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Financial Industry Regulatory Update

December 2014



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1. Introduction

International regulatory bodies, working alongside their regional and national counterparts, have spent over six years attempting to mend the global financial system by strengthening its stability and resilience. This financial industry regulatory update sets out the key financial industry reforms, and proposals for reform, in the international, European and UK spheres.

This update sets out the position as at December 2014. It should be noted that, as this is an ever-changing regulatory landscape, care should be taken when reading the update as it will become out of date relatively quickly.

2. The Financial Services (Banking Reform) Act 2013

[The Financial Services \(Banking Reform\) Act 2013](#) (the “Banking Reform Act”) received Royal Assent on 18 December 2013.

Below is a summary of some of the key provisions introduced by the Act.

(a) Ring fencing

In the UK, the Banking Reform Act introduces new measures for all firms accepting deposits as a core activity unless:

- It is exempted (e.g. building societies and credit unions)
- Its operations fall within a de minimis exception for small banks
- It has structured its operations so that it does not accept core deposits

Core deposits do not include deposits from high net worth individuals and large companies that have chosen to deposit outside of the ring fence.

The Banking Reform Act requires ring fenced banks (**RFBs**) to separate their retail and small and medium-sized enterprise (SME) deposit taking business from their wholesale and investment banking activities. RFBs will also be prohibited from carrying out “excluded activities” and from certain conduct, including having exposures to particular financial institutions and having non-European Economic Area (EEA) branches and subsidiaries carrying out certain regulated activities.

A “ring-fencing transfer scheme” is also introduced by the new legislation. The scheme permits the transfer to another body of all or part of a bank’s business without obtaining the consent of those affected by the transfer where such changes are required to comply with the new regime.

The Prudential Regulatory Authority (PRA) will be responsible for regulating the RFB regime and is currently developing the detailed rules relating to its implementation. Although these rules are yet to be finalised, in early October 2014 the PRA published a Consultation Paper on the implementation of ring-fencing (PRA CP 19/14) (the **CP**), which provides an indication of what the new regime will consist of.

The CP sets out the PRA's proposed ring-fencing policy, including rules and supervisory statements, in three main areas:

- The legal structure of banking groups
- Governance
- Continuity of services and facilities

Under the latest proposals, the PRA's expectation is that an RFB should not have an ownership interest in any entity which undertakes excluded or prohibited "investment banking" activities. Instead, RFBs and entities that can conduct excluded or prohibited activities are expected to be structured as separate clusters of subsidiaries beneath a UK holding company. This is known as a "sibling structure". By creating legally and operationally separate units to house their retail and commercial banking businesses away from their investment banking divisions, the PRA expects that risks to an RFB's provision of core services will be reduced by preventing losses related to "riskier" activities from being passed to an RFB from a subsidiary. The PRA also expects that the rules will prevent an RFB becoming financially dependent on the income or profits of such activities.

Regarding governance, the Banking Reform Act requires the PRA to make rules on board membership for group ring-fencing purposes. In the CP, the PRA proposes the following rules on the membership of the RFB's board:

- At least half of an RFB's board, excluding the chair, must be independent non-executive directors (NEDs)
- The chair of an RFB must be independent during his or her tenure as chair
- The chair of an RFB must not hold another chair position in another group entity board
- No more than one third of an RFB's board members may be current employees or directors of another entity in the group
- An RFB executive director on the board of an RFB must not hold other executive director positions on the board of another entity in the group that carries out excluded or prohibited activities
- An RFB must have its own risk, nomination, audit and remuneration non-executive board committees

In relation to continuity of services and facilities, the CP states that the existing regulatory framework fulfils, to a certain extent, the PRA's objective of ensuring that RFBs have appropriate arrangements in place in this area. The PRA proposes imposing additional restrictions in relation to:

- Any intragroup service arrangements an RFB may have
- Service arrangements an RFB may have with non-group entities where those arrangements may be affected by the financial position of a group entity

The PRA states that these proposals should be read in conjunction with the PRA Discussion Paper DP1/14 (the **DP**), which sets out the PRA's current proposals for the principles that all deposit-takers (excluding credit unions) and PRA-designated investment firms should follow to demonstrate operational continuity in resolution and facilitate recovery and post-resolution restructuring.

Consultation on other areas of the ring-fencing rules will follow in 2015. The current proposals are due to come into effect from 1 January 2019. This would be in accordance with the Independent Commission on Banking's timetable for reform.

(b) Approved persons

The Banking Reform Act introduces a new senior persons framework. On 30 July 2014, the PRA and FCA jointly issued a consultation paper outlining the new regulatory framework (FCA CP14/13/PRA CP14/14) (the Joint CP).

The Joint CP proposes the introduction of new rules to change the way in individuals employed by UK banks, building societies, credit unions and PRA-designated investment firms ("relevant firms") are assessed and held accountable for the roles they perform. The current powers and procedures of the PRA and FCA for approving individuals are described in the consultation paper as operating "largely as two parts of a whole". The new regime will operate in a similar way, although each regulator's approach will vary according to its differing statutory objectives. For this reason, the PRA and FCA have set out their respective proposals in the same consultation paper, with chapters divided into PRA and FCA sections where required.

Senior managers regime

The main proposals outlined in the Joint CP include the introduction of a new “senior managers regime” for holders of significant management functions at firms outlined above. Holders of significant management functions will need to be regularly vetted for their fitness and propriety. When applying for regulatory pre-approval for these individuals, firms subject to the new regime will have to include a statement of responsibilities setting out the areas of the firm that the prospective senior manager will be responsible for managing. These firms will also be required to prepare, maintain and update a responsibilities map, a single document that describes a firm’s management and governance arrangements. The purpose of the senior managers regimes is to focus accountability on a narrower number of senior individuals in a firm than the current approved persons regime.

Certification regime

This regime will require firms to assess and review, on an annual basis, the fitness and propriety of certain employees in positions, known as significant-harm functions, where the decisions they make may pose a risk of significant harm to the firm or any of its customers. The certification regime will apply to employees of relevant firms who are not performing senior management functions, but who nevertheless meet certain criteria set by each regulator. Holders of significant harm functions will not need regulatory approval before they are able to perform their roles, and instead the senior management will assume responsibility for carrying out an internal certification process. There is some concern that the absence of an external vetting and pre approval process for holders of “significant-harm functions” may result in employees holding these functions being able to “hide” from the FCA and avoid the scrutiny of the regulator. There is also a concern that certification holders will be less able individuals who would not have been able to be authorised under the current approved persons regime.

New conduct rules

The new rules take the form of brief statements of high-level principles, setting out the standards of behaviour for employees. These rules will replace the existing Code of Practice for Approved Persons (APER) for firms covered by the new rules. The FCA will also apply these rules to most employees of relevant firms based in the UK or who deal with customers in the UK.

Reverse burden of proof

Under the regime, a new reverse burden of proof will be introduced in order to make it easier for the regulator to successfully bring an enforcement action against the senior manager. Senior managers will be guilty unless they can prove otherwise. This, together with public warnings for those individuals facing enforcement action and the increase of attestations as a supervisory tool, will increase the risk of individual enforcement and may lead to difficulties with recruitment.

Next steps

The Joint CP states that the PRA and FCA each plan to publish one or more policy statements containing their respective final rules and relevant guidance and supervisory statements “around the end of this year”. However, a related press release states that the PRA and FCA aim to publish the final rules in early 2015.

What does this mean for firms?

Aside from changing the approved persons regime for firms falling within the scope of the new regime, it is likely that the new framework will be a sign of things to come in this area in the coming years. Rules initially apply to banks, building societies and credit unions may be extended to other regulated firms if the PRA/FCA deems the new regime to be successful.

