In the meantime firms have had to make progress with complex and inter-linked regulatory implementation projects which affect almost every aspect of their organisation.

Second, progress in completing the extensive set of post-crisis regulatory reforms was slow. In the EU, legislation to deal with bank structural reform and money market funds stalled, while the timetable for some implementing measures of the Directive on Markets in Financial Instruments (MiFID II)[2] and benchmark reform slipped. The much-heralded end to the Basel policymaking agenda remained elusive. It remains to be seen if this is a pause, reflecting the challenging nature of the open issues, or a more deep-seated impasse.

Third, there has been more emphasis on taking the system-wide perspective and asking questions about the cumulative impact of regulation. In this context, there are major unanswered questions about the consequences (intended and unintended) for market liquidity of a range of regulatory measures.

Looking forward

These themes will continue into 2016 and provide the backdrop for our predictions for the coming year.

We expect to see the trend of fewer brand new regulatory initiatives in the UK and elsewhere in the EU continue into 2016. Progress in completing "unfinished business" in the EU will be stately, leaving policy makers with a choice between delayed, or rushed, implementation.

1 Deloitte LLP

2 At the time of finalisation of this document (2 December 2015) it looked as if there would be a delay in the "go live "date for MiFID II. At present there is no clarity as to the scope or extent of any delay. While we have prepared the document on the basis of a January 2017 "go live", even if this date is pushed back, our view is that firms should, given the complexity of their implementation projects, press ahead where they are able to do so.

There is also a question over the many open items on the agenda of the Basel Committee on Banking Supervision (BCBS). Much of the talk around this relates to comparability and consistency; certainly we do not anticipate much support for measures that raise capital requirements in ways that are viewed as undermining the EU's jobs and growth mandate. Moreover, some senior policymakers have indicated that there should not be a major ratcheting up of capital for banks as a whole from the next set of changes. Until these residual (and significant) uncertainties are resolved, banks will be unable to take final decisions on their post-crisis business models and strategies.

We expect the authorities to continue to press for greater competition in financial services for the benefit of end users, despite what some saw as unambitious findings from the Competition and Markets Authority (CMA) in relation to personal and business banking in the UK. The FCA has reviews to complete in respect of investment and business banking and investment management. In the EU we expect the Commission's plans for retail financial services to be heavily influenced by competition considerations. Moreover, the pace of technological development and innovation in financial services ("FinTech") will continue to keep incumbents on their toes, as will challenger banks seeking to improve scale and operational leverage. That said, we expect further consolidation in banking markets, especially in continental Europe, driven both by overcapacity and vulnerabilities in banks' business models exposed by the low interest rate environment. In this context, for banks new guidelines on the Supervisory Review and Evaluation Process (SREP) in the EU come into force from 2016. Business models and business strategy – in terms of viability and sustainability – are core to the new paradigm of forward-looking supervision.

By now, over eight years after the onset of the financial crisis, we would have expected the policy making agenda to be largely complete. This is far from being the case: despite the enormous progress that regulators have already made, many loose ends remain. Moreover, there are reviews underway, especially in the EU, of aspects of the post crisis regulatory framework before the ink is barely dry.

This residual uncertainty has at least two consequences. First, it complicates and postpones some aspects of critical decisions that need to be taken about strategy, business models and legal entity structure, especially by banks. Second, it pushes out the point at which financial services firms are able to focus more on how to extract business benefits from the significant investments they have made, often in haste, to comply with the plethora of regulatory requirements. However, as soon as the dust begins to settle, those firms which are best able to translate regulatory spend into either competitive advantage or lower cost structures will prosper. Last, but by no means least, we expect resilience – the ability of firms to prepare for, withstand and, if need be, recover from shocks – to be high among supervisory priorities in 2016. The list of such possible event risks is long – cyber-attack, geo-political instability, rising interest rates, the UK's referendum on EU membership ("Brexit"), the bond market's ability to absorb sustained selling – and growing. This will in turn put the spotlight on IT infrastructure, contingency planning, stress testing and on market-wide exercises to assess the resilience of individual firms and the system as a whole. "Be prepared."

So much for background. The top ten regulatory issues which we predict for 2016 are set out on the following pages, together with our views on how each will affect the retail banking, capital markets, insurance and investment management sectors. We have also suggested song titles that, for us, capture the spirit of the issue.

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The top ten regulatory issues which we predict for 2016 are set out on the following pages together with our views on how each will affect the banking, capital markets, insurance and investment management sectors.

1. Culture
Respect

Larger firms will continue to grapple with defining and embedding a common culture, specifically one that resonates from the board and the top of the firm across all business areas and jurisdictions. Two key challenges will be to determine the levers that will encourage the right behaviours and to measure their effectiveness in facilitating cultural change.

Following the financial crisis regulators have unleashed a number of initiatives to improve standards of conduct across the financial services industry. Changing culture is seen as key to this. We predicted last year that firms would struggle with the "how" of implementing culture – this looks set to continue well into 2016.

In the meantime, supervisors will continue to search for indicators of "good" culture – in particular the role of boards will be scrutinised, including their decision-making process, their focus on customer outcomes and managing conflicts of interest and the quality of Management Information (MI). Remuneration will continue to be a key component to drive cultural and behavioural change as regulators continue their efforts to better align reward with risk and conduct.

The De Nederlandsche Bank (DNB) currently leads the way in assessing culture through a three-tiered framework of behaviours (leadership, decision-making and communication), group dynamics (cohesion and interaction between individuals) and mind-sets (values, convictions and attitudes that are regarded as important either individually or collectively). Other supervisors might well follow their lead.

The European Central Bank (ECB) is likely to push for more regulation to help drive harmonisation in areas such as fit and proper assessments of board members where diverse national transpositions of the amended Capital Requirements Directive IV (CRD IV) make it impossible to achieve consistency across the Single Supervisory Mechanism (SSM).

Retail banking and capital markets

Banking and capital markets are being pushed hardest and fastest to strengthen their cultures, driven in the UK by the SMR, the new FICC (Fixed Income, Currencies and Commodities) Market Standards Board (FMSB) and the Banking Standards Board (BSB). The BSB will undertake a market assessment exercise and issue further standards in an effort to improve practices. Supervisors in the major financial centres are focussing on culture, specifically the tone from the top and the board's role in identifying and managing risk as a measure of a strong culture. The board's role in determining and monitoring the culture of the organisation will be examined as both firms and supervisors continue their search for what good looks like.

