Deloitte.

Risk and Regulation Monthly

January 2017

CENTRE *for* REGULATORY STRATEGY EMEA

In January the UK Supreme Court ruled that the UK Government could only give notice of its intention to leave the European Union (EU) if it was given the power to do so by an Act of Parliament. The Government set out its priorities for the exit negotiations, confirming that the UK would not seek membership of the Single Market. Meanwhile, the FCA opened its doors to applications for authorisation or variation of permission from firms under the Markets in Financial Instruments Directive (MiFID) II.

This note is produced for information only on a best effort basis, and does not constitute advice of any kind.

Brexit

The UK Supreme Court ruled that the UK Government may give notice for the UK to leave the EU under **Article 50 of the Lisbon Treaty** of the EU only after the UK Parliament has given the Government power to do so by an Act of Parliament. The Government published its proposed Bill that would give the Prime Minister power to notify the European Council of the UK's intention to withdraw from the EU.

Theresa May, the UK Prime Minister, set out the Government's **priorities in negotiating the UK's exit from the EU**. She said that both Houses of Parliament would vote on the final deal, that the Government would aim for a "phased approach" to give businesses time to adjust, and that the UK would not seek membership of the Single Market. The UK would seek a best-in-class free trade agreement with the EU and would also seek to negotiate free trade agreements with non-EU countries.

The UK Parliament's Committee on Exiting the European Union published its first report on the **process for exiting the EU and the Government's negotiating objectives**, in which it called on the Government to seek to ensure continued access to EU markets for UK providers of financial services through passporting, mutual recognition of regulatory equivalence, "or some other means" as well as a "period of adjustment" in order to avoid an "extremely disruptive" cliff-edge.

The House of Commons European Scrutiny Committee published a report that covered **financial regulatory aspects of Brexit**, including in relation to the Capital Requirements Directive (CRD) V/Capital Requirements Regulation (CRR) II, revisions to the Bank Recovery and Resolution Directive, and the proposed Regulation on resolution planning for central counterparties.

The report called for the Government to set out whether it would seek to position the future UK regulatory framework closer to international or EU standards, if there were any divergence between the two.

The Treasury Select Committee (TSC) took evidence on the **UK's future economic relationship with the EU** from senior figures within the financial services industry. Douglas Flint, Group Chairman of HSBC, indicated that the bank was considering "pre-emptive action" to address risks relating to a loss of passporting. Xavier Rolet, Chief Executive of the London Stock Exchange, added that the existing conditions of trade needed to be grandfathered for a limited period of time to maintain stability.

The TSC took evidence from senior figures within the insurance sector on **EU Insurance Regulation**. John Parry, Head of Finance at Lloyd's of London, stressed that maintaining mutual market access to the EU post Brexit was a priority. Huw Evans, Director General at the ABI, added that equivalence did not guarantee market access and the best way to move forward was to broker a bespoke treaty between the UK and the European Union that would ensure the full range of access and regulatory cooperation.

Capital (including stress testing)

In response to the Treasury Committee's inquiry on **Solvency II**, the Prudential Regulation Authority (PRA) said that it would continue to assess whether Solvency II's implementation in the UK required adjustment, while the Financial Conduct Authority (FCA) said that Solvency II does not constrain the conduct side. During oral evidence to the TSC, the subjects Insurers were most concerned about were risk margin, the matching adjustment, balance sheet volatility, transitional provisions and reporting requirements.

Mark Carney, Governor of the Bank of England (BoE), rejected Sir John Vicker's proposal that the BoE should publish **stress testing results** that use market-based measures of equity capital, in addition to results based on regulatory capital. The Governor said that market-based indicators are sufficiently covered in the Bank's stress testing approach and monitored by the Financial Policy Committee.

The PRA invited firms subject to the **UK leverage regime** to apply for a waiver by consent to allow them to apply rule modifications in relation to the exclusion of certain central bank claims from the total exposure measure for the leverage ratio.

This is designed to align leverage reporting and disclosure requirements with the new definition of the total exposure measure, and would apply from 1 April 2017.

The European Banking Authority (EBA) published its Risk Dashboard for Q3 2016. The **capital ratios of EU banks** continued to improve, as did their non-performing loan portfolios, although there was wide variation between countries. Cost control and profitability remained areas of concern. The results of the EBA's questionnaire showed that half of respondents saw deleveraging as part of their strategy, although an increased number also intended to expand their portfolios of SME financing.