(c) Payment Systems Regulator

The Banking Reform Act provided for a Payments Systems Regulator (PSR) to be established by the Financial Conduct Authority (FCA). The PSR will be a competition-focused regulator with the power to investigate and impose sanctions, including fines. Amongst other things, the new regulator will have the power to amend agreements relating to payment systems and require banks to enter into agreements with smaller institutions to process transactions on their behalf. The PSR’s powers will come into force in late 2014.

(d) Publication of updated list of G-SIBs

On 6 November 2014, the Financial Stability Board (**FSB**) published an update on the list of banks identified by it and the Basel Committee on Banking Supervision (**BCBS**) as global systemically important banks (**G-SIBs**).

The FSB and the BCBS updated the list using end-2013 data and the updated assessment methodology published by the BCBS in July 2013. One bank, Agricultural Bank of China, has been added to the list of G-SIBs that were identified in 2013, increasing the total number from 29 to 30.

The BCBS has published separately the denominators used to calculate banks' scores and the cut-off score and bucket thresholds that were used to allocate them to buckets. The FSB states that the denominators will be updated annually using the most recently collected data, while the cut-off score and bucket thresholds will remain fixed until the first review of the methodology, due to be completed by November 2017. The FSB has also published a technical summary that further explains the methodology.

The changes in the institutions included in the list and in their allocation across buckets reflect the combined effects of data quality improvements, changes in underlying activity, and the use of supervisory judgement.

The FSB will next update the list of G-SIBs in November 2015.

(e) Primary loss-absorbing capacity requirements

In order to make G-SIBs more resilient, the new legislation introduces requirements for G-SIBs to hold loss-absorbing capacity to satisfy their capital requirements.

On 10 November 2014, the FSB issued a public consultation (the **Consultation**) containing policy proposals consisting of a set of principles and a detailed term sheet on the total loss-absorbing capacity (**TLAC**) of G-SIBs, with the goal of reducing both the probability and impact of failure of "too big to fail", systemically important firms.

The FSB has put forward proposals to achieve the availability of adequate loss-absorbing capacity for G-SIBs in resolution by setting a new minimum requirement for TLAC. The minimum Pillar 1 TLAC requirement is a requirement for loss-absorbing capacity on both a going concern and gone concern basis, incorporating existing Basel III minimum capital requirements and excluding Basel III capital buffers. The aim is to establish a framework that is consistent with the Basel capital framework and continues to set appropriate incentives for firms to be well-capitalised. The FSB has proposed that a single specific minimum Pillar 1 TLAC requirement be set within the range of 16 to 20 percent of Risk-Weighted Assets (**RWAs**) and at least twice the Basel III Tier 1 leverage ratio requirement.

The final calibration of the common minimum Pillar 1 TLAC requirement will take account of the results of the consultation and the quantitative impact study and market survey which will be carried out in early 2015. To help ensure that there are sufficient resources available in resolution, there is an expectation that TLAC in the form of debt capital instruments and other TLAC-eligible liabilities that are not regulatory capital will constitute an amount equal to or greater than 33 percent of the minimum Pillar 1 TLAC requirement.

The Consultation also goes on to consider:

- Eligibility of liabilities as TLAC: location of TLAC within group structures a crucial consideration of a resolution strategy's effectiveness is the availability of sufficient amounts of loss-absorbing capacity at the right location(s) within a G-SIB's group structure. In determining the individual requirements for specific firms, authorities have to take into account their preferred resolution strategies and identify the entity or entities within a group to which resolution tools would be applied (resolution entity or resolution entities).
- Internal TLAC: one of the main objectives of the new TLAC standard is to provide home and host authorities with confidence that G-SIBs can be resolved in an orderly manner and thereby diminish any incentives to ring-fence assets domestically. The FSB has proposed that subsidiaries located outside of their resolution entity's home jurisdiction that are identified as material and that are not themselves resolution entities are subject to an internal TLAC requirement in proportion to the size and risk of the material subsidiaries' exposures. The FSB has also proposed a quantum of internal TLAC for review in the quantitative impact study that must be pre-positioned at material subsidiaries be equivalent to 75-90 percent of the TLAC requirement that would apply to a material subsidiary on a standalone basis.

- Public disclosures: the FSB will work with the Basel Committee on Banking Supervision to specify the disclosure requirements.
- Regulation of investors: to reduce the risk of contagion, the FSB term sheet has proposed rules on deductions from G-SIBs' own TLAC or regulatory capital equal to their exposures to TLAC liabilities issued by other G-SIBs. The FSB intends to submit a final version to the G20 by the 2015 summit.

In early 2015, the FSB will, with the participation of the BCBS and the Bank for International Settlements (BIS), undertake comprehensive impact assessment studies to inform the calibration of the Pillar 1 element of the TLAC requirement for all G-SIBs. It is expected that the conformance period for the TLAC requirement will be informed by the quantitative impact study, but will not be before January 1, 2019.

What does this mean?

The purpose of the TLAC proposals is clear: to require that “too big to fail” banks hold enough additional loss-absorbing capital so that the chances of them requiring tax payer support or government bail outs are reduced to almost nothing. This means that the moral hazard associated with being “too big to fail” will have been removed, which will count as a political victory in the eyes of many. Some consider that politicians and policy makers are, by setting the capital bar so high, indirectly seeking to drive a reduction in the size and complexity of the biggest of financial services firms.

GSIBs will need to review their businesses to ensure that they are able to cope with the practical realities of higher capital requirements and enforced structural change. It is likely that G-SIBs will take matters into their own hands and restructure as a result of strategic decision rather than political and regulatory coercion.

(f) Bail-in stabilisation option

The Banking Reform Act amends earlier legislation (the Banking Act 2009) to establish a new bail-in power. The Bank of England (BoE) will be able to impose losses on shareholders and certain creditors with the aim of reducing the need to resort to public money where a bank or investment firm fails.

(g) Depositor preference

Amendments to the Insolvency Act 1986 mean that insured deposits will be made preferred debts with effect from 1 January 2019. Deposits that are eligible for protection under Financial Services Compensation Scheme (FSCS) will be deemed to be preferential debts which will rank ahead of the claims of other unsecured creditors in the event of a bank's insolvency.

This preference will not extend to debts relating to pension liabilities, overseas deposits and deposits placed by groups such as local authorities or charities.

(h) Fees for financial services firms

New sections will be added to the Financial Services and Markets Act 2000 (FSMA) which will permit HM Treasury to order the FCA, the PRA and the BoE to charge the firms that they regulate a fee in respect of expenses incurred by the Treasury in maintaining its membership within international bodies concerned with financial stability.

(i) Payday loans and high cost short term credit

The Banking Reform Act imposes a new duty on the FCA to implement rules capping the cost of high-cost short term credit, including “payday loans”. On 11 November 2014, the FCA published a policy statement on the price cap on high-cost short term credit (PS14/16), together with the final rules following its July 2014 consultation (CP14/10).

Most of the proposals the FCA consulted on will be implemented, subject to some changes and clarifications in response to points raised in the consultation. The price cap structure and levels remain unchanged, and are as follows:

- Initial cost cap: for new loans, or loans rolled over, interest and fees must not exceed 0.8% per day of the amount borrowed

- Fixed default fees: if borrowers do not repay their loans on time, default charges must not exceed £15. Interest on unpaid balances and default charges must not exceed the initial rate
- Total cost cap: borrowers must never have to pay back more in fees and interest than the amount borrowed

The new rules come into force on 2 January 2015. The instrument adds a new chapter 5A (cost cap for high-cost short-term credit) to the FCA's Consumer Credit Sourcebook (CONC).

(j) Attestations

An attestation is a request from a regulator such as the FCA to a senior individual at an authorised firm for confirmation that a particular set of circumstances exists, usually in relation to the state of affairs at a regulated firm. For example, the FCA may ask a senior individual to attest that a firm's systems, controls and procedures are sufficiently robust in a particular area. The signed attestation will then provide the FCA with a mechanism by which they can hold the senior individual to account should it transpire that this is not the case. Attestations are also a useful method of ensuring that senior management turn their minds to a firm's systems, controls and procedures.

