



Risk and Regulation Monthly

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November proved to be a busy month for regulatory and supervisory activity. There was a particular focus on the issue of **non-performing loans (NPLs)** in the European banking sector, with Danièle Nouy highlighting this issue as part of her opening remarks at a public hearing, and Sabine Lautenschläger saying that NPLs are probably the single biggest challenge and a drag on the entire European economy. The European Banking Authority (EBA) published guidelines on the **prudential supervision of significant branches within the EU**, while the European Central Bank (ECB) published a paper on developing **macroprudential tools for alternative investment funds**. On the conduct front, the Financial Conduct Authority (FCA) published a paper exploring **FCA's approach to regulating for retail consumers**, while also launching a **market study** to assess how competition is working in the **wholesale insurance broker sector**.

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

Brexit

The European Commission [proposed](#) legislative amendments for the **relocation of the EBA from London to Paris**. Following the agreement made in the General Affairs Council (Article 50 format), the European Parliament and Council are expected to prioritise these legislative proposals.

The ECB [published](#) its latest newsletter, covering **NPLs, low profitability** in the banking sector, **Brexit, FinTech bank licencing applications, and recovery and resolution planning**. The ECB said some aspects of banks' Brexit plans "do not fully meet" its expectations, as some "seem to lean" towards empty shell structures that would be "overly reliant" on group entities in third countries. Also, 'dual-hatting' arrangements, where staff members carry out functions in more than one group entity, needed to be "thoroughly assessed".

Capital (including stress testing and macro-economic issues)

The Bank of England (BoE) [released](#) the **2017 UK banking stress testing results**. For the annual countercyclical scenario, for the first time since 2014, no bank needs to strengthen its capital position. In aggregate, all banks were judged to have cleared the CET1 capital and Tier1 leverage ratio minimum requirements.

The Prudential Regulation Authority (PRA) [published](#) a consultation paper (CP) and a draft supervisory statement (SS) on **effective financial management and planning by insurance firms and groups**,

proposing to include risk tolerance limits and levels of capital that are expected to be maintained in reasonably foreseeable market conditions in the risk appetite statement, and to align business and financial plans, including planned dividends, with these risk appetite and risk tolerance limits.

The PRA [published](#) a CP on its expectations of firms regarding the application of the Solvency II **matching adjustment (MA)**, such as the way credit risk is calculated, the application of five-step framework for assessing risks in MA portfolios, or the application of a mechanistic approach.

The PRA [published](#) a CP on supervisory approval for the **volatility adjustment (VA)**, clarifying its expectations of firms seeking approval to apply a VA to insurance and reinsurance business, especially with regards to the risk that may arise from a VA and how firms should consider these risks, by reflecting the effects of the VA in their Solvency Capital Requirement.

The BoE [released](#) the 2017 **Financial Stability Report**, which found the UK banking system to be resilient to deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs. However, the BoE noted that combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in the stress test.

The EBA [announced](#) the final **timeline** for the 2018 **EU-wide bank stress test**. The exercise will be launched in January with three submission dates in early June, mid-July, and late October. Results will be published by 2 November 2018. The final methodology was [published](#) on November 17, and the macroeconomic scenario will be published with the launch of the exercise in January 2018.

The EBA [launched](#) a **consultation on draft regulatory technical standards (RTS) specifying the different methods of prudential consolidation** which can be applied when certain conditions and criteria are met, including full consolidation, proportional consolidation, and the aggregation method. In addition, the draft RTS included indicators that should be assessed by institutions in order to identify which undertakings could lead to 'step-in risk', i.e. the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support. The consultation will close on 9 February 2018.

The EBA held a [public hearing](#) on its discussion paper on **significant risk transfer in securitisation (SRT)**. The hearing focused on EBA proposals relating to the process of SRT assessment, structural features of SRT transactions, and quantitative SRT tests, as well as the regulatory treatment of NPL securitisation. The EBA proposals aim to harmonise further the regulatory and supervisory treatment of SRT.

The EBA [published](#) the results of its **latest annual benchmarking exercise** on the consistency of internal models used by banks to calculate their capital requirements, looking at credit and market risks. While the majority of credit risk-weighted asset variations were found to be the result of differences in risk fundamentals (consistent with previous exercises), the EBA said that the exercise confirmed that the definition of default and the treatment of defaulted assets are “key areas of supervisory attention”. It subsequently published new Guidelines on these risk parameters.

The EBA [published](#) its final Guidelines on the **estimation of risk parameters for non-defaulted exposures**, and on the treatment of **defaulted exposures under the advanced internal ratings-based (IRB) approach**. These Guidelines seek to restore market participants’ trust in internal models by reducing the unjustified variability in their outcomes, ensuring comparability of risk estimates while at the same time preserving risk sensitivity of capital requirements.

