

Risk and Regulation Monthly



August saw the adoption of the first Regulation to impose **clearing obligations** under the **European Market Infrastructure Regulation (EMIR)**. Two relatively young UK regulatory institutions – the **Competition and Markets Authority (CMA)** and the **Payment Systems Regulator (PSR)** – were also active. In the courts, Tom Hayes became the first person to be convicted in relation to **LIBOR manipulation**.

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Capital (including stress testing)

The European Banking Authority (EBA) *expanded* the scope of its forthcoming **leverage ratio (LR)** and Net Stable Funding Ratio (**NSFR**) calibration reports, to include further analysis on proportionality, the scope of application and the initiatives' effects on markets, following a request from the European Commission. The work on proportionality will look at the effects of the requirements (and, in particular, future reporting) on banks with different business models. The NSFR report is expected by end-2015 and the LR report by July 2016.

The EBA *published* a call for evidence on the **capital reduction for loans to small and medium-sized enterprises (SMEs)**, known as the "SME supporting factor", set out in the Capital Requirements Regulation (CRR). The feedback received will shape an EBA report, *expected* in early 2016, which will include analysis of lending trends and conditions for SMEs, as well as the "effective riskiness" of lending to SMEs over a full economic cycle. It will inform the European Commission's work on the impact of the CRR on lending to SMEs.

The EBA *consulted* on the procedure for excluding transactions with non-EU **non-financial counterparties (NFCs)** from the own funds requirement for credit valuation adjustment (CVA) risk. While the draft rules align the treatment of non-EU and EU NFCs, institutions must ensure that a non-EU counterparty would qualify as a NFC if it were established in the EU, and accurately calculates and does not exceed the EMIR clearing threshold.

The European Commission *reported* on the rules determining the level of application (i.e. at the consolidated and individual levels) of **banking prudential requirements** under the Capital Requirements Directive IV (CRD IV). The Commission concluded that it "does not appear suitable" to amend the framework at present.

The Prudential Regulation Authority (PRA) *consulted* on proposals for the prudential regime for insurers **not subject to Solvency II**. There were few substantive changes, other than enhanced governance requirements for firms with assets above £25mn, on which the PRA consulted separately (see the Governance section).

The PRA *published* a document on the intra-group reinsurance of matching adjustment (MA) business for **Solvency II**. It confirmed that the balance sheets of both involved parties will be valued independently, and specified that the "ceding entity" should not take credit for any MA available to the reinsurer; and in the context of group solvency calculations, any MA benefit received by the "cedant" on its retained risks will be preserved.

The PRA published supervisory statements on **Solvency II** for *life insurance product reporting codes*; and *internal model reporting codes and components*, which included a list of the relevant codes.

The PRA *consulted* on revisions to its supervisory statement on third country insurance and pure reinsurance branches under **Solvency II**, which included an expectation for such branches to comply with the relevant Branch Guidelines from the European Insurance and Occupational Pensions Authority (EIOPA), and details on reporting requirements for third-country branch undertakings.

The PRA *added* a chapter on reverse stress testing to its recent supervisory statement on **ICAAP** (the Internal Capital Adequacy Assessment Process) and **SREP** (the Supervisory Review and Evaluation Process), setting out its high-level expectations around firms' reverse stress testing practices. It subsequently *amended* its Pillar II framework policy statement to ensure consistency between the documents.

The Basel Committee on Banking Supervision (BCBS) *published* a set of Frequently Asked Questions (FAQs) in relation to the Standardised Approach for **measuring counterparty credit risk**. The FAQs provide answers on the capping of margined exposure at default, potential future exposure add-ons, and derivatives issues.

The BCBS updated a series of documents in relation to its **Basel III monitoring exercise**, with the aim of facilitating the collection of June 2015 data. Updates include new *FAQs* on its impact study on the proposed frameworks for market risk and CVA risk, *instructions* for completing the reporting templates, a *qualitative questionnaire* for interest rate risk in the banking book and the *monitoring workbook*.

Liquidity

The European Commission *informed* the EBA of its intention to amend the draft implementing technical standards (ITS) on additional monitoring metrics for **liquidity reporting** under the CRR for the liquidity coverage ratio (LCR) and the NSFR. The Commission said it intended to delete a template relating to the maturity of liquid assets, and to change the proposed date of application from 1 July 2015 to 1 January 2016. The EBA was invited to send its opinion on the intended amendments or a revised draft ITS within six weeks.