The FCA has recently clarified that it expects to use attestations in the following situations:

- When there is an emerging risk, an appropriately senior manager at the firm will be asked to notify the FCA if the risk changes in nature or extent
- Where the FCA requires a firm to undertake a particular action, a manager will attest that this will be done within a particular timeframe
- A person may be asked to certify that a particular risk has been mitigated
- A person may be asked to confirm that the firm has taken specific action, and that action has been verified internally

The FCA has made clear that breach of an attestation could constitute a breach of the Statements of Principles for Approved Persons.

3. Proprietary Trading and Ring Fencing (EU)

On 30 January 2014, the European Commission (EC) published a new [regulation on structural measures improving the resilience of EU credit institutions](#). The regulation targets EU banks and parent undertakings identified as being of "global systemic importance" or exceeding a specified financial threshold.

Prohibition on proprietary trading

Proprietary trading in financial instruments and commodities will be prohibited for affected credit institutions. Such institutions will also be prevented from investing in:

- Alternative investment funds
- Investment products referencing such funds
- Entities engaging in proprietary trading
- Entities investing in alternative investment funds

However, targeted banks will be permitted to invest in unleveraged and close-ended funds, for example private equity and venture capital funds. Notably, banks caught by the regulation will still be able to trade EU government bonds and buy and sell money market instruments for cash management purposes.

Separation of trading activities

To avoid the risk that banks will continue to engage in proprietary trading disguised through other transactions, competent authorities in Member States must monitor, and will be given the power to require the separation of, other high-risk trading activities. Market making, securitisation and trading in derivatives if not done for risk management purposes are specifically mentioned by the regulation in this regard.

In assessing trading activities, competent authorities will be required to use certain metrics e.g. leverage of trading assets and importance of market risk. In addition to considering these factors, the relevant authority will assess

whether there is a threat to the financial stability of the firm in question or the EU financial system as a whole. Following a decision by a national authority that separation should occur, a firm will have six months to submit a separation plan.

As the UK has already introduced ring-fencing provisions through the Banking Reform Act 2013 (see section 2(a) above) the Commission is widely expected to grant the UK derogation from the separation rules.

Timetable

The proprietary trading ban is due to apply from 1 January 2017 with separation of other trading activities from 1 July 2018.

4. Shadow Banking

Regulators have focused increasingly on the shadow banking sector since the financial crisis. Shadow banks are often highly leveraged and are exposed to similar risks as regulated institutions, yet lack the equivalent regulation and supervision.

(a) International

The Financial Stability Board (FSB) published various [policy recommendations](#) on shadow banking in August 2013. The FSB later published a roadmap towards strengthened oversight and regulation of shadow banking. This publication sets out steps to be taken between 2013 and 2015 when the FSB will review the implementation of its policy framework in Member States.

(b) Europe

On 4 September 2013, the European Commission (EC) published a [roadmap for tackling the risks inherent in shadow banking](#). The roadmap, which is broadly consistent with the FSB's aims, states that regulatory measures may need to be introduced in the following areas:

- Increasing transparency
- Enhancing the regulatory framework for investment funds
- Reducing risks in securities financing transactions
- Strengthening prudential banking framework to limit contagion and arbitrage risks
- Greater supervision of the shadow banking sector

As part of its aim to enhance the regulatory framework for investment funds, the EC plans to strengthen the Undertakings for Collective Investments in Transferable Securities (UCITS) framework. It has also proposed new rules for money market funds (MMFs). Key provisions of the new MMF measures include:

- Prescribed levels of daily and weekly liquidity so that MMFs can satisfy investor redemptions
- Clear labelling on whether the fund is a short-term MMF or a standard one;
- A capital buffer of 3% for constant net asset value funds
- Customer profiling policies to help anticipate large redemptions
- Internal credit risk assessments to be carried out by MMF managers (to avoid overdependence on external credit ratings)

Alongside the EC's proposals for structural reform (as discussed at above), the EC published further [proposals on the reporting and transparency of securities financing transactions](#) (STFs). The proposed regulation will apply to counterparties engaging in STFs or using client or counterparty assets provided as collateral. Investment funds will also be subject to additional disclosure requirements.

The new measures include:

- Reporting requirements for STF transactions
- Transparency requirements, including disclosure requirements going further than the existing requirements in Alternative Investment Fund Managers Directive (AIFMD) and the UCITS Directive

- Informed consent and other requirements are to be introduced where firms engage in “rehypothecation” – the use of client or counterparty assets provided as collateral

5. Mobile Banking and Payments

The FCA is responsible for regulating the mobile banking market in the United Kingdom. Over the past few years, this responsibility has become increasingly important, as the way in which individuals make everyday payments and do banking is changing.

Customers who use mobile banking facilities engage with their bank up to three times more than those who bank online, and twenty times more than those who bank in-branch. These interactions are usually for shorter periods of time and involve comparatively simple tasks, such as checking a bank balance and making small payments. Mobile banking has allowed banks to reduce their costs.

The Financial Conduct Authority (**FCA**) recently published its Thematic Review TR14/15 regarding mobile banking and payments (the **Review**). The purpose of the Review was to determine how firms are achieving good outcomes for consumers in the sector, following the publication by the FCA of an interim report (TR13/6) in August 2013 (the **Interim Report**) and a subsequent assessment of a sample of firms offering mobile banking and payment services.

In the Review, the FCA outlined five key areas which are relevant to the mobile banking sector to determine whether customers receive good or bad outcomes. These were:

- How easy it is for consumers to understand their legal rights and obligations when using mobile banking products and services, and what firms are doing to aid consumer education
- How firms ensure that the knowledge and understanding of key decision makers in the business is in line with the pace of innovation
- How firms ensure consumers' sensitive personal data and funds are secure, and technology is sufficiently robust to cope with changes in consumer behaviour when making payments
- How firms providing mobile banking products and services retain oversight of third parties and outsourced functions involved in the delivery of their product offering to consumers
- How new entrants to the mobile payments arena ensure they have adequate knowledge and understanding of the regulatory framework surrounding payments

The FCA did not find any evidence of crystallised consumer harm in the Review, and were also satisfied that other areas of focus highlighted in the Interim Report, such as fraud against firms and anti-money laundering, are adequately addressing these areas. The next steps will involve the FCA working with the industry to ensure firms have a clear understanding of the key areas identified in the Review.

6. Stress Testing and Asset Quality Reviews

(a) The European Central Bank's Comprehensive Assessment

The European Central Bank (ECB) assumed its single supervisory mechanism (SSM) role on 4 November 2014 for credit institutions in the Eurozone and other participating EU member states. In its new role, the ECB will primarily supervise “significant” banks¹.

Prior to formally assuming its role, the ECB published a note in October 2013 ([updated 3 February 2014](#)) on the comprehensive assessment of significant banks. The two main areas covered by comprehensive assessment, and highlighted in the note, are:

¹ A bank is deemed significant if it has total assets exceed €30 billion; it is one of the three most significant credit institutions in a participating Member State; the ratio of its total assets over GDP of the participating state exceeds 20% (unless its total assets are below €5 billion); the ECB decides that it is significant (subject to specific conditions); or public financial assistance has been requested or received by the institution directly from the EFSF or the ESM.