The European Systemic Risk Board published a report on the cyclicality of **capital requirements under the CRD IV/CRR**. It found only weak evidence for pro-cyclical effects, and recommended retaining the current rules. It noted that should pro-cyclicality materialise, a variety of available tools could be activated.

The **Group of Central Bank Governors and Heads of Supervision** (GHOS) that oversees the Basel Committee announced plans to postpone its January meeting. The GHOS said it expected to complete the Basel Committee's post-crisis regulatory reforms in the near future, but gave no specific timeline.

The Basel Committee on Banking Supervision published a first set of frequently asked questions on its **market risk capital requirements**, providing clarification in relation to the standardised approach and the internal models approach.

Liquidity
There are no updates this month.

Governance and risk management (including remuneration)
Mark Steward, Director of Enforcement and Market Oversight at the FCA, spoke about **financial penalties** and the new and challenging dynamic created by the Senior Manager's Regime, which the FCA expects to increase the difficulty in settling disputes by agreement. The FCA proposed to change the process for those who agree the facts but wish to dispute the proposed sanction, so that they are offered an opportunity to argue their case before the Regulatory Decisions Committee without losing the 30% reduction of the penalty.

The PRA updated its supervisory expectations for **building societies' treasury and lending activities**, setting out the key risks that societies are exposed to, and providing a framework for different approaches which the lending and treasury functions should employ to manage and control these risks.

Conduct of Business (including MiFID)
The FCA's **MiFID II authorisations gateway** opened. The FCA published an application and notification user guide outlining key considerations for firms, as well as information on exemptions, market data reporting and passport notifications. Applications for authorisation or variation of permission must be submitted by 3 July 2017 to ensure the FCA will assess them before the MiFID II implementation date.

The FCA published the first set of data from its **general insurance value measures pilot**. The initiative is intended to provide consumers with a broader range of information to assess firms and product value, both for add-on and stand-alone products. The scorecard covers 38 insurers (including both UK and EEA firms) who provided claims data on the pilot products for the year ending August 31st 2016.

The FCA set out its expectations on firms **advising on pension transfers**, noting that it expects firms advising on a pension transfer from a defined benefit scheme or other scheme with safeguarded benefits to consider the assets in which the client's funds will be invested as well as the specific receiving scheme.

The FCA published an alert highlighting risks arising from firms, and especially pension scheme operators, failing to carry out appropriate **due diligence on investment offerings**. It said that some scams deliberately obscure the nature of the ultimate underlying asset and that sufficient due diligence is needed.

The FCA updated its webpage on investment advisers' and authorised firms' responsibilities when accepting business from **unauthorised introducers or lead generators**. The FCA raised concerns at the increase in cases in which the introducer has an inappropriate influence on how the authorised firm carries out its business, in particular where the introducer influences the final investment choice.

The FCA consulted on proposed Handbook changes to reflect the new regulatory framework for **Insurance Linked Securities** (ILS). The FCA stated that the Treasury's proposal to restrict investments in ILS to 'Qualified Investors' significantly mitigates the risk to the FCA's consumer protection objective if these products had been available to retail investors.

The FCA published final guidance on how firms are required to notify **loan guarantors** of their intention to take payment. Firms can either obtain the guarantor's express consent to payment being taken, or pre-notify the guarantor and wait a reasonable period during which the guarantor can cancel the payment authority, or issue a default notice in accordance with the Consumer Credit Act 1974 and wait 14 days.

The European Securities and Markets Authority (ESMA) published reporting instructions under the Markets in Financial Instruments Regulation (MiFIR) to specify the exchange of reference data information between national competent authorities, trading venues, systematic internalisers and the financial instruments **reference data** system and to specify the provision of data necessary to support the MiFIR transparency regime.

ESMA published a follow-up report to its **Peer Review on Best Execution**. Following its previous recommendations in 2015, ESMA found that most national authorities had taken action to address deficiencies in the supervision of best execution requirements. The authorities that did not show progress had either not yet considered the findings or noted that there had been no changes to the issues they expressed in 2015, principally the application by regulators of a risk-based supervision approach where best execution was not a material risk in their jurisdiction.

The European Commission consulted on the **Capital Markets Union** (CMU) mid-term review. The Commission said it had completed 15 of the 33 initiatives set out in the Action Plan in September 2015. The Commission added a new action on benchmarking national loan enforcement frameworks to provide solutions to the handling of non-performing loans from a bank creditor perspective.

