

Time to prepare for finalised CRR 2 and CRD 5

HOT TOPIC

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Highlight

The EU banking reform package has been agreed and it will be published shortly in the Official Journal. The package includes CRD 5 and CRR 2 which are set to introduce strategic, operational and regulatory changes and challenges for firms.

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Summary

The revised Capital Requirements Directive and Regulation, commonly referred to as CRD 5 and CRR 2, refine and continue to implement Basel III in the EU by making important amendments in a number of areas including large exposures, leverage ratio, liquidity, market risk, counterparty credit risk, as well as reporting and disclosure requirements. They also introduce a new holding company requirement for large third-country G-SIBs. The final regime introduces changes to some of the rules proposed by the European Commission in 2016 to ease the compliance burden for smaller and less complex firms. It allows these firms to use more proportionate capital and liquidity approaches, subject to certain conditions and it asks for less frequent reporting. This Hot Topic highlights the main differences between what was proposed in 2016 and the final CRD 5 and CRR II frameworks, as well as the key areas where CRR 2 and CRD 5 deviates from the Basel framework, and explains how firms need to prepare.

CRR2 and CRD 5 proposals

As part of its banking reform package, the European Commission proposed amendments to CRR and CRD 4 in November 2016. The package was intended to finish the implementation of Basel III in the EU but some key aspects of Basel III such as changes to credit risk, market risk and CVA requirements are not covered and will probably be included in the next wave of regulation. The final version of Fundamental Review of the Trading Book (FRTB) adopted by the Basel Committee in January 2019 will also be part of the next CRR.

The final CRD2 and CRD5 framework complements and builds on the existing CRD 4 and CRR regimes with a number of important changes. In December 2016 we published separate Hot Topics on each of the key elements of the proposed CRD 5 and CRR 2 proposals. These included:

- [Revised market risk framework \(FRTB\)](#)
- [Standardised Approach for Counterparty Credit Risk \(SA-CCR\)](#)
- [Net Stable Funding Ratio \(NSFR\)](#)
- [Revised leverage ratio requirement](#)
- [Revised large exposures framework](#)
- [Revised Pillar 2 framework](#)
- [Revised regulatory reporting and Pillar 3 disclosures](#)
- [Intermediate EU parent undertaking rule](#)

While the [CRD 5 final text](#) includes amendments in areas such as the IPU rule, Pillar 2 capital requirements and remuneration, the [CRR 2 final text](#) introduces changes to a number of regimes including large exposures, liquidity and funding, regulatory reporting, FRTB and SA-CCR.

The final regime adopts a more tailored prudential regime for 'small and less complex' firms compared to the Basel regime and the current EU prudential framework.

For instance, the regime subjects those firms with assets of €5bn or less, on a consolidated basis, to less frequent reporting requirements. It also seeks to reduce the operational and implementation burden on these firms by allowing them to use simplified versions of NSFR and SA-CCR.

FRTB

Contrary to the 2016 proposal, and given the changes to the FRTB framework finalised in Basel in January 2019, the FRTB framework in CRR 2 only contains a reporting requirement.

It requires large firms to start reporting the calculation derived from the revised standardised approach within one year after the adoption of the Commission delegated act expected by 31 December 2019.

Firms which are authorised to use the revised internal model approach (IMA) of the FRTB framework will be required to report the calculation under this approach three years after its full implementation, with a delegated act again expected by 31 December 2019. Until then, firms will have to continue calculating their regulatory capital requirements for market risk using the current CRR framework.

As in the current regime, authorisation to use IMA will depend on firms' full compliance with strict qualitative and quantitative modelling requirements, including independent validation by qualified parties independent of the development process to ensure that any such models are conceptually sound and adequately capture all material risks.

While a reporting only requirement looks like a positive development for firms, it is worth noting that the implementation effort will still be substantial as firms in scope will have to adopt the new market risk framework in order to report.

Proportionate treatment of market risk exposures

Basel FRTB framework leaves it to the discretion of NCAs to allow banks with smaller or simpler trading books to use the simplified alternative to the standardised approach. Compared to the Basel framework, CRR 2 introduces more precise rules with respect to the proportionate treatment of market risk exposures.

