

Being better informed

FS regulatory, accounting and audit bulletin

*PwC FS Regulatory
Centre of Excellence*

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Executive summary

Welcome to this edition of “Being better informed”, our monthly FS regulatory, accounting and audit bulletin, which aims to keep you up to speed with significant developments and their implications across all the financial services sectors.



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We continue to see the convergence of a number of regulatory issues and themes this year. In May the G20 and national authorities progressed regulatory initiatives designed to address the risks posed by the increasing interconnectedness of global markets. Regulatory convergence is some way behind the convergence of the securities markets, which in full scope happened about a decade ago – a disconnect that contributed to the financial crisis.

The regulators’ preferred tools (thus far) for managing the risks of intrinsically linked markets are capital requirements, recovery and resolution plans (RRPs) and more extensive and intrusive securities market regulation. But these initiatives can’t really be viewed in isolation anymore. Our reporting each month shows that any material change to one has significant implications for the others.

In May the Basel Committee published its long awaited *Fundamental review of the trading book*, a review that will not only inform international capital requirements but will inevitably reshape banks’ approaches to participation in global securities markets. Trading firms must accommodate both the evolving CRD capital treatment and the new capital and collateral requirements under the G20 OTC derivative trading reforms. We expect the release of the EU’s EMIR consultations, containing a first look at the critical RTS details required to implement EMIR, in June.

Other reforms which impact capital are RRP and the new crisis management powers (particularly those relating to bail-ins). We saw advances in RRP in May with the FSA publication of its *Feedback statement on recovery and resolution plans (FS12/1)*. This sets out core rules and informing the industry of its progress on this initiative, as many

UK institutions plan to have their RRP in place by end of June.

The EBA published a *discussion paper* on information required in the EU recovery plan templates, foreshadowing the EC’s publication of its draft directive on recovery and resolution on 6 June. Banks will be scouring the new EU proposals to see how they compare with the FSA’s current initiatives, to anticipate more changes in this area.

Structural reform proposals to the banking industry remained in the spotlight in May and firms are watching for requirements to separately capitalise retail business. The EU’s High-Level Expert Group published its consultation *Reforming the structure of the EU banking sector*. The group’s mandate is to survey international structural reforms and then recommend whether structural limitations or reforms are advisable for EU banking institutions.

In June we'll also be absorbing the UK Government's white paper on Banking Reform, issued on 14 June, and comparing these to the US measures under the Volcker Rule.

The convergence, or overlap, of so many regulatory initiatives means that firms must carefully consider and coordinate their implementation planning and work streams.

Finally, reform of the UK financial services regulatory regime progressed last month, albeit slower than expected. After much urging, the BoE commissioned three *studies into lessons learned following the crisis* and the TSC published *terms of reference for its enquiry into potential BoE macroprudential tools*. Adding another round of considered scrutiny should be beneficial, but it does suggest that legislators may struggle to finalise the Financial Services Bill prior to the summer recess. At a more practical level, the FSA and BoE have published a *joint note* giving guidance as to which firms will be within the PRA's remit next year.

We hope that the updates in Being Better Informed will help you stay current with the latest in regulatory developments – there's plenty more to come over the summer.



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Gearing up for CASS Resolution packs

Firms are now beginning to prepare in earnest for the introduction of the FSA's client assets resolution pack (CASS RP). From 1 October 2012, investment firms that hold client money and assets (CMA) arising from investment business will be required to prepare a CASS RP.

The CASS RP will contain vital information and records to enable liquidators or a resolution authority to return CMA to clients more quickly if a firm fails. Preparing a CASS RP poses significant challenges around collecting data, meeting record keeping and document retrieval requirements and establishing appropriate processes and procedures for reporting on and maintaining the CASS RP. Firms need to begin their preparations now to meet the 1 October 2012 deadline.

What's behind the regulatory scrutiny on client money and assets

Since the financial crisis and the Madoff scandal, the international

regulatory agenda has focused much more heavily on client protection, including protection of CMA. Although the G20 and EU legislators are promoting measures to protect CMA, the UK developments relating to CMA are more advanced and detailed than proposals from other countries and are likely to continue to influence the ongoing debate about appropriate regulation of CMA, both in the EU and further afield.

The failure Lehman Brothers' brought to light significant inadequacies in the UK firm's handling of CMA, including its record-keeping and procedures. Last year HMT introduced a new Special Administration Regime (SAR) applicable to all firms holding CMA. The SAR requires liquidators to return CMA to clients "as soon as is reasonably possible" under insolvency legislation.

Three firms have already been placed into the SAR since its inception in October 2011, the largest being MF

Global. The FSA believes that CASS RPs will facilitate the speedy return of CMA to clients, consistent with the aim of the SAR.

Which firms are affected by these proposals?

All regulated firms (including non-EEA branches) that are subject to CASS rules in relation to their investment business will be required to prepare and maintain a CASS RP. A separate CASS RP is required for each legal entity which holds CMA in a group – the rules do not provide for a group company pack.

