

UK Financial Services Regulatory Focus

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

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PricewaterhouseCoopers¹ 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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One consequence of the current financial crisis is the increasing politicisation of regulation and supervision in the financial services sector. The realisation that banks and insurers have a crucial role to play in the maintenance of a buoyant economy and confident consumers has taken time to sink in at the highest political levels in the United Kingdom as well as elsewhere, and we are now seeing the consequences for regulated firms. There is talk of imposing some form of the discredited US Glass Steagall regime on the UK banking sector: in the long term it would surely be unattractive to restrict the way in which banks fund themselves and spread their risk, but the simplistic concept of a utility bank nevertheless has political appeal and will not disappear without a robust response from the industry.

The conflicting pressures between micro and macro prudential issues will be played out over the next 12 months: for example the conflict between government, which wants increased lending, and the Financial Services Authority (FSA), which urges caution on firms, as well as creating tougher capital and liquidity thresholds. There is conflict between the FSA's desire for ever greater liquidity buffers, consisting of ever more liquid assets, and the macro-economic consequences of absorption of a limited supply of such assets by the banking and investment firm sector. Similarly, the political pressure to curb generous bonus payments by institutions which have sought public financial support sits oddly with a regulator which is constantly pressing firms to attract the best managers and directors, and to improve the quality of control, governance and oversight.

Arguments for greater regulatory convergence are also growing, not just from the European Central Bank, and are articulated well in our European update in this issue. While the suggestions on supervisory colleges from the Committee of European Banking Supervisors,² in conjunction with those from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Interim Working Group on Financial Conglomerates (IWGFC), are good, they will not necessarily satisfy those who believe that systemically important financial services groups should be supervised at a regional or global level rather than a national level. Such arguments ignore practical and legal difficulties, also explained in our European update, and therefore the threat of yet another layer of supervision for international groups is a real one. PricewaterhouseCoopers thoughts on likely future developments have also been well aired in our 'The Day after Tomorrow' research.³

In this issue we comment on many of the current developments in regulation in the United Kingdom, both proposed and implemented: there are articles that should

be of interest to all sectors of the financial services industry. Changes are planned to toughen capital requirements for banks, to be incorporated into the Basel Accord, as explained in our first article, and also into FSA rules, as articulated clearly by Lord Turner, Chairman of the FSA, in his *Economist* lecture.⁴ There are more requirements in respect of liquidity reporting and maintenance, as explained in our second article, and for stress testing and scenario analysis, as expounded in our third: the effects of the liquidity reporting requirements, in particular, are likely to be very burdensome for many firms, particularly given the tight schedules proposed by the FSA. Firms need to take the opportunity that they now have to respond to the FSA and explain what they can and cannot achieve.

The issue of bribery and corruption is firmly back on the agenda following the significant fine imposed on Aon, and our fourth article explains the consequences for all firms, particularly those with overseas operations; it deserves careful study. Despite the pain that firms have suffered as a result of the credit crunch and recession, the FSA will continue to exercise its enforcement powers where it suspects bribery and corruption, insider trading and other market abuse. It is unlikely to be merciful where losses reveal poor governance and controls, whether global or regional. We include an article on the need to strengthen governance within firms, particularly regional governance, and the FSA itself has warned that it will be focusing its attention more strongly on those in 'Significant Influence Functions' (including senior management based overseas) in its latest Business Plan.⁵

There are other changes afoot: the pensions regulator has new powers, UCITS IV is now being implemented, the Banking Code is to be subsumed into the FSA Handbook, together with aspects of the Payment Services Directive, and the Retail Distribution Review is now turning into the Retail Distribution Implementation Programme, though there will be some time for this last to be implemented. We cover all of these developments in this issue.

The burden on firms in all sectors is significant: it is important that firms and trade associations remind their regulators, as well as government, of the burden that these developments could impose at a macro as well as a micro level, if the increasing politicisation of regulation is not to harm the industry.



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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 Committee of European Banking Supervisors, Template for a Multilateral Cooperation and Coordination Agreement on the Supervision of XY Group, 27 January 2009.

³ PricewaterhouseCoopers 'The Day After Tomorrow' (www.pwc.com/dayaftertomorrow) February 2009.

⁴ Adair Turner, The Financial Crisis and the Future of Financial Regulation, FSA, 21 January 2009.

⁵ FSA, Business Plan 2009/10, February 2009.

The credit crunch and lessons for Basel II

It will take a long time for a balanced perspective of the crunch to emerge. However, many commentators already cite as key drivers financial imbalances between the US and the rest of the world (particularly China), low real interest rates over an extended period, the resulting drive to gearing/leverage, the consequent asset price inflation and tumbling savings rates in the West. As regards the mechanisms through which the crunch hit us, commentators criticise banks by citing, for example: poor management, poor valuation processes and loose bonus schemes. Capital regulation, in particular, has also been attributed a role, with Basel II well up the list. With banking in its current situation, criticism of regulation is inevitable: if regulation does not stop all this, what is it for? At one end of the spectrum, perhaps the flood tide of cheap finance in the boom was too powerful to be held back by rules? Or was Basel merely a bystander, since it was not in place in the build up to the crisis and many institutions that channelled finance for the bubble are not in Basel's scope?

To explore the lessons we need to go back to basics. Basel II of course has three 'pillars'. Pillar 1 is a formulaic approach to capital based on applying credit, market and operational risk percentages to assets, often using firms' own risk models if the regulator has approved them. Pillar 2 requires management to assess the risks of the business and the capital needed to support those risks, and (critically) the regulators to review and approve that approach. Pillar 3 requires extended disclosure. The overall intention is for a better assessment of the risks a bank is taking on, better management of banks' risks and more transparency about those risks. This philosophy is there but the practice is not yet fully in place. However, we believe that the three pillars and the risk-based approach they are based on are the right starting point: a robust banking system involves more than the application of a few simple capital ratios. Nevertheless, the lessons of the credit crunch must be learned.

In this context, the first learning point is that regulators should review how the three pillars taken together could (if fully in place) have impacted the credit bubble and the following crunch: would they have enabled regulators to identify the crisis earlier by, for example, requiring better risk management, management information, stress testing and disclosure? Alternatively, would this 'intelligent' approach have been compromised by lack of resource/experience at regulators, economic and personal incentives to greater risk-taking at banks as the credit bubble grew, and the difficulty any manager, supervisor or analyst would have in challenging the consensus view that saw not a growing bubble but a long benign 'Goldilocks economy' (not too hot and not too cold)?

Looking at Pillar 1 in more detail, many commentators believe that the credit crunch losses show that Basel II's risk-based capital framework does not work. They cite the inadequacies in the credit ratings that Basel II uses in its 'standardised' approach to credit risk, and clearly the role of agencies before and during the crunch will continue to be examined. More work is needed here: it is difficult to find another simple indicator for credit risk without going back to the Basel I 'one size fits all' approach.

However, many major banks use their own credit models, not ratings, for capital calculations. Some would say that banks' risk models (for any risk) are only as good as the limited data they use; that the integrity of risk models can be corrupted by the incentives on banks and their staff to take on more risk; and that the regulators are insufficiently armed to fight back. George Soros addressed the use of 'Value at Risk' (VAR) models in regulatory calculations. He found this a 'shocking abdication' by the regulators:

'By relying on the risk calculations of the market participants, the regulators pulled up the anchor and unleashed a period of uncontrolled credit expansion' [George Soros: 'The New Paradigm for Financial Markets: the Credit Crisis of 2008 and What it Means'].

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The old central bank breadth of vision across the economy has faded and systemic risk has not received the attention it deserves.

The specific models he refers to have been permitted for 'advanced' banks' market risk capital calculations since 1996: the view is that the adoption of VAR in the trading book liberated banks to 'originate and distribute' originated long-term banking assets by mutating them into opaque trading book securities supported by far less capital. This in turn led to the growth of balance sheets whose true liquidity and value were questionable. Basel II now extends the use of models from the trading book to the banking book, but the damage was done years ago.

Stepping up to a higher level, some question if risk-based capital causes wider dynamic problems with the economy by building 'procyclicality' into the capital system. Absent some very good risk management and Pillar 2 disciplines, the risk figures that models generate easily underestimate capital requirements in a boom, as default rates fall ever lower, and increase them as the defaults hit harder than ever expected, making a credit crunch bite ever deeper. Again, the research after the event will be interesting.

There are therefore many accusations against Pillar 1 that need to be addressed. However, we believe that the concept is right: regulators cannot dismiss the tools (such as credit modelling and VAR) that management uses to run the bank. It has to assess them, influence them, and where possible work with them, but above all maintain scepticism and challenge robustly. To do this, Pillar 2 should be top priority.

Pillar 2 demonstrates the need for managements and supervisors to exercise experience and judgement. Mathematical models do not deal well with periods of stress: stressed markets are far from 'normal' and experience needs to be brought to bear if a bank is to understand where its biggest risks lie. In our experience early (pre-crunch) Pillar 2 stress tests were often inadequate, and banks have to be far more specific about 'destruction events' and the actions they would take if these materialised. We are seeing supervisors increasingly asking what it would take to break a bank, as well

as asking management what they would do to stop it.

All this will take resource by supervisors: they must be able to challenge the consensus. Where Pillar 2 is already properly in place we have seen a noticeable uptick in the understanding supervisors have of business models, risks and supporting capital needs.

As part of the focus on experience and judgement regulators need to build their resource on economic issues: it is at least arguable that the divorce of banking supervision from central banking in some countries has (despite its many advantages) led regulators to 'granularise' their analysis, carefully ticking off the risks of each bank separately on a 'bottom up' basis. The old central bank breadth of vision across the economy has faded and systemic risk has not received the attention it deserves.

In looking to refine Basel II we have the advantage (if it really is that) of a wealth of experience of crises and this needs reflection as policy is redefined. One huge area for review is the complex interaction of capital, liquidity, depositor confidence, deposit protection and lender of last resort.

The business model in banking typically involves funding income-earning assets by raising debt (from long-term bond issues through to overnight deposits) on a base of core capital. Historically the various elements of the pyramid have been dealt with largely separately by regulators. For example, the capital definition and risk measures have been chewed over for years, but non-capital funding has been outside the model and dealt with in most countries by a local liquidity regime. Similarly, deposit insurance (where it exists – not often for the offshore sector, for example) has been treated as a compensation mechanism for depositors, not a support for the whole capital/funding pyramid, while the role of the lender of last resort has in many countries been kept deliberately opaque. Finally, the attribution of costs to the various support mechanisms from the authorities has been unclear, with a suspicion (or maybe certainty) of significant subsidy to the

banking industry in many cases. In the crunch, tumbling capital ratios and bank runs have made clear the link between capital and liabilities, and the explicit or implicit support governments extend. To deal with this, a new 'general theory' is needed from the regulators.