For instance, as proposed in 2016, CRR 2 allows firms with trading book size of under €50m and less than 5% of their total assets to apply the credit risk framework for banking book positions for their trading books. Also, in line with the 2016 proposals, the final CRR 2 framework allows firms with medium-sized trading books, i.e. those with a trading book size of less than €300 m and less than 10% of their total assets, to use the simplified standardised approach as in CRD 4.

This means that the impact of FRTB on larger firms will be more significant while firms with small and medium sized trading books will be subject to a more favourable treatment.

Trading desk rules

While Basel FRTB requires a supervisory approval of the trading desk, CRR 2 only requires firms to notify their NCAs on how they comply with the requirements. CRR 2 also grants NCAs discretion to allow firms to continue using their internal models for market risks even if their trading desks no longer meet the requirements.

P&L attribution tests

In line with the Basel approach, CRR 2 requires desk level model approval, regulatory backtesting and profit and loss (P&L) attribution tests for the use of IMA. However, it does not have the Basel's "traffic-light" approach to the P&L which sets out the quantitative thresholds for the test. Instead, it mandates EBA to develop draft regulatory technical standards to set the related rules.

Also, unlike the Basel FRTB framework, the final CRR 2 framework does not include a detailed specification of the P&L attribution test such as how frequently it should be performed and the consequences for a firm's failure in the test. Again, it mandates EBA to submit draft regulatory technical standards to the Commission within nine months after the entry into force of CRR 2.

Non-modellable risk factors (NMRF)

In line with proposals, CRD 5 adopts the Basel conditions to determine the modellability of risk factors. But it does not provide details on extreme scenario of future shock applicable to non-modellable risk factors and the circumstances under which institutions may calculate a stress scenario risk measure for more than one NMRF. Instead, it mandates EBA to submit draft regulatory technical standards to the Commission by 15 months after the entry into force of CRR 2.

SA-CCR

In line with Basel framework, CRR II adopts a new SA-CCR, which is a more risk sensitive measure of counterparty risk reflecting netting, hedging and collateral benefits, as well as being better calibrated to observed volatilities. The final framework also adopts a simplified SA-CCR and retains the Original Exposure Method (OEM) for smaller firms.

Simplified SA-CCR

Although the Basel framework does not include a simplified approach to calculation of counterparty risks, CRR 2 includes one for firms that meet pre-defined eligibility criteria. This provision is in line with the Commission's initial 2016 proposal. But the conditions for the use of the simplified SA-CCR has been modified.

The use of this approach will be subject to the size of the on-and off-balance sheet derivative business being equal to or less than 10% of the institution's total assets and €300m, instead of €150m and the 10% of total assets criteria as proposed in 2016. This means that this simplified approach will now be available to firms that have a more sizeable on-and off-balance sheet derivative business than initially proposed.

OEM

As proposed in 2016, CRD 5 keeps OEM as an alternative approach for firms with very limited derivatives exposures who would find the use of the simplified SA-CCR too burdensome to implement. But the use of this approach will be subject to certain eligibility criteria with respect to contract netting agreements. It will also require prior approval of the NCAs.

NSFR

NSFR is the minimum amount of required stable funding (RSF) firms must maintain based on the liquidity, residual maturity and counterparty of the assets over one year time horizon. The ratio is calculated as available stable funding over required stable funding taking into account the accounting value of assets, liabilities, off-balance sheet items and regulatory capital. In line with the proposals, CRR 2 NSFR framework deviates from the Basel NSFR regime by introducing a number of EU-specific adjustments to make the rules more proportionate for small and non-complex firms.

Simplified NSFR

Unlike Basel rules, CRR 2 allows small and non-complex institutions to use a simplified and less granular version of the NSFR, which wasn't in the original proposal. The use of the simplified NSFR will be subject to supervisory approval by NCAs based on factors including the size of assets, trading book and derivative positions.

National Competent Authorities (NCAs) are allowed to make adjustments to those criteria. Simplified NSFR approach would provide a relief to smaller firms in terms of meeting the funding cost and compliance challenges that the new liquidity regime will bring.

Available Stable Funding (ASF) and Required Stable Funding (RSF)

While ASF under EU NSFR are generally consistent with the Basel framework and the 2016 proposals, the final framework includes changes to some of the RSF. Table in the Appendix summarises the key asset categories and associated RSF factors.

