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Risk and Regulation Monthly

Following a busy December, the new year started with the continued implementation of post-crisis reforms, such as the final rules implementing the **Bank Recovery and Resolution Directive (BRRD)** from the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), and some new policy initiatives, such as the **Capital Markets Union (CMU)**.

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Capital (including stress testing)

Regulations were *laid* before the UK Parliament, implementing the **"systemic risk buffer"** of the Capital Requirements Directive (CRD IV), in line with the government's 2012 white paper. The systemic risk buffer will only apply to the largest banks, building societies and investment firms (those with retail deposits of more than £25bn, or equivalent) and will be applicable from 1 January 2019.

The PRA *consulted* on proposed changes to the pillar 2 framework for capital adequacy for banks, building societies and PRA-designated investment firms. The consultation also introduced the PRA's methodologies for firms' Pillar 2A capital requirements and the operation of the new PRA buffer regime. Implementation is planned from 1 January 2016, in line with the introduction of the CRD IV capital conservation and systemic risk buffers, and the Supervisory Review and Evaluation Process guidelines from the European Banking Authority (EBA).

The European Systemic Risk Board (ESRB) *wrote* to Jonathan Faull at the European Commission, on macro-prudential risks that may temporarily require greater prudential requirements under the Capital Requirements Regulation (CRR). While there was no evidence such requirements were needed at present, the ESRB noted two theoretical situations in which a response might be required, namely "systemic fragilities in financial markets" and the spread of "indirect contagion in its various forms" to other member states.

The PRA *updated* its supervisory statement on **third country equivalence aspects of credit risk provisions** in the CRR, removing the transitional provisions on credit risk treatments of exposures to third country entities, following the Commission's list of third countries with equivalent supervisory and regulatory arrangements.

The PRA *consulted* on draft rules implementing transitional measures regarding risk-free rates and technical provisions under **Solvency II.** The transitional measures aim to avoid market disruption and limit interference with the existing availability of insurance products.

The PRA *published* a letter explaining how it will deal with Part VII transfers in 2015, due to a "significant number" of firms wanting to conduct **transfers of insurance business ahead of Solvency II**. For transfers that have not been paid (or a special project fee agreed), the PRA will review on a case by case basis the impact on the PRA's objectives and resources and agree a timetable with the individual firm.

The European Insurance and Occupational Pensions Authority (EIOPA) consulted on draft advice to the European Commission on the third country equivalence assessments under **Solvency II** for *Bermuda, Japan* and *Switzerland*. All three jurisdictions were deemed equivalent subject to certain caveats. A final decision by the Commission is expected by summer 2015.

The Basel Committee on Banking Supervision (BCBS) *published* its **2015-2016 work programme**. It plans to continue the finalisation of standardised approaches to credit, market and operational risk. Policy work was "well advanced" on capital floors based on standardised approaches, the criteria for "simple" securitisations, the fundamental review of the trading book and interest rate risk in the banking book. The BCBS plans to assess the interaction and overall calibration of its reform policies, given the range of metrics in the new regulatory framework, review the regulatory treatment of sovereign risk and assess the role of stress testing. For more information please see our blog on *Proposed revisions to the standardised approach to credit risk | More risk sensitivity, more complexity*.

Liquidity

The EBA *published* an impact assessment regarding the **liquidity coverage ratio** (LCR) requirements. The report pointed to improvements in EU banks' compliance with LCR requirements and concluded that the implementation of the LCR was not likely to have a negative impact on the stability of financial markets or the supply of bank lending.

Governance and risk management (including remuneration)

The International Organization of Securities Commissions (IOSCO) *published* final standards on **risk mitigation procedures** for non-centrally cleared OTC derivatives, to complement the margin requirements. The standards cover areas such as valuation, portfolio reconciliation, portfolio compression and dispute resolution. They apply to financial entities and systemically important non-financial entities as defined nationally.

Paul Fisher, Deputy Head of the PRA, *spoke* on insurance regulation, emphasising that the PRA was not looking to use **Solvency II** to increase capital standards nor gold plate the Directive. He clarified the role of non-executive directors at firms using internal risk models, stating that they did not need to be technical experts, but the board "collectively should understand the key strengths, limitations and judgements within their model".

