Financial Services

UK Financial Services Regulatory Focus

Providing up-to-date and authoritative insights into UK financial services regulation*

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Autumn 2008

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PricewaterhouseCoopers[1] Financial Services Regulatory Practice comprises over 125 partners, directors, managers and staff dedicated to providing proactive regulatory advice to authorised firms and other financial institutions within the UK, Europe and worldwide. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff from an assurance/client-facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework.

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The financial services regulatory scene is changing almost daily as I write this editorial: the Financial Services Authority (FSA) itself is to be subject to a review of banking supervision by its new Chairman, Adair Turner,[2] while the Conservative Party has commissioned a study of the tripartite arrangements covering the FSA, the Bank of England and the Treasury from Sir James Sassoon, former Head of Financial Services at the Treasury.[3] The increased use of fair value under financial reporting standards is being criticised by many politicians and a few regulators as the source of many of the problems of the sector. Regulated firms will need to stay close to developments.

The inescapable change for the FSA is towards greater focus on maintaining confidence in the financial system and in the major financial institutions. At the same time its new chairman will have to maintain confidence in the FSA itself: confidence in its ability to challenge the management of firms which take excessive risks or have inadequate checks and balances, confidence that its supervisors understand the businesses that they supervise, and confidence that they will anticipate systemic problems before such problems cause further damage to the reputation of the financial sector in the United Kingdom. Of course the Treasury is increasingly realising the political imperative of maintaining a buoyant banking sector to fund growth in the economy once confidence returns, and of maintaining consumer confidence in that sector as a secure home for savings. That does not mean that it will rescue banks at any cost, as the complex funding arrangements for the transfer of the Business of Bradford & Bingley to Abbey National have shown. The cost of maintaining confidence in the sector, or rescuing troubled firms, will inevitably be borne by those firms which were more prudent or perhaps more fortunate in their risk taking.

This cost will not only be seen in such matters as the sharing of the funding cost for the rescue loan to Bradford & Bingley among remaining credit institutions. The new Special Resolution Regime to enable future bank failures to be dealt with speedily, for which legislation has been introduced as the Banking Bill 2007-8 to Parliament during October, will require work by banks to ensure that their data on customers and their deposits is available for transfer. It may require further work on customers with multiple accounts and netting arrangements. But there will be a cost in tighter liquidity requirements, (of which we expect to see details in a consultative paper from FSA by the end of December), tougher capital requirements, and potentially more intrusive supervision. Tougher capital requirements have already been announced by the European Commission on 1 October in its proposed revisions to the Capital Requirements Directive (CRD),[4] including a penal 5% capital requirement on securitisations, and there are proposals from Basel for a new 'Incremental Risk Charge' on trading books[5] which will undoubtedly be replicated in the CRD. To these will be added tougher buffer requirements over basic capital requirements through the Basel II Pillar 2 process, which allows supervisors to impose extra capital requirements by way of 'Individual Capital Guidance'. And there are already indications from the FSA in a Dear CEO letter in October that there will be a focus on executive reward structures and incentives: those that encourage inappropriate risk taking will lead to sanctions, certainly in increased capital requirements. There is no such thing as a free lunch, as banks and other financial sector firms have come to know well.

The other victims in terms of tougher regulatory scrutiny will be the credit rating agencies, as the FSA has made clear in its latest International Regulatory Outlook.[6] The European Commission itself is leading the attack on such agencies, criticising them for poor management of conflicts of interest, lack of transparency about their ratings process, lack of regular monitoring of all their ratings, lack of due diligence on underlying collateral in structured securities, and allowing confusion by investors as to the reliance that can be placed on their ratings. They may escape direct regulation, which is wanted by few supervisors and certainly not by the Committee of European Securities Regulators, but will see rigorous enforcement of the Code of Conduct that has been proposed for them by the International Organization of Securities Commissions (IOSCO).

Does all this mean that the FSA's eyes will be off the ball as regards all the other matters on its agenda: the deadline for embedding of Treating Customers Fairly, Financial Crime, Market Abuse, the Payment Services Directive, and the implementation of Solvency II for the insurance sector? Almost certainly not, though priorities for individual line supervisors may be temporarily refocused. We have articles in this edition on the vexed issue of fair value definition and the role of the various regulatory committees in Europe, in our European update[7] and on continuing issues for firms such as identifying and preventing Market Abuse, Solvency II, the Payment Services Directive and Treating Customers Fairly, as well as two useful articles on preparing for an ARROW visit in these market conditions, and the application of UCITS IV. These are not easy times to be in financial services.

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[1] PricewaterhouseCoopers refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

[2] Alistair Darling's speech to the Labour Party Conference, September 2008.

[3] Conservative Party Plan for Change 2008, September 2008, page 6.

[4] http://ec.europa.eu/internal_ market/bank/regcapital/index_en.htm

[5] Basel Committee on Banking Supervision, Guidelines for Computing Capital for Incremental Risk in the Trading Book, July 2008.

[6] FSA, International Regulatory Outlook, September 2008, page 14.

[7] FSA, Dear CEO Letter "Remuneration Policies", 13 October 2008.

Committee of European Securities Regulators

The CESR publishes for consultation a statement on fair value measurement and related disclosures of financial instruments in illiquid markets

In July, the Committee of European Securities Regulators (CESR) joined the debate on the use of fair value accounting with the publication of a discussion paper. This sets out the CESR's views in three key areas of the debate:

- Determining whether a market is active or inactive
- The use of valuation techniques
- What are appropriate disclosures

The CESR's intention is to provide assistance to preparers and auditors of financial statements while recognising that the responsibility for setting and interpreting accounting standards lies with the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC). Comments were sought by 12 September and the CESR intends to issue a final version in October.

The first question posed by the paper is its status. The CESR clearly intends it to be guidance in applying International Financial Reporting Standards (IFRS), but which does not extend to new interpretations of what IFRS requires. It would therefore not be mandatory but, as the CESR members have an important role in enforcing compliance with accounting standards by issuers of securities in their jurisdiction, the CESR's views will carry significant weight.

The CESR also acknowledges the work of other bodies in this area and, in particular, endorses the recommendations made by the Financial Stability Forum (FSF) in April. In response to one of these recommendations, the IASB has tasked its Expert Advisory Panel with formulating its own guidance, which is also due to be published in October. There is clearly a risk that the CESR guidance will be superseded by the IASB's forthcoming paper and it may well be that the CESR will wait to see the IASB paper before deciding whether to proceed with its own.

In the first part of the paper, the CESR concludes uncontroversially that deciding whether a market is inactive is a matter of judgement and stresses that preparers should have a well-documented valuation policy. The paper then looks at aspects of the required judgement, such as transaction volumes, types of pricing source available and the reliability of those sources. None of this discussion will be a surprise to preparers, although the implication that there is a clear dividing line between active and inactive markets is certainly open to challenge. In practice the evidence is often conflicting.

The paper then moves on to discuss valuation techniques, again stressing the degree of judgement involved and the need for preparers to document the criteria, the assumptions and the inputs to their valuation techniques. There is relatively little discussions of the merits or otherwise of different types of input, although the paper does caution about the use of indices, as these may not be representative of the specific securities in a preparer's portfolio.

The disclosure section of the paper is likely to attract much more attention as the CESR is firmly of the view that the disclosures given in many 2007 annual reports did not go far enough. It is proposing significantly more granular disclosure of assumptions and data used for each class of financial instrument. This goes well beyond the level of detail specified by IFRS 7 and, if implemented, could represent a significant additional disclosure burden. The CESR also believes that these disclosures should form part of the financial statements in contrast to other commentators who have argued for fuller disclosure in the Operating and Financial Review (OFR), outside the financial statements.

The CESR paper has been rather overtaken by the IASB Panel of Experts paper published in September and it is unlikely that CESR will go forward with separate recommendations. Preparers though need to follow the continuing debate carefully as it is clear that there is considerable pressure from regulators for more granular disclosures on financial instruments for 2008 year end financial statements. IASB has also promised an exposure draft on amendments to the financial instrument disclosures standard (IFRS 7) before the end of the year.

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Market abuse: Are you adequately managing your risks?

Why is the Financial Services Authority getting tough on market abuse and insider dealing?