As can be seen in the table, while the 2016 proposal would introduce a 10% RSF for gross derivative liabilities, the final framework adopts a 5% RSF, which corresponds to the lowest possible RSF as per the discretion that the Basel Committee grants to NCAs.

Whilst the package is more advantageous for derivatives, firms should note that the EBA is mandated to assess if a higher RSF is needed to cover the funding risks of derivatives, and also whether the rules should distinguish between margined and unmargined derivatives contracts, by three years after the date of application of the NSFR in the EU.

A key area where NSFR regime diverges substantially from the Basel NSFR framework is the RSF for Securities Financing Transactions (SFTs), but the RSFs will be time limited for four years, after which the favourable treatment will be lifted and the corresponding RSFs will be reset at the Basel RSFs of 10% and 15%.

Similarly, for on balance sheet trade finance assets, firms should note that the 10% RSF for trade finance on-balance sheet related products with a residual maturity of less than six months will be time-limited for a duration of four years and then revert to 15% as introduced in the Basel framework.

Consistent with the Basel framework for interdependent liabilities, CRR 2 adopts 0% for promotional loans and pass-through loans, subject to prior approval of NCAs. But as a departure from the Basel rules, CRR2 provides a preferential treatment to covered bonds by treating them as interdependent liabilities subject to certain conditions.

Offsetting derivatives by High Quality Liquid Assets (HQLA)

As proposed, the final package allows all HQLA level 1 assets defined under the EU Liquidity Coverage Ratio (LCR) received as variation margin in derivatives contracts to offset derivatives assets. This excludes extremely high quality covered bonds. This is a deviation from the Basel framework which allow only cash received as the variation margin to offset the derivative assets. So this is a positive development for end-users of derivatives in the EU.

Leverage ratio

CRR 2 broadly reflects the Basel leverage ratio. It sets the Tier 1 capital-based leverage ratio requirement at 3% for all EU banks as per the EBA's recommendation. The final framework confirms that firms are allowed to use any Common Equity Tier 1 (CET1) capital that they use to meet their leverage ratio requirements to also meet their Pillar 1 and Pillar 2 capital requirements.

It also allows firms to use Additional Tier 1 capital to meet their leverage ratio. CRR 2 excludes certain EU-specific items from the exposure measure, in line with the 2016 proposals. Excluded elements include:

- exposures arising from assets that constitute claims on central governments, regional governments and local authorities where the firms is a public development credit institution
- parts of exposures arising from passing-through promotional loans to other credit institutions, where the firm is not a public development credit institution
- guaranteed parts of exposures that arise from officially supported export credits, where the guarantees are provided by export credit agencies or central governments, provided that a 0% risk weight applies to the guaranteed part of the exposure
- trade exposure of credit derivatives and SFTs, provided the institution is a member of a qualifying CCP under EMIR and meet certain conditions set out in Article 306(1) of CRR
- securitised exposures from traditional securitisations that meet the conditions for significant risk transfer. But firms are required to include any retained exposure in the exposure measure.

In the UK, the PRA already applies a more stringent regime, requiring firms with retail deposits over £50bn to have minimum leverage ratio of 3.25%, with at least 75% of the ratio to consist of CET1.

The CRR 2 leverage framework also adopts an add-on for global systemically important institutions (G-SIIs) equal to 50% of their G-SII capital buffers, which should also be met by Tier 1 capital.

For now, leverage ratio buffers will apply to G-SII only but the Commission will consider extending it to other systemically important institutions (O-SIIs) and will submit a report to the EP and the Council by 31 December 2020. In the UK, systemic banks have a leverage buffer, but it is calibrated at 35% of risk weighted buffers.

Large exposures framework

The revised Basel framework defines a large exposure as exposures to a single counterparty that are equal to or above 10% of firms' Tier 1 capital. The current and future CRR regime prohibits exposures exceeding 25% of firms' eligible capital.

The final CRR 2 large exposures framework is broadly in line with the 2016 proposals and the revised Basel framework, tightening the definition of capital used to calculate the large exposure limit by excluding Tier 2 capital.

The new framework also adopts a relatively more conservative approach than the Basel framework in terms of the approaches that firms can use and the related reporting requirements. Whilst it introduces favourable exemption options for group entities, the revised framework will overall have a material impact on some firms.