ESMA published an Opinion expressing concern about the **exclusion of fund management companies from the scope of product intervention powers** under MiFIR. It argued that there is a potential loophole within financial group structures containing MiFID firms and fund management companies where the former could market restricted instruments through the latter.

ESMA issued an Opinion on the **share classes** of undertakings for collective investment in transferrable securities **(UCITS)** to support firms in setting up different share classes under the UCITS Directive.

In ESMA's view, the following principles should be applied when setting up different share classes for UCITS: common investment objective, non-contagion, pre-determination, and transparency.

The European Commission wrote to the EBA partially to endorse and amend the EBA's draft regulatory technical standards on the requirements with which payment card schemes and processing entities must comply to ensure the independence of their accounting, organisation and decision-making processes under the **Interchange Fee Regulation**. The Commission endorsed the section relating to 'Accounting' but amended the sections related to 'Organisation' and 'Decision-making process'.

The Financial Stability Board (FSB) reported on **re-hypothecation and collateral re-use**. It highlighted improvements in risk management practices associated with re-hypothecation by prime brokers and their clients, and noted that regulators had also strengthened the relevant client asset protection regimes. It also reported on measure and metrics for non-cash collateral re-use. From January 2020, the FSB will be collecting national aggregated data related to the measure and metrics as part of its global securities financing data standards.

Crisis management (including special resolution, systemically important firms, and business continuity)

The PRA published a policy statement on the **deposit protection limit increase**. From 30 January 2017 the deposit protection limit was raised from £75,000 to £85,000. Firms must ensure customer facing material is up to date and staff are trained on the new rules. The PRA published an updated supervisory statement on **depositor and dormant account protection** to reflect these changes.

Sam Woods, Chief Executive of the PRA, wrote to Andrew Tyrie, Chair of the Treasury Committee, on the proposed reforms to **EU prudential requirements** for banks and investment firms. He said it was "not immediately clear" how the proposals on immediate parent undertakings would enhance the effectiveness of resolution. He also highlighted that parts of the Commission's proposal are not in line with international standards. Andrew Tyrie forwarded his letter to Philip Hammond, Chancellor of the Exchequer.

The FCA consulted on proposed changes to its **client assets** regime in the light of amendments to the Special Administration Regime by HM Treasury.

The FCA is seeking feedback on changes affecting the return of client assets as well as consequential changes to client money rules to address forthcoming indirect clearing requirements under European Market Infrastructure Regulation (EMIR) and MiFIR regulatory technical standards.

The FCA and the PRA consulted on the annual Management Expenses Levy Limit (MELL) for the **Financial Services Compensation Scheme** (FSCS). The MELL sets out the maximum amount that the FSCS can levy annually without further consultation. The consultation proposed a £74.54 million MELL for 2017/18, which allowed for £69.24 million to cover FSCS management expenses and a £5.3 million contingency.

The European Central Bank (ECB) consulted on a Regulation on oversight requirements for **systemically important payments systems**, and published a draft Decision on the methodology for calculating sanctions for infringements of these. The proposals include clearer liquidity risk mitigation requirements, new cyber resilience requirements and the provision of additional powers to Member State competition authorities.

The FSB published 14 policy recommendations to address **structural vulnerabilities from asset management activities**. These were designed to address risks associated with liquidity mismatch between fund investments and redemption terms, leverage within funds, operational risk in transferring investment mandates and client accounts, and securities lending activities of asset managers and funds.

Regulatory perimeter

The Chair of ESMA wrote to the Commission about the **EMIR Review** and **ESMA's sanctioning powers** under EMIR and the credit ratings agency regulation. ESMA restated areas where it would support action by the Commission, including the clearing obligation framework, the treatment of non-financial counterparties and increasing the transparency and predictability of margin requirements. ESMA also called for the third country central counterparty (CCP) recognition framework to be reconsidered.

ESMA consulted on guidelines on the transfer of data between **trade repositories** (TRs), establishing high-level principles to be followed by the TRs, TR participants, reporting entities, counterparties and CCPs. The guidelines address both cases in which the transfer is due to a withdrawal of registration of the TR and cases in which the transfer is done on a voluntary basis and under normal market conditions.

Steven Maijoor, Chair of ESMA, spoke on reforms in **over-the-counter derivatives markets and benchmarks**. He said that ESMA's focus had moved from developing a single rulebook to ensuring supervisory convergence when implementing the derivatives reforms. He also discussed the third country regime for CCPs, highlighting that ESMA has very limited opportunities to see the risks that third country CCPs might be creating in the EU due to limited powers on information collection and risk assessment.