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In June 2008, Margaret Cole, Head of Enforcement at the Financial Services Authority (FSA), stated: 'I should make clear that our aim is to clean up the market, to change behaviour by making best use of all the powers, criminal, civil and administrative that are available to us.' This statement of intent was quickly followed up with direct action when, for the first time in many years, insider dealing hit the front pages of the press as the FSA announced the arrest of a number of individuals using its criminal powers to investigate and prosecute. However, it is not only individuals who should be concerned – in many instances their employers need to take action as well.

Why is the FSA so determined to make the best use of its powers to tackle market abuse, including insider dealing? Because, the perceived extent of abusive behaviours jeopardise two of the FSA's four Statutory Objectives, namely, maintaining market confidence and the reduction of financial crime. A recent FSA survey found that 'Informed Price Movements' preceded 28.3% of all takeover deals in 2007, up from 23.7% in 2005. These stark figures perfectly illustrate why the FSA has taken such a strong stand on the issue.

Can you be certain that you are currently compliant with regulatory requirements?

It is worth reminding ourselves of the behaviours that constitute market abuse under the Financial Services and Markets Act (FSMA) 2000. These are grouped into two categories:

1. Insider dealing (insider dealing, improper disclosure, misuse of information).
2. Manipulating information (manipulating transactions, manipulating devices, dissemination and misleading behaviour and distortion).

Under the market abuse regime, behaviour includes both action and inaction. It is not necessary for intent to be demonstrated, nor does any profit need to have been derived.

The regime also imposes a number of important procedural obligations including:

- Issuers of securities should promptly disclose inside information as soon as possible.
- Senior executive (not just directors) trading notification requirements.
- Insider list requirements for issuers and their advisers.
- Suspicious transaction reporting firms must report reasonable suspicions to the FSA (in addition to any reporting under the Proceeds of Crime Act).

Although it is the high-profile criminal investigations of individuals under the Criminal Justice Act that are currently hitting the headlines, the FSA retains the power to discipline authorised firms and approved persons for failure to have adequate systems and controls in place.

How can you protect your firm?

Our own recent experiences of assisting clients, both in the financial services sector and the boards of listed companies, confirm many of the control weaknesses identified by the FSA.

Many such failings stem from nonexistent or inadequate risk assessments by firms that have then completely misjudged the risk levels they face and designed inappropriate or inadequate controls. Without a formally executed market abuse risks assessment it will be difficult for any firm to convince a regulatory that it has taken the issue seriously. Making an intuitive assessment that your firm has few risks, even if correct, is unlikely to be sufficient to protect against regulatory sanction.

Other common failings we have noted include:

- The underestimation of 'insiders', particularly in low level back-office functions.
- Miscalculating the numbers of staff who require market abuse training (particularly for lower level staff and non-professional staff in listed companies outside the financial services sector).
- The miscalculation of the speed at which price-sensitive information must be disclosed to the market, particularly by boards that infrequently find themselves faced with a price-sensitive announcement.

In 2006, Hector Sants intimated that in cases of market abuse, the FSA would take action against individuals whose behaviour was abusive rather than the institution, so long as the firm in question had good systems and controls in place and could show that it was complying with them. This message was reiterated by Sally Dewar in May 2007 and by the FSA's MarketWatch newsletter in April 2008. The arrests that recently made the headlines demonstrate that this approach still prevails.

In the current economic climate the temptation for individuals to abuse the trust of their employers by misusing confidential data will inevitably increase. No control environment is perfect and there can never be any guarantee that all of your people will comply with policy and the law. However, by ensuring that the expected level of control is not only in place but operating effectively, you can protect your firm from unnecessary regulatory attention and resulting poor press, both of which will require the investment of valuable management time and effort, which is better focused on core business issues.

MiFID – one year on

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Where is MiFID now?

The implementation of Markets in Financial Instruments Directive (MiFID) is now approaching its first anniversary. Following the rush to implement for November 2007, and with firms preoccupied more recently by deteriorating market conditions, many ongoing MiFID challenges may have been somewhat overlooked. However, the issue of how firms have implemented MiFID is coming back onto the Financial Services Authority's (FSA) list of supervisory priorities.

The FSA has been embedding MiFID checks into their risk assessment framework (ARROW – Advanced, Risk Responsive Operating frameWork) process and has been embarking on MiFID specific visits. It is therefore timely to review what the impact has been, and to look at what compliance-related issues, firms are likely to need to review and manage on an ongoing basis.

Markets and best execution

Best execution is likely to be the area of MiFID most often discussed, and with good reason, as the full impact of the changes is still being felt in equity markets. Chi-x has raised its market share to 13% of all deals in FTSE 100 shares, and a variety of Multilateral Trading Facilities (MTFs), including Turquoise, Nasdaq OMX Europe, and Bats Trading, all planned to go live in the autumn.

The increase in potential trading venues, while meeting the European Commission's goal of increasing competition in equity trading, has the potential to cause challenges for both firms and the FSA. The widening of the market created as a result of MiFID has raised industry concerns over the potential fragmentation of data, and the FSA has admitted that it will face a challenge in trying to ensure sufficient oversight of the market in terms of post-trade transparency, given the rapid expansion of competition.

In addition to challenges in post-trade oversight, the increased choice of trading venues places pressure on firm's best execution arrangements. The trading landscape has altered significantly since firms were writing and implementing their best execution policies 12 months ago, and for firms with a responsibility for providing best execution, they should be reviewing their best execution policy to ensure that it continues to provide best execution.

Best execution – the regulatory challenge

In its forthcoming ARROW visits, the FSA has identified best execution as a key area of focus, and firms must be prepared to defend their policies and demonstrate that they are working in practice.

We would expect that responsibility for keeping the best execution policy current and up to date sits firmly with the front office. It is only those that are interacting directly with the markets that can have a clear understanding of how to 'best' execute trades, given the changing landscape. As the number of trading venues grows, firms will need to continually assess which venues provide the best execution on an ongoing basis for their clients.

In order for firms to demonstrate that the best execution policy is being followed, good practice would indicate that there would be a combination of frontline monitoring, compliance desk reviews and internal audit testing on an ongoing and regular basis.

Demonstrating that the best execution policy is actually providing best execution the majority of the time to the majority of clients potentially poses a more complex challenge. Best execution consideration includes not only price, but total consideration, speed and likelihood of execution and settlement, which makes any consistent measurement of best execution difficult (even if the FSA has, in its guidance, stated that total consideration should be the main factor considered for retail clients). This challenge will only continue to grow more difficult as the number of trading venues grows. Even the FSA has admitted that there is no longer a cost-effective way for brokers to guarantee best execution.

If, upon review, it is determined that best execution is not being provided by the venues dictated in the policy, then this will need to be reflected in an updated policy that should be communicated to clients. While it may not be cost-effective to have direct access to the entire market – and there is certainly no expectation that a broker would – the rapidly expanding number of exchange venues means firms need to frequently review their policy, including the venues specified.

Client categorisation

With many firms having undertaken a large repapering exercise last autumn, client categorisation has in most firms been embedded as part of 'business as usual'. There are, however, still some pitfalls that firms should remain wary of, especially as the FSA has stated that it is specifically interested in how firms have classified their clients.

In the rules, it states that it is the responsibility of the client to notify a firm of any changes that could affect their classification. However, if a firm does become aware that a client no longer fulfils the initial conditions that made it eligible for its categorisation in the first place, the firm must take the appropriate action. It is therefore imperative that if front-office staff become aware of changes to a client's standing, that an appropriate review of the client's categorisation takes place. For example, in the current economic environment, trading conditions are having a pronounced impact on certain sectors, and firms may feel it appropriate to consider whether their clients in these sectors have fallen below the relevant thresholds.

In addition, a pitfall that many firms have made is the mis-classification of potential Eligible Counterparties (ECP), established in other European Economic Area (EEA) States. Firms must remember – and take into account that for dealing with entities located in different EEA States – they must defer to the status of the entity in the EEA State in which it is established.

Conflicts of interest

Firms must now have a comprehensive conflicts of interest policy in place, and keep a log of conflicts across the entire business. Our experience when working with firms for MiFID preparation was that

the development of a conflicts policy and conflicts log was not always completed with the rigour used in developing other MiFID policies, and was in many cases placed in the 'too difficult' box. While many firms had planned to work further on conflicts of interest after the November 2007 deadline, other priorities have since taken the focus off of this task.