Interbank exposures for G-SIIs

The Basel framework introduces a more stringent limit of 15% of Tier 1 capital for interbank exposures between G-SIIs, instead of the current 25% limit. As proposed in 2016, the CRR 2 adopts the same approach.

Use of SA-CCR

Unlike the Basel text, CRR 2 removed the use of Internal Model Method (IMM) and imposed the use of Standardised Approach for Counterparty Credit Risk (SA-CCR) for estimating counterparty credit risk for exposures arising from over the counter (OTC) derivative transactions. This requirement applies to all firms including those which are authorised to use internal models.

Collateral

In line with the Basel framework, CRR 2 removed the ability of firms to use their own estimates of the effects of financial collateral and the optionality in risk substitution. It requires firms to use Financial Collateral Comprehensive Method regardless of the method used for calculating own funds requirements for credit risk, with the exception of those firms which use the Financial Collateral Simple Method.

Reporting of exposures

In line with the 2016 proposals and the Basel standards, the final CRR 2 rules require firms to report the 20 largest exposures. Also, as proposed in 2016, firms are required to report, on a consolidated basis, exposures of a value larger than or equal to € 300m but less than 10% of their Tier 1 capital.

In addition, as in the 2016 proposals, CRR 2 goes one step further than the Basel framework and requires firms to report their top ten exposures to "shadow banks" which will be defined by a subsequent RTS to be published by the EBA. This requirement will replace the current requirement for firms to report on exposures to 'unregulated financial sector entities'. So firms should note that the counterparties captured by the reporting requirement may change.

Pillar 2 framework

In line with the initial proposals, CRD 5 revises the Pillar 2 capital regime in the EU legislation. The final framework clarifies the rules around the Supervisory Review and Evaluation Process (SREP) and introduces some limitations on the NCAs' discretion when imposing additional reporting and disclosure obligations under Pillar 2.

Capital composition

As initially proposed, firms are required to meet their Pillar 2 capital requirements with at least 75% Tier 1 capital, of which 75% of that must be CET1. But CRR 2 allows NCAs to require firms to meet their Pillar 2 requirements with a higher portion of Tier 1 capital or CET 1 capital, where appropriate. Firms should note that in the UK, the PRA currently requires firms to meet their Pillar 2A requirement with at least 56% CET1 and no more than 25% Tier 2 capital.

Also, in line with 2016 proposals, CRD 5 does not allow firms to use the same capital that they use to meet their Pillar 2 requirement to meet their Pillar 1 requirements or the leverage ratio buffer requirement. This is in line with the current UK capital regime where firms are not allowed to double count their capital resources.

Supervisory Review and Evaluation Process (SREP)

CRD 5 requires competent authorities to provide full explanation for each of the Pillar 2 capital add-ons in writing to firms. This means that the SREP will be more transparent requiring supervisors to provide a clear account and justification of the Pillar 2 capital charges. It also requires firms to publicly disclose the amount and composition of their Pillar 2 capital requirements. But firms should note that in the UK, the PRA's Pillar 2A disclosure policy currently does not allow the disclosure of the component parts of Pillar 2A capital charges or the PRA Buffer.

Firm-specific countercyclical capital buffer

As proposed in 2016, CRD 5 requires firms to maintain a firm-specific countercyclical capital buffer but Member States will be able to exempt small and medium-sized investment firms from this requirement if this would not threaten financial stability. But it requires this decision to include an explanation as to why the exemption does not threaten financial stability and to clearly define small and medium-sized investment firms which are exempt.

Regulatory reporting and Pillar 3 disclosures

Unlike the Basel framework but in line with the 2016 CRR 2 proposals, the final regime introduces less onerous reporting requirements for small and less complex firms to reduce their compliance burden.

The final regulatory reporting rules require large and listed firms to provide disclosures on a semi-annual and quarterly basis while requiring smaller non-listed institutions to make disclosures on an annual basis. In line with the proposal, CRD 2 allows NCAs to impose additional or more frequent reporting requirements as long as that the relevant requirement is proportionate and not duplicative.

Standardised disclosure templates

In line with the 2016 proposal, CRR 2 requires disclosure of key prudential metrics in a tabular format. These metrics include own funds and own fund requirements, total risk exposure amount, the amount and composition of additional own fund requirements and combined buffer requirement, among others.

The final framework mandates the EBA to develop draft implementing technical standards specifying uniform disclosure formats, and associated instructions and submit them to the European Commission by 31 December 2019.

