

UK Financial Services Regulatory Focus

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

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Autumn 2007



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As I write this, the fascination with Financial Services Authority's (FSA) principles-based approach seems to have declined rapidly in the wake of the credit crunch experienced by banks around the world, and closer to home the first run on a bank for many years. Politicians vie to voice the most articulate criticism of the FSA and the lack of clarity in the tripartite responsibility for the financial services sector in the UK. The inescapable truth is that, whatever the efficiency or cost of a regulatory structure, if it is perceived as ineffective in a crisis, then it deserves to be criticised. Liquidity risk cannot be tackled simply by increasing a firm's capital, as the Basel II, Pillar 2, model appears sometimes to suggest. If a firm is likely to face liquidity problems when markets tighten, then the regulator's duty is to ensure it takes mitigating action to reduce the risk.

We should not reject the FSA's recent endeavours on liquidity risk out of hand, but equally it would not be surprising if the various initiatives planned by them to improve the regulation of liquidity risk were brought forward. One publication over the summer which has generated little attention is the Survey of Current Regulatory Frameworks adopted by the European Economic Area (EEA) Regulators in respect of Liquidity Risk Management (Committee of European Banking Supervisors (CEBS) – August 2007), which while brief and only the first part of CEBS' technical advice on the subject to the European Commission, does reveal the UK to be something of an outlier. The FSA made clear after the publication of The Management of Liquidity Risk in financial groups by the Basel Committee (May 2006) that it recognised the need for change, but both CEBS and Basel stress the need for a harmonised approach to managing liquidity risk, particularly if the demand for regulators and central banks to recognise the central management of liquidity and collateral by major multinational groups is to be accepted.

Critics would, however, be justified in asking whether the FSA was right to drop its proposals for a more sophisticated approach to measuring liquidity risk, contained in Discussion Paper 24 – Liquidity risk in the Integrated Prudential sourcebook – a quantitative framework (October 2003): those proposals did not achieve wide support because they failed to address the need for a harmonised approach between major financial services regulators and to acknowledge the large groups' central management of liquidity, but it is quite possible that they would have highlighted sooner the risks involved in a strategy of heavy dependence on interbank funding. They certainly tackled some of the perceived faults of the current mismatch and sterling stock liquidity risk regimes operated by the FSA – for example the reliance on contractual cash

flows, and the inconsistent behavioural adjustments to cash flows. They also introduced a more disciplined approach to the use of stress factors.

The other object of much criticism has been reliance on models. Do the current credit problems prove that models are unreliable for the valuation of sophisticated credit instruments or merely that their calibration in some instances was incorrect? Many firms have continued to rely on their models since the crisis developed, albeit with some fine-tuning, and subsequent price movements have proved them right to do so. However, the crisis has also shown that if proper stress factors are not built in and regularly reviewed, models will fail.

We cover the role of credit rating agencies (CRA) in respect of subprime debt and the likely implications of the criticism of those bodies in an article in this issue, and also that other topical issue – the challenge of disclosure and transparency in the private equity sector – the subject of the study by the Walker Working Group, likely to generate some changes in approach when the final report is issued, even if the outcome does not satisfy all the current critics of the sector. We also cover another important area where there has been regulatory development – the changed investment powers in the UCITS III regime for unit trusts and open-ended collective investment companies – and return to an area that will continue to have focus from regulators financial crime, and in particular identity theft.

The pace of regulatory development will not slacken because of the current credit crunch: firms hoping to be able to relax after the implementation of the Markets in Financial Instruments Directive (MiFID) in November and the full implementation of Basel II in January should watch the output from the FSA and international bodies closely. Solvency II is of course getting slowly nearer, but the regulators, like those responsible for programming risk models, will also continue to adapt to reflect experience!

If you would like to discuss any aspect of this publication, please speak to your usual contact at PricewaterhouseCoopers LLP or one of those listed in the following pages.



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¹ PricewaterhouseCoopers refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom)

The tangled web of sub-prime: the unravelling of CRAs in Europe?

The liquidity crunch facing financial markets as a result of the sub-prime fiasco in the US has created some heroes. Industry commentators have called the intervention of the Federal Reserve and the European Central Bank both 'thoughtful and constructive'. However, the fingers of blame increasingly point at the credit rating agencies (CRA).

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Following the emergency rescues of IKB and Sachsen LB in August², German Chancellor, Angela Merkel was quoted in the press as saying, 'It is not acceptable that the wrong risk assessment in one place has to be paid for by the entire global community'³. Charlie McCreevy has reportedly invited securities regulators across Europe to a meeting this month to discuss rating agencies and the recent problems. An unnamed Commission official was quoted as saying, 'If the rating agencies believe that this is going to be business as usual, they are very wrong'.

However, other reports had indicated that the Commission was unlikely to do anything definitive, if at all, before Spring 2008. Why the contradiction? Essentially, a process was already well underway; however, the outcome may no longer be predictable.

In January 2004, following Enron and Worldcom, the European Parliament (EP) issued a report on the 'Roles and methods of rating agencies'. The EP rapporteur, in the explanatory statement, deplored the existing oligopoly – or even duopoly – of Credit Reporting Agencies (CRAs), and the strong US influence stating, 'the predominantly American character of the agencies and their supervisors (for example the Securities Exchange Commission (SEC)) creates a vast de facto imbalance towards the American side, an imbalance created not by design but capable, nevertheless, of upsetting the smooth operation of the markets'. The report itself noted that the registration by the SEC of a limited number of National Recognised Statistical Ratings Organisations has established among agencies a 'hierarchy fraught with serious regulatory implications and protectionist overtones'.

In light of the EP resolution on the basis of the above report (adopted by an overwhelming majority), in July 2004, the Commission asked the Committee of European Securities Regulators (CESR) for technical advice, by April 2005, in relation to four questions identified by the Commission in order to determine whether legislative action was required. The four questions related to:

- Potential conflicts of interest within rating agencies.
- Transparency of rating agencies' methodologies.
- Legal treatment of rating agencies' access to inside information.
- Concerns about possible lack of competition in the market for the provision of credit ratings.

² 'Sachsen LB rescue heightens concerns', FT.com – 19.08.07.

³ 'Credit rating agency boss resigns', Guardian Unlimited Business – 31.08.07.

In May 2006, the Commission formally requested CESR to report on credit rating agencies' compliance with the IOSCO Code by the end of 2006.

Having received CESR's input, the Commission issued a Communication in late 2005, which stressed that a suitable EU legislative framework already exists: the Market Abuse, Capital Requirements and Markets in Financial Instruments Directives are all relevant to CRAs operating in the EU, as well as competition law. It also noted the value of the International Organisation of Securities Commissions (IOSCO) Code of Conduct issued in December 2004. It concluded that 'at present no legislative initiatives are needed', going on to say that 'the Commission is confident that these Directives – when combined with self-regulation by the credit rating agencies themselves on the basis of the newly adopted IOSCO code – will provide an answer to all the major issues of concern raised by the European Parliament'.

In May 2006, the Commission formally requested CESR to report on CRAs' compliance with the IOSCO Code by the end of 2006. CESR's December 2006 report identified two common deviations from the code (ancillary services and unsolicited ratings), plus a number of individual deviations, where it saw room for improvement. This report was released in parallel with a review by an IOSCO task force that reached a similar conclusion in respect of unsolicited ratings, but noted that issues around ancillary services were not relevant in all cases.

CESR's second report, due initially in December 2007, aimed to see whether the deviations identified had been adequately addressed. In June, CESR indicated that – with the Commission's approval – the publication of this second report would be postponed until April 2008, because the four CRAs had notified it that no changes had yet been made as they planned to revisit their codes in the next few months, given CESR's findings, the new SEC Nationally Recognised Statistical Rating Organisation rules and the outcome of IOSCO's consultation paper.

This breathing space may have evaporated. On 5 September, the EP discussed the issue at a plenary session with the Commission and the European Council. Pervenche Berès, chair of the EP Economic and Monetary Affairs Committee has separately expressed the view that CRAs should have provided more timely warnings, and that the surveillance mechanism in place should be monitored and reviewed, given the inherent conflicts of interest.⁴ A Commission spokesperson also indicated that the Commission inquiry would focus on potential conflicts of interest, given what is perceived as the CRA's slow reaction to market deterioration since 2006.

The initial stance of the Commission was that, against the backdrop of Better Regulation, they were prepared to give the CRAs time to adopt the IOSCO Code

voluntarily before considering legislative measures. On 12 September, however, the Commission sent an additional request to CESR to review the role of CRAs in the context of their ability to manage conflicts of interest in various areas, the transparency – and availability of – information on the methodologies used to investors, the quality of rating information considering growth and high staff turnover experienced by the industry, and the role of CRAs in the context of Basel II⁵. The Commission asked CESR to respond no later than 28 April 2008. CESR were asked to make this investigation a priority issue and also consult with the SEC, as any legislation would need to be introduced in the context of the Transatlantic Dialogue.

The impact on the European markets in recent months has resulted in a stronger appetite for the EU institutions to take action.

CRAs may find that it is definitely not business as usual.

