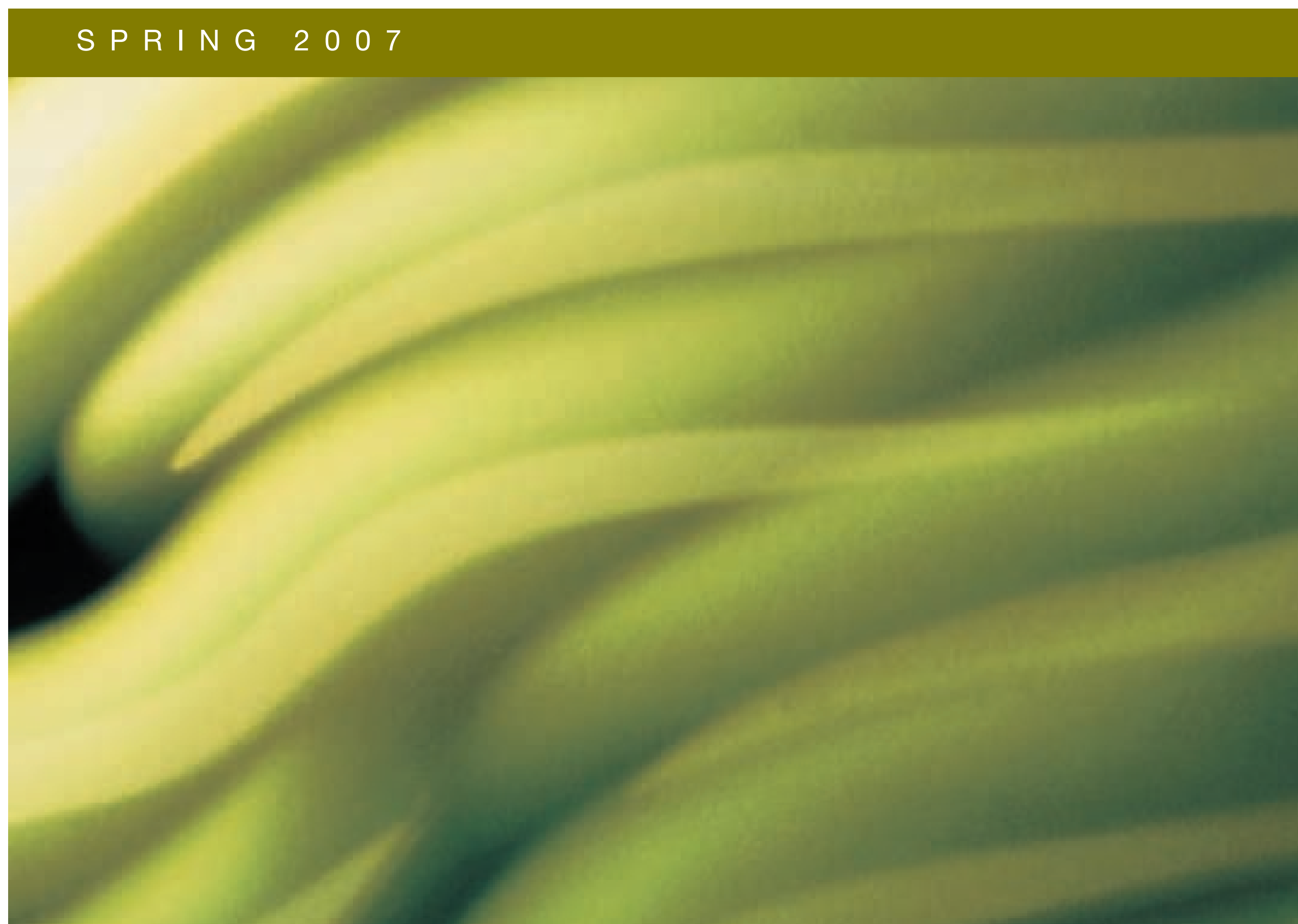
Financial Services

UK Financial Services Regulatory

Focus

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

SPRING 2007



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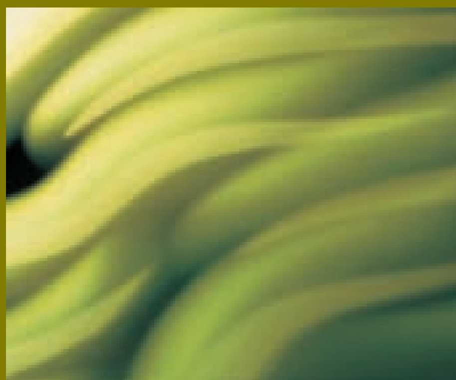
PRICEWATERHOUSECOOPERS

It must remain a moot point as to whether senior managers and compliance officers in financial services regulated firms are feeling the joys of spring as they read this – the burden of change in the regulatory sphere is showing no immediate signs of alleviation, despite promises from Brussels of a curb to the flow of new directives. Much of the change that we are facing is, of course, the result of the Financial Services Action Plan launched in the last decade, but changes such as the move to more principles-based Regulation in the United Kingdom are essentially self-imposed. As I write this, we await a further discussion paper from the FSA on Principles-based Regulation and indeed the launch of the new regime at a high profile FSA-run conference in Paddington in April.



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Much of the burden of the Principles-based regime will fall upon senior management: together with board members, they are that focus of the FSA's ARROW 2 visits and the ICAAP submissions (Initial Capital Adequacy Assessment Plans). If I am conscious of any trend in my conversations with firms over the last quarter, it is towards increasing concern over what engagement is expected of board members in relation to FSA regulation: what management information on regulatory compliance, capital planning and risk management should be provided to them, and what engagement is expected of them?

Non-executive directors (NEDs) are expected to challenge management, but they should not be expected to second guess them. Some of the questioning of NEDs by the FSA, for example in respect of Basel II waiver applications for Advanced Internal Ratings-based and Advanced Management Approaches has in many cases implied an expectation that directors should be second-guessing management. Of course, all NEDs are also consumers and might be expected to have a detailed understanding of some retail financial products, but it is to be hoped that questioning of NEDs on their involvement, for example, with applications for internal model method approvals for the trading book will not presume a detailed knowledge of the simulations needed for such models (though an article in this edition will provide some background for those that are to be questioned). NEDs need to understand the judgements that management have to make and the measures that are used to monitor their performance and risk-taking if they are to provide an effective challenge. However, if the FSA puts the expectation hurdle for financial services NEDs too high, it will in due course find that there is a real dearth of suitable candidates for this key role in governance and oversight. This is a particular issue in respect of UK subsidiaries of overseas banks and other firms.

The FSA's 2007/8 Business Plan and Financial Risk Outlook, issued earlier this year, should be compulsory reading for all, particularly those charged with briefing NEDs and senior management. The FSA obligingly provides an indication of the key themes on which it will focus over the next year or so in its ARROW 2 and themed visits. For wholesale banking and investment firms, the focus on unconfirmed trades will continue, extending to equity and potentially commodity derivative trades, as will that on collateral management, market abuse, transaction reporting, leveraged lending to hedge funds and private equity funds, and prime brokerage. For insurers, there will be continued focus on controls over underwriting strategy and contract certainty, and at an industry-wide level on transparency of commissions. In the investment management sector, focus will be on use of derivatives and adherence to the bundled and softed commission rules. Firms should expect more rules on liquidity management, and there is an article on the current regime in this edition

Within the retail sector, firms should both contribute to and be attentive to the output from the retail distribution review, on which there is also an article in this edition.
The study on wrap platforms appears to be complete, and the discussion paper on these in Q2 will be priority reading for firms involved with wraps. But the old favourites will continue as themes – Treating Customers Fairly, Financial Promotions Point-of-sale Disclosure and Sub-prime Lending: there will be no let up from regulatory focus for those involved in selling Payment Protection Insurance, either.

There will be challenge too for the FSA: the required linkages between ARROW 2 risk assessments and the ICAAP submissions for banks and investment firms (and more importantly the FSA's responses in the Supervisory Review and Evaluation) will not be easy to achieve; consistency across firms and within sectors will be even more difficult for supervisors who are still familiarising themselves with the new regime. This will be a demanding year. While many supervisors have experience of Individual Capital Guidance for insurers, the roll out of this regime to all firms is a greater challenge. Management will need to have some sympathy with their supervisors, and we must hope that such sympathy will be reciprocated.

John Tattersall
Chairman
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Review of Retail Distribution Policy: what will the future bring?

In June 2006, the Financial Services Authority announced that it planned to review how the models of retail distribution may evolve in the UK around the financial advice sector.

The review was initiated by the FSA's Retail Intermediaries Sector Team, which monitors market intelligence and had increasingly been aware that the industry had serious concerns over the current distribution model and some even consider it to be 'broken'. It noted problems within the savings market such as commission structures, product bias, churning, persistency rates and profitability.

In its desire to be 'forward-looking' the FSA's intention is to give firms the flexibility to best decide how to run their business, while remaining compliant with the FSA's overall objectives, they believe that it is not their job to dictate business models and that industry must lead on market solutions. The FSA does, however, see itself as the catalyst for change. The cynics out there may say for once industry and the FSA have a shared objective – providing investment products to retail customers in a way which meet both their personal and commercial needs.

Retail Distribution Themes and the Review

The intention of the Retail Distribution Review (RDR) will be to identify and address root causes of problems which continue to arise from the retail investment market. To enable it to do so the FSA needs to deepen its understanding of how its regulatory requirements can prevent or encourage the emergence of a market that is economically sustainable. It needs to answer the question of whether its current regulations protect those it was designed to protect without stifling innovation. To do this effectively the FSA needs to understand what the drivers for change might be and how they would

affect the market, including regulation, remuneration models and capital requirements.

In November 2006, the FSA announced the five themes that will form the basis of the review:

- The sustainability of the sector.
- The impact of incentives.
- Professionalism and reputation.
- Consumer access to financial services products and services.
- Regulatory barriers and enablers.

