Financial Services

UK Financial Services Regulatory Focus

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

02 Editorial
03 Basel and the credit crunch
07 The Tripartite Authorities
09 Governance in the aftermath of market crises
12 Shariah-compliant retail accounts: Risk and Return
15 Provider/distributor relationships nine months on
18 Data compromise: A new twist on avoidable losses
19 Implementing the Hedge Fund Standards: How hedge funds can differentiate themselves and build trust
21 Business continuity in the financial services sector: Rising standards?
23 Distribution Issues for with-profits funds
24 UCITS III: Proposals for change
27 Sovereign wealth funds: What to look out for
30 Spring 2008: Technical Round-up
32 Spring 2008: European update – a pivotal year for financial services regulation in Europe
34 Financial Services Regulatory Practice contacts

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

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The Financial Services Authority's (FSA) recent example of self criticism,[1] complemented by a supervisory enhancement programme, deserves careful study. It is rare for a public authority to be so frank in its analysis of what went wrong, though of course there is a precedent in its analysis of lessons learned on Equitable Life.[2] Interestingly, some of the same underlying issues can be identified in that report. The consequences should be seen in more joined up supervision from the FSA, more senior input from within the FSA into individual firms, and more challenge on business models as well as stress testing and liquidity issues. Many firms will be sceptical as to whether the FSA can deliver this – as a regulator it has never been short of bright ideas, but in common with much of the public sector in the UK, it has been weak in delivery.

One of the first challenges for the FSA will be to recruit more people into the retail business unit, both at a senior and more junior level. It needs people who both have an understanding of the financial services business, and can present the FSA's concerns articulately and unequivocally to the management of firms that it supervises. The potential pool of such staff is limited and already being fought over.

Operationally, it must show that it can cooperate at a working level with the Financial Stability Division of the Bank of England – not by ceding responsibility for individual firms, but by drawing on the Bank of England's immense knowledge of economics and risk, as well as the research of its own risk specialists within the FSA. As its internal report makes clear, it has not always done this.

Even those firms that remain sceptical as to the FSA's ability to deliver cannot afford to ignore this change within the FSA. Those responsible for management of the relationship with the regulator will need to anticipate more senior level visits and will need to ensure that members of firms' senior management are properly briefed and ready for some effective challenge. If the new team of supervision advisory specialists within the FSA does its job, this challenge will be at a higher level than hitherto.

Of course, it is difficult to generalise as to the areas on which the FSA will be focusing in rebirth: for many firms, there will be renewed focus on risk management, particularly credit risk management, and on the interaction between the board and risk managers. They will look for real challenge from the board to risk management. We cover some of these areas in our articles on the credit crunch and governance within this edition. Liquidity risk and stress testing on all areas of operations will also get more attention, and those who manage the agendas of main boards would do well to devote more time to some lateral thinking on appropriate scenarios for inclusion in stress tests, not avoiding the more extreme 'walk away' scenarios, if they are to be able to show the FSA that there has been proper board and senior management engagement.

Treating Customers Fairly (TCF) of course remains on the agenda: adherence to the existing March and December 2008 deadlines by firms will continue to be monitored, and they should expect continued mystery shopping and potentially customer surveys by the FSA, but it would not be unreasonable to expect a lesser focus on TCF than hitherto with the renewed emphasis on good old prudential supervision that is indicated in the supervisory enhancement programme.

We focus in this edition on other areas that will merit attention: Islamic finance, mortgage regulation, data compromise, hedge funds, business continuity planning, with-profit funds, and UCITS passports as well as other topics, and there is our regular technical update, all of which show that there is plenty to keep up to date with, even while the regulator is licking its wounds. As usual, we would welcome comments from our readers on other subjects that they would like to see covered.

If you would like to discuss any aspect of this publication, please speak to your usual contact at PricewaterhouseCoopers 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) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

[2] The FSA's internal audit review of its supervision of Northern Rock, and the FSA management response: www.fsa.gov.uk.

[3] Report of the Financial Services Authority on the review of the Regulation of the Equitable Life Assurance Society from 1 January 1999 to 8 December 2000 – 10.01.

Basel and the credit crunch

After the long and benevolent boom the last few months have seen significant volatility in the financial markets as a US sub-prime crisis has emerged, and then morphed into a broader financial downturn. Others have commented at length on both the macro-economics of this, and on the specifics of individual firms, particularly banks; the unfolding story will doubtless trigger more commentaries during 2008.

The stress is impacting the regulatory scene dramatically, and regulators across the world have been intimately involved in assessing both systemic and individual firm risks. Notably, the crisis has led them to refocus their attention on some basic prudential issues.

The banks they supervise have had to re-examine their regulatory position, and particularly approaches to their finances, to a degree they did not expect a few months ago. The banks have also had to grapple with the implementation of Basel II, with the combination of the credit crunch and Basel being one few would have wished for. This article reviews the combined impact and sets out some key action points for management.

The context

Since 2001-2, the ‘Goldilocks’ economy (with the macro variables all ‘just right’, including low real interest rates, low inflation and ready access to liquidity) contributed to a sustained period of economic growth and market confidence. However, as the boom ran its course and credit tightened, borrowers in the US sub-prime market started finding it difficult to fulfil their obligations, and as a result mortgage lenders started to find difficulties in refinancing their balance sheets: the credit crunch and liquidity crisis had begun. While seen by many as a localised problem that, like the First World War, ‘would all be over by Christmas’, it has proved to be a much bigger issue. Its effects spread as firms around the world had to look again at the quality and valuations of their US-originated asset-backed securities; its effects also spread across the financial sector as increasing mortgage default rates had the inevitable knock-on impact into retail lending and on into the ‘real’ economy.

Some key background facts:

- Huge losses announced by major banks worldwide – Credit losses reported are already well above $100bn and recently the G7 feared write-offs of losses on securities linked to US sub-prime mortgages could reach $400bn.[1]
- Sharp fall in the securitisation market resulting in shortage of short-term finance – Forecasts are that volumes in the various parts of the market in 2008 will be 50 – 75% of their 2007 levels at best.
- Liquidity crisis with widening spreads in inter-bank market – In the UK the spread between 3-month LIBOR and base rate had increased to historically extreme levels of more than 1% in December 2007.[2]

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[1] *Financial Times* – 11.02.08.

[2] http://www.bba.org.uk.

- Additional pressure on unsecured lending as a result of re-pricing of mortgage market – The re-pricing of the US mortgage market (estimated at $1 trillion) in 2008 is likely to add pressure on unsecured debt.
- A sharp fall and increasing volatility in equity markets – All the major equity indices worldwide suffered from sharp fall with increased volatility especially during second half of 2007.

Credit crunch, liquidity crisis, Basel II – a poisonous mixture?

At the same time as the credit crunch, banks, at least across the EU, have also had to bring in Basel II, the new capital framework that has been brewing for even longer than the last boom. This has involved huge amounts of work, and significant cost, to develop a 'risk-based' approach to capital usage. Some have questioned whether this has been money well spent, given the new system's substantial reliance on risk data and ratings that in some cases might have been shown to have been overtaken by events. Whatever the merits or otherwise of this argument it seems that the combination of pressure on profits as the cycle turns, and a more risk-based approach to capital assessment means that banks will find capital management a far more challenging discipline than before.

To illustrate the point, let's look at some simple examples:

- On the capital requirement side a fall in asset credit ratings caused by the market could significantly increase the capital a bank needs to hold to support its balance sheet. For example (for a bank on Basel's 'Standardised Approach' to credit risk), a rate cut on an asset from AAA to BBB+ will increase the risk weights on those assets fivefold, and even the (more realistic) smaller downgrades can double capital needs or more.
- In the retail lending sector banks have often expected and realised falls in capital requirements under Basel II. For example mortgage banks have benefited from lower risk weights on (adequately secured) retail mortgages, with a fall in the capital weighting from 50% under Basel I to 35% under Basel II under the standardised approach, and even lower if they get approval to use their own models for capital calculations.

  While models are supposed to be based on information through the economic cycle, and hence not be sensitive to current market conditions, default probabilities that rise significantly could mean that a figure of, say, 15% under a model approach may shift by a proportionally significant amount.

  The 35% standardised approach figure is based on no more than 80% loan-to-value ratio. A fall in property markets could breach this, again resulting in a notable increase as the rate jumps from 35% to 75%.
- On the capital available side of the equation, capital is suffering because of losses booked: a credit crunch inspired loss of regulatory capital of (say) £200m will result in a direct loss of £200m of Tier 1 capital. However, large scale losses can also result in a strain on, or breach of, the Tier 2 gearing limit (maximum 100%) in the rulebook with some of the bank's Tier 2 capital being invalid as a result. Until recently most banks never expected to reach their regulatory gearing limits, but now that's a real possibility for some. As a result capital falls caused by losses might be multiplied up significantly.

Consequently, even some of the largest banks are finding it difficult to maintain an adequate level of regulatory capital. They are recasting their published capital strategies and seeking to bring capital back to pre-crunch levels. To do this they have had little choice in the short term but to consider capital raising measures such as dividend cuts, capital raising from the market and/or sovereign wealth funds (SWF), and/or restructuring the liabilities. Some are also looking at longer term solutions, such as really exploring the return on regulatory/economic capital on their various activities and assessing whether they are in the right businesses given the new scenarios.

Politicians and regulators are worried too…

Naturally the regulators are also worried about the impact of the credit crunch on banks. They are being challenged by their political masters as to how they allowed this to happen (though one can question whether regulators have the omniscience that politicians would like to think). To demonstrate the renewed and highly visible political interest in the crunch and its aftermath one can quote John McFall, the Chairman of the Treasury Select Committee:

The 'best and the brightest' at our top investment banks have expended great energy designing ludicrously complex financial products, which you need a

Nobel Prize in physics to understand. Whilst financial innovation and securitisation have brought real benefits and allowed for risk dispersion through the system, it has come at a cost. Product complexity has introduced increased opacity into our financial system, making it almost impossible to determine where risk lies and making it much more difficult to achieve financial stability.'[3]

At the highest level, the politicians in the UK have been looking at the legal background and the bank failure regime. On 30 January HM Treasury, the Financial Services Authority (FSA) and the Bank of England jointly published a consultation document that outlines proposals for strengthening the framework for financial stability and depositor protection, including notably the introduction of a Special Resolution Regime for failing banks and the creation of a new bank insolvency regime.

This of course is for the extreme cases. In the Committee's mind the regulators need to be seen to do more than they have done to oversee all banks. This is not just complex rulebooks, they need to watch the horizon as well:

'The Bank and FSA can no longer hedge their bets, throwing potential risks out into the ether and then washing their hands of the consequences. We must ensure that in the future such warnings are heeded and acted upon by those at the top of financial institutions.'[4]

Clearly the regulators are under intense political pressure. However, they have to deal with the mechanics as well as the politics. In this field, they are showing their traditional concerns about the management of risk and adequacy of capital held by the banks. However, liquidity management, long in the shadow of capital as a policy area, has come though into the spotlight and policy work in this field has been brought to the top of the agenda.