Insurance

The Senior Insurance Managers Regime (SIMR) will reinforce individual accountability and through that a focus on culture. The UK Government's recent announcement about extending the SMR to all regulated financial services firms by 2018, will result in insurers being subject to the Certification Regime. The SMR must also be on the radar of insurance brokers as a result of the same extension. Solvency II remuneration requirements will apply from 1 January 2016, and include requirements for insurers to establish and maintain remuneration policies that promote a strong risk culture. We expect the PRA to release a supervisory statement early in 2016 to set out its expectations on remuneration for insurers. The International Association of Insurance Supervisors (IAIS) work on conduct of business risk emphasises the importance of insurers having appropriate remuneration and incentive policies, and the board and senior management being involved in promoting good culture.

Investment management

The UK Government announcement on SMR will also affect investment managers (from 2018). This will require a senior manager in each firm to take responsibility for determining the firm's culture and, separately, for implementing it. Although the deadline is some way off, it nevertheless will increase the focus on these issues.

Experience suggests that making an early start to the culture agenda stands firms in good stead. The latest Directive for Undertakings for Collective Investment in Transferable Securities (UCITS V) also introduces new remuneration requirements for investment managers and aims to encourage sound risk culture. CRD IV may further foster a risk aware culture in in-scope investment managers if the proportionality criterion for remuneration requirements is removed as proposed by the European Banking Authority (EBA).

2. Conduct risk
Ain't misbehavin'

Firms will increase investment in resources and IT infrastructure to improve conduct risk surveillance and MI, to meet supervisory expectations and to avoid further problems, and the accompanying fines and reputational damage.

Conduct regulation will remain high on regulatory and supervisory agendas in 2016. In the UK, work will continue on flagship initiatives: implementing the results of the Fair and Effective Markets Review (FEMR), the SMR and SIMR, and the Financial Advice Market Review (FAMR). In terms of EU initiatives, all hands will be on deck to implement MiFID II, the Market Abuse Regulation (MAR) and the Regulation on Packaged Retail and Insurance-Based Investment Products (PRIIPs), at both regulators and firms. Conduct risk will be taken up by the global institutions to an extent not previously seen, with increased focus on integrating conduct risk into prudential frameworks and work by the International Organization of Securities Commissions (IOSCO), the Bank for International Settlements (BIS), and the Financial Stability Board (FSB) on benchmarks, an FX code, and the alignment of remuneration and conduct risk respectively.

Firms will seek to improve surveillance and MI to better manage conduct risk. They will try to be more forward-looking and outcomes-focused in their management of conduct risk, and will start looking for support in this from data analytics. Most firms will move towards embedding conduct risk in their risk management frameworks, although articulating conduct risk appetite will remain challenging. Across all sectors, product governance obligations will lead firms to seek increased information about each stage in the product lifecycle and to understand whether products are distributed to the target market they were designed for.

Retail banking

MiFID II and FAMR will increase the focus on digital distribution, but conduct risk concerns will remain a barrier to some innovation. Supervisory focus on consumer credit, credit cards and mortgages will continue, with the FCA placing a high priority on affordability assessments and the fair treatment of vulnerable customers and those who are in arrears. The FCA, on the basis of its latest consultation, is seeking to draw a line under Payment Protection Insurance (PPI) redress through the proposal for a time limit on bringing complaints. However the judgement in the case of Plevin v Paragon Personal Finance raises some broader questions on the scope of the time limit and how effectively it can be applied. This may pave the way for additional claims.

Capital markets

Investment banks and brokers will continue to embed conduct risk into risk management frameworks, refining the metrics they use to report on conduct risk. The combination of MAR, the focus on FICC in FEMR, and the broad definition applied to benchmarks means that conduct risk surveillance will broaden to products, transactions and activities not currently monitored. Conflicts of interest, disclosure and incentives will remain key areas of focus, leading to professional clients being afforded more protections than previously.

Insurance

In 2016, the FCA will continue its focus on sales of annuities. Rule changes may affect distribution as the FCA implements MiFID II, seeking to ensure consistency between MiFID II investment products and insurance investment products, and looks to implement the Insurance Distribution Directive (IDD). Lloyd's insurers will continue work on implementing the Lloyd's conduct risk minimum standards, with the conduct risk MI rules coming into effect in 2016. Supply chains will start seeing material changes in the way conduct risk is overseen by insurers following the FCA's thematic review on delegated authorities and the upcoming FCA review of the role of appointed representatives in the distribution of general insurance (GI). Global attention will also increase on conduct risk, following work by the IAIS.

Investment management

Investment managers will seek to receive increased information from distributors about their end investors as they prepare to implement MiFID II product governance rules. This should allow them to strengthen some aspects of their conduct risk MI and help them to design metrics that are more forward-looking and outcomes focused. Work can, and arguably should, begin on these important issues ahead of 2017. Investment managers will review their product mix and distribution channels in 2016, with a view to increased use of direct-to-client and digital distribution.

3. Competition
Harder, Better, Faster, Stronger

While regulatory initiatives focused on competition will not lead to forced structural change or price regulation, regulators will continue to implement changes to improve competition. Consideration of competition issues will permeate and influence policy and supervisory decisions.

2016 will be the year when firms need to review and understand the costs for each product and how these costs are disclosed to the customer, leading to increased transparency and reduced product bundling and cross-subsidisation. MiFID II, IDD, and FCA market studies into investment banking and asset management are the main drivers for this change. And the FCA is also concerned about the value for money that consumers derive from financial services. As a consequence, firms will need to evaluate their product and service offerings.

The regulators are looking to improve competition in financial services through encouraging and facilitating innovation. Regulatory actions to promote competition will extend beyond financial services firms and to the institutions and infrastructure that support them. Crowd funding, peer-to-peer lending and foreign exchange transfers appear to be the biggest disrupters within FinTech.

However, regulators, in the EU and the UK will exert most of their effort on payments systems in 2016. The revised Payment Services Directive expected to come into force in 2017, will open the payments market to competition from non-bank players and will force banks to take clear decisions about their strategic response.

The European Commission's Green Paper on retail financial services and insurance, expected to be published in December 2015, is seeking to build a genuine Single Market by increasing competition and improving consumer choice in all sectors. The review will also look at the impact of digitalisation in the market and how new distribution channels can improve competition. We will need to wait and see how the European Commission will move forward with this project, but it is clear that improving competition is a priority at both the EU and UK level.