- Stress tests – The ECB stress tests were undertaken in cooperation with the European Banking Authority (EBA) to ensure that banks would not fail if economic conditions worsen
- Asset quality reviews (AQR) – the AQR is, in broad terms, an audit of the value of each significant bank's balance sheet. The AQR aims to determine the appropriate valuation of collateral and assess adequate provisioning for credit exposure. It also assesses the valuation of complex instruments and high-risk assets on bank balance sheets

Stress tests

On 31 January 2014 the EBA announced the key components of its 2014 EU-wide stress test. The EU wide stress test was designed to provide supervisors, banks and market participants with a common exercise that facilitates the creation of benchmarks to compare how EU banks will react to adverse market conditions. The EU-wide stress test was coordinated by the EBA in coordination with the ECB, the European Systemic Risk Board (ESRB) and the European Commission (EC). The exercise was conducted by national authorities on a sample of banks covering at least 50% of the national banking sector in each EU Member State

The test was focused on the assessment of the impact of risk drivers on the solvency of banks. Whilst competent authorities may include additional risks, the common risks that must be tested are:

- Credit risk
- Market risk
- Sovereign risk
- Securitisation
- Cost of funding

The test assumes a static balance sheet. Other issues covered by the communication include hurdle rates, details about how capital will be defined and risk-specific methodologies.

The [final ECB methodology and scenarios](#) were published in April 2014 and the results of the stress test were announced in October 2014. Twenty five of the Eurozone's largest banks failed the stress test, with banks in Italy, Cyprus and Greece giving rise to the greatest cause for concern. However, the ECB noted that most banks have successfully repaired their finances, to the extent that their capital holes have to a large extent been filled. The ECB vice President Vitor Constancio suggested that these results may encourage banks to increase their lending.

In order for banks to pass the stress test, the ECB required them to meet the minimum capital threshold of a CET1 ratio of 8% in the baseline scenario, and a CET1 ratio of 5.5% in the adverse scenario. Banks which were found to have a capital shortfall had a period of two weeks in which to explain how they will address the shortfall, followed by a period of nine months in which they must take remedial action.

It is worth noting that the stress tests fail to test the banking system's resilience to a period of sustained economic deflation in the Eurozone. Although the adverse scenario does entail material downward pressures on inflation, it does not represent a prolonged deflationary environment. Given the possibility of significant periods of deflation in the Eurozone, the absence of a deflation scenario from the stress test is surprising.

Asset quality reviews

The results of the AQRs were also announced in October 2014, in conjunction with the results of the stress tests. The AQR showed that, as of the end of 2013, the book values of significant banks' assets need to be adjusted by €48 billion. These adjustments will be reflected in the banks' accounts or prudential requirements. It was also found that, using a standard definition for non-performing exposures (any obligations that are 90 days overdue, or that are impaired or in default), banks' non-performing exposures increased by €136 billion to a total of €879 billion.

(c) Bank of England

In March 2013, the Bank of England's Financial Policy Committee (FPC) recommended that regular stress testing of the UK banking system should be developed to assess the system's capital adequacy. In a Discussion Paper published in October 2013, the Bank of England set out proposals for the main features of a framework for annual and concurrent stress-testing of the UK banking system.

On 29 April 2014 the Bank of England set out details of the scenario for the stress tests for the eight major UK banks and building societies. The UK stress-testing exercise built on the EU-wide stress test, announced in January 2014 by

the EBA (the results of which are set out above). The Bank of England added a number of additional UK layers to the EBA stress test (UK variant) which explore vulnerabilities facing the UK banking system.

The Bank of England has received firms' initial stress testing submissions and is in the process of analysing the results. The FPC and the PRA Board have discussed the analysis over the autumn. Final decisions on the results of the stress tests will be made by both committees on 15 December and will be fed back to the firms involved on the same day. The UK variant stress test results will be published alongside the Financial Stability Report on 16 December 2014.

7. CMA/FCA Review into Competition in PCA and SME Banking

On 18 July 2014 the Competition and Markets Authority (**CMA**) completed two market studies into: (i) the provision of personal current accounts (PCAs), and (ii) the provision of banking services for small and medium-sized enterprises (**SMEs**). The CMA's work on SME banking was conducted jointly with the FCA. Following the completion of the review, the CMA announced that it is consulting on its provisional decision to launch an in-depth investigation into markets for personal current accounts and SME banking. The findings of the market studies have led the CMA to believe that essential parts of the UK retail banking sector lack effective competition and do not meet the needs of personal consumers or SMEs.

The CMA has found that the market for the retail supply of banking services to PCA customers is characterised by the features of high levels of concentration, barriers to entry and expansion, low switching and lack of transparency; all of which are closely interrelated and mutually reinforce one another, resulting in competition being more limited than it would otherwise be.

In relation to SMEs, the CMA concluded that the sector is one in which a perceived lack of choice of providers combines with, and reinforces, SME inertia, apparently resulting in suboptimal outcomes for SMEs. In particular, the providers with the highest customer satisfaction scores are not winning significant market share, while the banks with the lowest satisfaction rates are barely losing market share, which are not the outcomes that would be expected in a well-functioning, competitive and dynamic market. The CMA invited responses on its provisional decision to make a market investigation reference in the consultation. The CMA confirmed that it would make a market investigation reference on 4 November 2014 and will now ask its Market Reference Group to conduct an in-depth investigation.

The Market Reference Group will be appointed shortly and will publish a timetable for the various stages of the investigation and develop and consult on an issues statement, which will set out the investigation's proposed focus.

8. Capital Requirements Regulation and Directive

The phase in of CRD IV – comprised of the EU [Capital Requirements Regulation](#) (CRR) and a revised [Capital Requirements Directive](#) (CRD IV) – began on 1 January 2014. CRD IV is the EU implementation of Basel III, a package of proposals agreed by global leaders in response to the financial crisis.

CRD IV includes enhanced requirements for quality and quantity of capital, a basis for new liquidity and leverage requirements, new counterparty rules, and new macroprudential standards including a countercyclical capital buffer and capital buffers for systemically important institutions. CRD IV also reforms rules on corporate governance, and introduces standardised EU regulatory reporting referred to as COREP and FINREP.

Capital

Capital is required to absorb losses that a firm does not expect to make in the ordinary course of business; the "minimum own funds requirement" in the CRD stipulates the amount of capital a firm is required to hold as a percentage of its assets. Assets are weighed according to how risky they are (risk-weighted), and in broad terms, the more risky the assets, the more capital a firm needs to hold according to its minimum own funds requirement.

A firm's capital is split into different tiers according to the level of risk associated with holding such capital. In broad terms, Tier 1 capital is capital that allows the firm to continue to operate as a going concern, while Tier 2 capital ensures that depositors and creditors are repaid in the event the firm fails.

The main changes to the capital rules under CRD IV are:

- Quality: CRD IV tightens the definition of “common equity” (the main component of Tier 1 capital). The definition of what amounts to tier 2 capital was simplified, with all sub-categories (such as upper tier 2 and lower tier 2) removed.
- Quantity: Minimum ratios for Tier 1 capital have increased from four per cent to six per cent of Risk Weighted Assets, although the minimum capital ratio has not changed:
 - The minimum requirement for Common Equity Tier (CET) 1 has increased from two per cent to 4.5 per cent
 - These capital ratios shall be calculated as a percentage of the total risk exposure amount.

Capital buffers

- A capital conservation buffer requires relevant firms to maintain common equity Tier 1 equivalent to 2.5% of their total risk exposure. Firms failing to implement the buffer will be restricted from making discretionary distributions.
- A countercyclical buffer requires relevant firms to build up capital during periods of excess credit growth. The countercyclical capital buffer rate set by designated Member State authorities must be between 0 per cent and 2.5 per cent, unless the designated Member State authority considers that the countercyclical capital buffer rate should exceed 2.5 per cent. Firms that do not meet the countercyclical buffer will be constrained in their discretionary distributions of earnings.
- Systemic risk buffers of between one per cent and three per cent for all exposures and up to five per cent for domestic and third country exposures can be applied by Member States without prior approval of the European Commission
- There will be mandatory buffer requirements for global systemically important institutions (GSIs); the buffer requirements will vary depending on how systemically important the institution is. The buffer requirements for other systemically important institutions (OSIs) are voluntary, and will be capped at two per cent.