With the FSA continuing to focus on good governance and the responsibilities of senior management, it is essential that firms that have not yet completed a comprehensive conflict mapping exercise, do so. With consolidation taking place across the financial services' sector, firms that have made acquisitions will, in time, need to focus attention on reviewing what new conflicts exist within their business and develop thorough methods for managing those conflicts.

Conflicts management must now take place, both within a given business, as well as across all business lines. The conflicts policy, the procedures for managing the conflicts and the conflicts log must then be updated as relevant. This should include a focus on ensuring the independence of research and the timing of research publication.

The FSA has stated that specific attention will be paid to the new rules on inducements, which are significantly more stringent than the previous ones. A firm is now prohibited from offering or accepting any non-monetary benefit, and firms should ensure that these rules are being adhered to.

Suitability and appropriateness

MiFID requires firms to ensure and document the suitability of advice that it offers to clients, and the appropriateness of any execution-only transactions. The implementation of the new requirements proved a challenge for many firms in the run-up to MiFID, and many firms developed a manual work-around to implement suitability and appropriateness in the short term. As a focus for the FSA in both MiFID implementation and as part of treating customers fairly (TCF), firms, especially those dealing with professional and retail clients, need to be confident that they are indeed providing suitable or appropriate products and that they have documented and can demonstrate how they have reached the relevant conclusions.

Once an appropriate method of analysing and documenting suitability and/or appropriateness testing has been put in place, the ongoing challenge becomes primarily one of monitoring. For those firms that opted to implement a manual process, monitoring processes should be adapted to include testing to ensure that the manual procedure is appropriate and being followed consistently by all relevant staff. Alternatively, for the firms that chose to use an IT system to support the fulfilling of these obligations, it is not simply enough to ensure that staff are following procedures and using the IT system; testing should be performed to determine that the system developed consistently allows staff to correctly determine suitability and appropriateness.

Outsourcing

The primary aim of the MiFID rules on outsourcing is to ensure that in using outsourcing arrangements, a firm does not take on undue additional operational risk, and does not impair its ability to meet its regulatory obligations, in particular from a TCF perspective. Senior management cannot delegate their responsibilities and, as such, it is vital that a firm maintains sufficient oversight of any party performing functions on its behalf. The Senior Management Arrangements, Systems and Controls (SYSC) rules apply to intra-group outsourcing (sometime referred to as 'insourcing') as well as the use of third parties.

Given the extent of the regulatory changes that took place in November, and the substantial changes in policies and procedures a number of firms found themselves having to make, there is a danger that the new outsourcing requirements were not focused on, sufficiently, at the time of MiFID implementation, and the FSA now has outsourcing on its list of priorities. Firms should focus on ensuring that appropriate legal agreements and service-level agreements are in place with all third-party and intra-group outsourcers, and that the SYSC requirements on due diligence and ongoing oversight are met.

In summary

With almost a year of operating within a MiFID environment, it is important that firms take a step back and think about how the changing environment that they are operating in impacts on the work done in the run-up to MiFID implementation. The FSA is unlikely to accept current market volatility as an excuse for not adhering to the principles or rules embedded in the rulebook by MiFID, especially where not following the rules puts clients at a disadvantage. It is therefore important that firms create the time to ensure that they are confident that the changes implemented as part of the MiFID process are both embedded and up to date.

Gaining the payback from Solvency II

How can insurers deliver the competitive payback from the changes and investment required to comply with Solvency II?

Solvency II has often been seen as primarily a technical exercise. However, many insurers are now coming to recognise its far-reaching competitive potential. This includes more efficient use of capital, a more informed basis for decision-making and an improved ability to convey the strength of the enterprise to analysts, investors, counterparties and rating agencies.

The Solvency II 'use test' will provide the regulatory impetus to bring risk-based capital evaluation and related enterprise risk management (ERM) into the forefront of the strategy, operations and communications of the business. This should help firms to strike a more sustainable balance between risk and reward, and provide greater assurance for the board and external stakeholders that risks are being actively controlled ('no surprises'). These requirements could in turn provide an incentive for organisations to upgrade their systems and an opportunity to bring actuarial modelling out of its 'black box'.

Making it work

The key foundation of improved decision-making and more efficient use of capital is reliable valuation. The parallels between Solvency II and IFRS Phase II should enable companies to realise cost-saving synergies in data, modelling and information systems. This would improve the consistency of both internal and external reporting, while avoiding the needless cost and disruption of 'digging up the road twice'. However, companies need to anticipate and explain what may be very different reported numbers to analysts and investors.

Equally, boards, management and business teams need to understand what for many may be complex and unfamiliar risk and capital analysis. Where necessary, they need to be able to challenge the assumptions and drivers underlying the risk and operational assessments to a great extent than today. Failure to do so could not only make it harder to meet the use test, but also limit the commercial value of investment in enhanced information systems.

Bringing risk considerations to the forefront of business decision-making will require close interaction between functions that may have different objectives, performance measures and ways of working.

This will require a shift in the culture and mindset of the business with implications for strategic planning, management skills, incentives and organisational behaviour. Running what could be a much more elaborate infrastructure of risk, governance and capital management under Solvency II will lead to heightened competition for qualified personnel, leading to further pressure on the availability of already scarce talent as the deadline for implementation in 2012 draws closer.

The proposed streamlining of group supervision under Solvency II could have an important impact on the way companies operate and structure their businesses. Although the details of how this is likely to work in practice are still subject to debate, a number of significant proposals have merged in recent months.

Making Solvency II work for the business is the subject of a newly published PricewaterhouseCoopers study.[1]

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[1] Free copies of 'Gearing up for Solvency II: Making Solvency II work for the business' are available for download or order by visiting www.pwc.com/solvencyII .

The Payment Services Directive

Harmonising the fragmented nature of national payment infrastructures and their supporting laws and regulation across the European Union (EU) is at the heart of the Payment Services Directive. A financial services industry which has been preoccupied by Basel II, Markets in Financial Instruments Directive (MiFID), Solvency II, Single Euro Payments Area (SEPA), Faster Payments and other initiatives has no pause for reflection with another EU programme of implementation looming on the horizon.

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Introduction

The Payment Services Directive 2007/64/EC (PSD) was proposed by the European Commission in December 2005 and on 5 December 2007 the PSD was published in the European Union Official Journal. Member States have until 1 November 2009 to implement this Directive fully into national law. The commercial, legal and political objectives of the PSD will remove barriers to trade, enhance competition between national payment markets, increase market transparency and standardise the rights and obligations of payment service providers and payment services users alike.

Aims

The PSD aims to establish a modern and comprehensive set of rules applicable to all payment services in the EU and provides for:

- Transparency of information and charges.
- Certainty of transaction execution.
- Clarity on rights and liabilities of payment service providers and users.
- Consumer protection.
- The opening up of national payment transactions' markets to competition from non-bank payment institutions.

Objectives

The core objectives of the PSD are to enhance competition, efficiency and innovation in the European payments market. Once implemented in national law, the PSD should:

- Harmonise payment infrastructures within Europe, rendering cross-border electronic payments, including credit transfers, standing orders, direct debit and card payments, as simple and secure as domestic payments within a Member State.
- Provide a legal framework for the Single Euro Payments Area (SEPA), an integrated payment services market for transactions in euros across the European Economic Area (EEA) and Switzerland.
- Increase competition by introducing a new EU-wide licensing regime to allow non-bank payment service providers to operate across borders.

- Protect customers by extending current conduct-of-business obligations to cover purely domestic (including non-euro) payments and expanding the scope of consumer protection into new areas.
- Promote transparency to enable better-informed consumers to compare prices for payment transactions more easily.

Scope

The scope of the PSD encompasses a wide range of EU payment products and services across the six categories of payment service provider identified in the Directive namely:

(i) Credit institutions.

(ii) E-money institutions.

(iii) Post office giro institutions, which are entitled under national law to provide payment services.

(iv) Payment institutions, which includes, for example, money transfer operators, bill payment service providers and mobile phone operators.