As a starting point here we are seeing a growing focus on leverage ratios. These have long been a favourite of the Federal Deposit Insurance Corporation (FDIC) in the US, but now other regulators are re-examining the idea. The essence is to put a restriction on the size of a bank's tangible assets based on its core Tier 1 capital. Arguably many of the banks that required emergency capital injections had adequate capital under the Basel risk measures, but that did not stop the liability side destabilising in days, or hours. Despite its inadequacies (notably not covering off-balance sheet instruments well) a debate is needed to assess if the leverage ratio's time has come again.

To sum up, the credit crunch has made very evident areas for further improvement in Basel II, but many of these should have been identified far earlier. Ratings and models under Pillar 1 need to be used wisely, they are not a one shot solution; Pillar 2 is critical and needs to be implemented effectively; Pillar 3 has yet to have a significant effect (and could in time change market perspectives significantly); and capital and liquidity regulation need to be properly integrated. Above all, regulators need sufficient resource to deal with complexity and the courage and authority to make judgements. Properly implemented and resourced Basel II remains an opportunity, not a threat.

Liquidity risk: Strengthening liquidity standards, but at what cost?

'Our proposals are far reaching... many institutions will need to significantly reshape their business model over the next few years as a result' The FSA

The Financial Services Authority's (FSA) Cost Benefit Analysis notes that its proposed requirements may lead to an increase in the average holding of government securities from 4.6% of total assets to between 6% and 10%. The FSA states that this could cost the industry between £1 and £5 billion (or even more if the spread between yields on government bonds and other debt widens).

The critical shortage of liquidity in the financial markets due to recent market events has put the management of liquidity at the forefront, both for the industry and regulatory bodies. The FSA has recently published a paper setting out its proposed approach to liquidity risk. This paper goes much further than the broad principles published by the Basel Committee on Banking Supervision (BCBS), the Institute of International Finance (IIF) and the Committee of European Banking Supervisors (CEBS) earlier last year.

The building blocks of the FSA's new regime are:

- Firms underestimate extreme liquidity events: The FSA believes that regulation has to address this potential shortcoming in firms' liquidity risk management approach.
- Liquid assets are not sufficient: Each firm should know its gross liquidity risk, not just the mechanisms to mitigate the risk when it crystallises. The FSA expects firms to stress test their balance sheets against certain scenarios and address any weaknesses identified.
- Legal entities matter: The FSA believes that recent events have shown that internationally active financial groups can default and that this can leave local creditors and customers at a disadvantage.

The date of commencement of the proposed liquidity regime has still to be finalised, but it is now considered likely to commence in early 2010 with detailed reporting currently likely to build up during 2010. It is a new concept for investment firms and will bring in much tougher standards for banks and building societies. Parts of the regime can be waived or implementation delayed for some firms (such as branches) but the finer details still need to be looked at. There is likely to be a further consultative paper on transitional arrangements.

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Outline of the FSA's proposals:

- Individual Liquidity Adequacy Standards (ILAS): firms will have to undertake an Individual Liquidity Adequacy Assessment (ILAA) in a similar way to the Internal Capital Adequacy Assessments Process (ICAAPs) required under Pillar 2 of the Basel framework. This will require stress testing a two week idiosyncratic (firm-specific) event and a market-wide event (longer term) against a range of risk 'drivers' including wholesale and retail funding, intra-group funding, cross-currency liquidity and marketability of assets. Ongoing reporting of the associated facts and figures to the FSA is also likely to be very onerous – an additional paper on the reporting aspect is expected this spring.
- Firms are also expected to maintain robust systems and controls. These replace the current requirements for liquidity risk which previously applied to all firms. Emphasis is placed on the role of the governing body, such as the proposed obligation for the governing body to approve and regularly review the processes, strategies and systems relating to the management of liquidity risk.

More emphasis is also placed on documentation (such as the proposed requirement to establish a documented liquidity risk tolerance). While this may sound sensible, the difficulty with such requirements is how far firms will go to achieve compliance and how the FSA will reach its conclusions as to whether the requirements are met.

- Following completion of the ILAA, the FSA will issue Individual Liquidity Guidance (ILG) which will take the form of a liquid assets buffer which can only comprise of high-quality, unencumbered assets. These are mainly defined as high-quality government securities. As noted in the introduction, this will obviously imply a high cost of maintenance. Worryingly, the FSA has commented that 'the ability of banks to lend to parties other than the UK government (or other governments) might be considerably reduced'.

It is important to note that liquidity risk will still need to be addressed under Pillar 2 in a firm's ICAAP. However this will clearly be at a higher level than in the ILAA. We would expect both ICAAPs and ILAAs to address interdependencies between risk types and ICAAPs to consider the implications for profitability and capital of stress events to liquidity.

The ILAS regime and liquid asset buffer requirements do not apply to limited licence/ limited activity firms such as most asset managers, but they will still need to comply with high-level systems and controls requirements and stress testing and contingency funding plan rules.

Has the FSA got the balance right?

The detailed proposals outlined in the consultation paper are understandable given the momentous events of the last 18 months. It is also generally acknowledged that liquidity management had been largely overlooked by both firms and regulators in the benign market conditions that prevailed until 2007. Nonetheless, some firms are questioning whether the FSA appreciates the full burden that this will place on the regulated community at a time when regulators and regulated are already at full stretch.

The proposed regime will impact all regulated firms in some way, but perhaps some more than others. For example, investment firms will need to move from a systems and controls-based regime to managing liquidity to a much more detailed framework for regulatory purposes. This may be considered as placing a disproportionate weight on smaller firms. While the FSA makes some provision for this through a standardised buffer or delayed implementation for



qualifying firms, many in the industry are uncertain about how far they will need to go to meet regulatory expectations.

A major concern is the weight of information that the FSA believes it requires to monitor systemic liquidity risk in the UK. By increasing the reporting burden the FSA may (in the eyes of some firms) unintentionally transfer the responsibility for monitoring liquidity risk to the regulator, as opposed to leaving it with the firms. There is a difficult balance to manage here.

A key unanswered question is the extent to which firms should assume central bank support may be available in stressed circumstance. In the current crisis the discount window has proved a critical tool in easing liquidity stresses. Similarly the Bank of England's response to the Barings crisis shows how important visible central support can be to mitigate the market impacts of idiosyncratic events and to prevent market stresses from gathering irresistible force. In our view it would be unrealistic for firms to ignore the probability of these interventions in their stress tests. However we also appreciate the FSA's dilemma in requiring firms to shoulder responsibility for their liquidity risks.

The methodology for calculating the liquid assets buffer is likely to be one of the most difficult parts of implementing the new regime, and very little guidance is currently

included. Certainly, the demand for the high-quality government securities mentioned (such as the UK and other EEA states, US, Canada, Japan or Switzerland) will increase but the overall impact of this on other aspects of the economy may require further consideration. One example could be the link to the Bank of England's plans for gilt issuance (and the broader management of monetary policy) and the subsequent effect of this on yield, particularly at the short end of the yield curve given the emphasis on acquiring the most 'cash-like' instruments possible. While most treasurers are waiting for the yield curve to steepen to encourage longer dated funding, the FSA's approach could have an unintended consequence of raising the cost at the shorter end.

The FSA states that the effect of its actions will include stronger balance sheets and better corporate governance which will all ultimately feed in to a stronger UK economy. Clearly these potential benefits need to be weighed against other considerations such as the competitiveness of the UK market. There is a risk that over-regulation could lead to migration of the activities of international firms and fewer balance sheets to supervise. While most firms may have sympathy with the pressures that the FSA is experiencing and what it is seeking to achieve, the industry is currently left with rather more questions than answers.

CP08/24 Stress and scenario testing

In December 2008 the Financial Services Authority (FSA) published Consultation Paper (CP) 08/24 titled 'Stress and Scenario testing'. The CP is the FSA's response to both governance weaknesses highlighted through recent market events and the FSA's findings as part of the Supervisory Review and Evaluation Process (SREP) reviews, namely a lack of robust and embedded stress and scenario testing among many firms.

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The CP is aimed at all UK banks, building societies, investment firms (subject to the Capital Requirements Directive 'CRD') and insurers. In addition, it should be read alongside other FSA papers, namely the recent CPs on liquidity and banking reform and also the forthcoming Discussion Paper on the reform of prudential standards for banks and investment firms. Recent speeches by the FSA Chairman are also extremely insightful into the FSA's current thinking on the future of prudential regulation and the package of reforms that are likely to ensue from the FSA and other regulators in due course.

The FSA states that its proposals are intended to be broadly consistent with the emerging internal and EU recommendations already published or in the process of development. The EU and international publications discuss the role of stress testing – or the lack of – as a contributor to the recent market events, and make recommendations for improving stress-testing practices in the industry.

What are the FSA's proposals?

The FSA states that 'This CP should be seen as part of a broader programme of planned actions ... and firms can expect to experience increased supervisory focus and challenge in these areas'. The FSA places great reliance on the robustness of a firm's stress and scenario testing framework and see this as a key management decision-making tool.

The FSA has identified four key themes that it would like to see in the design of stress and scenario testing programmes going forward:

- **Senior Management involvement** – This is necessary to ensure the correct parameters are used in the analysis and that the stress test is fully embedded in business decision making.
- **Contagion** – Management must understand how risks are transmitted in a stress event and how ripple effects reinforce the events of the primary stress scenario.
- **Firm-wide holistic view** – A firm's stress-testing programme should be holistic in terms of risk capture. Firms should carry out stress tests at both a group-wide level and also at a business line or business unit level; and
- **Liquidity stresses** – Contagion from one market may spread to another. Initial liquidity concerns may give rise to capital detriment.

Probably the most significant proposal in the CP is the introduction of a 'reverse stress test' or a stress test to destruction. This requires firms to explicitly identify and assess the scenarios most likely to cause their current business plan to become unviable. By unviable, the FSA means the point at which the market loses confidence in the firm and refuses to transact with, or provide capital to it. The requirement to carry out a reverse stress test applies at both a solo and a group level (if relevant) and should be updated at least annually. The requirements will be contained in a new chapter to the Senior Management Arrangements, Systems and Controls (SYSC) handbook.