Counterparty credit risk (CCR)

Counterparty credit risk is the risk of the counterparty defaulting on transactions involving bilateral credit risk. Article 194(1) CRR introduces a requirement for lending institutions to obtain legal opinions in respect of any credit risk mitigation technique. The legal opinion needs to establish that the relevant credit risk mitigation techniques are “legally effective and enforceable in all relevant jurisdictions”. There are no specific requirements as to the form of the opinion; the CRR requires only that they are “independent, written and reasoned”.

An institution is required to establish and maintain a CCR management framework which consists of:

- Policies, processes and systems to ensure the identification, measurement, management, approval and internal reporting of CCR
- Procedures for ensuring those policies, systems and processes are complied with

This management framework must take account of market, liquidity, legal and operational risks associated with CCR. Institutions must conduct regular independent reviews of its CCR management system through its internal auditing process.

Institutions are required to institute a routine and rigorous programme of stress testing, which must be reviewed periodically by senior management. Institutions must have in place sound stress testing processes for use in the assessment of capital adequacy for CCR. Stress measures shall be compared against risk appetite and considered by the institution.

Credit valuation adjustment risk (CVA risk)

CVA is an adjustment made to the market value of an over the counter (OTC) derivative contract to take into account the credit risk of the counterparty. Credit valuation adjustment can be defined as the difference between the “hypothetical” value of the derivative transaction, in which it is assumed that the counterparty is risk free, and the true value of the derivative transaction, which takes into account the possibility of changes in the creditworthiness of the counterparty.

Under the CRR, credit institutions and investment firms are required to hold additional own funds due to CVA risk when entering an OTC trade referred to as the “CVA Risk Charge”. Details of the calculation of the charge are set out in Articles 381 to 386 of the CRR.

Leverage ratio

CRD IV imposes a leverage ratio which aims to restrict the level of leverage that an institution can take out to ensure that an institution's assets are in line with its capital and to act as a safeguard for existing risk-based capital requirements.

The leverage ratio is defined as an institution's Tier 1 capital divided by a measure of non-risk weighted assets.

From 1 January 2015, firms will be required to disclose information on the leverage ratio, with full implementation of the leverage ratio expected for 1 January 2018.

Liquidity requirements

The CRR introduces two new liquidity buffers: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The LCR, which is intended to improve short term resilience of the liquidity risk profile of firms, requires institutions to hold a buffer of unencumbered high quality liquid assets (HQLAs) to meet net liquidity outflows under a stress scenario lasting 30 days. The objective of the LSR is to ensure that, during a period of market wide stress, institutions will be able to use the buffer to cover outflows.

The LCR will be phased in with institutions obliged to hold 60% of their LCR in 2015 with incremental increases on a year to year basis until 2018, at which time institutions will be expected to maintain a LCR of at least 100%. The CRR also imposes a general requirement on firms to hold liquid assets sufficient to cover their net cash outflows in stressed conditions over a 30 day period.

The NSFR is intended to ensure that a firm has an acceptable amount of stable funding to support its assets and activities over the medium term. The NSFR addresses long term mismatches and is aimed at incentivising institutions to use stable sources of funding in the long term. The NSFR will measure the amount of stable funding available to a firm against the required amount of stable funding. The CRR does not contain provisions directly relating to the NSFR, the Commission aims to introduce it from 1 January 2018.

Implementation in the UK

In the UK, The FCA is responsible for implementing CRD IV for FCA firms with the PRA implementing the legislation for banks, building societies and designated investment firms. Both the FCA and the PRA published policy statements in December 2013 which contained final rules and supervisory statements by the regulators. On 30 April 2014, the PRA published its [policy statement, rules and supervisory statement](#) on CRD IV capital buffers.

Corporate governance and remuneration

CRD IV's remuneration provisions are to apply to staff whose professional activities have a material impact on an institutions risk profile. The EBA published its [final draft regulatory technical standards on qualifying staff](#) on 16 December 2013. Staff will be identified as material risk takers if they fulfil one of the following:

Qualitative criteria

Broadly, the qualitative criteria aim to identify those staff which have a material impact on an institution's risk profile. The criteria cover:

- Members of the management body in its management or supervisory function
- Employees in senior management roles

- In relation to independent risk management functions, compliance functions or internal audit functions, those with managerial responsibility and those responsible or accountable to the management body for the activities of those functions
- In relation to material business units, heads of those units or individuals who have material responsibility within such a unit and report directly to the head of the unit
- Heads of functions responsible for legal affairs, financing (including tax and budgeting), HR, remuneration policy, IT or economic analysis
- Those responsible, individually or as part of a committee, for the management of a risk category described in Articles 79 to 87 of CRD IV other than credit risk and market risk
- In relation to credit risk exposures of a nominal amount per transaction representing 0.5% of the institution's Common Equity Tier 1 capital (and at least €5 million), those who, individually or as part of a committee
 - Are responsible for initiating or structuring credit products which can result in such exposures or
 - Have authority to take, approve or veto a decision on such exposures
- Those with managerial responsibility for a group of staff members who have individual authorities to commit the firm to transactions where the aggregate of those transaction exceeds certain thresholds
- Those with authority, either individually or as part of a committee, to take, approve or veto a decision on transactions on the trading book which in aggregate exceed certain thresholds
- Individuals with authority to take decisions to approve or veto the introduction of new products, either individually or as part of a committee
- Those with management responsibility for any individuals covered above

Quantitative criteria

The quantitative criteria focus on an individual's remunerations, both in absolute and relative terms. Employees earning over €500,000 and employees which fall in the 0.3% of staff with the highest remuneration are caught. Those awarded equivalent or higher remuneration than staff caught by certain qualitative criteria described above will also be caught.

The regulatory technical standards included a new exclusion not previously consulted on. Firms will be able to exclude employees who are not in fact material risk takers despite being caught by the qualitative criteria. Individuals may be excluded on the basis that their activities or authorities pertain to a non-material business unit or that their professional activities have no material impact on the risk profile of a material business unit. The competent authority will have to be notified or consulted with, depending on the total remuneration of the individual in question.

Affected individuals face a bonus cap of 100% of their salary. This cap can be raised to 200% with shareholder approval, if a quorum of shareholders representing 50% of shares vote, and 66% of them support the proposal. Even without the quorum, the proposal can also be approved if it is supported by 75% of the shareholders present. The bonus cap became effective on 1 January 2014. The cap applies to the staff of subsidiaries operating outside the European Economic Area (EEA) and the European Free Trade Area (EFTA). Firms will also have to disclose the number of individuals being remunerated €1 million or more per financial year.

HM Treasury lodged a legal challenge with the European Court of Justice (ECJ) on 25 September 2013 on the CRD IV rules relating to remuneration. In the meantime, the UK is proceeding with implementation. Amendments to the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) rules have been made through the [Capital Requirements Directive \(Governance and Remuneration\) Instrument 2013](#) and have been in force since 1 January 2014.

Role of the Board and Senior Management

The Basel Committee set out revised guidelines on corporate governance principles for banks; one of the primary objectives of the revision was to reinforce the collective oversight and risk governance responsibilities of the board.

The revised guidelines provide greater detail on what constitutes a good corporate culture, and require that the board set the "tone from the top". This shall be established by:

- The board adhering to corporate values for itself, senior management and other employees which create expectations that business is conducted in a legal or ethical manner

- Promoting risk-awareness, and conveying the board's expectation that it does not support excessive risk-taking
- Communicating corporate values throughout the bank
- Ensuring employees, including senior management, are aware that sanctions will follow transgressions

The revised rules make clear that as well as directing senior managers, the board must oversee their work. Senior managers must actively carry out and manage the bank's activities, not merely ensure the bank's activities are consistent with risk profile and strategy. Senior managers also have a general reporting duty to the board, and must keep the board informed of material matters, including:

- Changes in business strategy
- Bank performance and condition
- Breaches of risk limits or compliance rules
- Internal control failures
- Legal or regulatory concerns

There is a degree of overlap between corporate governance requirements and the ring-fencing provisions. The board of the parent company is expected to ensure that there is adequate corporate governance across the group, while the bank's board is expected to have an understanding of the overall operational structure and the risks it poses.