The EBA [updated](#) its list of Common Equity Tier 1 (CET1) instruments which have been assessed and evaluated as compliant with the Capital Requirements Regulation (CRR). The updated list includes **two new forms of CET1 instruments** issued in two Member States, namely, “non-voting share in the paid-up endowment capital” in Germany and “preferred share” in the Slovak Republic.

The ECB [released](#) an occasional paper on **European structured finance counterparty networks**, exploring the network between issuers and service providers for asset-backed securities (ABSs) and covered bonds (CBs). The paper’s findings “point to the importance of the Eurosystem’s risk management framework for ABSs and CBs and support the orientation of recent regulatory efforts at the European level.”

The European Insurance and Occupational Pensions Authority (EIOPA) [published](#) its first set of advice to the European Commission on **the Solvency II Delegated Regulation**, proposing simplified calculations in the Solvency Capital Requirement (SCR) standard formula. Specifically, EIOPA proposed simplifying calculations for lapse and mortality risks, reducing reliance on external credit rating agencies, creating a new asset class for guarantees issued by regional governments, and extending the look-through approach to related undertakings that invest on behalf of the insurer.

EIOPA [published](#) a report identifying a **search-for-yield trend in the investment behaviour of insurers**. It finds increased exposures towards lower credit rating quality fixed income securities, more illiquid investments, and an increase in the average maturity of the bond portfolios. EIOPA encouraged close monitoring of the situation by national authorities, stating that these trends could affect the risk profile of insurance undertakings and the sector as a whole.

The European Securities and Markets Authority (ESMA) [published](#) a final report on the **Money Market Funds Regulation (MMFR)**. The document sets out the key requirements for asset liquidity and credit quality, the establishment of a reporting template, and stress test scenarios carried out by MMF managers.

ESMA [consulted](#) on future guidelines on the **calculation of derivative positions by trade repositories** (TRs) authorised in the European Union under the European Market Infrastructure Regulation (EMIR). ESMA is concerned that divergent and inconsistent approaches to position calculations by TRs hinders the successful aggregation of data, which is required for monitoring systemic risks to financial stability. ESMA proposed to introduce guidelines in order to ensure consistency of position calculations across TRs.

ESMA [clarified](#) the **endorsement regime for third-country credit ratings**. Endorsement is a regime under the Credit Rating Agencies Regulation, which allows credit ratings issued by a third-country credit rating agency (CRA), and endorsed by an EU CRA, to be used for regulatory purposes in the EU. Endorsement is currently used by the largest CRAs in the EU.

Steven Majoor, the Chair of ESMA, gave a [speech](#) on **ESMA’s priorities for 2018** focusing on costs and charges, stress testing for funds, and supervisory convergence around Brexit. Regarding costs and charges, ESMA said it would deepen its analysis on UCITS funds and further extend its analysis to alternative investment funds and structured products.

The Financial Stability Board (FSB) [published](#) an updated list of **Globally Systemically Important Banks (G-SIBs)**, but announced that it decided not to publish a new list of **Globally Systemically Important Insurers (G-SIIs)**, although it said the policy measures set out in 2016 will still apply to those insurers named on the 2016 list. The updated G-SIB list sees one bank added (Royal Bank of Canada), one removed (BPCE), as well as others moving between categories, affecting their G-SIB capital buffers.

Liquidity

The ECB [published](#) a paper discussing **Liquidity Provision as a monetary policy tool**. The paper aims to provide a quantitative assessment of the impact of non-standard monetary policy in response to the Global Financial Crisis of 2008-09. The paper finds that interbank liquidity shocks led to a large increase in bank lending spreads and to a sizable fall in private investment. It hypothesises that the liquidity injected by the ECB played an important role in cushioning the macroeconomic impact of the money market distortions and lessened a more severe impact on investment.

Governance and risk management (including remuneration)

FCA [published](#) a report on **an independent review of Royal bank of Scotland (RBS) Group's treatment of small and medium-sized enterprise (SME) customers** referred to the Global Restructuring Group (GRG).

The FCA [published](#) a report on the **compliance function in wholesale banks**, which presents the key themes and issues arising from a questionnaire sent to individual firms, along with the FCA's observations. The report emphasises that compliance functions should be given adequate support and resources to conduct sufficient strategic thinking and effective planning in light of changes in the operating environment. The FCA sets out that this publication seeks to help heads of compliance develop their departments, and does not require any specific action from firms.