The intention behind the proposals is to encourage firms to more fully explore and understand their vulnerabilities and, as a result, to make decisions that better integrate business and capital planning and improve contingency planning. The FSA expects firms to document their reverse stress testing and provide evidence of sign off by the Board. Supervisors will discuss the process and results of the stress testing with firms and will consider the extent and quality of senior management involvement.

The proposal for reverse stress testing will affect all firms except BIPRU 50K limited licence investment firms, although larger firms with substantial funds under management will have to produce contingency plans for orderly run off or transfer of the business in the event the business plan ceases to be viable.

The CP also sets a number of clarifications and proposals to the Pillar 1 and 2 stress testing guidance. For Pillar 1, these mainly relate to internal model approaches to credit risk and credit risk mitigation. The proposals for Pillar 2 stress testing include, among others:

- A proposal to amend the current provision for assessing the effects of a recession of a severity such as is experienced once in 25 years to other economic or business cycles.
- Clarifying the FSA's expectations that firms should hold sufficient capital now in the face of adverse circumstances and events firms need to consider as part of their Pillar 2 stress testing.
- That reliance on overseas parents as a mitigating action is only likely to be credible in 'exceptional circumstances'.

- Clarification of the market risk stress tests for firms using standardised methods and extension of the range of factors to consider in stress testing for firms using the CAD2 models.
- Additional guidance on stress testing for securitisations and pension obligation risk.
- Clarification to the requirements for assessing group risk.

What will this mean for firms?

During these times of extreme market volatility stress testing becomes an even more powerful risk management tool. It is for management to understand how this tool can be most usefully deployed. Many have seen this CP as only having one output, 'the reverse stress test', however, the FSA is undoubtedly using this publication as a vehicle to remind senior management of the responsibilities they have when managing the business during these times of market dislocation.

It remains management's responsibility to ensure the regime is fully embedded in all levels of their business. A logical start would be to conduct a gap analysis to assess the extent to which existing processes and approaches to stress testing – including identifying the key 'destruction' risks of the business – meet the FSA's expectations going forward. Once any gaps have been highlighted, management will need to formulate a plan to address implementation and how the process will be embedded in the day-to-day operations of the firm. As part of this, firms will need to identify the potential impact on capital buffers and, importantly, the realistic management actions that could and would be deployed during a stress event.

These are certainly challenging times for firms and the burden for many firms of assessing and implementing the raft of FSA and international proposals on governance, stress testing and liquidity is huge. Management need to ensure the analysis of the requirements is conducted as soon as possible and resource deployed appropriately.

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Corruption now on the FSA's Financial Crime Agenda

In January 2009, the Financial Services Authority (FSA) sent out a clear message to the regulated sector when it levied its largest ever financial crime-related fine. The insurance company Aon Limited was fined £5.25 million for failing to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption. The FSA said the fine would have been higher had Aon not fully co-operated with it in its investigation.

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Between January 2005 and September 2007, the FSA found that Aon had failed properly to consider the risks arising from its dealings with overseas firms and individuals who had helped it to win business, and 'suspicious payments' in the region of \$7m were identified.

This is the first time that the FSA has taken enforcement action in relation to bribery and corruption, but the fine represents a clear indicator of its future intent. And it is not the only agency with bribery and corruption high up on the agenda. This year will also see a new Bribery Bill reforming the current range of UK corruption offences, which will enable much more effective criminal prosecution of bribery-related matters. The City Police and the Serious Fraud Office are also pursuing a variety of initiatives in this area.

Historically, companies in industries such as defence or construction have been the most alert to corruption risk in their business and they have developed compliance regimes to counter those risks. However, financial institutions can also be exposed in a similar way as other businesses to the risk of management or employees becoming directly involved in bribery and corruption.

The trend of globalisation in economic and business activity has contributed to an increase in these corruption risks. In particular, many financial institutions have made substantial investments in emerging markets, which are also countries generally recognised to represent significant challenges in terms of corruption risk.

The annual Corruption Perceptions Index, produced by Transparency International, ranks countries according to perceived levels of corruption. On a scale of zero (corrupt) to 10 (clean), 135 out of 180 countries ranked have a score of 5.0 or less, including all of the major emerging market economies, indicating a high degree of corruption risk. Firms that are considering outsourcing and/or off-shoring business processes in response to the current market conditions, or seeking investment from overseas sources, should ensure that the risk of corruption and bribery is a key factor in the decision-making process.

Legal framework

The UK's legal framework on corruption is complex, with provisions spread across a series of Acts of Parliament, including the Prevention of Corruption Acts 1889–1916, the Anti-Terrorism Crime and Security Act and the New Companies Act. The FSA's handbook requires all firms to maintain effective systems and controls to prevent the firm being used for the purposes of financial crime, which includes bribery and corruption.

Arguably, the most wide-reaching law in the area of bribery and corruption is the US Foreign Corrupt Practices Act (FCPA), originally enacted in 1977. This is robustly enforced by the US Department of Justice (DoJ) and the US Securities and Exchange Commission (SEC). Any UK company with securities listed on a US exchange is subject to the jurisdiction of the FCPA, but non-US listed UK companies should be aware that they may still find themselves caught by the FCPA on other grounds.

The penalties for non compliance with the FCPA can be severe – the German manufacturing giant Siemens agreed to pay around \$450 million to the DoJ and \$350 million to the SEC following extensive plea-bargaining. Siemens has also had to settle cases in Germany and it is estimated that the total cost to Siemens in terms of their investigation, remediation of control weaknesses and legal penalties was in excess of \$2.5 billion.

However, financial services firms also face corruption risks not experienced by companies in other industries, as they are exposed to the risk that it is their customers who are engaged in corruption, and they are using their products and services to send or receive the illegal payments. Corruption was one of the key targets of the latest Money Laundering Regulations, which took effect in December 2007. In particular, the regulations included requirements to enhance the due diligence conducted by financial services firms on customers who are foreign officials or politicians – commonly referred to as Politically Exposed Persons, or PEPs.

When conducting customer due diligence procedures, a firm needs to consider the activities the customer will be involved with. Will those activities increase the risk that the organisation will be used to channel corrupt payments? Customer transactions that generally heighten the risk of a regulated firm being used to facilitate corruption or launder the proceeds of corruption include:

- Sales to government and government-related entities.
- Other dealings with government such as settlement of tax affairs, applications for licences, concessions, planning consent, travel visas, provision of utilities, etc.
- Dealings with customs officials relating to the import or export of goods.
- Provision of gifts, entertainment, reimbursement of travel expenses, etc to government officials.
- Donations to or sponsorship of government-related entities, or even charities and not-for-profit organisations where there is a link to a government entity or official.
- Lobbying of government on policy, legislation, etc.
- Use of intermediaries, such as agents (sales, customs, etc), representatives, business consultants, lobbyists and anyone else interacting with government on the company's behalf.
- Entering into acquisitions of, or joint ventures, with companies involved in any of the above activities.

Mitigating the risk

Our experiences show a mixed level of awareness by UK financial services clients of corruption issues and a lack of clarity over who is responsible for ensuring that risks are addressed and that regulation and applicable law, such as the Foreign Corrupt Practices Act (FCPA), are complied with. A good anti-financial crime framework will address corruption risks but we have seen many examples of those that do not.

In the current economic climate it is likely that individuals and/or organisations around the world will become more vulnerable to committing corrupt acts. As legal and regulatory interest intensifies, now is an appropriate time for firms to review their anti-financial crime framework.

In particular an organisation's culture is key to fighting corruption and bribery, and it is now the time for senior management to address some tough core questions which lie at the heart of embedding an anti-corruption and bribery mindset throughout the organisation. The focus of these questions should be:

'Does our organisation instinctively seek to do the right thing?'

This goes beyond codes of conduct, policies and guidelines. It is fundamentally about leadership, culture and individual behaviour. Driving change in these areas is always challenging and requires real commitment as well as appropriate organisational structures with clear accountabilities.

In our view regulatory compliance should not be seen as a cost. The best compliance always adds something to the business by increasing efficiency through greater discipline and control over critical business processes. Strong ethics should be at the forefront of any forward-thinking organisation's culture.

All power to the regulator?

What will be the implication of new extensions to the powers of the Pensions Regulator?

For more information, contact:

Andrew Evans on 020 7804 3887

The Pensions Act 2008 extends the circumstances in which the Pensions Regulator can use its anti-avoidance powers to issue a contribution notice (CN) or a financial support direction (FSD) on employers giving additional funding or security to pension scheme trustees.

A key development in the powers of the regulator is that the employer can no longer use the fact that it acted in 'good faith' as a defence. Regardless of whether the main purpose of its action was avoidance of a pension liability, if the 'act or failure' has made it less likely that accrued scheme benefits will be received by members, the regulator is within its rights to act. It can then force employers to pay additional contributions (via a CN). In addition the regulator can now consider an entire group of companies' combined resources, as opposed to a 'sufficiently resourced' company, when deciding if it should issue an FSD.

This has caused companies understandable concern, particularly in the current economic environment, where many businesses are suffering cash-flow constraints.

Corporate concerns

In December 2008 PricewaterhouseCoopers issued the results of a survey of pension decision makers amongst 98 organisations (of which 29 were FTSE 100 companies). The survey found:

- 80% of companies are concerned about the impact of pensions commitments on cash flows.
- 45% of companies are concerned about the funding commitment impact on the ability to pay dividends.
- 85% are concerned about the company's lack of influence over cash funding commitments.

Companies are questioning whether the regulator will routinely target dividend payments, restructurings and corporate reorganisations following the introduction of this new legislation. Several companies are seeking to reduce their exposure to risk from their pension scheme. Of particular concern here is that many of the new buyout business models comprise a series of complex steps which, when taken in isolation, are indistinguishable from corporate activity. For these and other transactions it is often a good idea for companies to consider external financial or legal advice as to whether an



application to the regulator for clearance of a particular transaction is beneficial in such circumstances; forewarned is forearmed.

Having said this, the regulator has a statutory duty to use its powers reasonably. It has explicitly stated (as part of their code of conduct) that it is not its intention that the new powers will hamper appropriate market activity or innovations.

Trustee action:

There may be scope for trustees to use the Pensions Act 2008 to their advantage, notifying the regulator where the 'material detriment' test is satisfied. There are recent examples of high-profile cases where trustees have sought legal action to force the employer to put the necessary support in place for the pension scheme.