⁴ 'MEPs look for lessons from turbulence on world's money markets', European Parliament – 30.08.07.

⁵ The Committee of European Securities Regulators media release – 12.09.07.

Disclosure and Transparency in Private Equity – The Walker Committee Consultation Document

The British Venture Capital Association (BVCA), along with a group of major private equity firms, requested Sir David Walker to undertake a review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. The Walker Working Group on Transparency and Disclosure (the ‘Walker Working Group’) issued a consultation document on 17 July 2007, setting out the principles underlying the intended approach to setting guidelines later in 2007 and some key questions to be addressed.

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The summary conclusion of the Walker Working Group is that private equity needs to become more open. It notes that in comparison to reporting by public companies, the buy-out end of private equity in particular has been failing to address the legitimate interests in their policies and performance by wider stakeholder groups such as employees, suppliers and customers, as well as the public more widely.

Increased transparency is recommended by adaptation of reporting arrangements by portfolio companies, general partners of private equity funds and the representative industry association as three separate but related groups.

Conformity with the guidelines to be proposed is anticipated to be on a ‘comply or explain’ basis with explanation of reasons for noncompliance as a fully available option.

Portfolio companies

Enhanced reporting standards in excess of that required by law is proposed for portfolio companies:

- Previously listed as FTSE 250 companies; or
- Where the equity consideration on acquisition exceeded £300 million; or
- Where the company has more than 1000 employees and an enterprise value in excess of £500 million.

Significant changes brought about by enhanced reporting standards for portfolio companies include reporting annual audited financial statements within four months of the year-end, publishing a short interim statement within two months after the mid-year, disclosing the company’s approach towards managing employees, customers and suppliers, and its role in the wider community. There will also be additional requirements to report on balance sheet management, in particular, surrounding debt arrangements.

The Walker Working Group has stated that the above reporting is not intended to give rise to reporting obligations on portfolio companies, which would be more onerous than they would be had the company been listed.

It is not intended for this enhanced reporting to apply to operating companies not owned by private equity. However, it may be that this enhanced reporting could be viewed as a standard for other large private companies.

The main ingredients of such enhanced reporting for portfolio companies include:

- Publishing the annual report and financial statements on a company website within 4 months of the year-end.
- Detail on the composition of the board, indicating separately the executives of the general partner or fund.
- The narrative in the statements by the Chairman or CEO and in the board's operating review to refer to the company's values and approach to its reputation, with specific reference to employees, customers and suppliers and, as appropriate, the company's role in the wider community.
- Financial reporting to cover balance sheet management, including links to the financial statements to describe the level, structure and conditionality of debt.
- A short interim statement not more than 2 months after the mid-year.

General partners should publish an annual review, accessible on their website, which should communicate the values that inform their approach to business and the governance of their portfolio companies. This general communication should include:

- An indication of the leadership team of the management company, identifying the most senior members of the general partner team or general partner advisory group.
- A commitment to conform to the proposed guidelines on a comply or explain basis.
- The philosophy of their approach to employees and the working environment in their portfolio companies, to the handling of conflicts of interest that may arise, and to corporate social responsibility.
- A broad indication of the performance record of their funds, with an attribution analysis to indicate how much of the value enhancement achieved on realisation and in the unrealised portfolio flows from financial structuring, from growth in the earnings multiple in the market in the industry sector, and from their strategic and operational management of the business.
- A categorisation of the limited partners in their funds, indicating separately UK and overseas sources to include pension funds, insurance companies, corporate investors, funds of funds, banks, government agencies, endowments of academic and other institutions, private individuals and others.

General partners of private equity funds

General partners of private equity funds will be required to publish an annual review on their website including information on the management team, identifying the most senior members of the general partner team, a commitment to conforming with the proposed guidelines on a comply or explain basis, the philosophy of their approach to employees and working environment in their portfolio companies, to the handling of conflicts of interest as they arise and to corporate social responsibility (CSR).

Some of these requirements represent a significant change in the nature and extent of reporting by general partners from both a qualitative and quantitative perspective.

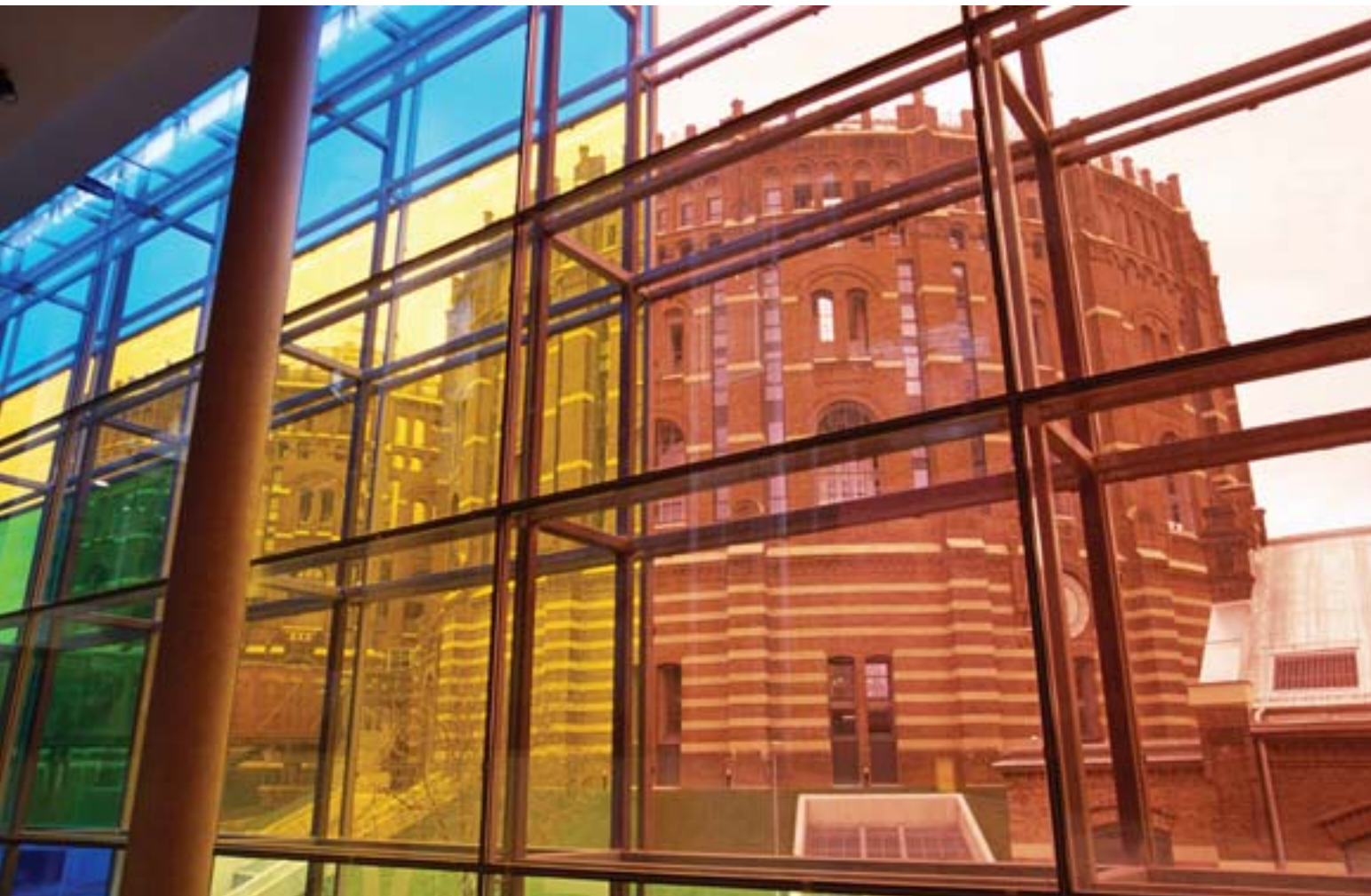
The proposals also recommend that general partners give an indication of the performance record of their funds, including an attribution analysis to indicate how much of the value enhancement is due to strategic and operational management of the company, growth in the earnings multiple in the market or industry sector and from financial structuring. In practice this may prove complex and the Treasury Select Committee report on Private Equity released on 24 July 2007 reinforces that there is a debate on how such gains can

be allocated to financial engineering, compared to value creation in other ways.

Alongside the annual reviews, private equity firms would be expected to be more accessible to specific enquiries from the media and more generally, particularly with respect to large transactions, which in the listed sector would attract full public presentation. This proposal is, however, made in recognition of the confidentiality constraints governing each situation. No size criteria are specified to define a threshold for a large transaction. The overarching recommendation is that the line between openness and secrecy is drawn with much greater flexibility than hitherto.

Industrywide initiative and communication

The Walker Working Group sees a big role for the industry trade body to collect, aggregate and disseminate data as an authoritative industrywide basis to cover various aspects of performance of the industry such as fund performance and funds raised as well as leverage levels and capital investment in portfolio companies and changes in employment. The necessary data requirements are acknowledged to be substantial and the Walker Working Group invites views on the coverage of data and the amount of evidence-based analysis.