Firms with permission to hold client assets but which do not hold client money or assets will be excluded from the CASS RP requirement. Also, the CASS RP requirements do not apply to insurance intermediaries holding client money.

What's in the CASS RP?

Firms will have to collect a wide range of new information for their CASS RPs, including:

- a master document – with details on how to locate and retrieve certain key documents included in the pack
- a list of key employees – those critical or important to the performance of CASS operational functions
- a list of service providers that the firm uses to meet any of its CASS responsibilities – including any relevant legal agreements
- a document identifying the institutions where the firm has placed CMA or that handle CMA as the firm's agent – including account details
- a document showing significant relationships with other entities – including each member of the firm's group and any third parties

involved in operational functions related to compliance with CASS 6 or CASS 7

- copies of legal agreements with third parties that hold CMA for the firm – including any trust acknowledgement letters
- a copy of the firm's CASS manual – documenting its procedures for the management, recording and transfer of CMA.

Firms are already required to maintain some of these records under existing FSA rules in CASS and COBS, including:

- client money held for each client including internal reconciliations
- retail and professional client agreements
- reconciliations with external records
- the method the firm uses for internal reconciliation of client money balances
- the appropriateness of its selection of a third party with which the firm deposits CMA

- safe custody assets held for each client including internal reconciliations
- the use of safe custody assets
- MiFID client categorisation for each client for whom the firm holds CMA.

As part of preparing their CASS RP, firms should take the opportunity to check that their existing records meet FSA's requirements, to ensure the integrity of the information included in their pack.

Recording and retrieval requirements

Firms are permitted to hold CASS RP documents electronically but must have the organisational arrangements in place to enable retrieval of all required documents within 48 hours, but certain documents and records will have to be immediately available.

The 48 hour retrieval period is likely to prove challenging – it is based on hours rather than business days, so weekends count as well. Ensuring appropriate retrieval times becomes more complicated where firms have third party outsourcing or group

arrangements in place, and may require re-negotiation of some contracts.

Going forward, the firm will have to ensure that the CASS RP remains up to date. If any of the information in the pack changes or the firm identifies inaccuracies in the information, it will have only 5 business days when information changes or if it finds information that need to be corrected.

Collecting the data

One of the biggest challenges firms face in preparing for CASS RPs is data collection. Firms will need to consider whether their existing IT systems can accurately deliver the information required. As part of the CASS RP preparation, firms should check that the data they are producing is complete and accurate, and that the reports can be retrieved within the timeframe required.

This will include:

- identification of the source system(s) for each report
- identification of the system used to generate the report (if applicable)

- reconciliation of report against source system(s)
- assessment of the technology controls over report generation & storage.

To support an orderly resolution, firms will most likely require data beyond the reports detailed above. This additional data may include:

- supporting records for failed/disputed transactions
- records of transactions cleared but pending settlement
- pending asset loans & returns
- pending repo transactions.

As part of the data gathering for the CASS RP, the source systems for additional data and the retrieval mechanisms to meet the 48 hour requirement will also have to be identified and documented.

Governance and reporting

Most firms will have experienced the FSA's increasing focus on governance over the past few years, and the CASS RP requirements reflect the FSA's ongoing emphasis on accountability of senior personnel. Both the CF10a and the Board have an important role to play on CASS RPs. The CF10a or other employee with responsibility for CASS operational oversight will be required to report to the firm's governing body in respect of its CASS RP on at least an annual basis. In addition, firms must notify the FSA if they have not complied with the CASS RP requirements.

Although the FSA originally proposed that firms be required to report annually to the FSA on CASS RP compliance, this requirement is not included in the final rules. However, we anticipate that the FSA will ask firms to produce their CASS RP for review as part of supervisory visits, along with the related governance and compliance measures that the firm has implemented. We may also see the FSA carry out thematic work on CASS RPs, once the requirements have been implemented.

What should firms be doing now?

Putting together a CASS RP will be a time consuming process given the complexities inherent in most firms' CASS arrangements. Moreover, each legal entity within a group that holds CMA will have to prepare its own CASS RP, presenting a further challenge for large groups. Further complexities may arise from the requirement to quickly update the CASS RP when circumstances change.

To comply with the new requirements by 1 October 2012, firms should be establishing a working group with personnel from CASS oversight, legal, compliance, IT and operations to plan for these changes, given the cross-operational nature of the tasks involved now.

Other CASS initiatives on the horizon

Although the FSA and firms are currently focused mainly on CASS RPs, we expect to see a lot more activity on other areas of CASS in the coming months. The FSA is currently undertaking a wider review of its CASS rules, and is expected to consult with industry on a number of changes to the CASS regime this summer. The consultation is likely to cover clarifications on CMAR, changes to the mandate rules and changes to CASS 5.