Conduct of Business (including MiFID)

The FCA *reported* on its **cash savings market study**, concluding that "competition in the market is not working effectively for many consumers." Major providers had a considerable competitive advantage because they could attract most "easy access" balances, while accounts opened more than five years ago paid lower interest rates than those opened more recently. Consumers were discouraged from switching accounts due to a lack of information. The FCA made a number of proposals, focused on timely, clear and targeted product information (including rates on "old" products), making switching "as easy as possible", and reducing the advantages of large providers by enabling consumers to manage accounts with different providers in one place.

The FCA *consulted* on guidance on the **concurrent competition powers** it will acquire from 1 April 2015 alongside the Competition and Markets Authority (CMA). It will be able to impose a penalty for competition law infringements; gather information on unregulated firms for market studies; use both its regulatory and competition powers when taking enforcement action; and accept undertakings instead of making a market investigation reference. Prior to exercising its traditional regulatory powers, the FCA must consider if it would be more appropriate to use its competition powers.

The Payment Systems Regulator (PSR) *consulted* on the use of its concurrent competition powers with the CMA. The consultation paper affects payment system operators, banks, building societies and other payment system providers. The PSR will be able to carry out market studies and make market investigation references to the CMA. In addition, the PSR proposes to mirror the approach taken by the FCA in exercising its powers.

The UK Government *published* legislation implementing the **Mortgage Credit Directive** in the UK. While the UK already complied with the majority of the new EU rules, changes under the new legislation included bringing second charge mortgage lending into the scope of the mortgage regime and introducing a new set of rules for buy-to-let lending, where the lending is to consumers rather than for business purposes.

The FCA *finalised* its guidance on **retail investment advice**, clarifying different types of retail investment sales models, the boundaries between them, and associated regulatory requirements. It also provided detailed scenarios of what constituted a personal recommendation or regulated advice in relation to retail investments.

The FCA *updated* guidance on reporting requirements for firms authorised to carry out regulated consumer credit activities. The update included changes to the *data items*, the *guidance notes* for completing the data items, and a new *complaints return form* that consumer credit firms would be required to complete.

The FCA *published* a "Dear CEO" letter on its expectations of **high-cost short-term lenders,** summarising concerns uncovered since it began supervising these firms in April 2014. The letter covered firms' responsibilities in credit broking and lead generation, affordability of loans, fair treatment of customers in financial difficulties, and governance and controls to monitor compliance.

In another "Dear CEO" letter, the FCA *stated* its intention to make additional rules on **retirement reforms and the guidance guarantee**, after firms said it was not clear how far they should go in helping people who chose not to use Pension Wise or regulated advice. The FCA said pension providers should ask consumers about key aspects of their circumstances regarding their pension choice and then provide relevant warnings based on the response. They must also highlight that Pension Wise, or regulated advice, is available to assist the customer.

The FCA *reported* on cases where firms believed regulators had applied a more demanding standard or interpretation of rules when **acting retrospectively**. The most frequent examples cited related to the branding of Traded Life Policy Investments as "toxic" (18 responses) and to decisions of the Financial Ombudsman Service (FOS) (8 responses). The FCA said most examples referred less to retrospective action than to issues which had persisted in the market before coming to regulators' attention. By contrast respondents felt previous inaction suggested either approval or indifference and had continued to sell these products, saying that when a regulator turned its attention to certain issues in this way, this was tantamount to "changing its mind". The FCA will try to improve communication of its thinking with the market, with a view to being more forward-looking.

The FCA *banned and fined* two former senior executives of interdealer broker, Martin Brokers, a total of £315,000 for compliance and cultural failings in relation to **LIBOR**. The FCA found that the executives' failings contributed to a culture at the firm which permitted LIBOR manipulation to take place and enabled the misconduct to continue undetected over a prolonged period.

The FCA *announced* it will gather evidence to assess if the **Payment Protection Insurance (PPI)** complaints process is working. It will decide by the summer if further interventions are appropriate, which could include a consumer communication campaign or a time limit on complaints.

The FCA *reached* an agreement with Affinion International Limited and 11 high street banks and credit card issuers about the way that certain **card security products** had been sold. The agreement will permit customers to claim compensation. The amount of redress will depend on how long the product was held and whether any successful insurance claims had been made on the product. The FCA estimated that approximately two million people will receive a letter about the agreed compensation scheme.