The chosen approach was to appoint industry leaders to chair each of the RDR themes, whilst taking a holistic view. The industry group was established in January 2007 and comprises practitioners across a variety of firms of differing sizes, other stakeholders and senior FSA staff. It is envisaged that the groups will meet regularly and that key issues and themes will feed into a Discussion Paper which is due to be published in June/July 2007.

The Association of British Insurers (ABI) believes that the FSA is asking the correct questions and the five themes are in tune with its own thinking. Many believe that the product-led regime is outdated and prevents the market's ability to reshape itself. Industry currently faces numerous challenges from economic and market pressures as well as having to comply with regulatory standards, but there is now a feeling that the industry is ready for change. The FSA has renewed its commitment to a 'principles-based' regime, and the RDR should not be treated as a surprise or threat, but viewed as a real opportunity to develop a sustainable retail distribution sector.

Whatever the outcome of the Review, it appears that there will still be an important role for financial advice, as this currently accounts for more than 60% of total Life and Pensions sales in the UK. One new suggestion is that the use of platforms may provide a better solution for more affluent customers, allowing them to find a 'wrap' to suit. It is important to try to predict any consequences the proposed structures would have for customers, firms and the FSA, in order to minimise the risk to meeting their overall objectives. The RDR aims to help the FSA to understand the steps industry and the Regulator should be taking in order to secure a market place that is 'economically stable, attracts scarce capital and talent which is able to meet the changing needs of the consumer'.

It is certain that any benefit from subsequent changes will not be immediately realisable and will take time to bed down. With the implementation deadline the end of March 2007 for TCF upon firms and the 1 November 2007 MiFID deadline looming, have firms already got too much on their plate? There may be mixed responses to this question. However, one consistent comment is that many feel the time is right to revisit the way in which the industry is currently operating. The release of the FSA's Summer Discussion Paper will be eagerly awaited.

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...the use of platforms may provide a better solution for more affluent customers, allowing them to find a 'wrap' to suit.

The challenges of EPE Models in the Trading Book

Just as many firms have grappled with the challenges of bringing their internal credit rating models into line with Basel II requirements, the process of developing models, or indeed bringing existing models up to Basel II standards, for the measurement of counterparty credit risk in the trading book has produced its own unique set of challenges.

With tougher rules under Basel II than under the previous regime for the determination of capital charges for counterparty credit risk in the trading book, many firms will need to obtain model approval if they are not to face substantial increases in capital requirements. Under Basel II rules, the measurement of the exposure and related capital requirement for counterparty credit risk in the trading book is calculated with reference to one of a number of formulaic solutions such as the mark-to-market and standardised approaches.

Trading positions that carry counterparty credit risk may consist of over-the-counter derivative positions, securities financing transactions (such as Repos, Reverse Repos and Stock Lending and borrowing transactions), margin lending and long settlement transactions. Whilst there is a level of risk sensitivity built in to the current calculations, the resulting exposure is predominantly a function of the current mark to market value of the transaction. Basel II rules give firms the option to apply an advanced 'Internal Model Method' to trading book positions, resulting in an Effective Expected Positive Exposure (Effective EPE) at the counterparty (or netting set) level which then feeds into the consolidated Credit Risk Capital charge calculation.

Effective EPE in itself is not a simple measure to understand or indeed calculate! In order to be consistent with the Basel II requirement to use a one-year probability of default (PD) time horizon, Effective EPE is measured as the average of Effective Expected Exposure over a period of one year. Exposure calculations are termed 'Effective' in the sense that they are adjusted in order to address the roll-over of short-dated transactions and in order to differentiate counterparties with more volatile exposure time profiles from those with relative stable profiles.

The main challenge in building an internal model lies in the fact that at the core of an Effective EPE calculation is a complex simulation of a distribution of future prices at a number of discrete time buckets – typically monthly out to 1 year and then semi-annually or annually after that out to the maturity of the individual transaction. In order to generate this distribution of future prices, a Monte Carlo based simulation approach is often used. Firms have a number of alternatives when it comes to building the models that will simulate the risk factors (such as interest rate curves and foreign exchange rates and volatilities) required to price individual transactions at these future time buckets. The most complex of these is the model used for the simulation of a distribution of interest rate curves at the future time buckets. There are three broad categories of interest rate models – spot rate models (e.g. Ornstein-Uhlenbeck, Hull-White, Black-Derman-Toy), forward rate models (e.g. Heath-Jarrow-Morton) and Libor market models (e.g. Brace-Gatarek-Musiela, Jashmidian). Each of these model types has its own set of complexities which must be addressed.

Additional models are also required for the simulation of other risk factors and pricing models are then required to generate exposures using the simulated risk factors. Path dependent options (such as Asian options and Bermudan options) that use a simulation based approach for basic pricing result in further complications as a simulation within a simulation becomes unfeasible both with respect to computer time and computer capacity. Closed form approximations can be developed but these must be clearly demonstrable as conservative in order to meet regulatory expectations.

Model inputs such as market and trade data are also key elements of an internal model method. The standards for data integrity and reconciliation processes are a fundamental element of any application to regulators for permission to use the internal model method.

A number of firms have been generating future exposure distributions for many years and actively use the outputs of these models to monitor and manage counterparty credit risk in the trading book. Our experience has been that these firms have often underestimated the level of effort required to bring their internal models up to a standard that regulators will accept as being sufficiently robust to base capital calculations on. Those firms who have built models from scratch have been able to plan projects which align build requirements to regulatory expectations and aspects such as model documentation and model validation have been incorporated into the process. With the complexity of the models themselves and the large capital savings that can be recognised following approval, it is little wonder that the application and approval process is an involved and lengthy process requiring significant resource and senior management engagement. In view of the significant potential capital savings to be obtained when an EPE model is approved, it is very important that firms do not underestimate these challenges.

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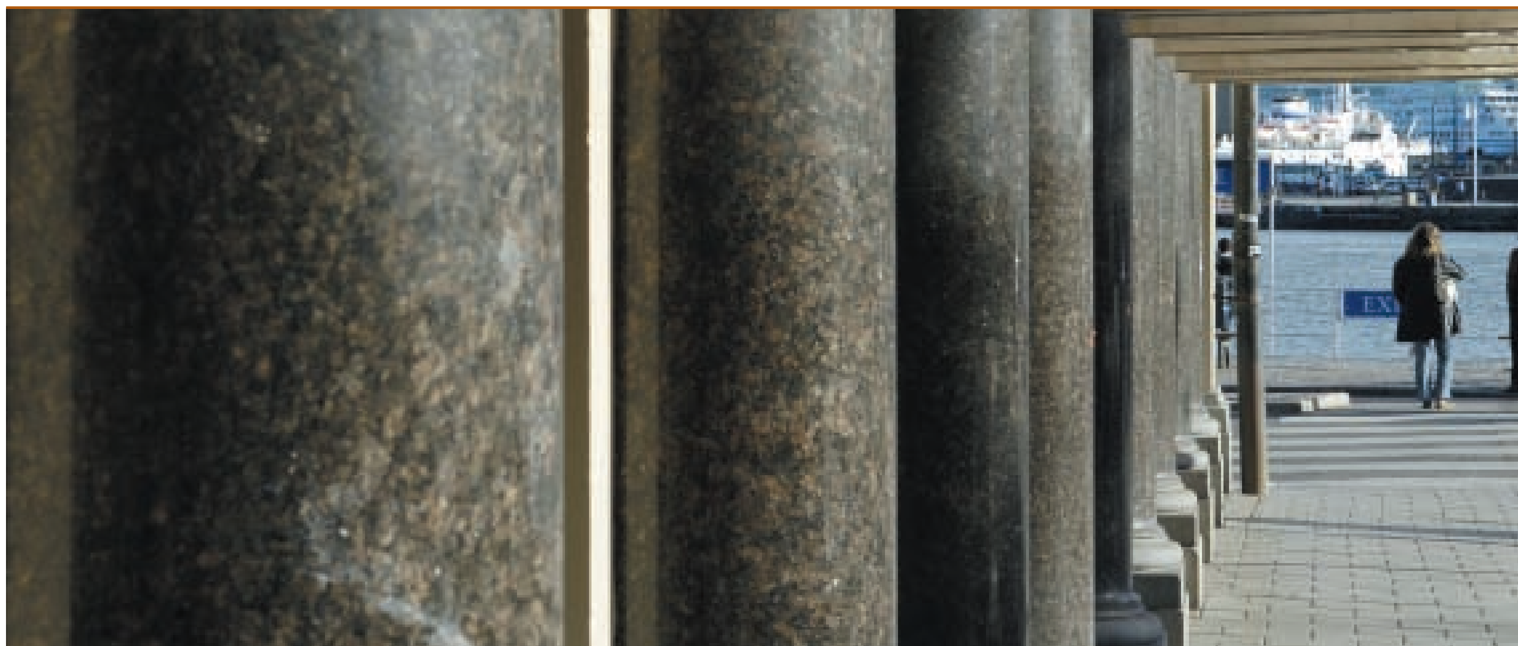
Solvency II: decision time



The formulation and consultation of the new EU Solvency II is reaching a decisive stage with the draft framework directive due to be published in July 2007. The proposal will outline the principles on which the future solvency regime will be built.

For the quantitative 'Pillar 1' requirements, the proposal is that assets and liabilities will be valued on a market consistent basis, with the regulatory capital requirement being based on a 99.5% confidence level of remaining solvent in the next 12 months. The Solvency Capital Requirement for the standard approach will be based on a modular approach setting capital against a number of different types of risks including underwriting risk (for life and non-life), market risk, default risk and operational risk.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is testing the quantitative requirements through a series of Quantitative Impact Studies (QISs). The first study in 2005 tested different evaluation bases for valuing technical provisions focusing on the percentile approach. The second study took place during the summer of 2006 with the goal to test the design layout, the practicalities of the calculations involved and the potential impact on the balance sheet and amount of capital needed.

The upcoming third Quantitative Impact Study (QIS3) is considered by the European Commission to be a key milestone for Solvency II: for ensuring that the future regime is well-calibrated and based on sound analysis, backed-up by evidence.

The focus of QIS3

QIS3 will aim to test:

- Impact of the new valuation basis for assets & liabilities (both measured on a market consistent basis).