Data requirements proposed range from data on consistent activity and investment performance – on which there is currently aggregated data available and published – to details of leverage levels and debt structures.

In recognition of the cross-border nature of private equity, the Walker Working Group sees a need for engagement with similar bodies abroad, especially in continental Europe and North America.

The consultation period for the consultation document is closed on 9 October 2007 and final guidelines are expected to be published on 20 November 2007. Further refinements to the current proposals may give more clarity as to application of certain of the guidelines as well as additional requirements, but for the private equity industry these proposals spell the start of an era of greater disclosure and wider stakeholder engagement.

Industrywide initiative and communication: alongside enhanced reporting by portfolio companies, there is a major role for data collection, aggregation and dissemination on an authoritative industrywide basis, broadly to cover:

- Scale of funds raised.
- Categorisation of limited partners by type and geography.
- Scale of existing private equity portfolios and of recent buy-out activity.
- Leverage levels and debt structures, indicating the relative significance of covenants (or their absence).
- Estimates of levels and changes in employment and new capital investment by portfolio companies.
- Aggregate performance measures for portfolio companies, including revenue and profit growth.
- Estimates of aggregate performance measures for funds.
- Estimates of aggregate fee payments by private equity management companies and by portfolio companies to other financial institutions and for legal, accounting, audit and other advisory services.

FSA Feedback on Private Equity: A discussion of risk and regulatory engagement (07/3)

In November 2006, the FSA published a discussion paper (DP06/6) on the impact that the growth of the private equity market had on the UK's wholesale markets and how the FSA was meeting the challenges this posed. Key questions raised were whether the FSA was exercising an appropriate level of regulatory engagement with the sector and whether it had correctly identified and prioritised the risks posed to its statutory objectives.

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This paper was issued at a time of increased debate regarding the profile and role of private equity within the UK, and although limiting its scope to questions of regulatory responsibility, formed one of a number of reviews that took place during the year on various aspects of private equity, such as The Walker Report (Consultation document on disclosure and transparency in private equity), July 2007 (The Walker Report is reviewed on page five) and the Treasury Committee enquiry into private equity (Tenth Report of Session, July 2007).

Following a substantial response by various stakeholders, the FSA published its feedback to DP06/6 in June 2007. The conclusions drawn were that:

- An appropriate set of risks to their statutory obligations were identified.
- An appropriate significance had been assigned to these risks.
- The proposed regulatory response was proportionate to the significance of those risks.

The seven key risks identified, responses received and future proposed action were:

- **Excessive leverage** – the amount of credit that lenders are willing to extend on private equity had risen substantially and may not, in some circumstances, have been entirely prudent.

Responses were supportive of the FSA, periodically repeating their 2006 survey of leveraged lending within the UK (starting first quarter of 2008) in order to better understand the complexities, distribution of exposure and the risks this may present.

- **Unclear ownership of economic risk** – the duration and potential impact of any credit event may be exacerbated by operational issues that make it difficult to identify who owns the economic risk associated with a leveraged buy-out and how these owners will react in a crisis.

The FSA will seek to continue its fact finding exercise regarding the issues and risks that may arise in the event of financial distress, and report in the future.

- **Reduction in overall capital market efficiency** – substantial inflows of capital into private equity funds and a considerable appetite of the debt market for leveraged finance products was fuelling a significant expansion of the private equity market, which may damage the quality, size and depth of the public markets.



While the FSA have indicated they have no remit to promote or favour the private or public ownership, they will maintain a watching brief on this with respect to their Listing Rules to ensure that they are proportionate and do not unduly influence firms to be either publicly or privately owned. This approach was confirmed by responses as being appropriate, given the low impact of this risk relative to the other risks identified. No further action was being considered.

- **Market abuse** – a significant flow of price-sensitive information in relation to private equity transactions creates considerable potential for market abuse.

This was confirmed to be an area of key risk, especially with public-to-private transactions, and was in line with the FSA's statutory objective regarding a reduction of financial crime. Focus on market abuse through supervisory interaction would continue, together with ongoing work in the Markets division and the implementation of a new transaction monitoring system during 2007.

- **Conflicts of interest** – material conflicts arise in private equity fund management between the responsibilities the fund manager has to itself, the investors in the separate funds/share classes and the companies owned by the fund.

This is acknowledged as an area of considerable risk with conflicts management forming an area of supervisory focus for all authorised firms involved in private equity markets and further thematic work will be conducted.

- **Market access constraints** – current UK retail investors have limited direct and indirect access to private equity.

The FSA acknowledges that indirect access to unlisted private equity firms is greater than stated in DP06/6 and a very low level of direct access is appropriate, given the risks involved. The FSA will continue to review the situation if demand for direct retail investment increases. For listed firms it will continue to review the listing regime for investment entities.

- **Market opacity** – although transparency to existing investors is extensive, transparency to the wider market is limited and subject to significant variation in methodology and format, making relative performance assessment and comparison complex.

The FSA perceived a lack of clarity about its remit with respect to transparency in private equity, which it explained as being to ensure appropriate disclosure to existing, and potential, investors in private equity firms. Feedback confirmed that this transparency is extensive and no further work is proposed.

It was questioned whether a distinct regulatory regime for private equity was being considered in the light of the DP. However, the FSA have confirmed this is not the case and that their intention was to identify specific risks within the existing regulatory framework.

Private Equity houses can feel some relief at this, but they should not think that the FSA's eyes will not be on them in respect of some of the risks described above.

UCITS III: Developments in European alternatives

The UCITS regime has evolved a great deal since its initial introduction, and in this article we consider some recent developments aimed at making UCITS III an attractive proposition for investors interested in alternative investments.

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The Undertakings for Collective Investments in Transferable Securities (UCITS) regime was first developed in the mid-1980s to harmonise the European market in retail oriented open-ended collective investment schemes and to guarantee minimum standards of consumer protection.

Since this time, UCITS has developed into a successful pan-European brand for retail investment fund products and has also achieved market penetration overseas, e.g. in Hong Kong.

Keeping UCITS relevant and improving its functioning has led to further refinement of the original directive, notably through further directives in 2001 concerning the management of UCITS and products available within UCITS, leading to the so-called UCITS III regime. Earlier this year certain grey areas around eligible assets under UCITS III were addressed through Directive 2007/16/EC (the Eligible Assets Directive), which clarifies the eligibility of a number of instruments for UCITS, including derivatives, financial indices and money market instruments.

For product development, the Eligible Assets Directive's major contribution is the confirmation that derivatives are capable of being eligible per se as an asset class under the rubric of 'liquid financial asset'. Conditions apply to the type of underlying asset used and for an asset to be UCITS-friendly, accurate valuation and risk management techniques must be effectively deployed. In addition, the Eligible Assets Directive must be read in conjunction with guidance issued by the Committee of European Securities Regulators ('CESR'), which aims to ensure that harmonisation occurs at the operational level through the EU Member States.

The confirmed availability of derivatives is likely to encourage UCITS to explore alternative asset profiles, for example by emulating shorting through the use of derivatives over shares. As Member States are not required to transpose the Eligible Assets Directive until 23 March 2008, we are still waiting to see if they will all embrace derivatives equally.

The FSA has put forward proposals to amend the Collective Investment Scheme sourcebook in order to implement the Eligible Assets Directive. The draft rules are contained in the FSA Quarterly Consultation Paper (No.14) and are proposed to come into force on 23 July 2008, although transitional provisions will apply from 6 March 2008.



In July, CESR agreed in principle that hedge fund indices are capable of falling within the UCITS ambit by virtue of being 'financial indices', and can be included within a UCITS fund, provided that the indices meet the requirements listed at article 9(1) of the Eligible Asset Directive, which lays down basic principles on index design. In addition, the index must adhere to a series of supplementary guidelines, including:

- Index providers receiving payments from index components for inclusion in exchange for inclusion in the index is prohibited.
- Exposure to hedge fund indices via OTC derivatives will require compliance with the derivative-related conditions set-out in the Eligible Assets Directive.
- The UCITS must carry out due diligence on the index, including considering the comprehensiveness of the index methodology, the availability of information and how the index treats its components.

CESR expects Member States to comply with these guidelines at the same time as implementing the Eligible Assets Directive. It remains to be seen whether the increased regulatory costs and scrutiny are likely to warrant hedge fund exposure in UCITS funds via indices. Also, given the recent nervousness around the use of derivative products, the traceability of risk and the failures of some significant hedge funds, it will be interesting to see whether product providers, investors and politicians embrace the use of hedge fund indices within a retail product with enthusiasm.

CESR published its paper on hedge fund indices (Ref: CESR/07-433) in July 2007. Member States have until March 2008 to transpose the Eligible Assets Directive, taking into account CESR's recommendations.

The FSA's consultation on implementing the Eligible Assets Directive is open for responses until 5 December 2007.

Know your enemy – data compromise and identity theft from a corporate perspective

The profile of data compromise and identity theft in the UK is growing rapidly, with regular media coverage the norm rather than the exception. However, much of this coverage focuses on the consumer and reflects the personal cost to individuals. For example, typical news articles provide advice on how individuals can protect themselves by shredding documentation and exercising additional caution when divulging personal details, but while rising levels of consumer awareness should be welcomed and encouraged, the focus on the behaviour of individual consumers is only the tip of the data compromise iceberg.

