FS regulatory, accounting and audit bulletin

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In this month's edition:

- HMT, PRA and FCA consultations on BRRD
- FCA looks at competition in the cash savings market
- PRA and FCA propose new remuneration and approved persons regimes
- AIFMD transitional period ends

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Executive summary

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Welcome to this edition of "Being better informed", our monthly FS regulatory, accounting and audit bulletin, which aims to keep you up to speed with significant developments and their implications across all the financial services sectors.

They say a year can be a lifetime in politics. In the financial system, six years feels like an eternity. Many will remember August 2008 as if it were yesterday, but in many ways we are still struggling to understand the full implications of what happened. August 2008 was a watershed. Although arguably problems initially began surfacing over a year earlier, in August after months of denials, governments, regulators and banks started to admit that the financial system was in serious trouble and that a painful economic downturn was on the cards.

With this admission, the remaining liquidity in the wholesale money markets evaporated as financial institutions lost confidence in their peers –forcing central banks' hand. EU banks started to issue large profit warnings as their exposure to troubled US housing and credit markets became apparent—and shareholders reacted by jettisoning bank stocks.

Houses prices started to fall in many EU countries, unemployment ramped-up and production ground to a halt. Lehman Brothers' failure a month later ratcheted the crisis up to a new level: an apocalypse that threatened the global economy. In terms of the banks, the emperor had permanently lost his clothes: problems of poor risk management practices, thinly capitalised balance sheets and misaligned funding patterns came to light at many institutions.

We are still experiencing the fallout of these events and their aftermath on a daily basis. The cost of bailing-out failed banks has been enormous. Between October 2007 and the end of 2011, EU governments injected €440 billion into their teetering banks and provided guarantees of €1.1 trillion.

Add in the costs in terms of lower economic production and the loss of householder wealth, and the true cost of the financial crisis runs into the trillions. Politicians felt they had little option but to bail-out feckless banks because after the Lehmans collapse, it was clear that no-one knew what would happen if governments didn't act.

Size was an obvious concern: certain banks, whose assets equated to multiples or large percentages of national GDP were just too-big-to-fail (TBTF) from a global, regional or national perspective. Others were too embedded in the financial system overall: these were too-interconnected-to-fail. Public bail-outs proved necessary, sparking deep public anger which has persisted, fuelled by subsequent banking scandals.

Handling systemically important institutions remains an ongoing, and difficult, process in the EU as elsewhere – we still have many firms that are TBTF or too-interconnected. EU attempts to address these problems have many strands - from structural reform, enhanced supervision to capital buffers. The EU reforms also include a requirement for financial institutions to develop recovery and resolution plans to make any failure less disruptive and to ensure that taxpayers no longer foot the bill. This requirement was laid out for all EU banks and designated investment firms in the Bank Recovery and Resolution Directive (BRRD).

In July *HMT*, *PRA* and the *FCA* all issued consultations setting out their approach to implementing the BRRD. The FCA's paper is particularly important given that it requires investment firms to prepare these plans for the first time - large UK banks have prepared them since 2011. But most investment firms (82%) will be eligible to apply the simplified obligations and approach, which should be less arduous and time consuming.

Amongst other things, BRRD forces troubled banks to bail-in creditors using CoCos or similar instruments. CoCos are automatic bail-in hybrid debt securities which have grown in prominence and popularity since the financial crisis. ESMA *issued* a warning in July that CoCos may not be

appropriate for retail investors because they require "a sophisticated level of financial literacy and a high risk appetite". ESMA's announcement was followed in August by the FCA's *first use* of its temporary product intervention powers to ban the distribution of CoCos in the UK to retail investors from 1 October 2014. The FCA plans to introduce changes to its Handbook over the next year to formalise this ban.

In July, the FCA also focused on consumer credit, *announcing* plans to cap the amount that payday lenders can charge their customers. The proposals include caps on the daily interest rate, on default fees and on total interest and charges. In short, the measures would make sure that no-one pays back more than twice what they borrowed. The FCA's own research indicates that the cap will force some market exits because firms will find it uneconomic to serve some customers.

In the EU, the Italian Presidency of the Council published its *work programme* for the next six months. The Presidency will seek to oversee the smooth transition to the SSM in November 2014, work on finalising regulations on MMF and benchmarks and pushing forward negotiations in plans to revise IMD and AML3.

A big test for the Presidency will be dealing with fall-out from the comprehensive assessment (i.e. the stress tests and asset quality review) which is expected in November.

Over the summer, insurers should start to think about getting approval of their internal models under Solvency II. For those firms that choose to go down this route, it provides essential groundwork for implementing Solvency II. But it remains a daunting challenge for firms. Our *blog* on this issue will help insurers understand some of the key considerations involved.

We have two feature articles this month. In our continuing focus on MiFID II we look at dealing commissions – the FCA issued a *discussion paper* to look at how the market is performing in line with current expectations and the changes MiFID II might make to the dealing commissions rules. For asset managers and investment banks this issue is critical. We also focus on the continuing benchmark reform, where July saw a number of publications looking at how developed these reforms are and how well administrators are performing in their new roles.

We hope you make the most of last of our summer sun this month, and can enjoy some well-earned time away from risk and regulation!

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How to read this bulletin?

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Who will pay for dealing commissions?

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What are "dealing commissions"?

An asset manager pays a "dealing commission" to a broker every time it places and order to buy or sell shares in a company for the portfolios it manages. It then allocates the dealing commission costs to the relevant fund or portfolio, so ultimately investors bear these costs.

The FCA's COBS rules also allow firms to pay dealing commissions for execution-related goods and services such as research, because they are linked to the investment decision to buy or sell shares in a company.

The EU financial sector is known for its diversity, but ESMA encountered a rare display of the industry speaking with one voice in the responses to its MiFID II consultation. Buy-side and sell-side, UK and mainland Europe, everyone is concerned about the advice that ESMA intends to give the EC concerning payment for investment research under the new regime. The dress rehearsal for this change is playing out in the UK, and many people suspect that the FCA is driving ESMA's position. So examining the UK position may shed light on what lies in store for the wider EU.

The FCA issued *Discussion on the use of dealing commission: feedback on our thematic supervisory review and policy debate on the market for research* on 10 July 2014, two days after the ESMA open hearing where the industry voiced its concerns. The FCA questioned the way in which asset managers use dealing commissions to pay for research – Specifically are they are buying eligible research and should investors bear the cost?

Martin Wheatley, FCA CEO, devoted his 2013 asset management conference speech to this issue, building on remarks he made in 2012. The FCA has conducted two thematic reviews, introduced one change to its rules and has now launched this discussion paper - all intended to drive asset managers to pay for research themselves without passing the cost to the end investor.

Not just asset managers and their clients would be affected - any change to dealing commission policy will also impact firms that provide research. The FCA believes some brokers and investment banks subsidise other areas of their business by using bundled prices for all their services. The FCA questions whether some firms are providing meaningful research at all.

Good news and bad news

In the short-term there's some good news for UK based asset managers – with MiFID II on the horizon, the FCA does not propose any immediate policy changes. But in the longer term the news isn't all positive as, sooner or later, either MiFID II or the FCA will require changes.

Only two of the 17 asset managers that the FCA visited lived up to its current expectations, so the FCA believes the need for change remains widespread. It also visited 13 brokers as part of its review, to look at how brokers must adapt to meet the changing needs of their asset manager clients. The regulator wants brokers to price research separately from trade execution so that asset managers can correctly allocate payments for research and other services.

FCA's findings

The FCA identified several issues that need to be addressed:

- Brokers are still linking dealing commission spent on research to the volume of trades they carry out. The FCA wants these services to be distinct so asset managers can demonstrate that they pay for the value of the research they receive and it isn't linked to order flow.
- Some asset managers continue to use dealing commissions to pay for ineligible research. The FCA recently clarified its rules around eligible research, including the outright ban on using dealing commissions to pay for corporate access.
- Although asset managers disclose how much they pay for research over a given period, the FCA found that customers and depositaries don't comment on or complain very much about these figures. This behaviour suggests that increased transparency around research payments is not the only answer.

- Only one broker treated its research function as a standalone business. Most firms use their own research, as well as selling it to asset managers, and fail to effectively price the cost of producing the research. This situation makes it more difficult to ensure that brokers are charging asset managers a fair price.

In 2012, Wheatley said "as an investor I want to be reassured that asset managers are keeping my investment safe and growing, without fees taking out more than their fair share". The recent paper shows that the FCA still believes asset managers don't do much to ensure that they get commensurate value from research that they pay for from dealing commissions. The FCA believes that they would pay much more attention if they were footing the bill themselves.

Wider debate

Introducing such radical changes at the national level could put UK firms at a competitive disadvantage internationally. Ideally, the FCA would like to see a global move towards unbundling but it recognises that might be a tall order. Instead, its goal may be to bring such changes into the EU by means of MiFID II.

Dealing commissions, a form of 'inducement' under MiFID, are not banned under MiFID II but they will be significantly restricted. Firms providing independent investment advice or portfolio management services will still be able to receive inducements if they pass them on in full to their clients. Asset managers may find it very difficult to ensure they pass on inducements received for bundled services, so this requirement may be enough to persuade firms to dispense with them.

Firms providing non-independent advice are not subject to the same restrictions under MiFID II. They can receive inducements if they are designed to enhance the quality of the service provided to the client. But in the consultation documents, ESMA's definition of what enhances the quality of the service appears to preclude commissions relating to investment research. If the EC upholds this position, the FCA will achieve its apparent goal with regards to unbundling for all forms of investment advice and for portfolio management services.

But firms across the EU have reacted strongly against a proposal which would radically change business models. They claim ESMA doesn't have a clear justification in the Level 1 text for its position. ESMA clearly takes the interpretation of 'quality enhancement' under the original MiFID to another level. EU firms also stress that restrictions on investment research would put them at a competitive disadvantage globally. The proposals could seriously threaten the investment research industry in the EU, to the considerable detriment of investors.

It's not a done deal at this stage. Although the EC seems inclined to be restrictive, the risk of serious investor detriment may be enough to convince it to delay the final decision until it completes a full impact assessment. The UK asset management industry is calling for a similar impact assessment through the Investment Management Association[1].

What you should be doing now

MiFID II is not going away. Although we await many details, the long-term direction of travel at both UK and EU level is clear. These changes will lead asset managers that have to pay for research to adopt fundamentally different business models. Similarly, investment banks and brokers may find increasing expectations and perhaps decreasing demand for their research services as asset managers focus more on the value of research and the price of individual services.

Whatever happens at the EU level, the FCA may still push ahead, using its 'gold plating' option in this area. For the rest of Europe, beware the evolving views of national regulators and the long shadow of MiFID III!

For UK firms, the immediate focus should be on aligning your activities with FCA expectations. You should be reviewing your research spend from dealing commissions and determine whether this spend is linked to where you place orders. You should consider any commission sharing arrangements and calculate how to price the research you do pay for. Consider also whether or not this information is actually "research" in the FCA's eyes.

Finally, you should ensure that you implement the FCA's latest rules from PS14/7 on the records you keep. We expect the FCA to take a dim view of any remaining outliers in this area.

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[1] In February 2014, the Investment Management Association's paper "The use of dealing commission for the purchase of investment research" recommended ways for investment managers to reduce research costs and improve procurement practices. It also committed to reviewing disclosure codes to ensure that both retail and institutional clients receive specific and simple-to-understand disclosure of the precise costs of the research that they have paid for from dealing commissions.

Benchmarks: the net widens

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Manipulation of LIBOR and other benchmarks is among the most high profile and extensive abuses to emerge from the financial services industry in recent years. Following hot on the heels of the financial crisis, revelations of benchmark manipulation did nothing to restore confidence in the financial system. Regulators reacted swiftly, creating new rules and undertaking tough enforcement action. Yet evidence of further benchmark manipulation continues to come to light. We see a change in regulators' focus on new benchmarks, particularly in currencies and commodities. Regulators clearly have to go further to reduce the opportunities for individuals to manipulate benchmarks, and punish individuals who have already done so.

The response so far

In the UK, HMT commissioned the *Wheatley Review*, resulting in new rules for LIBOR. The House of Commons Treasury Select Committee conducted its own *inquiry*. Politicians established the *Parliamentary Commission on Banking Standards*. Banks' senior managers faced a wall of anger and criticism for tolerating such behaviour, and the scandal forced the CEO of one of the UK's largest banks to step down.