Eight major foreign exchange committees, including the London Foreign Exchange Joint Standing Committee, *said* they were considering how best to incorporate the Financial Stability Board's (FSB) final guidance on **Foreign Exchange Benchmarks** into best practice documentation. They "strongly recommend" that all foreign exchange market participants review the FSB Report and ensure that it guides their behaviour.

Andrew Hauser, Director of Markets Strategy, Bank of England (BoE), and head of the **Fair and Effective Markets Review (FEMR)** secretariat, *spoke* about the aims of the FEMR. He stressed the need to realign private and public interests in wholesale financial markets in light of the recent cases of misconduct in LIBOR and foreign exchange markets.

The European Securities and Markets Authority (ESMA) *consulted* on what constitutes a share class for **undertakings for collective investment in transferable securities** (UCITS). ESMA identified diverging national practices as to the permitted types of share class, ranging from very simple share classes e.g. with different levels of fees, to much more sophisticated share classes e.g. with potentially different investment strategies. Views were sought on the extent of differentiation between share classes that should be permitted.

The FCA *clarified* how **copy trading, or 'mirror trading', in the contracts for difference** retail market should be treated for the purposes of Markets in Financial Instruments Directive (MiFID) investment activities. On automatic execution of trade signals, the FCA agreed with ESMA's Q&A that while such services would not necessarily amount to portfolio management under MiFID, they could still involve other investment services such as investment advice in the case of personal recommendations, and reception and transmission of orders.

The FOS *consulted* on its proposed **plans and budget** for 2015-16. It plans to resolve 250,000 disputes involving mis-sold PPI and tackle an additional 88,000 complaints related to banking, 33,000 complaints related to insurance and 17,000 related to investment firms.

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

The *FCA* and *PRA* issued separate policy statements on the final rules for the implementation of the **BRRD**. The FCA did not make any significant policy changes, but amended rules to remove overlap with PRA rules, confirmed its approach to the contractual recognition of bail-in, and provided additional guidance, including on the scope of the BRRD and financial support. The PRA responded to points raised by respondents on recovery planning requirements and bail-in, such as the number of scenarios that global systemically important institutions (GSIIs) and non-GSIIs should include in their recovery plans, and provided further guidance on wind-down analysis and intragroup financial support.

The Committee on Economic and Monetary Affairs (ECON) of the European Parliament *published* a draft report on the proposed **'Liikanen' Regulation** on structural measures to improve the resilience of EU credit institutions. It proposed that where the metrics used to analyse the riskiness of trading activities were met, only a threat to the resolvability of a particular credit institution should lead to supervisory action, rather than a general threat to financial stability. The report favoured a risk-based approach rather than a structure-based approach to address systemic risks. For more information please see our blog, *EU Bank Structural Reform – progress, of sorts*.

The EBA *consulted* on draft implementing technical standards (ITS) in relation to the procedures, forms and templates required for **resolution planning**. These provide the detailed procedures that should be followed when resolution authorities require information about an institution for the purpose of drawing up a resolution plan. The consultation annex set out the minimum set of templates that firms must provide, including reporting on payment systems, off-balance sheet activities, interconnectedness, and critical counterparties.

An order *entered into force* implementing sections of the **BRRD**, including the obligation to ensure that deposits which are eligible for compensation under the Financial Services Compensation Scheme, and other deposits which would be eligible but for the fact that they are made in branches of UK banks outside the EEA, are both treated as 'preferential debts'. Further, within the class of 'preferential debts' eligible deposits will be given a higher priority than other deposits.

The International Swaps and Derivatives Association (ISDA) *proposed* a **Central Counterparty (CCP) default management, recovery and continuity framework**. The framework follows ISDA's publication of a set of high-level principles for CCP recovery in November 2014, which called for greater CCP transparency, use of standardised stress tests and significant CCP "skin in the game." The position paper also set out the tools that can be used to re-establish a matched book following the default of one or more clearing members, but did not cover non-default losses and those relating to liquidity shortfalls.

Regulatory perimeter

The European Commission *commenced* work on creating a **CMU** by holding a first orientation debate at the College of Commissioners on the key challenges and priorities for the integration of capital markets. It *confirmed* it will launch a Green Paper consultation on the CMU on 18 February 2015. Based on the feedback it receives, the Commission will unveil an Action Plan on the CMU during the third quarter of 2015.