In the UK the FSA issued DP07/7[5] on liquidity in late 2007, which provides a useful *tour d'horizon* of the current issues and risks. Actions that a review of this suggests for banks are listed below.

Other regulators are also assessing the position. The Basel Committee plans to issue for comment a set of 'enhanced sound practices' for managing liquidity risk in the summer of 2008. In advance of this, its paper 'Liquidity risk: management and supervisory challenges' (21 February)[6] highlights financial market developments that affect liquidity risk management, discusses national supervisory regimes and outlines initial observations and potential future work related to liquidity. It takes a holistic view and, for example, points (amongst many other areas) to the greater speed of settlement arrangements

[3] http://www.parliament.uk/parliamentary_committees/treasury_committee/tcfst.cfm.

[4] http://www.parliament.uk/parliamentary_committees/treasury_committee/tcfst.cfm.

[5] FSA Discussion Paper 07.07 – Review of the Liquidity Requirements for Banks and Building Societies – 12.07.

[6] Basel Committee on Banking Supervision – Liquidity Risk: Management and Supervisory Challenges – 02.08.

such as RTGS and CLS in recent years and the much wider use of collateral; both assist banks hugely to manage credit risk, but both put far greater stress on the proper management of liquidity and intra-day operational process than was needed before.

What should banks do?

The regulators, and politicians, have pointed to some of the issues that need to be dealt with. However, ultimately they refer the execution to 'senior management' – the regulators' first port of call when things go wrong. To assuage the regulators' concerns (as well as those of other stakeholders) management needs to focus on some important activities and take the necessary action.

The main actions focus around demonstrably managing risk, capital and liquidity better. Key to this is the bank's Internal Capital Adequacy Assessment Process (ICAAP). This is the document through which management demonstrates its efforts to identify and assess the bank's risk and manage capital over and above Pillar 1 requirements. Banks prepared these during 2007 as the Basel II framework that requires them came in, and the FSA is going through review process and setting 'individual capital ratios' for banks as a result.

Even absent the crunch, 2008 would have been a period when banks should have been bedding the ICAAP into their regular governance and risk processes. With the crunch they need to address more than just processes: the market turmoil has often raised questions about the continuing relevance of the risk assessments, the assumptions about those risks, and the approaches used for measuring/assessing them. It also raises questions about the validity of countervailing controls over risks (other than capital), the capital consequences of residual risks, and the quality of the document itself. Management now needs to address all these. If the bank is looking at its risk and capital as a result of the impact of the crunch then it needs to do this as part of a robust ICAAP governance process, not as a one off.

To complement the ICAAP work regulators now expect management to consider whether the more operational aspects of risk control are really as robust as needed:

- Are risk monitoring and mitigation controls adequate in the new situation?
- Is the operational risk framework still adequate in light of the current market turmoil?
- Are internal models validated and measured?
- What lessons can be learnt from operational failures at other institutions, and how does the bank have them covered?

As well as ICAAP, and critically, management needs to review liquidity levels and liquidity risks. FSA's DP07/7 is a good starting point for such a review:

- Are funding sources diversified by counterparty, market and product?
- Is access to money markets and central bank's standing facility readily available?
- Are all commitments within the stress testing, including off balance-sheet items?
- Is the contingency funding plan realistic and evaluated critically for all assumptions?
- Is the availability and quality of collateral supporting the business critically evaluated?
- Do we undertake both separate 'Firm Specific' and 'Market Wide', and 'Chronic' and 'Shock' liquidity stresses?
- Have we reviewed implicit assumptions in our liquidity assessment (for example the assumption that funding markets will remain open to us even in a crisis)?
- Have we considered risks of off balance-sheet vehicles?
- Do we face additional problems in managing cross-border liquidity in a highly stressed position?

Finally, from the last few months, it seems that one of banks' greatest risks is the adverse perception of stakeholders, whether they are depositors, influenced heavily by the media, or are more professional financiers and investors. Raising new capital, rolling over long-term borrowings, maintaining a stable retail deposit base, maintaining committed funding lines: all demand that the bank pays very serious attention to managing its public profile actively and consistently. From a Basel II perspective Pillar 3 has much to say on the technicalities of quantitative disclosure, but in 2008 banks need to make disclosure not an accountant's data gathering process but a true process of presenting the right qualitative and quantitative information to the right stakeholders at the right time and in the right way. This needs to be managed from the very top in a coherent way, reflecting both the bank's capital and liquidity needs and the needs of those providing funds that keep the business solvent and, hopefully, growing and successful.

The Tripartite Authorities

There is much talk about the role of the Tripartite Authorities in the wake of the credit crunch and various 'lessons learned' reports. Firms might reasonably be excused for expecting a visit from the Bank of England and HM Treasury alongside the regular visits of the Financial Services Authority (FSA), but this is not likely, though the respective roles of these three bodies within the financial services sector is inevitably being reviewed and the level of communication between them will have to be improved.

The respective roles of the Tripartite Authorities in relation to financial stability are set out in a Memorandum of Understanding, available on the Treasury website, and dated 22 March 2006,[1] being an updated version of the original 1997 memorandum. The division of responsibilities between them is based on four guiding principles:

- **Clear accountability** – Each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities.
- **Transparency** – Parliament, the markets and the public must know who is responsible for what.
- **Avoidance of duplication** – Each authority must have a clearly defined role, to avoid second guessing, inefficiency and the unnecessary duplication of effort. This will help ensure proper accountability.
- **Regular information exchange** – This helps each authority to discharge its responsibilities as efficiently and effectively as possible.

The Bank of England's responsibilities involve 'contributing to the maintenance of the stability of the financial system as a whole', the Treasury has responsibility for the 'overall institutional structure of financial regulation and the legislation which governs it', together with the flow of information and accountability to Parliament and within government, and the FSA has responsibility for authorisation and prudential supervision of individual firms, the supervision of financial markets, regulatory policy, and the conduct of operations 'in response to problem cases affecting firms, markets and clearing and settlement systems'. But it is the Bank of England that undertakes 'official financial operations' where required, exceptionally, by such problem cases, which is code for the provision of emergency liquidity support.

This division of duties has come in for plenty of criticism in the press and from expert evidence to the Treasury Select Committee, as described in its report 'The run on the Rock' of 24 January 2008:[2] surely the institution which has detailed knowledge of individual firms should be the one that dispenses liquidity support in times of difficulty, or has a credit line enabling them to require the Bank of England to do so? It is also clear from the Memorandum that ultimate authority in the Tripartite structure lies with the Treasury, and there is reliance on clear, timely communication between the parties to make it work.

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[1] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority: www.hm-treasury.gov.uk.

[2] The run on the Rock, House of Comments, Treasury Committee: www.parliament.uk.

Firms would anyway be well advised to take advantage of the opportunity for discussions at a generic policy level with the financial stability directorate at the Bank of England, to ensure that their views are understood.

However, the Treasury Select Committee did not call for the Tripartite system to be dismantled, but to be reformed, with better communication and more meetings at Principal level, which would include the Chancellor of the Exchequer himself. The Financial Services Authority's own Supervisory Enhancement Programme in response to its internal audit report into the supervision of Northern Rock, published in March 2008,[3] indicates that coordination with the Financial Stability Directorate at a working level will also be improved, and it appears that they will be looking to use a wider range of regulatory tools at firms to ensure that their regulatory objectives are achieved.

It is, however, to the likely legislation arising from the Tripartite Authorities' consultation paper – 'Financial stability and depositor protection: strengthening the framework' – published in January 2008[4] that we should look for the real change that can be expected. While this paper is essentially focused on banks, its conclusions may well be applied to other financial services sector firms. These include proposals to strengthen the legal underpinning of the Bank of England's role in respect of financial stability, and perhaps more importantly legislation to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for purposes related to financial stability, and that there is flexibility over the immediate disclosure of the provision of liquidity assistance to particular firms. Firms would anyway be well advised to take advantage of the opportunity for discussions at a generic policy level with the financial stability directorate at the Bank of England, to ensure that their views are understood.

It would be wrong, however, to conclude that this is uniquely a UK problem: most of the more significant financial institutions in the UK are international in nature, and the Tripartite Authorities' consultation paper rightly proposes greater international coordination and cooperation; they will also work with international counterparts to improve the effectiveness of the Financial Stability Forum and to share information gleaned from financial surveillance both by the International Monetary Fund and Financial Stability Fund members.

While firms may have some concern at the additional sharing of information relating to individual firms that is being proposed, the reforms to the Tripartite system that are emerging can only improve the stability of the financial system, and should be supported. There is a risk that some of the legislation proposed may be over-complex and over-hasty: hopefully HM Treasury will listen carefully to the comments received in the consultation process. However, the main change really requires very little by way of legislation: improved and more frequent communication at a working level between the Tripartite Authorities, and wider use of the regulatory tools that are already available to them, as well as improved articulation to firms of regulatory concerns, can only be of benefit to the financial services sector generally.

[3] The FSA's internal audit review of its supervision of Northern Rock, and the FSA management response: www.fsa.gov.uk.

[4] Financial stability and depositor protection: strengthening the framework, Bank of England, HM Treasury and FSA – 01.08.

Governance in the aftermath of market crises

Amidst the turbulent market conditions of Q1 2008, which saw a variety of financial institutions lurch from one crisis to another, there has been much soul-searching played out by international regulators, as a result of finger-pointing and questions emerging from the media and politicians. The apportionment of blame and accountability quickly rose to the top of the financial news headlines and stayed there long after the queues around the corner to withdraw retail deposits from UK high street banks had gone away.

The balance of criticism – tipped towards regulators or senior managers?

In its lead article of the March 2008 edition, *Global Risk Regulator* reported that:

'The first round of official preliminary studies and reports, issued in February and March, broadly conclude that responsibility for the failures behind the crisis is spread widely, and shared by debt originators, underwriters, credit rating agencies, investors and regulators.'

Later in the article, an eye-catching quotation from Chris Dodd, Chairman of the US Senate Banking Committee, was highlighted:

'Where were the regulators? Why didn't they do more? Were they asleep at the switch? And when the alarm went off, did they merely hit the snooze button?'

Criticism of the ability of senior management of financial institutions to have effectively discharged their duties of governance and oversight has not been entirely absent from the debate, but there has arguably been a disproportionate focus on the regulators, with a few obvious exceptions, at the expense of those charged with:

- Designing the business model and strategy.
- Accepting the level of risk appetite on new business.
- Challenging the management information they received and reviewed.

The journalists and politicians have not (yet) concentrated their fire towards senior management with the same intensity as they have upon the regulators. That task has been left to the shareholders, who often find it difficult to gather an effective collective voice unless some of the more prominent fund managers who own a significant proportion of the financial institution make their concerns heard.

Whilst there have been a number of high-profile departures at the leading investment banks – Stan O'Neal (Merrill Lynch), Chuck Prince (Citigroup) and Marcel Ospel (UBS) – these former leaders were the prominent public figureheads, inevitably bowing to crises of confidence in their leadership brought on by a collapse in share price. It is likely that even with the departure of senior leaders of the business, fundamental questions about the day-to-day governance of risk management will not go away.