The autumn may bring a further consultation on areas such as how CASS interacts with the European Market Infrastructure Regulation (EMIR). We also expect FSA to undertake a wider review of CASS in 2013.

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Regulation

Capital and liquidity

Basel Committee commences trading book review

The Basel Committee published a consultation on *Fundamental review of the trading book* on 3 May 2012. The review seeks to address shortcomings in the overall design of trading book regimes as well as weaknesses in risk measurement protocols under both internal model and standardised approaches. Whilst Basel 2.5 introduced changes in areas which the Basel Committee identified as especially weak, stakeholders recognised then that the revisions did not fully deal with the lessons of the financial crisis. Comments received on this consultation will inform the development of more detailed proposals in the Basel 3 framework and are likely to lead to higher capital requirements.

Key elements of the proposals include:

- Setting clear boundaries between the trading book and the banking book, to reduce the scope and

incentives for regulatory arbitrage, either through a 'trading evidence' based boundary and a 'valuation' based boundary.

- Moving from a value-at-risk measure to an 'expected shortfall' measure for capital requirements, to better captures 'tail risk' (i.e. losses arising beyond a certain probability threshold).
- Calibrating both the revised standardised and internal models-based approaches to a period of significant financial stress - consistent with the stressed value-at-risk approach adopted in Basel 2.5.
- Comprehensively incorporating the risk of market illiquidity into both approaches, another proposal following Basel 2.5.
- Introducing measures to reduce model risk in the internal models-based approach, including a more granular process for approving models and restricting the capital requirement reduction for diversification and hedging.

- Revising the standardised approach to be more risk-sensitive, more closely calibrated and more closely related to the internal model approach, together with measures to allow the standardised approach to act as a credible fallback to internal models.

Interest rate risk in the banking book and the interaction of market risk and counterparty risk changes in Basel 3 are outside the scope of these proposals. The consultation closes on **7 September 2012**.

EU publishes ECOFIN CRD IV text

The ECOFIN reached an agreement on CRD IV on 15 May 2012. The rules include more and better capital and liquidity for EU banks, and impose additional requirements to ensure financial stability and good corporate governance. CRD IV will tighten requirements for the Member States to apply sanctions on non-complying institutions.

Michel Barnier, EU Commissioner for Internal Market and Services, made a statement welcoming the ECOFIN agreed text.

Barnier stated that that weak bank capitalisation, poor liquidity rules and uncoordinated supervision of banks contributed to the financial crisis. He noted that the main objectives of CRD IV are:

- strengthen the resilience of the banking sector in the EU
- ensure banks continue to finance economic activity and growth.

Barnier said that further improvements to CRD IV are still possible. However, he stressed the importance of finding a global agreement to meet the EU's Basel III commitments on time.

The Council has now begun its triologue negotiations with the EP to reach final agreement on the text.

EBA issues stressed VAR and ICR guidelines

The EBA published two sets of CRD III related guidelines on 16 May 2012: *Stressed Value-At-Risk (Stressed VAR) and Incremental Default and Migration Risk (ICR)* modelling approaches. These guidelines address perceived weaknesses in the regulatory capital framework and the risk management of financial institutions

using the Internal Model Approach (IMA).

The main provisions of the Stressed VaR guidelines relate to:

- *Identification, Validation & Review.* This addresses the scope of judgement involved in ensuring the stress period meets the requirements of a competent authority's supervision.
- *The Stressed VaR methodology.* Firms must recognise changes within their VaR methodology that need to feed into the model used to calculate stressed VaR charge, and where incompatible, take steps to show that their effects are limited.
- *The Use Test.* Firms should use the output of the stressed VaR test to supplement both risk analysis and management information. In circumstances where the model reveals vulnerability, firms should take prompt action.

The main provisions of the IRC guidelines relate to:

- *Scope.* This outlines the criteria for positions that fall within the scope of the IRC.
- *Individual Modelling.* This section clarifies the sources of individual parameters and ratings within the IRC, and the relevant documentation to substantiate.
- *Interdependence.* This discusses the interdependence between default and migration events, elaborating on the use of transitions matrices and providing guidance on the use of liquidity horizons and rebalancing of positions.
- *P&L Valuation.* This demonstrates how ratings changes can affect the market price, and the follow through computation of P&L.
- *Liquidity Horizon.* This section outlines how to define the liquidity horizon, with key factors that can affect the relevance and the process involved in monitoring the effectiveness.
- *General Matters.* This includes the requirements for validation of IRC models, use testing and the overall

documentation required to reach minimum standards.

National authorities are required to respond by **16 July 2012** on whether or not they intend to comply with the regulations, after which period they are expected to implement the provisions within a period of six months. Going forward, the EBA expects national authorities to carry out effective monitoring to ensure institutions are complying.

EBA publishes responses to CRD IV Pillar 3 questionnaire

The EBA published the *responses to the questionnaire* on 8 May 2012 which set out its views on users/investors needs for CRD IV Pillar 3 disclosures. The improved Pillar 3 disclosure requirements will allow market participants to better assess CRD regulated firms.