See also first item under 'Capital' for developments on the NSFR.

Governance and risk management (including remuneration)

The PRA and the *Financial Conduct Authority (FCA)* published final and near-final rules on the application of the **Senior Managers Regime (SMR)** to UK branches of foreign banks. The rules were published prior to the finalisation of secondary legislation (expected in autumn 2015) to "give firms as much time as possible to prepare for the changes." Among the changes made were the removal of the prescribed responsibility on whistleblowing, and the FCA's partial replacement of the Overseas Branch Senior Management function with a function to be referred to as 'Other Local Responsibility'.

The PRA *published* a policy statement containing its final rules on the **Senior Insurance Managers Regime (SIMR)** for non-Solvency II insurers with assets below **£25mn**, for which the scope of the SIMR would be streamlined. It also *consulted* on proposals for non-Solvency II insurers with assets of more than **£25mn**, including in relation to its scope the approach to non-executive Directors, the individuals who will be key function holders, and the application of Conduct Standards. The FCA also *consulted* on proposed changes to the SIMR for such insurers, and set out amendments for firms below and above the **£25mn** assets threshold.

The PRA and FCA published final **SIMR** rules for individuals working in insurers subject to Solvency II. They made some amendments to the proposals, including the extension of scope of key function holders to include investment managers and traders within insurers. The PRA also now requires all persons performing a key function "to observe the relevant Conduct Standards".

The PRA and FCA censured Co-op Bank for "serious and wide-ranging failings" in its **control and risk management** framework, and for failing to deal openly with regulators in 2012/13. Co-op Bank was found not to have appropriately considered, and been unable to manage, the level of risk it assumed in some of its business. Management information was deficient, and the Board not informed of key issues, while the bank's culture inappropriately prioritised the short-term financial position of the firm. The regulators did not impose a fine (which otherwise would have been around **£120mn** without a settlement discount) as the bank is currently engaged in a "turnaround plan" to meet its capital requirements.

The Group of Thirty (G30) *reported* that some of the world's largest banks are failing to implement necessary **cultural and conduct reforms** in their businesses. Reforms should address remuneration, and hiring and dismissal processes. Boards should play a greater role in ensuring cultural and conduct changes. The report recommended significant sanctions on remuneration in cases of wrong-doing, improved protection of whistle-blowers, and greater attention to values, culture and conduct in recruitment processes and staff training.

The Financial Stability Board (FSB) *published* a summary of its workshop on **compensation practices** in the insurance sector, which it co-hosted with the International Association of Insurance Supervisors in May. Issues discussed included the relationship between compensation and risk taking and culture, and governance surrounding compensation. While insurance participants said the FSB's Principles and Standards for Sound Compensation Practices were geared towards the banking sector, they acknowledged that risk-aligned compensation was an important feature in the insurance sector.

The FCA *published* details of its upcoming thematic review on remuneration and incentives in **consumer credit firms**, as well as firms where consumer credit is secondary to their main business. The review will focus on the risks that can arise from firms' reward arrangements, and how those risks are controlled and mitigated, and will analyse examples of good and poor practices. The findings will be published by Q2 2016.

Following an earlier consultation on Part 3 of the PRA Rulebook, the PRA *expanded* its supervisory statement on **internal governance** to include a section on its high-level expectations of the typical responsibilities and activities undertaken by chief risk officers (CROs) and risk committees.

The PRA *consulted* on a draft supervisory statement setting out its expectations of firms and its general approach to a range of EIOPA Guidelines, including the second set of **Solvency II** ITS and Guidelines, those on the system of **governance**, and those on the own risk and solvency assessment (**ORSA**).

The PRA *published* a supervisory statement on **aggregation of holdings** for the purpose of prudential regulation of controllers of firms.

Conduct of Business (including MiFID)

The CMA published a series of consultative working papers as part of its **investigation into retail banking**. The publications covered *results* of an analysis of actual and perceived behaviour of personal current account (PCA) customers, which found that few assess their overdraft usage correctly; an *update* on the comparisons of prices paid by PCA and business current account holders, which showed significant variation between banks' charges, although these might reflect differences in the quality of services; *evidence* on bank branches, which were in decline but remained important for the acquisition and retention of customers; and *analysis* of financial performance, which showed a small decline in total revenues in UK retail banking between 2011 and 2014, improvements in impairment rates, and higher average revenues for larger banks.