Enforcement action relating to LIBOR is ongoing. The FCA *fined* Lloyds Banking Group £105 million for misconduct relating to the Special Liquidity Scheme (SLS), the Repo Rate benchmark and LIBOR on 28 July 2014. £70 million of this fine related to manipulation of the SLS, a taxpayer-backed government scheme to support banks during the crisis, reigniting public outrage. On the same day, the CFTC *fined* Lloyds $105 million for manipulating LIBOR and, by extension, US derivative markets.

Beyond interest rate benchmarks

So far, the enforcement action and regulatory reform has focused on interest rate benchmarks, in particular LIBOR, EURIBOR and TIBOR. But recently FX and commodity benchmarks have fallen into the firing line.

This month, the UK Serious Fraud Office (SFO) *announced* that it has opened a criminal investigation into allegations of the fraudulent activity in the FX market, although it didn't provide any details at this stage.

The FCA has been *investigating* 15 banks in connection with the FX market since October 2013, working alongside several international agencies. EU banks have already indicated to investors that the cost of fines or settlements associated with the wide-ranging inquiries could be material. Again, the FCA has not publically revealed the details of these investigations, but they are likely to centre on the WM/Reuters 4pm London Fix. This benchmark provides a snapshot of exchange rates during a 60 second period and is used as a reference to execute a large number of FX deals.

The UK government has tried to mitigate the potential damage to London's position as the world's leading FX market. Chancellor George Osborne announced the *Fair and Effective Markets Review* at his *Mansion House Speech* on 12 June 2014, a joint BoE, HMT and FCA Review. Osborne made it clear that the government plans to extend recent LIBOR legislation to cover other benchmarks. As with LIBOR, this extended legislation would include criminal sanctions.

In the US, investors have filed a class action lawsuit against Deustche Bank, HSBC and the Bank of Nova Scotia, accusing them of rigging the silver price. The investors argue that "the extreme level of secrecy creates an environment that is ripe for manipulation. They believe that the defendants have a strong financial incentive to establish positions in both physical silver and silver derivatives prior to the public release of silver fixing results, allowing them to reap large illegitimate profits." Nothing is proven yet, but suspicion is rife.

Increased regulatory attention has driven some benchmark administrators to be more proactive. London Gold Market Fixing Limited has appointed an advisory committee to oversee the fixing process. It also published a new *conflicts of interest policy*, effective from 14 July 2014. Meanwhile, some banks have begun to withdraw from the commodity fixing processes, particularly the London gold and silver fixes. Many banks are radically reducing their commodity trading activities. If too many players withdraw, it may prove difficult to generate reliable benchmarks, a concern that also rose when banks started getting cold feet about continuing to participate in the LIBOR setting process.

What is the international view?

While local enforcement action makes headlines, international regulators have been busy crafting new rules to prevent future benchmark manipulation. International bodies naturally tend more towards principles than hard rules, but those principles set the course for future legislation.

IOSCO published its final report on *Principles for Financial Benchmarks* in July 2013. Benchmark administrators had until 18 July 2014 to publically disclose the extent of their compliance with the IOSCO Principles. Their disclosures varied from a one-line statement of compliance to extensive third-party assurance over controls. IOSCO published its own *report* on LIBOR, EURIBOR and TIBOR compliance with its principles on 22 July 2014. Its findings were mixed – it believes that the administrators of these key benchmarks have work to do. IOSCO singled out Principle 7 on data sufficiency as a concern across all three benchmarks, and requested further information from the administrators.

The FSB published its *final report on interest rate benchmarks* on 22 July 2014. The FSB working group is led by the FCA's Martin Wheatley. Wheatley has been keen to highlight this work as a way in which the FCA is helping to set the international conduct regulatory agenda. He is well qualified, having led the HMT review into LIBOR before joining the FCA. The FSB is pushing for greater use of transaction data and wants to encourage new 'nearly risk-free' rates.

The FSB's work on FX is less developed than that on interest benchmarks. It published a *consultation paper* on 15 July 2014, identifying suggested reforms to FX benchmarks. It believes the problems with FX benchmarks are different from those with interest rates. The major FX benchmarks are based on actual trades, supported by bids and offers extracted from electronic trading systems. But the structure of the FX fixing process means that dealers have an incentive to influence the exchange rate. Such influence might include collusion over prices or information sharing. The FSB recommends widening the fix window so that more trades will contribute to the final benchmark price. The consultation closes on 12 August 2014.

What's still to come?

The G20 Leaders November Summit in Brisbane looms large on the regulatory agenda. The FSB will deliver its final recommendations on reforming interest rate and commodity benchmarks to world leaders. If past FSB recommendations are any indication, we expect G20 leaders to give a green light to any reforms that it proposes.

When EU policy makers return from their summer recess they will pick up the proposed EU *Benchmark Regulation*. This measure failed to progress under the previous European Parliament because MEPs were unable to agree on the scope of the legislation. We expect most of the existing provisions to become law in time, although the new EP may narrow the current broad scope.

The UK government expects recommendations of the Fair and Effective Markets Review findings to be published before June 2015. We are likely to see some benchmarks drawn within the regulatory perimeter even before then, perhaps as soon as the end of this year.

Regulators and policy makers have done much to clean up benchmark administration and financial institutions' participation in the processes, but the work is not done. We will see more enforcement action and further rules over the next couple years. As long as abuses continue to emerge, politicians and regulators will face continuing public pressure to take further action to prevent abuses.

Cross sector announcements

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Regulation

Benchmarks

Reforming FX benchmarks

The FSB consulted on *Foreign Exchange Benchmarks* on 15 July 2014. In February 2014, the FSB included an assessment of foreign exchange benchmarks in its ongoing work analysing financial benchmarks. A specially convened Foreign Exchange Benchmarks Group (FXBG) has carried out this work. The FXBG engaged with market participants around the world as well as carrying out its own analysis.

The FSB set out recommendations for views and feedback from market participants including:

- the methodology for calculating the WM/Reuters (WMR) benchmark rates
- reference rates published by central banks
- market infrastructure for executing fix trades
- market participants' behaviour when the major FX benchmarks are fixed (primarily the WMR 4pm London fix)
- recommendations from a forthcoming IOSCO review of the WMR fixes.

The consultation closed on 12 August. The FSB's final recommendations will be put to the G20 leaders in November at the Brisbane Summit.

Amending interest rate benchmarks

The FSB published its *final report on interest rate benchmarks* on 22 July 2014. An Official Sector Steering Group (OSSG), led by FCA CEO Martin Wheatley carried out the review, which had two strands. First, the OSSG considered principles for sound benchmarks, including assessing the major interest rate benchmarks against IOSCO's Principles for Financial Benchmarks. Second, the OSSG teased a Market Participants Group (MPG) with identifying additional benchmark rates and analysing what might happen more market participants used alternative rates.

The FSB recognises that different currencies face different challenges and therefore some divergence will occur in how reforms are implemented. But it believes that two key elements should apply across all currency areas:

- Greater use of transaction data to strengthen the use of existing IBORs to create 'IBOR+' rates
- Development of new 'nearly risk-free' rates as an alternative to existing benchmark rates.

The FSB recommends that currency groups from the MPG work with the private sector to implement the reforms. The FSB expects to see benchmark administrators consult on IBOR+ reforms by the end of 2015 and implement at least one risk-free rate by Q2 2016.

More improvement required

IOSCO published a review of benchmark administrators' implementation of its *Principles for Financial Benchmarks for Euribor, Libor and Tibor* on 22 July 2014. It found that all three administrators have made significant progress in implementing the majority of the Principles.

But IOSCO also found that they still need to make further progress in some areas. In particular it urged the LIBOR administrator to consider how it defines a conflict of interest and encouraged all three administrators to do further work on data sufficiency.

Capital and liquidity

Assessing risk transfer legitimacy

The EBA published *Guidelines on significant credit risk transfers (CRTs)* on 7 July 2014. Concerned about the complexity of CRTs, the EBA hopes these guidelines will help competent authorities understand how they transfer or mitigate credit risk. It believes banks may be taking advantage of the opacity of CRTs to artificially reduce their capital requirements.

The EBA specifies the criteria competent authorities should use to assess whether a CRT is legitimate and the requirements institutions should meet to facilitate this assessment. It proposes requirements in the guidelines to:

- clarify the ways a firm can demonstrate a significant transfer of credit risk from its balance sheet
- harmonise approaches by providing competent authorities with a uniform framework to make decisions on significant CRTs.

Institutions using significant CRTs need to abide by the EBA's procedures when claiming capital relief. Firms should also provide all relevant information to the competent authority when seeking to reduce their capital requirements by securitising. Competent authorities should follow the specific criteria and tests outlined by the EBA when assessing whether the reduction in capital requirements is justified by a commensurate transfer of credit risk to third parties.

The guidelines will be effective two months after the official translations are published.

Creating a consistent supervisory approach

The EBA published Draft Guidelines for common procedures and methodologies for the supervisory review and evaluation process under CRD IV on 7 July 2014. These guidelines provide a common framework for supervisors in assessing business models, solvency and liquidity risk.

The assessment will be summarised in a common scoring format and should lead to consistent supervisory requirements for firms to hold additional capital and liquidity resources as needed.

These guidelines will be a key component of the EU's Single Rulebook aimed at improving the functioning of the internal market and promoting supervisory consistency throughout the EU.

The consultation closes on **7 October 2014**.

Questions answered on risk charge

The EBA published a *list of Q&As* on 10 July 2014 to help with its Credit Valuation Adjustment (CVA) data collection exercise. The EBA launched the exercise in April 2014 with the aim of advising the EC on appropriate amendments to the CVA framework and of informing BCBS discussions on the CVA risk charge.

To address some of the issues raised by the industry and ensure consistency in the conduct of the exercise, the EBA also published *a second template*. Participating banks should submit the second template alongside their main template to respective supervisors by 31 July 2014.

The EBA will perform data quality checks during the first week of August 2014. Where necessary, it plans to ask banks to complete and resubmit templates by 29 August 2014. The EBA will then finalise the data analysis during the first week of September 2014.

Calculating counterparty risk

The EBA published its *final draft RTS on the margin periods of risks (MPOR) used for the treatment of clearing members' exposures to clients under CRR* on 4 July 2014. The RTS will affect how clearing members calculate their capital requirements for counterparty credit risk (CCR).

The firm must first determine the MPOR by reference to a derivative transaction's liquidity. It then uses the MPOR value to calculate the CCR.

The EBA will now submit the RTS to the EC. After they are published in the Official Journal they will form part of the EU's Single Rulebook for prudential regulation.

Prudential filters here to stay

On 2 July 2014, the EBA published its *technical advice to the EC* on applying prudential filters. The advice focuses on the CRR prudential filter which requires firms to deduct from their capital any fair value gains and losses on derivatives arising from changes in their own credit standing. The filter aims to prevent banks from benefitting from their credit standing deteriorating, which would lead to misaligned incentives.

The EBA recommends that this treatment be continued. But it acknowledges that these rules may be amended in future if a suitable alternative is agreed.

Banks should bulk up on capital

On 8 July 2014, ECOFIN issued a *statement* on addressing bank capital shortfalls on 8 July 2014. It stated that public funds should only be used to recapitalise a failing institution as a last resort. These taxpayer funded rescues

should only occur after all other attempts to salvage the institution have been explored. These measures should include private funding and the 'bailing in' of shareholders and junior bondholders.

ECOFIN also encourages banks that may need capital to take advantage of current favourable market conditions by raising capital now before the EU stress test results are released. This suggestion may be a purely pre-emptive statement rather than foreshadowing potential negative outcomes of the stress tests.

EBA looks at BRRD

The EBA also consulted on this issue in its *draft guidelines on the types of tests, reviews or exercises that may lead to support measures under the BRRD issued on 9 July 2014*. It considers the types of tests and exercises that may lead to a decision to provide such public support, and proposes a timeline and scope of such reviews.

The EBA also suggested that short term injections of capital into banks may be allowed where necessary to remedy a serious disturbance in a member state's economy or to preserve financial stability.

The consultation closed on 9 August 2014.