- Impact of the proposed Solvency Capital Requirement standard approach against available capital.
- Impact on solo entities as well as groups.

In addition, companies will be encouraged to compare the Solvency Capital Requirements under their standard approach with the results from their own Internal Capital Assessment (ICA)/internal models.

QIS3 will take place during April – June 2007, with the QIS3 pack being available to the market on 2 April. Companies will be encouraged Europe-wide by CEIOPS and in the UK by the ABI and the FSA to participate on a best effort basis.

Background information on Solvency II

Solvency II is set to mark a move away from the simplistic regulatory capital requirements currently in force across most of Europe. In their place will come a more qualitative and quantitative approach in which capital levels are geared to the risks being run within each business and the effectiveness of the measurement, monitoring and control functions in operation to manage them.

The focus is on revising and extending the current solvency rules in Europe for life, non-life and reinsurers. Solvency II will be based on market consistent valuation of assets and liabilities. The main objective of the system will be to assess 'overall solvency' build and it will be based on a three-pillar structure capturing 1) the quantitative aspects including the bases for calculating technical provisions, the definition of the minimum capital requirement (MCR) and Solvency Capital Requirements (SCR), 2) the supervisory review process and 3) disclosure/market discipline.

If all goes according to plan, Solvency II is expected to be implemented by 2010.

QIS3 – Why participate?

The QIS2 results from the UK showed a wide range in terms of impact on the industry when comparing the ICA results with the level of capital derived by the Solvency Capital Requirement. The SCR in many cases was coming out at a higher level than the ICA, which perhaps is to be expected given that Solvency II encourages and gives incentives for firms to use internal models.

One key difference, however, is that these models will have to be formally approved by the regulators under Solvency II; a very different procedure from what we know in the UK today. In a recent speech at an ABI conference, the FSA made it clear that few, if any, existing ICA models could, as they are presently, be expected to be approved, at least when compared with the criteria currently being envisaged within Solvency II. The criteria are however still to be defined in detail and will form a core part of the information available to the market under the implementing measures for Solvency II.

In summary, the key reasons to participate in QIS3 include:

- Being able to influence the debate.
- Getting a better understanding of how the new regime compared with an entity's current measurement basis for liabilities and the ICA.
- Establishing the need for a Solvency II project or roadmap within the individual's own organisation.

Further information

PricewaterhouseCoopers will be facilitating Solvency II QIS3 workshops for the industry during April.

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EU Savings Directive: a first year assessment

The European Union Savings Directive (EUSD) is a regulatory compliance regime which targets a particular aspect of financial crime in the EU, the evasion of tax by individuals on offshore savings income.

Originally conceived as a withholding tax system, the EUSD subsequently developed (as a result of pressure from the UK fearing the damage that a withholding tax would cause to London's position in international bond markets) into an information exchange system, although a handful of EU countries with banking secrecy traditions can operate a withholding tax model for an indefinite 'transitional period'. Unsurprisingly, most of the non-EU countries and EU dependencies that adopted the EUSD, e.g. Switzerland and the UK offshore islands, decided to opt for a withholding tax system too.

In its exchange of information form, the EUSD requires EU banks and other financial intermediaries to report annually details of individual customers based in other EU countries and the amount of interest paid to these individuals. These details are then passed on to the country where the individual in based, the idea being that this information allows the receiving country to check the relevant income has been declared for tax purposes.

A simple enough idea in theory – but how has it worked out in practice so far? The EUSD began in 2005 and according to HM Revenue & Customs (HMRC), the authority responsible for administering the EUSD in the UK, some 500 UK institutions filed their first reports last year, amounting to approximately 800,000 lines of data.

PricewaterhouseCoopers has undertaken a survey of the first year EUSD experience of UK reporting institutions. The key findings of this survey are that:

(i) Understanding the impact of the Directive was more difficult than many institutions expected. Directive concepts often carried specialised meanings which did not match existing data categories (for example, reportable 'interest' could include redemption payments from UCITS funds, whereas much interest on listed debt did not qualify as reportable, and 'beneficial owners' could include pure nominees).

(ii) Relevant product data was often hard to obtain, particularly in relation to investment funds. New customer data was also needed which went beyond existing KYC information e.g. local tax ID numbers had to be asked for, and this caused considerable inconvenience. Nevertheless, the reported impact on customer behaviour was negligible, and fears that the EUSD would lead to large scale account closures and loss of business proved unfounded.

(iii) Implementing an IT-based EUSD compliance system was expensive and cost much more than initial HMRC estimates – a significant proportion of survey participants spent hundreds of thousands or millions of pounds, even though the number of customers needing to be reported in many cases was in the hundreds or low thousands.

(iv) Institutions doubted whether the cost of compliance was justified by the value of the information actually gained by the tax authorities. There was no de minimis reporting level so even amounts as small as a penny had to be reported, and it was only very belatedly realised that the UK tax year (used as the reporting period by UK institutions) did not coincide with the calendar year (used as the tax assessment period in all other EU countries), meaning that much of the data produced by the UK savings industry is unlikely to match the taxable income of overseas customers.

(v) Overall, barely 50% of survey respondents thought the EUSD was fit for purpose.

It will be some time before one can properly judge whether the EUSD is meeting its policy objectives. A great deal of effort has certainly been expended and much data is now being produced, but the real test of success will be whether the EUSD will actually change taxpayer behaviour by deterring individuals from concealing their offshore income from the taxman. It will certainly have a significant impact on the firms that are required to report under it.

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ICAAP: the story so far

Banks, building societies and investment firms of all sizes are in the process of assembling their Basel II 'ICAAP' – a document to demonstrate to the FSA how they manage their capital. We look at the progress so far.

Few firms are yet fully confident in their Internal Capital Adequacy Assessment Process documents (ICAAPs): it seems that everyone involved in Pillar 2, from the Regulator to the CEOs of major banks, is still in that 'learning' phase where practices are emerging but without clear consensus. Perhaps this is not surprising given that ICAAP is new, but also because it is not just an FSA return drawn up at a specific point in time, rather a demonstration of the firm's strategic decision making processes.

It is the scope (and indeed the requirement) for individuality which many, perhaps most, firms have wrestled with as they make the transition to ICAAP from a largely rules-based process under Pillar 1. In Pillar 1 a relatively small group of specialists have commonly engaged themselves in complex models and detailed statistical analysis, whereas in Pillar 2, and ICAAP as a major part of that, a firm must bring its own stamp to the principles that underpin Basel II: capital considerations must dovetail into the business risk environment and infrastructure.

At the simpler end of the spectrum we see firms taking the FSA's template for ICAAP submissions, available from the FSA's website, and using that to determine and develop their ICAAP, amending their existing processes to shoe-horn them into the required format without really reflecting on what is best for the firm. For most it is becoming apparent that this approach diverges from the spirit of the accord and is likely to result in longer term remedial work and issues with the 'use test', as well as potentially poorer business decisions.

A large number of firms have created separate risk committees to oversee risk and capital management; however, this has created some confusion as to the role of other risk forums such as credit committee, capital planning and ALCO.

On the other hand, we see other firms who have spent considerable time in genuinely analysing how they manage their business and how they make risk-based decisions around strategy and business objectives. These firms use the FSA's suggested submission format more as an aide memoire to ensure the completeness and rigour of their thought process as they amend their risk and governance activities to meet the new challenge.

So what is characterising firms' activities as they develop and embed their ICAAP? Firstly, ICAAP has created an opportunity and an impetus to revisit the risk governance framework. Some firms are updating and reconfiguring the committees that support risk taking and risk governance, particularly asset and liability committee (ALCO) reviews, where the measures and limits structures used to manage financial risk have become stale and outdated.

A large number of firms have created separate risk committees to oversee risk and capital management; however, this has created some confusion as to the role of other risk forums such as credit committee, capital planning and ALCO.

We have seen some instances where firms have conducted their initial Basel II capital requirements only to find that significant and urgent changes to their capital resources are required. This is particularly true for some mortgage based firms who had anticipated a net reduction based on current regulatory capital but once the numbers have been cranked through the machine shortfalls have resulted.

Who owns ICAAP?

The question is being debated in some firms at the moment: clearly there is no right or wrong answer, except that it should be owned, and by an appropriate party who does not have direct business management responsibility. Typically we see either a centralised risk function or finance as being the current favourite choices. It remains to be seen if capital management will strengthen its position as a distinct discipline.

How frequently should ICAAP be conducted?

The frequency of ICAAP is generally determined by the frequency that significant decisions are taken or when environmental factors deem it prudent to revisit capital adequacy. Above all, firms need to take care to ensure that timing reflects the risk environment and not the calendar. Thus firms that have moved towards an economic capital view of the world (particularly the larger banks), where return on risk adjusted capital is at the heart of decision making, need to maintain a very current view of capital adequacy; many of their ICAAP elements are embedded within existing activities and brought together on, for example, a quarterly basis. For less sophisticated and perhaps lower risk profile firms, we are seeing an annual ICAAP being proposed with six monthly interim reviews.

From our work so far, the presentation of ICAAP submissions varies significantly. For us, the key is to see the ICAAP from the FSA supervisor's perspective and, as we are aware, the FSA is most concerned that firms can demonstrate that senior management is controlling the business properly. In the case of the submitted ICAAP document the board perspective is therefore the key starting point. In preparing FSA submissions many firms do not focus sufficiently on this board level story and on demonstrating the rigour of management's determination/assessment of factors beyond Pillar 1 that impact risk capital. Instead the ICAAP dives into detail from the beginning. We thus see a trend for the better ICAAPs to demonstrate the breadth of their thinking in the main body text and submit the detail in appendices.

Stress testing continues to challenge the larger firms, as well as the smaller, and is a critical element of ICAAP for all firms, with the relative importance being larger for smaller and simpler firms. Many of these firms are recognising the importance of combining macro economic considerations with more local factors that influence pro cyclicality along with the potential for there to be positive correlation.

During the next few months we will no doubt see slow building of a consensus on the standards to be applied. Board level and other senior management views will be of growing importance and need to be incorporated. However, we expect continuing diversity of approaches to reflect differing businesses and styles of management across the wide spectrum of firms impacted by the new regime.