Conduct of Business (including MiFID)

Mark Carney, Governor of the Bank of England, [spoke](#) on the **Fair and Effective Markets Review (FEMR)**, assessing its recent progress, and discussing the forward working agenda for the FICC market Standards Board (FMSB). He concluded that enormous progress had been made in building "real markets" for the good of the people, owing to a combination of more robust regulatory requirements, new compensation arrangements and the Senior Managers Regime (SMR).

The BoE and the FCA [announced](#) the next phase of work with market participants on **LIBOR transition**. From January 2018, the market-led Working Group on Sterling Risk-Free Rates will work on a broad-based transition to SONIA (Sterling Over Night Index Average) over the next four years across sterling bond, loan and derivative markets, so that SONIA is established as the primary sterling interest rate benchmark by end 2021. The FCA [confirmed](#) that all 20 of the panel banks that currently contribute to LIBOR have agreed to remain on the panels they currently submit to until the end of 2021.

The FCA [published](#) its **Future Approach to Consumers**. The FCA highlighted that in all markets it would like to see consumers enabled to buy the products and services they need, high-quality and good value services and products which have taken the needs of vulnerable customers into account, inclusion so that everyone is able to access financial products and protection from harm for consumers.

The FCA [contributed](#) to the **Payment Systems Regulator's (PSR) paper on authorised push payment (APP) scams**. The PSR found that the procedures for handling cases of push payment scams are often unclear and not consistently applied, and that there are insufficient data to understand the scale of the issue. The FCA will actively monitor the adoption, implementation and impact of UK Finance's Best Practice Standards.

The FCA [launched](#) a market study to assess how **competition is working in the wholesale insurance broker sector**, setting out the topics that will be explored (market power, conflicts of interest, and broker conduct). It expects to publish an interim report in the Autumn of 2018.

The European Commission [published](#) regulatory technical standards (RTS) on the **trading obligation for derivatives under MiFIR**, which specified the implementation timeline. The trading obligation for interest rate derivatives and credit default swaps (CDSs) will be implemented from 3 January 2018 for those counterparties who are already subject to the clearing obligation. For counterparties subject to the clearing obligation at a later date, the trading obligation timeline will follow the implementation of the clearing obligation.

ESMA [consulted](#) on a proposed amendment to clarify the **systematic internalisers' (SI)** quote rules under MiFID II/MiFIR. For equity instruments subject to the minimum tick size regime, ESMA proposed that SI quotes would only be considered to reflect the prevailing market conditions where those quotes reflect the price increments applicable to EU trading venues trading the same instruments.

ESMA [published](#) the **peer review results for the MiFID Compliance Function**, covering national competent authorities' supervision of investment firm's compliance obligations. The report found that there is "high-level of compliance with the Guidelines" among national competent authorities (NCAs), but it also found diverging standards in the supervisory approaches applied by NCAs.

ESMA [clarified](#) the application of the **trading obligation for shares under MiFID II/MiFIR**. The trading obligation for shares requires investment firms to ensure that transactions in any shares admitted to trading on a regulated market, or traded on a trading venue, take place on one of a variety of specified types of trading venues. ESMA clarified that where investment firms transact in shares as part of a "chain of transmission", they should ensure that the ultimate execution of the trade complies with the overall share trading obligation, including where they have passed the trade on to a non-EEA firm.

EIOPA [published](#) guidelines applying to "**execution-only" insurance-based investment product (IBIP) sales**, to minimise the risk of consumer detriment and mis-selling, defining the underlying characteristics of products that may be sold "execution only". Products that have features that are difficult for the customer to understand, especially with regards to the associated risks, will not be eligible for sale via "execution only" such as via telephone and online sales.

The FSB Regional Consultative Group for Middle East and North Africa [discussed](#) the FSB's work related to international post-crisis policy reforms and the reduction of misconduct risk in the financial sector. The meeting further discussed global and regional macroeconomic and financial markets developments and their impact on economies in the region, as well as the **financial stability implications of FinTech, non-performing loans (NPL) and the rise of debt levels globally**.

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

The EBA [published](#) its final recommendation on the **coverage of entities in banking group recovery plans**, defining common criteria for identifying entities that need to be covered in recovery plans and specifying that the coverage of entities in a group recovery plan is proportional to the relevance of the entities.

Danièle Nouy, Chair of the Supervisory Board of the ECB, and Sharon Donnery, Chair of the ECB's High Level Group on non-performing loans (NPLs), [made](#) introductory remarks to the public hearing on the **draft addendum to the ECB guidance to banks on NPLs**. The addendum seeks to clarify supervisory expectations related to the provisioning of loans that become non-performing. Danièle Nouy explained that although these expectations are firm, supervisors will consider the specific circumstances of banks on a case-by-case basis before taking any action under the Pillar 2 framework.