(v) The European Central Bank and national central banks, when not acting in their capacity as monetary authority or other public authorities.

(vi) Member States or their regional or local authorities, when not acting in their capacity as public authorities.

How the Directive will work

The Directive has three main components:

1. Payment Service Providers (Title II)

Title II contains the rules that create a new licensable and passportable activity for payment institutions and will require providers of payment services to abide by bank-like regulatory rules covering such areas as regulatory capital, governance, systems and controls, restrictions on outsourcing and requirements for statutory audit. Payment service providers (PSPs) are identified as banks, e-money and payment institutions, and the registration regime is intended to work in a similar way to the existing authorisation and passporting regimes for banks and investment firms. The new EU-wide licensing regime will allow non-bank PSPs to operate across borders, thus achieving the PSD's objective of opening up markets to competition and improved consumer protection.

2. Transparency of conditions and information requirements (Title III)

Title III introduces a number of information requirements for payment services. Some of these are general pre-contract information requirements requiring the PSP to communicate to payment service users, before they become bound by any contract, certain specific terms and conditions, under which the service will be

From opening up national payment transactions markets to increased competition from new entrants, and the harmonisation of COB rules, the commercial, legal and political objectives of the PSD will harmonise the regulatory regime across the EU for payment services.

provided. Other requirements refer to post-contract information, required to be given to the payer and the payee, respectively, when the order for payment is accepted by the PSP and once the funds have been made available to the payee. The standardisation and harmonisation of the conduct of business (COB) rules should facilitate the protection of customers, and provide consumers with fair and open access to the payments market.

3. Rights and obligations in relation to the provision and use of payment services (Title IV)

Title IV sets out the core rights and obligations of users and providers of payment services to promote clarity and certainty in the use of electronic payments. The Directive introduces strict rules on the speed of execution of payment transactions, including a maximum execution deadline of D+1 (the business day after the date on which the payment instructions were received by the payment service provider) by which PSPs must execute electronic payment transaction. In addition, the Directive eliminates the use of value-dating, thus ensuring consumers can use monies credited to their account immediately. Title IV also introduces a right of refund for the payment service user, identifies the rights and liabilities of each party in the case of unauthorised transactions, with the onus being on the product service provider to prove that the transaction was authenticated properly, out-of-court complaint and redress procedures for the settlement of disputes, and operational requirements relating to the authorisation of payment transactions to assist in the prevention, investigation and detection of payment fraud.

Key challenges for implementation

1) Timing

Implementation of the PSD is not optional and needs to be reflected in national legislation by 1 November 2009. This deadline brings with it a number of challenges and decisions for PSPs, concerning the consumer to PSP relationship.

2) Applying the scope correctly

Identification of the providers, services and products falling within the scope of the PSD will be the first challenge. While it is clear that a bank’s current account falls within the remit of the Directive, other accounts from which you can make occasional payments or those accounts whose dominant purpose is not making payments, but which allow disbursements or cash withdrawals, may also be in scope. In addition, customers of securities and investment firms typically hold cash accounts that could be characterised as ‘payment accounts’ under the PSD.

UK timeline for implementation

Date	
Dec 2007	HM Treasury consultation document published
Mar 2008	Consultation period closed
Summer 2008	HM Treasury consultation on the draft regulations that will implement the PSD
Summer 2008	FSA consultation on:
	– Changes to Dispute Resolution (DISP) section of the FSA Handbook
	– Changes to the jurisdiction of the Financial Ombudsman Service (FOS) so that it can perform the out-of-court redress function
	– Changes to the Decision Procedure and Penalties Manual (DEPP) and the Enforcement Guide (EG) to explain the FSA's approach to enforcement of the PSD implementation legislation
Oct 2008	FSA consultation on their approach to PSD fees
End of 2008	Final legislation will be laid before Parliament
Early 2009	FSA to publish an 'Approach Document' outlining their approach to matters such as authorisation and supervision under the PSD
1st Nov 2009	PSD implementation legislation will come into force

3) Repapering and planning for transition

EU directives very rarely contain 'grandfathering' provisions and the PSD is no exception. Relevant retail clients will have to be repapered with PSD-compliant terms and conditions before the 1st November 2009 deadline and, if the transparency and COB rules are extended to include micro-enterprises as indicated in the recent HM Treasury consultation, business customers falling under the definition of micro-enterprises will need to be identified and repapered accordingly.

4) Regulatory overlap and overload

The PSD overlaps with areas covered by other European directives, making compliance risk management a more difficult task. Firms will need to revisit credit and operational management processes along with regulatory capital and liquidity models to consider the impact of, for example:

(i) The various time limits imposed by the PSD.

(ii) The inter-bank right of recourse.

(iii) Potential cross-border refund exposure to other banks with lower credit ratings.

(iv) Foreign exchange risk.

(v) Liability in respect of refunds.

(vi) Cash flows for profit extraction purposes.

The introduction of a maximum execution deadline will impact and extend to all parts of the supply chain, placing significant operational burdens on firms falling within the scope of the PSD. Existing payment infrastructures (including legacy systems) will need to be geared to execute payments efficiently, quickly and safely in accordance with the rules; service agreements with third parties will need to be reviewed and updated to reflect the strict timetable for performance and interfaces with non-PSD products that settle under different market conventions and timelines – for example, foreign currency exchange will need to be considered.

Financial institutions will be required to examine their payment service offerings in light of the PSD and consider the strategic, risk and documentation implications it contains.

From opening up national payment transactions markets to increased competition from new entrants, and the harmonisation of COB rules, the commercial, legal and political objectives of the PSD will harmonise the regulatory regime across the EU for payment services.

The challenge in implementation will be to ensure a level playing field, which establishes fair, clear and open access for consumers and providers.

Preparing for ARROW

While not all financial services firms will have experienced it first-hand, most will be aware of the Financial Service Authority's (FSA) ARROW process. They may or may not know that it stands for 'Advanced Risk Responsive Operating frameWork', but they will certainly know that it is fundamental to the FSA's risk-based supervisory approach. Where an ARROW is conducted, it is the single most important determinant of the FSA's view of a firm's overall level of risk. Indeed, following recent criticisms and the recent internal review of its supervisory approach, the FSA has been increasing the robustness of ARROW visits as part of its Supervisory Enhancement Programme. For those firms that are due a visit, they should be prepared for a regulator eager to prove that its risk assessment approach works.

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Two things have changed since the FSA first launched ARROW. First, the process itself has been enhanced to create ARROW II. The new model is intended to improve communication with firms, adopt a more thematic approach towards risk assessment and improve the skills and effectiveness of its own staff. Secondly, the universe of firms likely to experience ARROW first-hand has been expanded by the implementation of Basel II. Whereas ARROW had been reserved for larger firms in the past, Pillar 2 of Basel II requires the FSA to conduct the Supervisory Review and Evaluation Process (SREP), whereby senior managers at firms are challenged face to face on the contents of their Internal Capital Adequacy Assessment Process (ICAAP) documents that were submitted at the end of last year. The FSA is using ARROW to do this.

For small firms that might not have warranted an ARROW review in the past but are now subject to Basel II, the FSA is using ARROW Light – a shortened, but in some ways just as intense, process. In all ARROW reviews, the success or otherwise of the visit will determine, in the FSA's own words, 'the overall intensity of our regulatory approach'. While a 'good' ARROW review will by no means guarantee that the regulatory burden for a business is reduced, a 'bad' experience will very likely result in a more onerous one.

The other common factor for all ARROW reviews is the significance that the FSA places on the performance of senior managers during the visits, particularly in the face-to-face interviews. The degree to which senior executives engage with the FSA can have a major influence on the conclusions that it reaches. Indeed, recent market events have highlighted failures, at senior management level, to understand and fully manage risks in financial services businesses and the FSA is likely to strengthen its scrutiny of senior managers in its next round of ARROW reviews.

Senior executives are usually more than comfortable talking about the business areas for which they are responsible. However, they tend to have more trouble articulating firm-wide issues and the manner in which they exercise collective responsibility for the totality of a firm's operations. Moreover, senior managers must be aware of the broader range of non-business line specific FSA concerns.