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Conflicts: a battle ahead for some

From November 2007, all European financial services firms that carry on investment business must comply with new rules on conflicts of interest. These rules, introduced by the EU's Markets in Financial Instruments Directive (MiFID), have greater depth and reach than some firms may realise. Aaron Caplan and Adrian Jackson of PricewaterhouseCoopers LLP examine the implications of this new regime and set out a practical approach to compliance with it.

It is no longer enough for financial services firms to disclose actual or potential conflicts of interest.
By November, a firm must be able to prove, through documentation, that it has a conflicts of interest policy, that the policy is implemented throughout the entire business, and that it works. This is central to the change imposed by MiFID and the phrase 'don't just tell me, show me', aptly sums it up. However, proving that a working policy exists is not the only new and significant departure from the familiar: there is also MiFID's recommendation that a documented group-wide policy should be put in place.

Most firms will already have some conflict of interest policies in place. The challenge for firms is that these are unlikely to be extensive enough. Companies will now have to look at their operations holistically and this is likely to be new to many that have UK or EU management teams. Although most managers will be familiar with having to identify conflicts of interest within specific areas of business, looking for conflicts across an entire group, such as any large banking or investment organisation, and developing a comprehensive conflicts policy presents a far more complex challenge.

MiFID aligns the EU with the US approach on conflicts of interest more than it does with the current UK approach. The UK has to date favoured a more market-led, principles-based approach which in general terms is more reliant on disclosure rather than requiring firms to actively manage conflicts as is more the case in Australia and the United States.

But the issue of independent investment research presents a knotty problem for many, particularly mid-sized firms. The rules here could force some firms to rethink their business completely.

MiFID is prescriptive

At present the UK has what is effectively a half-way house. The UK Financial Services Authority (FSA) has moved on the conflicts issue though rules on soft commissions and bundled brokerage arrangements, and the FSA's conduct of business rules, generally prohibit dealing ahead of the publication of research. But MiFID is very prescriptive and brings with it a US feel. It requires that research either be labelled independent or be easily identifiable as independent. Any research material that cannot be defined as independent must not be presented as such, even with a disclosure saying that there may be conflicts. One possible solution is to present such research as marketing communication.

MiFID is also prescriptive about the way analysts are deployed. As in the US, the rules are designed to physically separate researchers from the bankers, brokers or fund managers. Analysts cannot, for example, take part in marketing promotions or road shows. Potentially, this could force a change in a company's entire mode of operation; how it markets itself and sells its services.

Some firms do operate in sectors of the market where their analysts are known to be specialists and who help to close deals. They may have to restructure, effectively hiring separate sales staff and giving them just enough information with which to sell effectively – on the far side of a Chinese wall from the analysts. Most larger firms at least claim to have separated their businesses, but these changes have the potential to be a difficult and expensive process for mid-sized firms.

Of course, it is acceptable to produce research as part of a marketing operation. The underlying problem is how the market might perceive this research. Little value might be placed on 'research' that is not signed off by an analyst as fully credible and independent. It is improbable that anyone would actually be willing to pay for material presented simply as marketing literature or financial promotion. A worst case scenario might be that companies have to have completely separate independent research arms, with separate and different compensation arrangements. Remuneration strategies will also have to be reviewed by firms to make sure they do not give analysts the incentive of commissions or bonuses based on the amount of business brought into the firm.

No one-size-fits-all

It remains to be seen how all this plays out, but what is very clear is that there can be no one-size-fits-all solution to MiFID's conflict of interest rules. A conflict only occurs where there is a gain, or where a loss is avoided, at the expense of a client who suffers a loss when a duty was owed to that client. All companies are required to take all reasonable steps to avoid conflicts, but each firm has a different character and the conflicts each firm has to manage will be different. Some will have much more work to do than others. Each financial services group has a different make-up and the way that it has to manage its conflicts will also be different. But the conflicts do generally fall into four categories:

1. Conflicts inherent in the operation of the business, where the firm may have an interest that is distinct from the client's;
2. Conflict between a specific department and its clients;
3. Conflict between two different clients or groups of clients;
4. Conflicts between a firm's employees or other associated personnel and clients or client groups.

In short, under no circumstance should a firm gain from a conflict at a client's expense. There are basically two ways of approaching the conflicts project. One is to frame and document a policy and hope that it can create or use existing controls to fit and make it work. The other is to identify what all the conflicts are, how those conflicts are managed, identify any gaps in the policy and then write the new one, filling in the gaps. Many companies have used the first approach: they write a policy and hope that it covers their conflicts.

The second method is more comprehensive and should provide advantages in the medium term, although it requires more time and resource. Followers of the second approach examine each of their businesses in light of the four categories above; conflicts between clients and the business and conflicts between businesses within a group. They then make sure that they have in place processes and systems to manage those conflicts and finally, that their fully documented policy operates all of those processes and systems.

Conflicts of interest mapping and policy development is potentially a large exercise and some firms are struggling with it. They are still just trying to find the gaps in their current conflicts policy and still have to change systems and put monitoring in place. Depending on IT change schedules and how easy it is to find and align all the necessary resources, they could be hard pressed to effect necessary changes.

Serious risks

But there are serious risks inherent in not having a workable policy on conflicts of

interest and legal risk could be a real possibility. The regulations are due to come into force in November and they are very unlikely to be delayed. Firms that are still a long way from completing the process may well be tempted to follow the first course of action and write a policy that they have not checked will work and which they may not, in reality, be able to implement.

There are two main issues with this. The least is that the regulator will reject the policy as inadequate and allow a certain amount of time to rectify the shortcomings. This will force the firm to throw costly resources at the job just to get it done and it may well be difficult. But the bigger concern is that the firm has a conflict it has not identified and that something happens to bring this fact to light. This carries an obvious reputational risk, however the possibility of legal risk also looms large.

Workable policy

A step-by-step approach to establishing a workable policy will achieve the desired result. First:

- Review existing policies, maybe setting up a cross-business workshop;
- Identify and document where conflicts might or do arise. This should include determination of which clients are shared across groups;
- Determine what information flow and access there are that might result in conflicts paying particular attention to access and flow from one line of business to another, for example, corporate finance might affect investment management, dealing or advising on shares;
- Determine what existing controls there are in place within the organisation.

Once existing controls are assessed and conflicts identified, begin by building the governance structure, this should include determining what information is collected for management and how it is reported. This should reveal any remaining gaps in the policy and these can then be dealt with. Senior management should be closely involved in all decisions, because it must decide what constitutes 'all reasonable steps' to avoid conflict. Regulators do not expect every firm to spend fortunes on IT systems. That might be appropriate for some, but for others simple, straightforward policies will be sufficient. All firms, though, will find it worth considering:

- **A no-conflict policy.** For example, rejecting a client likely to set up conflict with an existing business or client, or with whom dealing might become too complex;
- **A general independence policy** that applies to all staff, determining what information they may have access to, when they may make deals and so on;
- **Chinese walls**, maintaining separation of information across business lines, making sure confidential information is kept confidential by giving only relevant personnel access to it;
- **More monitoring and control** depending on the company's activities, such as a dealing risk committee for particular bits of information and making sure that senior management is involved in decision making about what business the firm will take on.

Many of these controls will be in place within particular business units: the difficulty will occur in building the new group-wide approach if true operational independence cannot be created between operating units to provide sufficiently robust Chinese walls to satisfy MiFID's requirements. Eventually it all has to come together in an overall policy and overall structure.

Finally, where managers believe they do not have adequate control or mitigation of risks, they have to have a process in place for informing clients that those risks still do exist. For retail clients MiFID also requires a firm to issue a summary of its policy on how it manages risks. When those risks do affect clients, they have to be informed effectively before they deal or enter into an agreement or activity. Clients can then make a judgement about whether or not their interests will be suitably considered. MiFID is about avoiding detriment to clients.

Records will be vital

Once firms are compliant, staying compliant will be equally important and demanding. Documenting conflicts and updating records will be vital. This also represents a marked change from existing regulation. Firms need to prepare for more record keeping. They need to decide how and when they will be updating those lists of conflicts and potential conflicts and to keep them relevant. They then have to think about what presentation and documentation will be given to the group committee or oversight function and what records they are going to keep of the decisions they make.

And at the same time, they are going to have to keep control over those decisions to make sure that conflicts do not actually spread. A lot of confidentiality will go into the whole mix. Certainly, it will be vital to make sure that everybody in the firm understands what is required, particularly the ongoing management of the conflict management system.

This time last year, a common approach was: 'Well we've got a conflicts policy, what more do we need to do?' That is a far less common approach now.

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Treating Customers Fairly: prove it

The Financial Services Authority's deadline for the implementation of Treating Customers Fairly is now upon all regulated companies.

The next few months will arguably be the most important in defining the state of the industry regarding TCF implementation, and the FSA's ongoing approach to the initiative. In January of this year, the FSA described the 'implementation' stage of TCF within firms as being when the firm is:

- Developing plans and processes.
- Allocating TCF resources and responsibilities.
- Creating capability among its staff.

March and April 2007 will be crucial to both firms and the FSA regarding TCF as this implementation deadline is a key milestone in the journey towards a TCF culture being embedded across financial services. Given this fact, there is likely to be increased scrutiny over firms' approaches to TCF, and their demonstration of TCF progress. The FSA has already announced that TCF will be a Supervisory priority throughout 2007 and 2008 and it has renewed its commitment to 'principles-based' regulation. As they will no longer need to identify breaches of detailed rules, senior managers need to be able to ensure that they can demonstrate how they are treating their customers fairly, and any changes implemented, together with their rationale for any decisions made. It is vital that decision making should be transparent and auditable.

We often hear from firms that they believe TCF to be at the heart of their organisation, but cannot demonstrate it. Where TCF projects have been established, even where there is senior management buy-in and accountability for the initiative, it can still be difficult to demonstrate progress.