The published responses included submissions from Deutsche Bank, Moody's Investors Services (Moody's), and Standard & Poor's (S & P's). Deutsche Bank noted Pillar 3 disclosures are generally helpful to assess the risk profile of firms, but noted that it is important to strike the

right balance between the volume and usefulness of information required.

Moody's welcomed the focus on increased frequency, detail and consistency of publicly available information. They also noted inconsistencies and varying quality of firms' disclosures, and suggested creating a prescribed template which would standardise disclosure and introduce a free text section explaining material risks.

S & P's view was that Pillar 3 reports have improved their assessment of banks' risk profiles but called for:

- more consistency (standardised, transparent and comparable disclosures)
- reconciliation with accounting information
- publication of the Pillar 3 disclosures more frequently than once a year and more promptly.

The EBA expects that its analysis of the responses and any meetings with interested parties will be completed in 2012.

AFME proposes changes on CRD IV countercyclical capital buffer

AFME released a *briefing note* on the Basel Committee's proposed changes to the operation of the countercyclical capital buffer (buffer) under CRD IV on 4 May 2012. The buffer is a tool that would force banks to increase capital when excess credit builds up in the market.

The AFME calls for ESRB to take a stronger role in implementing and monitoring the use of buffers, to bring more certainty to buffer rules and increase transparency of banks' buffer levels.

This proposal to strengthen the ESRB includes:

- requiring the ESRB to give guidance on setting countercyclical buffer rates to Member States' authorities
- defining the ESRB as the unique authority for the publication and disclosure of all the countercyclical buffer rates applicable within the EU
- putting the ESRB in charge of defining the applicable

countercyclical buffer rate for third countries

- incorporating third party announcements into ESRB publication mechanism
- removing national regulators' discretion.

AFME has also proposed changes designed to increase certainty around how countercyclical buffer rates are set. This proposal includes:

- requesting the EBA and the ESRB to articulate how they intend to deal with "gold-plating" activities undertaken by Member States, or alternatively removing national regulators' discretion
- putting in place a maximum 'cap' on the level of quarterly and annual increases in the buffer
- aligning CRD IV with the 2.5% ceiling for international reciprocity set by Basel III for all countries and all institutions.

AFME also suggested allowing more flexibility to the way the buffer is set, and stressed the importance of coordination between ESRB and EBA

to ensure effective cooperation among regulators.

BBA considers interaction of bank and insurance prudential regulation

The BBA published a paper on the *Interaction of bank and insurer prudential regulations* on 17 May 2012. The prudential regulations for banks, CRD IV (and the underlying Basel III framework), and for insurers, Solvency II, have been developed in parallel. The BBA argues that greater consideration should be given to the interrelation between the activities of the banking and insurance sectors, to avoid adverse and unintended consequences of regulatory reform.

The paper argues that Solvency II rules are likely to result in insurers holding less long term assets in favour of holding shorter term assets and high quality debt. This in turn will result in banks issuing less unsecured debt and will increase their asset encumbrance.

Similar disincentives arise in relation to capital issuance. In aggregate, the paper argues that these impacts are likely to reduce the ability of insurers to play their traditional role as providers

of long dated financing, both unsecured debt and capital to banks.

The paper also noted other potential areas of concern: a fall in demand for securitisation assets, the application of Solvency II type capital requirements to defined benefits schemes and irregularity and volatility in sovereign debt markets.

The BBA warns that if CRD IV and Solvency II are implemented in isolation, significant asymmetries and inconsistencies may disturb the vital, and often complementary, roles that banks and insurers play in the wider economy.

Consumer Protection

Consumer Panel discusses growing retail advice gap

The Consumer Panel published a *Position Paper on Advice on 22 May 2012*. This paper discusses the growing gap in the provision of affordable advice for UK consumers. The Consumer Panel believes that although people need advice, particularly at critical stages in their lives such as when doing retirement planning, cost-effective advice is becoming

increasingly difficult to find. It believes that this situation may be exacerbated by RDR.

The Consumer Panel set out its views on advisory models, urging the industry to develop more reliable products that 'do what they say on the tin'.

Adam Phillips, Consumer Panel Chair commented: 'While we are fully supportive of the RDR in eliminating bias and raising professional standards in the industry it may not solve the ever widening advice gap and we want the industry to look more innovatively at developing appropriate solutions'.

However, the Panel noted providers cannot innovate in isolation - the industry's highly regulated nature means that it must collaborate with regulators in developing low cost advisory models.

FSA reviews sale of interest rate swaps

The TSC published on 23 May 2012 correspondence between Andrew Tyrie, TSC Chairman, and representatives from the FSA and the FOS concerning the sale of interest rate swaps to small and medium sized companies.

Following Tyrie's suggestion in March of this year, the FSA confirmed that it is now undertaking a review of the types of such products that were sold and the way they were sold.