What would lead trustees to bite the hand that feeds them? Such action is more likely in extreme cases where, as a result of an acquisition or restructuring taking place, the trustees perceive the security of pension scheme members' benefits is under threat. In most situations, forcing a further contribution from a cash-strapped employer is likely to further exacerbate any problems that it already has. This would not seem a very good idea, particularly given the fact that the ratio of scheme liabilities to market capitalisation of the employer is in excess of 1:1 for many

schemes, and in the event of the employer becoming insolvent the pension scheme is an unsecured creditor.

The trustees would almost always rather negotiate with the employer; which is in effect their lender of last resort. The regulator would also expect this, and increasingly the employer is relying on the employer covenant as a basis for negotiation.

Employer covenant review as a basis for funding negotiations

The employer covenant is defined as the employer's financial position and prospects, as well as its willingness to continue to sponsor the pension scheme. A review of this covenant should cover company structure, financial strength, the likely future cash flows of that company, and any other market issues which will impact on the employer's long-term viability. Whilst some trustees are able to assess the strength of the employer covenant on their own, most will commission an independent review from financial advisers with credit advisory skills.

Many trustees are finding that an employer covenant review provides a good platform on which to base any negotiation. The trustees will use the findings in their negotiations on a range of issues, the ongoing contribution levels, pension

scheme investment strategy, additional security to the trustees through contingent assets and in evaluating merger and acquisition activity, restructuring or refinancing. In the current economic climate it may be necessary to reach a deal with an employer that conserves cash, for example a back-ended funding plan, if necessary supported by contingent assets.

Importantly employer covenant-based negotiation enables trustees to maintain an effective working relationship with the employer; whereby each party acknowledges the interests of the other. Such negotiations recognise that the long-term interests of the sponsoring employer promote the long-term health of the pension scheme and produce a solution which, with the benefit of hindsight, will stand up to external scrutiny.

Extending the FSA's SYSC requirements to include firms not currently covered by MiFID: What actions should affected firms be taking?

Firms caught up by these requirements are expected to be in a position to comply with them by April 2009.

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Background

In its September 2008 Policy Statement¹ the Financial Services Authority (FSA) announced its intention to extend the organisational and systems and controls (SYSC) requirements as applied to 'Common Platform' firms to those organisations (other than insurance companies) not currently subject to the Markets in Financial Instruments Directive (MiFID) and/or the Capital Requirements Directives. It is expecting firms caught by these new requirements to be in a position to comply with them by April 2009.

The types of firms soon to be captured by these requirements include insurance intermediaries, mortgage brokers, venture capital firms, personal investment firms, authorised professional firms, credit unions, commodity firms, operators of collective investment schemes, energy market participants, oil market participants, providers of custody services, pension schemes, Undertakings for Collective Investments in Transferable Securities (UCITS) qualifying firms and UK branches of overseas firms ('Newly In-Scope Firms'), in fact almost all types of non-MiFID firms except insurers.

Firms only have a few weeks to ensure that existing compliance arrangements have been enhanced to reflect the extension of these SYSC requirements by 1 April 2009. As with all principles-based regulations, the FSA is not stipulating what firms must do, but is expecting firms' management to give them due consideration and proportionate responses. However what each firm does in practice is very much a function of what the existing arrangements are and how far off they might already be from regulatory expectations.

The most significant changes will be to firms' organisational arrangements covering:

- Conflicts of interest.
- Outsourcing arrangements.

In addition, by April 09, firms will be required to ensure that they are in a position to comply with the new requirements covering the following areas:

- General organisational requirements.
- Employees, agents and other relevant persons.
- Compliance.
- Risk controls.
- Record keeping.

¹ Policy Statement 08/9 'FSA Organisation systems and controls – extending the common platform' September 2008.

Key issues to consider

Conflicts of interest: Most firms will have implemented some form of controls around managing conflicts of interest. For many, we believe existing arrangements will comprise merely a policy statement which relies upon disclosing potential conflicts to actual or prospective clients as the principal control mechanism. From April, minimal arrangements such as this will no longer be sufficient; instead there will be a requirement to:

Identify conflicts of interest that:

- Are inherent in the operation of the business, where the firm may have an interest that is distinct from their clients.
- Exist between a specific department and its clients.
- Exist between two different clients or groups of clients.
- Exist between a firm's employees or other associated personnel and clients or client groups.

In addition, firms will need to ensure that structural arrangements are in place (such as IT architecture, physical access control and organisational reporting lines) which are consistent with the firm's policy.

They will also need to revise the existing policy to ensure that it is consistent with the new requirement, as well as be prepared to make it available to clients on request.

Outsourcing: Outsourcing operational activities continues to be an effective strategy in managing costs and in enabling management to focus on core skills. However, in operating such arrangements the FSA is concerned that management do not lose sight of the fact that they retain regulatory responsibility for the performance of their outsourced service providers and for ensuring that regulatory protections are provided by those organisations to their customers.

For firms that have longstanding outsourcing arrangements, these new rules may present practical and contractual difficulties, particularly where contracts were signed without considering such matters as:

- Ensuring that the outsource provider has in place effective processes to identify, manage, monitor and report risks.
- Ensuring appropriate escalation processes are in place to report on these risks.

- Ensuring contracts are written in such a way as to transfer governance responsibility from the regulated firm to the outsourcing provider.
- Confirming that appropriate disaster recovery plans are in place.

Secondary issues needing consideration

General organisational requirements: Essentially, that firms will be required to have:

- Appropriate governance and organisational arrangements, including audit committees, supported by proper and effective internal controls.
- Up-to-date business continuity arrangements.
- Clear accounting policies.
- Clear understanding by individuals and by the organisation as a whole of senior management responsibilities.

Most well-run organisations should already have a robust governance structure in place, supported by internal control mechanisms and accounting policies. Firms should remember that there is an existing requirement periodically to review and assess the adequacy and effectiveness of systems and controls and therefore care needs to be taken to ensure that any readiness assessment for these new rules should not assume that existing governance and control arrangements will automatically be suitable under the new arrangements. In the recent past, the FSA has stressed the importance of having robust governance arrangements in place and there is every reason that this issue will continue to be key on the agenda for any FSA ARROW review.

Employees, agents and other relevant persons:

Organisations will now need to be able to demonstrate, by way of records and due process that appropriate consideration has been made as to the skills, knowledge and expertise of all potential employees. Although for non-retail firms, this will not necessarily involve the implementation of training and competence requirements to the standard that is required of firms involved in retail sales, it will, for many firms, require a more formalised approach to documenting recruitment decisions and evidencing staff competence.

The more significant aspect of this requirement is a need to ensure appropriate segregation of duties. In many firms, particularly larger organisations, this will have been common practice for many years, but for some the need to segregate will be a new requirement and will present a number of challenges, including implementing controls around systems access, creating physical separation between front and back office activities, and revising organisational structures to ensure independence of reporting lines.

Compliance, internal audit and financial crime:

The new rules will require organisations to implement sufficient processes to ensure compliance by all staff with the FSA rules. This is likely to include:

- Introducing monitoring and review processes to control regulatory risks as well as anti-money laundering controls.
- Implementation of escalation routes to report on breakdowns in the control structure.
- Creation of permanent compliance functions that have independent reporting lines and that are staffed by suitably qualified people.
- Creation (depending on size and complexity) of an independent internal audit function.
- Appointment of a money laundering reporting officer.

Risk control: Organisations should review their overall risk control framework so as to ensure that there are:

- Effective processes to manage risks supported by risk management policies and procedures in place.
- Effective procedures for risk assessment.

Record-keeping: Organisations will need to review their record-keeping arrangements to ensure that appropriate records are kept for the required time periods.

In order to adopt these extended requirements, most firms should be carrying out some form of gap analysis work which will help to highlight any areas for development and provide appropriate evidence of formal consideration and implementation.

Banking Conduct of Business: FSA regulation of retail banking products

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Background: Why change?

Retail banking products are currently regulated through the voluntary Banking Code to which virtually all retail banks and building societies subscribe. The Code covers current accounts, deposits, overdrafts and personal loans, cards and other banking services. The Banking Code Standards Board (BCSB) monitors Code compliance.

Whilst the FSA views the scope of the Code as broadly 'correct' and believes BCSB provides effective monitoring, the FSA has voiced some concerns:

- The current approach is less principles-based and transparent than the FSA's approach.
- BCSB has limited sanctions for enforcement action, as a non-statutory regulator.
- There are perceived gaps in the Code's content, such as the lack of an overarching fairness objective.
- FSA regulation provides 'a more credible deterrent' than a voluntary Code.

However, a key driver for change is the deadline for implementation of the EU Payment Services Directive (PSD) on 1 November 2009. The PSD introduces conduct of business rules for all firms providing payment services, in two areas:

- Information requirements.
- Rights and obligations of payment service providers and their customers.

The PSD will replace aspects of the Banking Code, so action is needed to deal with those banking products not covered by the PSD. Additionally, turmoil in the banking sector has brought additional pressure to bear for the FSA to take full responsibility for all aspects of banking supervision, thereby avoiding a common public misunderstanding of its role.

Scope

The FSA consultation (CP08/19) impacts all retail banking firms carrying on the regulated activities of accepting deposits and issuing e-money. Firms doing these activities are already required to be FSA authorised.



The FSA's proposals:

1. Full application of FSA Principles for Businesses to the activities of accepting deposits and issuing e-money.
2. New high-level rules applying to retail banking services for accounts falling outside the scope of the PSD, to be set out in Banking Conduct of Business Sourcebook.

Accordingly the day-to-day provision of core retail banking products and services will fall under the FSA regime.

BCOBs: the detail

BCOBs is designed to protect 'banking customers' who are defined as:

- Retail consumers (individuals not acting in the course of business).
- 'Micro-enterprises' (employing fewer than 10 people with a turnover/balance sheet of less than €2 million).
- Charities with an income of less than £1 million per annum; and
- Trustees of a trust with a value of less than £1 million.

The threshold of €2 million for micro-enterprises introduces another variable for firms to juggle, with the need to account for volatility in exchange rates. There is

also a degree of inconsistency with the £1 million threshold, found in BCOBs and elsewhere in the FSA's rules.

BCOBs applies to 'retail banking services' – both accepting deposits and providing services in relation to deposits (e.g. cheques and foreign exchange services). It will not apply when the service is within the scope of the PSD.