TCF management information is essential in order to provide a basis for conclusions within organisations regarding TCF progress. Although TCF MI is considered to be one of the areas that comes to the fore in the embedding and ongoing monitoring of TCF, it also is a guide as to the progress the firm is making 'on the road' to embedding TCF. The better MI, the more understandable the approach and progress of TCF within the firm can be. A key challenge for firms is deciding what level of MI is appropriate for the firm, as all firms are different, so too will be the level of TCF MI required. Much relevant MI will already exist within a firm, but reports may require refinement or additional analysis of Key Performance Indicators, to ensure that the relevant indicators are being captured accordingly. It is a matter of turning Management Information into meaningful information that can measure TCF outcomes. MI should include sufficient information that enables management to make informed decisions and to understand what action is being taken where issues have been identified.

Senior management must be involved in the review of MI and the decision making process for TCF embedding to be successful. There should be a clear review process in place to enable it to measure performance against outcomes. Key questions that firms should be considering at this time include:

- 'how are we as a firm progressing with the actions that were developed from our TCF gap analysis?'
- 'how is TCF incorporated into our corporate strategy and culture?'
- 'how can we demonstrate our progress to the regulator?' and
- 'has TCF filtered through into the business at all levels?'

If there are any aspects of these questions that cannot be demonstrated, the firm should consider what actions need to be taken in those areas.

For firms, knowing who their customer is and understanding what fairness means to them and the firm and having procedures in place to monitor and promote this can lead to a real competitive advantage.

TCF can provide firms with a new perspective, with a renewed focus on their customers. PricewaterhouseCoopers has seen a number of occasions where firms have looked at the TCF initiative as an opportunity to question their practices and put under scrutiny their claims that customers are treated fairly. These firms that are proactive regarding TCF will have enhanced their understanding of how they interact with their customers and as a result, often re-engage with them in a more customer-centric way. By doing this, they open the possibilities of unlocking real, long term value; it could lead to a positive impact in many areas, which could include enhanced reputation, increased customer loyalty, revenue growth and improved governance effectiveness, to name but a few.

It is well worth remembering that there is no single right answer to TCF, one size certainly does not fit all, but in the new principles-based FSA regime, differing approaches across the industry are not the problem that previously they might have been. The FSA hopes the changes will give firms greater flexibility to innovate and find competitive solutions. This allows firms to consider TCF specifically within their firm, and ensure it is implemented in a manner commensurate with their operations, to ensure a tailored fit.

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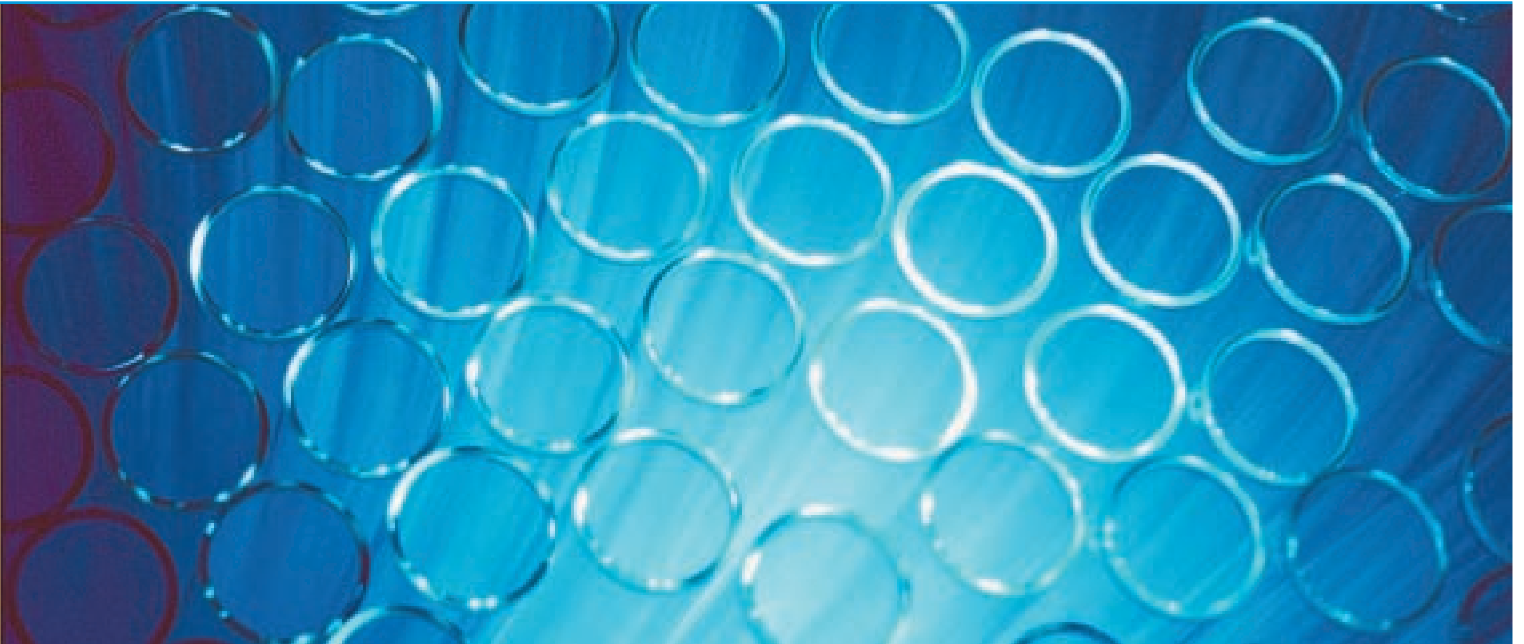
Lenders face further scrutiny: the call for fairer practices



Whilst the regulation of mortgages and general insurance has been with us for some time, the FSA is directing its searchlight on a number of specific areas with a particular emphasis on fairness.

These include affordability in the credit sales process, the application of mortgage exit administration fees and the sale of related payment protection insurance (PPI) to name a few.

This article looks at these three areas of the FSA's current agenda. In those cases where enforcement action has led to the issuance of a Final Notice, notably in the PPI arena, the FSA has been very clear as to the emphasis placed on Principles 6 and 7, often with equal weight on Principles 2 and/or 3:

- Principle 6 – '…pay due regard to interests of customers and treat them fairly'
- Principle 7 – '…information needs of clients, and communicate information…which is clear, fair and not misleading'
- Principle 2 – '…due skill, care and diligence'
- Principle 3 – '…organise and control affairs responsibly and effectively…'

Affordability – what's the issue?

The FSA's recent commentary on the results of its review of mortgage affordability processes highlighted some concerns about reliance on gross income and how this relates to the assessment of affordability. In the intermediary sector, the FSA's thematic work has also identified failings relating to affordability in the sale of, and advice on, self-certification mortgages and whether borrowers were being encouraged to take on larger mortgages than their income would justify.

Specifically, the FSA is looking for firms to (demonstrably) assess:

- Net income after tax and taking off costs such as repayment of other borrowing, maintenance and other regular outgoings.
- Whether the borrower can afford the payments over time, such as at the end of any discount period or when rates change (the potential impact of possible future increases in interest rates).
- Whether the borrower can repay the capital amount (where the loan is interest-only).

Where the mortgage goes into retirement, and the borrower's financial position changes, affordability also means taking account of a customer's likely income and expenditure in retirement.

Responsible lending

Affordability assessment approaches vary across the industry. Responsible lending decisions require checks to be made concerning income and outgoings (typically using a combination of income multiples and affordability models) when assessing ability to repay now and into the future. Also the type of lending undertaken and the type of borrower (for example, applicants with impaired or low credit ratings) may require more detailed assessments to be carried out.

Other (unregulated) lending

Mortgage lending is only part of the affordability picture. Under the auspices of Treating Customers Fairly (TCF), affordability assessments are equally relevant to other borrowing, including personal loans and credit cards, and a number of lenders are looking at how their affordability assessment processes may need to be strengthened for these types of credit.

In an effort to strengthen existing rules, new Banking Code guidance concerning assessing affordability in relation to unsecured loans (overdrafts and other borrowing) was issued by the Banking Code Standards Board in April 2006. Any assessment should now include at least two of the following:

- Income and financial commitments.
- Repayment history.
- Credit reference agency information and past repayment history.
- Credit scoring.

It is also worth noting that the Office of Fair Trading's recent guidance (the OFT Guidance)[1] reinforces the need for firms to have regard to its earlier guidance on non-status lending and confirms its intention to consider further specific guidance with regard to irresponsible lending and what this may mean in different market sectors and circumstances.

Responding to the concerns

In responding to these concerns, firms will wish to consider how the results of the FSA's findings impact each of their lending businesses, improving the basis by which affordability is determined, or evidence of affordability assessment is retained, where necessary.

Mortgage Exit Administration Fees – a fair deal?

As with certain other costs associated with post sale credit activity, such as overdraft fees and default charges, mortgage exit administration fees (MEAFs) are being challenged. Higher exit fees are receiving attention on two fronts – firstly in relation to a borrower's understanding of the quantum of such charges when the mortgage was taken out, and secondly in relation to the actual cost of administering the exit.

The key issues

The FSA is looking for firms to act fairly (charges should not be excessive, disproportionate or an unfair barrier to repaying a mortgage or switching lender) and consider:

- Variation clauses in existing contracts that allow changes which the customer has not agreed to in advance and that do not require the customer's agreement (e.g. an increase in the MEAF amount).
- Variations only where there is a 'valid reason' (e.g. increases in charges proportionate to any increase in the associated cost of the administration services which a lender provides when customers exit a mortgage).
- Transparency: mortgage contracts should be clear in explaining, in plain and intelligible language which costs will be charged, and the basis of any increases, and at what point in the life of the contract.

Setting charges – what should firms consider?

The FSA expects firms to 'consider whether their terms might be unfair and provide evidence of how decisions to increase MEAFs were taken'. The FSA's Statement of Good Practice on Mortgage Exit Administration Fees (January 2007) sets out what lenders should be doing.

Whilst the FSA has no remit to require retrospective action under the Unfair Terms in Consumer Contracts Regulations 1999 (which it is currently using when assessing the fairness of MEAFs), a number of lenders will have to refund elements of MEAFs where customers have a valid complaint.