9. Markets in Financial Instruments Regulation (MIFIR) and Directive (MIFID II)

On 14 January 2013, political agreement was reached on MiFID II and its accompanying Regulation, MiFIR.

Summarised below are some of the key newly agreed areas:

Commodities

The MiFID II text will extend the definition of commodity derivatives to physically settled contracts traded on organised trading facilities, except for wholesale energy products covered by the [Regulation on wholesale energy market integrity and transparency](#) (REMIT) (i.e. natural gas and electricity contracts). In addition, the broad exemptions for firms trading commodity derivatives are being narrowed (see Investor protection, below).

Position limits

The final text will set mandatory position limits to help prevent market abuse. The new regime will include:

- Spot month limits
- Limits to net positions aggregated at group level
- A hedging exemption for positions held by or on behalf of non-financial entities

Details of positions must be reported to trading venues on a daily basis, and these will be sent to ESMA each week. ESMA will publish reports which distinguish between the positions held by commercial firms and by financial firms. More detail on calculation methodologies and other aspects of the regime will be set by ESMA through regulatory technical standards (RTS).

A selection of the changes already agreed for MiFID II:

Trading

The new legislation will ensure that more trading takes place on regulated platforms. To help facilitate this new move, a new category of trading venue, Organised Trading Facilities (OTF) will be created. This category can include discretionary brokerage services in non-equity investments such as bonds, derivatives and structured products. Certain requirements will be imposed on those who operate OTFs. Any transactions which take place in this venue will be subjected to pre- and post-trade transparency provisions. With regard to pre-trade transparency, trading venues will need to make information about trading interest available to the public, and post-trade details of transactions must be published as close to real-time as possible, although under certain circumstances deferred publication will be possible. MiFID II will also implement new requirements for algorithmic and high frequency trading activities.

Transparency

Increased transparency rules will apply to equity markets. The legislation will also extend pre-and post-trade transparency obligations to non-equity instruments such as derivatives and bonds for the first time. Trade reports will need to be published through Approved Publication Arrangement (APA) firms. These will be subject to authorisation and organisational requirements. Furthermore, the process by which an investment decision was arrived at will be recorded through the capturing of data which identifies the individuals or algorithms responsible for the decision.

Investor protection

New requirements for product and product intervention by European Securities and Markets Authority (ESMA) and the EBA will be introduced. A greater range of products will be subjected to an appropriateness test. Advice from investment firms will have to comply with two criteria in order to be considered independent: they must not accept inducements from third parties, and they must advise on a broad range of products. Furthermore, detailed information on fees and commissions paid and received by the firm will be provided to the client. The definition of non-complex instruments will be narrowed to exclude structured products, including structured Undertakings for Collective Investment in Transferrable Securities (UCITS). The exemption for firms trading commodity derivatives alluded to in the commodities subsection (above) is being narrowed, with the effect that commercial firms will only be able to benefit from this exemption where this activity is “ancillary” to their main business and financial services is not their main business.

The MiFID II Directive and the MiFIR Regulation came in to force on 2 July 2014. EU Member States now have until 3 July 2016 to implement the MiFID II Directive into their national law. The provisions must be enforceable in the Member States by 3 January 2017.

10. Market Abuse

The European Parliament (EP) [adopted](#) the EC’s proposal for a new regulation on market abuse (MAR) in September 2013. The regulation imposes restrictions on market conduct and, through a Market Abuse Directive (MAD II) increases authorities enforcement powers. The UK has opted out of MAD II.

Scope

MAD II and MAR extend the scope of the new regime in the following ways:

- Market abuse framework: MAR extends the scope of the market abuse framework to any financial instrument admitted to trading on a multilateral trading facility (MTF) or OTF, as well as to any related financial instruments traded OTC which can have an effect on the covered underlying market. Related financial instruments, which are currently only subject to insider dealing will be caught by market manipulation as well.
- Commodities and derivatives: the legislation is extended in various ways to cover commodity and related derivatives markets.
- High frequency trading (HFT): MAR provides an indicative list of HFT strategies which will be considered market manipulation.
- Benchmark manipulation: MAR also ensures the manipulation of benchmarks (including non-financial benchmarks) is an offence by prohibiting it expressly.

Enforcement

The following changes will be made to the enforcement rules under the new regime:

- Whistleblowing: Member States will have to provide whistleblowing mechanisms whereby actual and potential breaches of MAR can be reported. MAR will also prohibit attempted market abuse making.
- Investigatory powers: new supervisory powers are given to regulators to investigate possible cases of market abuse.
- Sanctions: with regard to sanctions such as fines, common principles are proposed.

The adoption of MAR is dependent on the MiFID II timetable. It is therefore likely that the regime will take effect from 3 January 2017.

11. Benchmark Manipulation

Investigations into the manipulation of benchmarks such as LIBOR and EURIBOR as well as gas and oil prices has put benchmarks firmly on the regulatory agenda.

(a) International regime

The International Organization of Securities Commission's (IOSCO) July 2013 [report](#) sets out principles to guide financial benchmark administrators in areas including governance, benchmark quality, methodology and accountability mechanisms. This report follows IOSCO's Principles for Oil Price Reporting Agencies. Since this report was released, IOSCO has [encouraged](#) benchmark administrators to take measures to comply with the principles by July 2014.

The FSB [announced](#) in June that it had created an official sector steering group composed of regulators and central banks. The group will investigate, amongst other things, whether international standards surrounding benchmarks are being met in the financial industry.

IOSCO continues to consult with the industry, particularly with regard to the question of whether there should be a separate reform of financial and commodity benchmarks.

(b) EU regime

The EC published a [draft regulation on the Production and Use of Indices serving as Benchmarks in Financial and other Contracts](#) (the Benchmark Regulation) in September 2013.

The proposed regulation would bind EU supervised entities, including credit institutions, investment firms, trade repositories, Alternative Investment Fund Managers (AIFMs) and UCITs.

Under the new regulation:

- Benchmark administration will be subject to authorisation
- EU supervised entities will be prohibited from using unauthorised benchmarks
- EU supervised entities will be prohibited from using non-EU benchmarks unless there has been an equivalence ruling for the regime in question
- Conduct of business obligations will be imposed for authorised administrators and contributors
- National competent authorities and a new college of supervisors for "critical" benchmarks will take on an increased supervisory role

The Benchmark Regulation has been passed to the European Parliament and the Council of the EU for consideration under the ordinary legislative procedure throughout 2014. The European Parliament was scheduled to consider the Benchmark Regulation during its plenary session in April 2014. However, the process was delayed.

The proposals for the Benchmark Regulation are currently being discussed by the European Council's Working Party on Financial Services (the **Working Party**). The Working Party has been meeting regularly throughout 2014 to continue its examination of the Benchmark Regulation. Prior to meetings, compromise proposals on the Benchmark Regulation have been published, in which proposed changes and deletions to the text of the Commission's legislative proposal have been marked up. On 28 October 2014, the Presidency of the Council of the EU published the latest compromise proposal (dated 27 October 2014) on the Benchmark Regulation, ahead of the Working Party meeting on 17 November 2014.

It is expected that this process will continue into early 2015.

12. Consumer Credit

On 1 April 2014 the FCA took over responsibility from the OFT for all consumer credit regulation.

The licensing and regulatory framework of consumer credit regulation from the Consumer Credit Act 1974 (CCA) was replaced by FSMA (as modified by the Financial Services Act 2012).