The FSA has made information request from the largest providers of these products and will assess if mis-sales were a widespread issue and any action it should take. The FSA will publish its findings when the work is concluded.

Dodd Frank Act CFTC/SEC swap dealer definitions published

The joint rule and joint interim rule adopted in April by the SEC and CFTC to further define the terms 'swap dealer,' 'security-based swap dealer,' 'major swap participant,' 'major security based swap participant,' and 'eligible contract participant under the Commodity Exchange Act and the Securities Exchange Act of 1934 was published on 23 May 2012. The rules clarify for market participants whether or not their current activities will captured by the scope of the Dodd Frank Act's new OTC derivatives regime, and when they will need to comply.

The joint final rule and joint interim final rule will be effective on July 23, 2012, except for certain CFTC regulations which will be effective December 31, 2012. Dealers and major participants will not have to register with the SEC until the dates provided in the final rules, which will be 31 December 2012 for most firms.

The consultation closes on **23 July 2012**.

CFTC approves final rule on swap record keeping

The CFTC approved a final rule on swap data recordkeeping on 18 May 2012, which was published in the Federal Register on 6 June 2012. The rule contains reporting requirements for counterparties to 'historical swaps' (those entered into prior to the Dodd-Frank Act or between its enactment and the compliance date for swap recordkeeping and reporting requirements).

These rules specify the records counterparties have to keep and the data they have to report. The rule is also designed to ensure that historical swap data is available to regulators through swap data repositories (SDRs).

The rule becomes effective on **13 August 2012**, although compliance dates for firms are determined by the nature of counterparty and the type of instrument.

CFTC approves proposed rulemaking on futures and swaps position limits
The CFTC also proposed modifications to its rules on aggregation provisions for limits on speculative positions on 18 May 2012.

The proposed rules would permit any person with more than 10 percent ownership or equity interest in an entity to disaggregate the owned entity's positions, provided that person has put protections and firewalls in place to ensure trading decisions are made independently of one another.

The CFTC proposed these rules in response to a petition from the Working Group of Commercial Energy Firms (WGCEF) filed under section 4a(a)(7) of the Commodity Exchange Act, seeking relief from the aggregation provisions of rule 151.7.

The consultation period closes on **29 June 2012**.

Financial Stability

BIS reviews relationship between financial stability and monetary policy

The BIS published a working paper, *When capital adequacy and interest rate policy are substitutes (and when they are not)*, on 7 May 2012.

The working paper reviews the links between monetary stability and financial stability. The BIS believes that interest rate policies and capital adequacy policies can act as substitutes for the monetary policy objective of price stability. BIS demonstrated this by using interest rate and capital adequacy policies in a simple macroeconomic model. The macroeconomic model shows the similar effects that these tools can achieve.

Both tools can achieve a monetary and financial stability. However, use of the tools must be properly coordinated when looking to achieve financial stability. If not coordinated, the tools may be used at different times to achieve different goals, which may clash and lead to worse outcomes.

The BIS encouraged policymakers to think about interest rate and capital adequacy policies differently in future. Interest rates could be used to control financial stability and capital adequacy could be used to address monetary stability. The BIS stated that macroeconomists should place further research into the coordination of these tools at the top of their agenda.

ESRB Chair Draghi speaks on regulatory priorities

Mario Draghi, in his role as ESRB Chairman, made a *speech* to the EP on 31 May 2012 discussing key areas of the ESRB's work and introducing the ESRB's first *annual report*.

In the first part of his speech Draghi noted that risks to the EU financial system had become systemic, spreading from country to country. He said that managing systematic risk requires decisive action from national and European authorities, with the aim of limiting contagion between the Member States. Systematic risks also affect growth and economic imbalances within the EU, so regulators' strategies must consider these effects. Draghi suggested measures such as

recapitalisation, bank restructuring and improving bank supervision and resolution. He noted that the current reforms to the financial system should have the high level aim of restoring confidence in banks and achieving economic growth.

Draghi also addressed the macro-prudential framework for the EU, noting that the ESRB is currently working on identifying the minimum tool set for national authorities. He also observed that significant EU financial services regulation (e.g. CRD, EMIR and Omnibus II) must take macro-prudential issues into consideration.

In reaction to recent structural developments in the EU financial systems, the ESRB is reviewing structural aspects of both the traditional and shadow banking sectors. Draghi believes that shadow banking will start playing a more important role in the EU economy and needs to be closely monitored to avoid the emergence of new vulnerabilities.

Finally, Draghi mentioned shortcomings in banks' funding structures. The ESRB analyses shifts in banks' funding behaviours, such as the

development of innovative funding instruments. He expressed concern that if banks had insufficient unencumbered bank assets, this could reduce the stability of funding. He also stressed the importance of achieving consistency in implementing international initiatives.