One of the principal changes of the Consumer Credit Act (CCA) 2006, which amends the CCA 1974, is the introduction of the concept of an 'unfair relationship'.

[1] Source: Unfair relationships – Enforcement action under Part 8 of the Enterprise Act 2002 OFT guidance, December 2006

Whilst the FSA has no remit to require retrospective action under the Unfair Terms in Consumer Contracts Regulations 1999 (which it is currently using when assessing the fairness of MEAFs), a number of lenders will have to refund elements of MEAFs where customers have a valid complaint.

Under the Act, an unfair relationship may arise by virtue of the terms of the credit agreement or any related agreement (for example, altering the terms of a contract 'unilaterally' without a valid reason and to the detriment of the consumer, including price variation clauses if these are not recognised as 'core terms' under the Unfair Terms in Consumer Contracts Regulations 1999). Whilst the unfair relationship provisions do not apply to regulated mortgage contracts, the principles of fairness referred to in the OFT Guidance can be readily mapped across.

Going forward, it looks as though the focus on, and the consequential drive for comparability, of MEAFs across the industry will drive down the highest charges.

Payment Protection Insurance – the good, the bad and the ugly?

The sale of PPI has been a key area of regulatory focus by the FSA during 2005 and 2006; it will continue to attract regulatory scrutiny during 2007. The FSA has been assessing how firms sell PPI against standards set out in the ICOB rules, and in the context of Treating Customers Fairly. In reality, most of the sales process issues identified by the FSA fall under the TCF umbrella.

Regulatory scrutiny

As a result of regulatory scrutiny, distributors (and product providers e.g. restructure of cancellation refunds; improved policy documentation) have had to respond to the ongoing challenges in a number of areas:

- Reassessment of the basis adopted for selling PPI (advised and non-advised sales).
- Elimination of risks associated with selling to ineligible customers.
- Redesign of PPI suitability assessment processes.
- Redesign of core marketing and customer insurance documents.
- Focusing on what TCF means for PPI distribution.
- Design of new product propositions (alternative products, unbundling etc.).

What does all this mean for businesses?

In practice this means that today's selling practices are very different from 18 months ago, as many lenders have undertaken extensive work to improve processes. At its simplest, scrutiny by the FSA has meant the adoption of new sales processes with new technologies (for example, automated suitability assessment models). This is likely to have required the roll-out of new training, new staff remuneration arrangements, and the introduction of new controls and MI reporting models.

In addition, some distributors have decided that it is appropriate in the interests of customer care and fairness, to identify cases where today's standards suggest that customers may not have been treated fairly and make these good through compensation.

However, some distributors have had specific and extensive FSA Enforcement-driven remedial activity to handle; typically this revolves around both prospective change and retrospective action on previously sold PPI.

The FSA's scrutiny of the PPI market continues into 2007, with additional firms being identified as part of both specific enquiry and PPI mystery shopping work to be undertaken by the FSA.

Some lenders have already engaged extensively with their providers as to how PPI products are to be designed for particular target customers and what alternatives are available. For others, this dialogue is still 'early days'.

Conclusions

What does this all mean? Even for long-established product offerings, it is clear that nothing stays still. Aside from regulation by the FSA, the market still needs to respond to the challenges of Competition Commission investigation into the PPI market.

As a minimum, it means management teams (business unit leaders and compliance) need to be alert to emerging and identified areas of regulatory focus – responding proactively to issues as they arise will enable firms to stay in the game.

But is this sufficient? Maybe a better strategy for firms is to engage actively in the fairness debate, identify opportunity from it and seek to create space between them and their rivals.

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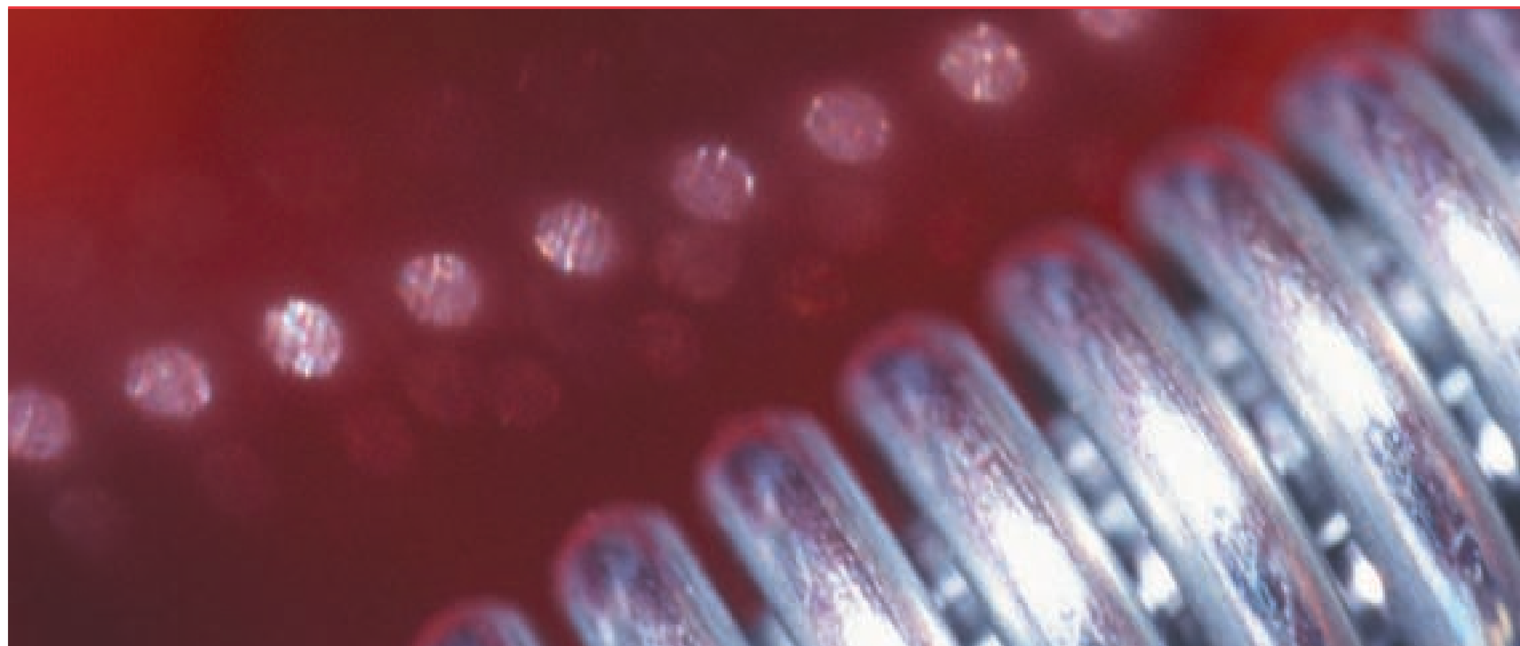
SYSC 11: new liquidity risk SYSC requirement for CRD investment firms that are not own account dealers



SYSC 11 ('Liquidity risk systems and controls') is one of the new SYSC chapters that the FSA has introduced as part of its implementation of the Capital Requirements Directive (CRD).

For CRD investment firms that are not own account dealers, e.g. asset managers, matched principal brokers, etc., SYSC 11 represents a significant extension of scope of the liquidity risk regime. The FSA perhaps did not highlight this extension of SYSC liquidity risk as clearly as some investment firms would have wished in its various consultation papers and policy statements prior to 31 December 2006. As a result, some CRD investment firms may find themselves with little time to prepare before SYSC 11 came into force.

SYSC 11 combines the new CRD text on liquidity risk systems and controls requirement and the old text from PRU 5.1 (with some amendments). SYSC 11 applies to BIPRU firms, insurers and UK branches of EEA and third country banks, and was effective from 31 December 2006. Note that PRU5.1 only applied to banks, building societies, insurers and own account dealers (i.e. investment firms that have permission to deal as principal, but excluding matched principal brokers). SYSC 11 is of course only one step towards the more sophisticated liquidity regime that the FSA has announced it will be considering over the next year or so.

So what are the requirements under SYSC 11? There are only two specific rules under SYSC 11, the rest being guidance and evidential provisions only. Those two rules are as follows:

- SYSC 11.1.11R: A BIPRU firm must have policies and processes for the measurement and management of its net funding position and requirements on an ongoing and forward looking basis. Alternative scenarios must be considered and the assumptions underpinning decisions concerning the net funding position must be reviewed regularly; and

- SYSC 11.1.12R: A BIPRU firm must have contingency plans in place to deal with liquidity crises.

The guidance and evidential provisions mainly cover the following areas:

- Management information should be adequate for liquidity risk management purposes, and be available on a timely basis.
- Management needs to decide what limits should be set in accordance with the nature, scale and complexity of the firm's activities. Such limits should be regularly reviewed and adjusted where appropriate, and any exceptions to those limits escalated to management and resolved in a timely manner.
- Documentation of the policies and procedures of liquidity risk management, stress test and scenario analysis and contingency funding plans, where relevant.

SYSC 11 does emphasise that the systems and controls for the management of liquidity risk should be appropriate and proportionate to the scale, nature and complexity of the firm's activities. Therefore it is up to senior management of the firm to assess the appropriateness of any particular item of guidance, taking into consideration also the firm's obligations as set out in Principle 3 to organise and control its affairs responsibly and effectively.