Once the regulators re-group after their period of soul-searching and embark upon enhancing their levels of supervision, it is unlikely that the subject of governance will go away untouched, and the tiers of newly appointed senior management will face the same questions that should have been asked of their predecessors.

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The response of the Financial Services Authority

In the UK, the Financial Services Authority (FSA) has squarely accepted the portion of blame laid at its door over the Northern Rock affair, its failings being laid bare by John McFall, Chairman of the Treasury Select Committee, as follows:

'The failure of Northern Rock, while primarily a failure of its directors, was also a failure of its regulator. The FSA appears to have systematically failed in its duty and this failure contributed significantly to the difficulties and risks to the public purse that have followed.'[1]

The response of the FSA has been constructive, with a clear public response as to how it will reprioritise its efforts to discharge its own duties as set out in the Financial Services and Market Act 2000.

In summary, firms can expect to see:

- Increased levels of engagement with the FSA, led by more senior personnel.
- A much greater focus on prudential supervision in general.
- Particular focus on liquidity and stress testing.
- A greater application of resources directed towards combating market abuse.

The FSA's perspective on governance

The FSA has already been revisiting the difficult questions posed when it comes to considering governance across borders. As waves of crises tend to come and go in financial services – and come back again – the FSA has sought to revisit the work it did with the industry in 2005, when a Roundtable involving global investment banks was held to complete a piece of thematic work on the regional governance arrangements of global investment banks.

The rationale for that initial piece of work was that banks tend to go through different phases in their organisational life cycles of having greater or lesser periods placed on the relative importance of global lines of business versus the importance of having regional autonomy and independence to run the affairs of banks. Another familiar theme is whether or not a bank is dominated by a single individual rather than operating with a management style which enables a number of responsible and accountable individuals to flourish.

The governance issue with complexity and corresponding controls

The seemingly ever-increasing complexity of the origination and distribution of wholesale credit business linked to asset backed securities, the securitisation of that business and the subsequent sales and trading of financial instruments relating to credit risk of default required corresponding management information (MI) to allow for a clear line of sight of the risks being taken. The matching of controls did not match the growth of the business and it is at least arguable that senior management charged with supervising cross-border business did not have a clear picture of the levels of risk being taken by the business.

The FSA had identified some of these issues in 2005, although not specifically in relation to securitisation, collateralised debt obligations and structured investment vehicles. Some specific examples of risk were:

- Insufficient attention to the adequacy of the infrastructure in the governance process.
- Insufficient review of business practices to reflect environmental changes.
- MI that does not reflect an appropriate balance between financial risk and controls.
- Weaknesses in escalation of reputational risk issues.
- Key strategic, risk and transactional decisions being made at a global level without adequate challenge or representation from a regional perspective.

What firms can expect from the FSA as it renews its efforts in Q2 2008 and beyond

The work undertaken in 2005 would appear to remain valid when considering market developments since August 2007 to April 2008. The FSA devised a framework of 10 questions to pose in the context of reviewing the effectiveness of regional governance.

Whilst the questions would benefit from some refinement in light of current market conditions, this approach is still currently being used by FSA supervisors. They are likely to want to see evidence of how firms with cross-border dimensions to their business have reviewed their controls and governance and can answer the following key questions:

- Is the risk and control structure aligned to business unit decision making – and in turn to the boards and control structures of individual legal entities grouped within a region – regardless of where the business is originated?
- Is there a common approach to measuring and evaluating credit, market and financial risk across the global functions, regional divisions and legal entities?
- Do senior management receive MI in a form which enables them to deliver effective risk oversight in addition to the review of financial performance?
- Are new lines of business truly understood in the approvals process and how can senior management be satisfied that the quantification of risk associated with innovative products has been adequately assessed?
- What levers are senior management using to assure themselves that the operating culture of the firm supports effective governance?
- Is there true 'weight' given to the views of Regional CEOs, Regional CFOs and Regional CROs when global business initiatives are being rolled out?

[1] Treasury Select Committee – 29.01.08.

- Is there some form of ultimate veto which is written into the governance structure and could be recognised in the event of a regional head fundamentally disagreeing with a global head?

These questions are still relevant when reflecting on market crises. In addition, the FSA is likely to add additional questions in relation to balance sheet management; liquidity and stress testing of market and credit risk scenarios.

What boards of directors should look for in evaluating good governance

Whether pressure on corporate governance is arising from regulators, shareholders (Marks & Spencer), employees (pilots at British Airways) or criticisms from a former chief executive seeking to engineer change (Olivant and UBS), the approach to analysing the effectiveness of good governance is a very simple one. Boards of directors look at the people and the processes, as the diagram indicates.

The year ahead

The year ahead is likely to prove to be a difficult and challenging time for those involved in governance. Risk managers and senior managers charged with overseeing their effectiveness have rarely faced such challenges. Financial regulators are scrambling to maintain and improve their own levels of credibility amidst the recent market crises. There is no 'silver bullet' to get to the heart of failures of governance. A solid, workmanlike approach – simply by answering some fundamental key questions – is likely to pay greater dividends.

Organisational process

- A clear organisational structure
- Well-defined, transparent and consistent lines of responsibility
- Processes to identify, escalate and report risks
- Consolidated management information which can be understood and challenged by those charged with discharging oversight duties
- Effective internal controls and safeguards
- A management structure which gives effect to strong regional governance
- Coherent, consolidated global oversight and control of the regions

Senior executives

- Must satisfy themselves that controls and systems of risk management are robust and defensible
- Ensure that internal controls are embedded in the operations and culture of the company, without relying solely on internal monitoring processes
- Seek regular assurance that the system and day-to-day monitoring of controls are functioning effectively
- Ensure that they are supplied in a timely manner with information in a form and of a quality appropriate to enable them to discharge their duties
- Actively analyse and challenge management information
- Obtain consolidated oversight at regional governance level
- Work effectively between global and regional functions

Shariah-compliant retail accounts: Risk and return

Last November, the Financial Services Authority published a paper on Islamic finance (the 'FSA paper')[1] setting out the background to the development of Shariah-compliant financial services in the UK, and identifying regulatory issues and priorities for the FSA. The main thrust of the FSA paper was to reiterate that the UK continues to pursue the 'no obstacles, but no special favours' approach to regulating Shariah-compliant products.

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In this article we outline the structure and regulatory framework of Shariah-compliant savings accounts, and consider how these compare with conventional savings accounts. The fundamental issue is: Do Shariah-compliant savings accounts for retail customers really achieve equal opportunities and equal regulatory protection for customers as for customers with conventional savings accounts? Retail current accounts are not addressed, because an Islamic bank does not pay a return to investors on these accounts, but conversely the bank promises to repay any deposits in full.

Shariah-compliant retail savings accounts

A traditional savings account pays interest at a specified rate. One of the central features of Shariah compliance is the prohibition on Riba (interest) being paid or received. As a result, the striking difference between conventional and Shariah-compliant accounts is that instead of paying interest on any balances, the Shariah accounts offer a share of the profits that the bank derives from investments made using the customer's deposited funds. Therefore, a Shariah savings account carries exposure to potential volatility and risks (which we examine further below) which markedly exceeds the relative certainty of interest payments and low risk associated with conventional savings accounts available to other retail customers.

Traditional savings accounts also provide the depositor with certainty that the deposited funds will be repaid, so long as the bank remains solvent. The risk element of a Shariah savings account is raised because the most common structure used for savings accounts is Mudharaba (profit-sharing). Under this structure, the investors as a provider of capital must assume the risk of loss from the deployment of that capital, while any profits are shared between the investor and the bank's shareholders. If the bank manages the investments badly, the investor could lose all or a substantial part of the sum invested.

In contrast to the protection that FSA regulation provides for deposits in conventional savings accounts, e.g. through compensation schemes, the Shariah approach requires risks to be fully assumed by the investor, even if the investor is a retail client. Indeed, in the case of Shariah-compliant savings accounts, for the arrangement to remain halal (acceptable), the depositor must agree to waive any rights he or she may have to protection provided by a guarantee from the bank in the first instance, and ultimately by the regulatory system through deposit insurance or other compensation schemes.

[1] Financial Services Authority, 'Islamic Finance in the UK: Regulation and Challenges' – 11.07.

The FSA paper states that to meet the requirements of Shariah compliance for Mudharaba (profit-sharing) accounts, an Islamic bank must offer depositors the right to have their funds returned to them, but customers are allowed to waive these rights – thus incurring 100% exposure to risk.

If we accept the proposition that an increase in risk is an inherent characteristic of Shariah-compliant savings accounts, are customers holding these accounts really getting their money's worth? In practice, this will depend on each bank's formula for sharing its profits with its customers. In return for accepting increased risk, customers with Shariah-compliant savings accounts should be afforded a greater return vis à vis traditional account customers. Figure 1 below illustrates this point.

Fig 1. Illustrative table of returns

Year	Banking results*/ interest rate	Shariah-compliant account return	Shariah-compliant account balance	Conventional account return	Conventional account balance	Shariah return less conventional return
0	Opening balance	-	100	-	100	-
1	Good return/ medium interest	2	102	2	102	0
2	Excellent return/low interest	5	107	1	103	4
3	Poor return/high interest	0	107	4	107	0
4	Bank default or other critical event**	0	0	0	85.6	(85.6)

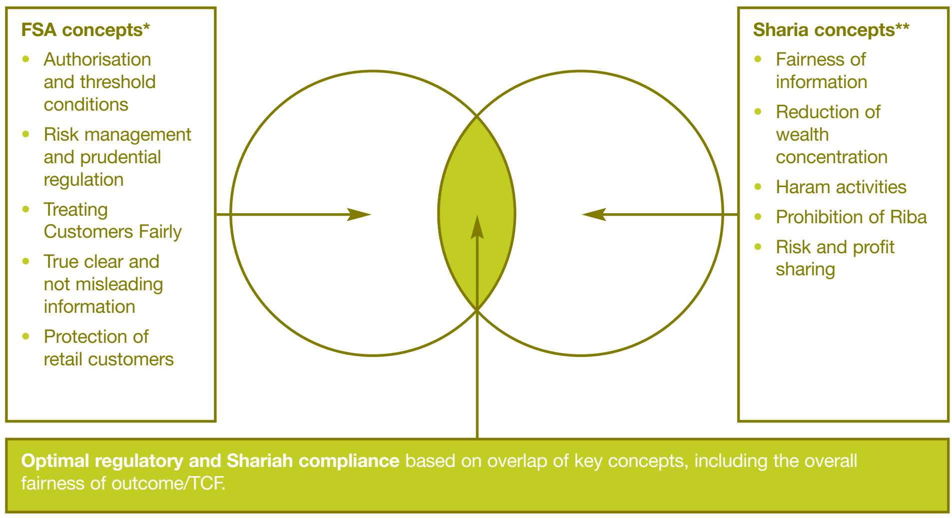
* it is assumed that the bank's level of profit will correlate with returns to Shariah-compliant savings accounts.

** it is assumed that a critical event occurs, e.g. insolvency of the deposit-taking bank and that conventional depositors are protected as to 80% of their deposits.