FPC considering further leverage tools

The FPC launched a consultation on its *review of the leverage ratio* on 11 July 2014. It seeks views on whether or not it should supplement the Basel III leverage ratio with additional leverage requirements, such as:

- A leverage conservation buffer (similar to the existing capital conservation buffer).
- A supplementary leverage requirement for systemically important banks.
- A countercyclical leverage requirement which could be varied over the course of the economic cycle.

The FPC has recommended that HMT take responsibility for overseeing the introduction of any additions to the leverage ratio.

The consultation closed on 14 August 2014.

Competition

FCA reviews wholesale competition

The FCA published *Wholesale sector competition review – call for inputs* on 9 July 2014. One of the FCA's objectives is to promote competition and effective markets. Benchmark activities are not included in this review because they are covered already by the Fair and Effective Financial Markets Review.

The FCA is seeking input into how competition could be improved in market infrastructure, investment banking, asset management and corporate banking. Based on feedback, the FCA plans to take forward a full market study in specific features of these markets. It intends to carry out a market study where it sees most potential harm and the best opportunity to intervene.

The FCA already has identified some competition issues in each sector:

- market infrastructure –trade data not being freely available for all market participants and market access issues.
- investment banking – bundling and cross-selling of services leading to lack of competition
- asset management –have little incentive to seek competitive prices because they often use their investors' cash to pay for services
- corporate banking –high barriers to entry.

The call for input closes on **9 October 2014**.

Conduct

Making senior managers more accountable

The FCA and PRA jointly consulted on *Strengthening accountability in banking: a new regulatory framework for individuals* on 30 July 2014. The PCBS recommended a new framework for regulating banking approved persons, a "senior persons" regime. The regulators introduce this proposal as a Senior Managers and Certification (SMAC) regime with Conduct Rules:

- Senior Managers Regime (SMR) - senior individuals with specific allocated 'Senior Management Functions' whom the regulators will pre-approve
- Certification Regime (CR) - firms will need to annually assess and certify individuals who could pose significant risk to a firm or customers
- Conduct Rules - new rules replacing the Statement of Principle and Approved Person Code which are applicable to all staff, except a few specific roles such as security, catering and cleaning staff.

The proposals do not generally apply to incoming EEA branches, although some non-EEA branches will be caught after the FSMA definition of an 'authorised relevant person' definition is amended. Insurers and FCA-only regulated firms are not in scope. So a financial adviser in an insurer will be subject to a different approval regime to a retail bank's financial adviser.

The SMR will see all Board, Executive Committee members and heads of key business areas caught - subject to quantitative criteria. Individuals in parents or groups who exert significant influence will also be in scope. Senior Managers with relevant existing Controlled Functions will be grandfathered into SMR.

The CR will capture staff who can pose a risk of significant harm to the firm or its customers. Client-facing staff subject to qualification requirements (financial advisers and mortgage advisers) and other significant influence functions not explicitly caught by the SMR (such as benchmark setters) will also be in scope. Firms will have to annually assess and reconfirm fitness and propriety of these individuals.

The consultation closes on **31 October 2014**. The regulators expect to publish final rules by the end of the year with implementation six months later.

Consumer protection

Stay away from virtual currencies

The EBA published its *Opinion on virtual currencies* on 4 July 2014. It advised national supervisors to "discourage financial institutions from buying, holding or selling virtual currencies" until an adequate regulatory regime is in place. This opinion follows a similar *warning* that the EBA issued to consumers on the dangers of virtual currencies on 13 December 2013.

The EBA identified more than 70 risks across several categories associated with virtual currencies, including risks for users and market participants, risks related to financial integrity (e.g. money laundering) and risks for existing payments in conventional (so-called fiat) currencies. Many of these risks are driven by the anonymity associated with creating virtual currencies.

The EBA believes that the EU will need a substantial body of regulation to address these risks. In particular, the EU's regulatory approach would need to cover governance requirements for several types of market participants, client account segregation, capital requirements and the creation of "scheme governing authorities" accountable for the integrity of a particular virtual currency scheme and its key components, including its protocol and transaction ledger.

Firms reminded to respect customers

On 31 July 2014, the JCESA reminded financial institutions of their *responsibilities when placing their own financial products with consumers*. It wants to ensure firms comply with rules governing conflicts of interest, remuneration, advice, suitability and appropriateness. Firms are required to respect consumer needs and demands, as well as providing investors and customers with appropriate information.

The JCESA concedes that banks and insurers are under pressure to meet the ongoing and impending capital requirements of CRD IV, Solvency II, BRRD, the comprehensive assessment and other regulations. But it stressed that firms should not use this pressure as a rationale to mis-sell financial products to consumers, particularly retail consumers, investors and policy holders.

Firms have been selling instruments to investors that will subject them to first losses during distress. The JCESA feels the complexity, heterogeneity and untested nature of contingent capital and bail-in instruments make them unsuitable for retail investors. It found the combination of these product characteristics and poor governance around sales practices has led to unsuitable sales and consumer detriment.

The JCESA reminds firms of their MiFID obligations on conflicts of interest, remuneration, client information, providing investment advice, suitability and appropriateness and product governance. It also considers the future impact of MiFID II on firms, implying that firms should take note of these changing requirements. In its draft technical advice on MiFID II, ESMA aims to persuade firms to effectively manage and avoid conflicts of interest. It proposes more tailored requirements specific to conflicts of interest management, including the placing of own instruments (or instruments issued by other entities of the group). Under the proposals, firms which place their own instruments with consumers must have clear procedures for identifying and managing potential conflicts of interest.

ESMA warns about retail CoCos

ESMA published a statement on *Potential Risks Associated with Investing in Contingent Convertible Instruments* on 31 July 2014.

CoCos are automatic bail-in hybrid debt securities which have grown in prominence and popularity since the financial crisis. They are highly complex and each issue will have different terms for trigger levels for conversion, necessary capital buffer levels and loss absorption mechanisms.

ESMA considers that CoCos may not be appropriate for retail investors because they require "a sophisticated level of financial literacy and a high risk appetite". They are also concerned that institutional investors are not fully

aware of the CoCos' risks (e.g. trigger, coupon cancellation, capital structure inversion, call extension risk). It fears consumers aren't correctly factoring those risks into their valuations.

In August, the FCA subsequently used its temporary product intervention powers for the first time, to ban the distribution CoCos in the UK to retail investors from 1 October 2014. The FCA plans to introduce changes to its Handbook over the next year to formalise this ban. The ban does not extend to execution only, so retail investors can still access CoCos this way.

Regulator turns innovator

On 11 July 2014 the FCA issued *Project Innovate: a call for input*. Project Innovate is the FCA's initiative designed to help both start-ups and established businesses launch innovative new products and services.

The FCA will build an 'Incubator' to see applicants through the authorisations process and an Innovation Hub providing a dedicated contact for existing firms. The Hub will also work with existing businesses with innovative ideas, using the FCA's expertise to understand whether or not their innovation is compatible with our existing regulation. The Hub and Incubator will allow firms to discuss new ideas with the FCA pre-launch, to identify any regulatory issues that may exist and deal with these issues before they crystallise and cause consumer detriment. They will also help firms get better clarity on FCA's expectations before launching particular new products or services to avoid an expectation gap.

The consultation closed on **5 September 2014**. The FCA expects to publish its plans for Project Innovate in autumn 2014.

Consumers spoilt by choice?

The FCA published the findings of *TR14/11 – price comparison websites (PCWs) in the general insurance sector* on 16 July 2014. The FCA wanted to understand how consumers used PCWs. It focused on general insurance products such as private motor, home and travel insurance. The FCA found a lack of clarity and consistency in the information provided to customers by PCWs and a lack of transparency around the role played by PCWs. A number of PCWs had also failed to implement the FSA's 2011 *guidance* which suggested areas around the regulatory perimeter that PCWs should focus on, to ensure they are not breaching the RAO.

The FCA recommended that PCWs note EIOPA's report on *Good Practices on Comparison Websites* issued earlier this year. The FCA plans to check on PCW's progress towards implementing its and EIOPA's guidance by the end of the year.

CRAs

Harmonising CRA reporting

ESMA published draft guidelines on *Periodic information to be submitted to ESMA by Credit Rating Agencies* on 16 July 2014. The draft guidelines cover:

- Harmonising the level of detail in CRA's periodic submissions
- What constitutes a material change to the conditions of initial registration
- The information that CRA should provide provided to ensure a more accurate and appropriate calculation and allocation of supervisory fees
- CRAs providing their financial accounts for the full calendar year to help ESMA calculate their market share.

The consultation closes on **31 October 2014**. ESMA intends to publish a final report in early 2015.

Raising sovereign debt standards

ESMA published *Technical Advice in accordance with Article 39(b) 2 of the CRA Regulation regarding the appropriateness of the development of a European creditworthiness assessment for sovereign debt* on 18 July 2014. ESMA identifies best practice conditions for robust sovereign debt ratings:

- Rating process independence (including the annual review of rating methodologies).
- Independent review function.
- Confidentiality of all rating sensitive information.
- Sufficient resources at CRAs to conduct both a rigorous rating process and ongoing monitoring.

ESMA also provides information on the market for sovereign debt ratings in the EU, which amounted to an aggregate of €9.2 trillion of debt outstanding by end of 2013. The EC plans to submit a report to the Council and the EP setting out whether it believes it is appropriate to develop an EU creditworthiness assessment for sovereign debt by the end of 2014.

Financial conglomerates

Regulators' propose group risk tools

The ESAs published a *joint consultation paper on draft RTS on risk concentration and intra-group transactions within financial conglomerates* on 24 July 2014. The ESAs are required to produce these RTS under the FICOD 1 Directive.

The RTS sets out definitions and examples of risk concentration and

intra-group transactions. Where a firm has a large volume of such transactions, the ESAs proposed that regulators should have the power to require it to enhance its internal controls and monitoring processes to manage the increased risk.

The consultation runs until 24 October.

EBA sets O-SII thresholds

The EBA consulted on *Guidelines on the criteria to determine the conditions of CRD IV in relation to the assessment of other systemically important institutions (O-SIIs)* on 18 July 2014. The Guidelines set out a series of indicators against which regulators must score firms which are not already designated as G-SIBs. If a firm exceeds a certain score it will be designated an O-SII. The indicators include:

- asset value
- total loans
- total deposits
- size of OTC derivative business
- scale of involvement in interbank lending.

In borderline cases, regulators are allowed some flexibility to move a firm into or out of the O-SII category.

The consultation closes on **18 October 2014.**

Financial crime

More AML work needed

The FCA published its *Anti-Money Laundering Annual Report 2013/14* on 10 July 2014. The FCA's dedicated whistleblowing unit has increased to 5 employees.

Over the past year the FCA found that wealth managers and private banks performed better than retail and wholesale banks on AML issues. It is currently half-way through an AML review of 14 major retail and international banks in the UK and has so far found:

- inadequate governance and oversight of money laundering risk
- inadequate risk assessment processes to identify high risk customers
- poor management of higher risk customers and politically exposed persons
- inadequate due diligence on correspondent banks
- inadequate AML sanctions related IT systems
- weaknesses in trading alerts relating to sanctions and/or transaction reporting
- poor judgements or questionable decisions leading firms to take an unacceptable money laundering risk.

The review suggests large banks must undertake substantial work to review their AML frameworks and address any shortcomings. The FCA might refer firms with significant failings to enforcement for further action.

The FCA also identifies two risks it will be closely monitoring - virtual/digital currencies (e.g. bitcoin) and mobile banking.

Firms will face a new regulatory process for AML later this year when the fourth Money Laundering Directive is implemented in the UK.

FX criminal investigation

On 21 July 2014, the SFO announced it has opened a *criminal investigation* into allegations of fraudulent conduct in the foreign exchange market. It didn't include any information regarding the allegations or scope of the investigation in the announcement.

The FCA has also been conducting an investigation into a number of firms relating to trading on the foreign exchange market since October 2013, working alongside several international agencies.

Market infrastructure

Setting penalties for settlement failure

On 23 June 2014, the EC sent ESMA a *letter* requesting technical advice on delegated acts under CSDR.

The EC attached *two formal mandates* for technical advice. The first mandate addressed penalties for settlement failure. CSRD provides a set of strict measures to address settlement failures. The EC is required to specify the parameters for the calculation of a "deterrent and proportionate level" of cash penalties for settlement fails.