The new rules are included in a new sourcebook within the FCA Handbook: the Consumer Credit sourcebook (CONC). The CONC includes both conduct requirements for consumer credit firms and prudential requirements for debt management firms.

The new regime requires firms to comply with:

- An approved persons regime
- Periodic reporting requirements, including providing data on consumer loans
- Enhanced complaints reporting and publication rules
- Financial promotions rules
- A client assets regime (debt management firms and large not-for-profit debt advice bodies only)

The client assets regime requires relevant firms to comply with prudential standards requiring them to hold the higher of £5,000 or 0.25% of their relevant debts under managements. Such firms must also ensure that their prudential resources exceed their requirements at all times

To determine the level of regulatory scrutiny, firms are categorised as undertaking low risk activities or high risk activities. Low risk firms enjoy more limited reporting requirements and less proactive supervision.

Certain professional firms may be supervised by their Designated Professional Body, rather than the FCA. Self-employed agents and appointed representatives of authorised firms also need not apply for full authorisation.

Existing consumer credit licences expired on 31 March 2014. Before April 2014, consumer credit firms were required to either apply for interim permission or interim variation permission (FCA registered firms). Firms without interim permission on 1 April 2014 will be required to immediately register for full authorisation. Firms with full authorisation will have to comply fully with all of the new requirements missing out on a number of transitional benefits available to firms with interim permission. The FCA will consider firms with interim permission for full authorisation between 2014 and 2016.

13. Retail Distribution Review

On 31 January 2014, the FCA published a [policy statement](#) on referrals to discretionary investment managers and adviser complaints reporting. The new rules will form part of the FCA's Retail Distribution Review (RDR).

The new rules will:

- Ban new referral payments by a discretionary investment manager to an adviser when the adviser recommends that a client places additional money with the same discretionary investment manager from whom they receive payments following a pre-RDR referral
- Prohibit referral payments where an adviser firm does not provide personal recommendations to particular clients, but provides other services to them

The new rules on referral payments will come into force on 31 December 2014.

14. Packaged Retail Investment and Insurance Products

In July 2012, the EC proposed a [new regulation](#) requiring a "Key Information Document" (KID) to be produced for packaged retail investment and insurance products (PRIIPs). PRIIPs are investment products marketed to retail investors which offer investors exposure to underlying assets in packaged forms. As such they involve an element of engineering which alters the client's exposure compared with direct holdings.

The main aim of the regulation was to address two specific market failings relating to: (1) asymmetries of information between retail investors and those producing and selling investments to them, and (2) conflicts of interest between manufacturers, distributors and investors, e.g., as a result of commission payments.

The regulation prescribes uniform rules on the format and content of the KID and uniform rules on the provision of the KID to retail investors. It sets out the overall principles on the approach and content of the KID, and will be supported by detailed delegated and implementing acts which will standardise the presentation of the information required by the regulation.

The KID is a new pan-European pre-contractual disclosure document that all retail investors should receive when they are considering purchasing certain types of investment products, including investment funds, retail structured products and certain types of insurance contracts used for investment purposes. A KID is, in essence, a short document presented in a consumer-friendly way that sets out clear information that the average investor would require to make an informed decision on the PRIIP in question.

The regulation does not apply to:

- Non-life insurance products
- Life insurance contracts whose benefits are only payable upon death or in the event of incapacity due to injury, sickness or infirmity
- Deposits other than structured deposits and securities
- Officially recognised pension schemes
- Pension products whose primary purpose is to provide the investor with a retirement income
- Individual pension products for which an employer contribution is required

On 10 November 2014, the European Council adopted the regulation without discussion. The regulation is likely to come into force in December 2014 once it has been published in the Official Journal of the European Union, and is likely to apply to firms two years after it comes into force, which is likely to be in late 2016.

15. Payment Services

On 24 July 2013 the European Commission proposed repealing the PSD and replacing it with a new [directive](#) (PSD2) combined with a [regulation on interchange fees](#) for card-based payment transactions.

Scope

The PSD2 will:

- Narrow the scope of existing exemptions, including the “commercial agent”, the “digital download” and “limited network” exemption
- Third party providers of payment initiation services and account information platforms will be required to be authorised as payment institutions
- Remove the “independent ATM operator” so that such operators will become subject to the PSD2
- Lower the threshold for being a small payment institution (subject to a less onerous regime)
- Apply existing transparency rules to transfers and money remittances outside the EU and when making payments in non-EU currencies, in respect of those parts of the payment transaction carried out in the EU (one-leg transactions).

Conduct

The PSD2 will:

- Require stronger customer authentication for payments to increase online security
- Increase consumer protection against fraud and provide a lower maximum that consumers may be charged in the event of an unauthorised card payment
- Provide an unconditional refund right for consumers in a disputed payment transaction, unless the good or service has already been consumed

The proposed regulation on interchange fees would ban surcharges on transactions using consumer debit and credit cards, and it would impose a maximum limit on interchange fees using these types of cards. The cap will initially apply to cross-border payments transactions and it will eventually be applied to domestic transactions.

16. OTC Derivative Reform

The [European Markets Infrastructure Regulation](#) (EMIR) came into force on 16 August 2012. The regulation introduces requirements primarily aimed at improving transparency and the reduction of risk associated with the derivatives markets. In addition, it establishes rules applicable to the organisational framework required to deliver those objectives. It does this by imposing rules on market participants and minimum organisational, capital and conduct of business standards on clearing houses (central clearing counterparties or CCPs) and trade repositories (TRs).

Broadly speaking, EMIR applies to entities that are established (which regulators take to mean directly “incorporated”) in the EU2 who enter into derivatives trades as principal. EMIR classifies firms as either financial counterparties (FC) or non-financial counterparties (NFC). NFCs whose OTC derivative volumes exceed the clearing threshold are classified as NFC+. FCs and NFCs+ are required to clear their OTC derivatives trades, as discussed below.

A high level summary of EMIR’s main requirements on market participants is set out below. These requirements are subject to phased implementation and are set out below in the order in which they are expected to apply.

Risk mitigation requirements (non-collateral related)

Risk mitigation requirements aim to ensure that parties entering into OTC derivatives contracts that are not centrally cleared have appropriate procedures and arrangements in place to measure, monitor and mitigate operational and counterparty credit risk.

The requirements include:

- Timely confirmation (the documented agreement of the counterparties to all of the terms of a transaction – there are prescribed time limits by which this agreement should be acknowledged dependent on the classification of the parties to the relevant trade)
- Portfolio reconciliation (the process whereby the counterparties periodically confirm that their records of the key terms of trades between them are the same)
- Portfolio compression (netting trades to maintain the same risk profile whilst reducing the number of contracts. This is not a “hard” obligation and applies to counterparties who have a very large number of trades outstanding with each other at any time)
- Dispute resolution procedures and processes.

Transaction reporting

Transaction reporting began on 12 February 2014. Counterparties are required to report any derivative contract that they have concluded, modified or terminated to a trade repository registered or recognised by ESMA by the close of the following day. Whilst a party may rely on its counterparty – or on a third party – to report for it, responsibility for the reporting obligation itself cannot be delegated. This applies to both OTC and exchange traded derivatives (e.g. futures).

Central clearing

OTC derivatives (other than intragroup trades) entered into by FCs and NFC++ exceeding certain thresholds must be centrally cleared. The earliest central clearing is likely to come into effect is late 2014.

² This will change to the EEA when it finally adopts EMIR

Risk mitigation requirements - Valuation and collateral

FCs and NFC+s must also comply with requirements to conduct daily mark-to-market (or “mark-to-model”) valuations and to exchange appropriately segregated collateral on uncleared OTC derivatives.

17. Promotion of Structured Products

The FCA’s [ban on the promotion of unregulated collective investment schemes and equivalent pooled vehicles](#) to retail investors came into effect on 1 January 2014.