Furthermore, conventional depositors know in advance the rate of interest that will apply to their deposit. Where the bank can re-set the rate, it normally has to publish the new rate, with the investors being entitled to withdraw their deposits if dissatisfied with the new rate. Conversely, the Shariah-compliant investor is subject to the bank having discretion over the allocation of investment returns between the bank and the investor. This introduces a further element of risk for the investor.

To fully compare rates of return between Shariah savings accounts and conventional retail savings accounts, other factors also need to be taken into account. For example, Shariah savings accounts are often subject to fewer charges (e.g. overdraft interest and fees) than conventional savings accounts. Taking into account such factors, the overall difference in financial treatment of customers may be less than first appears. However, even if that is the case, the overall economic terms and adjusted return for Shariah investors may not be transparent enough to provide a reasonable basis on which to compare risk and return of Shariah products with similar conventional products.

Fig 2. FSA ‘Treating Customer Fairly’ and Shariah compliance and key ‘fairness issues’



* selected principles from FSA rules and guidance

** as described in brief in Chapter 2 of the FSA Paper

For banks offering these products, the FSA’s current emphasis on Treating Customers Fairly will have a significant impact on how the risks and rewards of Shariah products are communicated to retail customers. Financial institutions will need to interpret and apply the FSA guidance in this area carefully, to ensure that the information provided to retail customers for Shariah products meets the required standards for retail products generally.

Regulatory and Shariah compliance: interaction

More fundamentally, the Mudharaba example provides the basis on which to briefly examine the relationship between UK regulation and Shariah compliance.

As the FSA notes, although it cannot give opinions relating to Shariah compliance, indirectly it must influence the construction of Shariah-compliant products to ensure that regulatory protection afforded to retail customers is not prejudiced. Thus, the relationship between FSA regulation and Shariah compliance is a dynamic interaction, whereby the FSA must identify areas in which it may agree to interpret rules differently, and areas in which it cannot justify different treatments for conventional and Shariah products. As the FSA notes in relation to applications for FSA authorisation from Shariah-compliant financial institutions, ‘the FSA is prepared to review each case on its merits and will try to reach solutions that are acceptable to all those involved’.

As demand for Shariah-compliant products gathers momentum, the FSA is likely to come under increasing pressure to draw the lines between what it, as the financial services regulator charged with protecting retail investors, deems acceptable, and how far Shariah structures may go before a Shariah product is deemed unsuitable for the UK retail market due to level of risk to the investor.

In managing the development of regulation of Shariah products for retail customers, the FSA must continue to strive to strike a balance between its statutory object of protecting investors and the desire to foster an inclusive financial environment which provides appropriate financial products for Shariah investors.

Provider/distributor relationships nine months on

'Responsibilities of providers and distributors for the fair treatment of customers' was published as PS 07/11 by the Financial Services Authority (FSA) in July 2007.

The original proposal for a 'Statement of responsibilities' attracted widespread comment and some criticism, not just on the subject matter, but also due to the suggestion that the FSA was introducing 'regulation by stealth', circumventing the Consultation process to rush through an additional layer of responsibilities. However, the regulator was listening and the two key responses were:

- There were no additional (rule-based) regulatory requirements as a result of this publication, but it does represent the FSA's view on how it expects providers and distributors to interact in the context of treating their customers fairly.
- The proposed Statement is now a 'Regulatory Guide' – in essence a toned down version of the Statement, with some of the most controversial areas removed.

Edited highlights of the Guide are summarised in this article.

General

- A customer's experience should not be affected by whether a product or service was provided and distributed by a single institution or by two or more institutions.
- The traditional roles of provider and distributor are now sometimes less distinct, particularly in markets where larger distributors have significant input into product design.
- Where there is a lack of clarity, 'responsibilities flow from the actual roles or functions undertaken in a transaction, and firms should take this into account in considering their responsibilities under the Principles. In considering which responsibilities apply to it, a firm should consider the functions and roles that it undertakes in the product lifecycle'.

Product design

- The provider should identify the target market – which types of customer the product is likely to be suitable for. If a distributor is sufficiently involved in the product design process, then it will effectively take on the responsibilities of the provider.
- The provider should consider stress-testing the product to identify how it might perform in a range of market environments and how this might affect the customer. When stress-testing, the provider should consider the vulnerability or level of financial capability of the target market.

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- Mortgage case study (published in the original Discussion Paper): the lender should be very careful when identifying the target market and may wish to identify which type of customer the product is NOT suitable for.

Provision of information to distributors

- Where information is designed for distributors alone, the provider 'should make clear that the information is not intended for customer use'. This is an area where a consistent level of good practice already exists in most markets.
- The provider may wish to consider what information the distributor has, its likely level of knowledge and understanding, its information needs and what form or medium would best meet those needs. This is perhaps the most controversial proposal to remain in the Guide as it involves assessment at an individual distributor level.
- Where information is unclear, a distributor is more likely to meet its obligations to the customer, if it asks the provider for answers before providing the material to the customer. 'It should consider whether to distribute the product if it does not understand it sufficiently'. If a distributor requires further clarification, the provider should be asked to provide additional information or training. Some networks and larger distributors are already requesting this support from providers in some market sectors.

Financial promotions

- Again, providers should consider their target market, including the likely level of customers' financial capability.
- A distributor will not contravene the financial promotions rules (or Principles 6 & 7), where it communicates a promotion produced by another person provided it takes 'reasonable care to establish that the other person has confirmed compliance' with the relevant detailed rules. This is another area likely to prove controversial, as it requires a specific challenge as to the basis of the promotion.

Considerations regarding distribution channels

Whilst a provider's obligations under Principle 6 are a given in these days of TCF, the FSA is also reminding firms to pay particular regard to obligations under Principles 2 (Skill, care and diligence) and 7 (Clear, fair and not misleading customer communication) when deciding which channels are appropriate.

- Providers should consider whether a product's characteristics means that customers would be wise to seek advice.
- A provider 'should act when it has concerns, for example by ceasing to use a particular distribution channel'.

Monitoring distribution

One key concession is around the expectations of providers to monitor their distributors. Whilst the original proposal was for monitoring of all channels at 'a high strategic level', the expectation is that providers will review what happens in practice against what was planned for the distribution of any given product or service, including appropriate MI. Providers are not required to 'police' their distribution.

- The distributors should consider the appropriateness to its customer of the provider's products or services.
- Selection criteria should include an assessment of the financial strength of the provider, levels of charges and service quality (where measures are available).

Monitoring

- Providers have a responsibility to maintain adequate management information in order to understand and manage the risks posed by their chosen distributor firms. 'The provider should act when it has concerns,' for example, by ceasing to use that distribution channel.
- Management information should be detailed enough to monitor performance by distribution channel and detect variances to expectation: the inadequacy of management information in this respect is clearly a major concern at the FSA.

Post-sale responsibility

- A firm should do what it says it is going to do – honour its contractual obligations, contact customers when it says it will and manage complaints and claims in a timely and fair manner.
- The provider should review products if performance varies materially to check whether the product is continuing to meet the general needs of the original target audience, or whether the product's performance will be

significantly different from that the provider originally expected. If this is likely to have a material negative impact, the provider should consider whether and how to inform the customer of this 'and of their option to seek advice'.

- A distributor's responsibility to a customer after the point of sale is in part determined by any contract or agreement made with the customer at the outset. The distributor should also consider any commitments made to the customer.

So to what extent have firms so far embraced these regulatory expectations?

To some extent, the FSA's expectations can be compared with a journey. Over time, we should expect to see greater traction on more of the provider / distributor relationship components. However, in the short term there will inevitably be providers and distributors which are ahead or behind their peers. In our experience, many firms still have a long way to go on their relationship journey. Having said that, there are many good practices which are indicative of firms embracing the principles behind the FSA's relationship policy requirement.

- Most providers have reviewed their literature and documentation provided to distributors, to include more information about typical target customers.
- The roles of intermediary sales or business development staff within product providers have been widened to include some support elements.
- Providers' telephone and internet sales support areas have been developed or expanded.
- Some providers have introduced product specific training or telephone 'hotlines' for intermediaries.
- Management information has been enhanced to provide the necessary information regarding products and distribution channels. In many firms, this naturally forms part of the more general progress towards effective TCF management information and meeting the FSA's March and December 2008 deadlines, but it should not be overlooked.

Understandably, many regulated firms have faced significant challenges in the market since this Guide was published in July 2007, but now that the requirements have been in place for some time, it seems likely that the FSA will start to review the progress of both providers and distributors as part of its normal Supervisory activity.

Data compromise – a new twist on avoidable losses

Avoidable losses used to be a phrase associated with fraud and theft in the retail industry, but we believe it is about to get a new lease of life.

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Data compromise is currently one of the highest profile business risks that we have seen for many years as organisations across all industry sectors suffer losses that typically result in significant adverse publicity or even financial and regulatory censure. The Financial Services Authority (FSA) has recognised that the threat of data compromise raises serious concerns for the security of consumer data in the UK and has been working hard to change the way the challenge is perceived by treating it as a financial crime issue – one of its statutory objectives. Over the last 12 months the FSA has consistently demonstrated its commitment to reducing the risk of customer data compromise by reiterating its message, educating the market and in some cases by placing organisations in enforcement. It also recently completed a thematic review on customer data compromise, with the findings suggesting that there is still a significant amount of work to do across the financial services sector if the threat of data compromise is to be effectively managed.

One of the key changes in focus is that the thematic review was conducted under the financial crime agenda. Treating the problem as a financial crime issue forces one to look beyond matters relating just to technology. This is important because there are a range of major data compromise threats which do not fall into the technology space. Yet despite this, many organisations appear to be missing the point and continue to treat the threat primarily as an IT issue. Examples of common threats might include corrupt employees gaining employment through the lack of an effective pre-employment screening regime – that is an HR, not a technology issue, or it could be that you have no contractual right to audit the supplier that disposes of your confidential waste when in actual fact it is cutting corners and disposing of your waste inappropriately – that is a procurement, not a technology issue. Yet it is easy to see how both of these scenarios could result in the compromise of an organisation's data.

Another important point is that in our experience many high-profile data compromises are caused by human errors or carelessness such as not following existing procedures, and can best be classed as unintentional or avoidable.

This message was also echoed by the FSA's Phillip Robinson (Director, Financial Crime and Intelligence Division), who last year stated that 'The most common financial crime incident we have been dealing with this year is the compromise of customer data by firms holding large amounts of sensitive information. Worryingly, nearly all of these data compromises were because of carelessness, breaches of procedures or poor controls – they were not due to sophisticated hi-tech attacks by organised criminal gangs. Data compromises can affect a limited number of customers, but the sensitivity of the lost data puts those consumers at a very high risk of financial crime and identity fraud.'

We believe that in the long run it is these avoidable losses that may go on to cause organisations suffering data compromise incidents the most trouble, as questions are asked by regulators and the press about the effectiveness of governance and risk management and what oversight those at board level actually had. After all, in most cases an avoidable loss should be exactly that – avoidable.