The second mandate covers supervisory cooperation. CSDR provides for various co-operation measures between home and host member states. Formal cooperation arrangements between supervisors must be in place where a central securities depository's activities become "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host member state. EC is seeking ESMA's advice on the meaning of "substantial importance".

The EC request is provisional, given that CSDR has not yet been published in the Official Journal, but the EC wanted to give ESMA sufficient time to prepare its advice.

SEPA goes live

On 1 August 2014, the SEPA *became fully operational*, signalling a major milestone in the journey towards harmonised euro payments.

SEPA creates a true EU Single Market for retail payments in euro where transfers, direct debits and payments between Member States are as easy and fast as the equivalent domestic transactions. Commenting on the milestone, Commissioner Barnier said that "faster and safer transfers between bank accounts in the euro area will benefit the European economies at large."

Overseeing payment systems

The EU published the *ECB Regulation on oversight requirements for systemically important payment systems (SIPS)* on 3 July 2014. This Regulation defines criteria for identifying SIPS. The ECB plans to publish a list of SIPS in due course.

The Regulation applies the CPSS-IOSCO principles to EU oversight of SIPS, which cover:

- legal soundness
- governance
- risk assessment framework for credit, liquidity, business, custody, investment, operational and principal risks
- collateral acceptance rules
- access and participation criteria
- efficiency and effectiveness measurement criteria.

The Regulation entered into force on 23 July 2014.

Best execution needs to improve

The FCA published *TR14/13: best execution and payment for order flow* on 31 July 2014. It visited 36 firms from across financial services (including retail and investment banks, wealth managers and brokers) to identify whether or not they follow the FCA's best execution rules and have embedded the FSA's guidance (FG12/13) to not pay for order flow.

The results were not encouraging. On best execution the FCA found poor practice where firms relied on market competition (i.e. that their clients would move to a rival if they felt they were not getting best execution on orders) rather than specifically following FCA rules. In particular the FCA found issues with:

- scope – firms were unsure which of their activities were caught by the best execution rules
- monitoring – firms lacked effective monitoring of their compliance with the rules and did not report through management information
- internalisation – firms that predominantly used other internal companies to place trades were unable to demonstrate how they ensured that they delivered best execution and managed conflicts of interest
- accountability - in some firms it was unclear who was accountable for ensuring that the firm met its internal policies and FCA rules on best execution.

On payment for order flow, the FCA found some firms were still making payments, despite it having stated in FG12/13 that these payments were unlikely to be compatible with its inducement and best execution rules. Some firms changed the terms of these payments after receiving the information request. The FCA still believes that these firms aren't meeting its expectations and didn't rule out enforcement action for continued rule breaches.

The FCA recommends that all firms placing and broking trades review their policies to ensure that they meet FCA rules – and consider how MiFID II might impact these policies.

Other regulatory

Fresh start to finalising reforms

On 2 July 2014, the Italian Presidency of the Council published *Europe: a Fresh Start. Programme of the Italian Presidency of the Council of the European Union 1 July to 31 December 2014*.

The Presidency will oversee the smooth to SSM in November 2014, including establishing the single resolution board, and having participating Member States ratify the related Intergovernmental Agreement.

The Presidency plans to manage the Council's response to the comprehensive balance sheet assessment (which includes the asset quality review and stress tests) and any subsequent actions (if necessary) in November. It is also working towards finalising proposed Regulations on:

- European Long-Term Investment Funds
- MMFs
- benchmarks.

The Presidency intends give "special focus" to updating the current regulatory framework for payment systems and push forward negotiations on the revision of IMD and AML3. It also plans to progress structural reforms proposals to reduce the interconnectedness of institutions that are "too big to fail" with a view to improving prudential safeguards and reducing the possibility of using public funds to bail-out troubled banks.

Financial institutions will also have to keep their eye on the progress of cross-sectoral data protection and cybersecurity rules. For example, the Presidency plans to finalise the EC's Directive on Cybersecurity which aims to enhance network and information security across the EU and cyber-security preparedness and capabilities at national level.

The next six months promise to be a busy and challenging time for the Council, particularly with the new MEPs only just starting their new roles and changes at the top of the EC.

ESRB reflect on last year

The ESRB published its *Annual Report 2013* on 21 July 2014. It compared its 2013 work against five intermediate objectives (prevention and mitigation of systemic risks arising from excess leverage, market illiquidity, exposure concentrations, moral hazard and financial infrastructures).

To meet its objectives, the ESRB established a new macroprudential policy framework for Europe. In March 2014, the ESRB published its principles for the use of this new macroprudential framework in its report on *Macro-prudential Policy in the Banking Sector* and handbook on *Operationalising Macro-prudential Policy in the Banking Sector*.

Examining the UK's relationship with EU

HMT published the full outcome of the *Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market: Financial Services and the Free Movement of Capital* on 22 July 2014. The report reflects evidence submitted by 68 experts, non-governmental organisations, businesses, Members of Parliament and other interested parties (excluding oral evidence), following a *Call for Evidence* in October 2013. It forms part of the Government's wider two year review of the UK's participation in the EU.

HMT found that market participants believe that the UK's membership of the Single Market provides significant benefits for the UK financial services industry and consumers. But most respondents felt that "significant reform of the existing EU policy-making processes and framework" is required. In particular, they criticised the type, volume and pace of legislation experienced in the last five years and the quality of consultations, impact assessments and drafting of rules. HMT called on the EU to take a "proportionate approach to legislation in all subsectors, and give greater consideration to the principle of subsidiarity in retail market sectors".

PRA needs more money

The PRA increased this year's annual funding requirement by nearly 4% to £247m in *PS64/14- Regulated fees and levies: rates for 2014/15* on 2 July 2014. The fee provides for the PRA's ongoing budgetary activities (£232m) and the remaining costs incurred by the BoE in creating the PRA (£15m).

The PRA has increased its requirement to:

- Allocate greater numbers of front line staff to supervise insurance
- Expand the PRA's remit in relation to specific new policy initiatives
- Enhance the scope of work or perform it to a shortened timescale.

The PRA spent £23m less than its budget for 2013/14 and this will be refunded to firms that contributed to the original budget. New entrants in 2014/15 will no longer benefit from any underspend in the previous year.

...and so does the FCA

The FCA increased their funding requirement by 3% to £446m *PS14/11: FCA Regulated Fees and Levies* on 3 July 2014. This increase is due to the FCA spending more than expected last year, so having less money to refund to fee-payers and driving up its cost expectations for 2014/15 (£10m was returned to firms in 2014/15 compared to £19.5m in 2013/14).

The FCA's Ongoing Regulatory Activity (ORA) Budget which increased from £445.7m in 2013/14 to £452.0m in 2014/15, an increase of 1.4%, accounted for the remainder. The FCA believes the budget increase is necessary for the new competition team to deliver the FCA's competition objective.

FOS' funding remains the same for 2014/15 (at £23.3m), which will be collected through the general levy. MAS requires £81m for 2014/15 (£3m less than 2013/14) which it will collect from two separate levies - £43m for delivering money advice and £38m for coordinating and providing debt advice.

FCA progress report

The FCA published its *Annual Report 2013/14* on 10 July 2014, reflecting on its first year in operation, highlighting successes and identifying challenges for the year ahead. Overall, it believes that it has made a solid start. It argues that, by putting conduct on the map, it has gone a long way towards helping firms understand what it means to put the consumer at the heart of their thinking.

In the Report, the FCA identifies some initiatives as highlights of its first year including:

- publishing studies on behavioural economics

- warning consumers on interest-only mortgages
- announcing a redress package for mis-sold card protection
- reaching agreement on the retry system for banks.

The FCA says it has paid much more attention to culture in firms and how they establish and run themselves. It suggests that over the last year, firms' boards have made improvements, e.g. on remuneration. But the FCA now wishes to see this change filter down to all individuals in firms.

Looking ahead to the coming year, the FCA identifies implementing the PCBS' recommendations as an important challenge, particularly changes to the personal accountability of the most senior individuals in banking.

Industry happier with FCA

The FCA Practitioner Panel published its *Annual Survey of Regulated Firms* on 15 July 2014. In total 3,146 firms participated in the survey, representing 32% of all firms. Respondents felt that the FCA is more effective and has improved its relationship with firms compared to the FSA. But they had concerns about the FCA's ability to achieve its statutory objective of promoting competition in the interests of consumers.

Many firms called for a period of stability to allow them to implement existing regulatory initiatives, warning that the burden of regulation is too high.

New FCA application process

The FCA published details about its new application tool – *Connect* - on 16 July 2014. From 1 October 2014 Connect will replace the existing Online Notifications and Applications system (ONA) for all applications relating to:

- approved persons
- appointed representatives
- variations of permissions
- cancellations
- standing data.

FCA plans to release more information on Connect, and the process for ongoing applications, in due course.

Taking stock of EU reform

The House of Lords EU Sub-Committee on Economic and Financial Affairs *launched* an inquiry into the EU financial regulatory framework on 16 July 2014, with a view to assessing whether it is sufficiently robust to prevent future financial crises.

The inquiry will look at:

- Effectiveness of post-crisis reforms
- Strength and weaknesses of the institutional structure
- Degree of EU harmonisation
- Inconsistencies between regulation of the Eurozone and the wider EU.

The Committee started taking oral evidence in late July. The consultation closes on **30 September 2014.**

No cash for whistleblowers

On 30 July 2014, the FCA confirmed that it will not introduce *financial incentives for whistleblowers*. It researched the impact of financial incentives on whistleblowing and found that introducing these rewards would probably not increase the number or quality of disclosures.

The FCA also felt that such rewards could create perverse incentives and introduce moral hazard into disclosure and enforcement cases. Instead it plans to require firms to have effective whistleblowing procedures in place and to make senior management accountable for meeting this requirement.

Pensions

EIOPA reviews IORP developments

EIOPA published its *2014 Report on Cross Border IORP Market Developments* on 10 July 2014. This report gives a brief overview of the European occupational pensions landscape and developments in IORPs' cross-border arrangements, particularly after the IORP Directive was implemented.

Pensions Regulator publishes annual report

The Pensions Regulator published its *Annual report and accounts for 2013 - 2014* on 10 July 2014. The annual report and accounts details the regulator's work in 2013/14 including:

- Automatic enrolment
- Reducing risks to defined benefit scheme members
- Improving outcomes for defined contribution scheme members
- Improving governance and administration.

Next year it expects to focus on dealing with ongoing pension developments driven by new government policy.

SIPP providers have work to do

The FCA *wrote* to the CEOs of SIPP providers on 21 July 2014, warning them to take notice of the FCA's recent thematic review and guidance. The FCA specifically requested that firms using non-standard investment business ensure that the firm's capital position is accurately reported.

The FCA indicated that further enforcement action may follow against

firms who fail to meet their expectations.

Pension transfers review

The FCA published *TR14/12 Enhanced transfer value (ETV) pension transfers* on 21 July 2014. The FCA identified poor practice by some firms advising on enhanced pension transfers and signalled that it intends to take enforcement action against the worst offenders. Of the 300 ETV cases reviewed, it found that firms gave unsuitable advice in a third of them, with disclosure failings in 74% of cases. Firms must now review cases, contact customers and pay redress where appropriate.

The FCA also sees heightened risk in the defined benefit pension transfer sector following the recent pension liberalisation. In particular it believes that firms might take advantage of the increased possibility for pensioners to transfer their pension to cash. It plans to keep an eye on this in the coming months.

Pension guidance guarantee

The FCA issued *CP14/11 Retirement reforms and the Guidance Guarantee* on 21 July 2014. It has a formal role in delivering the 'Guidance Guarantee' prescribed in the 2014 Budget – the promise that all defined contribution pension holders will receive free impartial guidance at retirement. The FCA intends to set standards for delivery partners, maintain and monitor compliance with the standards and collect the levy.