Jon Cunliffe, Deputy Governor for Financial Stability at the BoE, *spoke* about balancing the development of a **single market for financial services** with the need for financial stability. To achieve the CMU's objectives, significant reforms were required. On the supply side, household and corporate savings must be able to flow to vehicles that will invest in capital markets, and investors should be encouraged to allocate capital across borders to reduce home bias. On the demand side, more diverse forms of borrowing will be needed, both where investors directly acquire assets, e.g. equity and corporate bonds, and where they do so indirectly e.g. through securitisation. The change needed to achieve a CMU will require "a carefully planned, detailed and sustained effort over a number of years".

Steven Maijoor, ESMA Chair, *spoke* about the interaction between **regulation and long-term sustainable growth**. Agreement on new legislation was "only half the job done" as laws passed must work in practice, with effective implementation, supervision and enforcement. He warned against losing focus on the regulatory reform agenda because "it contributes to sustainable growth." He also outlined his view of the four "main building blocks" of the CMU, which consisted of a greater diversity in funding; increasing the efficiency of capital markets; strengthening and harmonising supervision; and increasing the attractiveness of capital markets.

ESMA *opined* on the draft technical standards on the **clearing obligation** on interest rate swaps under EMIR (the European Market Infrastructure Regulation) in response to the European Commission's stated intention to endorse, with amendments, the draft RTS. ESMA supported the Commission's intention to postpone the start date of the frontloading obligation, to provide counterparties with sufficient time to determine whether their contracts are subject to it. However, ESMA did not support the proposal to exclude for three years non-EU intra group transactions, considering the provision to be outside the RTS mandate contained in EMIR.

ESMA *published* its first annual review of the colleges established under EMIR to authorise and supervise **CCPs**. The review, based only on ESMA's participation in the colleges, found a good level of cooperation and engagement amongst the colleges in meeting deadlines to reach a joint opinion. However, some national competent authorities chairing the CCP colleges needed to improve their willingness to share information.

Execution Noble, a London subsidiary of a Portuguese bank, was *fined* £231,000 by the FCA for **breaches of the Listing Rules** in relation to sponsors. The firm did not disclose to the UK Listing Authority that two-thirds of its sponsor team had left between June and November 2013, and continued to market itself as a competent sponsor throughout this period. This is the first use of the FCA's power, introduced in 2013, to fine sponsors.

Rethinking the domestic and international architecture for regulation

As part of the ongoing **regulatory dialogue between the US and EU**, participants *discussed* the commitments made by the G20 leaders on Basel III capital, leverage and liquidity rules, OTC derivatives reforms, and policy developments on cross-border resolution. Views were exchanged on the equivalence of derivatives and CCP regulations, and the equivalence regime in the proposed EU benchmarks regulation.

Andrea Enria, EBA Chair, *spoke* about the **"challenges for the future of EU banking"**. He focused on the steps required to maintain the momentum on regulatory reform; and challenges faced by the EBA, such as reducing excess capacity in banking, improving banks' internal risk models, and addressing conduct issues.

Danièle Nouy, Chair of the **ECB's Supervisory Board**, *wrote* to the management of the largest Eurozone banks, clarifying the approach to existing supervisory processes in Single Supervisory Mechanism (SSM) countries. While the ECB had assumed the role of key point of contact for "significant" banks, it would cooperate with national competent authorities in processing and approving banks' requests, applications and notifications.

The Council of the EU published *amendments* to the Regulation on the **ECB's powers to impose sanctions**, aimed at establishing a coherent regime in relation to the performance of the ECB's supervisory tasks under the SSM. Amendments included changes to provisions on publication of the ECB's decisions on sanctions, limits for fines, and powers to impose periodic penalty payments.

The UK Regulators Network (UKRN) *consulted* on its **work programme for 2015-16**. Areas of focus included consumer engagement and switching, and market returns and the cost of capital. The UKRN consists of various economic regulators, including the FCA, the PSR and Office of Communications, and aims to promote effective cooperation, strategic coherence and information-sharing between sectors.

Disclosure, valuation and accounting

The BCBS *issued* its final standards for the revised **Pillar 3 disclosure** requirements. Some substantive changes were made, including rebalancing the types of disclosures required, streamlining requirements on credit risk exposures and mitigation techniques, and clarifying the framework for securitisation exposures. The guidelines introduce harmonised templates, a hierarchy of disclosures, and expectations on qualitative narrative information. Pillar 3 reports must now be published concurrently with financial statements. Authorities will enforce the requirements from end-2016.