In light of the above, a CRD investment firm, if it has not already done so, will need to take immediate actions to ensure compliance with SYSC 11. These actions may include, but not be limited to, the following:

- Identify the firm's existing liquidity risk policies and procedures in place and assess whether any enhancement to those existing policies and procedures is required to comply with SYSC 11. For some smaller firms with relatively simple business, management accounts which include cash flow and regulatory capital projections may be sufficient. However, it is important that such management justification is properly documented and signed off.
- Determine the most appropriate approach of conducting stress testing and scenario analysis which should be proportionate to the firm's activities. For smaller firms, straightforward sensitivity analysis (i.e. looking at movement in one market variable) may suffice so long as the assumptions for constructing such scenarios are properly documented and justified, e.g. by historical data. Note that under Pillar 2/ICAAP, firms will need to consider stress testing and scenario analysis. Many firms are also taking advantage of the transitional rules, which means they do not need to have an ICAAP in place until end of 2007. However, SYSC 11 is not subject to those transitional provisions, consequently, the stress testing and scenario analysis on liquidity risk needs to take place soon rather than waiting until the end of the year.
- Ascertain the most appropriate contingency funding plans. The level of sophistication of such contingency funding plans will depend on a number of factors, including:
  - the scale, nature and complexity of the firm's activities;
  - how well the firm is capitalised (i.e. how much headroom is available); and
  - how susceptible the firm is to liquidity risk (in particular the impact of stressed market conditions) based on the result of the stress testing/scenario analysis mentioned above.
- In terms of the SYSC 11 guidance and evidential provisions (as discussed above), firms also need to decide whether they are appropriate and relevant to firm's activities, and if so, the most appropriate and pragmatic way of implementing those guidance and evidential provisions.

In summary, SYSC 11 is new to many CRD investment firms and is mandatory now. Firms need to have appropriate liquidity risk management systems and controls which are proportionate to the scale, nature and complexity of the firm's activities.

SYSC 11 is new to many CRD investment firms and is mandatory now. Firms need to have appropriate liquidity risk management systems and controls which are proportionate to the scale, nature and complexity of the firm's activities.

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Towards a truly single market in investment funds: their management and distribution

It has been a long time in coming, but finally it seems that there is the will to drive through substantive change in the way in which investment funds are managed and distributed throughout Europe.

The White Paper from the European Commission on 'Enhancing the Single Market Framework for Investment Funds' issued on 15 November 2006 identifies a substantial number of market failures that make the management and distribution of funds across Europe inefficient, costly and to the detriment of both investor and product manufacturer.

The paper proposes a range of measures to alleviate some of the more obvious inefficiencies, for example the current inability of a UCITS management company to operate other funds in different jurisdictions and the fact that application to competent authorities to distribute already authorised funds in the home state is time consuming, inefficient and adds no value to the end investor. Helpfully, the commission recognises that the existing regime of simplified prospectus has 'manifestly failed' in its objective, noting that it has been the 'victim of divergent implementation' and 'gold plating': the relevant Commission Recommendation has been 'honoured more in the breach than in the practice'.

The White Paper took some two years of consultation and debate to reach the point where publication was possible. The paper pulls few punches, recognising that for example, master feeder funds are an efficient and well-developed model and proposes that they be permitted for use within a UCITS fund.

Helpfully, the paper articulates why, for example achieving freedom for firms to appoint a depository in another member state is in the 'too difficult' box, but it does recommend that a branch of an authorised depository be permitted to act as a depository.

The paper also raises the prospect that the regime for passporting non-UCITS funds will be overhauled such that funds suitable for retail customers, or professional investors be allowed the freedom to market across Europe.

The above changes, and others contained within the White Paper, raise the real prospect that there will be a fundamental shift in the regulatory environment applied to funds. While the paper stops short of advocating an asset management directive, it makes clear that the interplay between the requirements of MiFID and UCITS will be closely examined to ensure that the interests of investors are served by permitting a wider range of funds and fund services to be provided cross-border.

It is fair to say, assuming that the support received for the proposals is reflected in national regulatory changes to the rules that the consequences for the fund management industry will be far reaching. The proposals would seem to assist in the rationalisation of funds, and fund managers and permit the rapid development of true cross-border fund ranges. UCITS will still remain, the 'brand' being well recognised and there is no desire to repeal or rewrite in full the directives, but there is a desire to make changes to facilitate the development of the market place.

We would advise management to work on the assumption that a fundamental shift in the market is about to be delivered opening the way for those firms with strategic foresight to design and develop new ranges of cross-border funds and, for those firms prepared to take a radical decision, to reduce substantially the number of funds available to be sold to the market place.

There is a genuine first mover advantage to be gained in this arena and, like most markets, to succeed will necessitate substantive changes to business models and an appetite to fundamentally reappraise existing strategy. The next few years are likely to prove an exciting time for the asset management industry.

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There is a genuine first mover advantage to be gained in this arena and, like most markets, to succeed will necessitate substantive changes to business models and an appetite to fundamentally reappraise existing strategy.

Managing credit risk beyond Basel implementation

The banking industry is now well into the implementation phase of Basel II and, despite the fact that there are still many problems to fix, the risk community is already looking beyond implementation to a promised hiatus of major new regulation.

The main question that they are asking for the future is how to explore ways in which the business can benefit the most from the significant, and in some cases huge, investment in Basel II systems, processes and methods. Basel has forced major developments in risk rating and pricing models, collateral management, risk monitoring and reporting, data management and capital management methods. Effective employment of these new methods has the potential to create a step change in the commercial advantage created by credit risk management.

Concurrent with Basel related improvements, another major development that has changed the world of credit risk management is the increasingly liquid nature of credit assets. The industry has seen a proliferation of options for distribution of credit assets that allow risk in the portfolio to be held more selectively, releasing capital and enhancing risk adjusted returns.

Despite the developments in credit risk management, however, there remain significant challenges in implementing these developing methods and embedding them in business decision making. One of the key challenges in many Basel framework implementations has been that often implementation has been heavily focused on regulatory compliance rather than the commercial needs of the business; to such an extent, in fact, that the regulators introduced the concept of the so called ‘use test’, to ensure that Basel credit risk frameworks would not be implemented in isolation of day-to-day risk decision making.

Increasing options for distribution of credit assets, e.g. credit derivatives, loan syndications and securitisations, allow the possibility of originating transactions without necessarily holding all of the risk in the portfolio.

The most effective way to ensure that new credit risk methodology becomes truly embedded in business decision making is to demonstrate to the business that rating systems can provide an effective decision support tool if implemented properly and that they can also allow streamlining of credit processes, e.g. through developing confidence in risk-based credit approval limits, and thereby improve responsiveness and customer service without compromising portfolio quality.

To establish an environment in which the commercial benefit of effective credit risk management is really transparent, it is necessary to develop a performance management framework that recognises the cost of holding risky assets and prices in the additional capital cost attached to those assets, i.e. adopting risk adjusted measures such as Risk Adjusted Return on Capital (RAROC). Performance metrics often place undue focus on volumes and asset growth without sufficient regard for the additional risk which a given transaction 'contributes' to the portfolio. Developing risk adjusted performance measures allows front office decisions to be linked more closely to the delivery of a pre-determined strategy and risk appetite by setting a 'target' portfolio profile and attaching a lower capital cost to transactions that, other things being equal, serve to deliver that target portfolio (and conversely, a higher charge for transactions that are not aligned or in which the portfolio is becoming over-concentrated).

Increasing options for distribution of credit assets, e.g. credit derivatives, loan syndications and securitisations, allow the possibility of originating transactions without necessarily holding all of the risk in the portfolio. Distribution of assets becomes more important under a risk-adjusted performance regime where the risk/return profile of a transaction can be improved by securing revenue fixed fee elements such as agency fees whilst distributing the assets, transferring risk and releasing capital. Distribution can also be used to reduce exposure where there is unacceptable concentration on a single name, sector or other defined asset grouping.

The increasing use of portfolio management techniques has in some cases led to the development of new organisational models built around the concept of active portfolio management. Here the origination and portfolio management functions are established as separate profit centres with originators deriving revenue from providing the 'service' of arranging transactions, and the portfolio management function deriving revenue from the ongoing management of the assets. Most organisations have not developed this more radical model, but elements of active portfolio management are becoming more commonplace as asset distribution (as opposed to 'buy and hold') becomes more prevalent.

Developing these more sophisticated approaches to credit risk management will require significant improvements to credit risk frameworks that Basel implementation work has really only started to accomplish for many organisation. These challenges include:

- Confidence in rating systems is still variable – for many banks it will require significant further investment in risk analytics to develop a suite of models that provides confidence in their effectiveness as a value-adding decision support tool.
- Data quality remains poor – consistent delivery of high quality data formats is essential to confidence in management information if it is to form the basis of commercial decision making.
- Documentation quality requires improvement – this will become increasingly important to improve liquidity of assets as the saleability of credit assets is dependent on transparent documentation.
- Practicality of capital-based management – the development of risk-based capital frameworks and risk-adjusted performance management requires a finely tuned balance between the sophistication required to be appropriately risk-sensitive and practical flexibility to be applied across sometimes diverse business activities.

In the UK, only two institutions have so far been given formal approval for their Advanced Internal Ratings Based framework and the Basel II implementation phase is likely to continue far beyond the initial adoption of Basel II. Basel II was originally described by regulators as an exercise in recognising good banking practice. The time has now come to prove that this is the case by demonstrating the commercial value delivered by effective credit risk management.