ECB President Draghi speaks on monetary policy

Mario Draghi, in his role as president of the ECB, spoke about '*Monetary Policy in Unconventional Times*' at a colloquium on 16 May 2012, discussing the ECB's non standard measures and monetary policy during crisis times. He noted that the ECB aimed to stabilise short term rates in a volatile environment at an early stage of the crisis by adjusting the timing of its liquidity provisions and lengthening the maturity of its open market operations. In the later stage of the crisis the ECB helped to transmit monetary policy throughout the Euro area. In addition, the ECB designed and launched longer-term refinancing operations, adjustment of collateral framework and various purchasing programmes.

Draghi also highlighted certain ECB objectives: reducing fiscal and macroeconomic imbalances and achieving growth. He stressed the importance of maintaining fiscal discipline while balancing interests of present and future generations. Finally, he welcomed the decline in the euro area government deficit and noted that public debt should stop rising next year.

Draghi believes that not all issues can be dealt with at the EU level. He called for Member States to adopt national policies to foster competitiveness, which he believes can be achieved through a combination of cost moderation, productivity gains and technological change.

IMF reports on UK economic development

The IMF published their annual review of UK economic development in its *2012 Article IV Consultation Concluding Statement of the Mission* on 22 May 2012. Christine Lagarde, IMF Managing Director, agreed that the pace of fiscal consolidation this year is appropriate, but reported that the UK's budgetary stance "can be improved to provide support for

growth" and that "this includes budget neutral shifts towards more infrastructure spending and measures to shield the poor".

In the IMF's view is that the UK Government is implementing strong fiscal consolidation to reduce budgetary risks and the BoE has been nimble in easing monetary policy to support growth. This policy mix is helping to rebalance the economy toward investment and to focus on external demand. With inflation well anchored, the UK has room to cut the base interest rate and embark on a further round of quantitative easing.

The IMF also believes that more monetary and credit easing and improvements in the quality of the fiscal adjustment may be needed to close the output gap and reduce the risk of a permanent decrease in output. Options to further boost demand (in particular through credit easing measures that use the government's balance sheet) should be explored.

In addition, the IMF confirmed its *previous recommendation* that the PRA should be given greater authority over financial holding companies. This

change would help the PRA supervise large financial groups and would be consistent with rules proposed under the emerging international crisis management framework for G-SIFIs.

Speaking at a *press conference* George Osborne, UK Chancellor, underlined the IMF's view that "*reducing the high structural deficit*" remains essential. The UK has been a member of the IMF since 1945, as a borrower in times of stress, and more recently has provided loans to the Fund to support IMF activities.

FSA forecasts macroeconomic impacts of prudential policy

The FSA estimated that the net benefits of the Basel III package of reforms to the UK economy will be £11.9bn per year in an occasional paper - *Measuring the impact of prudential policy on the macroeconomy* published on 17 May 2012 estimating that.

In terms of benefits, the FSA expects Basel III to reduce the probability that a systematic financial crisis will occur which would permanently reduce the UK's GDP. On the other hand, the FSA foresees higher costs to the UK economy because banks will hold more

capital and liquid assets. That will have a knock-on effect on both corporate and household investment and spending decisions.

The FSA also concluded that the UK economy could experience a net benefit even if we adopted stricter requirements than Basel III. Regulators could raise prudential standards by a further 22 percent in terms of banks' aggregate risk asset ratio and still produce net benefits to the UK economy in the long run, indicating regulators have significant headroom to adopt measures that go beyond Basel III.

MiFID

Financial Markets Law Committee recommends improvements to MiFID II

The UK Financial Markets Law Committee (FMLC) published *European Commission's Review of the Markets in Financial Instruments Directive* on 25 May 2012. The FMLC seeks to identify issues of legal uncertainty in wholesale financial market legislation and to consider how such risks should be addressed.

The FMLC notes the following points which could raise legal uncertainty:

1. *Third country firms*. The proposals fail to clarify how 'Equivalent Requirements' and 'Reciprocity' decisions might work in practice, the framework under which they operate and the detailed rules required to achieve them. The FMLC suggest that definitions and guidance are drafted to clarify the parameters of third country rules.
2. *Algorithmic trading*. The Recitals suggest that only high frequency algorithmic trading should be regulated, but the legislation seek to regulate all types of algorithmic trading. The rules could capture index tracking algorithmic and other types of non-speculative trading. The EC should review and scale back the scope of this part of the legislation.
3. *Structured deposits*. MiFID II does not include a fixed definition of 'deposit' or 'structured deposit' and the definition of investment services does not include services related to these types of products.

4. *Organised Trading Facility*. This concept is widely defined, so may be difficult to apply in practice.
5. *Product intervention rules*. The FMLC believes that the scope of powers, and the circumstances in which the powers are expected to be used, should be made clearer.

The FMLC concludes that the current drafts of MiFID II and MiFIR present significant legal uncertainties that the EC should address in its review. The FMLC believes it is essential that this legislation not increase legal risk for parties to transactions, which would undermine the objectives of the MiFID regime.