In light of recent events, the FSA's present focus is firmly on governance and control issues. Executives will be expected to talk confidently about the governance structure in their firm, the effectiveness of that structure and the management information and other reporting that underpins that structure. The integration of the Basel II process also means

that executives of Basel firms that sit on the board or governing body of the firm will be expected to be able to talk about the contents of the ICAAP document and, in particular, to justify the assumptions made in that report. Other regulatory themes that are likely to feature, depending on the type of business in which the firm is engaged, include liquidity, the implementation of the Markets in Financial Instruments Directive (MiFID), market abuse and the stress testing that the firm engages in.

Given the significance for firms and the regulatory environment in which they operate, the importance of proper preparation for these visits cannot be stressed enough. Firms must approach the visit as they would any significant project and ensure that all arrangements, from document provision to meeting bookings are managed in as professional a manner as possible. During the preparation phase, firms must ensure that they make themselves at least as familiar with the contents of the document pack that they have provided to the FSA as the supervisors will be, and must ensure that their senior executives are ready for the interviews. Executives must be comfortable talking to regulators in an interview situation, something they may well have had limited experience of in their careers to date. Firms that PricewaterhouseCoopers has worked with to prepare for ARROW visits have reported a real benefit in formalising the preparation ahead of ARROW visits: setting up authentic-feeling mock interviews with external interviewers to get their executives familiar with the format, and comfortable with fielding questions across the range of issues discussed above.

Firms that are properly prepared tell us that ARROW reviews can be a genuinely positive experience for firm and regulator alike. It is the one opportunity that firms have to set the tone for their ongoing engagement with their regulator for the next review period and to demonstrate first-hand the quality of the management, in the broadest sense, at their firm. The prize for firms for a well-executed ARROW review can be an increased review period, a reduced level of scrutiny (with a corresponding reduction in associated regulatory costs) and a better relationship with their regulator.

Treating customers fairly

The Financial Services Authority (FSA) Principle 6 requires a firm to have due regard to the interests of its customers and treat them fairly. This has been a requirement since the FSA became the UK regulator, but their thinking has developed over the years and now, seven years on, the conclusion of the FSA's drive to embed this principle into business-as-usual is imminent. By the end of 2008, firms must be able to demonstrate to themselves and to the FSA that they are consistently treating their customers fairly – or face regulatory sanction.

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By its nature, a move away from detailed rules means less certainty and a very different approach to Compliance. Firms need to think through the risks they pose to consumers and how they can mitigate those risks. Clearly, a provider of mutual funds selling through Independent Financial Advisors (IFAs) will interpret – and monitor and deliver – fairness, differently from a mortgage broker that operates through a call centre. But that, of course, is the whole point of principles-based regulation (PBR). The FSA has provided a wealth of guidance to illustrate the point, but in a PBR environment it can never provide the complete answer: that has to be down to each firm.

Looking forward to Christmas

By now, treating customers fairly (TCF) projects should be looking at closure. There should be a project plan (or at least a list) showing what has been done and when, an analysis of how these actions will ensure that the changes have the desired effect, and internal review and challenge.

In addition, there are some relatively simple things individual board directors (including the non-execs) can do to reassure themselves about TCF:

1. Rate the fairness culture of your business on a scale of one to 10 where 10 is 'a balanced, consumer-focused culture and cannot be improved' and 0 is 'not fit for purpose – we do not consider fairness and seek to maximise profit by any means'.
2. Consider how individual departments would score on the same scale. If you don't know, then ask yourself why not?
3. Think about where the touchpoints are for your business. Obvious high-risk areas for customers will include the sale of complicated products, the use of commission-only sales teams, and the way you consider and process customer complaints, and so on. Now rate those touchpoints on the same scale.
4. Finally, justify why you drew your conclusions. What management information (MI) did you call to mind, if any? Are you happy with the corporate culture? Are there blind spots where the business is hidden from your view?

Clearly, the aim is to score as close to 10 out of 10 as you can. You might run this exercise as a workshop involving the board or the senior management team: the results are often surprising.

Figure 1: The six outcomes

Outcome 1:	Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
Outcome 2:	Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
Outcome 3:	Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
Outcome 4:	Where consumers receive advice, the advice is suitable and takes account of their circumstances.
Outcome 5:	Consumers are provided with products that perform as firms have led them to expect; and the associated service is of an acceptable standard and as they have been led to expect.
Outcome 6:	Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Figure 2: The uses of TCF MI

Seen	The appropriate level of management receives, understands and reviews the MI. The board is the ultimate recipient of the information, but lower levels of management are also expected to see TCF MI.
Challenged	MI should provoke discussion, and anomalous or unexpected results are to be challenged at each level.
Analysed	The right messages and conclusions must be drawn from the data. Where necessary, qualitative commentary is added to provide clarity.
Acted on	Where appropriate, actions are taken to remedy the situation, to investigate further and to follow up on those actions.
Recorded	Records are made of what is done and information is subsequently gathered to enable the success of those actions to be assessed.

To treat customers fairly in the way FSA now expects requires firms to think from a different perspective – that of the customer. This is hard. Is the firm challenging current practices and then changing things where it finds problems? This means asking some searching questions and using the answers to inform the wider understanding of fairness in the business. Evidence should be retained so that the FSA can see the line(s) of enquiry as well as where improvements have been made.

Wood for the trees

Many firms have struggled with MI that supports TCF. It is worth remembering that TCF MI has only one aim: to enable the firm's board to be sure that the firm is meeting the six outcomes (see figure 1). As the FSA has said, that evidence does not have to be in a stand-alone TCF MI pack. It may, in fact, be more effective to give the board a one-pager – provided the underlying data is reliable and does, in fact, cover all the outcomes. In short, if the directors cannot see clearly that the firm is (or is not) achieving these outcomes, then the MI pack is not fit for purpose.

Many firms have approached the MI question by asking, 'What data have we got?' (a bottom-up approach) when the board should have been telling the business, 'This is what we need to know' (top-down). TCF MI packs will fail to deliver if they rely only on a bottom-up approach.

Having finalised their TCF MI, boards need to use it. Figure 2 is drawn from the guidance provided by the FSA and is a simple guide to regulatory expectations in this area. It helps to address what may become an issue as we move into 2009: that of sustainability. If, as we expect, TCF remains on the regulatory agenda for the foreseeable future, then firms must rise to the challenge of keeping TCF front of mind. Supported by an occasional 'refresh' of the gap analysis, this five-point checklist will help to form the structure of a business-as-usual TCF strategy.

Conclusion

Notwithstanding the change of chief executive and chairman over the last 15 months at Canary Wharf, TCF remains the cornerstone of the FSA's consumer protection objective and will become part of the ARROW framework in 2009. As the first significant iteration of PBR, the FSA will want TCF to be seen as a success. FSA expects many firms to fail to deliver to the December deadline and they would see this as a significant regulatory failure by those firms. Ahead of the deadline, therefore, take action to ensure that your TCF approach will be effective.

UCITS IV: Stepping stones to a mature EU funds industry

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Background

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive has been key to the development of the European fund market since the mid-1980s, with funds having grown successfully both within the European Union and beyond its borders. However, a mere 20% of the European funds can be strictly classed as 'true cross-border funds'[1]. Furthermore, the industry is characterised by a certain concentration of activity, with fund management typically performed in financial centres such as London, Paris and Frankfurt, and fund administration in Luxembourg and Ireland. Indeed, Luxembourg and Ireland funds accounted for 89%[3] of the total European fund subscription in 2006.

On a global scale, the European fund market consists of a high number of small funds, with 54% of European funds at the end of 2006 managing less than €50 million in assets. Indeed, the average European fund is more than five times smaller than its American counterpart.[3]

After a process of analysis and open consultation, targeted amendments to the UCITS Directive have been proposed, focusing upon five key areas of change:

(i) Cross-border fund mergers.

(ii) Pooling ('master-feeder' structures).

(iii) Improving key investor information.

(iv) Improving efficiency of notification process.

(v) Enhancing supervisory cooperation.

In addition the Committee of European Securities Regulators (CESR) has been asked to provide its advice on a management company passport.

The management company passport – A bridge too far?