Retail banking

We do not expect significant changes to the measures the CMA has proposed following its market investigation into retail and business banking when it publishes its final report by May 2016. It remains to be seen whether the European Commission will heed the PRA's call to move away from a "one size fits all" approach to bank capital adequacy to improve the ability of smaller banks to compete. Final remedies from the FCA's cash savings and credit card market studies are expected to be published shortly, and will mainly focus on increasing disclosure to customers. The UK mortgage sector will be under the spotlight as the FCA intends to launch an extensive market study in Q1 2016 that will examine both regulated and unregulated activities.

Capital markets

Banks and investment banks operating in the UK will hear the results of the FCA market study of investment and corporate banking in spring 2016. This is the first FCA study into competition in wholesale markets, and participants can expect some of the remedies used by the FCA in its competition work in retail markets to be read across. These may take the form of a clamp-down on bundling and cross-subsidisation and improved transparency of cost and charges. There is significant interest in how FinTech can be deployed to make various aspects of the trade lifecycle more cost efficient and competitive, including through the use of Blockchain technology.

Insurance

The European Commission's Green Paper is expected to touch on many of the issues the FCA has been trying to address with its competition studies, including improving customer choice, increasing shopping around and enhancing disclosure to improve comparability of products. The immediate question is whether or not the EU will take the lessons learned from the FCA if it decides to suggest any policy proposals. In the UK, the FCA's study into GI add-ons will lead to significant market changes, not only for add-on products but for the entire industry. The FCA has already introduced a deferral period for Guaranteed Asset Protection insurance, in which the insurance product cannot be introduced and sold on the same day as a motor vehicle purchase. The introduction of value measures for most GI products (another remedy from the study) will force insurers to re-evaluate their product offerings and improve value for money.

Investment management

MiFID II and PRIIPs will require increased disclosures of costs and charges and will increase the comparability of different products. Investment managers should review their pricing structure and product range in light of this. In the UK, the FCA's competition study will look at how investment managers compete to deliver value for money for end investors, including how they control costs and quality along the value chain. This is likely to lead to increased scrutiny of products which may offer poor value for money compared to close substitutes, and of poor value ancillary services purchased on behalf of clients. The FCA will take behavioural biases into account when considering potential remedies, which may include measures to help consumers increase their scrutiny of the services they receive.

4. Structural reform
Breaking up is hard to do

Delivering structural reform in financial services has proceeded in fits and starts. In 2016, resolvability will increasingly drive regulatory interventions as authorities focus on the practicalities of resolution planning. For banks in particular, there will be increased focus on what is being done to ensure operational continuity.

Global systemically important banks (G-SIBs) are at the top of the action list. Work has progressed in Crisis Management Groups, but the FSB recently said that "significant work remains" in order to make resolution plans operational. Within the EU the UK authorities will continue to lead the way. The focus will be on operating models, and "operational continuity" will be a motivating factor for a range of initiatives. Within the Banking Union, the new Single Resolution Board (SRB) will have to get to grips with the roughly 150 banking groups within its remit. In 2016 the SRB is more likely to be gathering information than requiring banks to restructure.

The globally agreed standard for Total Loss-Absorbing Capacity (TLAC) was "finalised" in November 2015, but left many questions to be answered on a bank-by-bank basis. Investors will want to understand their position in the creditor hierarchy, forcing banks to be more transparent, with possible consequences for their funding costs. The work on TLAC – implemented as the Minimum Requirements for Own Funds and Eligible Liabilities (MREL) in the EU – may act as a link between resolution issues and those relating to prudential requirements more generally.

The EU's attempts to implement its own framework for bank structural reform will progress slowly as EU Member States continue to disagree about the proposed Regulation. If the Regulation is agreed in 2016, we would expect a framework which closely ties resolvability to the separation of trading from retail deposit-taking.

Retail banking

The PRA and FCA will finalise some of their guidelines on ring-fencing in 2016, and will consult on currently outstanding topics, including the data and reporting requirements to enable the regulators to monitor compliance. There will also be a focus on the implications of design decisions for customers. But given that the bulk of the detailed rules for UK retail ring-fencing is already visible, UK banks will press ahead to be able to deal with the enormous practical challenges arising from the implementation work for ring-fencing. Although the 2019 implementation deadline seems far off, the scale and complexity of the tasks that need to be completed before then will demand extremely disciplined programme management, especially if some banks decide to aim to be ready early. Banks will also seek to understand how much flexibility the PRA and FCA will show in applying the rules to take account of their individual circumstances.

Across the EU, mid-tier banks may struggle to catch up with their larger peers on resolution planning, and to meet the systems and data challenges they face. Groups with an operating bank as their top company will watch as various European countries pursue their own legislative initiatives to subordinate senior unsecured debt in order to render them eligible for loss absorbing capacity requirements. The more that individual countries introduce their own legislative initiatives, the greater pressure the European Commission will feel to introduce harmonised requirements.

Capital markets

Resolution planning for central counterparties (CCPs) is high on the regulatory agenda – a proposal for a regulation on CCP recovery and resolution planning will be published by the European Commission in the first half of 2016. The proposal will include consideration of loss absorbency mechanisms. The FSB will also be looking at how CCPs' legal structures and other factors may impede their resolution.

Bank structural reform will prompt universal banks to continue to reappraise their investment banking businesses, with further retreats from the sector still on the cards. Non-US banks putting US Intermediate Holding Companies (IHC) in place will have to flip the IHC "on" switch mid-year. In 2015 UK regulators asked various UK investment banking subsidiaries of foreign banking groups to produce solvent wind-down plans. Some institutions have taken the view that solvent wind-down is becoming more of a default option for resolution authorities looking at investment banking businesses. The implementation of bail-in may also prompt capital markets participants to review their investments in forms of bank debt that will be unambiguously bail-in-able in the event of a bank failing. And derivatives counterparties cannot assume immunity from bail-in – they too need to work through the implications of bank resolution, including the imposition of stays on early termination rights and the potential for derivatives to be written-down or bailed-in.

Insurance

Insurance resolution planning has lagged behind the banking sector; however, momentum will increase in 2016 with the FSB recently consulting on draft guidance for developing effective recovery and resolution plans (RRPs) for global systemically important insurers (G-SIIs), and any other insurers deemed systemically important by their national authority. The complex structural issues facing the banking sector are less acute for insurers, and the likelihood of an insurer being required to overhaul its operating or legal entity structure in the immediate future for resolvability purposes is low.