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When one poses the question, ‘where does the identity thief get the compromised personal data that they require to commit this type of offence?’, it is simply not credible to suggest that the continued high levels of reported identity theft cases – over 39,000 so far in 2007 according to the Credit Industry Fraud Avoidance Scheme (CIFAS)⁶ – is wholly due to poor data security at customer level. Put bluntly, one of the major sources of customer information for the criminal comes from large-scale data compromise incidents at a corporate level, yet often publicity tends to centre upon the steps an individual can take personally to protect their data. However, this anomaly is unlikely to continue for much longer as the financial services sector itself comes under increasing scrutiny from a range of sources, including the regulator.

For example, almost a third of the financial crime cases investigated by the FSA in the first half of 2007 involved compromised customer data and there are continual reminders in the press and media of just how common these high-profile incidents are.⁷ In the UK alone, estimates of losses run into the billions and the situation has deteriorated to such an extent that even the Information Commissioner in his 2007 annual report stated that ‘the roll call of banks, retailers, government departments, public bodies and other organisations which have admitted serious security lapses is frankly horrifying’.⁸

Confidential data such as customer data, intellectual property and market-sensitive information all have an intrinsic value of their own on criminal data markets. While in the UK it is generally accepted that standards of information security are increasing, the sheer quantity of compromised data that is available in criminal data markets suggests that there is still room for significant improvement around the typical organisation’s understanding of the threat posed by today’s financial criminal.

This issue is important from a corporate perspective because there is a range of costly consequences that may follow a high-profile data compromise incident. These consequences could include legal and regulatory censure, reputation and brand damage, reduced customer confidence, reduced shareholder value as well as approved persons liability.

To compound the situation, the sheer number of records involved in typical corporate data compromise incidents almost guarantees that the criminal has a plentiful supply of valuable customer information, which is, after all, the lifeblood of the identity thief. This endless supply of high-quality customer data virtually guarantees that for the foreseeable future crime of this nature is likely to remain a lucrative business. The magnitude of the supply can be substantiated by looking at the chronology of data breaches published by

the Privacy Rights Clearinghouse (PRC). This resource gives a conservative indication of the extent of the problem. Between 15 February 2005 and August 2007 the number of personal records documented as being involved in an information security breach and potentially compromised was in excess of 160 million – and these incidents are predominately US-centric; if UK and European breaches were factored in, the total number would be significantly higher.⁹

In the 6th century BC, Sun Tzu said in his military treatise *The Art of War*, ‘know your enemy and know yourself; in a hundred battles, you will never be defeated.’ It could be argued that this advice, even today, still applies to organisations seeking to mitigate the threat of data compromise, particularly when one considers the increasing sophistication (and determination) of the high-tech criminal, regarding not only compromising organisational data, but also to its subsequent use and deployment. Experience has shown that many organisations are unaware of how readily the criminal will exploit control weaknesses and how easy it is for them to subsequently, sell trade or use that data for a range of unlawful activities.

If organisations do not know their enemy and are unaware of current criminal trends and techniques, it becomes difficult to see how effective controls can realistically be put in place. For example, how many organisations routinely harvest the criminal intelligence that is openly available to anyone with access to the internet? How many organisations know how to monitor criminal data markets so that they can see if any of their corporate data is being offered for sale, thus indicating that they have had a security breach? In addition, without an understanding of the way the high-tech criminal thinks, it becomes difficult to anticipate future attacks and have robust and tested controls in place, long before an incident. This is especially important because experience tells us that mature controls are more effective than those that are hurriedly implemented following an unanticipated event.

It is also useful to recognise that the criminal will respond to opportunities rapidly. For example, within three days of Hurricane Katrina striking New Orleans in 2005, over 250 web domains linked to the words hurricane, relief and Katrina had been formally registered. This flurry of registration activity was swiftly followed by a range of scam emails, emanating from many of these domains, fraudulently requesting donations. In short, criminals

tend to exploit emerging opportunities much faster than most organisations can design and implement controls.

Does it really help to have an understanding of how the criminal operates when seeking to mitigate the threat of data compromise? One of the more frequent challenges to the value of knowing your enemy is the traditional view that the existing body of best practice, including regulatory and audit guidelines and industry standard procedures, when properly implemented, is more than adequate. However, in response it can be argued that despite all the regulation and adherence to best practice and recognised standards, there is plenty of evidence suggesting that additional tactics are required to augment existing controls. Some of the key considerations include:

- The continued growth and sophistication of criminal data markets.
- The sheer number of reported data compromise incidents that occur on an almost daily basis across the world.
- The growing risk/reward ratios for this type of crime.
- The increasing challenges that organisations face to keep up with technological advances.

One such tactic successfully deployed is to conduct a targeted exposure assessment to help identify areas where organisations are most exposed to the threat of data compromise. Exposure assessments are designed to get under the skin of potential control weaknesses and to examine existing control regimes with a view to identifying opportunities for data compromise to occur. However, if there is not a genuine understanding of the way that criminals operate in this space, many potential control weaknesses may go unidentified. In these circumstances, knowing your enemy is no longer an option – it’s a necessity.

⁶ ‘Worrying fraud trends – the rise continues’, CIFAS – 25.07.07.

⁷ ‘Keynote address on anti money laundering and financial crime’, Philip Robinson, Financial Crime & Intelligence Division Director, City and Financial Annual Financial Crime Conference – 05.07.07.

⁸ Annual report 2006/07, Information Commissioner’s Office – 10.07.07.

⁹ The Privacy Rights Clearinghouse website: www.privacyrights.org.

Condensing the giant – summary of the Solvency II Framework Directive

The 10th July 2007 saw the publication of the long awaited European Commission's Solvency II framework Directive. It is expected to be adopted by the European Parliament in 2009/2010 and allows entities until October 2012 to implement it.

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Called 'groundbreaking' by the European Commission, what is it that this ambitious proposal contains? PricewaterhouseCoopers¹⁰ has published a White Paper response to the Directive, which was published in mid-August 2007.¹¹ This article is a brief summary of the headline themes in the Directive.

Content of Directive

The Directive introduces an entirely new, harmonised EU-wide solvency regime and also updates and recasts 13 existing EU insurance directives, setting out the regulation of life insurance, non-life insurance, reinsurance, insurance groups and the winding-up of insurance entities.

At the heart of Solvency II is the need for adequate policyholder protection with the derivation of a forward-looking risk-based solvency regime. However, Solvency II is not just about Capital. As Thomas Steffan, Chair of The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) mentioned in his speech at the official launch of the Directive, 'it is also about driving a change in behaviour....' and this is reflected in the importance placed by the Directive on the need to have sound governance, risk and compliance systems in place.

Scope of coverage

- Applies to insurers and reinsurers, underwriting or in run-off.
- The smallest (re)insurers (premium income less than Euros 5m annually) are exempt with an opt-in clause.
- Reinsurers that are in run-off on or before 10 December 2007 will be exempt in full.
- Branches/subsidiaries of non-EU groups are included as are all legal forms of a (re)insurer, meaning that Lloyd's syndicates, mutuals, cooperatives and proprietary insurers are all affected in the same way.

Overview

Solvency II has borrowed the mutually reinforcing three-pillar structure from Basel II, Pillar 1 covering the Quantitative Requirements, Pillar II – the Qualitative Requirements and Pillar III covering Disclosure. A brief summary of the Pillar components is given below.

¹⁰ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

¹¹ For copies of this paper 'Gearing for Solvency II: the new business environment', see www.pwc.com/SolvencyII

¹² The 'best estimate' is to be calculated based on sound actuarial techniques, good quality data and regularly checked against actual experience; generally it will correspond to the expected present value of all future cash flows (in and out flows; adjusted for inflation).



Pillar 1

Valuation of assets and liabilities

A market consistent valuation of all assets and liabilities is introduced. Implementing measures to be developed will set out how the fair value of specific balance-sheet items should be calculated. Own credit standing is not taken into account in respect of liabilities; current credit and liquidity characteristics are taken into consideration in relation to assets.

Market consistent valuation of technical provisions

Technical provisions are categorised into hedgeable and non-hedgeable risks. Mark-to-market values will be used for hedgeable risks and non-hedgeable risks are to be calculated as the sum of the discounted 'best estimate'¹² and a risk margin (using a cost-of-capital approach).

Solvency Capital Requirement (SCR)

The 'risk-sensitive' solvency capital requirement (SCR) is set to include an assessment of capital requirements by risk categories (underwriting, market, credit and operational risks). The SCR is based on a 99.5% confidence level of remaining solvent in the next 12 months, along the lines but not identical to the approach taken in the UK's Individual Capital Adequacy Standards (ICAS).

The SCR should be calculated at least once a year, monitored on a continuous

basis and should be recalculated as soon as the risk profile or strategic aims of the undertaking change significantly. The SCR is to be covered by eligible own funds (see below).

The SCR can be calculated using either the European standard formula or the entity's own internal model. The latter is subject to a supervisory approval process; the application must demonstrate that the model meets the use test and statistical quality, calibration, validation and documentation standards.