The FCA sets out its proposed delivery standards, and possible methods of allocation and collection of the levy across the financial services sector. The consultation closes on **22 September 2014.**

RDR

Guidance on simplified advice

On 11 July 2014 the FCA published three retail advice papers:

- ***GC14/3** – retail investment advice: clarifying the boundaries and exploring the barriers to market development*
- ***TR14/10** – developments in the distribution of retail investments: purchasing investments without a personal recommendation or with simplified advice*
- *The motivations, needs and drivers of non-advised investors: a qualitative research project.*

The FCA wants to bridge the expectations gap that it sees in the retail advice market –the gap between what advisers think the FCA expects from them and what the FCA actually expects. It believes advisers think they need to do more than they actually do – which inhibits innovation because they don't want to fall foul of FCA rules. So in GC14/3, the FCA sets out all guidance relating to regulatory advice in one place so firms should be clear what is expected of them. This guidance includes prior guidance from CESR and the FSA which the FCA has adopted.

The FCA also provides a series of examples of different advice models to illustrate when a firm is providing regulated advice (under the RAO) or a personal recommendation (under MiFID):

- using a website with filtering and general generic information – probably not a personal recommendation or RAO regulated advice
- using a website which generally classifies products – not a personal recommendations but probably is RAO regulated advice
- guided simplified sales model – probably a personal recommendation and would be RAO regulated advice.

The FCA's policy on simplified advice models hasn't changed. Many firms will still look to these examples to see where the boundaries lie – to identify where they may be able to avoid providing personal recommendations when using some form of simple model. The FCA is keen for more firms to offer these types of models. It appeals to firms to go through its new "innovation hub" if necessary to get FCA input into any new or innovative models so they can understand the regulator's views early in the project.

In future, the FCA plans to focus on two other areas - giving advisers more confidence to produce shorter disclaimers and how it will help market innovation.

GC14/3 closes for comments on **10 October 2014.**

Remuneration

Increasing remuneration transparency

The EBA published revised Guidelines on the *Remuneration benchmarking exercise* and on the *Data collection exercise regarding high earners* on 16 July 2014. The changes reflect enhanced disclosure requirements in CRD IV and repeal *Guidelines* published on 27 July 2012.

During both exercises, the EBA is looking to conduct more detailed analysis of remuneration trends by asking firms to submit more granular data. In particular, the EBA is seeking additional details about the job responsibilities of high earners and a breakdown of their fixed and variable remuneration.

The Guidelines include new and updated templates for data collection and will apply to the 2013/14 financial year data collection.

Clawing bonuses back

The PRA published *PS7/14: Clawback* on 30 July 2014, its response PCBS recommendation that bankers' variable remuneration should be clawed back if a bank subsequently suffers financial stress. It made three main changes to the proposed policy:

- The minimum period over which banks should be able to recover variable remuneration is now seven years from the date of award rather than six years from the date of vesting or payment of the award.
- Grounds for clawback now exclude a material downturn in financial performance – Which the PRA presumably felt would be too hard to measure and enforce against.
- Clawback applies to awards made after 1 January 2015 instead of applying to awards paid after 1 January 2015.

Banks can still claw back bonuses where they find reasonable evidence of employee misbehaviour or a material risk management failure. So wrongdoing that occurs now could result in bonuses being clawed back in 2022.

The new rules apply to banks, building societies and the PRA's nine designated investment firms. The FCA included equivalent proposals as part of *CP14/14: Strengthening the alignment of risk and reward - the new remuneration rules*. See below for more information.

The clawback rules come into force on 1 January 2015.

PRA and FCA align risk and reward

The PRA and FCA published jointly the Consultation paper *PRA CP15/14 / FCA CP14/14: Strengthening the alignment of risk and reward - the new remuneration rules* on 30 July 2014. The consultation responds to the PCBS recommendations that variable bonuses should be deferred for longer than the three years currently required.

The regulators propose extending the deferral period between the date a bonus is initially awarded and final payment to a minimum of seven years for senior managers and five years for other Remuneration Code staff. They suggest a phased approach to vesting with senior manager awards starting to vest no earlier than three years after the date of the award and no earlier than one year for other Remuneration Code staff.

The FCA's consultation here for its firms mirrors the PRA's rules in PS7/14. Clawback requirements are designed to ensure that variable remuneration paid to Remuneration Code staff can be recouped. The regulators are also consulting on risk adjustment measures where bonus pools are based on regulatory prudent valuation fair values instead of accounting fair values.

The regulators propose some different policy options for dealing with buy-outs - where employees resign from one firm to join another, losing their unvested bonus awards, and are compensated for the lost bonus award by their new firm. This buy-out would effectively insulate an employee from the risk that past awards with the original employer might be clawed back.

The PCBS also recommended that sale-based incentives should be restricted more generally. The FCA intends to revisit financial incentives schemes for sales staff as it implements MiFID II and MiFIR II.

The consultation closes on **31 October 2014.** The PRA and FCA intend that all the new rules will come into force for awards made for performance periods starting on or after 1 January 2015.

RRPs

Resolution planning

On 9 July 2014 the EBA published two consultations relating to the BRRD:

- *draft RTS on resolution planning*
- *draft Guidelines on measures to reduce or remove impediments to resolvability*.

The proposed RTS specify the contents of resolution plans and the criteria on which the resolvability assessment will be based.

For the resolvability assessment, the draft RTS propose a staged approach. First, resolution authorities should assess whether liquidation under normal insolvency procedures is feasible and credible. If not, they should identify a preferred resolution strategy. It may be single-point-of-entry (SPE) or multiple point of entry (MPE). The draft RTS propose criteria to help authorities choose between the two options. For cross-border banks, colleges of supervisors will have to determine whether a bank's resolution plan is workable in the heat of a crisis.

The draft RTS recognise the need for proportionality. Future EBA Guidelines will expand on the BRRD criteria for applying simplified obligations.

The proposed guidelines complement the RTS by setting out the circumstances under which resolution authorities can impose measures to overcome obstacles to resolvability identified by the assessment. They provide additional details on the list of

measures that resolution authorities can take as well as on the circumstances under which authorities can apply the measures.

The guidelines are not meant to favour certain business models or structures but rather to indicate how analyse impediments to resolvability and identify the best way to address them.

The consultations close on **9 October 2014**.

Recovery planning

On 18 July 2014 the EBA published final draft RTS and guidelines in relation to BRRD specifying:

- *the information to include in a recovery plan*
- *the criteria to assess a recovery plan*
- *guidelines providing the range of scenarios to use when testing recovery plans.*

The first set of RTS specifies the information which institutions should include in their recovery plans:

- the summary of the recovery plan
- governance information
- a strategic analysis
- a communication plan
- a description of preparatory measures.

The second set of RTS identifies the principles and criteria which supervisory authorities should follow when assessing the completeness, quality and credibility of recovery plans.

The guidelines specify the range of scenarios which institutions should consider to test the effectiveness and adequacy of their recovery options. At least three scenarios of severe macroeconomic and financial distress should be included to ensure coverage of a system-wide event, an idiosyncratic event and a combination of system-wide and idiosyncratic events. Those scenarios should take into account the specific characteristics of the bank involved, including size and interconnectedness. They should include situations where the bank would be at risk of failing absent recovery measures.

The RTS and guidelines recognise the need for proportionality. Future EBA guidelines will expand on simplified obligations.

Securities and Derivatives

Benefits of T2S

Eurosystem (made up of the ECB and Euro area central banks) promoted its T2S system's collateral management ability in three papers published on 7 July 2014. First, the Eurosystem defines improvements to the repo market to better support *collateral and liquidity management* arrangements. It expects concerns over the efficient management and optimisation of collateral assets to be alleviated in part when firms begin settling through T2S.

Second, Eurosystem suggested improvements to *commercial bank money (CoBM) settlement arrangements* for collateral operations. It explores current settlement practices in CoBM and puts forward recommendations to support better use of collateral, in particular removing structural constraints and inefficiencies in the settlement of collateral operations in CoBM.

Third, Eurosystem published *collateral eligibility and availability*. It finds that the overall supply of high quality assets that may be used as collateral is approximately €41 trillion. But it expects new regulation, such as mandatory central clearing for OTC derivatives, collateral requirements for uncleared derivatives and provisions for high-quality assets under the Basel III LCR, to consume a considerable portion of this amount. Eurosystem insists that T2S will support the mobilisation of collateral across national borders, more efficiently allocating collateral around the EU to mitigate this burden.

Supranational regulators seek market views on securitisation

IOSCO and BCBS issued a *questionnaire* for market participants on developments in securitisation markets on 3 July 2014. Working alongside the IAIS and the IASB, IOSCO and the BCBS will feed the results of the questionnaire into a review of the securitisation markets since the global financial crisis.

The regulators seek views on:

- market developments in securitisation since the crisis
- market and regulatory developments which may be impediments to the development of sustainable securitisation markets
- increasing the participation of non-bank investors in securitisation markets
- the development of simple and transparent securitisation services.

The consultation closed on 25 July 2014.

EMIR clearing mandates published

ESMA published two consultations on 11 July 2014, containing draft RTS which propose the first classes of

interest rate and credit derivatives to be subject to central clearing.

The Clearing Obligation under EMIR (no 1), proposes that the following interest rate derivatives be subject to mandatory clearing:

- basis swaps
- fixed to floating rate swaps
- forward rate agreements
- overnight index swaps.

But ESMA proposes that interest rate derivatives related to covered bond programmes which meet certain conditions would be exempt from clearing requirements.

ESMA also considered applying central clearing requirements to equity derivatives and listed interest rate futures and options contracts, but didn't recommend central clearing for those contracts.

The Clearing Obligation under EMIR (no 2), sets out the case for mandatory clearing of untranched index credit default swaps:

- iTraxx Europe Main
- iTraxx Europe Crossover.

ESMA wants central clearing to be phased in over a three year period, starting six months after the RTS is completed. Contracts with remaining minimum maturities longer than the maturities in the clearing mandates will be subject to clearing under the EMIR "frontloading" requirement. ESMA has created a schedule designed to exclude most contracts opened prior to the date when the relevant RTS comes into force. The remaining minimum maturity for interest rate and credit derivatives opened after an RTS takes effect is six months.

ESMA expects to publish clearing consultations for currency and commodity derivatives in due course.

The consultations close to comments on **18 August 2014** (no 1) and **18 September 2014** (no 2). The first clearing mandates are expected to apply from Q2 or Q3 2015.

EMIR impacts third country entities

ESMA and the EC published new guidance on 10 July 2014 looking at how EMIR applies to non-EU entities. ESMA updated its *EMIR Q&A* to reflect that:

- The EMIR three year clearing exemption for EU regulated pension schemes does not apply to third country pension schemes.
- Third country entities which are clearing members of EMIR authorised CCPs are subject to EMIR segregated and omnibus account rules. The information also clarifies that all clearing members must meet these requirements for third country clients, as well as EU clients.

The EC confirmed this guidance in its updated *EMIR FAQ document*.

Accounting

Enforcement

Aligning accounting enforcement

ESMA published its *Guidelines on enforcement of financial information* on 10 July 2014.

The aim of the guidelines is to strengthen and promote supervisory convergence in existing enforcement practices amongst EU accounting enforcers. The guidelines set out the principles to be followed by accounting enforcers throughout the enforcement process by defining objectives, the characteristics of the enforcers, and some common elements in the enforcement process. The guidelines apply to all national securities regulators and other bodies responsible for enforcing financial information requirements in the EU. In the UK the FCA, as the UK Listing Authority, and the FRC have this responsibility.

The guidelines replace standards on enforcement issued by CESR in 2003 and 2004. After the guidelines are translated, regulators will have two months to confirm to ESMA whether or not they comply or intend to comply with the guidelines by incorporating them into their supervisory practices.

IFRS

IFRS 12 for asset management

In the EU, IFRS 12 (disclosure of interests in other entities) is mandatory for annual financial periods beginning on or after 1 January 2014. See our *practical guide* for an overview. Our new *In depth* publication highlights some of the disclosure requirements of IFRS 12 as they relate to the asset management industry.

IASB issues IFRS 9

The IASB published IFRS 9 - 'Financial instruments' on 24 July 2014. The final version includes requirements on the classification and measurement of financial assets and liabilities. It also includes an expected credit losses model that replaces the incurred loss impairment model.

The new standard is effective from 1 January 2018, subject to EU endorsement, with early application permitted. Our *In brief* publication looks at the details.

Implementation of new revenue standard

The IASB and FASB joint transition resource group met for the first time in July 2014, to look at potential

implementation issues relating to the new revenue standard. In this blog Andrea Allocco, Global Accounting Consulting Services director, considers the group's first discussions, in particular the concerns raised on the identification of principal versus agent for a transaction.