Investment management

Some investment managers are covered by the Bank Recovery and Resolution Directive (BRRD), and may be taken by surprise by having to submit RRP information to their regulators. Around 40[3] FCA-regulated investment firms will be required to put together full recovery plans, and to pass information on their structures and operations to the regulator. Elsewhere, the recent focus on (declining) market liquidity may put the spotlight on the impact of the outright "failure" of an investment manager, with the FSB and IOSCO continuing to work on what they refer to as "asset management structural vulnerabilities". Asset managers will also have to consider the consequences of various bank liabilities becoming bail-in-able, particularly where investment mandates may prohibit ownership of higher risk securities.

3 See p.14 of https://www.fca.org.uk/static/documents/policy-statements/ps15-02.pdf

5. Measuring risk exposures
Let's twist again

New proposals being developed for the measurement of risk exposures will have a widespread impact and place significant new demands on firms, both in terms of the capital required to be held and the systems and processes needed to calculate the requirements.

Even as the overall shape of the new regulatory regime settles down, policymakers are developing a broad range of proposals that set in their crosshairs the consistency, comparability and transparency of risk weights across different types of risk and between institutions. The effect on firms will vary by business model, and according to their current approach to regulatory capital modelling.

Changes to date to prudential capital requirements have focused on the absolute level of capital held. The interest in how much capital is held against different risk exposures will have implications for the overall requirement, but is primarily concerned with ensuring that regulatory incentives to take one risk over another are not skewed, for example by a particular modelling approach.

In some cases, there is also concern from regulators and legislators about the potential for mis-alignment between the regulatory capital agenda and the broader political interest, particularly in the EU, in promoting financing for businesses to accelerate economic recovery. The outcome of the European Commission's consultation on the possible impact on bank financing of the economy, and its call for evidence on the EU regulatory framework for financial services more broadly, will be instrumental in setting the policy direction for future capital requirements in the EU.

A related concern that more complex requirements will raise barriers to new entrants and/or stifle competition from existing challenger banks is exercising policymakers, including the PRA in the UK, and will weigh on the form of the final solution.

Retail banking and capital markets

Taken together, initiatives including the Fundamental Review of the Trading Book (FRTB), the review of the standardised approach to credit risk, operational risk, a new capital floor for internal models, interest rate risk in the banking book, the treatment of sovereign risk and a revised treatment for securitisations, will result in substantial changes to the capital framework for banks across their banking and capital markets activities.

Depending on their final shape, the new rules – which will bring risk weights calculated under the standardised and advanced approaches closer together – will alter the economics of internal modelling itself. Banks currently using the standardised approach will feel the impact first, as proposals to make capital more "risk-sensitive" will carry significant implementation costs. That said, longer term, the difference between these approaches and models is likely to narrow, for instance through the use of "floors". Policymakers will also be re-assessing the optimal level of complexity and risk sensitivity.

Despite some rather optimistic timelines put forward by the BCBS on when this work will be finalised, we expect that it will take its time in 2016, as the industry and some regulators continue to raise concerns over the drawbacks of the proposed new approaches.

Supervisors have also been investigating banks' internal models to tackle concerns identified in relation to pro-cyclicality, and variability between modelling approaches. The resolution of that work will need to take into account changes to models being introduced in response to IFRS 9. The ECB has embarked on a multi-year review of internal models, and of supervisory options and national discretions in order to tackle variation from the bottom up. Greater scrutiny of non-performing loans (which remains a priority for the supervisors in the SSM, for example) will compound the effect of these initiatives on the amount of capital required to be held against a particular risk exposure.

Insurance

Solvency II takes effect from the start of 2016. Some insurers, including those in the UK, will not receive their regulator's decisions on model approvals until just before the end of the year. While the likelihood of complete surprises in regulators' decisions is low, there is equally little doubt that insurers' and regulators' work on models will not stop then. There will be fine-tuning of, and changes to, existing models as well as new models to approve. As a consequence, a significant Solvency II-related work programme will continue into 2016.

Furthermore, some risk weightings are already being reviewed under Solvency II. These include the weighting of exposures to infrastructure investments, and other asset classes such as securitisations. In this case – as highlighted in the foreword – the changes are driven by the desire to promote the CMU initiative, and the "jobs and growth" agenda.

Investment management

As investment firms in the EU are currently captured under the same capital requirements regime as banks, any changes to the standardised approach are likely to affect MiFID investment managers. The impact will depend on how any new requirements are implemented at EU level and in the UK, and the outcome of the Commission's review of how the CRD applies to investment firms.

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Market participants adjusting to a new order

The times they are a changin'

Uncertainty over future market structure and dynamics will persist as prudential and collateral rules bite deep and transaction costs for trading activities continue to increase. The seeds of significant change will be sown in 2016 for trading across all instrument classes, affecting both pre- and post-trading structures.

Operational resilience

Livin' on a prayer

Supervisors will pay increasing attention to operational resilience. The spotlight will be on risk identification and mitigation, contingency planning, stress testing and on market-wide exercises (such as the recent UK-US joint cyber-incident exercise with major financial institutions) to assess the resilience of individual firms and the system as a whole.

Technology and innovation

Under pressure

Technology must remain close to the top of firms' agendas in 2016. Established players will need to invest in technology, not only to satisfy the demands of their supervisors, but also to compete. If they don't, they will see their business shrink. Innovators will increasingly have the ear of politicians and supervisors.

Data and regulatory reporting

I still haven't found what I'm looking for

Firms can deal with data by investing heavily now to realise the long-term benefits, or by using ever-bigger "sticking plasters". The ultimate winners will be firms that bite this bullet soon. In 2016 this will become much more apparent as the number and overall complexity of demands on firms increase further, and supervisors spend more time assessing firms' capabilities.

Capital calibration

Get the balance right!

After several years of changes to the make-up of the regulatory capital regime, in 2016 the focus will be on the calibration of the overall framework, and the distribution of capital between firms. That said, there remains significant uncertainty about just how many elements of the debate will be finalised in the coming year.

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Culture

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Firms will increase investment in resources and IT infrastructure to improve conduct risk surveillance and MI, to meet supervisory expectations and to avoid further problems, and the accompanying fines and reputational damage.