Minimum Capital Requirement (MCR)

The MCR represents a level of capital which, if breached, will trigger ultimate supervisory action with authorisation withdrawn. It should be calculated quarterly in accordance with a simple robust formula, the exact nature of which is yet to be decided. Further discussion on the form of the MCR is expected and a number of alternatives may be tested in the next quantitative impact study (April 2008).

Own funds

This refers to a (re)insurer's available financial resources, which have to cover the regulatory capital requirements. 'Own funds' equates to the sum of:

- Basic own funds comprising the excess of assets over liabilities plus subordinated liabilities that can serve as capital.

- Ancillary own funds including commitments that can be called upon to increase an entity's financial resources such as members' calls and letters of credit. Ancillary own funds are subject to prior supervisory approval.

Own funds will be classified into three tiers, depending on the nature and extent to which they meet key criteria of subordination, loss-absorbency, permanence, perpetuity and absence of servicing costs. Tier I (T1) is the highest quality of capital. In relation to Own funds covering the SCR at least 1/3rd should be T1 capital and Tier 3 (T3) should be no higher than a 1/3rd. No T3 capital can count towards the MCR, which has to have at least 50% T1 capital.

Investments

There is a notable move away from detailed rules stipulating admissibility of assets and types of investments that a firm may invest in. Solvency II adopts the 'prudent person' principle similar to that espoused in the Reinsurance Directive.

Pillar II

Supervisory authorities and general rules

The main objective of supervision is adequate policyholder protection with supervision based on a prospective risk-oriented approach through the Supervisory Review Process (SRP). The SRP involves a

One of the more controversial parts of the Directive is the introduction of a dedicated European group supervisor. This will potentially allow groups to lower their regulatory capital requirements, recognising diversification across the group.

review and evaluation process of all the strategies, processes and reporting procedures, as well as risk assessment practices of entities. The supervisors will have the power to impose actions on undertakings and in exceptional circumstances may require (re)insurance undertakings to hold more capital ('Capital add-ons').

Impact on organisations with introduction of governance requirements

The system includes compliance with requirements of fit and proper, system of governance, own risk and solvency assessment (ORSA). The ultimate responsibility for compliance with Solvency II rests with the administrative and management body.

The Directive introduces a number of functions or specific areas of responsibilities and expertise that any organisation is expected to have in place, namely risk management, internal control, internal audit and actuarial function.

The system of governance should be proportionate to the nature, scale and complexity of the business. The requirements include written policies (to be reviewed on annual basis) and the ORSA is required to be an integral part of the business strategy and taken into account on an ongoing basis in strategic decisions. It applies independent of whether an entity

applies full or partial internal models and requires firms to consider all significant risks they are exposed to. If an internal model exists, that may be used. The supervisory authorities will review the ORSA as part of their supervisory review process.

Outsourcing

Supervisory authorities of the outsourcing entity will have the right to access all relevant data held by the outsourcing service provider. They can also conduct on-site inspections at the premises of the outsourcing services provider, regardless of whether the latter is regulated, unregulated or situated in a third country.

Pillar III

Disclosure of information publicly is expected to a much greater extent than is currently the case. Entities must have a policy on public disclosure and are required to publicly disclose an annual Solvency and Financial Condition Report, in addition to the annual accounts.

Treatment of insurance groups

One of the more controversial parts of the Directive is the introduction of a dedicated European group supervisor. This will potentially allow groups to lower their regulatory capital requirements, recognising diversification across the group.



In circumstances of group supervision, individual entities may be granted waivers (derogations) from certain aspects of the capital/solvency regime, in favour of a group-led approach. The particular derogation aspects are:

- The SCR might be determined using a group internal model taking account of group diversification.
- The difference between MCR and SCR can be covered by 'group support', whereby the parent undertaking has declared in a legally binding document to the satisfaction of the group supervisor that it guarantees funds will be transferred as and where necessary. This would mean that a subsidiary in a group would need to hold only the MCR as capital while the balance of funds making up the SCR can be held at parent entity level.

While EU groups may benefit from these proposals, the full implication for third-country groups is difficult to assess at this stage. The Directive allows for a 'verification of equivalence', implying that if equivalence can be determined, the group supervision requirements and potential benefits can be extended, although this is unclear. In the absence of equivalence, group calculations have to be carried out as for Community level groups, but significantly the entity derogations, particularly around group support, are not available. Accordingly, third-country

groups may wish to establish Community subgroups and the Directive permits supervisory authorities to require this.

Next steps for entities

Although the implementation date has been pushed back to 2012, the steps to be taken by entities to implement Solvency II are not insubstantial and therefore entities would do well to start their Solvency II planning early on. In particular they need to establish their ambition for Solvency II, i.e. whether it is going to be primarily a compliance project or an opportunity to embed Enterprise Risk Management techniques more closely into the fabric of the business. Whichever way one is to look at it, even with effective planning the cost of implementation is likely to be significant. Companies might therefore choose to use Solvency II as an opportunity to strengthen the governance, operations and competitive potential of the business, thus realising a payback on their investment. Even though an early mover approach is not entirely without risk, the experience from Basel II seemed to suggest that those that did not allow enough time found themselves resorting to straightforward compliance as opposed to those that had allowed enough time.

Is the focus on PPI by the FSA nearing an end point?

The FSA's scrutiny of the Payment Protection Insurance (PPI) market represents the longest single thematic review of any part of the financial services marketplace. It has now published the results of its Phase III PPI findings. So does this signal that we are now nearing the end of the line in relation to FSA scrutiny in this marketplace?

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The answer to this lies within the FSA's PPI thematic update publication (September 2007). While a number of improvements have been identified (e.g. clarity that PPI is optional), there remains a number of areas where weaknesses will require attention by firms in this marketplace.

Phase III set out to assess where the FSA has concerns regarding the sale of PPI – these include:

- Eligibility.
- Optionality.
- Suitability.
- Cost transparency.
- Explanation of the basis of refunds and refund policies.

In addition to improvements around PPI optionality, the FSA scored a direct hit on nil refunds and obtained an immediate change in approach to these policies. However, there are some policies where the terms are still more severe than the Rule of 78 and it is difficult to see how a firm can continue to operate with such refund arrangements in the context of Treating Customers Fairly (TCF) – outliers will always be easy targets for the regulatory marksmen!

The more unwelcome news is that through a combination of on-site visits and mystery shops the FSA has identified continued weaknesses in the remaining areas of concern. The main issues relate to:

- Inability to comply with Insurance Conduct of Business (ICOB) rules.
- Failure to provide customers with adequate information (on costs, policy exclusions and limitations, cancellation rights and refund terms).
- Inability to demonstrate that customers were eligible for PPI and that products recommended were suitable.

In our experience, particularly in larger firms, much work has been and continues to be, undertaken to address these issues, but there remains much more to do in order to pass FSA muster. We believe the root cause of these continuing problem areas are:



- Insufficient questions being asked about the customer's needs and circumstances to adequately assess eligibility and suitability, and to determine relevance of any policy exclusions and limitations.
- Insufficient consideration of, and discussion around, the customer's sensitivity to cost, and need for flexibility to repay the credit early on single premium policies.
- Insufficient linkage between the enquiry process and the advice process where there is an automated production of the tailored demands and needs statement.
- Poor articulation around the extent to which particular parts of the (bundled) cover do not meet the demands and needs of the customer.
- Overreliance on an automated PPI suitability assessment to deliver a compliant sale at the expense of increasing the competence of PPI sellers to deliver it.

Previous reports from the FSA on PPI have focused on these sales process-related issues. However, firms will now also need to extend the focus of their attention to check their status against additional areas of FSA concern. As you might expect, the FSA sees any rule-based weaknesses it has identified as also weaknesses in a firm's ability to meet its Principles, in particular, TCF.

In this thematic update, under the TCF banner, the FSA is now questioning whether the PPI products sold by firms are suitable for their intended market. This is a clear message for firms to refer to, and check their status against, the FSA's guidance on product design published in July 2007.

From a broader TCF perspective, it also means that firms selling PPI should revisit and review the robustness of their TCF programmes to ensure that it has considered the firm's business model in appropriate scope and depth before the FSA decides to.

The FSA has also highlighted concerns about the adequacy of firms' systems and controls and has stated that it sees failures in this area as indicators that senior management are not giving appropriate priority to compliance with regulatory obligations.

So, how should we expect the FSA to react to these findings? It should come as no surprise that the FSA has now signalled its intention to take a much firmer stance against continuing failures in the PPI marketplace. We should therefore expect more than just a further round of fines and censures.

This phase of FSA's thematic work has already resulted in further referrals to Enforcement (with another 20 under further consideration), some firms having to

undertake past business reviews and/or Section 166 Skilled Person Reports. The thematic update makes abundantly clear what more we can expect:

- Pursuing formal disciplinary action against those firms where standards fall short of FSA expectations.
- Increasing the level of fines where warranted.
- Undertaking further visits to firms and mystery shops and using the results against those firms where appropriate.
- Consideration of further use of fining individuals.
- Consideration of varying or cancelling a firm's permission and suspending sales forces.