Offsetting financial instruments for financial institutions

The IASB added guidance on the application of the offsetting rules to IAS 32 - 'Financial Instruments: Presentation' for annual periods beginning on or after 1 January 2014. This amendment has prompted many financial institutions to reassess when they offset financial instruments for accounting purposes. Offsetting is a complex area of accounting, where understanding the operational and contractual arrangements is key to arriving at the right conclusion. The recent reassessments have highlighted the extent of these complexities. Our *In depth* publication sets out our views on the main questions we are seeing in practice.

UK GAAP

Amending new UK GAAP

The FRC published *amendments to FRS 101 and FRS 102* on 23 July 2014 to improve the accounting for financial transactions including valuation of debt instruments and hedge accounting. The amendments are effective from 1 January 2015. See our *In brief* publication for details of the changes.

Banking and capital markets

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Regulation

Capital and liquidity

Joint decisions on internal models

The EBA published a consultation paper on *Draft implementing technical standards on joint decisions on prudential requirements in accordance with the CRR* on 3 July 2014. The ITS specify the joint decision processes that national supervisors should undertake when deciding whether or not to grant permissions (i.e. rule waivers) on using the:

- internal-ratings based approach for credit risk
- internal model method for counterparty risk
- advanced measurement approach for operational risk
- internal models for market risk.

The ITS also detail the process for approving material model changes for cross-border CRD IV firms. The consultation closes on 3 October 2014.

Competition

Competition for savings

On 8 July 2014, the FCA published *interim findings* of its cash savings market study, which is looking at whether or not market competition is working well for consumers. So far the FCA has focused on easy access cash accounts and no-term cash ISAs.

It found evidence of competition for cash savings products such as:

- cash ISAs
- fixed-term savings accounts and bonds
- children's savings accounts.

A large number of firms offer cash savings products and some customers do shop around for products, which helps foster competition. Some customers engage in "rate-chasing", swapping products to chase the best rates. But a large number of customers don't products due to perceived difficulties with switching, customer loyalty, convenience and lack of transparency. In general, customers who stay in products for long periods are often disadvantaged because product providers tend to offer better interest rates on newer products. Many customers hold their savings with their personal current account provider, and that those providers generally pay lower interest rates than other providers in the market. The FCA also found that challenger banks face significant hurdles to winning new

business, due to low switching levels and having to pay higher interest rates to attract new customers.

The FCA is considering whether to intervene in the market to ensure that customers receive fair rates and have greater awareness of the availability of products. It has asked for responses to the interim findings by 8 August 2014, and intends to publish its final report and provisional remedies at the end of 2014.

SME banking competition

The FCA published the results of its joint *market study on banking services for SMEs* on 18 July 2014. Alongside the CMA, the FCA has been looking at competition in the SME banking market. The regulators found similar competitive concerns on the demand side to those identified in the retail banking market, namely that firms:

- switch accounts infrequently
- don't shop around for better loan deals
- don't see enough of a difference between providers to warrant a change
- are unaware of alternative sources of finance.

They also found similar supply side competitive concerns, namely little market share outside the four high street banks and significant barriers to entry and expansion for new entrants. Despite these concerns they didn't conclude the market is functioning poorly – less than 20% of SMEs rated their banking service as poor – but suggest that competition is insufficient to drive the best possible outcomes for SMEs.

Consumer credit

Payday loan interest capped

On 15 July 2014, the FCA published *CP14/10: proposals for a price cap on high-cost short-term credit*. The FCA decided to introduce the cap because its research showed that excessive charges for high-cost short-term credit are harming significant numbers of customers. The cap affects all unsecured lending (including peer-to-peer lending), where the APR of the loan is equal to or exceeds 100% and the loan period is for no more than 12 months – or the majority of the amount owed is required to be repaid within this period.

The cap has three components:

- an initial cost cap - for new loans, or loans rolled over, interest and fees must not exceed 0.8% of the amount borrowed
- a £15 limit for late payment fees
- a total cost cap on the amount of the loan so that customers don't ever repay more than 100% of what they borrowed.

The consultation closes on 1 September 2014. The FCA aims to introduce its final rules in January 2015.

Financial stability

HBOS reviews parameters

On 11 July 2014, the FCA and PRA published *detailed Terms of Reference (ToR)* for their joint review into the failure of HBOS plc (HBOS). The regulators want to better understand why HBOS failed, in particular:

- why it failed
- its capital, asset quality and liquidity positions, as well as systemic vulnerabilities during the period
- its management, governance and culture
- how it was supervised.

The regulators will analyse the pre-merger balance sheets of the Bank of Scotland and Halifax in 1998–2001, and examine the quality of the HBOS loan book in 2008, considering what was known before October 2008 and what subsequently came to light. They will also assess the reasonableness of the FSA's enforcement investigations into HBOS' failure. If necessary they will reconsider whether any other former members of HBOS's senior management should be subject to an investigation.

The regulators aim to publish the final report by end 2014.

Mortgages

FCA debates mortgage fairness

The FCA opened a discussion on the *Fairness of changes to mortgage contracts* on 7 July 2014.

The FCA examines the interaction of its Principles for Business with the unfair consumer contract terms legislation, clarifying how the legislation may be applied and where applications differ. While the FCA judges each situation on its own merit, it provides general examples of likely fair and unfair changes to mortgage contracts, such as changes to SVRs or portability criteria. The assessment includes the lender's actions, transparency, communication with clients and the underlying drivers of the proposed change.

The discussion paper closes on **30 September 2014.**

Retail banking

More banks authorised

On 7 July 2014 the PRA and the FCA published *A review of requirements for firms entering into or expanding in the banking sector: one year on*. They found that more firms are discussing the possibility of becoming a bank since

the introduction of a new entrant application process. Firms have been encouraged in part by the regulators' new 'mobilisation system' which allows for a shorter application timeframe (and thus quicker time to launch) with restrictions on certain activities.

Firms welcomed the mobilisation system - Three of the five banks authorised in the last year used this system. The FCA and PRA responded to feedback by clarifying the level of detail required, the scale of new business a firm can undertake during mobilisation and whether or not a firm's IT systems should be complete on authorisation.

The FCA and PRA also identified some further changes to the application process to reflect regulatory change and other user feedback:

- The Financial Resources section of the application pack has been overhauled to include guidance on capital and recovery and resolution to implement CRD IV and BRRD changes.
- The PRA plans to conduct a supervisory review and evaluation process (SREP) for new entrant banks on a yearly basis (rather than at 12, 36 and 60 months post-authorisation as initially proposed).
- Banks identified as small specialist banks need to hold the higher of £1m or €1m rather than €5m. The PRA will review how these banks can increase their capital requirement to meet the €5m after they are authorised.
- The PRA sets a bank's capital requirements using a 12 month projected balance sheet at the point of authorisation. The PRA will use the actual balance sheet for subsequent SREPs.
- The PRA intends to implement NSFR for all banks, including new entrants.

The regulators plan to continue to review the success of their amended approach to new banking entrants.

Securities and Derivatives

Our survey says...

The ECB provided the results and interpretation of its quarterly *survey on credit terms and conditions in euro-denominated securities financing and OTC derivatives markets (SESFOD)* on 10 July 2014. The survey collects information from large banks and dealers active in targeted euro-denominated markets on trends in the credit terms offered in wholesale markets, and provides insights into the main drivers of these trends.

The ECB found that credit terms have remained almost unchanged since its March 2014 survey, though responses differed depending on whether respondents are domiciled in the euro area. It found credit terms for funding collateralised by euro-denominated securities have become less stringent. Only hedge funds reported an increase in financing rates and spreads.

Survey respondents domiciled within the euro area reported continued easing of credit terms offered to banks and dealers, and lower financing rates and spreads for most types of collateral. Respondents outside the euro area reported less favourable credit terms and higher financing rates and spreads for most types of collateral.

Alongside the SESFOD survey the ECB published its *survey guidelines* and the *detailed data series*.

SSM

Exchanging supervisory information under SSM

The EP and Council published a *Decision on the provision to the ECB of supervisory data reported to the national competent authorities by supervised entities pursuant to Commission Implementing Regulation 680/2014* in the Official Journal on 19 July 2014.

The Decision specifies how national supervisors should submit the information that they receive from banks in relation to supervisory reporting under CRR to the ECB. It covers the formats, frequency and timing, and the quality checks that national supervisors should perform before submitting information.

The Decision came into force on 8 August 2014.

Stress testing

Kicking the EU banking tyres

On 17 July 2014, the ECB published its *latest note* on the processes, disclosure schedule and next steps of its comprehensive assessment of EU banks. It outlines how well the asset quality review (AQR) is progressing and how it will use the results from the AQR as the basis for the stress testing exercise.

In October 2014, the ECB plans to disclose the AQR and stress test results in a standardised template for each participating bank. Alongside the stress test results, the ECB expects to publish any capital raising activities undertaken by banks which occurred after the stress test but before the disclosure date. The ECB will request all banks facing a capital shortfall to submit capital plans in November 2014, detailing how they will cover the shortfalls within the foreseen timeframe.

Structural Reform

Ring-fencing banks' pension liability

On 24 July 2014, HMT published a consultation paper *Banking reform: Draft pensions regulations* inviting comments on the draft *Financial Services and Markets Act 2000 (Banking Reform Pensions) Regulations 2014*.

In line with the ICB recommendations, HMT wants to ensure that ring-fenced banks are not liable to group-wide pension schemes. The Banking Reform Pensions Regulations therefore require that ring-fenced banks are not, and cannot become, liable for the pension liabilities of other group entities (except other ring-fenced banks in their group, or wholly owned subsidiaries of ring-fenced banks).

The consultation closes on **15 October 2014.**

Too big to fail

Reviewing the G-SIB framework

On 4 July 2014, the FSB launched two thematic peer reviews on the current supervisory framework and approaches to G-SIFIs.

The FSB has directed the first thematic review to national supervisors, to take stock of how supervisors have changed, or plan to change, their prudential supervisory framework and approach for G-SIBs and D-SIBs.

In the second thematic review, the FSB is seeking to identify what G-SIBs view as the changes that have been the most and least effective in:

- influencing their risk behaviour
- enhancing risk governance
- supporting their resilience to financial shocks.

As part of the review, the FSB is also seeking feedback from other financial institutions, industry associations and stakeholders on the topics covered in both questionnaires. The consultation closes on **12 September 2014**. It expects to publish a draft report outlining the key findings from the review in early 2015. The FSB then plans to co-ordinate with standard-setting bodies to develop policy recommendations in areas where challenges and obstacles remain.

Asset management

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Regulation

AIFMD

AIFMD transitional period ends

The one year transitional period ended on 22 July 2014. From that date forward all EU AIFMs must act within all relevant AIFMD requirements, even if they are still waiting for formal authorisation from their regulator.

The FCA marked this date with an *update* to its website. This marks the end of a busy application period for the FCA – which received 1,130 AIFMD applications from UK firms. 644 were approved by 22 July 2014, leaving these firms free to make use of the AIFMD marketing passport. Those firms still waiting authorisation may now find cross-border marketing more of a challenge.

For non-EU managers and funds 22 July also marked an important deadline. They must now deal with local AIFMD private placement regimes and the challenges of understanding how these differ from one to another. Some will look ahead to the introduction of the passport for authorised non-EU AIFMs (potentially as soon as 2015, though more likely to be 2016) as a time when they can again ramp up their European fundraising.

The AIFMD challenges don't end here. Most managers will report to their local regulators for the first time at the end of January 2015, and they have yet to get to grips with all the intricacies of the reporting templates. And managers will need to embed their new AIFMD controls and processes in business as usual activities.

See our *blog* for more AIFMD insights.

More AIFMD clarity

ESMA published an updated *Q&A: application of the AIFMD* on 21 July 2014. The updated Q&A provides more information on:

- regulatory reporting – particularly deep line-by-line questions for completing the templates
- cash monitoring – depositaries do not need to carry out cash monitoring on an AIF's underlying investments and cannot delegate this function

- oversight – depositaries need only confirm AIFMs and AIFs comply with applicable rules, not (for example) local labour law
- custody – generally holdings in collective investment undertakings should be held in custody by the depositary (or its delegate)
- private equity – AIFs do not need to include debt raised by non-listed companies when calculating their exposure, unless the debt exposes the AIF to potential losses beyond its investment.