The management company passport would aim to allow the management company of a UCITS fund to be authorised and supervised in a Member State other than the Member State where the relevant UCITS fund has been formed. Under the current UCITS framework, the UCITS fund, its management company, and its depositary must all be domiciled in the same Member State. The proposed changes could bring a number of benefits to UCITS firms, such as more competition, lower costs through improved economies of scale, greater specialisation benefits and improved risk management.

However, the proposed changes have proved a difficult area for the EU Commission, in the face of political opposition from Ireland and Luxembourg, two of the main centres for UCITS domiciliation.

On 16 July 2008, the EU Commission asked for the CESR's advice on some of the challenges raised by the management company passport, including how to ensure a high level of investor protection and effective regulation of UCITS firms on a cross-border basis. The deadline for the submission of responses to the CESR was 22 August 2008, and the CESR now has until 1 November 2008 to provide its advice to the Commission. The Commission are hoping that the advice from the CESR will allow them to make the necessary amendments to the recast Directive to implement a viable management company passport.

Overall, an effective management company passport is one of the key measures necessary for the continued development of an effective UCITS framework.

Fund mergers

The 'Heinemann report'[2] estimated that the European fund industry could achieve €5 billion in annual cost savings if the European average fund size were increased to that of an average American mutual fund. In 2005, an Invesco report considered that European investors were being charged an estimated €2 billion–€6 billion[3] in annual fees more than they would if scale economies could be fully exploited. Furthermore, investors and distributors would find making product choices easier if the diverse range of funds currently available across Europe were consolidated.

The absence of a common EU fund merger framework has been identified as one of the main obstacles to further consolidation across borders. Different legal regimes, national regulatory approaches and rules currently render cross-border mergers expensive, complex and time-consuming. Some countries' criteria are overly prescriptive, requiring 100% shareholder approval, which is often unachievable in a fund with a large number of shareholders.

A single EU fund merger approach would enable those fund managers looking to offer a range of funds from a single location, an opportunity to benefit from operational cost savings.

The proposed fund merger framework would cover a series of commonly used merger techniques. See Figure 1.

In relation to regulatory approval of mergers, it has been proposed that the regulator of the non-surviving fund would be required to approve the proposed merger. To maintain investor protection

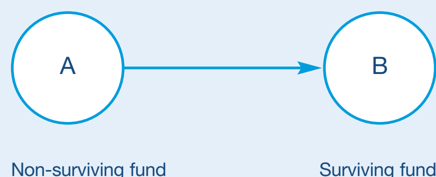
[1] Funds that are notified for sale in at least two countries other than their fund domicile (PricewaterhouseCoopers-Lipper data).

[2] 'Towards a single European market in asset management', ZEW, May 2003.

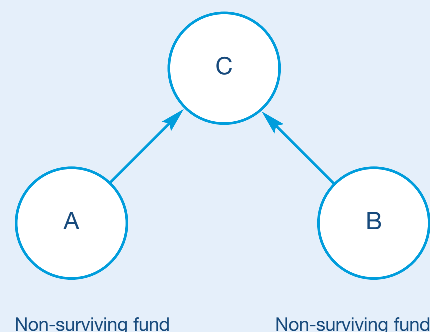
[3] European Commission's 'Impact Assessment of the Legislative Proposal Amending the UCITS Directive' (http://ec.europa.eu/internal_market/investment/docs/legal_texts/framework/ia_report_en.pdf).

Figure 1

Merger by absorption/Scheme of amalgamation



Merger by way of creating a new fund



Source: PricewaterhouseCoopers

provisions, the regulator responsible for approving the merger would be responsible for considering the impact on investors of the surviving fund and deciding whether investors were adequately informed about the implications of the merger.

Pooling

From investors' tax perspectives, it may be preferable for fund managers to pool their existing funds under a 'master-feeder' structure. This approach would maintain the individual characteristics designed to meet specific investor tax needs rather than subject a single merged fund to a tax regime that may not be beneficial to all investor classes. See Figure 2.

The UCITS IV proposal provides the following characteristics for master-feeder structures:

- Prior regulatory approval of the feeder's investment into the master fund.
- Minimum of at least two feeder funds.
- Minimum investment into master fund by feeder funds to be set at 85%.
- Proper arrangements between master and feeder funds (and their respective depositaries and auditors) to be established.
- Information to investors should clearly explain the implications of the two-layer investment.
- Master and feeder funds, as UCITS funds, should comply with provisions within the UCITS Directive.

As an added level of investor protection, the proposal provides that feeder funds created from existing UCITS funds will require approval from investors, and that investors should be given the right to redeem their interests in the fund at no cost should they not wish to participate in the fund conversion.

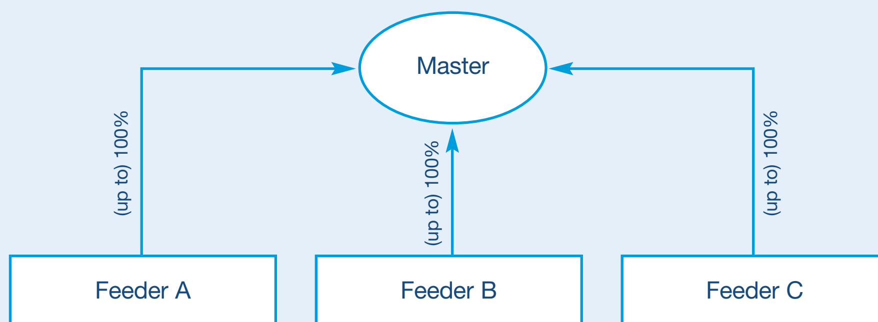
Other improvements to the UCITS directive

Other amendments to the UCITS Directive focus on:

- Increasing speed to market by improving the existing notification process, to reduce the time frame between notifying the host state regulator and promoting the fund in the new jurisdiction from two months down to just three days.
- Providing more flexibility in providing investor information, by replacing the simplified prospectus with 'key investor information', which does not have to be confined to a specified document.

Figure 2

Master-feeder structure



Source: PricewaterhouseCoopers

- Increasing supervisory cooperation, potentially through strengthening supervisory powers and cooperation via aligning relevant UCITS Directive provisions on comparable provisions in the MiFID Directive and other recent securities legislation.

Expected timetable

The Commission have stated that they expect the recast Directive to be adopted by the European Parliament and Council in the second quarter of 2009. The Member States will then have two and a half years to implement the new provisions and adopt their national rules suggesting the UCITS IV framework will become applicable in mid-2011.

- September 2008 – Start of the discussions by the European Parliament and Council.
- 1 November 2008 – Deadline for the advice from the CESR on Management Company Passport.
- First half 2009 – expected mandate to the CESR to start work on the Level 2 implementing measures.
- Mid 2009 – UCITS IV Directive expected to be adopted by the Council of Ministers and the European Parliament.
- Late 2009/2010 – Expect FSA consultations on the necessary changes to FSMA and FSA Handbook.
- Throughout 2010 – Firms impacted by UCITS start preparing systems and controls for new UCITS framework.
- Mid-2011 – UCITS IV Directive and implementing measures expected to come into force.

Autumn 2008: Technical Round-up

This article contains reminders of regulatory developments that may be significant to some firms, but are not covered in more detail elsewhere in this issue.

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Conduct of business

Simplifying disclosure – information about services and costs
The Financial Services Authority (FSA) has published Policy Statement 08/7, which implements the proposals set out in Consultation Paper 08/3 on simplifying the guidance about disclosure of information to consumers by investment firms concerning their services and costs. The FSA Handbook changes took effect from 6 August 2008 with transitional rules permitting the continued use of the old disclosure documents until 31 August 2009.

The changes introduced a new optional disclosure document known as a Services and Costs Disclosure Document (SCDD), which investment firms may use to explain their services and costs to consumers. This new document brings together information currently included in the existing Initial Disclosure Document (IDD) and key information about cost of services.

Providing customers with the SCDD is just one way for firms to comply with a number of the Conduct of Business Sourcebook (COBS) requirements. Firms are still free to design their own disclosure material to comply with COBS and the Principles for Businesses if they want to. The FSA has also updated the Combined Initial Disclosure Document (CIDD) in order to ensure consistency between the SCDD and the investments section of the CIDD.