So, is FSA's scrutiny of PPI nearing the end of the line? Clearly not, but there are indications that its patience certainly is!

Pressure on mortgage fees and charges – the challenge continues

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The mortgage market is currently experiencing immense turbulence and change.

- Customers are becoming more demanding and sophisticated, but less loyal.
- The market is increasingly competitive.
- Lenders are offering more and more innovative products.
- Margins are increasingly under pressure.

In addition the cost of regulation far exceeded market expectations.

All the above have forced lenders to look again at ways to protect and enhance margins via their revenue models, including both interest and fee structures.

FSA rules and guidance

There are clear rules set out by the regulator to ensure firms do not impose excessive charges on the customer. In determining what is excessive, lenders are required to consider:

- The amount the lender charges for the service and products compared to charges for similar products and services offered in the market.
- The degree to which charges could be argued to be an abuse of the trust customers have placed in the firm.
- How the charges are disclosed.

Also, where there is a variation in the actual charge levied, the lender must comply with the law on unfair terms in consumer contracts. To do so, the charge must be justified by a valid reason specified at the time the contract was agreed.

Regulatory response to market concerns

The regulator has shown concern around mortgage exit administration fees for some time now. The FSA first set out their concerns with the increase in mortgage exit administration fees (MEAFs) in a Statement of Good Practice in January 2007. The statement also encouraged the industry to implement its own solutions to the issues raised and set out a number of suggested principles. The FSA at that time requested firms to confirm to it the basis upon which they would operate MEAFs. These principles included:



- **Clarity in contract terms**

For lenders who wish to increase the MEAF amount because of a change to the level of their costs, the contract must contain a clear and fair term that allows the lender to do this.

- **Evidence of justifiable increases and relevant costs**

The contract terms may allow for an increase to a MEAF because of an increase in costs for the administration services that a lender provides when a customer exits a mortgage contract. If so, lenders should be able, if challenged, to show what those costs are and that the increase in the MEAF is justified by the increase in costs.

An increase to a MEAF, based on an increase to such costs will only be fair if it is demonstrably in proportion to the increase in those costs. If a lender cannot show this, then it is possible that any increase to the MEAF on this basis would be in breach of contract.

- **Terms putting the 'burden of proof' on customers**

Given the risk of an imbalance of power and knowledge between the lender and customer in this area, terms that require customers to prove that increases to MEAFs are not reasonable are unlikely to be fair. It will be easier for lenders to show that their costs, and increases to them, which are passed on to

customers, are reasonably incurred and reasonable in amount.

In August 2007, the FSA provided feedback on lender responses that fall generally into two categories:

- Most major lenders have opted either to charge a fee that cannot be varied during the lifetime of a mortgage, or to remove the MEAF altogether.
- Other lenders have chosen to charge a MEAF that reflects the administration costs when the customer exits the mortgage and would only be varied for valid reasons, clearly explained at the outset.

The future of mortgage fees

We have already seen the removal of fixed-rate/discount penalties, which extend outside the fixed rate/discount period and the specific regulatory challenge around the increase in MEAFs. The question is: what next?

There is a clear regulatory focus on fees charged to consumers in the UK market, examples being current account and credit card charges.

Have we seen an end to lenders being able to charge fees where they are not able to demonstrate how the costs are made up and supported by appropriate terms and conditions that clearly set out how and why fees will/may increase?

Firms may also need to consider the application of fee structures where the underlying cost base has changed through advances in technologies – the use of automated valuation technologies may be a good example.

How lenders should be responding

Lenders should be reviewing lending charges generally, paying due regard to the practical application of fairness principles involving quantification and justification, and the substance of Treating Customers Fairly, more widely.

MiFID

This autumn we focus on two main issues emerging from the imminent introduction of the Markets in Financial Instruments Directive (MiFID) from a Governance, Risk and Compliance perspective. The first is a consideration of the risk of introducing MiFID-compliant systems and controls in highly volatile markets. The second is an issue of quality, as the introduction of new terms of business and deals with counterparties becomes a reality for those charged with the responsibility of 're-papering' and securing the correct status and terms for the business.

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(1) Introducing MiFID in the thick of market turmoil

Retail market crises

As the date for MiFID going live draws near, attention in UK banking and capital market circles has inevitably been diverted away from the virtues of pan-European trading to the present liquidity crisis. While in the summer, the wholesale divisions of many leading banks were pursuing the seemingly endless search for 'dark pools' of liquidity, which would enhance the level of service provided to clients by their sophisticated trading platforms, more fundamental questions of liquidity have been at stake on the High Street.

A robust Wholesale infrastructure?

Whilst retail banking comes under a huge strain amidst the scrutiny of the media, the Bank of England and the markets, the IT infrastructure and day-to-day business of clearing and settling in the wholesale market seems to be holding up well in the thick of turbulent conditions. The present level of volatility in liquid financial instruments remains manageable. This raises a number of questions:

- If the volatile market conditions continue for the rest of the autumn, will the introduction of new MiFID compliant systems create a Big Bang with serious trading and settlement backlogs and constraints on the capacity of the business?
- Has enough time been allowed for user-acceptance testing of IT systems and have the systems been stress tested to handle current market volumes and volatility?
- Have sufficient assessments been made of the market risk inherent in a failure during the transition period to enable the business to take a strategic view of whether implementation may need to be delayed?

(2) A question of quality in implementation

In our work with clients over the last 18 months, we have observed that a considerable amount of time and energy has been devoted by compliance staff attending various industry forums in an attempt to try to understand 'the approach everybody else is taking'.

A herd mentality?

In many discussions about the impact of the regulatory changes on individual business lines, we have often encountered some defensive behaviours to challenge – usually



accompanied by phrases such as ‘well, this was the view that emerged from the MiFID Connect meeting last week’ or ‘this is the line law firm “x” is taking on this interpretation and we’re following them’.

No hiding place

In our view, some good work has been done by industry forums, with the FSA giving its approval to a small number of initiatives. From a governance perspective, there can, however, be no hiding place when the regulations come into force. Even for a regulator espousing a more principles-based approach to regulation, there have been whole-scale changes to the Conduct of Business Sourcebook (CoBS), which need to be implemented. As from 1 November 2007, the focus shifts from compliance to the business.

The business matters most

A banking client recently contacted us to vent their anger and confusion at receiving a repapering letter from a leading fund manager, which purported to address MiFID changes required to client classification, securing terms of best execution and other matters relating to the all important Terms of Business. The banking client had their own MiFID programme and the front office was fully aware of the significance of changes, particularly around best execution. What they could not understand was how a valued counterparty could:

- 1) Get some basic compliance matters wrong in the letter.
- 2) Send out a clumsy communication that appeared to be, in their words ‘a one size fits all approach with a bit of cut, copy, paste’.

Preparations in the final weeks

The main observation we drew from this episode is that there is a risk that once all the arguments over MiFID interpretations and considerations about ‘what everybody else is doing’ is over, there is no substitute for stepping back, reviewing the quality of the work undertaken and consulting with the business and the impact new communications may have with their clients.

Financial returns: the changing role of the auditor

The FSA is removing some, but not all, of the remaining requirements for financial returns to be audited. What does this mean for regulated companies?

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Six years after taking over the functions of the nine predecessor regulators, the FSA is now bringing some consistency to the way in which it uses auditors as part of its supervisory regime.¹³

The current position

The requirement for companies (other than 'small' ones as defined by companies legislation) to have an audit of their statutory financial statements is long-established, but there has not been a consistent approach as to whether financial returns to regulators should be audited. The current position is summarised below:

Sector	Audit of financial returns	Publication of financial returns
Banks	Not required	No
Building societies	Not required	No
Credit unions	Required	No
Insurers	Required	Yes
Insurance brokers	Not required	No
Investment businesses	Required for some firms	No

When the Bank of England supervised banks, s39 of the 1987 Banking Act gave it powers to require a bank to appoint a reporting accountant (usually, but not necessarily, the auditor) to examine any return(s) that the supervisor might select for review. The power tended to be exercised quite extensively when first introduced, but in later years was reserved for situations where supervisors had particular concerns. The form of report and the nature of the reporting accountant's work were set out in guidance developed by the Bank and the auditing profession. The FSA has similar powers under the skilled persons provisions of the Financial Services and Markets Act (FSMA), but has so far used them to only a limited extent for regulatory returns.

For insurers, there is a long-established requirement for the financial returns to be published and audited. In 2004, the scope of the audit in respect of long-term insurers was extended to include the results of the actuarial valuation.

For investment businesses, the statutory audit requirement for small non-Investment Services Directive (ISD) companies was removed in 2006 and the FSA lifted its own audit requirement at the same time. When the Capital Requirements Directive (CRD) rules

¹³ FSA CP 07/15, External Assurance on Regulatory Returns, was published on 15 July 2007 and was open for comment until 17 October 2007.

came into force on 1 January 2007, the FSA decided not to continue with the audit of the financial returns of what are now BIPRU firms. This left the anomalous position of retaining an audit just for UCITS firms and some other non-BIPRU firms.