The content of BCOBs is mercifully short, with the FSA holding onto its high-level, risk-based approach to market sectors that are clearly lower risk to consumers. The five key BCOBs chapters cover:

- Communications with banking customers and financial promotions.
- Distance communications (incorporating the Distance Marketing Directive and the E-commerce directive).
- Information to be provided to banking customers, pre and post sale.
- Post-sale requirements.
- Cancellation rights.

BCOBs does not apply to any lending activities – consumer credit remains within the remit of the Office of Fair Trading (OFT). For payment accounts, BCOBs applies where PSD rules do not (e.g. rules on financial promotions and moving a retail banking service).

New rules in BCOBs: watch the wording

BCOBs focuses primarily on information to be provided to banking customers and post-sale requirements. These broadly mirror the Banking Code and include:

- Information on the firm, the types of services offered, the terms and conditions of the services, interest rates, costs and charges, complaints and compensation.
- The provision of regular statements for non-payment accounts where appropriate.
- The provision of a 'prompt, efficient and fair' level of service.
- The fair treatment of customers in financial difficulties.
- A 'prompt and efficient' service to enable a customer to move to a retail banking service provided by another bank.

The terms 'prompt' and 'efficient' in these contexts may give rise to debate or dispute, as such subjective terms are notorious for generating complaints and may need a court ruling or two before firms feel confident in applying them in practice. Recent experiences with varying interpretations of 'fairness' across the industry do not bode well.

Market reaction

The BCSB, with support from subscribers, has argued that the Banking Code offers a degree of flexibility not available to a statutory regime, allowing for changes to the Code at relatively short notice.

The alternative scenario, for the FSA to regulate payment services under the PSD whilst leaving other banking products and services to voluntary regulation, has considerable potential to confuse consumers, so there is a feeling of a degree of inevitability about BCOBs, both from the FSA and the market.

Some banks have expressed a reluctance to lose the benefits of a useful leaflet that is widely available to customers, a role that the Banking Code fulfilled admirably.

What impact will BCOBs have?

In practice, many of the requirements of BCOBs are already being met by banks, through a combination of compliance with both the FSA Principles and the Banking Code.

The real benefit should be an increase in consumer confidence at a time when this is much needed. Despite this, there is little in BCOBs that would have mitigated any of the risks faced by consumers during the recent unprecedented turmoil.

One area where BCOBs might have more significant impact, however, is on structured deposit products, such as the 'capital guaranteed' equity-linked savings products that currently fall outside the FSA's investment regulation regime. With issues still rumbling due to these products being structured by investment banks (previously including Lehman Brothers), it would seem to be an obvious area where clearer product information and disclosure will offer benefit to consumers.

Whilst the Financial Ombudsman Service already has jurisdiction to consider complaints relating to banking business, it is likely that consumer awareness will rise as a result of FSA regulation.

So will we now have one regulator for firms and a clear and simple regime for consumers? Not quite. The potential for confusion still exists, with BCOBs sitting alongside the existing OFT consumer credit regulation as well as the OFT's high-profile work on bank and credit card charges. The FSA and OFT acknowledge that increased co-operation will be required and there is speculation that this could lead eventually to consumer credit also being moved to the FSA.

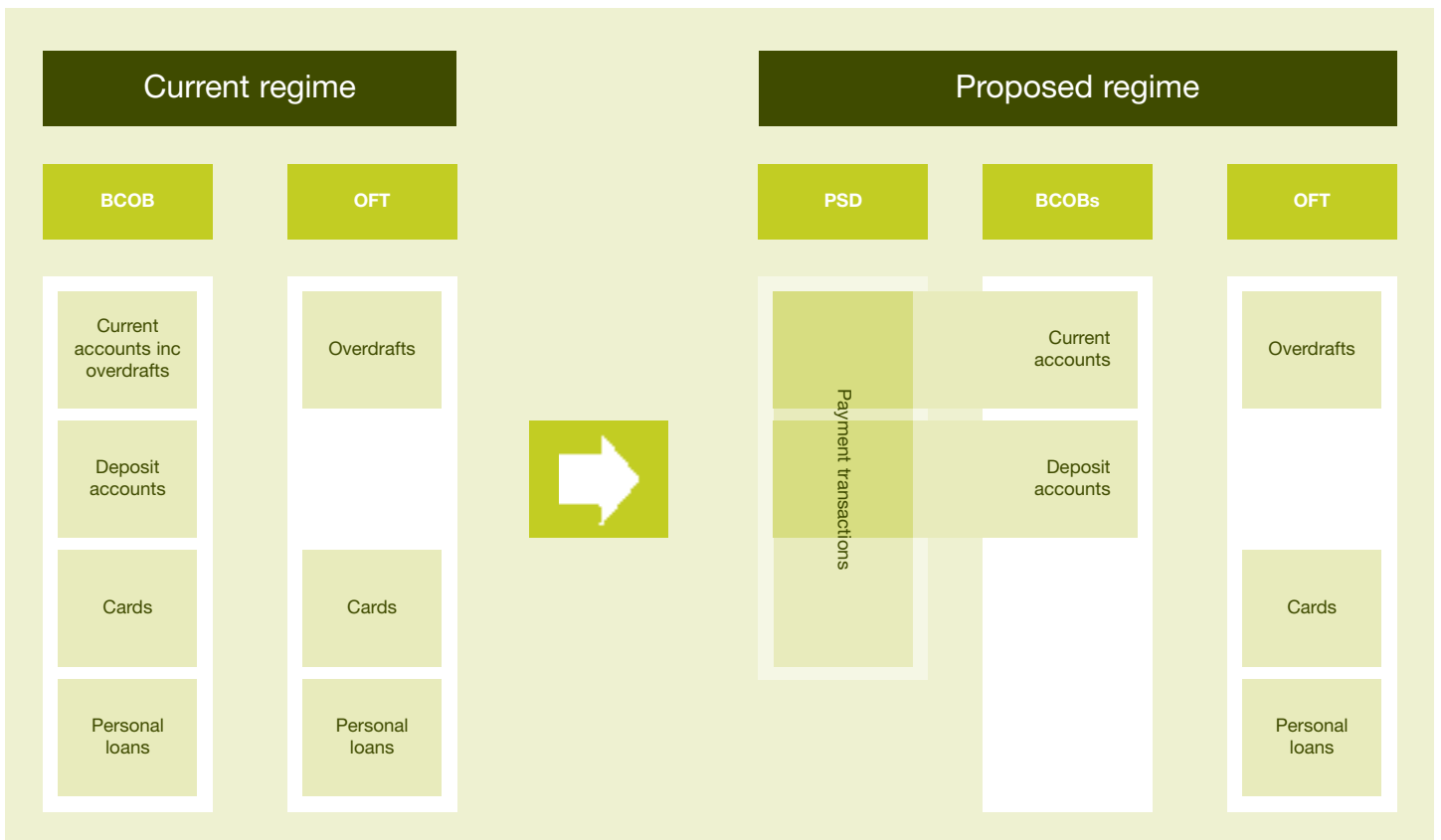
In essence, for the main retail banking services, the regime will migrate as shown below:

Strong messages have come from the FSA that BCOBs should be supported by Industry Guidance (FSA 'confirmed guidance' by means of their formal process), in order to flesh out the lack of prescription in BCOBs and also to keep some of the commitments present in the Banking Code, particularly where consumers are reminded of their responsibilities. Could this mean the survival of the Banking Code in another guise?

There is also a swell of feeling within the market that industry guidance, if it is necessary at all, should come directly from the regulator, rather than via FSA-confirmed Industry Guidance. Could the ideal solution be another FSA factsheet?

What next?

The FSA proposes to implement the changes on 1 November 2009 when the PSD comes into effect. Whilst this date is subject to confirmation post-consultation for BCOBs, it seems unlikely to change. The good news is that the FSA is willing to consider a lengthy transition period, to allow for the inevitable process, documentation and systems changes.



Approval for final UCITS IV detail by European Parliament

Recent announcements

On 13 January 2009, the European Parliament approved the proposed reform of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive with a significant majority - 589 votes in favour and 28 votes against. Significantly, this incorporated the approval of the Management Company Passport (MCP), which is seen as a major step towards an efficient internal market.

History

The Directive, designed to allow cross-border marketing and sales of funds, has been instrumental in the successful development of the European funds market since the mid-1980s. Funds within the EU have grown substantially in recent years but this growth has been coupled with an increasing fragmentation of the market, which now consists of a large volume of small funds (the average European fund size is one fifth of its US equivalent).

There has been a process of analysis and consultation between Member States to reform the Directive in a bid to address this fragmentation and geographic concentration, referred to in the industry as UCITS IV. At the same time the focus has been to enhance the growth of cross-border sales of UCITS products by tackling inefficiencies created by different national interpretations of the rules.

A number of reforms have been proposed as part of UCITS IV to address these, including:

- A framework for cross-border UCITS fund mergers and eligibility of the use of 'master-feeder' structures.
- Removing administrative barriers to cross-border distribution of UCITS funds by simplifying the notification process from two months to three days.
- Replacing the 'Simplified Prospectus' with a short 'Key Investor Information' document.
- Improving co-operation mechanisms between national supervisors.
- The creation of the MCP.

The Management Company Passport

One of the key, contentious changes to the Directive is the introduction of the MCP. This allows funds authorised in one Member State to be managed remotely by an authorised management company established in another Member State. This will be a significant development for the market and will provide competitive challenges to the dominant position that Luxembourg and Ireland have had in the UCITS market. Challenges to the MCP have focused upon potential supervisory and investor protection concerns, but advice from the Committee of European Securities Regulators ('CESR') to the European Parliament recommended its inclusion and European Members of Parliament were satisfied that the level of investor protection for retail investors could be maintained whilst improving efficiency by opening up the single market.

Potential opportunities

The MCP will help many asset managers address the prospect of the costly operation of running a number of funds across Europe. The ability of one authorised Management Company to operate a selection of funds across Europe on both a cross-border basis and also through establishing local funds across Member States may significantly reduce the cost of funds for retail investors, who typically pay higher rates than their US counterparts. We see this development leading to a consolidation in the market by many operators looking to reduce their operational cost base.

What next?

The directive will need to be approved by the European Council of Ministers but it is anticipated that this will be a formality.

Member States will then need to enact national legislation to implement the reformed directive by 1 July 2011 with consultations on the necessary changes to the FSMA and FSA Handbook occurring in late 2009 and 2010.

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Credit Rating Agencies: The end of self-regulation in Europe?