Implementing the Hedge Fund Standards: How hedge funds can differentiate themselves and build trust

The Hedge Fund Standards Board (HFSB) published its Hedge Fund Standards on 22 January 2008.[1] The intent is to improve transparency and disclosure across the sector and to deflect any over burdensome regulation in the future. The Board is generally expecting that all organisations across the industry will conform to these standards.

The standards are voluntary and comprise a comprehensive framework covering Risk, Governance, Activism, Valuation and Disclosure. Becoming a signatory to the standards (the undertaking to conform to the standards) will require hedge funds to demonstrate how they comply with the standards or otherwise 'explain' why they feel they cannot. Adherence to this 'comply or explain' regime allows conformity, even in the event that all standards are explained away, which should not be seen as an inferior option to complying.

The standards specify that a 'conformity statement' should be submitted to the HFSB on an annual basis (the first submission being no later than 31 December 2008) and this is a public declaration of conformity. A 'disclosure statement', providing investors with overview details of the standards with which the signatory does not comply, must be made available to investors and other interested parties by the same date. The drafting of an 'explanatory statement' (which explains in detail to the HFSB where business practices do not currently conform to the standards) is also a requirement.

There is, however, no suggestion that any of these statements will be monitored or assessed, by the HFSB or any other oversight body, to ensure the quality or integrity of their content; and therein lies the problem with any unsupervised, voluntary standards if they are not simply to be viewed as self assessment, self certification and ultimately self serving.

The HFSB, on receipt of conformity statements, will allow its logo to be used on hedge fund signatories' websites, offering documents and marketing materials, but there is a risk that the HSFB's reputation and this regime will be tarnished should a signatory claiming conformity be found subsequently to have submitted an inaccurate conformity statement. The explanatory statement submitted to the HFSB would also have to be sufficient in detail to allow suitable dispensation under the 'comply or explain' regime.

Similarly, from an investor's perspective, the receipt of a disclosure statement that ultimately lacks detail and looks much the same from fund to fund will not increase an investor's ability to make an informed decision with respect to conformity to the standards unless they have confidence in how a disclosure statement was prepared in the first instance.

It is not only investors and the wider market place that need to be confident of a level playing field. Those funds which invest time and money in a managed, due process when implementing the Hedge Fund Standards and disclosing conformity would rightly feel disadvantaged if a peer did not approach its implementation and

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[1] The Hedge Fund Standards Board website: http://www.hfsb.org.

By differentiating themselves and not following the crowd, hedge fund signatories can deliver better value to their organisation and investors whilst gaining or maintaining competitive advantage over their peers.

disclosure with the same level of rigour and professionalism.

To really stand out, to differentiate themselves from the pack and to generate the most value from implementing standards, hedge funds need a managed process in place to:

- Document current practices, processes and controls.
- Identify gaps in current practices and controls where furthest from the required standard.
- If necessary, enhance practices and controls to meet the standards.
- Prepare the necessary evidence, to the appropriate level of detail, to enable full disclosure through the ‘comply or explain’ regime and associated statements.

An independent validation from a reputable and competent third party over the implementation process and subsequent disclosures would lend significant weight to the assurances that the signatories are giving to their investors (both current and prospective) and could be a real differentiator – a demonstration that they have taken the process seriously and have confidence to open up their disclosures to scrutiny. It is reasonable to assume that validation of this nature would also be sought by the directors of hedge funds before any public declarations of conformity are made. Additional value, by-products of a managed implementation approach and validation, would potentially include:

- Process improvements and realisation of operational efficiency gains.
- Enhancement of the overall risk and control environment.
- Cost reduction, as a result of the above.
- Reduced management disruption and costs involved in supporting investors’ due diligence reviews.
- Reduced direct regulatory oversight in the future, should this arise.

In summary, these voluntary standards are a measured approach to an important issue facing the sector, but how they are implemented will be key. By differentiating themselves and not following the crowd, hedge fund signatories can deliver better value to their organisation and investors whilst gaining or maintaining competitive advantage over their peers. Simply going through the motions and ‘ticking the compliance box’ is surely not the best option and action should be taken now.

Business continuity in the financial services sector: Rising standards?

The bombs that rocked London on 7 July 2005 dramatically heightened awareness of business continuity issues for financial services (and other) companies within and beyond London. The bombings also occurred at a time when the Tripartite Authorities (the Bank of England, the Financial Services Authority and HM Treasury), were already, through the resilience benchmarking survey, putting business continuity very firmly on the agenda of banks and financial infrastructure providers.

In some ways this combination of external events and regulatory scrutiny represented the zenith for business continuity visibility in the financial services sector. Since 2006, business continuity activities have attracted less media attention. Nonetheless, plenty of work has been going on, particularly in the evolution of business continuity standards. It is interesting to speculate whether these activities have produced real benefits, i.e., does the fall in column inches and increased formality of guidelines and procedures really mean that financial services firms have raised their business continuity standards?

The short answer is 'not completely'. Financial services firms' business continuity plans have improved overall, but they often remain weak in specific areas.

The Tripartite group's resilience benchmarking report, published in December 2005,[1] identified key areas for improvement in businesses' interaction with, and dependence on, third parties. It also highlighted the need for greater consideration of the role of people, rather than just processes and technology. The Market-Wide Exercise, by focusing on a specific event, a flu pandemic, was also very successful in emphasising the human side of business continuity. Many firms responded positively, and have strengthened their business continuity plans to address many of the issues the exercise raised. Similarly, our work with firms indicates greater efforts are being made to work more effectively with emergency services, local government and utility providers.

Business continuity standards have also progressed in the last two years. The British Standard for business continuity, BS25999 part 1,[2] was introduced in November 2006, largely replacing PAS 56. Part 2 came into effect from November 2007, providing businesses with an opportunity to demonstrate compliance with the standard through a certification scheme. In May 2006 the European central bank published a document entitled 'Business continuity expectations for systemically important payment systems (SIPS)'.[3] More recently, in February this year, the Securities Industry and Financial Markets Association (SIFMA) published 'Expanded practices guidelines'[4]. Formal adoption of standards and guidelines is still relatively immature, but our experience suggests that it is starting to help firms reach a more consistent minimum baseline.

Beyond generic business continuity standards, the Tripartite Authorities have published a business continuity practice guide which seeks to assist financial services firms in addressing the issues observed in both the resilience benchmarking and market-wide test initiatives. The document included some guidance on the business continuity considerations of engaging with third parties. This, in particular, was a direct response to an observation in the benchmarking survey regarding firms' lack of understanding of the

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[1] 'The Discussion Paper, Resilience Benchmarking Project' – 14.12.05.

[2] 'BS 25999-1:2006 Business continuity management, Code of practice' – 11.06.

[3] 'Business continuity oversight expectations for systemically important payment systems (SIPS), European Central Bank' – 06.06.

[4] 'The Business Continuity Program Expanded Practices Guidelines SIFMA Business Continuity Planning Committee, Best Practices Sub-Committee' – 02.08.

‘In particular we are concerned that firms are too inward-looking in respect of their testing and planning arrangements, that more could be done to increase transparency of information between firms and their critical suppliers, and that crisis management arrangements need to be more realistic.’

resilience and recovery capabilities of key third parties. Sir Callum McCarthy in his foreword to the benchmarking discussion paper commented that:

‘In particular we are concerned that firms are too inward-looking in respect of their testing and planning arrangements, that more could be done to increase transparency of information between firms and their critical suppliers, and that crisis management arrangements need to be more realistic.’

Despite the prominence given to the issue, our work with financial services firms indicates that few have fully addressed this issue. This is a cause for concern, particularly given the continued adoption of outsourcing critical business processes to third parties, sometimes outside the UK. For example, few firms are actively involving both business and business continuity staff in the evaluation of outsourcing options. As a result they risk being unaware of whether they would still be able to meet recovery point and time objectives. In other cases, risk assessments are not performed that provide a detailed understanding of the changing probability of events that might disrupt business.

Another area of business driven change is that of merger and acquisition activity. Here too, firms seem slow to address the implications for business continuity. The situation is often exacerbated by a lack of real integration between business continuity professionals and those directly responsible for business processes. At best this will lead to inefficient plans, but at worst it increases the risk of business disruption and impairs the ability of firms to quickly recover disrupted services.

The lessons from the last two years are clear. Improvements have been made, and the strengthening of standards and guidelines has helped raise the business continuity bar. But both firms and those providing guidance must pay greater attention to changing business models and in particular to dependencies on third parties. Business events such as the credit crunch, the Northern Rock crisis and recent high-profile data losses may have eclipsed business continuity in terms of media and regulator interest. However, senior management should not wait for another disaster before putting business continuity firmly back on its agenda.

Distribution issues for with-profits funds

The Financial Services Authority's (FSA's) 'Dear CEO' letter in September[1] emphasised the need for closed with-profits funds to have an orderly and fair approach to the final distribution of the fund and its inherited estate. More generally all funds have an annual duty under FSA rules to review a fund's estate and whether a distribution is called for.

The FSA's letter in September 2007 reported back on two thematic reviews; one of which assessed the extent to which firms are appropriately managing closed with-profits funds. This thematic work followed on from the earlier 2005 sector briefing on closed with-profits funds. The FSA 2007 review of 13 closed with-profits funds 'concluded most were unable to demonstrate effective management of their fund(s)'. A key aspect to this management in run off is the distribution of the estate.

Separately over 2007 the FSA has asked many open funds for the result of their assessment of what is termed 'excess surplus' under the conduct of business rules that cover treatment of with-profit policyholders. The existence of excess surplus raises the question of whether a distribution is required so as to treat customers fairly.

Firms clearly need a clear policy over distribution that accords with their view of Treating Customers Fairly. The FSA seems likely to continue to press firms for well-documented approaches that are carried through in practice for claims, projections and risk management. Weakness in this area will not help a firm in meeting the FSA's demands for minimum TCF requirements by end 2008. However, a firm with good risk management and a clear risk appetite for the with-profit fund will already be ahead in this area.

There are three common distribution methods, all of which have their advantages and disadvantages. The first method is the distribution to current asset shares of the excess capital over and above the fund's risk appetite. This could be subject to a number of further conditions at each review, but at heart is a process of recycling the capital releases to the survivors. The second method aims for a more planned distribution set as a percentage uplift each year of surviving assets shares. This can be adjusted in the light of experience but is trying to steer a course between over-hasty distribution and not disadvantaging the early claims. Lastly the fund could assign all the estate to current asset shares in a very deliberate attempt to ensure all claims receive a similar uplift.

All these methods, and the variants in between, are currently being followed in the UK. Prior Part VII Scheme rules, or implications, may also be a determining factor. All methods must tread the line between fairness and security; all should be part of a holistic risk management approach.

The capital necessary for security is, for the industry as a whole, less driven by market risk than it has been for many decades. Market risk has been historically high by virtue of traditionally backing guarantee costs by a similar mix of assets as back asset shares. The reduction in equity exposures, the hypothecation of assets, lower guarantee products and the specific hedging actions taken, have all mitigated market risk. Non-market risk, and the less tractable market risks, such as property, are likely to continue to grow in dominance. Good risk management takes a full view of what risks are being taken for policyholders, for shareholders, for what reason and with what mitigating options.

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[1] FSA – CEO letter to With-profits funds – 19.09.07.