Competition

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Structural reform

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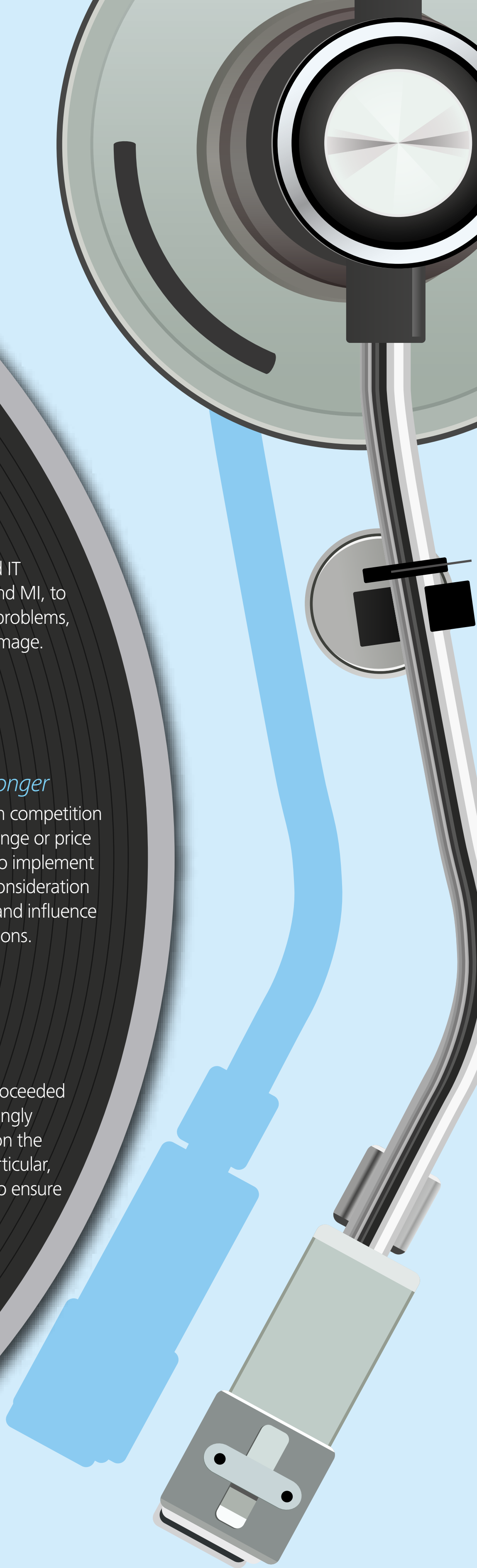
New proposals being developed for the measurement of risk exposures will have a widespread impact and place significant new demands on firms, both in terms of the capital required to be held and the systems and processes needed to calculate the requirements.



6. Capital calibration
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The calls for more and better quality capital were easy to make in 2008 as the financial crisis unfolded and undercapitalisation was seen as a root cause of the failure of individual firms, and of the systemic contagion that unfolded. Roll the clock forward to now and the considerations are more complex.

There is a growing constituency for reviewing whether new requirements have "overshot". Initiatives such as the Bank of England (BoE)'s Open Forum (and the follow-up it will catalyse), the EU's CMU, and the European Commission's consultation on the impact of capital requirements on the economy, tackle inter alia concerns – which to some policymakers are misplaced – that regulation is constraining economic growth.

There are related questions about how different but connected changes to the regulatory framework interact, the possibility of double-counting of risks, and whether there have been any unintended consequences.

Mark Carney, Governor of the BoE and Chair of the FSB, has noted that "given the complexity and scale of financial reform, it would be remarkable if every measure were perfectly constructed. Or if they all fit[ted] seamlessly into a totally coherent, self-reinforcing whole".

In the UK, the Financial Policy Committee (FPC)'s paper in December 2015 on the framework of capital requirements for UK banks tackled some of these themes.

In this respect, the growing importance of stress testing as a lever for supervisory risk assessment is an important consideration. More broadly, changes to accounting standards, changing practices around risk modelling and efforts to improve the resolvability of financial institutions, amongst others, need to be weighed against judgements on the right level of regulatory capital buffers in order to understand aggregate capital requirements.

Retail banking and capital markets

Some senior regulators have signalled that they are not looking for the banking sector to raise yet more capital in aggregate. Andrew Bailey, for example, has said that "To argue for much higher capital on top of what has been done since the crisis is to argue that what is being done on resolution and loss absorbency is of little use. […] [T]here are more important things for us to do, which revolve around getting the incentives for behaviour right in firms." And the FPC has indicated a target level of 11% Tier 1 capital for the UK banking system. That said, individual measures still in development may lead to increases to some banks. One of the final pieces in the capital calibration jigsaw will be the publication of the BCBS's proposals for a capital floor based on the revised Standardised Approaches. The method of calculating the floor, and the level at which it will be set, have the potential to significantly affect bank business models.

The new SREP, including revised expectations on the Internal Capital and Liquidity Adequacy Assessments Processes (ICAAP and ILAAP) that banks are expected to undertake, supervisory stress testing exercises, macro prudential policy proposals for banks to hold loss absorbing capacity and changes to accounting rules under IFRS 9 all need to be factored in to understand the overall change in capital requirements for banks. Revisions to the BoE and EBA supervisory stress testing exercise support this. The EBA will consult on revisions to ICAAP and ILAAP reporting requirements and to its guidelines on stress testing.

Insurance

G-SIIs will begin confidential reporting to supervisors on the Higher Loss Absorbency (HLA) requirements starting in 2016, while the IAIS will continue its field testing programme to support the development of the new Insurance Capital Standards (ICS). The market will be looking for signs of any change in behaviour by the largest insurers, as the IAIS consults on the revised definition of Non-Tradition and Non-Insurance (NTNI) activities and changes to the G-SII assessment methodology. The implications of supervisory stress testing, and new supervisory regimes may in time be important, but is a less pressing issue in 2016 than is the case for banks.

Investment management

In 2016 the FCA will review its implementation of CRD IV as it applies to investment firms following the results of the EBA assessment. Some firms will look to change, or are already in the process of changing, their activity mix to escape the more onerous requirements of CRD IV. The FCA has become much more demanding of larger investment managers in terms of the degree of rigour and detail with which they prepare their ICAAPs and the capital they hold. The increasing challenge from regulators will continue, and across a wider scope of firms, with the implementation of the EBA's SREP guidelines for all CRD IV investment firms.

7. Data and regulatory reporting
I still haven't found what I'm looking for

Firms can deal with data by investing heavily now to realise the long-term benefits, or by using ever-bigger "sticking plasters". The ultimate winners will be firms that bite this bullet soon. In 2016 this will become much more apparent as the number and overall complexity of demands on firms increase further, and supervisors spend more time assessing firms' capabilities.

Regulators and supervisors want financial services firms to provide them and the firms' clients and customers with better quality data, more quickly and in a format that is more easily interrogated. They are also setting new expectations for how firms manage data for their own purposes. Supervisors need the information to assess risks and to police compliance with an ever-more-complex regulatory framework. Greater transparency for the public is considered key to enabling real choice and ensuring fair treatment.