Quality of advice
Following a series of visits to firms and a 'mystery shopping' exercise, the FSA has published its findings on the quality of advice being given to retail clients. It has identified a number of areas where firms have inadequate procedures and controls, and also issued the first in a series of factsheets, setting out examples of good and poor practice. These two documents provide a useful benchmark against which firms may measure the quality of their own advice processes.

Risk management for UCITS
With the increasing use of financial derivatives in Undertakings for Collective Investment in Transferable Securities (UCITS), the Committee of European Securities Regulators (CESRs) has published a consultation paper on the risk management principles. It is proposing 13 key principles that may become mandatory in the European Economic Area (EEA).

Using the words 'consequential loss' in general insurance contracts
The FSA has issued a statement expressing a concern that a consumer general insurance contract that excludes liability for 'consequential loss' may be unfair under UK legislation. The statement encourages the use of plain and intelligible language, which is less likely to be considered unfair.

Conflicts of interest
Various regulatory pronouncements have focused on the avoidance and management of conflicts of interest recently. Issues identified by the FSA include:

- Insurance groups using in-house investment management services (Life Insurance Newsletter 13).
- Private equity firms (Capital Markets Bulletin 3).
- Public takeovers (Market Watch 27).
- Anti-market abuse controls in the commodities markets (Market Watch 28).
- Disclosure of short positions on rights issues (Press Release 57).

Insurance commission transparency
The FSA decided last year, not at that time to make commission disclosure on insurance sold to commercial customers mandatory; however, there remained certain concerns about

transparency and wider market efficiency issues. The FSA is focusing in 2008 on: improving the quality, clarity and consistency of key disclosures relating to commission, status, service; thematic work on conflicts of interest arising from commission paid by insurers to intermediaries; and ways to raise commercial customers' awareness of the value of commission information disclosed by intermediaries. A discussion paper was published in March 2008, inviting views on the cost benefit analysis of mandatory commission disclosure.

Taking into account the thematic work being conducted and responses to the discussion paper, the FSA will determine whether any changes to rules or supervisory approach are appropriate. Any new rule requirements will be consulted on in the fourth quarter of 2008.

Prudential requirements

Insurers
The FSA rules currently allow insurance companies to pay the costs of compensation and redress from the inherited estates of their with-profits funds. The FSA has re-examined these rules and concluded that there is a case to consult again on whether shareholders alone should meet the cost of compensation and redress, as the current rules may not lead to the fair treatment of policyholders. CP08/11 (With-profit funds – compensation and redress) proposes that proprietary insurance companies will, in respect of payments made after 1 November 2008, no longer be permitted to charge compensation for mis-selling to the inherited estates of with-profits funds.

Proposed amendments to the Insurance Prudential Sourcebook are detailed in Chapter 4 of CP08/12. The main amendments proposed are around asset reporting in the Insurance Annual Returns from the December 2008 year-end in the light of the impact of the credit crunch. In particular, there are proposals for enhanced reporting in respect of derivatives and, for life insurers, asset-backed securities. The most substantive changes are to Form 17 (analysis of derivative contracts), Form 49 (fixed and variable interest assets) and Form 56 (index-linked business).

Dear CEO letter – valuation and product control
The FSA has published a 'Dear CEO' letter, identifying valuation and product control concerns. The FSA's review work over the last 12 months has revealed that firms' valuation processes and controls have become increasingly stretched and, in some cases, have proven to be materially flawed or inadequate. In particular, the FSA is concerned about a large number of material mis-marking incidents that have crystallised and by the failure of firms to implement processes to evaluate their position regarding the FSA's 'prudent valuation principles' (GENPRU 1.3). These principles are designed to ensure a prudent approach to issues such as liquidity, concentration and model risk, all of which are critical to valuation in the current market environment.

The FSA also urges that, in the current period of increased cost control, firms consider carefully any headcount reductions that will affect valuation control functions at this sensitive time.

The FSA's focus on this area will continue and in the first half of 2009 it will undertake a series of visits at firms with material trading operations to evaluate progress in applying 'prudent valuation principles'.

Liquidity requirements for banks and building societies
The FSA has published feedback (FS 08/3) on responses to its proposed liquidity requirements for banks and building societies. Discussion Paper 07/7 had looked at ways that liquidity policy should develop and focused on lessons learnt following recent market conditions. Respondents broadly agreed with the policy objectives set out in the discussion paper and with the FSA's current high-level standards and principles-based approach. The FSA expects to consult further, later this autumn.

The key points arising from the responses were:

- There was strong agreement on the need to continue coordinating the FSA's work on liquidity, both at a national level (with the other Tripartite Authorities) and on an international level.
- Most respondents are reviewing their stress-testing scenarios and contingency funding plans in line with lessons learned over the past year.
- The majority of respondents stressed the importance of the close relationship between the central bank's role, actions and provisions, and firms' internal liquidity risk management processes, as well as any measures developed by the FSA under a new regulatory regime.
- Most respondents agreed that quantitative requirements were a necessary component of any regulatory regime, particularly for the short term, and agreed that one single quantitative regime should replace the existing three. There was some scepticism, however, about the usefulness of quantitative requirements to safeguard against long-term chronic liquidity stresses and about the possibility of standardisation across institutions.

Financial stability and depositor protection
In July 2008, HM Treasury, the FSA and the Bank of England (the Tripartite Authorities) published a further consultation on their proposals to address enhanced financial stability and depositor protection in the wake of Northern Rock and the sustained turbulence in global financial markets more generally. This further consultation is an update of a January 2008 consultation and refines those proposals in the light of developments since then and responses to, and the dialogue arising from, that earlier consultation.

The updated proposals cover the following areas:

- Strengthening the stability and resilience of the financial system.
- Reducing the likelihood of banks failing.
- Reducing the impact of banks failing.
- Effective compensation arrangements.
- Strengthening the Bank of England and tripartite coordination.

There are 50 specific proposals covering changes to primary and secondary legislation, FSA rules and a range of operational changes. The proposals include the Special Resolution Regime (SRR), which would give the Tripartite Authorities additional powers to take control when a bank is judged to be failing and where voluntary action by the firm and existing regulatory options are deemed insufficient. These powers are needed to secure the broader public interest in managing the risks to financial stability, protecting the public finances, protecting depositors and ensuring continuity of key banking and payment arrangements.

The SRR would include a new bank insolvency procedure and would enable the Tripartite Authorities to:

- Transfer part or all of the failing bank to a private sector third party.
- Transfer part or all of the failing bank to a publicly controlled bridge bank.
- Take a bank into temporary public sector ownership.
- Provide financial support, through funding or guarantees to a failing bank – subject to legal and other constraints.

Interaction of solo and group capital requirements
The FSA has published feedback statement (FS08/4) on Discussion Paper 07/5, which outlined two possible approaches for determining the capital adequacy requirements of firms in a group. The first approach was based on abolishing solo requirements entirely and replacing them with some form of group support requirement. The second approach involved retaining the solo requirement, but with modifications.

The responses received did not provide the FSA with conclusive evidence to support a change and so the FSA is not going to alter the current solo/group arrangements at this time.

Autumn 2008: European update – Challenges to supervisory convergence

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Challenges to supervisory convergence

In December 2007, against the backdrop of the financial turmoil, the EcoFIN Council set down a roadmap[1] for enhancing the Lamfalussy legislative procedures. These procedures, introduced initially for securities regulation in 2001 and subsequently extended to cover European Union (EU) regulation for all financial sectors in 2004, are designed to make the EU legislative process more flexible. Underpinning the roadmap's specific initiatives is an expectation of enhanced supervisory cooperation and convergence, on both a sectoral and cross-sectoral basis, and also in the context of group supervision.

The Level 3 Committees – the committees of financial sector supervisors[2] – play multiple roles within the overall Lamfalussy structure. They provide technical advice for Level 1 framework legislation and its Level 2 implementing measures, but come to the fore in Level 3, which focuses on consistency in interpretation and implementation of EU rules. Later this year, the European Commission (the Commission) intends to revise its Decisions, establishing the three committees to ensure their Charters are consistent and to support increased supervisory cooperation and convergence. In May this year, it released a consultation paper,[3] raising possibilities for specific amendments to the Decisions. Responses were requested by 3 September and feedback from the Commission should be imminent.

This article considers some of the challenges for the Level 3 committees in terms of supervisory convergence.