Danièle Nouy also [spoke](#) on **progress and developments in European banking supervision**. She addressed the ECB's ongoing work in tackling non-performing loans and focused on banking sector sustainability, particularly given current challenges such as low profitability and increased competition from the fintech sector.

Sabine Lautenschläger, Member of the Executive Board of the ECB, [spoke](#) on **risks to the European banking sector**, covering NPLs, Brexit and internal models. She outlined the ECB's assessment of banks' strategy to reduce NPLs. In relation to Brexit, she noted that provision for the continuity of contracts to existing customers must be factored into firms' contingency plans. As part of the targeted review of internal models (TRIM), the ECB will begin to assess internal models that cover low-default portfolios from mid-2018 to 2019.

The FSB issued a [consultation](#) on two proposals for the implementation of particular aspects of its "**Key Attributes of Effective Resolution Regimes**" for global systemically important banks (G-SIBs) in order to end "too-big-to-fail". The consultation document proposes a set of principles to assist authorities as they make G-SIB bail-in resolution strategies operational, while looking to minimise the impact of resolution on financial stability, ensure the continuity of critical functions, and avoid exposing taxpayers to loss. Regarding the development of a plan for funding in resolution, the consultation proposes a set of key funding strategy elements, building on existing guidance on liquidity risk management and resolution planning.

Regulatory perimeter

Stefan Hunt, Head of Behavioural Economics and Data Science at the FCA, [delivered](#) a speech on how **machine learning is starting to make an impact on the tools regulators use for market surveillance** and for tackling many other problems. Using an array of examples, Stefan Hunt argued that much of what regulators do is about recognising patterns in data and making predictions, and that machine learning can help regulators find those patterns.

The EBA [published](#) final guidelines on the prudential supervision of significant branches within the EU.

The guidelines provide a framework for the identification of 'significant-plus' branches which will face heightened supervision, including having a branch risk assessment carried out as part of the SREP of the institution or group to which they belong. The guidelines will apply from 1 January 2018.

The ECB [published](#) a paper on developing **macroprudential policy for alternative investment funds**. The paper devises a framework for assessing financial stability risks from leverage in investment funds, and explores the potential effectiveness and efficiency of different designs for macroprudential leverage limits.

Gabriel Bernardino, Chairman of EIOPA, [spoke](#) at EIOPA's annual conference **about maintaining sound regulation in an evolving landscape, supervisory convergence, and establishing a common European supervisory culture**. He also announced that a discussion paper on the need for a harmonised insurance compensation scheme across the EU would be released in the near future.

EIOPA [published](#) a report on a **common supervisory culture**, setting out the key characteristics of an effective supervisory culture, and the tools needed to achieve them, such as legal standing, a proper governance structure, a clearly defined strategy and cooperation with other authorities.

Rethinking the domestic and international architecture for regulation

Christopher Woolard, Executive Director of Strategy and Competition at the FCA, [delivered](#) a speech on the **future of competition and regulation in retail banking**. He highlighted that PSD2 and Open Banking represent significant opportunities for incumbents and challengers alike, and will foster competition in the retail banking industry. However, regulators will need to monitor the impact of such regulatory and market changes on consumers and on firms' business models.

The PRA [published](#) documents on the authorisation and supervision of **insurance special purpose vehicles (ISPVs)**. Most notable is the requirement to include sufficient detail in relation to all transactions, including future planned transactions. If new transactions were not initially authorised by the PRA, firms will have to apply for an extension of scope of the permission.

The EBA [published](#) its third annual **report on the convergence of supervisory practices across the EU**. The report found a good degree of progress has been made by competent authorities in the implementation of the SREP guidelines. However, it noted that challenges remain in converging capital adequacy assessments and determining institution-specific additional own funds requirements (P2R). Further progress on convergence will be supported by adjustments to the SREP framework and revisions to the Pillar 2 framework in the CRR/CRD.

The European Commission [consulted](#) on a **fitness check on supervisory reporting**. The report sought to gather evidence on the cost of compliance with existing EU-level supervisory reporting requirements, and more specifically to collect quantitative evidence on any investments required and to gather examples of inconsistent, redundant or duplicative requirements.

Sabine Lautenschlager, Member of the Executive Board of the ECB, [spoke](#) about what is next on the banking supervision agenda highlighting that **non-performing loans "NPLs"** are probably the single biggest challenge and a drag on the entire economy. Since 2015, significant banks in the euro area have brought down their non-performing loans by almost €200 billion; from €989 billion to €795 billion but the ECB considers that NPLs are still too high in parts of the banking sector.