UCITS III: Proposals for change

The European funds industry is currently awaiting the outcome of the latest attempts by the European Commission (the 'Commission') to improve the operation of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive (85/611/EEC).

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In March 2007, following publication of a consultative White Paper in 2006,[1] the Commission published for consultation initial orientations setting out possible amendments to the UCITS Directive.[2] This article provides a summary of some of the Commission's proposals arising from the White Paper and initial orientations. The Commission is expected to publish draft legislation in the spring of 2008.

The UCITS Directive was originally adopted in 1985 with the aim of coordinating the laws of Member States relating to collective investment undertakings and facilitating cross-border marketing of retail funds across Europe. Perceived failings in the operation of the original directive, due, in particular, to the narrow definition of permitted investments and the ability of individual Member States to impose rules governing the marketing of funds in their own jurisdiction, led to the adoption in 2002 of the Management and Product Directives. These amended the UCITS Directive by, amongst other things, broadening the range of permitted investments and introducing the simplified prospectus and management passport. However, shortcomings in the amendments, together with a rapidly evolving funds market, have meant that calls have continued to be made for further changes to the UCITS regime. The latest proposals are the result of a review process dating back to the publication in 2005 of the Green Paper on the future of the EU funds regime.

The Commission estimated that at the end of 2005 there were more than 29,000 UCITS funds, representing approximately 75% of all investment funds in the EU.[3] However, despite the success of the UCITS model, the Commission commented in its White Paper that the UCITS regime was coming under strain and the UCITS Directive was no longer sufficient to support the changing European fund industry, with core elements failing to function effectively.[4] To address this, the Commission proposed targeted and specific reforms to the existing framework rather than a fundamental revision of the regime. Such reforms included:

- Removal of administrative obstacles and delays to cross-border marketing via an overhaul of the UCITS notification procedure (the fund passport).
- Changes to the management passport to allow fund managers to manage funds domiciled in another Member State.
- Facilitating fund consolidation through fund mergers.
- Permitting master-feeder structures to provide for centralised management of assets gathered through local funds.

[1] White Paper on enhancing the Single Market Framework for investment funds (COM(2006) 686 final), Commission of the European Communities – 15.11.06.

[2] Initial orientations of possible adjustments to UCITSDirective (85/611/EEC): overview of key features. Working document DG Markt Services, and accompanying detailed Exposure Drafts – 03.07.

[3] Commission staff working document accompanying the White Paper on enhancing the Single Market framework for investment funds: executive summary to the impact assessment (SEC(2006) 1452 – 15.11.06.

[4] White Paper on enhancing the Single Market Framework for investment funds (COM(2006) 686 final), Commission of the European Communities – 15.11.06.

[5] Exposure Draft: Initial orientations for discussion on possible adjustments to the UCITS Directive – 2 Management Company Passport – 03.07.

[6] White Paper on enhancing the Single Market Framework for investment funds (COM(2006) 686 final), Commission of the European Communities – 15.11.06.

- Improving the information provided to retail investors.
- Changes to improve cooperation between supervisory authorities, thereby improving effective oversight of the fund market.

The fund passport

In the initial orientations, the Commission noted that current procedures for cross-border marketing of funds are cumbersome, costly and subject to undue supervisory interference. Failings highlighted include intrusive checks of funds during the notification procedure, requirements for additional information and requests for modifications of fund documentation or fund features reviews, each of which are creating opportunities for delay and having the effect of undermining the effectiveness and credibility of the funds passport. To counter these difficulties the Commission proposed a complete overhaul of the notification procedure, introducing a regulator-to-regulator filing similar to the approach adopted by the Prospectus Directive.

Under the proposed new procedure, a UCITS fund would submit a defined set of documents to its home supervisory authority, which would be responsible for verifying completeness of the information and forwarding the information to relevant host state authorities. The home state authority would also certify that the UCITS fund was duly authorised. The proposals also provide for a notification letter to be submitted by the fund manager containing a description of the marketing arrangements. A fund would be permitted to begin marketing the UCITS fund in a host Member State three days after transmission of the notification by the home authority.

The management passport

The creation of an effective management passport is viewed by many in the funds industry as a key driver for further amendment of the UCITS Directive. Despite the 2001 amendments, and to the disappointment of the industry, fund managers are currently required to establish a fully functional management company in each country where their funds are located, generating estimated costs of between €500,000 to €1million per management company per year.[5]

The Commission identified several options to amend the current regime and broaden the scope of the management passport, including permitting management companies to provide the full range of collective portfolio management services to funds domiciled in another Member State, or permitting a partial passport, that would require certain key functions to be carried out in the Member State of the fund. In the initial orientations the Commission favoured the partial passport with activities related to administrative functions being required to be physically undertaken in the Member State in which a fund is domiciled. To counter potential concerns which might be raised in relation to establishing the identity of the fund or fund manager's domicile, in particular from tax or supervisory authorities claiming jurisdiction, the initial orientations envisaged the establishing of clear tests to identify domicile.

The simplified prospectus

The simplified prospectus was a key innovation of the 2001 amendments to the UCITS Directive (although it was not fully implemented in all Member States until 2005). However, in its White Paper, the Commission declared that the simplified prospectus had manifestly failed to achieve its intended purpose of providing investors with basic information about the risks, charges and expected outcomes of a particular investment in a concise and understandable manner. Due to national 'gold plating' and varying implementation in Member States, in practice investors often receive lengthy and unhelpful information which is provided at considerable cost to the fund industry.[6]

To address these failings the Commission initially proposed replacing the simplified prospectus with the concept of key investor information disclosures which

would be provided to potential retail investors prior to purchasing units in a fund. Key investor information should define the product information, be fair, clear and not misleading and consistent with the relevant parts of the full prospectus (which would continue to be produced and made available on request).

Such is the urgency to address the problems with the simplified prospectus, the Commission announced that rather than wait for formal amendment of the Directive practical steps should be initiated as soon as possible, with non-legislative improvements to be introduced potentially by mid-2008.[7] As part of this process the Commission asked the Committee of European Securities Regulators (CESR) to provide guidance as to the potential content and form of key investor information disclosures. CESR published its advice to the Commission in February 2008, stating, in particular, that to be useful to retail investors, disclosures need to be short, focused, expressed in plain language and presented in a way that enables comparisons to be easily made between different offerings. CESR recommends a short single document avoiding technical financial terms and legal jargon.[8]

Fund mergers

In the White Paper the Commission highlighted inefficiencies in the European fund industry, in particular the proliferation of funds of sub-optimal size which fail to benefit from economies of scale and have disproportionate costs which are borne by investors.[9] To facilitate rationalisation of the fund industry and cross-border fund mergers, a new regime requiring Member States to provide for the possibility of two UCITS funds merging or amalgamating has been proposed. Fund mergers could be effected via creation of a new fund; mergers could occur by way of a scheme of amalgamation or merger by way of absorption. The regime would also be available for mergers between funds domiciled in the same Member State.

Asset pooling

The availability of asset pooling would provide funds with another means of realising economies of scale. However, the Commission rejected the possibility of having a feeder invest into several masters, raising issues such as a lack of practical experience and demand for such an approach, supervisory concerns and difficulties in preventing operational risks or possible investment policy breaches. The Commission has instead proposed the creation of a special regime providing for a master-feeder structure in which the feeder fund should invest at least 85% of its assets into a single master fund. A feeder would not, however, be permitted to invest in more than one master fund. Both the master and feeder funds would have to be UCITS funds and could employ the same management company.

Industry reaction

In general, reaction to the Commission's approach and proposed changes has been favourable. However, the shape of the new management passport has divided regulators and the funds industry. Whilst the Commission alongside Ireland and Luxembourg, both countries in which significant numbers of UCITS funds are based, are believed to favour the 'partial passport', other Member States such as the UK, France and Germany would like to see the introduction of a full management passport. Critics of the latter have raised concerns regarding supervision of 'virtual' funds and of fund managers performing all functions on a remote basis.[10] In contrast the reaction of the UK's Investment Management Association (IMA) was one of extreme disappointment at the proposal for a partial passport. The IMA has argued that this would represent a step backwards, and have potential for unintended consequences for the industry.[11] Recent press coverage has suggested that the Commission may be considering dropping the management passport proposals altogether from the soon-to-be published draft legislation. For many in the funds industry this would represent a lost opportunity.[12]

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[7] White Paper on enhancing the Single Market Framework for investment funds (COM(2006) 686 final), Commission of the European Communities – 15.11.06.

[8] CESR_s advice to the European Commission on the content and form of Key Information Document disclosures for UCITS, CESR/08-087 – 02.08.

[9] White Paper on enhancing the Single Market Framework for investment funds (COM(2006) 686 final), Commission of the European Communities – 15.11.06; Commission staff working document accompanying the White Paper on enhancing the Single Market framework for investment funds: executive summary to the impact assessment (SEC(2006) 1452 – 15.11.06.

[10] 'Admin passport' splits Europe, Steve Johnson, FT Report – Fund Management – 14.01.08.

[11] Investment Management Association: The European Commission exposure draft to enhance efficiency of the European fund market, IMA Response – 14.06.07.

[12] Threat to 'vital' rules for Europe by Pauline Skypala, FTfm, 25.02.08; Brussels must keep full passport proposal by Robert Jenkins, FTfm – 25.02.08.

Sovereign wealth funds: What to look out for

Over the last few months there has been a focus of attention on sovereign wealth funds. For many their activities have seemed to mark the emergence of a new class of investor within asset management. Is such a view justified? What impact will these funds have in the future?

A brief review of history will show that sovereign wealth funds are not a new phenomenon. However, what has been unusual is the publicity that has been given to their activities. In addition, the financial services community has raised an eyebrow at the scale of their recent investments and the fact that these are considered far removed from the traditional areas of investment. To consider what may happen next, it is instructive to review the basis for their existence and why their size has increased seemingly so rapidly recently.

Wealth funds are, in essence, the product of economic success. As economies grow the respective governments accrue foreign exchange reserves. The faster the economy grows, and becomes stronger, as measured by export success, then the faster the reserves of currency will grow. Traditionally, most have assumed that such reserves have been 'managed' on a pretty benign basis, with assets invested in foreign currency bonds of economies deemed to be stable if indeed these assets are invested in foreign currency assets at all. Most will be familiar with the purchase and sale of foreign currencies within the foreign exchange markets as a natural day-to-day activity but may have failed to appreciate the fact that the scale of investment in other assets has been escalating at such a rate.

The so-called rise of the sovereign wealth fund has been accelerated by two factors. The first is the pace of economic expansion within the emerging economies such as China and other Far Eastern economies and the second is the rapid price inflation of commodities, oil being the most obvious example, that has seen the rapid rise in the fortunes of the United Arab Emirates and others. Coupled together, there has been a substantial increase in the funds available to sovereign states. The question that has been asked is what are they to do with them?

To answer the question, the first point to make is that the rationale for holding these assets is changing. Despite the fact that these funds have existed for many years, albeit there were fewer of them, one would have argued that their primary use was to smooth or stabilise the exchange rate or to be available to secure the stability of the financial system. Both of these objectives are still true to an extent. However, by far the more interesting aspect of the activities of sovereign wealth funds is that they are actively seeking to diversify their investment portfolio.