ESMA published its methodology for the annual mandatory **peer reviews of supervisory activities** of competent authorities in relation to the **authorisation and supervision of CCPs** required under EMIR. The methodology covered the adequacy of resources and governance arrangements of the competent authority, the degree of convergence reached in the application of EU law, and best supervisory practices.

The EBA and ESMA jointly published a report on the **functioning of the CRR with EMIR**. The report focuses on the potential duplication of requirements for derivative transactions in relation to central counterparties, in light of some CCPs holding banking licenses. The EBA and ESMA called for the European Commission to clarify issues relating to credit, market, and counterparty credit risk in the CRR.

Mark Carney, Chair of the FSB, spoke on **financial technology**. He recognised fintech's potential to make the financial system more inclusive, efficient, effective and resilient. He focused on how technology can be developed to maximise opportunity and manage risk to avoid undermining financial stability. Overall, he noted that policymakers are expected "to pursue a more intense focus on the regulatory perimeter" of fintech.

Rethinking the domestic and international architecture for regulation

The FCA published key themes from the feedback it had received on its **future mission**. It found that respondents wanted a clearer rationale for its decisions; largely agreed with affording vulnerable customers more protections but had different views on the definition of a vulnerable customer; were divided on whether clear principles were better than prescriptive rules; and thought the FCA should adopt a more active role in sharing lessons learned on risks for their particular market.

Chris Salmon, Executive Director of Markets at the BoE, spoke on **market functioning** with reference to the sterling FX market and the sterling corporate bond market.

He said that central banks need to deepen their understanding of market structures in order to design their operations, broaden their range of tools, and address market vulnerabilities.

Peter Andrews, Chief Economist at the FCA, spoke at a **behavioural finance** conference exploring the role of the regulator, how economics helps regulators in their role, innovations in regulatory economics and challenges for the future. He noted that a central challenge is to understand consumers' decision making well enough to work out the causes of market problems and the most effective remedies.

Andrew Bailey, Chief Executive of the FCA, spoke on **free trade in financial services and global regulatory standards**. He highlighted that regulation should not be seen as "an obstruction to growth and the competiveness of finance", and that global regulatory standards should be further developed and used to open up financial markets to support global trade in financial goods and services.

Valdis Dombrovskis, Vice-President of the European Commission, spoke on the **Commission's agenda for financial services**. A high priority would be the harmonisation of financial governance on a global level. Other focus areas would include the EU Banking Reform Package, reducing reporting requirements for smaller banks, completing the Banking Union and building the CMU.

Malta commenced its six-month Presidency of the Council of the EU. The **Maltese Presidency's priorities** for financial services include supporting rules on securitisation, venture capital legislation and SMEs' access to finance under the CMU, continuing work on the European Deposit Insurance Scheme and concluding negotiations on the proposal amending the 4th Anti-Money Laundering Directive.

Danièle Nouy, Chair of the Supervisory Board of the ECB, spoke on **European banking supervision**. She said that Europe's implementation of supra-national banking supervision is an example of innovation which has created rather than destroyed value. She also set out the following supervisory priorities for banks in 2017: adapt business models to ensure profitability, improve risk management to remain stable and deal with legacy assets by freeing themselves of bad loans that weigh down balance sheets.

Gabriel Bernardino, Chairman of the European Insurance and Occupational Pensions Authority (EIOPA), spoke on the **future of the European insurance industry in a digital era**. He said that disruptive challenges from technology can be embraced and turned into opportunities for the entire insurance value chain.

Donald Trump issued an Executive Order on **reducing regulation and controlling regulatory costs**. This provided that for "every one new regulation issued, at least two prior regulations be identified for elimination". The Order stated that no costs should result from new regulations unless prior authorisation from the Director of the Office of Management and Budget has been obtained pre-implementation.

Disclosure, valuation and accounting

The Financial Reporting Council published a **risk perspective update** report. The report concerned the work of the actuary and identified heightened areas of risk including: inadequate embedding of Solvency II for insurers, competitive pressures on insurers, the implementation of pension freedoms legislation, the increased use of Big Data, and the management of defined benefit pension schemes.

The EBA published a new taxonomy for competent authorities to use for the remittance of **supervisory reporting data** relating to the CRD. This taxonomy was primarily developed for data transmission between competent authorities and the EBA, but many authorities have been using it for the collection of supervisory reporting from the credit institutions and investment firms they supervise. The PRA also published the taxonomy for UK firms to use for regulatory submissions.