This trend has been clear for several years, but relatively limited progress has been made towards meeting expectations. In part that is because the end state is still evolving, as new requirements are introduced. It is also because of the complexity and cost of the remediation work required to firms' systems and operations; and the cost of fulfilling requirements (including, sometimes, reporting to different bodies for the same topic but using different templates).

From an implementation perspective, major challenges arise from the definition of a firm-wide data policy and data dictionary, and from the need to integrate risk and finance data. Any solution will require looking for innovative ways through the challenges. Firms should also consider how investment to meet regulatory requirements can be leveraged to tackle the need to deal with the ever-increasing quantity of data being generated and the expectations of clients and customers to deliver a personalised digital experience. That said, firms will need to grapple with the implications of the EU General Data Protection Regulation and 'Safe Harbour 2.0' in 2016, which may be a counterweight to a desire to integrate and consolidate data sources.

Retail banking

The number of banks within scope of the global principles for effective risk data aggregation and risk reporting ("BCBS 239") will be extended in 2016 as firms recently designated as domestic systemically important banks will subsequently be expected to take steps to comply within three years. Further developments in prudential regulation and supervision, including extensions to Basel III and stress testing, and the EBA's guidelines on supervision, will necessitate further investment in data. Significant investment in MI will be needed to tackle expectations for monitoring conduct and demonstrating good governance. For those banks with an IT infrastructure composed of numerous legacy systems, the balance continues to shift towards the need for a holistic approach to systems and data, rather than a piecemeal or tactical one.

Capital markets

Conduct regulations and supervisors require capital markets activity to be monitored at an ever-more granular level, and for firms to demonstrate greater dexterity in reporting information. As firms are still getting to grips with European Market Infrastructure Regulation (EMIR) reporting, they will need to implement increased transaction reporting ahead of the application date under the Markets in Financial Instruments Regulation (MiFIR). Disclosure of information to clients is another key theme. In preparation for the requirements that will be introduced by MiFID II and as part of PRIIPs, MAR and FEMR, there will be increased focus on surveillance of market abuse and conduct risk.

Insurance

The regulatory reporting requirements under Solvency II will be the foremost practical challenge for the insurance sector in 2016, but it is a known quantity for which firms have planned. Insurers too will need to start working towards the implementation of the requirements that will be introduced by PRIIPs and MIFID II, and by the IDD from the end of 2016 and through to the end of 2017. As in other sectors, insurers face tighter scrutiny of conduct of business activities and governance, which will necessitate investment in MI.

Investment management

Many of the data and reporting requirements discussed in relation to banking, capital markets and insurance will also apply to investment managers, either directly or indirectly. In 2017 MIFID II will extend data and reporting requirements in the key areas of transaction reporting, pre-and post-trade transparency, product governance and distribution, disclosure of costs and charges and best execution, all of which will require implementation in the coming year. PRIIPs requires firms to produce a key information document for their clients for certain products. Under Solvency II insurers must report around 80 asset data fields, around half of which will need to be provided by their investment manager.

8. Technology and innovation
Under pressure

Technology must remain close to the top of firms' agendas in 2016. Established players will need to invest in technology, not only to satisfy the demands of their supervisors, but also to compete. If they don't, they will see their business shrink. Innovators will increasingly have the ear of politicians and supervisors.

Lack of investment in the past decades has left many financial institutions with the legacy of "unfit for purpose" IT systems, as discussed in the "Data and regulatory reporting" section. Not only do these create exposure to costly IT "glitches", and cyber-attacks, but they also expose them to fierce competition from new FinTech start-ups.

The good news is that through investment in technologies, incumbents can respond effectively to these challenges. Strategic partnerships with FinTech start-ups will also be part of the solution.

Technology, as well as being a challenge, also promises to help firms solve some of the issues they are facing. RegTech innovations marry technology and regulation and will help firms investing in them to manage their regulatory compliance responsibilities cost effectively by making it easier to identify risks and improve efficiency.

But it is not only financial services firms which are being "disrupted". Technology is challenging the way regulators think and operate. In particular, whereas overall technology has improved access to financial services (especially in developing countries), there are important unanswered questions around the adequacy of consumer protection and profiling, as well as data privacy issues.

Regulators will need to develop the capabilities to understand, respond, and leverage new technological developments, e.g. Blockchain, and the risks they pose without stymieing innovation. The FCA is leading this effort through "Project Innovate" which is designed to support new and established businesses understand the regulatory framework and how it applies to new innovations.

More generally, we expect to see competition developing between countries as the authorities seek to make their financial centres and regulatory frameworks "FinTech friendly" to attract new business.

Retail banking

Banks will need to decide how much to invest into payments innovation. When developing their strategy, banks should consider partnering with, or acquiring, FinTech companies. Larger banks could make selective in-house investments in areas where they can be seen as market-leading innovators, but also build up scale as payments utilities. As explained in the previous section on "Data and regulatory reporting", supervisors will continue to demand better, quicker, and easy to interrogate data from banks. If replacing legacy systems is not an option, agile RegTech solutions, constructed to operate on existing infrastructure, can help banks deliver improved and cost-effective compliance, and, through analytics, harness the potential of their data (within the constraints of data protection requirements) for the benefit of both customers and bottom line.

Capital markets

In capital markets too, RegTech solutions can be a clear strategic choice to respond to increased regulatory demands. In particular the enhanced monitoring and surveillance demanded by MAR and, in the UK, FEMR could be more easily met by investing in analytics technology able to, for example, analyse trading behaviours and identify potential issues. Blockchain will remain a hot topic, particularly in relation to settlement and processing more generally, but neither the technology nor regulators nor the industry are ready for mass adoption (yet). Firms will continue to experiment with the technology and explore its vast potential to simplify the post-trade processes and reduce cost and risks. Regulators will need to clarify their position on this technology – their attitude, and international co-ordination, will play a major role both in the scale and pace of adoption.

Insurance

Although the FinTech limelight has been largely grabbed by banking products and services, technological developments will also have a major impact on insurance firms. Those with the best analytics capabilities (whether incumbents or new entrants) will use the information gathered through telematics and other connected devices to develop increasingly accurate actuarial and individualised pricing models. Those which do not keep pace risk being left well behind. Insurers can expect more regulatory pressure for transparency about the data they collect, why it is collected, and how it is used and shared. The FCA in the UK is already looking into this and has recently put out a Call for Inputs on the use of "Big Data" in the retail GI sector, which is likely to be followed by a full market study in the latter part of 2016. Regulators will need to consider if and how they wish to protect those consumers who choose not to be "monitored", or whose data makes them uninsurable.