The CMA *published* an Order following its **payday lending market investigation**. The Order prohibits the supply of payday loans unless information is published on an authorised price-comparison website and the customer is provided with a summary of the cost of borrowing. It also introduces an obligation for payday lenders to produce compliance reports and submit them to the CMA.

The CMA *published* the results of its consultation on new guidance on **unfair contract terms**, including updated guidance on what makes terms and notices unfair, the risks for business in using unfair wording, and advice on how to ensure terms and notices are fair and clear.

ICE Benchmark Administration (IBA), which administers and provides LIBOR, *published* a second position paper on the **evolution of ICE LIBOR**, in its drive to "anchor LIBOR to the greatest extent possible in transactions". It proposed to expand the eligible counterparty types to include large wholesale counterparties, and to expand the range of eligible transactions, among other changes. The reforms are expected to be finalised by December 2015 and implemented in 2016.

HM Treasury (HMT) *published* the terms of reference for the **Financial Advice Market Review**, which will examine how to improve access to financial advice for consumers, and the quality of advice available. The interplay between the regulatory framework for advice and the role of the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS) in providing redress is also in scope. The review, led by HMT and FCA, will result in principles to govern the operation of financial advice, among other reforms.

The European Securities and Markets Authority (ESMA) *issued* a final report under the **Central Securities Depositories Regulation (CSDR)**, which details its technical advice on the level of penalties a central securities depository (CSD) would normally charge for settlement failures and the criteria under which a CSD is to be regarded as having "substantial importance" in a host Member State.

ESMA *compiled* its opinions and those of its predecessor (the Committee of European Securities Regulators) on waivers from **pre-trade transparency** under MiFID, with the intention of ensuring that national authorities' supervisory activities are converging with ESMA's views, and to provide clarity to firms.

ESMA *consulted* on MiFID II standards regarding **trading suspensions, data service providers and derivatives reporting**. This covered issues such as the suspension and removal of financial instruments from trading on a trading venue, the notification and provision of information for data reporting services providers, and the weekly aggregated position reports for commodity derivatives, emission allowances and derivatives thereof. ESMA will send the standards to the European Commission for endorsement by 3 January 2016.

The Upper Tribunal *upheld* a decision by the FCA to fine and ban two directors of Catalyst Investment Group Ltd, a UK distributor of bonds, for **misleading investors**. Mr Roberts' £450,000 fine was confirmed alongside a ban from performing any role in regulated financial services, while Mr Wilkins was fined £50,000 and prohibited from performing any significant influence function in regulated financial services.

The FCA *launched* a thematic review into how lenders treat customers in **early arrears on unsecured lending**, and the customer outcomes which result. The FCA's work will include a review of firms' policies and procedures, using file reviews to test customer outcomes, and visits to firms to interview and observe staff. The FCA said it intended to publish a report at the end of the review setting out its findings and expectations of firms.

The FOS *published* complaints data for the six months to 30 June, during which time it took on 8% more cases than in H2 2014. Complaints about Payment Protection Insurance (PPI) made up half the total, while those for other issues rose by 45%, as a result of an increase in complaints about packaged bank accounts.

The FCA *informed* holders of certain **card security products** that they can start claiming compensation. The redress scheme is open until 18 March 2016 and covers sales and renewals since 14 January 2005. The first compensation payments will be made in late September 2015.

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

The EBA *issued* technical advice to the European Commission under the BRRD (the Bank Recovery and Resolution Directive) on what arrangements should be protected in a **partial property transfer in resolution**. The EBA opted to develop rules and definitions for the identification of protected arrangements, rather than setting out a list of specific arrangements.

The PRA *published* a policy statement and final rules on **depositor and dormant account protection**. The rules follow a consultation on the change in the level of protection from £85,000 to £75,000 after 31 December 2015. It also *updated* an earlier supervisory statement to include expectations on deposit-takers in areas such as eligibility and disclosure with respect to depositors with aggregate deposits over £75,000.