The EBA *published* final consolidated guidelines on the information that institutions should disclose under Pillar 3 in accordance with the CRR. The guidelines cover how firms should apply the concepts of 'materiality', 'proprietary nature' and 'confidentiality' when meeting disclosure requirements. The guidelines also set out the expectations relating to the frequency of disclosures and the process and criteria for the use of any waivers.

The EBA *amended* its final **draft RTS on prudent valuation** required under the CRR. In order to avoid adverse side-effects in the initial implementation, all references to "volatility" have been replaced by "variance" which will lead to a "slight relaxation" of how volatility tests are calibrated and performed. The EBA is planning to undertake a review of the test's calibration within two years of implementation.

Information security and data privacy

The BCBS *published* a progress report on global systemically important banks' (G-SIBs) adoption of the **principles for effective risk data aggregation and risk reporting** (BCBS 239). The report, based on a "stocktaking" self-assessment by banks, found that 14 out of 31 will fail to comply fully with the Principles by the 2016 deadline, compared with 10 who reported this a year earlier. The average compliance rating (on a scale of 1-4, 4 being "fully-compliant") across all 11 principles was 2.85, indicating most G-SIBs are not yet "largely-compliant" with the Principles, compared with 2.81 last year.

The UK Government *updated* guidance on how businesses can protect themselves from **cyber threats**. The guidance, primarily consisting of the Government's "10 Steps To Cyber Security," now includes a document which sets out what a commonly-seen cyber-attack looks like and how attackers typically execute them.

Andrew Gracie, Executive Director of Resolution at the BoE, *said* the BoE was working with firms to improve cyber resilience via a cross-sector review of current cyber risk management practices and vulnerability testing via the CBEST framework. He warned that the cyber threat would be "ever-present" and "ever-evolving" and consequently addressing cyber risk in the financial sector is a "high priority" for the BoE.

The EU Agency for Network and Information Security (ENISA) *published* its latest research on **network and information security** for the EU's finance sector. Large banking groups demonstrated a "good understanding" of the risk landscape and many had introduced enhanced good practices, especially for IT governance. The report suggested convergence of regulations could reduce the differing standard of security levels and remove duplication, and international cooperation on security issues could define common and appropriate guidelines.

Financial crime

The founder of Weavering Capital Limited was *found guilty* of eight counts of **fraud, forgery, false accounting and fraudulent trading**. The individual used illegal trades to artificially inflate the Weavering Macro Fund's investment performance and "thereby mislead investors of its true value".

The **Society of Lloyd's** *published* a market bulletin to help Lloyd's managing agents establish appropriate systems and controls in order to comply with international sanctions, covering compliance, delegated authorities and claims handling business areas.

Other

Latvia *published* the **programme for its Presidency** of the Council of the European Union for the six months to 30 June. It will continue to move forward on the revised Insurance Mediation Directive (IMD II); work towards finalisation of the revised Payments Services Directive; and continue discussions on Banking Structural Reform. On 1 January 2015, **Lithuania** *joined* the Euro and the Single Supervisory Mechanism. SEB Bankas, Swedbank and DNB Bankas now fall under the direct supervision of the ECB.

EIOPA *updated* its **quarterly risk dashboard for Q3**. Market risks remained unchanged from Q2; profitability was still challenged by low investment yields. While Solvency I figures were robust, the recent stress test showed that 14% of firms did not reach the Solvency Capital Requirement threshold of 100% if calculated on a Solvency II basis, but EIOPA believed the sector was in general sufficiently capitalised in Solvency II terms.

The BoE *announced appointments to its Executive team*. Alex Brazier was appointed Executive Director for Financial Stability Strategy and Risk, and Sam Woods was appointed Executive Director for Insurance Supervision, effective from 16 March 2015 and 7 April 2015 respectively.

The PRA published the *December* and *January* editions of its **Regulatory Digest**, which covered results of the UK stress test, a supervisory statement on the PRA's expectations relating to firms' compliance with the EBA's guidelines on disclosure of encumbered and unencumbered assets, third country equivalence aspects of the credit risk provisions in the CRR, and the BoE Court Minutes for the period June 2007 – May 2009.

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