Investment management

New reporting, disclosure and product governance requirements under MiFID II will generate a significant amount of new data. Although the new data will not be available in 2016, firms should use this prospect to invest in the analytics technology necessary to analyse the data and gain competitive advantage by ensuring their data infrastructure is flexible and cost effective. The investment management landscape will also continue to be disrupted by the rise of the "robo-advisors".
As with payment services in banking, we expect incumbents to consider partnering with new entrants, or buying them, while some of the larger firms will invest in their own platforms.

9. Operational resilience
Livin' on a prayer

Supervisors will pay increasing attention to operational resilience. The spotlight will be on risk identification and mitigation, contingency planning, stress testing and on market-wide exercises (such as the recent UK-US joint cyber-incident exercise with major financial institutions) to assess the resilience of individual firms and the system as a whole.

Operational resilience is the ability of financial services firms and the financial system as a whole to withstand and, if need be, recover from crystallised event risk. Its focus is predominantly on the critical functions and services that firms provide, both in terms of the functioning of the financial system (including the "plumbing", e.g. in relation to payments and settlement systems) and ultimately to the real economy itself.

There are two broad reasons for this heightened supervisory interest. First, IT is playing an even greater role in the services that firms provide (e.g. through increasing automation of previously manual process and through digital service channels), thereby increasing dependencies on the resilience of IT infrastructure.

Second, the level of threat is increasing. The vulnerability of financial services firms to cyber-attack is gaining increasing public and political prominence. At the same time there is no shortage of other possible "event risks", whether from the current, increasingly fragile, geo-political situation in some regions, possible market reaction to rising interest rates, "Brexit", the bond market's ability to absorb sustained selling and so on.

Retail banking

Unsurprisingly, when it comes to operational resilience, the supervisory spotlight tends to shine most brightly on the banks, given their key role in the vital payments, clearing and settlement systems. In their case, operational resilience should be thought of as the summation of a number of initiatives on which they have been working in recent years – cyber defence programmes, stress testing, reverse stress testing, incident response playbooks, recovery planning and, in the case of the largest banks, the need for operational continuity in resolution. The key will be to recognise the linkages between these programmes and integrate them within the overall risk management and governance framework.

Capital markets

Two important themes arise from operational resilience in capital markets and will attract supervisory attention. First, the resilience of critical financial market infrastructures, including CCPs. Although today more attention is being given to resolution frameworks for CCPs, their ability to withstand and recover from an operational disruption is arguably just as important. The second concern is the trading infrastructure for capital markets and the growth of electronic trading (including algorithmic and high frequency strategies). The Commodity Futures Trading Commission (CFTC) recently identified 35 "flash crashes"[4] so far in 2015 and we expect supervisors to focus both on reducing their incidence (e.g. though greater scrutiny of the algorithms that underpin trading strategies) and also their impact (e.g. by introducing trading halts and other circuit breakers).

Insurance

Insurance firms are also vulnerable to cyber-attack as well as other operational disruptions. At the EU level, the Joint Committee of the European Supervisory Authorities (ESAs) identified cyber risk as a high priority in its May 2015 Risk Report, while in the UK, the PRA has asked insurance firms to complete an extensive cyber risk questionnaire. We expect 2016 to see follow-up to this initial exercise once the PRA has digested the first round of results, as has been the case in a similar exercise with the banks. As insurance firms' activities become increasingly automated and "digitised", so supervisory interest in their overall resilience will grow.

Investment management

Investment managers are making increased use of digital means to connect with clients (e.g. online sales platforms, robo-advisors), and digital processes to enhance their operations (e.g. advanced analytics, cloud computing). While improving the efficiency of their operations, this also increases their vulnerability to the risk of IT failure or cyber-attack. Many investment managers also rely on third party providers to carry out key functions and need to ensure they have effective oversight to incorporate any residual risks into the overall risk management framework. With the implementation of MiFID II approaching, investment managers will need to enhance their systems, controls and record-keeping related to high-frequency trading.

4 Remarks of Chairman Timothy Massad before the Conference on the Evolving Structure of the U.S. Treasury Market – http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-30

10. Market participants adjusting to a new order

The times they are a changin'

Uncertainty over future market structure and dynamics will persist as prudential and collateral rules bite deep and transaction costs for trading activities continue to increase. The seeds of significant change will be sown in 2016 for trading across all instrument classes, affecting both pre- and post-trading structures.

Uncertainty will reign, both in understanding how to implement the plethora of new regulatory requirements introduced following the financial crisis but also in understanding the cumulative effect on market dynamics. While the consequences of the individual regulatory changes were clearly intended and thought through, some of the others, particularly those consequences arising from their cumulative effect, may well be unintended. This uncertainty is clearly vexing policymakers, with the FSB, European Commission, ECB and BoE all advocating further work to understand the complex factors at work.

Concerns around fragile market liquidity will be compounded by additional regulatory pressures, such as the penalties introduced by the Central Securities Depositories Regulation (CSDR) for settlement failure, which could serve to further dis-incentivise market makers in addition to existing prudential restrictions. All market participants will face increased pressure to consider how they will manage sudden shifts in liquidity.

Firms will be gearing up for the go live date of MiFID II, and implementation programmes will need to tackle known challenges such as how to meet best execution requirements in over-the-counter markets. Expect to see the start of a proliferation of new trading venues over the next year or so. At least in the near-term, reduced liquidity in fixed income markets, in some part caused by capital and liquidity requirements on the sell side, are likely to result in reduced trading.

EMIR will be a significant cost as the final and most onerous provisions come into effect. The introduction of the clearing obligation will lead to significant variation in pricing, and the margining requirements will only add to the existing regulatory pressures for eligible collateral and will compound the demand for high quality liquid assets. Sourcing collateral is likely to be more difficult than ever before.