In its policy statement on restricting the retail distribution of unregulated collective investment schemes and close substitutes (PS 13/3), in which the FCA announced the final restrictions on the promotion of Non-Mainstream Pooled Investments (NMPs), the FCA also announced its intention to consult on introducing marketing restrictions for other products which it did not consider to fall within the definition of NMPs.

In particular, the FCA highlighted that banks and building societies were beginning to introduce a range of securities (including contingent convertibles (CoCos), building society deferred shares and similar instruments) as a means of raising loss-absorbing capital to meet enhanced prudential requirements. In the FCA’s view, these products carried risks unfamiliar to and inappropriate for many ordinary retail investors.

In August 2014, the FCA announced the introduction of temporary product intervention rules restricting the retail distribution of CoCos. These rules entered into force on 1 October 2014. Shortly thereafter the FCA announced a consultation on the introduction of permanent rules to replace the temporary product intervention powers when they expire on 1 October 2015 (CP 14/23).

18. UK Implementation of the Mortgage Credit Directive

The Mortgage Credit Directive (2014/17/EU) (**MCD**) came into force on 21 March 2014. Member states have until 21 March 2016 to implement the MCD. The MCD applies to first and second charge mortgages. Its purpose is to ensure that consumers who purchase a property or take out a loan secured against their home are adequately informed and protected against the risks of doing so.

In September 2014, HM Treasury published a consultation on the transposition of the MCD, together with a draft impact assessment (a final stage impact assessment will be published when the legislation is finalised) and draft Mortgage Credit Directive Order 2015.

The FCA published a separate consultation paper on implementing the MCD and its proposed regime for second charge mortgages (CP14/20), which will move from being regulated under the consumer credit regime to the mortgage regulation regime in order to comply with the MCD. The deadline for responses is 29 December 2014. The FCA has stated that it will publish a policy statement with its final rules by the end of March 2015. To allow firms time to adjust to the proposed changes, the FCA stated in the consultation paper that firms can choose to start applying the MCD rules to new business from 21 December 2015.

Whereas, for some EU Member States, the implementation of the MCD could have far-reaching effects for mortgage providers, the impact of the MCD is likely to be less significant due to the existing rules and guidance in the FCA’s Mortgages and Home Finance Conduct of Business sourcebook (**MCOB**) and the reforms introduced in April 2014 as a result of the FSA’s mortgage market review (**MMR**).

However, there are a number of changes to the existing rules that the FCA proposes to make to harmonise the current rules with the MCD requirements. These include:

- Expanding the definition of a “regulated mortgage contract” under the RAO to include for example, certain buy-to-let mortgages and second charge lending, the latter of which is currently part of the FCA’s consumer credit regime
- Introducing a new product disclosure document for all mortgages. Firms must provide all customers with an European Standard Information Sheet (**ESIS**)
- New requirements on firms to calculate the APRC using the method set out in the MCD and providing a second APRC where borrowing is on a variable rate

Further changes to the definition of a “regulated mortgage contract” are proposed. HM Treasury does not anticipate that these changes will have a significant impact on UK firms. These changes relate to:

- Equitable mortgages: these are not currently caught by the definition of a “regulated mortgage contract” but will be brought within the FSMA regime to comply with the requirements of the MCD.
- Secured lending on timeshare properties: lending secured on timeshare accommodation is currently excluded from the scope of UK mortgage regulation, but falls within the MCD. Although HM Treasury has indicated that this type of lending does not exist within the UK, it is being brought within the scope of the new rules.
- Secured lending to consumers by government: mortgage lending undertaken by the government is generally exempt from the scope of the FSMA regime, as is the intermediation for such activity. The government intends to change the legislation so that it limits the exemption as far as this is required by the MCD. This may bring some government schemes within the scope of the new rules. However, this is unlikely because the MCD only seeks to limit lending to consumers by governments in circumstances where there is no benefit to the consumer over what is provided by the market.
- Location of the property: the existing regime is limited to mortgages secured on property located in the UK. This limitation will be removed, although this change is not expected to have a significant impact on UK firms as it is rare for lenders in the UK to provide mortgages on properties located outside of the UK.
- Changes to the activity of arranging a mortgage contract: the government intends to add further detail to the definition of the regulated activity of arranging regulated mortgage contracts
- Limiting certain existing exemptions: the existing regime provides a number of exemptions from FCA mortgage regulation for certain activities by mortgage lenders and intermediaries. These exemptions are not mirrored by the MCD and it may be necessary to reduce the scope of these exemptions. For example, an unauthorised person who makes arrangements for a borrower to enter into a mortgage through an FCA-authorized person is currently exempt under the FSMA regime, but may no longer be exempt under the new rules.

The implementation of the MCD means that lenders, administrators and intermediaries in both the first and second charge mortgage markets need to review their policies, processes, systems and staff training to ensure that they are ready for the new regime on 21 March 2016.

19. FCA Review of Client Assets Regime

On 10 June 2014, the FCA published a policy statement setting out final rule changes following its review of the client assets regime for investment business (PS14/9), as well as a guide summarising the key FCA Handbook changes being introduced and the dates on which they come into force.

PS14/9 summarises the comments the FCA received on its proposals to amend the rules in the Client Assets sourcebook (CASS) which were set out in a July 2013 consultation paper (CP13/5) and the FCA’s response to them. The proposals in CP13/5 were intended to address specific risks and clarify the existing CASS requirements with a view to improving the protection of client money and custody assets held by investment firms

The changes to CASS set out in PS14/9 cover the entire operation of the client money and custody rules for investment firms (including loan-based crowdfunding firms) that hold client money, custody assets, collateral and/or mandates in relation to investment business (or rely on an exemption contained within CASS).

The final rules reflect a rewrite of the client money rules in CASS 7, and substantial changes to the custody rules in CASS 6. They also include changes to the mandate rules in CASS 8 and the rules relating to client reporting and information in CASS 9. The FCA is also introducing provisions allowing clearing member firms operating net margined omnibus client accounts (OCA) at EMIR-authorized or recognised central counterparties (CCPs) to offer multiple client money pools to their clients.

The key CASS changes and the dates on which they will come into effect are set out in chapter 2 of PS14/9. The changes are being introduced in three stages:

- 1 July 2014: clarifications of existing rules and guidance and the introduction of optional arrangements that firms may choose to comply with or impose minimal regulatory burdens have been in force since this date. This includes the introduction of the option to operate multiple client money pools.

- 1 December 2014: requirements relating to the provision of information to, or obtaining the agreement of, new clients and the documenting of agreements and arrangements with any new counterparties with whom firms deposit or otherwise place custody assets or client money, have been in force since this date.
- 1 June 2015: this is the date on which the majority of the new rules come into force.

The requirements that come into force before 1 June 2015, will only apply to new arrangements and existing arrangements that have been materially altered after this date. After that date, firms will need to fully comply with the rules being introduced in PS14/9 for both existing and new counterparties and clients.

In its policy statement, the FCA made clear that it was not proceeding with most of the changes to the client money distribution rules which it originally proposed in its consultation paper. These proposals were intended to speed up the distribution of client money on a firm's insolvency. This decision was taken following feedback from stakeholders on potential issues with the speed proposals. In addition, the FCA acknowledged that any changes made would need to work with the recommendations published in the final report on the independent review of the special administration regime (SAR) for investment banks commissioned by the government (the Bloxham report). The recommendations made in the Bloxham report include changes to the SAR legislation and to CASS, some of which are addressed in PS14/9 including in relation to recordkeeping, reporting, a better understanding of the FCA client assets regime and clarity regarding certain intra-group relationships.

The FCA is also liaising with the European Commission in respect of notifications under Article 4 of the MiFID implementing Directive (2006/736/EC), which are necessary regarding CASS rules that are or may be considered to be beyond the provisions of that Directive. The FCA will publish the notifications in due course.

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The business of relationships.

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