Daniele Nouy, Chair of the Supervisory Board of the ECB, [spoke](#) on the **banking union**. Her speech highlighted the benefits of supervision and resolution under the banking union, whilst noting that a third pillar, the European Deposit Insurance Scheme, still needs to be finalised. She also commented on the importance of further integrating the European banking market to address issues including "overbanking" in the market.

The International Association of Insurance Supervisors (IAIS) [announced](#) a **Global Agreement on Actuarial Services** between itself, the International Actuarial Association (IAA), and the Access to Insurance Initiative (A2ii). The agreement seeks to increase the use of actuarial skills by supervisory authorities and develop supervisory capacity building programs.

The IAIS launched a [consultation](#) on **Insurance Core Principles (ICPs)** for risk management and internal controls, investment requirements for solvency purposes and enterprise risk management for solvency purposes.

The IAIS [published](#) a press release on the ICS, setting out the **implementation phases of ICS Version 2.0**: a five-year monitoring phase where mandatory confidential reporting by all Internationally Active Insurance Groups (IAIGs) of a reference ICS to their group-wide supervisor will apply, followed by a phase where the ICS could be used to set the prescribed capital requirement.

The International Organization of Securities Commissions (IOSCO) [published](#) a report on the implementation of the **G20/FSB post-crisis recommendations aimed at strengthening securities markets**. The report pointed to the fact that most responding jurisdictions have taken steps to implement the G20/FSB recommendations and IOSCO guidance. Implementation is most advanced on hedge funds, structured products and securitisation, and the oversight of credit rating agencies.

The Monitoring Group, composed of international financial institutions and regulatory bodies, [published](#) a CP and a Call for Comments on **reforms to enhance the governance, accountability and oversight of the international audit standard-setting process**. The paper highlighted key principles that standard setting should observe, including independence, transparency, credibility and cost-effectiveness. The consultation is open until 9 February 2018.

The Board of IOSCO [published](#) the final report on the Fourth **IOSCO Hedge Fund Survey**. The survey observed that in the two years since the previous results, global assets under management (AUM) of hedge funds captured by the Survey rose 24% to \$3.2 trillion. This increase may reflect a combination of more widespread reporting across jurisdictions.

Information security and data privacy

Karina McTeague, Director of Retail Banking Supervision at the FCA, [spoke](#) about **regulatory priorities in retail banking**. She explained that innovation in the sector, as well as regulatory changes (in particular PSD2 and Open Banking) will foster competition and present opportunities both for businesses and consumers. Nevertheless, the FCA will be looking for firms to focus on three major risks, namely IT stability and security, fraud, and conduct risks.

Nausicaa Delfas, Chief Operating Officer at the FCA, [spoke](#) about **cyber resilience and supplier risk**,

highlighting that firms should not see this as a tick-box exercise, that it should be driven from the top, and should scrutinise people, processes, and technology. Importantly, she stressed the need for firms to manage risks posed by suppliers and partners.

The EBA [published](#) its **final Guidelines on the treatment of connected clients** as defined in the CRR. The guidelines clarify requirements for firms to identify interconnections among their clients, in particular when relationships of control or economic dependency lead a group of clients to be regarded as a single risk. They also consider developments in shadow banking and large exposures in the EU and internationally, and replace 2009's "Guidelines on the implementation of the revised large exposures regime".

The European Commission [released](#) the Regulatory Technical Standards (RTS) on **strong customer authentication and secure communication** under PSD2. The final text bans screen scraping, however, Account Servicing Payment Service Providers (ASPSPs) will still be required to put in place contingency measures in case of unavailability or under performance of their dedicated interfaces during a communication session with Third Party Providers (TPPs).

The European Parliament [discussed](#) the RTS on **separation of payment card schemes and processing entities under the Interchange Fees Regulation (IFR)**, which has recently been adopted by the Commission with some amendments to the original EBA draft RTS. The European Parliament and the Council have a three months scrutiny period until 4 January 2018.

The FSB [published](#) a report on the **financial stability implications of the growing use of artificial intelligence (AI) and machine learning in financial services**. The report presents the potential risks and opportunities of these technologies for financial markets and institutions, customers and investors, and the overall financial system. Key areas of concern for the FSB include the lack of auditability and interpretability of AI and machine learning, their potential network effects and scalability, and the risks they present in terms of conduct and cybersecurity.

Other

The FCA [launched](#) a consultation on various proposals to change how the **Financial Services Compensation Scheme (FSCS)** is funded to ensure adequate protection for consumers, including, increasing the FSCS compensation limit for investment provision, investment intermediation, home finance and debt management claims to £85,000.

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