Retail banking and capital markets

Banks will face the largest collateral challenge due to the cumulative effect of a large number of sometimes competing demands under the capital frameworks, including the EMIR derivative margining rules and conditions placed on re-hypothecation under the Securities Financing Transactions Regulation. Banks will also begin to strategically position themselves with regards to a future classification as systematic internalisers (SI) under MiFID II. It may be more favourable to retreat from certain markets, to maintain low trade volumes so as to fall outside of the SI regime, or where firms are squarely within the regime, to limit their participation to large trades which are subject to less burdensome requirements. Market infrastructure will start to respond to challenges and increased competition in the market as the pressure of rules, including the introduction of access rights, under the CSDR, MiFID II, and EMIR start to take hold. Trading venues and CCPs will need to keep pace with significant changes around access rights and platform evolution, whilst competition for market share will be fierce as participants take advantage of the increased trading on venues and clearing volumes. CSDs and custodians will also continue to re-position themselves for the emergence of the new unified settlement systems and increased demands for collateral.

Insurance

Insurers will not be immune to the changes occurring in trading. The clearing obligation and margin requirements for derivatives will be a particular challenge and cost for insurers which have traditionally used these as hedging instruments. Like banks, insurers will face the challenges of sourcing and managing collateral.

Investment management

MiFID II implementation will dominate the attention of investment management firms in 2016. For many firms it will require a revolution in capabilities to comply with the new standards. 2016 will also likely see policy recommendations from the FSB and IOSCO on mitigating risks and vulnerabilities associated with market liquidity in fixed income markets, and asset management. The policy proposals may include more stringent requirements on the stress testing of investment funds, measures on redemptions, including the inclusion of a gate or the suspension of redemptions in stressed periods; limitations on illiquid securities; and transparency on fund liquidity. Once these policy proposals are complete, the FSB has indicated that it will return to the controversial question of whether, and in what circumstances, investment managers may be systemically important.

Top 10 for 2015
How did our predictions fare?

Topic	What we said	What happened	Score out of 10
Structural reform and resolution in the financial sector	• The resolvability agenda should be watched closely. • It will be an intense year for UK ring-fencing. • Uncertainty hangs over the EU Bank Structural Reform (BSR).	• In the UK a number of crucial PRA secondary standards were issued. • Submission of RRPs (UK). The development of loss absorbency rules (EU/FSB) has continued. • EU Member States have struggled to address the issue of subordination of bail-inable liabilities in MREL and TLAC. • The Council of the EU has agreed its position on BSR, but ECON divisions delayed progress on the file.	9
New institution in action	• The SSM will be a sharp learning curve for eurozone banks. • The Single Resolution Mechanism (SRM) will get up and running. • The new European Commission will step up its focus on economic growth.	• As the SSM gathers speed, banks face multiple layers of supervision. • Uncertainties around how the SRM will work, in part due to delays in the BRRD. • The European Commission has indeed shifted its focus towards growth.	8.5
Data and regulatory reporting	• Supervisors' appetite for data shows no sign of abating. • Banks should look beyond the follow-up to asset quality review (AQR) to RRPs and data aggregation. • There is increasing emphasis by supervisors on process as well as outcome.	• All the initiatives identified at the start of the year came to pass, and more. Supervisors' expectations on data continued to expand, and the focus on method as well as outcome was there. • Despite those developments, there is no sense of a big turning point in the approach banks are taking, nor of supervisors pushing banks to take strategic solutions – yet.	8
Culture and treatment of customers	• Firms must "do" culture, not just talk about it. • Supervisors will expect to see evidence of progress. • SMR will focus individuals' attention. • It is increasingly important for firms to produce reliable conduct risk "data".	• "Doing" culture has been a focus of SMR and new PRA governance rules, and will be the subject of a FCA thematic review. • The FEMR delivered 21 wide ranging recommendations for FICC markets, with focus on individual and collective accountability and firms identifying and managing their conduct risk.	9.5
Competition and innovation	• 2015 will bring clarity on the FCA and CMA's concurrent competition powers. • Competition will be prominent at the EU level. • Regulators' competition-related work will likely have implications for strategy and business models.	• As part of its new role, the FCA published the wholesale sector competition review. • The FEMR, Payment Systems Regulator (PSR) and the European Commission have all prioritised competition. • CMA published provisional report on retail banking. It did not suggest any structural changes, and left some stakeholders unimpressed. • FCA interim findings of its credit card market study found competition worked well in most of the market. The remedies focussed on long-term debt and helping consumers find the best deal.	6.5

Topic	What we said	What happened	Score out of 10
Stress testing and risk management	• Stress testing will become an increasingly important supervisory tool. • Firms need to be thinking about a 'one firm' approach. • Murmuring about cross-border coordination of stress testing will get louder.	• 2015 exercises in the UK and US pushed banks to higher standards as expected, and the trend is set to continue. • EBA's SREP guidelines, now being implemented, codify the importance of stress testing as a core component of supervisory analysis. • International alignment still mentioned, but no concrete steps forward, and the prospects do not look favourable.	8.5
Capital markets union	• CMU is a flagship new agenda for the Commission. • Questions remain, including how it will interact with existing initiatives. • CMU will be well debated as stakeholders vie to influence the agenda.	• Following an avalanche of responses to the Green Paper and vocal debate, the CMU action plan was delivered with 33 initiatives. • The first wave of initiatives is being consulted on. • The CMU is set to be rolled out over the next four years.	10
Business model mix	• Managing the implications of ongoing changes to the Basel framework is a strategic challenge. • Devising a business model that leverages spend on regulatory change is key.	• Many banks continue to re-evaluate their mix of activities/business lines in which they operate. The primary driver is often given as cost, however reducing capital requirements is frequently a major target. • Supervisors' awareness of the aggregate implications of regulatory requirements is increasing, as evidenced by the publication in 2015 of the EBA's "Overview of the potential implications of regulatory measures for banks' business models".	7
Solvency II and insurance capital	• Implementation of Solvency II (SII) will enter its final year. • Solvency II will raise questions on insurers' business model mix. • Work on a global ICS is gaining steam.	• Work on the ICS is delayed by a year and due to be completed in Q4 2019. • Development of HLA was endorsed by G20. • PRA is expected to communicate the results of the internal model approvals in early December 2015 ahead of go-live date.	7
The interaction of market structures	• Financial market structures will be radically altered by regulatory requirements. • Issues on extraterritoriality will not go away. • Transatlantic Trade Investment Partnership (TTIP) will be one to watch. • Debate will continue on the technical details of MiFID II.	• There have been further delays to the US equivalence decision although significant progress has been made on equivalence for other jurisdictions leading to the recognition of the first third country CCPs. • There are clear indications of fragmentation in derivatives markets. • The MiFID II RTS have been delayed in the form of Delegated Acts, leaving the market without clarity on key details. • In the TTIP negotiations, no concrete solutions have been found with respect to the framework for regulatory cooperation on financial services.	7

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