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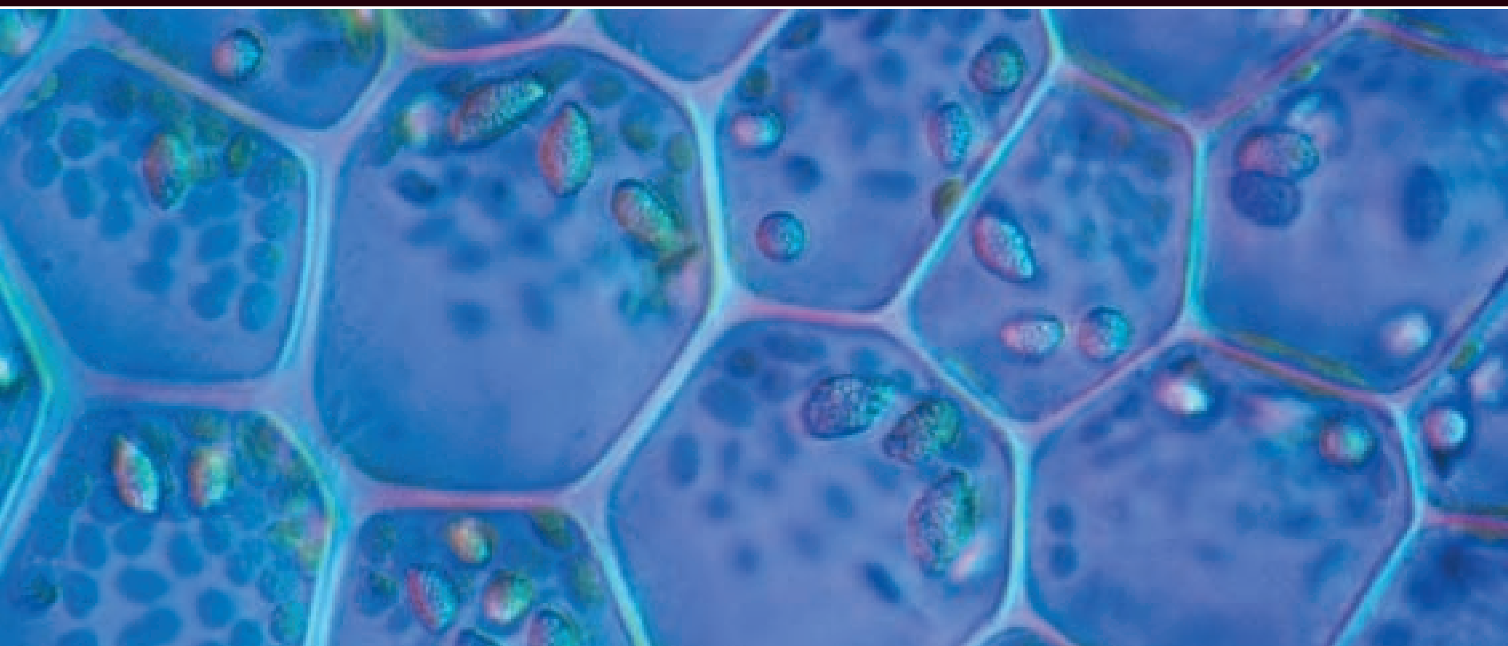
Spring 2007: technical round-up



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.

Prudential rules

Insurance

The FSA wants insurers to consider the risks outlined in its Financial Risk Outlook 2007 (FRO) and to plan accordingly. The FRO is designed to raise awareness of the priority risks. In addition the FSA is urging firms to improve their stress testing following a recent FSA review which found that, while good work was being done, some firms could be underestimating the probability of severe events. In particular, some firms appeared to be overestimating their ability to take action in an effective and timely manner.

The ABI, in partnership with ILAG, the IUA, Lloyd's and the LMA, has published 'A Guide to the Individual Capital Assessment process for Insurers'. This guide complements the updates made to the ICA regime by the FSA on 31 December 2006 with additional advice and examples of good practice aiming to help firms in preparing their ICA.

At the international level, the focus for insurers continues to be on the development of the Solvency 2 initiative. In its International Regulatory Outlook, the FSA wants firms to take away three key messages:

- Do not underestimate the continuing challenge of implementing EC measures.
- To influence policy, stakeholders need to be involved at an early stage in the development of policy thinking and to engage fully in consultations.
- As well as looking at individual measures, stakeholders need to support fully the adoption of 'better regulation' processes aimed at achieving outcome-focused solutions that are risk based and take account of market reality.

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Likewise the EC is encouraging all interested parties (policyholders, industry, consultants, rating agencies, supervisors and regulators) to be involved in the Solvency II project. In particular, they are seeking feedback through a short questionnaire on Solvency II, which can be found on the insurance section of the EU's website. This questionnaire was due to close on 23 March 2007.

Investment firms

Investment firms affected by the Capital Requirements Directive should by now have agreed their regulatory capital category with the FSA and, from 1 January 2007, be applying the new calculations, subject to any applicable transitional provisions. For years and interim periods ending in 2007, firms will need to submit additional returns under the integrated regulatory reporting rules, again subject to transitional arrangements.

Limited Liability Partnerships may need to change their capital structures again in order to comply with the rules on eligible capital that apply to CRD firms from January and others from April 2007.

The next set of changes will impact non-ISD firms that will be within the scope of MiFID and therefore potentially become subject to the CRD requirements. Firms that wish to qualify for the lighter regime as 'Exempt CAD Firms' should review their permissions.

Conduct of business rules and other issues

Insurance

On contract certainty, the FSA has accepted the insurance industry's solution but in 2007 will ask the market to focus its efforts going forward on reducing the number of contracts that do not meet the market's contract certainty standards. In those cases where it believes that firms have fallen behind the rest of the market it will consider regulatory action to address this.

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Banks

The FSA has issued a statement of good practices on mortgage exit administration fees (MEAF) in its role under the Unfair Terms in Consumer Contracts Regulations. The measures, which have been agreed with the Council of Mortgage Lenders, aim to ensure that borrowers know the size of any exit fee at the start of the loan period or that they understand how a fee may be increased in a fair manner. As from February 2007 mortgage lenders have to have decided their approach to MEAF. The FSA indicates that it is unlikely to investigate any lender which either charges no MEAF or charges the original (or a lower) MEAF. However other approaches will need to be justified. Past customers who now complain about fees they were charged on termination must be treated in the same manner as comparable current customers.

Following a UN resolution, the Bank of England has issued a notice announcing the imposition of financial sanctions on funds and economic resources of certain individuals and entities involved with proliferation sensitive nuclear activities in Iran. Banks (and other financial institutions) must freeze the assets of the named parties and report any accounts held to the Bank of England.

HM Treasury has announced the creation of a new Payments Industry Association to manage and deliver a national strategy for payments in the UK. The body will have an independent chairman and four independent directors with a 16-strong governing body. It will develop a strict set of rules covering cheque clearance times, when interest becomes payable and when monies can be withdrawn. The intention is that by November 2007 payments made by phone, internet or standing order will clear within hours rather than days. The impact of the proposed Payment Services Directive has yet to be seen, but is likely to be even more demanding for banks and others involved in payment services.

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European watch: the evolving Lamfalussy process from MiFID to Solvency II

In January 2007 the Inter-Institutional Monitoring Group (IIMG) issued its second interim report monitoring the Lamfalussy process, levelling a number of valid criticisms at the way in which the process has been operating.

The final report is due in Autumn 2007 but this interim report will continue the evolution of the process itself which will have an important impact on future and indeed current legislation under development, not least the Solvency II Directive.

The Lamfalussy approach to EU legislation was first adopted for the securities industry in 2001 following a report by a group of Wise Men chaired by Baron Alexandre Lamfalussy. The approach envisaged four Levels:

Level 1: Basic framework directive decided by way of usual EU co-decision process to set down basic principles

Level 2: Implementing measures (directives or regulations) adopted by the Commission with approval by a Level 2 committee representing national governments

Level 3: Application of the law through cooperation and convergence of national supervisors

Level 4: Enforcement of timely and correct transposition by the Commission.

In 2004, this approach was extended to cover banking and insurance legislation and will apply to all financial services directives going forward. As a result, the Inter-Institutional Monitoring Group (IIMG) was re-established in July 2005. To date, four of the Financial Services Action Plan (FSAP) directives – all focusing on the securities markets – have been introduced using this approach: the Prospectus Directive, the Market Abuse Directive, the Directive on Markets in Financial Instruments (MiFID) and the Transparency Directive. (In addition, on 17 January 2007, the European Securities Committee (Level 2 committee) voted in favour of the Commission proposal for an implementing measure on eligible assets for UCITS on the basis of the 2001 UCITS III Directive.) Of these, MiFID was by far the most complex but its complexity pales in comparison with what we expect in Solvency II.

Solvency II introduces the new solvency regime using a similar three Pillar approach to that used for the Capital Requirements Directive(s) (CRD) (which did not use the Lamfalussy approach). However, it goes beyond CRD in adopting a 'total balance sheet' approach and is more innovative, in that it does not have the benefit of an international framework for guiding the debate. In addition, like CRD, Solvency II will constitute a major legal codification process: all existing EU rules for insurers (as well as solvency rules) are to be codified in the Directive.

The IIMG January report raised some important issues about the process overall: three of which are relevant to the Solvency II debate as it currently stands.

The IIMG, firstly, called for 'regulatory self-restraint' and a 'practical, flexible distinction' between the rules adopted at Level 1 and Level 2. The IIMG also felt that it is important to ensure that the principles established at Level 1 are closely adhered to and that increments do not creep into Level 2 and Level 3 measures over time. In this area, the markets were concerned about the level of detail in MiFID Level 1, which was then further developed in Level 2. Currently, there is debate around certain 'additional' rules, such as the so-called 'proportionality' rule in terms of inducements, being adopted at Level 3. The extremely technical nature of Solvency II raises questions about the level of detail necessary to make the European Parliament comfortable with Level 1.

The IIMG sees merits in 'parallel working' in that Level 2 implementing measures could be outlined at the same time as the Level 1 framework concept is developed. Parallel working has been considered in depth in earlier reports. The IIMG set up after the adoption of Lamfalussy for the securities industry, in its second report stated 'that provisional mandates for Level 2 technical advice should be limited to subject matters already acceptable to the European Parliament, the Council and the Commission after the first Parliamentary reading. Provisional mandates should not be granted where issues remain controversial.'

Solvency II has already moved beyond this scenario. Twenty wide-ranging consultation papers have been issued by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and three quantitative impact studies will have been undertaken before the draft directive is released – and before a European Parliamentary rapporteur was appointed. These detailed consultations have targeted both Level 1 and Level 2 measures and demonstrate that with an issue as complex as this, it is necessary to delve into considerable detail before finalising the principles above them.

The IIMG also stressed realistic transposition deadlines. In their response paper, the Level 3 committees stressed that adequate time for consultation needs to be factored into the timeline. The publication of the draft Directive has been postponed once: after July gaining agreement as to what ends up in Level 1 will take some time. Finalising Level 2 also will not be quick. Although a considerable amount of consultation has already taken place, it will still be important for ongoing dialogue with stakeholders throughout the process.

This provides a few thoughts. Clearly, Lamfalussy as a process continues to evolve. Experience with MiFID can indicate possible issues for the Solvency II directive: however, the latter is likely to have a significant impact on the process.

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