ESMA published questions and answers on Guidelines on **Alternative Performance Measures** (APMs), aimed at increasing the usefulness and transparency of APMs in prospectuses and regulated information. ESMA clarified concerns around the applicability of ESMA's Guidelines on APMs, measures presented simultaneously inside and outside financial statements, interim financial reports and labels used on APMs.

ESMA published further extracts from its confidential database of **enforcement decisions on financial statements**, with the aim of providing issuers and users of financial statements with relevant information on the appropriate application of the International Financial Reporting Standards. ESMA will continue to publish further extracts from the enforcement database on a regular basis.

The **Legal Entity Identifier** (LEI) Regulatory Oversight Committee published an update on developments within the LEI System. The Global LEI Foundation published the first accreditations of LEI Issuers, and is finalising its technical specifications for recording relationship data between direct and ultimate parents of legal entities in the Global LEI System, which will be implemented from early 2017.

Information security and data privacy

Matt Hancock, the UK Minister of State for Digital and Culture, confirmed that the UK will implement data protection legislation that mirrors the EU **General Data Protection Regulation** (GDPR) to enable 'unhindered data flows' between EU countries and the UK. Implementing legislation will be brought forward in the next parliamentary session.

Countries in Europe, along with the United States, Canada and India, celebrated annual **Data Protection Day** on 28th January to raise awareness of data protection and privacy rights. The Information Commissioner's Office, the UK's Data Protection Authority, used the opportunity to remind businesses about the 'once in a generation change' that the EU GDPR will drive.

The Article 29 Working Party, an advisory body made up of EU data protection authorities, has published its 2017 **GDPR Action Plan**. The plan sets out the Working Party's new priorities for the coming year, which include producing new guidelines on consent, profiling, and transparency, as well as updating its current guidance on data transfers to third parties and data breach notifications.

Financial Crime

The HM Treasury's Insurance Fraud Taskforce published its final report on **insurance fraud**. The report made recommendations to tackle application fraud during policy purchase and claims fraud. These were designed to raise public awareness, improve consumer trust, increase cooperation between regulators and (re)insurers to prevent fraud, and strengthen the regulation of claims management companies.

The FCA took its first criminal action against an individual acting as unlicensed consumer credit lender. Mr Dharam Prakash Gopee was believed to have lent over £1 million, whilst neither in possession of a consumer credit licence nor an equivalent FCA authorisation. He was alleged to have engaged customers who were often in difficult circumstances, registering charges over homes to enable him to take possession of a property if borrowers failed to pay debt. The case has been sent to the Crown Court.

The FCA fined Deutsche Bank £163 million for failing to maintain an adequate **anti-money laundering control framework** in its Corporate Banking and Securities division, which enabled the use of "mirror" trading to transfer more than $6bn from Russia to overseas bank accounts. To address the deficiencies, the bank has committed significant resources to a large scale remediation programme

The Takeover Panel issued a statement imposing "cold shouldering" on two individuals, Mr. A.L.R. Morton and Mr. J.B. Garner. The panel found that the two individuals had deliberately mis-led the Panel, and that the degree of deception warranted cold shouldering, which means that no FCA-regulated entity can act for these individuals on any transaction subject to the Takeover Code. The cold shouldering was imposed for a period of 6 years for Mr. Morton and 4 years for Mr. Garner.

The European Parliament objected to the Commission Delegated Regulation on the fourth **Anti Money Laundering Directive**. The Parliament said it fundamentally disagreed with the Commission's proposal of an absolute distinction between non-cooperative tax jurisdictions on the one hand and jurisdictions with anti-money laundering and counter-terrorist financing deficiencies on the other, particularly when it comes to requirements to report suspicious transactions.

Other

The TSC took evidence from the BoE on its **Financial Stability Report**. Mark Carney said there would be financial stability risks associated with the UK leaving the EU and that an "implementation phase" was highly advisable. Other topics discussed included regulatory equivalence, preparations for incorporating International Financial Reporting Standards 9 in stress testing, the risks of triggering CoCo bonds, and a rise in consumer credit.

Contacts

Andrew Bulley
Partner, Centre for Regulatory Strategy
+44 (0)20 7303 8760

Rod Hardcastle
Director, Centre for Regulatory Strategy
+44 (0)20 7007 1640

Joy Kershaw
Manager, Centre for Regulatory Strategy
+44 (0)20 7303 6575

Alexandra Boehme
Senior Associate, Centre for Regulatory Strategy
+44 (0)20 7303 7960

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. J11255