Some commentators have tried to distinguish between the investment philosophy of sovereign funds in an effort to separate the activities of certain elements of the fund from the activity of foreign exchange management and those designed to diversify investment

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Historically, direct investment in corporate entities has been undertaken in a relatively circumspect fashion, most funds (with the exception of that of the Norwegian Government) being silent upon their holdings and certainly with no or extremely limited publicity attached to their investment objectives or profile.

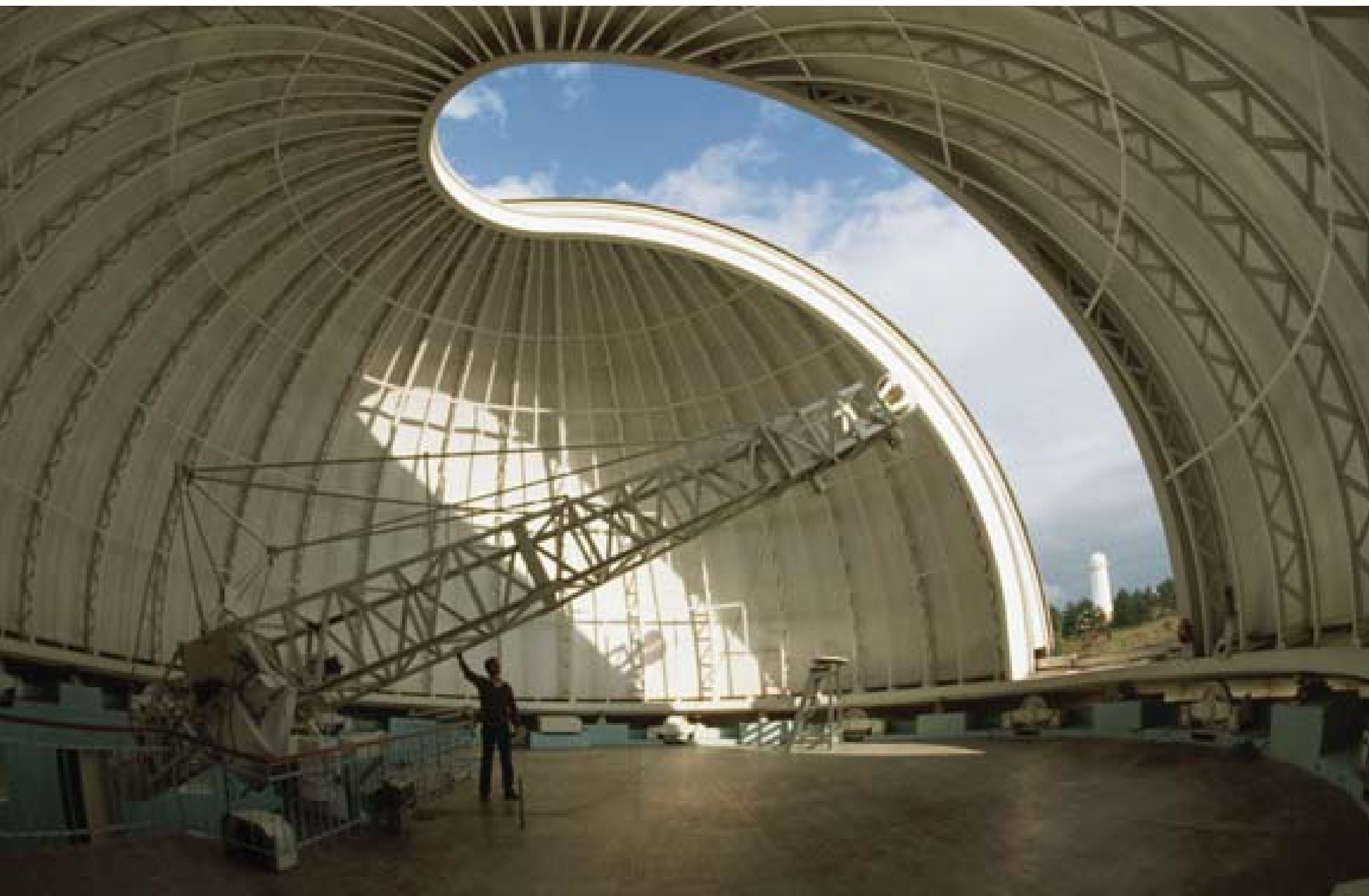
risk. I have much sympathy for this analysis. It seems self-evident that the exponential growth of certain economies and the rise in commodity prices has provided certain sovereign states with a unique ability to diversify away from their traditional sources of wealth. The activity of Dubai is a striking illustration of this. Recognising that the oil reserves will run out sooner rather than later, there has been a determined effort to diversify into financial services, medicine and tourism that has been reported in the pages of many a newspaper. However, the formation of the Dubai International Financial Centre (DIFC) is an example of only one means by which a sovereign state can seek to diversify away from its traditional core source of wealth. Utilising wealth funds to invest directly in other countries' assets is, however, something that has caught the attention of many.

Historically, direct investment in corporate entities has been undertaken in a relatively circumspect fashion, most funds (with the exception of that of the Norwegian Government) being silent upon their holdings and certainly with no or extremely limited publicity attached to their investment objectives or profile.

Today there is a heightened focus on their activity, not least because of the well publicised purchases of shares in the banking system. This activity suggests the funds are migrating towards a far more 'public' investment stance, but in any event indicates a more active investment profile. Given the enormous size of these funds their active involvement in the markets will make them a substantial force.

For any asset manager, then, obviously the funds will be an attractive potential client, but equally the acceptance of investment by these funds could be viewed with suspicion by governments of a nervous disposition. Does one wish, for example, to cede ownership of the local banking system to an overseas government? Personally I doubt whether this would ever actually happen given the diversity of the markets, but if Morgan Stanley's estimates of the size of assets is correct sovereign wealth funds are double the size of the hedge fund market and therefore constitute a significant force.

What seems certain is that these funds will continue to look to substantially diversify their assets in order to seek additional returns. This means that they will be more active players in all forms of investment, e.g. hedge funds, commodities, private equity and so on. They would also be expected to be long-term holders of assets and while there is no evidence yet to suggest that they are looking to exert influence on the management of companies, some commentators have expressed concern that the funds may become more active and take a political approach to their decision making process.



If greater concerns are expressed as to the activities of the funds then there are perhaps two potential outcomes. The funds could become more transparent and follow the lead taken by the hedge fund and private equity industry in promoting standards of behaviour and disclosure, and given the funds are managing the assets of their populations I cannot see why there is not full disclosure of their investments and their strategies. Alternatively, and not mutually exclusively, these funds could appoint external managers to act as a buffer between them and the ultimate investee companies. This would put them on an equal footing with pension funds and other institutional investors with managers operating to a predetermined mandate. The second option would serve to alleviate the concerns of those regarding the investments as having been made for political purposes. The most likely outcome would appear to be seeing the funds making a combination of direct investment when the circumstances appear to warrant it (for example in taking a view that the financial services sector offers good long-term growth despite the current turmoil in the markets and the corresponding falls in share prices) and using the skills of external managers to access new markets, strategies or infrastructure projects.

It seems certain that these funds will continue to expand as the emerging economies generate wealth and their governments seek to follow the tried and trusted doctrine of diversification of investment. For the asset management industry they offer a significant target market. In common with other industries, the winners in the sovereign wealth fund market will be those that come to terms with the aims and objectives of these funds and are able to offer a specialised service to them. The alternative view is that they represent some form of cross-border nationalisation of industries, a view which some may subscribe to but which in practice is somewhat unlikely.

Spring 2008: Technical Round-up

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

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The FSA's regulatory approach

Financial Risk Outlook 2008

In January, the Financial Services Authority (FSA) published its annual review of risks in the financial services sector. This focuses on risks arising from the events of the second half of 2007 and the less benign prospects for the next eighteen months. The review informs the FSA's supervisory activities and influences its priorities and these are reflected in the 2008/9 Business Plan.

The review sets out some key messages to help firms consider how to respond to both the priority risks and to other sector-specific risks. The five priority risks identified are:

- Existing business models of some financial institutions are under strain as a result of adverse market conditions.
- Increased financial pressures may lead to financial firms shifting their efforts away from focusing on conduct of business requirements and from maintaining and strengthening business-as-usual processes.
- Market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system.
- A significant minority of consumers could experience financial problems because of their levels of borrowing.
- Tighter economic conditions could increase the incidence or discovery of some types of financial crimes or lead to firms' resources being diverted away from financial crime.

The Financial Risk Outlook also sets out industry-sector-specific risks covering banks and building societies, retail intermediaries, asset management, capital markets and financial exchanges, life insurance and general insurance. It is worthwhile for firms to study what the FSA is thinking about in respect of their sectors.

FSA's Business Plan and Budget 2008/9

The FSA has also issued its Business Plan. The plan sets out the FSA's programme of work for the year ahead to address the risks highlighted by the Financial Risk Outlook.

Specific priorities for insurers include:

- Increased focus on insurers' Individual Capital Assessments (ICAs). Insurers should have an integrated approach to risk and capital management and use their ICAs to make business decisions. Valuation is an important aspect of firms' monitoring of capital adequacy. Following the turmoil in credit markets, the FSA intends to focus on how firms are valuing illiquid instruments.
- Continued focus on firms that provide with-profits funds regarding Treating Customers Fairly. In particular, the FSA intends to (a) take a close interest in ensuring that there is appropriate governance in place, (b) pursue the closed funds agenda outlined in last year's Business Plan, and (c) review firms' progress in improving the quality of their post-sale communications.
- Commission disclosure projects looking at transparency and market efficiency.
- Review of life Mutuals' compliance with the Friendly Societies version of the Combined Code.
- FSA involvement in the Solvency II Directive project.
- Work within the International Association of Insurance Supervisors.

The Plan's priorities for banks and investment businesses include:

- Initiatives arising from lessons from Northern Rock, e.g. a review of the supervisory approach and the regulatory framework for liquidity, improving the depositor protection regime and the reform of the insolvency laws for financial institutions together with the review of the Tripartite arrangement.
- Heightened supervisory oversight in relation to financial risk outlook risks such as liquidity, stress testing and general operational preparedness for unexpected events.
- Continued commitment to the area of greatest structural concern – retail markets – namely Treating Customers Fairly, Retail Distribution Review and Financial Capability programme.
- Enforcement: the FSA's strategy is to achieve 'credible deterrence' including increased penalties where there is evidence that standards are not improving despite clear messages to industry.
- Continued working with European regulators and looking to play a strategic role in encouraging integration of European capital markets. In particular, Solvency II will require a large commitment over the next three years.
- The review of ICAAPs, which all BIPRU firms needed to have in place by 1 January 2008.
- Ensuring that firms have properly implemented MiFID.
- Rolling out the integrated regulatory reporting system.

The FSA's budget for regulatory activities increases by 7.1% from £302m to £323m due mainly to underlying cost increases and investment in its enhanced supervisory strategy for small firms. The amount to be raised from firms through fees and levies increases by 6.9%.