The FSA has concluded that the current position is not consistent, proportionate or logical and does not fit with its risk-based approach to supervision.

The proposals

The FSA is therefore proposing to abolish the audit requirement for the remaining investment businesses (non-BIPRU firms) with effect from years ending on or after 31 December 2007.

Insurers will continue to have an audit of their annual solvency return. Their position is different because the financial returns are public documents rather than private submissions to a regulator. The returns include significant areas that are not covered as part of the statutory audit or where the reporting basis is materially different from that applied to the statutory financial statements. As a result, the FSA believes that the audit of insurers' financial returns provides additional assurance and strengthens market confidence. The requirement will be kept under review in the light of developments such as Solvency II, which are likely to impose new requirements for public disclosure by insurers as part of the 'Market Discipline' pillar of Solvency II.

The routine audit requirement is also to be retained for credit unions.

Return Assurance Reports

As a partial, risk-based substitute for the audit of financial returns, the FSA has announced that it proposes to call for Return Assurance Reports (RARs) on a selective basis. The objective is to focus on the higher risk firms, but also to encourage the others to continue to report accurately. There will be two types of RAR:

Type	Authority	Application	Cost borne by	Indicative frequency
s166 RAR	FSMA s166	Perceived risk at an individual firm	Firm	35 reports pa
Thematic RAR	FSA's supervisory powers	Categories of firm, eg those with small surpluses or subject to new rules	FSA (normally)	170 reports pa

The FSA has said that it may require RARs not just from investment businesses that used to be subject to an annual audit, but also from banks, building societies and insurance brokers.

If the FSA follows the practice adopted by the Bank of England under s39 of the Banking Act, it may call for a s166 RAR on just part of the suite of returns that firms will have to submit from 2008 and could include interim returns rather than just the year-end figures. Over the coming months, the FSA will be having discussions with the auditing profession on the scope and reporting format for these RARs.

Consequence for firms and auditors

The FSA has emphasised that a firm remains responsible for the quality of its regulatory returns. Senior management who may, in the past, have placed some reliance on their auditors to have checked that the annual returns were properly compiled, may need to consider whether to introduce any further controls over reporting quality. This will be important where there has been a history of adjustments being required to a return as a result of the audit or where the firm is having to apply unfamiliar new rules.

The FSA has also indicated that it may make more use of firms' internal audit functions in obtaining assurance, so it may be necessary to reconsider the scope of their work and the skills they need.

In accordance with International Standards on Auditing (ISAs) governing the audit of statutory financial statements, auditors must consider whether the firm is complying with laws and regulations and is a going concern. So, auditors will continue to have to carry out some review of their clients' regulatory returns, even if they do not have to report on them expressly. In addition, auditors still have a statutory duty to report to the FSA when, in the normal course of their audit work, they come across matters that may be of

regulatory significance. This is likely to include significant misstatements in regulatory returns, which come to their attention.

Firms conducting investment business and certain general insurance brokers will continue to have an audit of compliance with the client money and custody asset rules.

Conclusion

We expect that the FSA's proposals will be welcomed by the firms affected. They fit well with the FSA's move to more risk-based supervisory practices and at the same time bring more consistency in approach across the different Financial Services sectors, insurers and credit unions apart. There is every indication that the proposals will be implemented substantially, as drafted. Firms will need to consider the impact, where relevant, of the removal of the audit on their own control processes for the preparation and submission of regulatory data. It will be interesting to see whether internal auditors are now deputed to put more resources into this area or indeed whether some firms may even continue with an external audit review on a voluntary basis.

FOS: a lone soldier or a brother-in-arms?

It is a busy time at the Financial Ombudsman Service (FOS). Pension review, mortgage endowment and most recently bank charges complaints, have all been major industry issues that the FOS has had to handle. After years of looking after retail banking and insurance complaints, the hands of time are turning. Until recently, the FOS dealt almost exclusively with complaints relating to Financial Services Authority (FSA) authorised firms. However, from April this year, its jurisdiction was widened to cover consumer credit complaints about firms licensed by the Office of Fair Trading (OFT) to carry on unsecured consumer credit business.

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The FOS was created to settle disputes between businesses providing financial services and individual consumers, and has been designed to be independent and impartial. FOS currently deals with over half a million enquiries a year and settles over 100,000 disputes. It aims to ensure that complaints are listened to and dealt with impartially, quickly and with a minimum of formality.

FOS and the FSA

The FSA has statutory oversight of the FOS and appoints its chairman and directors, but crucially, the FOS is operationally independent. The FSA is prevented from influencing or changing decisions made by the Ombudsman and this independence has allowed it to widen its jurisdiction.

The FOS and the FSA have regular updates on the main issues they confront and both organisations have dedicated teams to work with one another. Since 2005, they have had a 'Wider Implications' process in place to deal with complaints that potentially could have significant implications for firms and cause widespread consumer detriment. With the Ombudsman's added complaint handling responsibilities for consumer credit, the OFT joined this process in June 2007.

The arrangement clarifies the different roles and responsibilities of the FSA, the FOS and the OFT, when wider implications issues arise. Industry and consumer representatives are also brought into consideration at an early stage, to ensure that issues are addressed in the most effective way. The handling of unauthorised overdraft default charges on current accounts is one example of how the three organisations and industry and consumer representatives have worked closely together on a matter of mutual interest. Issues raised by complainants were brought into the process as they were new issues involving a large number of banks and consumers.

Staying sharp, remaining effective

Whereas, previously there were different Ombudsman schemes, today's FOS is a single and independent statutory service, intended to make it easier for consumers to appeal against decisions made by firms. However, it is not just a service that provides lip service; the FOS does have power to make decisions, which if accepted by the complainant are binding on firms.

In order to ensure that they meet their objectives: being independent; effective; fair; and publicly accountable, the FOS is committed to having independent reviews every three

years. The current review by Lord Hunt is focusing on whether the service is visible enough to the people it is designed to help and if it is effectively using the information derived from its work to the benefit of consumers, firms and regulators.

Some consumers see making a complaint to a firm as a daunting and time-consuming process. So what can FOS do for the dissatisfied consumers who feel that there are barriers in place to prevent them from complaining?

FOS has demonstrated that they do respond to the information they receive. Recently, they are becoming increasingly concerned that only 10% of people who brought complaints to them last year were under 35, which did not correspond with the ownership of financial products. FOS research also suggests that people under 25 have a significantly lower level of awareness, of how to complain and of their rights to go to the Ombudsman, than older people. In order to combat this, the FOS has launched a pilot youth awareness campaign, designed to encourage firms to pay more attention to their younger customers; this incidentally dovetails with the Government's own plans to make the general public more financially capable.

Ignoring FOS: at what cost?

Firms realise that while the FSA may be the financial regulator, it is not the only body to which they are accountable. There exist different bodies, with different codes and different standards of fairness. Legislation demands that complaints to FOS are assessed, as to what, in the opinion of the Ombudsman, are fair and reasonable. However, while the FOS is not the regulator, they do exert a significant influence over firms and can make awards of up to £100,000. The decisions they make are binding and are seen as an integral part of the dispute resolution process. Firms can ask for a judicial review of a FOS decision, although simply disagreeing with a decision is usually not grounds enough.

There is uncertainty that with the FSA moving to a principles-based regime, the Ombudsman may interpret high-level rules and principles differently from the FSA. Firms may argue that the FOS's definition of what is 'fair and reasonable' may not be the same as the FSA's; however, they should remember that management information relating to FOS decisions, and particularly overturn rates, could be a key

indicator for the FSA to determine whether firms are truly treating their customers fairly.

In the past, there have been firms that look for a 'good result from FOS', e.g. achieving a low FOS overturn rate by upholding high numbers of complaints in order to avoid FOS case fees. Upheld complaints are less likely to end up on the desk of a FOS adjudicator; however, high levels of upheld complaints will still raise eyebrows among the FSA's supervisory teams. Upholding complaints may give some customers what they want, but it may not necessarily be treating all of their customers fairly.

Firms may try to focus their efforts on the FSA, as the regulator, but can firms afford to ignore the FOS? We have seen firms that actively seek to build a strong relationship with the FOS. They understand the close links that it has with the FSA and are actively involved in the wider implications process.

While the number of mortgage endowment complaint cases is assumed to reduce, there is still uncertainty about the future patterns of complaints. Even with improved practices complainants will still challenge decisions and cases will continue to go to the FOS, as complaints assessment is not an exact science. The key thing for firms to do is to listen to what FOS is telling them. FOS can deliver messages that enable firms to put in place appropriate mechanisms, ensure that they are able to identify systemic issues and demonstrate that lessons have been learnt from trends identified through complaints received.

So where now?

For some years the FOS may have been in the background to both industry and consumers; however, its existence is fundamental to achieving the objectives of the FSA. It is time for the FOS to step forward and be recognised as one of the pillars of the UK financial services industry.

Actively engaging with the FOS can enable a firm to feel that they can influence events, understand more about the reasons behind decisions and have a more rounded picture of industry issues. FOS decisions can also help firms improve their processes and the adequacy of their management information. While the FOS can eat into a complaints budget in the short term, in the long term a strong relationship between FOS and a firm can also produce a regulatory dividend.