It also mandates EBA to assess the costs and benefits of the reporting requirements and provide its findings to the Commission within 12 months after entry into force of CRR 2. Firms should note that the final framework also mandates the Commission to identify any additional systematic reporting requirements and remain vigilant for any further regulatory reporting requirements.

Operational risk management

In line with the proposals, CRR 2 requires firms to disclose information about their operational risk management processes including the approach that they use for the assessment of own funds requirements for operational risk as well as the scope and coverage of any different methodologies firms use.

However, in line with the Basel IV framework, CRR 2 does not include disclosure requirements for historical loss data and business indicators. This represents a deviation from the 2016 CRR 2 proposals which would have required firms to disclose total operational risk losses over the last ten years, including a breakdown of historical losses by year, among other requirements.

Intermediate EU parent undertaking (IPU) rule

CRD5 requires large non-EU banking groups with over €40bn assets (including third country branch assets) which have with two or more subsidiaries in the EU to restructure their EU entities under an intermediate EU parent undertaking (IPU). The EC's original IPU proposal would have applied to all third country G-SIBs with two or more subsidiaries in the EU regardless of their size, but the final rules remove this requirement, meaning those G-SIBs with a relatively limited presence in the EU will no longer be in scope. Despite third country branch assets contributing to the threshold, these branches will not sit under the IPU. The EBA will however submit a report two years after CRD 5 enters into force on whether third country branches should be supervised more closely to avoid regulatory arbitrage.

Under the requirement the IPU can either be an authorised financial holding company or subsidiary. In contrast to the EC's original proposal, the final package allows a dual-IPU structure if the establishment of a single IPU would be incompatible with home country regulations on structural separation or if the firm's EU resolution authority agrees having one IPU would render resolvability less efficient than under a dual structure. This will provide a relief to groups where home country regulations require deposit taking and investment banking to be separated. Firms will have to comply with the requirement from three years after the Directive comes into force, which means it is likely to apply from early 2024.