'I have been listening to many advisory bodies to the Commission and watching developments in the industry and in other jurisdictions for the last year. I am convinced, like others in Europe, of the need to legislate in this area at EU level. Credit Rating Agencies will have to comply with exacting regulatory requirements to make sure ratings are not tainted by the conflicts of interest inherent to the ratings business. The crisis has shown that self-regulation has not worked.' European Commissioner Charlie McCreevy 31 July 2008.¹

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Recent events

The question of how best to regulate Credit Rating Agencies (CRAs) in Europe is not a new one, and the Commission last considered it in March 2006, when it concluded that the existing European legislative framework and the then newly adopted International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals for CRAs (the 'Code') would suffice and that no further legislative measures were necessary. Although the Commission stated that it would consider introducing legislative proposals if new circumstances arose, such as 'serious problems of market failure'.² This market failure arose in late 2007 in the form of a credit crunch that was triggered by structured credit products, many of which had received the best rating possible from the CRAs.

In response to the deepening financial crises the EU finance ministers met in Luxembourg in October 2007 to agree a 15 month 'roadmap' to improve the handling of financial banking crises in the future.³ During the course of the meeting it became clear that some Member States wanted CRAs to be made more accountable to them as part of the roadmap, so the Commission was charged with reassessing the regulation of CRAs in the light of the credit crunch and this new political impetus.

Commission's position on CRAs

In July 2008 the Commission concluded that CRAs should share a large part of the responsibility for underestimating the credit risk of structured products and for failing to react quickly enough to changing market conditions. The Commission attributed these failings to the lack of competition amongst the main CRAs, a lack of communication with users of the ratings and inherent conflicts of interests, at the heart of which was the issuer pays model. The Commission did recognise, however, that the users of the ratings should have undertaken more due diligence as well, instead of relying so heavily on the ratings provided. In order to restore market confidence the Commission concluded that statutory regulation of CRAs in Europe would be required.

Views of the CRAs on the first draft of the legislation

In early September 2008 the international CRAs provided detailed comments on the Commission's first draft of the legislation. Whilst they all supported the aims of the legislation, they expressed a number of concerns in relation to its content. In particular there were concerns that the legislation should:

- Be based on global standards, such as those already contained in the Code.
- Match the language of the Code insofar as possible.
- Be principles based, instead of based on prescriptive rules.
- Maintain the analytical independence of CRAs.
- Be consistently implemented across Europe.
- Require CRAs to deal with only one regulatory authority.

The Commission has taken account of the CRAs' comments in some respects, for example it has proposed a Regulation rather than a Directive to allow for greater consistency across Member States. However, the Commission has proposed detailed rules, rather than principles, and has suggested a legislative framework that is much wider than the provisions of the Code.

The Commission has maintained the current international approach in relation to methodologies by stating that supervisory authorities should not interfere in the methodologies, models and rating assumptions which underlie the opinions that CRAs produce.

The proposed Regulation

On 12 November 2008 the Commission adopted its proposal for the regulation of CRAs. The proposal has four main objectives:

- To ensure that CRAs avoid what they see as inherent conflicts of interests in the rating process or to manage those conflicts adequately.
- To improve the quality of the methodologies used by the CRAs and the quality of ratings.
- To increase transparency on the part of CRAs.
- To create an efficient registration and surveillance framework for CRAs.⁴

The proposed Regulation is based on the Code, which until the recent problems was seen as international best practice for CRAs. Indeed, in its advice to the Commission dated 16 September 2008, the CESR was still advocating a self-regulatory regime for CRAs based on the revised Code.⁵ However, European Commissioner Charlie McCreevy has made it clear that he now sees the Code as something of a 'toothless tiger' and he wants the proposed Regulation to become the new global standard.⁶

The proposed Regulation provides for the registration and supervision of CRAs, enforced by sanctions that will be left to the discretion of each individual Member State. Much of the proposed Regulation is already familiar to the international CRAs from the requirements of the Code. For example, the Code already provides for the identification and management of conflicts of interest generally, the transparency and timeliness of ratings disclosure, the treatment of confidential information and communication with users of the ratings. The Code is made up of broad principles, however, and it is not supported by enforcement sanctions.

The international CRAs also proposed some of the provisions themselves when regulatory authorities were reviewing the need for formal regulation in early 2008. Some of these proposals were to rotate credit analysts, provide better training to credit analysts (especially in relation to structured finance), increase the information available to users of ratings and provide more information on the comparability of ratings across asset classes. The Commission has incorporated these proposals into its proposed Regulation, even though at the time they were not viewed as being persuasive enough to maintain the self-regulatory approach.

The proposed Regulation goes further than the broad principles of the Code in a number of areas by specifically requiring:

- Annual disclosure of market-sensitive client revenue information to the Competent Authority of the home Member State.
- The appointment of three independent non-executive members to the administrative or supervisory board of a CRA, including at least one member with an in-depth knowledge and experience at a senior level of the structured credit and securitisation markets.

- That CRAs that must record and justify all instances of 'notching' (a practice whereby a CRA issues or threatens to issue a lower credit rating, lowers or threatens to lower an existing credit rating, refuses to issue a credit rating, or withdraws a credit rating, where part of the assets, instrument or entity have been rated by another CRA).
- That a CRA cannot provide consultancy or advisory services.
- The disclosure of historic performance data and information about past credit-rating activities through a central repository established by the CESR.

Next steps

The proposed Regulation is part of a package of proposals to deal with the financial crises and adds to the Commission's proposals on Solvency II, the Capital Requirements Directive, deposit guarantee schemes and accounting.

The Commission is hopeful that the proposed Regulation will be adopted when the European Parliament meets in plenary session in Strasbourg on 21 April 2009. If the proposal becomes law, it will herald the end of self-regulation for CRAs in Europe.

1 Consultation by the Commission Services on Credit Rating Agencies, (IP/08/1224).

2 Communication from the Commission on Credit Rating Agencies, 11 March 2006 (2006/C59/02).

3 Council conclusions on enhancing the arrangements for financial stability in the EU, 9 October 2007.

4 Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies (COD/2008/0217).

5 The CESR's response to the consultation document of the Commission services on a draft proposal for a Directive/ Regulation on Credit Rating Agencies (CESR/ 08-671).

6 Speech by Charlie McCreevy, European Commissioner for Internal Market and Services on Credit Rating Agencies, 12 November 2008.

Retail Distribution Review (RDR): The end of the beginning for retail distribution

Published on 25 November 2008, the Financial Services Authority's (FSA) Retail Distribution Review Feedback Statement delivered the final communication on the Retail Distribution Review (RDR) and set out the final themes to be carried forward under the newly named Retail Distribution Implementation Programme (RDIP).

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The feedback statement finalises the three fundamental outcomes driving the future of retail distribution. Namely to:

- Improve the clarity for consumers of the characteristics of different service types and the distinctions between them.
- Raise professional standards.
- Reduce the conflicts of interest inherent in remuneration practices and improve transparency of the cost of all advisory services.

The feedback statement did not allow for any further consultation and confirmed that the changes required to meet these objectives must be completed by 31 December 2012. Detailed implementation plans will continue to be developed as the RDIP takes shape, with the first consultation paper scheduled for release in June 2009.

Despite the lack of any formal opportunity to input at this point, many opinions on the content of the Feedback Statement have been aired within the marketplace. The lack of detail around topics such as guided sales and the route required to reach certification levels has caused heated debate and discussion. These views have been recognised and a formal consultation process has been set in motion. The message is clear, however, retail distribution will undergo substantial change.

Examining the detail of the statement exposes several key and possibly contentious issues within the broader themes. We expect firms, given the opportunity to consult on detailed implementation, will wish to both challenge and praise the work done to date. It is already clear from the industry debate that the broad themes are supported but, as ever, the details still need some tuning. The following themes seem likely to be included within the ensuing debate:

Services and business models

June brings consultation around the rules that require adviser firms to set their own charges. Businesses will need to be more transparent in their charging model as it stands. Implementation in 2012 will bring with it the end of the Commission-based approach.

Independent advice will need to be truly independent. Businesses should consider the model that they would fit into given their current activities and the distinctions between the provision of independent and non-independent advice must be clear to customers.

Professional standards

The proposed Professional Standards Board should be able to clearly demonstrate its value, by considering the functions of existing bodies, avoiding duplication of effort and therefore duplicated cost. With respect to 'qualification', there is no planned consultation on grandfathering. The current view is that individuals must raise their game or exit the market. It is, however, interesting to note that options will be considered with regard to other possible ways of meeting the criteria that may not be exam based.

Capital resources

Capital requirements will be raised, with the new minimum threshold being £20,000; also the coverage of the Expenditure Based Requirement (EBR) will be extended. This EBR requires a three month reserve based on the total annual expenditure of the combined entity which could have a significant impact on some firms based on their current structure. Capital calculations will allow the inclusion of working capital, so this calculated value doesn't need to be retained as a cash reserve; however, the liquidity of any assets will also need to be considered when performing any calculation. The overall objective is to demonstrate not only that the business is a going concern, but also that it is creditworthy and has enough reserves to ensure an orderly wind down if required.

Whilst many firms have been making steady progress guided by the broad direction given to date, some firms still persist in waiting until the waters have finally settled and there is clarity.

Examining past regulatory change, firms acting early to plan and make progress are typically best positioned to capitalise on opportunities, have their opinions and views heard more readily by stakeholders, including the regulators, and therefore best positioned to lobby and shape the final structure of the regulation. Conversely, firms waiting for clarity often struggle to have the same impact, playing catch up and scrambling around for both resource and budget late in the day.

So, with just under four years to go before the implementation deadline, and the final stages of consultation just about to begin, is now the right time to formalise a firm's approach to the changes in retail distribution? Perhaps not surprisingly we believe that now is exactly the right time. Our executive checklist poses some challenges.

Governance

- Does your board have an awareness of the forthcoming changes, risks, threats and opportunities within retail distribution?
- Have you got the correct governance and sponsorship in place to establish and authorise budgets and control your change programme?
- Have you got the appropriate knowledge, skills and availability within your team not only to respond to the FSA consultation papers but also to structure and run an implementation programme?
- Can you explain where RDIP sits in relation to the inevitable regulatory changes expected due to the current financial crisis?

Market

- What is your firm's future business model? i.e. The position and services your firm will aim to deliver to the marketplace? Has RDIP been considered when drafting this model?
- Is there a significant change required to achieve this business model? Do you have a plan to get there?
- What are your competitors doing in response to the retail distribution changes?