The Q&A is a useful guide for firms to identify how ESMA, and local regulators, will interpret AIFMD.

Retail products

UCITS changes for EMIR

ESMA published *Discussion paper: Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations* on 22 July 2014. The UCITS Directive requires UCITS managers to limit counterparty risk exposure for OTC derivative transactions and some exchange-traded derivatives contracts to 5% of scheme property (increased to 10% where the counterparty is a credit institution).

ESMA proposes some changes to these counterparty risk limits for OTC derivatives centrally cleared through a CCP. It suggests different approaches depending on a CCP's segregation method:

- Individual client segregation – because the UCITS' position is segregated from other clients, it bears no counterparty risk. ESMA therefore believes the counterparty risk limits could be relaxed. Omnibus client segregation –where the UCITS' assets are grouped with other CCP clients, ESMA believes this carries more risk of counterparty failure because its own assets are not segregated. So ESMA suggests that the existing counterparty risk exposures should be used in this case.
- Other segregation arrangement – ESMA has seen CCPs using different methods within individual or client segregation arrangements. It proposes applying some counterparty risk limits here, consistent with the capital treatment of a bank's CCP exposure.

If a UCITS enters into an OTC arrangement through a non-EU CCP, then ESMA suggests that the existing limits should apply. This approach reflects the higher risk to which the UCITS is exposed because the CCP might not be required to fulfil the same standards as an EU CCP.

ESMA sees any indirect clearing arrangements as equivalent to the direct clearing models, so it propose using the same risk limits as for the individual and omnibus segregation models.

The discussion paper closes for comments on **22 October 2014.**

Tax

Widening tax reliefs

HMT and HMRC jointly opened a consultation on *tax-advantaged venture capital schemes* on 10th July 2014. Over the last 20 years HMT has launched Enterprise Investment Schemes (EIS), Venture Capital Trusts (VCT) and, since 2012, Seed Enterprise Investment Schemes (SEIS), each of which gives investors income and capital gains tax reliefs thereby encouraging investment in small and medium-sized enterprises that might not get other investment.

In Budget 2012 HMT announced changes to EIS and VCTs to ensure they were continuing to make financing available to suitable companies and that investors were appropriately incentivised to invest through them. HMT is using this consultation (as per its Budget 2014 announcement) to check whether those 2012 changes have worked, and whether it could make other changes to improve the EIS, SEIS and VCT regimes. Possible changes include:

- making more information available to retail investors on the tax reliefs available
- allowing the funds to invest through convertible loans
- introducing a more principled approach to reduce investments into lower-risk companies which might receive outside funding already, for example through government support.

The consultation closes on **19 September 2014.**

Insurance

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Regulation

Solvency II

Consolidated Solvency II available

The Omnibus II Directive (*Directive 2014/51/EU*) entered into force on 23 May 2014.An updated version of the Solvency II *consolidated text* was published in July 2014, including the Omnibus II changes.

Assessing capital assumptions

EIOPA published *Underlying Assumptions in the standard formula for the solvency capital requirement (SCR) calculations* on 31 July 2014. This paper adds to EIOPA's Solvency II Preparatory Guidelines on the forward looking assessment of own risks (FLAOR). EIOPA published this paper to help firms understand which risks are included within the SCR and areas where the standard formula does not reflect their risk. It gives firms additional guidance on:

- The assumptions on which the SCR is based.
- Assessing the deviation of their own risk profile from these assumptions.

Firms are required to complete this deviation assessment as part of their FLAOR from 2015 onwards. The SCR standard formula is designed to capture the material quantifiable risks facing most insurers but is unlikely to cover all material risks for a particular firm.

EIOPA issues July updates

In July 2014, EIOPA published updates to its insurance stress test 2014 *Q&As and reporting templates, as well as Q&As on the technical specifications.* These documents provide corrections and clarifications on the existing publications.

PRA Solvency II update

The PRA confirmed that insurers have made *significant progress towards complying with Solvency II* on 25 July 2014. It provided an update on:

- Group own fund availability - Including new guidance on the standard of evidence needed, use of third country and non-insurance own funds at group level.
- Group level limits – Looking at how firms make assumptions on capital tiering limits and preparing the required group capital calculations.

- Deferred tax – Insurers may face significant impacts on their own fund calculations through the loss absorbing capacity of the deferred tax effect on the calculation of own funds.
- The matching adjustment – In particular the common questions they've received on mismatching, diversification benefit and asset eligibility
- Pension schemes - Many firms are currently considering how they treat pension risk under Solvency II.

Some uncertainties remain for Solvency II, including the Level 2 delegated acts and EIOPA's final guidelines, so firms cannot yet comply with many of the new requirements. The PRA plans to consult further on implementing Solvency II in August 2014.

Life insurance and Solvency II

On 15 July 2014, Gabriel Bernardino, EIOPA chairman, spoke about *The future of life insurance, Solvency II and investment strategies.* Bernardino focused on:

- The current state of Solvency II implementation, including EIOPA's regulatory and supervisory initiatives
- The future of life insurance business and the link to investment strategies in a new economic environment.

He warns insurers that a robust risk assessment is essential when searching for better yields in a prolonged period of low interest rates, and that they must ensure that they are managing assets in the best interest of their clients. Mirroring similar views from ESMA, EIOPA will be focusing closely on insurers' investments in CoCos and the possible increase of interconnectedness in the financial market.

Where to go for more information

Read more about Solvency II UK on our webpages at *www.pwc.co.uk/solvencyII*

International developments

G-SIIs' capital needs

The IAIS consulted for a second time on *basic capital requirements (BCR) for G-SIIs* on 9 July 2014. In its first consultation the IAIS sought feedback on designing the BCR. Here the IAIS is seeking input on a specific proposal to facilitate the final design and calibration of the BCR before it is delivered to the G20 summit in November 2014.

The IAIS is proposing that the BCR should be calculated on a consolidated group-wide basis, with all holding companies, insurance legal entities, banking legal entities and any other service companies included in the consolidation. The BCR has been developed to reflect major categories of risks impacting G-SIIs' business and to account for on- and off-balance-sheet exposures. It will be made up of:

- Insurance component
- Banking component applying the Basel III leverage ratio or risk weights
- Non-insurance component capturing other activities not currently subject to regulatory capital requirements.

The consultation provides an opportunity for the industry to comment on a specific BCR proposal based on an illustrative calibration level. IAIS will determine the actual calibration, after further analysis in July and August of information collected from field testing volunteers.

Developing the BCR is the first step towards applying group-wide global capital standards. Next the IAIS needs to develop G-SIIs' Higher Loss Absorbency (HLA), due to be completed by the end of 2015. The HLA will build on the BCR and address additional capital requirements for G-SIIs, reflecting their systemic importance in the international financial system. The third step will be the development of a risk based group-wide global insurance capital standard (ICS), due to be completed by the end of 2016. Internationally Active Insurance Groups (IAIGs) will have to apply that standard from 2019.

The consultation closed on 8 August 2014.

Stressing insurers

The IMF published *Macroprudential Solvency Stress Testing of the Insurance Sector* on 22 July 2014. This paper reviews current solvency stress tests for insurance based on a comparative review of national practices and the experiences from IMF's Financial Sector Assessment Program with the aim of providing practical guidelines.

The IMF recommends that national supervisory authorities move towards a more integrated stress testing approach, ideally based on a common framework for banking and insurance stress testing.

EU/US insurance strategy announced

The Steering Committee on the EU-US Insurance Project published an updated strategy, '*The new Way Forward document*' on 23 July 2014. The updated strategy includes new initiatives and prepares the way for the future negotiation of a reinsurance bilateral between the two parties.

UK developments

Reforming insurance contract law

On 17 July 2014, the Law Commission of England and Wales and the Scottish Law Commission (the Law Commissions) published a joint report and draft bill, *Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late* Payment. The Bill aims to reform insurance contract law in:

- The duty on a business policyholder to give information to the insurer before taking out insurance (referred to as 'fair presentation')
- Insurance warranties
- The insurer's remedies for fraudulent claims
- Damages for late payment of claims.

The Law Commissions started this project to reform insurance contract law in January 2006, splitting it into two phases on account of its size. The first phase considered pre-contract issues and resulted in the implementation of the Consumer Insurance (Disclosure and Representations) Act 2012 on 6 April 2013. This second phase concerns post-contract issues. The Law Commissions intend to publish a third and final report in 2015 looking at insurable interest, the broker's liability for premiums and the requirement for a formal marine policy.

Studying investment allocation behaviour

The BoE published a discussion paper to stimulate debate on *'Procyclicality and structural trends in investment allocation by insurance companies and pension funds'* on 31 July 2014. The BoE reported the results of its study into how life insurance companies and pension funds manage investments for people.

The study found that a combination of factors influenced life insurers and pension funds when choosing investments, and that they had a tendency to invest procyclically. The BoE defined procyclical investment as investing:

- in the short term, in a way that intensifies market movements and adds to asset price volatility
- in the medium term, in line with asset price and economic cycles, so that willingness to bear risk diminishes in periods of stress and increases in upturns.

The BoE observed that factors influencing investors included the underlying structure of liabilities, regulation, industry practices, and accounting and valuation methods. The BoE concluded that policymakers should consider the overall impact of regulatory and industry trends on financial stability and the macro economy to avoid serious consequences for the economy.

Other regulatory

Studying investment allocation behaviour

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Accounting

IFRS

Insurance Contracts project update

In July 2014, the IASB continued its discussions on the 2013 Exposure Draft Insurance Contracts (the 2013 ED). See our *Insurance alert - IASB meeting on 22 July 2014* for a summary of the tentative decisions from the meeting and preliminary discussion on contracts with participating features.

At this meeting, the IASB continued to discuss insurance contracts with participating features. In particular the Board discussed the work required if insurers use the effective interest rate method for presentation of interest expense in profit or loss. For contracts without a participating feature, the IASB decided to retain its 2013 proposal to apply the discount rate that applied at initial recognition of an insurance contract for the accretion of interest on the contractual service margin and calculation of amounts that offset that margin.

The IASB also decided to adopt an accounting policy on recognizing changes in discount rate in either profit or loss or other comprehensive income, according to the requirements in IAS 8 for accounting policy changes, without any modifications. This outcome means that such a change will need to be applied retrospectively.

Monthly calendar

Open consultations

Closing date for responses	Paper	Institution
18/08/14	*Consultation paper Clearing Obligation no1 IRS*	*ESMA*
22/08/14	*Recovering the costs of administering the regulatory gateway through application fees*	*FCA*
26/08/14	*EBA consults on technical standards on the permanent and temporary uses of the IRB approach*	*EBA*
27/08/14	*EBA consults on RTS on counter cyclical buffer disclosure*	*EBA*
29/08/14	*EIOPA consults on the proposal for Guidelines on the use of the Legal Entity Identifier*	*EIOPA*
31/08/14	*Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending*	*PRA*
01/09/14	*CP14/10: proposals for a price cap on high-cost short-term credit*	*FCA*
01/09/14	*British credit unions at 50: call for evidence*	*HMT*
02/09/14	*Review of the Money Advice Service: call for evidence*	*HMT*
04/09/14	*CP14/12: removing the Transparency Directive's requirement to publish interim management statements*	*FCA*
05/09/14	*Project Innovate: call for input*	*FCA*
12/09/14	*Thematic Peer Review on Supervisory Frameworks and Approaches to SIFIs - Questionnaire for national authorities*	*FSB*

Closing date for responses	Paper	Institution
12/09/14	*FSB Peer Review on Supervisory Frameworks and Approaches to SIFIs - Questionnaire for G-SIBs*	*FSB*
12/09/14	*Consultation on the potential economic consequences of country-by-country reporting under Directive 2013/36/EU (Capital Requirements Directive or CRD)*	*EC*
18/09/14	*Consultation paper Clearing Obligation no2 CDS*	*ESMA*
19/09/14	*Tax-advantaged venture capital schemes: ensuring continued support for small and growing businesses*	*HMT*
19/09/14	*CP13/14: implementing the Bank Recovery and Resolution Directive*	*PRA*
26/09/14	*Review of the Pillar 3 disclosure requirements*	*BCBS*
28/09/14	*Consultation – transposition of the Bank Recovery and Resolution Directive*	*HMT*
30/09/14	*DP14/2: fairness of changes to mortgage contracts*	*FCA*
30/09/14	*Call for evidence: EU financial regulatory framework*	*House of Lords*
01/01/14	*CP14/15: Recovery and Resolution Directive*	*FCA*
03/10/14	*Consultation paper on the implementing technical standards on joint decisions on prudential requirements*	*EBA*
07/10/14	*EBA consults on draft guidelines for common supervisory procedures and methodologies*	*EBA*
09/10/14	*Wholesale sector competition review*	*FCA*
09/10/14	*Consultation Paper: Draft Regulatory Technical Standards on the content of resolution plans and the assessment of resolvability*	*EBA*