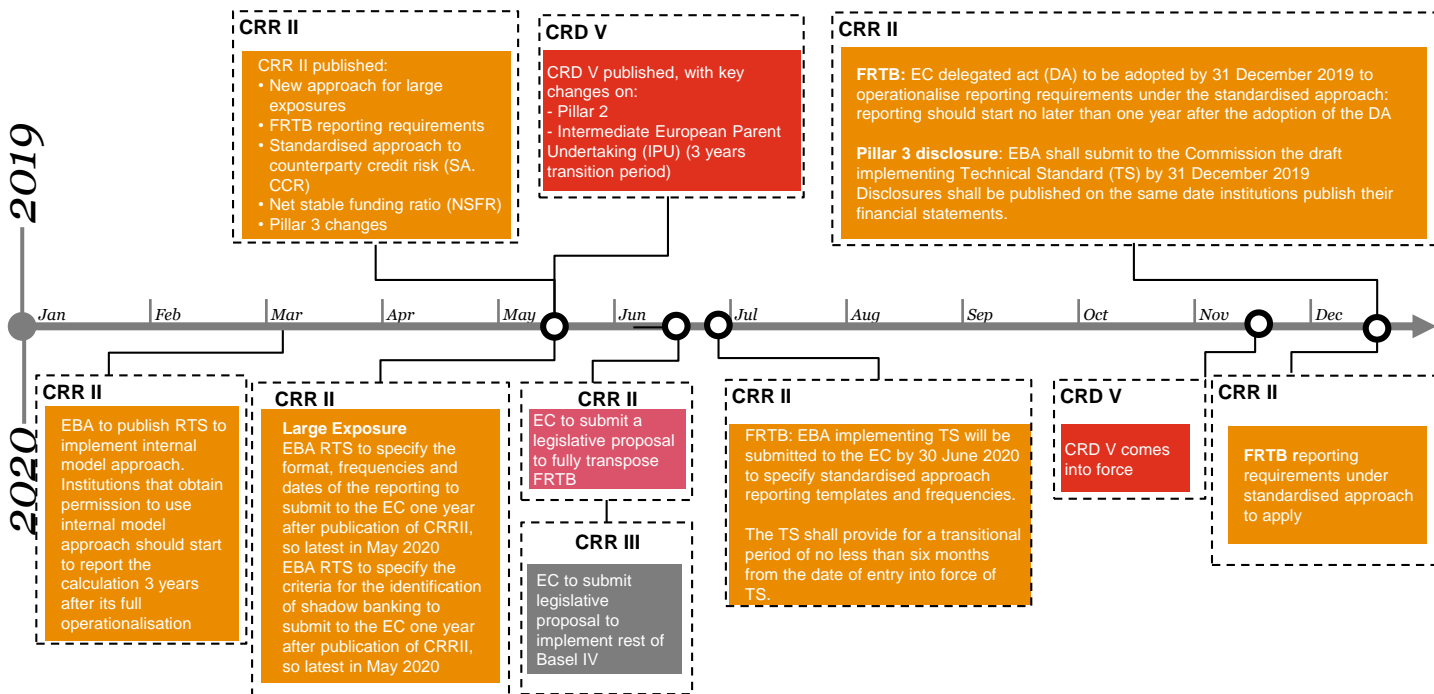
Next steps

While the final text of the package is expected to be published in the EU's Official Journal in May or early June 2019, the transposition period will span 18 months for CRD and two years for CRR. See next page for a more detailed implementation timeline. So CRD 5 and CRR 2 are expected to be implemented by December 2020 and May 2021, respectively. This means firms should start ramping up their implementation programmes.

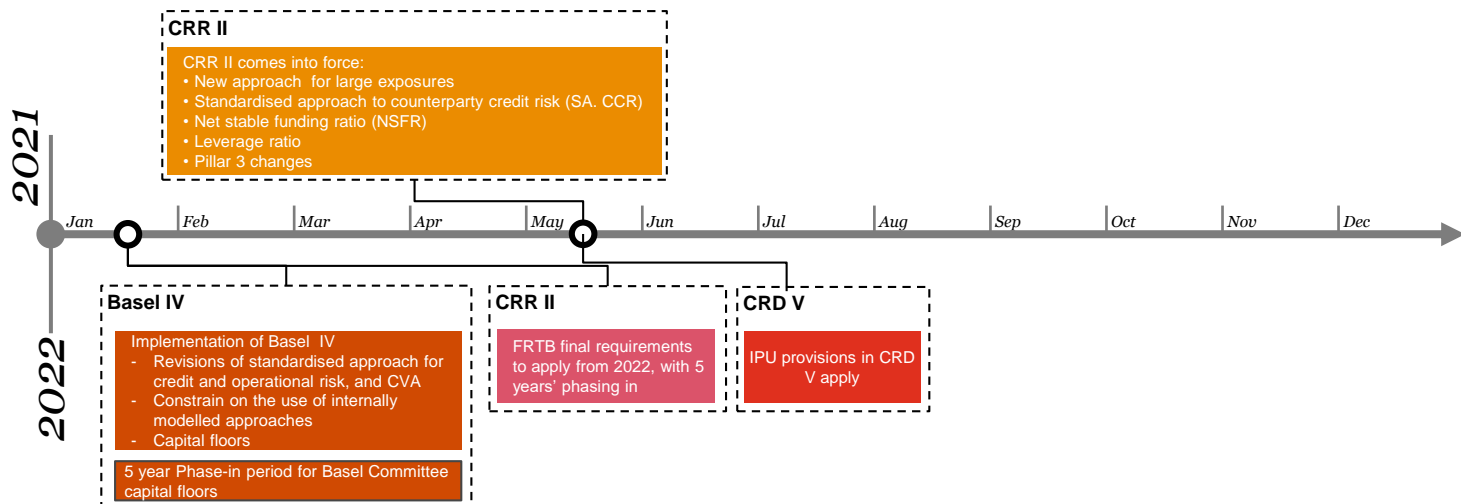
The CRD 5 and CRR 2 package includes a number of other standards that may have implications for firms' internal processes, ranging from remuneration standards to environmental, social and governance criteria. Compliance with these will result in additional strategic and operational challenges for firms.

Also, given the framework does not include certain Basel IV rules which were agreed on in December 2017, firms should remain vigilant for further rules and make sure their implementation programmes can accommodate the future changes in credit, operational and market risk which will come via CRR 3.

Implementation Timeline – 2019/2020



Implementation Timeline – 2021/2022



What does this mean for firms?