Customer

- What level of knowledge do your customers have about the change to retail distribution?
- Will your customers expect you to educate them?
- What are their expectations or response to your proposed business model changes?

Change programme

- Do you know who you need to get involved to cover and implement the changes required? HR? IT? Legal?
- Have you performed a Cost Benefit Analysis against any of your strategic plans?

If you're comfortable you can answer the questions above, you're probably in good shape to progress, if not, we suggest running an impact analysis to uncover the threats and opportunities RDIP may open up for your firm.

Whilst many firms have been making steady progress guided by the broad direction given to date, some firms still persist in waiting until the waters have finally settled and there is clarity.

Strengthening governance standards

It has been widely anticipated that the increase in rogue trader incidents and risk and control failures and, more generally, excessive risk taking in credit derivatives would elicit a move by the Financial Services Authority (FSA) to strengthen governance within UK-authorised firms.

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The FSA's response to these issues (CP08/25) emphasises the personal responsibility of senior management and those that put authorised firms on risk. Overall, the proposed enhancements and changes to the existing regime are aimed at providing a clearer incentive for firms to implement more appropriate regional governance systems and at making it easier for the FSA to pursue enforcement cases against individuals who fail in their duties. The FSA is also making it clear that it will more actively pursue cases where individuals fail to demonstrate competence or capability in discharging these duties. The consultation paper also clearly acknowledges that governance and risk management arrangements have not been sufficient to deter excessive risk taking by individual traders.

Generally, the FSA has found there to be an inconsistency between firms' application of the regime. It is often the case that there are inconsistencies between firms that centralise power and authority and those that devolve it. While some firms have allocated significant influence functions to persons outside the UK where they have a significant influence over the business within the UK, many have not.

Usually, where the London business of a non-UK based global firm or group has a pivotal role in executing a part of a firm's global strategy, many firms (but not all) locate their global heads in London to be close to this part of the business. As such, those in significant influence functions are often those who have the real power to make decisions. One of the clearest examples of this is in the credit markets, where London had become the global capital of credit derivatives trading due in part to the pool of available skills and expertise for this business. However, in many cases, the voice of reason (high quality and experienced Non Executive Directors (NEDs) that should achieve the right balance in decision making between the exuberance of rainmaking executive management and the wisdom and objectivity of an informed outsider has been absent. Sometimes, the global business heads have too much power, thus diminishing the role of the UK country head.

Other firms have preferred to keep strategic decision making and oversight and control at the corporate centre, relying upon a UK branch to implement strategy. The senior management responsible for implementing that strategy have been put forward by these firms as those persons who have significant influence. It is probably fair to say that in many cases the substance and authority of the 'General Manager' role within UK branches is weakened by matrix management structures. Recent risk and control failures as well as losses made in the market turmoil have highlighted the inconsistency and point to the fact that the FSA itself has limited ability to influence where senior managers outside the UK do not have a personal responsibility to uphold UK regulatory standards.



There will, therefore, be changes to the existing guidance on the duties of NEDs and the guidance on what is expected of NEDs has been expanded. Secondly, the FSA has already begun to 'screen' some senior managers as part of its approval process and it will continue this going forward, not just to assess the competence and capability of applicants as part of its vetting process but also to seek assurance that senior managers understand their responsibilities under the UK regulatory system. Neither of these changes will require consultation.

The FSA is also proposing to extend the definition of the significant influence functions of Director (CF1) and Non-Executive Director (CF2) to individuals outside the UK-authorized firm. For example, those overseas senior managers who exert significant influence over the decision making of UK senior management will now be caught. The aim of this is to provide a more consistent application of the approved persons regime among authorized firms and ensure that individuals with the appropriate level of seniority and authority are held to account.

The FSA is also proposing that, effectively, all proprietary traders should be approved for the significant management function, whether or not they are senior managers within the firm. Therefore, while the FSA is emphasizing senior management responsibilities, it is also seeking to be more directive in pushing responsibility for risk management and control down to the individual traders on the floor.

The new rules could prove to have significant implications for some overseas firms in determining how to shape their business models and governance arrangements. There is clearly a need for firms to achieve systems of regional governance that avoid a tick-box approach. Individuals with the real power to influence and put the firm on risk, wherever they are located, will be made personally responsible for upholding UK regulatory standards. Certainly the proposals, if implemented effectively, should bring about a better alignment of corporate responsibility and local regulatory responsibility within governance systems and management structures.

European update: Calls for revamped supervisory systems in the EU grow

'...there is now a broad consensus that our supervisory systems are not and have not been up to the mark or fit for purpose. Not fit for purpose at an EU institutional level. Not fit for purpose at a Member State level.' European Commissioner Charlie McCreevy, 27 January 2009¹

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The supervisory systems in Europe have been found wanting and EU regulation, particularly prudential regulation, is not fit for purpose: these were the conclusions voiced by Commissioner McCreevy in January. At the end of February, the De Larosière working group will publish its recommendations on how to strengthen the EU supervisory structures. This group was set up by the European Commission to identify a more effective supervisory structure in order to promote stability and efficiency. Its report will shape future Commission work in this area in the coming months and years and feed into the upcoming G20 summit on 2 April 2009. But there is no 'quick-fix' and even M. De Larosieré's 'fix-it' approach may not yield instant improvements.

Regulators, alongside banks, have come in for considerable criticism as the result of their uncoordinated reactions to the financial crisis. Some observers say that the 'our folks first' reactions by both regulators and governments have brought European unity into question. Crisis management measures proved far from smooth and, obviously, substantial work is needed to ensure that these will be smoother and more efficient in the future. The next crisis, after all, will be different from this one. The first priority must be to extricate ourselves from this one and to set a coherent path for the future.

In terms of revamping EU regulatory structures, there are several points for consideration. The crisis has brought home clearly that the main regulatory direction in Europe and internationally in recent years was based on a 'fallacy of composition'^{1,2} i.e., the assumption that, by ensuring the stability of each individual financial institution, the stability of the whole financial system could be ensured. This ignored the growing leverage and interconnectivity in the global financial markets and also assumed, misguidedly as it turns out, that the European consumer could be insulated from a crisis in the wider international financial markets because there is no direct link between these and the real economy. A false premise to say the least.

The inherent conflicts of interest in supervisory objectives were also overlooked. Supervisors, essentially, have a four-fold responsibility:

- To ensure financial system stability.
- To ensure the efficiency of financial markets.
- To ensure the ongoing viability of institutions operating in those markets.
- To protect the interests of 'consumers' in those markets.

One might say that the structure of the EU institutional framework has obfuscated the reality that supervisors need to meet these objectives at the national level. Consumer protection – in the form of depositor or (retail) investor protection – relies on national legal systems, whether it be insolvency law, deposit or investor guarantee schemes, or contract law. As the current crisis has shown, when there is a run on a bank or retail investors are put at serious risk, it is national governments which need to bail out the industry.

An effective supervisory system would encompass all aspects of the above objectives adequately while mitigating the conflicts. Thus, observers are currently promulgating a two-pronged approach to supervision of the banking industry encompassing both macro- and micro-prudential supervision: essentially splitting the focus between the financial system and individual players in the associated markets. Macro-prudential supervision would entail monitoring the interconnectedness of the markets and the impact of gearing, and establishing mechanisms to alleviate the impact of the boom/bust cycles, including ‘herd’ behaviour, market euphoria and downward pressure on market and risk prices, which accentuate a boom cycle, on the industry as a whole. For some financial markets, this can only be done at an international level and so both the G20 statement in November³ and the more recent recommendations⁴ published by the Group of Thirty provide insights into the possible way forward. From a European perspective, the European Central Bank (ECB) has expressed its willingness to step up to this plate, noting that its Statute permits it to assume this role already and that this would not require any change in the EU Treaty. However, the Treaty currently does not permit insurance supervisors to delegate any responsibility to the ECB and, therefore, its ability to shield the system overall is restricted unless the Treaty were revised.

Looking at the stability of individual institutions, prudential regulation geared towards their individual solvency is still required. The conundrums created by the current crisis around ‘moral hazard’ have to be resolved through institutions clearly being responsible for their own futures. ‘Too big to fail’ or ‘too interconnected to fail’ does not sit well within a market economy, but this is the reality when faced with huge financial groups that span the globe. Basel II and the Capital

Requirements Directive (CRD), although flawed, have a critical role to play in ensuring the stability of individual institutions, and these will not go away. The European Commission has already tabled some amendments to the CRD which it hopes will clear the initial co-decision legislative procedure before the current European Parliament dissolves in June this year. It has already announced a more comprehensive overhaul of the regime going forward, in line with recent proposals released by the Basel Committee.

Europe will also continue to work with international fora in terms of group supervision. Colleges of supervisors are being established (in line with a G20 recommendation) for all major international groups. The Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Interim Working Group on Financial Conglomerates (IWGFC) have recently issued joint principles for the working of these colleges which set the framework, but the difficulties will lie in:

- The supervisory resources needed to ensure that group supervision for all groups can be carried out effectively and consistently.
- The challenges for each national supervisor to run a dual supervisory system – one for international groups and one for domestic players.
- Legal certainty around the distribution of tasks and responsibilities within the colleges.

But how does all this tie into the concept of a single EU market? With difficulty. Since the adoption of the Lamfalussy approach for the securities market in 2001 and its extension to banking and insurance three years later, we have seen significant progress in terms of EU financial services legislation. It is inconceivable that the Financial Services Action Plan could have been implemented on time with the pre-existing regime. Political tensions, however, still dominate at Level 1 and Level 2, as the current debate on the Solvency II proposal clearly demonstrates. At Level 3, the Lamfalussy committees have made considerable progress towards supervisory convergence. But there is only so much they can do without authority commensurate with their increasing responsibility. Charlie McCreevy has indicated that, in future, these committees

should be given more ‘teeth’; however, how this can be accomplished within the current EU institutional and national contexts is far from clear. At Level 4, the Commission has stepped up its enforcement activities but clearly is resource-constrained in this area.

Some very fundamental rethinking is needed to unravel all these disparate threads. We can only hope that M. De Larosière and his group of eminent colleagues will cut through the complexities and come up with a realisable programme of reform which can set us on the right path to ensuring that a crisis of the dimensions of the current one never reoccurs.

1 Charlie McCreevy, Internal Market and Services Commissioner, speech at the ‘Financial Markets & Economic Recovery – Restoring Confidence and responding to Public Concerns’, 7th Annual Financial Services Conference, 27 January 2009.