A key challenge to the Level 3 committees' encouragement of supervisory convergence is the non-binding nature of the committees' standards and guidelines. The EcoFin Council has stipulated that any amendments to the Decisions, and the associated activities of the Level 3 committees, should 'strengthen the national application of guidelines, recommendations and standards of Level 3 committees, without changing their legally non-binding nature[4]'. Essentially, the Level 3 guidelines, etc., cannot constitute binding rules, as this would upset the constitutional legislative balance within the EU.

'It is clear that EU regulators need to cooperate more – it is not sufficient to have a national focus when financial markets are integrated at the EU level, and sometimes even at the global level. EU finance ministers agree with this, and there is a continued call for improvements to be made. That is why the Commission is preparing to revise its decisions establishing the EU supervisory networks.' Charlie McCreevy, European Commissioner for Internal Market, 9 September 2008

The reality of the challenge has come to light in terms of the implementation of the Markets in Financial Instruments Directive (MiFID), most notably in relation to the Committee of European Securities Regulators (CESR) guidelines on inducements. This paper established that any fee that was not a payment between the relevant investment firm and the investor, or a 'proper' fee such as exchange, custody or legal costs, was an 'inducement', including all forms of commissions. MiFID requires inducements to either be avoided or disclosed in advance to investors. A number of Member States have introduced national requirements closely reflecting the spirit of these guidelines – even when this has forced a rethink of market practice – but some have not. This impacts both the EU level playing and supervisory convergence. It is not clear at this stage how, or whether, the CESR can address this discrepancy, as this is now entrenched in national law. As non-binding rules, Level 3 guidelines also fall outside the ambit of the Commission's Level 4 enforcement powers.

The EcoFIN Council has also called upon the Level 3 committees to promote convergence through influencing the national legislative process. However, in some Member States, supervisors are not closely involved in, nor have significance influence over, national processes. However, they have to adhere to national laws, and are accountable on this basis. It's a catch-22.

Some amendments discussed by the European Parliament for the Solvency II Framework Directive aimed to address this dichotomy, suggesting either legal personality for the

Level 3 committees or an EU mandate for national supervisors. These amendments were proposed with the challenges of group supervision in mind and, indeed, Eurofi, the Paris-based think-tank, has recently called for an EU mandate in the context of group supervision. The rationale is that, in certain circumstances, group supervisors may need to put the interests of policyholders in other EU States before those of national policyholders. However, the existence of such a mandate could also facilitate supervisory convergence. The likelihood, though, of any amendment along these lines being adopted is unclear.

So, for the time being, in this regard, supervisory convergence relies to a considerable extent on national legislators introducing the appropriate measures to implement Level 3 guidelines. Amending the Decisions to strengthen national application, though, could enable the Commission to exert more pressure when discrepancies occur in the future.

In terms of the functioning of the Level 3 committees, the EcoFin Council targets further convergence through enhancing the workings of the committees, stipulating their adoption of Qualified Majority Voting (QMV) procedures for issues where a consensus cannot be reached. (This was also raised in the Commission's consultation paper: the Commission is contemplating a specific reference to this practice in the revised Decisions).

In their response to this paper,[5] the Level 3 committees indicated that they have already adopted or are in the process of adopting QMV, together with an accompanying 'comply or explain' procedure. However, they also underlined that, as any committee decisions will remain legally non-binding, reaching a consensus, wherever possible, is preferable to this approach.

The problem is clear – if Member States currently do not feel obliged to adopt rules reflecting Level 3 committee guidelines devised through consensus, how will QMV improve the situation? While the increased transparency brought by the 'comply or explain' procedures may provide some additional encouragement to adhere to Level 3 guidelines, this is not foolproof. How will these procedures be enforced? QMV may also lead to increased political pressure on the workings of the supervisory committees – another catch-22!

The dichotomies continue when you consider the mediation mechanisms advocated by EcoFIN. The Commission has suggested the establishment of mandatory mediation mechanisms – the outcome of which would nevertheless be non-binding on the parties concerned; definitely reminiscent of the old proverb: you can take a horse to water, but you can't make it drink. Not surprisingly, the Level 3 committees' reaction to this proposition is guarded, saying that future requirements should reflect the mechanisms that the committees already have in place and that 'ultimately the use made of mediation will depend on Members' perception of their need in the circumstances, including any alternative'.

The bottom line is that substantial progress in supervisory convergence is still predicated on national legal frameworks that permit it. Although the need for supervisory convergence has been outlined in more recent EU legislation,[6] it has not always been translated effectively into national supervisory objectives. It appears misguided to place too much responsibility on the Level 3 committees (and their members) for meeting an objective for which they do not, yet, have the legal authority. Hopefully, the revised Commission Decisions will go a long way in removing some of the dichotomies.

Moving beyond these issues, the size of the convergence challenge needs to be fully appreciated. Supervisory convergence (combined with a principles-based regulatory approach) implies the adoption of supervisory practices that produce an equivalent supervisory outcome, from both a solo and a group perspective (obviously applying the proportionality principle). This, essentially, means a common understanding – by multiple stakeholders – of the required outcome, equivalent resources and powers, and a common supervisory culture, based on mutual trust and confidence in other supervisors' capabilities.

The protection of depositors, investors and policyholders is the required outcome; however, there is still much work to be done on how supervisory practices should be designed to achieve this (and perhaps the level of protection required). In line with the EcoFIN roadmap, the Commission is beginning to address some of the other issues by undertaking a stocktaking exercise of the coherence, equivalence and actual use of sanctioning powers, and ensuring that all EU financial services' legislation adequately facilitates supervisory cooperation and information exchange. It is also considering possibilities for EU funding of tools designed to help build a common supervisory culture.

For the Level 3 committees, a common culture is a primary goal, promoted, inter alia, through 'the intensity and diversity of supervisors regularly working together in the Committees', as well as personnel exchanges and common training programmes. Activity in these areas has increased significantly over the past four years. In recent months, further evidence of increased supervisory convergence includes 16 agreements on cooperation on the supervision of branches under MiFID, and progress made by banking supervisors in delegating supervisory tasks between home and host supervisors.[7] These are small steps, but in the right direction.

Supervisory convergence could gain much-needed momentum through the Solvency II negotiations. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has recently published an issues paper on the solo supervisory review process under Solvency II, which sheds light on some of the potential convergence challenges. This paper is a preliminary move in developing technical advice around the supervisory review process for the Commission on Solvency II Level 2 measures, due in October 2009. The CEIOPS is still working on group supervisory practices (and associated issues such as capital add-ons, model validation) which, in light of the Solvency II proposals for 'colleges of supervisors', may pave the way for cultural changes that extend beyond the insurance sector and, indeed, beyond the EU (given the recommendation by the Financial Stability Forum[8] to introduce 'colleges' for all major financial institutions internationally).

Essentially, Europe has been moving towards supervisory convergence for many years, but it is time to 'put the pedal to the metal'. Political actions, at the EU and national level, should aim to support this and the various stakeholders should work in concert towards this common goal. The problems in the financial markets over the past year have underlined the need for better supervisory cooperation and collaboration internationally, in good times and bad. Europe needs to be able to speak with one supervisory voice, and take a leading role in this. There is much at stake.

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1. Economic and Financial Affairs (www.consilium.europa.eu) 12.07.
2. The Committee of European Securities Regulators established by Decision 2001/527/EC (as amended), the Committee of European Banking Supervisors and the Committee of European Insurance and Occupational Pensions Supervisors established by Decision 2004/5/EC and 2004/6/EC, respectively.
3. 'Public Consultation Paper on Amendments to Commission Decisions establishing CESR, CEBS & CEIOPS (http://ec.europa.eu) 05.08.
4. Economic and Financial Affairs page 20 (www.consilium.europa.eu) 12.07.
5. The 3 Level 3 committees' Joint Response to the European Commission's 'Public Consultation Paper on Amendments to Commission Decisions establishing CESR, CEBS and CEIOPS' (www.ceiops.eu) 09.08.
6. See recital 55 of Directive 2006/48/EC.
7. CEBS publishes its work on delegation (www.c-ebs.org/News--Communications/Latest-news.aspx) 3.9.08.
8. Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (www.fsforum.org) 04.08.

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