Closing date for responses	Paper	Institution
09/10/14	*Consultation Paper: Draft Guidelines on the specification of measures to reduce or remove impediments to resolvability and the circumstances in which each measure may be applied*	*EBA*
10/10/14	*DP14/3 - The use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research*	*FCA*
10/10/14	*GC14/3 Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development*	*FCA*
14/10/14	*Joint consultation paper – draft RTS on risk concentration and intra-group transactions under the Financial Conglomerates Directive*	*ESAs*
16/10/14	*Consultation – Banking Reform: draft pensions regulations*	*HMT*
18/10/14	*Consultation paper – guidelines on the criteria to determine the conditions of application of CRD IV in relation to the assessment of other systemically important institutions (O-SIIs)*	*EBA*
31/10/14	*CP14/13 – strengthening accountability in banking: a new regulatory framework for individuals*	*FCA/PRA*
31/10/14	*CP14/14 – strengthening the alignment of risk and reward: new remuneration rules*	*FCA/PRA*
31/10/14	*Consultation paper on periodic information to be submitted to ESMA by Credit Rating Agencies*	*ESMA*

Forthcoming publications in 2014

Date	Topic	Type	Institution

Date	Topic	Type	Institution
Client Money			
TBD 2014	Review of the client money rules for insurance intermediaries	Policy statement	FCA
TBD 2014	Regulated client money regime for consumer credit companies	Consultation paper	FCA
Consumer protection			
TBD 2014	National Depositor Preference and UK depositors	Policy statement	PRA
TBD 2014	Mortgage Market Review: Arrears and Approved Persons – final rules	Policy statement	FCA
Financial crime, security and market abuse			
Q4 2014	Market Abuse Review	Technical advice	ESMA
Insurance			
TBD 2014	Institutions for Occupational Retirement Provision	Legislative proposals	EC
TBD 2014	Advice or technical standards for IMD2	Technical advice or technical standards	EIOPA
Securities and markets			
Q4 2014	Harmonised transaction reporting	Guidelines	ESMA
Q4 2014	Exchange-traded derivatives reporting	Guidelines	ESMA
Q4 2014	Technical standards following the revision of MiFID (MiFID II and MiFIR)	Technical standards	ESMA
Q4 2014	Transparency Directive and Prospectus regime	Technical standards	ESMA

Date	Topic	Type	Institution
Q4 2014	Credit Rating Agencies Regulation	Guidelines	ESMA
TBD 2014	Securities Law Directive	Legislative proposals	EC
TBD 2014	Revision of the Transparency Directive	Discussion papers	ESMA
TBD 2014	Close-out netting	Legislative proposals	EC
Products and investments			
Q4 2014	European Social Entrepreneurship Funds	Technical advice	ESMA
Q4 2014	European Venture Capital Funds	Technical advice	ESMA
Q4 2014	Packaged Retail Investment Products	Technical standards	ESMA/EIOPA
Q4 2014	Undertakings For The Collective Investment of Transferable Securities V	Technical advice	ESMA
Q4 2014	Money market funds	Technical standards	ESMA
TBD 2014	Development of high level principles for the product approval process	Principles	ESAs
TBD 2014	A framework for the activities and supervision of personal pension schemes	Advice	EIOPA
Recovery and resolution			
TBD 2014	EU framework for recovery and resolution plans	Technical advice	EBA
Solvency II			
TBD 2014	Solvency II – draft Level 2 delegated acts	Level 2 text	EC

Date	Topic	Type	Institution
TBD 2014	Solvency II Level 3 measures	Level 3 text	EIOPA
Supervision, governance and reporting			
Q4 2014	Alternative performance measures	Guidelines	ESMA
Q4 2014	Electronic reporting format and access to regulated information	Regulatory technical standards	ESMA

Main sources: ESMA 2014 work programme; EIOPA 2014 work programme; EBA 2014 work programme; EC 2014 work programme; FCA policy development updates

Glossary

2EMD	The Second E-money Directive 2009/110/EC
ABC	Anti-Bribery and Corruption
ABI	Association of British Insurers
ABS	Asset Backed Security
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive 2011/61/EU
AIMA	Alternative Investment Management Association
AML	Anti-Money Laundering
AML3	3rd Anti-Money Laundering Directive 2005/60/EC
ASB	UK Accounting Standards Board
Basel Committee	Basel Committee of Banking Supervision (of the BIS)
Basel II	Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework
Basel III	Basel III: International Regulatory Framework for Banks
BBA	British Bankers' Association
BIBA	British Insurance Brokers Association
BIS	Bank for International Settlements

BoE	Bank of England
BRRD	Bank Recovery and Resolution Directive
CASS	Client Assets sourcebook
CCD	Consumer Credit Directive 2008/48/EC
CCPs	Central Counterparties
CDS	Credit Default Swaps
CEBS	Committee of European Banking Supervisors (predecessor of EBA)
CET1	Core Equity Tier 1
CESR	Committee of European Securities Regulators (predecessor of ESMA)
Co-legislators	Ordinary procedure for adopting EU law requires agreement between the Council and the European Parliament (who are the 'co-legislators')
CFT	Counter Financing of Terrorism
CFTC	Commodities Futures Trading Commission (US)
CGFS	Committee on the Global Financial System (of the BIS)
CIS	Collective Investment Schemes
CMA	Competition and Markets Authority
CoCos	Contingent convertible securities
Council	Generic term representing all ten configurations of the Council of the

	European Union
CRA1	Regulation on Credit Rating Agencies (EC) No 1060/2009
CRA2	Regulation amending the Credit Rating Agencies Regulation (EU) No 513/2011
CRA3	proposal to amend the Credit Rating Agencies Regulation and directives related to credit rating agencies COM(2011) 746 final
CRAs	Credit Rating Agencies
CRD	'Capital Requirements Directive': collectively refers to Directive 2006/48/EC and Directive 2006/49/EC
CRD II	Amending Directive 2009/111/EC
CRD III	Amending Directive 2010/76/EU
CRD IV	Capital Requirements Directive 2013/36/EU
CRR	Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms
CTF	Counter Terrorist Financing
DFBIS	Department for Business, Innovation and Skills
DG MARKT	Internal Market and Services Directorate General of the European Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act (US)
D-SIBs	Domestic Systemically Important Banks
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council (configuration of the Council of the European Union dealing with financial and fiscal and competition issues)
ECON	Economic and Monetary Affairs Committee of the European Parliament
EEA	European Economic Area
EEC	European Economic Community
EIOPA	European Insurance and Occupations Pension Authority
EMIR	Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (EC) No 648/2012
EP	European Parliament
ESA	European Supervisory Authority (i.e. generic term for EBA, EIOPA and ESMA)
ESCB	European System of Central Banks
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurosystem	System of central banks in the euro area, including the ECB
FASB	Financial Accounting Standards Board (US)

FATCA	Foreign Account Tax Compliance Act (US)
FATF	Financial Action Task Force
FC	Financial counterparty under EMIR
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation (US)
FiCOD	Financial Conglomerates Directive 2002/87/EC
FiCOD1	Amending Directive 2011/89/EU of 16 November 2011
FiCOD2	Proposal to overhaul the financial conglomerates regime (expected 2013)
FMI	Financial Market Infrastructure
FOS	Financial Ombudsman Service
FPC	Financial Policy Committee
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSB	Financial Stability Board
FS Act 2012	Financial Services Act 2012
FS Reform Bill 2012	Financial Services (Bank Reform) Bill 2012
FSCS	Financial Services Compensation Scheme
FSI	Financial Stability Institute (of the BIS)
FSMA	Financial Services and Markets Act 2000
FSOC	Financial Stability Oversight Council
FTT	Financial Transaction Tax
G30	Group of 30
GAAP	Generally Accepted Accounting Principles
G-SIBs	Global Systemically Important Banks
G-SIFIs	Global Systemically Important Financial Institutions
G-SIIs	Global Systemically Important Institutions
HMRC	Her Majesty’s Revenue & Customs
HMT	Her Majesty’s Treasury
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICAS	Individual Capital Adequacy Standards
ICB	Independent Commission on Banking
ICOBS	Insurance: Conduct of Business Sourcebook
IFRS	International Financial Reporting Standards
IMA	Investment Management Association
IMAP	Internal Model Approval Process
IMD	Insurance Mediation Directive 2002/92/EC
IMD2	Proposal for a Directive on insurance mediation (recast) COM(2012) 360/2

IMF	International Monetary Fund
IORP	Institutions for Occupational Retirement Provision Directive 2003/43/EC
IOSCO	International Organisations of Securities Commissions
ISDA	International Swaps and Derivatives Association
ITS	Implementing Technical Standards
JCESA	Joint Committee of the European Supervisory Authorities
JMLSG	Joint Money Laundering Steering Committee
JURI	Legal Affairs Committee of the European Parliament
LCR	Liquidity coverage ratio
LEI	Legal Entity Identifier
LIBOR	London Interbank Offered Rate
LTGA	Long-Term Guarantee Assessment
MAD	Market Abuse Directive 2003/6/EC
MAD II	Proposed Directive on Criminal Sanctions for Insider Dealing and Market Manipulation (COM(2011)654 final)
MAR	Proposed Regulation on Market Abuse (EC) (recast) (COM(2011) 651 final)
Member States	countries which are members of the European Union
MiFID	Markets in Financial Instruments Directive 2004/39/EC
MiFID II	Proposed Markets in Financial Instruments Directive (recast) (COM(2011) 656 final)

MiFIR	Proposed Markets in Financial Instruments Regulation (EC) (COM(2011) 652 final)
MMF	Money Market Fund
MMR	Mortgage Market Review
MTF	Multilateral Trading Facility
MoJ	Ministry of Justice
NAV	Net Asset Value
NBNI G-SIFI	Non-bank non-insurer global systemically important financial institution
NFC	Non-financial counterparty under EMIR
NFC+	Non-financial counterparty over the EMIR clearing threshold
NFC-	Non-financial counterparty below the EMIR clearing threshold
NSFR	Net stable funding ratio
OECD	Organisation for Economic Cooperation and Development
Official Journal	Official Journal of the European Union
OFT	Office of Fair Trading
Omnibus II	Second Directive amending existing legislation to reflect Lisbon Treaty and new supervisory infrastructure (COM(2011) 0008 final) – amends the Prospectus Directive (Directive 2003/71/EC) and Solvency II (Directive 2009/138/EC)
ORSA	Own Risk Solvency Assessment
OTC	Over-The-Counter

PERG	Perimeter Guidance Manual
PRA	Prudential Regulation Authority
Presidency	Member State which takes the leadership for negotiations in the Council: rotates on 6 monthly basis
PRIPs Regulation	Proposal for a Regulation on key information documents for investment products COM(2012) 352/3
RAO	Financial Services and Markets Act 2000 (Regulated Activities Order) 2001
RDR	Retail Distribution Review
RRPs	Recovery and Resolution Plans
RTS	Regulatory Technical Standards
RWA	Risk-weighted assets
SCR	Solvency Capital Requirement (under Solvency II)
SEC	Securities and Exchange Commission (US)
SFT	Securities financing transactions
SFD	Settlement Finality Directive 98/26/EC
SFO	Serious Fraud Office
SIPP	Self-invested personal pension scheme
SOCA	Serious Organised Crime Agency
Solvency II	Directive 2009/138/EC
SSM	Single Supervisory Mechanism
SSR	Short Selling Regulation EU 236/2012
T2S	TARGET2-Securities
TR	Trade Repository
TSC	Treasury Select Committee
UCITS	Undertakings for Collective Investments in Transferable Securities
XBRL	eXtensible Business Reporting Language

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