The FSA is implementing a number of changes to its approach to raising fees for 2008/9, including the introduction of special project fees to partially recover the 2008/09 project development costs related to Solvency II internal model approval, affecting the larger life and general insurers; and application fees for Part VII transfers, affecting life or general insurers who chose to make such transfers of liabilities to another insurer.

Changes to FSCS funding

The FSA has published its final policy for the future funding arrangements of the Financial Services Compensation Scheme (FSCS), which take effect from 1 April 2008. The most significant change is to the maximum amount of compensation costs which the FSCS could levy in any one financial year. In particular, for general insurance providers the levy for compensation costs was previously capped at 0.8% of net premium income, giving an approximate maximum levy of £267m per annum across the industry. The new approach increases the maximum potential levy for general insurance providers to £775m per annum.

The system continues to function, for the time being, on a 'pay as you go' basis, with the compensation costs levy being made up of the compensation costs which the FSCS has incurred and expects to incur in the next 12 months. However, the other main change is that if one class reaches its limits others will be required to contribute to make up the shortfall up to their limits, hence, for example, a problem stemming from the deposits class could lead to a levy on insurers.

Firms should be aware of the potential for a far larger levy going forward and ensure that this is incorporated in their risk modelling. It should be noted that these changes affect the mechanism by which compensation may be raised and the maximum potential level of compensation. They do not provide any indication of the actual levies FSCS will raise in the coming year, which are expected to be the subject of announcements by FSCS in the normal way.

Prudential requirements

External assurance on regulatory returns

In December 2007 the FSA published policy statement PS07/22 which provides feedback on CP07/15 and contains the final handbook text. The policy statement drops the routine annual audit of regulatory returns for non-BIPRU investment firms with financial years ending on or after 31 December 2007. This brings the FSA regulatory audit requirements of non-BIPRU investment firms into line with those BIPRU investment firms (broadly, former ISD investment firms) where the FSA audit requirements of regulatory returns ceased for firms with years ending on or after 1 January 2007. The client asset audit component of the FSA regulatory audit continues for both BIPRU and most non-BIPRU investment firms.

The routine annual audit of the capital adequacy return is replaced by a more flexible and more risk-based approach. However the audit requirement is retained where the risk is perceived to be greatest, i.e. insurers and credit unions. The FSA intends to make more use of:

- Reports by skilled persons, requiring the provision of assurance on regulatory returns (these will be termed section 166 return assurance reports (s166 RARs) – the FSA expects around 35 a year.
- Thematic reviews as part of their normal supervisory approach (to be termed 'thematic RAR') – the FSA expects approximately 170 a year.
- Firms' own internal audit functions.

This new s166 RAR regime took effect from 1 January 2008.

Systems and controls – extending the common platform

In December 2007 the FSA published consultative paper CP07/23 which sets out proposals to extend the organisational systems and control requirements currently applicable to common platform firms – SYSC 4 – 10 (firms subject to MiFID and/or CRD) to all other FSA-regulated firms (non-scope firms) except insurers, which will be dealt with as part of the Solvency II work in 2009.

Conduct of business

Banking Code revision

In November 2007 the sponsors (BBA, BSA and APACS) of the Banking Codes announced changes that will be made to both the personal and business codes with effect from March 2008, following a public consultation and review by independent reviewer Mike Young.

The new measures being adopted include prohibition of account closure solely because a customer has made a valid complaint, greater certainty in cheque clearance and more transparency of information for credit cards and credit card cheques.

JMLSG revised guidance

In November 2007 the JMLSG published its revised guidance, 'Prevention of money laundering/combating terrorist financing', in part reflecting the changes in the UK money laundering regime arising from the introduction of the Money Laundering Regulations 2007 which took effect from 15 December 2007. Following a risk-based approach is now a legal requirement.

Collective investment schemes

Two of the new year's consultation papers contain material relating to collective investment schemes. CP08/1 proposes changes to COLL in relation to electronic communication and settlement. CP08/4 confirms the policy for retail funds of alternative investment funds (FAIFs).

Spring 2008: European update – a pivotal year for financial services regulation in Europe

2008, in many ways, is pivotal to the future of financial services regulation in the European Union.

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A number of key draft legislative measures are tabled – or due to be tabled – this year for adoption prior to the election of a new European Parliament of the summer of 2009 (any legislative proposals tabled but not adopted at that time will be 'scrapped'). Those which definitely need to be progressed this year are the Solvency II proposals, UCITS IV and certain amendments to the Capital Requirements Directive (the pressing need for which has been highlighted by the recent market turmoil).

Solvency II

The 'big one' is Solvency II. The first draft of the Framework Directive[1] was issued last July.

In February this year, the Commission issued an amended draft[2] which streamlines further the 'recast' sections of the Directive and includes the 2007 'Acquisitions Directive'.[3] The current ambitious timetable is for all amendments to the Framework Directive to be tabled by this summer with a Parliamentary plenary vote in October/ November, and adoption of the Framework Directive in the spring of 2009 – before the election of the new Parliament over the summer of 2009. The amendments, apparently, run into thousands: however, the Commission remains confident that the necessary agreements between the European Parliament and the Council will be reached to make the adoption of the Level 1 Directive possible before the dissolution of Parliament.

Preparations for the Solvency II Level 2 measures, an evolutionary facet of the Lamfalussy process, continue in parallel with the Level 1 co-decision procedure, with the fourth quantitative impact (QIS)[4] study, scheduled to be launched in April (with results due in November 2008) contributing crucial elements to these measures (at least one and possibly more QIS are expected to follow).

With the Level 1 Directive in place, work on the Level 2 measures will continue without interruption. The current plan is for the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to provide its final advice to the Commission in October 2009, with a view to their adoption of Level 2 measures in 2010.

UCITS IV

The second, still anticipated piece of legislation relates to the UCITS IV agenda. The Commission's Green[5] and White papers[6] on UCITS IV looked at a combination of five key initiatives. In addition to simplifying the UCITS cross-border notification procedures, the papers promoted the simplification of the 'simplified prospectus' for UCITS, harmonising

and streamlining investor disclosure requirements (cf key investor disclosure, or KID). More fundamentally, they also put forward the idea of providing an EU passport for management companies, and of facilitating fund mergers and asset pooling.

However, contrary to a key principle of the Single Market (albeit with good reason), the Commission[7] suggested the adoption of a 'partial' passport for management companies.

According to this 'partial' passport, a German management company could set up a fund in France but would be unable to manage the fund completely from Germany: certain key administrative functions (i.e. NAV calculation and shareholder register) would still need to be performed in France. This proposition has proved highly contentious amongst the Member States (a number strongly supported a 'full' passport). Indications now are that the draft measure will omit the passport, full or partial, and, given the conceptual interdependency, it is also likely to omit the proposals relating to fund mergers and asset pooling. Removing particularly contentious issues from the draft enhances the possibility of the measure's adoption in time: however, the removal of these key initiatives leaves just a shell of the original initiatives, and will be a disappointment to many in the investment management industry.

CRD amendments

With the adoption of the Capital Requirements Directive (CRD),[8] work commenced, in a number of key areas, with a view to complementing and enhancing (and amending) CRD provisions.

A review of the rules on large exposures was launched in late 2005[9] (before the official publication of the Directive), with review results and appropriate proposals due by 31 December 2007. Work on own funds continues with a view to the Commission putting forward (Level 2) proposals by January 2009 for revisions to the recast Capital Adequacy Directive,[10] and in the United Kingdom the FSA has started the ball rolling with its own Discussion paper, DP07/06, entitled 'Definition of Capital'.[11]

In March 2007, the Commission issued a call for advice to the Committee of European Banking Supervisors (CEBS) on liquidity risk management.[12] (In the call, the Commission identified five areas for further focus – liquidity, crisis management, emergency liquidity assistance, deposit insurance schemes and reorganisation and winding-up of credit institutions – the importance of which became glaringly obvious a few months later.)

CEBS' response on liquidity risk management was due in two phases: the results of the first, fact-funding phase were submitted to the Commission in August 2007[13] (before the markets began to experience liquidity problems). The results of the second analytical phase were initially due in January 2008, but given the turmoil, the submission of CEBS' advice has been postponed in order to take into account the work of the Basel Committee Working Group on Liquidity.[14] The Commission hopes to table proposals for amendments to CRD covering securitisation, large exposures, reputation risk and liquidity risk management by September 2008 and that these will be adopted before the Parliamentary elections in 2009.

Many may have thought that, with the completion of the Commission's Financial Services Action Plan, the regulatory agenda this year should be relatively empty. Indeed, the Commission itself suggested a period of reflection. As it turns out, 2008 does not look likely to leave too much time for contemplation.

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1 COM(2007) 361 final, 2007/0143 (COD) – Proposal for a Directive of the European Parliament and the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II): http://eur lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0361en01.pdf.

2 COM(2008) 119 final, 2007/0143 (COD) – Amended Proposal for a Directive of the European Parliament and the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II – Recast): http://ec.europa.eu/internal_market/insurance/ docs/solvency/proposal_en.pdf.

3 Directive 2007/44/EC of the European Parliament and of the Council: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:247:0001:0016:EN:PDF.

4 CEIOPS: Quantitative Impact Studies : http://www.ceiops.eu/content/view/118/124/.

5 (COM (2005) 314) (12.07.05) – European Commission Green Paper: Enhancement of the EU Framework for investment funds: http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm.

6 European Commission White Paper on enhancing the Single Market Framework for investment funds {SEC(2006)1451} {SEC(2006)1452}: http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#whitepaper.

7 European Commission: Initial orientations of services outlining future possible adjustments to the EU single market framework for investment funds – the UCITS Directive: http://ec.europa.eu/internal_market/investment/ legal_texts/index_en.htm.

8 The Capital Requirements Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC, was published in the Official Journal on Friday 30 June. Directive 2006/48/EC: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf and Directive 2006/49/EC: http://eur lex.europa.eu/LexUriServ/ site/en/oj/2006/l_177/l_ 17720060630en 02010255.pdf.

9 European Commission: Call for technical advice (N°5) from the Committee of European Banking Supervisors (CEBS) on large exposures: http://ec.europa.eu/internal_market/bank/docs/calls/051208_call_for_tech_advice_en.pdf.

10 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0255:EN:PDF.

11 See: http://www.fsa.gov.uk/pubs/discussion/dp07_06.pdf.

12 European Commission: Call for technical advice (N°8) from the Committee of European Banking Supervisors (CEBS) on liquidity risk management: http://ec.europa.eu/internal_market/bank/docs/calls/070306_call_for_tech_advice_en.pdf.

13 First part of CEBS's technical advice to the European Commission on liquidity risk management: Survey of the current regulatory frameworks adopted by the EEA regulators: http://www.c-ebs.org/Advice/documents/CfA_8_LiquidityStockTakesurvey.pdf.

14 BIS Liquidity risk: Management and Supervisory Challenges http://www.bis.org/press/p080221.htm.

Financial Services Regulatory Practice contacts

United Kingdom

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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In addition to our UK regulatory practice, PricewaterhouseCoopers 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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