Operating rules and standards

ESMA publishes short selling update

ESMA published an *update on measures adopted by Competent Authorities on short selling* on 29 May 2012. Short selling describes the practice of selling shares that which an entity does not own, with a view of buying the shares at a later date (and better price for the seller) to meet delivery.

The update provides a summary of Member State short selling rules currently in force. A permanent EU-wide ban on naked (uncollateralised) short selling will take effect on 1 November 2012.

Austria is extending its ban from 31 May 2012 to 31 October 2012 for certain Austrian entities on the naked short selling of shares (cash market). No other Member States have changed their rules on short selling since ESMA published its last update in February 2012.

FSA publishes guidance on reporting of strategy trades

Following a consultation in January 2012, the FSA published its finalised guidance *Transaction reporting of strategy trades (FG12/14)* on 16 May 2012. FG 12/14 applies to exchange traded strategy trades whereby two or more legs of the transaction that are dependent on each other are executed simultaneously.

The FSA expects all transactions that include multiple legs should be reported as individual transactions. Each leg should be reported with the correctly populated venue identification

field for that individual leg. Special rules will apply to the reporting of derivative and cash equity legs in certain circumstances.

The guidance is effective from 15th August 2012.

Other regulatory

IOSCO corporate announcements

IOSCO issued several corporate announcements on 16 May 2012, the first day of its 2012 Annual Conference in Beijing.

Reconstitution of working committees

A *transitional IOSCO Board* will subsume the functions of the Technical Committee (TC), the Executive Committee (EC) and the Emerging Markets Committee Advisory Board. The merger is designed to streamline IOSCO's governance structure and decision-making process, positioning the Organization for a larger role in developing global framework for securities market regulation. The reorganisation is anticipates the increased prominence of securities markets in the financial system, in filling the funding gap left by cash-

strapped governments and financial institutions.

More signatories to MMoU

Four IOSCO members signed the Multinational Memorandum of Understanding (MMoU) in Beijing, bringing the total number of signatories to 86. Together these participants cover about 95% of the world's securities markets. The new signatories include:

- Labuan Financial Services Authority
- Peruvian Superintendencia del Mercado de Valores
- Egyptian Financial Supervisory Authority
- Mauritius Financial Services Commission.
- The MMoU provides a mechanism through which securities regulators share essential investigative material, such as beneficial ownership information, and securities and derivatives transaction records, including bank and brokerage records. It sets out specific requirements for the exchange of information, ensuring that no domestic banking secrecy,

blocking laws or regulations prevent the provision of enforcement information among securities regulators.

IOSCO consults on CRA internal controls

IOSCO published a consultation report on 25 May 2012 on the controls and procedures established by CRAs to promote the quality and integrity of their credit rating process and to manage conflicts of interest.

IOSCO identified four steps CRAs should follow when determining credit ratings, along with the internal controls they use to ensure quality and integrity within each step:

- *Preparatory phase.* CRA gathers information about the issuer and the security.
- *Assessment phase.* CRA analyst applies the CRA's models and methodologies to the information gathered.
- *Decision phase.* The rating committee considers the rating outcome of the assessment phase and settles on the final credit rating.

- *Dissemination phase.* The CRA publicly announces the final credit rating.

IOSCO also provided information within the consultation report on the internal control and audit functions that CRAs have established to manage conflicts of interest and protect the integrity and quality of credit ratings.

IOSCO may use feedback from the consultation to inform future amendments to its CRA code of conduct. The consultation provides an in-depth insight into processes established by CRAs to protect the quality and integrity of their credit ratings and the way they manage conflicts of interest. It will also inform final negotiations on CRA3 in the EU: 'trilogue' negotiations between the Council, the EP and the EC are due to start shortly.

EC publishes CRA delegated regulations

The EC published four Delegated Regulations which supplement the new Credit Rating Agencies Regulation No 1060/2009 (known as CRA III) in the Official Journal on 30 May 2012.

The delegated regulations establish the regulatory technical standards that CRAs will have to act within under CRA III (effective dates in brackets):

- *EC Delegated Regulation (EU) No 446/2012.* This sets out the information CRAs have to submit and when this information must be submitted to ESMA (effective 30 November 2012).
- *EC Delegated Regulation (EU) No 447/2012.* This sets out how ESMA will assess a CRA's rating methodologies (effective 20 June 2012).
- *EC Delegated Regulation (EU) No 448/2012.* This sets out the information CRAs must disclose to allow investors to compare the performance of different CRAs (effective 20 June 2012).
- *EC Delegated Regulation (EU) No 449/2012.* This sets out the information CRAs must provide to ESMA when applying for registration (effective 20 June 2012).

EC publishes feedback statement on Acquisitions Directive consultation

The EC published a feedback statement to its consultation issued in December 2011 on the application of the Acquisitions Directive 2007/44/EC ('the Directive'). The Directive lays down the procedures and criteria for the prudential assessment of acquisitions and increases of holdings in regulated firms. The consultation will assist the EC in its review of the Directive's implementation.