While the regime introduces less stringent SA-CCR and NSFR approaches for smaller firms and more proportional reporting requirements which should reduce the operational cost of the framework for smaller banks, the overall impact of CRR 2 and CRD 5 on firms will be significant. Rules under the new framework will take effect following an implementation period but firms would be well advised to start preparing now for substantial strategic, operational, legal and changes.

- While the FRTB is taking effect as a reporting requirement only, firms should have their market risk infrastructure for the new SA ready and prepare their IMA model approvals in line with the implementation timeframe set under CRR 2. In particular they should start improving their infrastructure to handle greater data processing volumes and computational requirements. The reporting ask is a significant one and it remains to be seen how the supervisors will process the reports and whether they will be used to monitor a 'quasi requirement'.
- Smaller firms should determine whether they would qualify to use the simplified SA-CCR, simplified NSFR or OEM.
- NSFR's impact will be higher for wholesale funded banks and banks with sizeable SFTs and derivatives' portfolios. Firms will have to ensure their funds transfer pricing process captures all the funding and liquidity costs associated with the regulatory requirements. They should also note that preferential RSFs for SFTs and certain trade finance on-balance sheet related products will reset after four years (unless this is changed as a permanent rule by the EU) in order to avoid any cliff effects in their NSFR calculations.
- International groups should note the differences between the CRR 2 leverage ratio and the leverage ratio framework used in the UK both in terms of the quality and quantity of capital required.
- Large exposure rules will require some firms to reconsider their lending businesses and the introduction of new reporting requirements will increase the data ask.
- The IPU rule will affect legal entity structures of international banking groups, requiring them to apply for authorisation. In particular, groups that will need to set up separate IPUs for the deposit taking and investment banking parts of their business should start planning early. This will be especially relevant for UK G-SIBs post Brexit.

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Appendix: Summary of the EU-specific adjustments to RSFs

| | Basel framework | 2016 CRR 2 proposal | Final CRR 2 |
|---|--|---|---|
| Level 1 HQLA as defined under EU LCR rules, with the exception of extremely high quality covered bonds | 0% for coins, banknotes and central bank reserves 5% for other level 1 assets (other than coins, banknotes and central bank reserves) | 0% | 0% |
| Covered bonds | 15% for covered bonds with ECAI step 1 (level 2A asset) No covered bonds in level 2B assets under Basel LCR rules | 7% for covered bonds with External Credit Assessment Institutions (ECAI) step 1 (level 1 asset) 30% RSF for covered bonds in level 2B assets | 5% and 30% depending on their types. |
| Unencumbered shares or units in collective investment undertaking (CIU) | 85% | 0% to 55% depending upon the underlying securities | 0% to 55% depending upon the underlying securities |
| Gold and other physically traded commodities, excluding commodity derivatives | 85% | 85% | 85% |
| Level 2B securitised assets | 50% | 25% or 35% depending upon the haircut under the EU LCR rules 50% for other level 2B assets | 25% or 35% depending upon the haircut under the EU LCR rules 50% for other level 2B assets |
| Trade finance products (off-balance sheet) | grants discretion to NCAs | 5% (less than 6 months) 10% (up to 1 year) 15% (above 1 year) | 5% (less than 6 months) 7.5% (up to 1 year) 10% (above 1 year) |
| Trade finance products (on-balance sheet) | grants discretion to NCAs | 10% (less than 6 months) 50% (up to 1 year) 85% (above 1 year) | 10% (less than 6 months) 50% (up to 1 year) 85% (above 1 year) |
| Derivatives with residual maturity < than 6 months entered into with central banks for monetary policy purposes | 0% | 0% | 0% |
| Gross unmarginated derivative liabilities | 5% to 20 % | 10% | 5% |
| Loans to financial institutions with maturity < 6 months and secured by level 1 HQLA | 10% | 5% (except for those secured by extremely high quality covered bonds) | 0% |
| Loans to financial institutions with maturity < 6 months and secured by other assets or unsecured | 15% | 10% | 5% |
| Residential loans with maturity > 1 year and risk weight <= 35% (excluding loans to financial institutions) | 65% | 65% | 65% |
| Residential loans with maturity > 1 year and risk weight > 35% (excluding loans to financial institutions) | 85% | 85% | 85% |
| Interdependent liabilities | grants discretion to NCAs | 0% | 0% |

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