2 ICMB-CEPR, Geneva Report N° 11, ‘The Fundamental Principles of Financial Regulation’.

3 Statement from the G20, November 2008.

4 Group of Thirty, Financial Reform: ‘A Framework for Financial Stability’, 15 January 2008.

Spring 2009: Technical Round-up

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

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Conduct of business

Treating customers fairly (TCF): beyond 31 December 2008

TCF remains central to the Financial Services Authority's (FSA) strategy and the FSA expects firms to have fully implemented the requirements. Therefore, from January onwards, the FSA intends to test the delivery of TCF as part of firms' usual supervision under the Advanced Risk Responsive Operating framework (ARROW) process.

Mortgage arrears and repossession practices

In November the FSA published a Dear CEO letter as a second warning to firms of the requirements for the fair treatment of consumers in arrears or facing repossession. This follows on from the FSA's thematic work in this area, published last August, which revealed shortcomings. Firms are expected to review their policies and procedures to ensure they are compatible with the relevant FSA Handbook conduct of business and the wider TCF requirements. Firms were expected to have informed the FSA of their conclusions and proposed actions by 31 January 2009.

Payment protection insurance (PPI)

The Competition Commission (CC) has been investigating the sale of PPI at the request of the Office of Fair Trading. In November 2008, it published a proposed package of measures which it considered would be practical and effective in increasing competition in the market to the benefit of customers. This report resulted in a number of responses which revealed some confusion regarding the scope of the measures. Therefore, the CC has published a separate document setting out the scope of the proposed remedies package as it is intended to apply to intermediaries. Once finalised, firms will have between six months and a year to implement the requirements.

Pension transfer advice

Following a review of the quality of advice given to customers who switch into a personal pension or self-invested personal pension, the FSA is looking for improvements in the standard of advice. Therefore, the FSA is writing to firms that advise on pension transfers, setting out its findings, the standards it expects of firms and the action firms should take to ensure customers receive suitable advice. The FSA will undertake further assessments in the third quarter of 2009. Firms that fail to take steps where necessary will face further action. The FSA has also given individual feedback to firms involved in the review, setting out the action it expects them to take. Several firms are expected to be subject to

enforcement investigation as a result of significant failings identified during the review.

Insurance comparison websites

A further review of insurance comparison websites has found that many sites have made significant improvements and are consistently providing clear, fair and not misleading information, but some firms need to go further to address a few specific concerns. Two areas to consider are:

- Obtaining better information from insurers about the level of excesses that apply to insurance policies.
- Making the assumptions about consumers' needs and circumstances that some websites use to obtain quotes more clear.

Persistency of life and pensions policies

The FSA has published the results of its 2008 survey of the persistency in the first four years of a contract of life and pensions policies. The rates continue to be considerably lower than historically, but are broadly in line with those reported last year. In particular, less than 50% of personal pension policies are still in force after four years.

FSA reviews the Conduct of Business Sourcebook (COBS)

The conduct of business rules underwent a major revision at on 1 November 2007 when the FSA implemented Markets in Financial Instruments Directive (MiFID) requirements and made further steps towards principles-based supervision. The FSA is committed to a post-implementation review running through to 2010; in December 2008 it published its interim findings. It has found that, so far, firms have not made extensive use of the greater discretions available. The review concentrated on financial promotions, suitability/appropriateness and disclosures.

The FSA has also been conducting a thematic review of compliance with MiFID rules in the wholesale sector, covering the following priority areas:

- Best execution.
- Inducements.
- Investment research.
- Client classification.
- Conflicts of interest.
- Senior management systems and controls.

Overall, the FSA was satisfied with the level of compliance in these areas, apart from inducements (where it felt that many firms had not understood the rules) and the disclosure of best execution and conflicts of interest policies (considered to be often too vague).

Client assets sourcebook: change to non-MiFID rules

The FSA has published Policy Statement 08/10 implementing changes to the client assets sourcebook (CASS). From 1 January 2009 there is a single set of client money and custody asset rules that apply to both MiFID and non-MiFID business.

The FSA had recognised that for firms which conduct business across both regimes, navigation and compliance with the provisions of CASS could prove comparatively cumbersome. In addition, there are differences between the MiFID and non-MiFID CASS regimes, with the MiFID chapters generally being less prescriptive than the respective non-MiFID chapters. The revised rules condense the MiFID and non-MiFID requirements into one set of rules but retain certain exceptions and exemptions for non-MiFID business.

Regulation of Sukuk/Islamic bonds

The FSA and HM Treasury published a consultation paper in December setting out the proposed legislative framework for the regulatory treatment of Alternative Finance Investment Bonds (AFIBs), commonly known as Sukuk or Islamic bonds. HMT is seeking to introduce legislative changes to align the regulatory treatment of AFIBs with conventional debt securities. This is a continuation of several initiatives to create a 'level playing field' for Islamic finance.

Classifying Islamic financial instruments, including sukuk, under existing regulatory frameworks has posed challenges in the UK and other jurisdictions. Although many instruments are designed to replicate the economic functions of certain conventional financial products, their legal structure and risk characteristics may be different. It may therefore be difficult to map these products into the existing legal framework. Some of these instruments currently appear to fall within the definition of a Collective Investment Scheme (CIS) but other interpretations exist and assessment is currently conducted on a case-by-case basis.

Four policy options are outlined in the consultation but the preferred option is to introduce legislative amendments to exempt AFIBs from CIS regulations and create a new specified investment under the Regulated Activities Order.

Governance and controls

Significant influence functions: extension and clarification

The FSA has published a consultation paper which clarifies its expectations of those within firms that perform significant influence functions. In addition, the CP proposes to extend the approved person regime (in particular proprietary traders and senior managers in non-EEA

branches) and it also sets out how the FSA is enhancing its scrutiny of senior management competence.

The proposals will particularly affect firms which are part of a group and those which have non-executive directors.

In its Supervisory Enhancement Programme, the FSA stated that it would place greater emphasis on the role of senior management, including non-executive directors. The FSA is seeking to ensure that all directors and senior managers understand their regulatory obligations, have relevant experience and carry out their roles with integrity. The FSA has already started to interview more applicants for 'significant influence' posts at high-impact firms. Once in post, where individuals fail to meet the required standards, the FSA will consider enforcement action.

Société Générale rogue trader update and market abuse controls at hedge fund managers

Market Watch newsletter issue 29 covers issues arising from activity following the reporting of the Société Générale rogue trader incident in January 2008. It also reports on market abuse controls in hedge fund managers (HFMs). Firms are encouraged to review their systems and controls in this area and to consider the issues that are identified.

The FSA reported on market abuse controls in the HFM sector in Market Watch 24. It has made follow-up visits and in this newsletter has sought to raise awareness of areas of concern and emphasise the importance of well-thought-out and applied market abuse control procedures under the headings:

- Culture/senior management responsibility.
- Compliance.
- Control over inside information.
- Monitoring of trading activity.
- Training.
- Personal account dealing.
- Telephone taping.

Systems and controls: extending the common platform

Policy Statement PS08/9 extends, mainly as guidance, the organisational systems and control requirements (SYSC4-10) currently applicable to common platform firms (firms subject to MiFID and/or CRD) to substantially all other FSA-regulated firms (non-scope firms) except insurers. The change takes effect from 1 April 2009.

The FSA has now confirmed changes to INSPRU, IPRU(INS) and the Annual Return for December 2008 year ends.

Prudential requirements

Insurance companies

The FSA has now confirmed changes to INSPRU, IPRU(INS) and the Annual Return for December 2008 year ends. For the Annual Return, major revisions have been made to Form 17, which shows an analysis of derivative contracts, and Form 56, which presents an analysis of index-linked assets and their mean term and gives further information on the credit profile of fixed and variable interest securities.

Integrated regulatory reporting

'GABRIEL', the system by which firms submit financial and other reports to the FSA electronically, has started to bed down. In January, the FSA consulted on some tidying up on the published guidance, which is an opportunity for firms to raise any teething problems they may have had.

Financial stability and depositor protection

Special resolution regime: safeguards for partial property transfers

HM Treasury has published a further consultation (November 2008) on matters relating to the Special Resolution Regime which is to be introduced by the Banking Act 2009. The consultation sets out proposals for providing adequate safeguards arising from the exercise of powers to split a failing firm (transferring a 'good' part to a separate entity leaving a residual part behind). A draft code of practice (as provided by the Banking Bill) on the authorities' use of the stabilisation powers, bank insolvency procedure and bank administration procedure was also presented for consultation.

Financial stability and depositor protection: FSA responsibilities

The FSA is consulting on changes to the threshold conditions guidance in the FSA Handbook to reflect its responsibilities under the Special Resolution Regime (SRR).

Under the SRR the authorities' have allocated lead responsibilities. The FSA will be responsible for taking the regulatory decision that a bank has failed (or is likely to fail) to meet its threshold conditions and, having regard to timing and other circumstances, it is not reasonably likely that action will be taken by or in respect of a bank that will enable the bank to satisfy the threshold conditions. The FSA will also be responsible for supervisory decisions and regulatory actions in respect of any bank subject to the SRR.

The CP discusses potential contractual barriers to effective action and refers to the relevant draft BIPRU12 provisions on liquidity published in CP08/22. The FSA's experiences during the current market turmoil have also highlighted the shortcomings in firms' ability to produce timely information requested by the FSA and on information available internally to firms for the purposes of managing risks and running their businesses.

Financial Services Compensation Scheme

In addition to one-off announcements made by the Government last autumn relating to customer compensation concerning banks that had failed, the FSA has issued various consultation papers and policy statements regarding changes to and reforms of the Financial Services Compensation Scheme (FSCS). These include:

- Review of compensation limits, including depositors' compensation limit increased from £35,000 to £50,000 from 7 October 2008 (CP08/15 included related proposals).
- FSCS funding – tariff changes to take effect in respect of the April 2010 to March 2011 levy period (PS 08/11).
- Regulatory fees and levies – policy proposals for 2009/10 (CP08/18).
- FSCS reform – proposals for arrangements to enable customer to be repaid within seven days of a deposit taker failing are intended to take effect from December 2010 (CP09/3).

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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The European regulatory network is coordinated from Brussels by Wendy Reed, with the support of experienced individuals who bring both knowledge of regulation in the European Union and sectoral expertise.

There are experts in each industry in nearly all EU countries where we are able to advise on local regulatory matters relevant to our clients' needs. While we have an extensive network throughout Europe, you may find it simpler to channel any requests through:

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