Autumn 2007: Technical Roundup

Summer is traditionally a quiet time for regulatory change, but in 2007 the FSA has kept up a steady flow of Discussion Papers (DP), Consultation Papers (CP) and Policy Statements (PS). The main emphasis continues to be on Markets in Financial Instruments Directive (MiFID) implementation and the new conduct of business sourcebook, but other topics covered include the 'treating customers fairly' and 'move to principles-based regulation' initiatives. This article contains reminders of regulatory developments that may be significant to some firms, but are not covered in more detail elsewhere in this issue.

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Prudential rules

Insurance

The FSA has published in CP 07/13 various proposed amendments to the Insurance Prudential Sourcebooks for implementation from 31 December 2007. The more significant proposals include:

- **Asset admissibility:** an asset that is a derivative, quasi-derivative or stock lending transaction will only be admissible if it is 'approved' in accordance with the relevant rules in INSPRU (Prudential Sourcebook for Insurers), even if it also meets the definition of some other form of admissible asset. Similarly, units in collective investment schemes (CIS) (not a derivative, quasi-derivative or stock lending transaction) will only be admissible if the admissibility requirements for CISs are met.
- **Capital requirement for general insurers when net technical provisions have fallen to nil:** the FSA is proposing that in these circumstances the general insurance capital requirement (GICR) should not be less than the previous year's. The FSA acknowledges that this will mean the GICR will never reduce as the business runs off and so will be prepared to consider waiver applications.
- **Reporting to the FSA following a transfer out of all long-term business:** it proposed that within three months of a transfer of all long-term business, certain audited revenue forms (Forms 40, 41, 42, 43, 45, 46 and 47) should be submitted, covering the period from the previous year-end to the date of transfer.
- **Rules regarding Insurance Special Purpose Vehicles:** the FSA is not proposing changes to the rules, but has indicated that it may grant rule modifications allowing some accounting liabilities to be counted towards solvency for regulatory purposes.
- **Reporting of long-term insurance new business on Form 47:** in response to developments in annuity business, FSA propose further analysis of new business on Form 47 to identify business arising from transfers and index-linked business.
- **Reconciliation of changes in reserves with profit and loss account (Form 3):** an additional supplementary note to Form 3 will be introduced, showing a reconciliation of the change in profit and loss account and reserves with the profit retained in Form 16.

The FSA has also published a paper to explain how it handles solvent and insolvent schemes of arrangement for insurance firms. A scheme of arrangement is an arrangement between a company and its creditors (or any class of them) under CA85 section 425, aimed at closing the business. Schemes were originally used for insolvent insurers as an

alternative to liquidation. However, recently schemes have also been used by solvent insurers as a useful tool to conclude all or part of their business.

Personal investment (PI) firms

About 5,000 PI firms will fall outside the scope of MiFID and therefore continue to be subject to the Interim Prudential Sourcebook for Investment Firm IPRU (INV), a set of capital requirements that is largely unchanged since the 1980s. In DP 07/4, the FSA is starting a debate on the appropriate approach to prudential requirements for such firms. Proposals are likely to be published in 2008, along with the results of the Retail Distribution Review.

Internal capital adequacy assessment process (ICAAP)

In May, the FSA published a paper that aims to give firms an insight into what they can expect of the Pillar 2 process and how this will be applied proportionately, according to the firm's risks to the FSA's objectives, and in particular how the FSA will apply the Supervisory Review and Evaluation Process (SREP) when it reviews a firm's ICAAP.

Conduct of business and other rules

Insurance

HM Treasury has announced its intention to add the sale of travel insurance sold with a holiday or related travel to the FSA's scope. If the proposal is confirmed, the FSA will itself consult with industry and consumer bodies towards the end of the year on the regulatory approach to be taken.

A new contract certainty code of practice for the UK general insurance industry has been issued by the Contract Certainty Steering Committee, aimed at ensuring that policies continue to be fully agreed, prior to coverage becoming active. This updates the previous code, which has been in force since October 2005, and brings together all guidance issued over the past two years.

Capital markets

HM Treasury has issued a consultation paper on a proposed new legislative framework for covered bonds in the UK. At the same time, the FSA is consulting on its proposed principles-based implementation of a covered bond regime and associated guidance. These proposals are designed to allow UK-issued covered bonds to benefit from options in European Union (EU) directives (including regulatory capital risk weights), in order to increase their attractiveness to investors and thereby enhance and deepen the market.

In a 'Dear Chief Executive' letter directed to major global investment banks that operate in London, the FSA sets out its views on good practices for managing compliance risk, which it has observed in 15 such institutions. The good practices are grouped into six areas. The FSA points out that a common theme through all the areas highlighted is senior management engagement. Firms adopting measures fully in line with the practices highlighted will not be subject to FSA action in relation to the management of compliance risk.

The results of the FSA's review of controls over inside information in relation to public takeovers identified a number of areas where both regulated and non-regulated firms could strengthen their controls around inside information. The FSA's Markets Division is progressing work on a Statement of Good Practice, which could be used as a basis to demonstrate high standards and robust controls for handling inside information.

Treating customers fairly (TCF)

FSA has published two short guides to support the delivery of the TCF initiative. The first publication looks at firms' culture regarding treating customers fairly and highlights examples of good and poor practice seen in firm visits and the FSA's own TCF experiences. It also introduces a framework to be followed by FSA supervisors when assessing firms' TCF progress within the ARROW risk assessment process.

The second publication is designed to help firms develop management information to demonstrate that they are treating their customers fairly.

In another thematic review, this time into the behaviour of intermediaries and lenders within the sub-prime mortgage market, the FSA found weaknesses in responsible lending practices and in firms' assessments of a consumer's ability to afford a mortgage. As a result, the FSA has started enforcement action against five firms.

Complaints

The FSA has also been addressing matters related to customer complaints. It issued PS 07/9, which implements the customer complaints provisions of MiFID as well as reducing prescription around the existing rules on process and timing. The FSA's aim is to create a shorter set of rules, effective from 1 November 2007, which will allow firms to improve the speed, quality and fairness of efforts to resolve complaints. It also issued a consultation paper with proposals to simplify the rules in the

Dispute Resolution: Complaints (DISP) module of the FSA Handbook.

In addition, following a decision by the Office of Fair Trade and certain banks to initiate a test case to clarify the legal position regarding bank overdraft fees, the FSA has issued a waiver from complaints handling rules for complaints to banks relating to unauthorised overdraft charges. Until the test case is resolved any bank or building society that applies for the waiver will not be required to handle complaints on this matter within the usual FSA time limits. However, banks must deal promptly with complaints once the position is resolved, must communicate with customers throughout the process and must continue to deal with hardship cases.

Anti-money laundering and data protection

In the money laundering arena the Joint Money Laundering Steering Group (JMLSG) issued a draft of a revised set of its guidance notes. The new draft proposes amendments to incorporate changes for the EU Third Money Laundering Directive, which incorporates the FATF Forty Recommendations into law as well as the EU wire transfer regulation. Separately, JMLSG has published for comment, sector specific guidance for invoice financing and updated guidance for e-money.

The FSA issued a report on thematic work conducted on anti-money laundering (AML) systems and controls in private banks. The FSA concluded that the sample of private banks covered by the review acknowledged the relatively high inherent money laundering risk within many of their business activities and recognised the need to develop and implement strong AML systems and controls. However, the FSA did raise specific issues with some of the firms visited.

The British Bankers' Association issued a note highlighting concerns within the banking industry about a conflict between the EU Data Protection Directive and the provision by SWIFT of certain data to the US Treasury. Sample wording has been prepared to be given to customers to advise them that SWIFT transfers may be subject to disclosures in the US. All SWIFT transactions are held on US servers for 124 days. The EU subsequently announced that the US Treasury Department has made a unilateral commitment to handle 'EU originating personal data' that it obtains from SWIFT in a manner that 'take[s] account of EU data protection concerns', but banks may still wish to include the caveat in their terms and conditions.

Financial Services Regulatory Practice contacts

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In the UK, we have a dedicated team of over 125 regulatory compliance specialists offering proactive regulatory advice to authorised firms and other financial institutions in the UK, within the EU and across the world. The group comprises teams of partners, directors, managers and staff with extensive knowledge of regulatory rules, codes of conduct and prudential supervision focusing on delivering particular solutions and products to certain sectors of the financial services industry. The team blends the experience of former senior regulators, compliance managers, industry personnel and staff with a broader industry/professional background. Our principal contacts are as follows:

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Europe

In addition to our UK regulatory practice, PricewaterhouseCoopers¹⁴ has outstanding regulatory expertise in locations across Europe. The team is led and coordinated from Brussels by Wendy Reed, with the support of a multinational team, comprising experienced individuals who bring both knowledge of regulation in the European Union and sectoral expertise.

We have experts in each industry in over 15 EU/CEE countries (with regulatory reach into many more) where we are able to advise on local regulatory matters relevant to our clients' needs. While we have an extensive network throughout Europe, the principal contacts are as follows:

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