Regulatory perimeter

The European Commission *adopted* a Delegated Regulation to impose **mandatory central clearing** for certain over-the-counter (OTC) interest rate derivatives. The Regulation is the first to implement the clearing obligation under EMIR, and applies to fixed-to-float interest rate swaps, float-to-float swaps (basis swaps), forward rate agreements and overnight index swaps. The clearing obligations will be subject to scrutiny by the European Parliament and Council of the EU, and will be phased in over three years.

ESMA *published* four reports to assist the European Commission's **EMIR review**. The first three relate to non-financial counterparties, limiting pro-cyclicality, and segregation and portability. The fourth report provides input to the Commission's consultation on the review. ESMA made a series of recommendations, including simplifying the process for determining whether a non-financial counterparty is above the clearing threshold, introducing a mechanism to suspend temporarily the clearing obligation, removing the frontloading requirement, and amending the procedure for making third country equivalence determinations.

The International Organisation of Securities Commissions (IOSCO) *supported* greater post-trade transparency in the **credit default swaps** (CDS) market. It encouraged member jurisdictions to follow the example of the US, Canada and EU member states, and put in place legislative or regulatory measures to increase transparency, such as requirements to make publicly available the price and volume of CDS transactions.

The PSR *published* final guidance on its *powers and procedures under the Competition Act* explaining how it intends to exercise its **enforcement powers** in respect of anti-competitive agreements and conduct in relation to participation in payment systems. It also *published* final guidance on **market reviews, market investigation references and market studies** describing its powers and how it will carry out this work, and its approach to disclosure and use of information.

The PSR *published* a consultation paper which set out its decision to **allocate PSR fees** equally between relevant payment systems. It also set out proposals for **calculating and collecting fees from participants** in each regulated payment system. The PSR's preferred approach is 'indirect billing' – direct members of regulated payment systems will be liable for PSR fees, which will be collected on its behalf by payment system operators – to minimise the regulatory burden on industry.

The PSR *announced* it will survey **payment service providers** that access payment systems indirectly to understand their experiences and concerns. The results will serve as an input to its market reviews on the supply of indirect access and on the ownership and competitiveness of infrastructure provision. It also *welcomed* an **industry code of conduct for indirect access to payment systems**, which complements the PSR's work in this area and its directions to increase transparency and accountability.

ESMA *consulted* on a review of its Regulatory Technical Standard (RTS) under EMIR which deals with the liquidation period applied for calculating **margin on client accounts at central counterparties (CCPs)**. EMIR requires a minimum liquidation period for instruments other than OTC derivatives of two days for EU CCPs, while the US requires one day. ESMA is seeking input to aid a decision as to whether the EU framework should be aligned with that of the US.

The Committee on Payments and Market Infrastructure (CPMI) and IOSCO *consulted* on the harmonisation of the unique transaction identifier (UTI) for **OTC derivatives transactions**. The report looked at which transactions should be assigned a UTI, which entity is responsible for generating them, the structure and format of a UTI, and steps that would help ensure UTIs are distinct from those generated under existing regimes.

The CPMI and IOSCO *issued* a note on how their Principles for Financial Market Infrastructures (PFMIs) apply to **FMI's owned and operated by central banks**.

The European System of Central Banks *reported* on the need for measures to facilitate the access of CCPs to **central bank liquidity facilities**. It concluded that the introduction of any measure would have to respect the independence of central banks to perform their statutory duties. Furthermore, the report said that introducing requirements regarding CCP access to central bank facilities would not address potential weaknesses, and creating an automatic right to central bank liquidity could create moral hazard on "an extraordinary scale".

The European Commission *published* the final text of a Delegated Regulation supplementing the **Financial Conglomerates Directive (FCD)** related to definitions and the coordination of supplementary supervision of risk concentration and intra-group transactions. The rules clarify when risk concentrations should be considered to be "significant", provide a set of measures (such as reporting requirements) for significant intra-group transactions, and set out additional measures that should be available to supervisors.

ESMA *consulted* on draft RTS for the **European Long-Term Investment Fund (ELTIF) Regulation**. It sought views on the circumstances in which derivatives solely serve hedging purposes, the length of time sufficient for a fund to be considered an ELTIF, and rules for the valuation of assets upon disposal, among other issues.

ESMA *published* an official opinion agreeing to renew, for a period of 28 days, an **emergency short selling prohibition** originally imposed by the Hellenic Capital Market Commission. The renewal of the emergency measure applies to any natural or legal person, regardless of their country of residence.

Rethinking the domestic and international architecture for regulation

Mark Carney, Bank of England Governor, *confirmed* how the **Financial Policy Committee (FPC)** will implement recommendations from the Chancellor of the Exchequer in relation to the FPC's remit and functioning. The FPC generally supported the proposals, although it highlighted the potential for actions taken to increase the resilience of the financial sector to have a short-term negative effect on growth. The letter also confirmed that the FPC will conclude the design and calibration phase of its work on the UK capital framework by the end of the year, reviewing the overall calibration, establishing the criteria and methodology for the systemic risk buffer, and clarifying the medium-term stress-testing framework.

The FCA *published* data on the number of skilled person reports commissioned in the quarter to August 2015. Of the 14 reviews commissioned, five covered conduct of business and four covered governance, controls and risk management frameworks, while three dealt with financial crime, and two with client assets.

The FCA and PRA launched their **new and separate handbook websites**. Both websites included timelines enabling a view of how rules have changed, as well as search functions with improved filters, and a glossary.

The FCA *published* a webpage setting out next steps for **Project Innovate**. These included a planned consultation in Q4 2015 on new guidance on how firms can outsource data to the cloud while remaining compliant with regulatory requirements. The FCA will also publish a paper on a feasibility study of regulatory "sandboxes": safe spaces for both authorised and unauthorised firms to experiment with products, services, business models and delivery mechanisms without immediately facing the "normal regulatory consequences".

The FCA *published* quarterly performance data for authorisations; variations of permission, payment services and e-money; and waivers. The average processing time for retail firm authorisation applications increased due to the complexity of cases being received, while total applications increased significantly year on year. Authorisation applications received from payments and e-money institutions also increased significantly. The average processing time for a variety of applications was now expected to rise.

Disclosure, valuation and accounting

The PRA *consulted* on **Solvency II** reporting and public disclosure options provided for supervisory authorities. It set out its expectations of how firms should comply in relation to reporting currency, exchange rates, reporting of external credit ratings, as well as for annuities stemming from non-life obligations.

The PRA *published* a supervisory statement on the consistency of UK generally accepted accounting principles (GAAP) with **Solvency II**, with no policy changes from proposals contained in an earlier consultation. Firms will be allowed the option of recognising and valuing assets and liabilities under UK GAAP if the valuation method is "proportionate to the nature, scale and complexity inherent in the business of the undertaking" and the firm can demonstrate that using international accounting standards (IFRS) would impose disproportionate costs.

EIOPA *announced* the publication of draft ITS on **Solvency II** templates for the submission of information to the supervisory authorities and technical annexes; and draft ITS on procedures, formats and templates for the solvency and financial condition report and technical annexes.

Information security and data privacy

The Information Commissioner's Office (ICO) *fined* the Money Shop **£180,000 for data protection** failures after the firm lost two computer servers containing details of several thousand customers, including bank account and payment card information. One server was stolen from a branch, and another was lost by a courier firm.

The PRA *published* a questionnaire and cover letter on **cyber resilience** capabilities which it sent to insurers. This is intended to provide the PRA with an overview of firms' cyber risk policies and capabilities, and on how far firms are underwriting cyber insurance business. The document also included additional questions drafted by the FCA to ascertain what confidential customer information firms receive and how this is handled and stored.

Financial crime

Tom Hayes, a former derivatives trader, *was sentenced* to 14 years imprisonment for conspiring to **manipulate Yen LIBOR**, following a two and a half year criminal investigation by the Serious Fraud Office. He is the first individual to stand trial in the UK for LIBOR manipulation.

The High Court *ordered* that the FCA was entitled to permanent injunctions and penalties totalling £7,570,000 against Da Vinci Invest Ltd, Mineworld Ltd and three individuals for committing **market abuse** using a trading strategy known as "layering". The defendants were found guilty of manipulating the prices of 186 UK-listed shares using such techniques.

Other

The Money Advice Service (MAS) *published* its annual report and accounts for the year ended 31 March 2015. The report set out its performance against plan and the key performance indicators agreed with the FCA.

The FSCS *published* its annual report and accounts for the year ended 31 March 2015. It detailed its performance and achievements including raising awareness of the scheme, modernising its services, and the total number of compensation payments made.

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