The feedback statement, released on 8 May 2012, summarises the comments received from 10 respondents including public authorities, private companies and associations, on the topics presented in the consultation:

- application of the Directive
- the procedures laid down in the Directive: notification requirements, exemption from the notification requirement, competent authorities, time limits and relations to other regulatory procedures
- substantial aspects of prudential assessment: criteria and required information

- other issues: sanctions, harmonization and the need of similar framework in other legislation in financial sector.

The EC will submit its report with recommendations to the EP and the Council following this review.

ESAs consult on FICOD review

The EC recently conducted a technical review of FICOD which resulted in amendments to the legislation in December 2011 (FICOD1). The EC then called for a fundamental review of FICOD (FICOD2). On 14 May 2012, the ESAs launched a joint consultation on their proposed response. The EC asked the ESAs to make 'an assessment of supervisory practices and experiences' with regard to (1) scope of application, (2) group-wide internal governance requirements and (3) sanctions and supervisory empowerment.

The ESAs pointed out that this review has to be put in the context of the current financial crisis, citing an emerging consensus that unregulated entities within a group must be appropriately supervised. Tax and regulatory capital incentives often lead to complex structures which hinder the

adequate identification and management of risks. Therefore, legislators need to extend the scope of supervisory powers, and also place more stringent requirements on unregulated parent holding companies.

The ESAs proposed recommendations in the following areas:

- scope and perimeter of supervision
- governance requirements and the ultimate responsible entity
- requirements that should be imposed on the qualified parent entity
- incentives (special benefits or sanctions) that would make the enforcement of group-wide requirements more credible
- more powers for national supervisors.

The consultation closes on **13 August 2012**.

ESMA publishes annual regulatory programme

ESMA released its annual regulatory programme on 7 May 2012., the programme provides more details on

the individual workstreams set out in Annex 3 of the ESMA 2012 work programme published on 4 January 2012.

ESMA plans to deliver technical standards, technical advice and guidelines and recommendations mainly in the areas of Short Selling Regulation, EMIR, MiFID and AIFMD this year. It also plans to progress developments on revising the UCITS Directive, Transparency Directive, Prospectus Directive and Omnibus II are also planned to be issued this year.

FSA publishes payment for order flow guidance

The FSA published Finalised Guidance on the practice of 'Payment for Order Flow' (FG 12/13) on 14 May 2012. Payment for order flow (PFOF) refers to market makers paying brokers for receiving all or part of the broker's client order flow. PFOF confers some advantages, but the FSA concluded that PFOF arrangements create a clear conflict of interest between firms and their clients.

FG 12/13 describes the practice of PFOF, sets out the Conduct of Business Sourcebook (COBS) and Senior

Management Arrangements, Systems and Controls Sourcebook (SYSC) provisions, and explains why this issue is not generally applicable to market maker fee arrangements under most trading platforms. FG 12/13 does not ban PFOF. However any PFOF activity must comply with the FSA's conflicts of interest, inducements and best execution rules:

- Conflicts of interest - SYSC rules set out conflicts of interest rules which require firms to identify and manage conflicts in a way to avoid disadvantaging its clients.
- Inducements - COBS rules permit PFOF, provided that such payment satisfies the COBS inducements tests.
- Best execution - COBS rules also contain 'best execution' obligations which require firms to take all reasonable steps when executing retail and professional client orders.

In practice, it will be difficult for firms to justify that any PFOF activities do not breach FSA rules.

The guidance relates to payments between market intermediaries.

Although the FSA noted that certain fee structures and incentive schemes exist between some trading venues and their participating market makers, the FSA clarifies that this guidance does not apply to such arrangements.

FSA publishes firms' 2012/13 rates and levies

The FSA published their final Consolidated Policy Statement on our fee-raising arrangements and regulatory fees and levies 2012/13 (PS 12/11) on 29 May 2012. The final policy covers funding for FSA, FOS, FSCS and the Money Advice Service.

The FSA's annual funding requirement (AFR) from industry for 2012/2013 is £559.8m, which is 3.2% less than estimated in CP12/3 but still represents an 11.9% increase over last year. The FSA received £70.7m in financial penalties last year, which was 20.4% than estimated in CP 12/3, but 18% lower than last year. Overall, the burden for firms will be 5.9% less than anticipated in the consultation paper, but still 18.1% higher than the fees collected from firms for the prior year. Most firms Some firms are hit harder than other

Deposit taking firms will experience a 21.1% increase. Fund managers' fees will increase by 28.8%. General insurers are facing a rise of 32.5%, and life insurers a 33.1% increase. Firms dealing as principal are hit the worst, with an increase of 39.3%.

FSA publishes Policy Development Update

The FSA published its latest Policy Development Update Number 147 on 25 May 2012. The policy development update is published monthly and provides:

- lists of publications issued since the last edition
- information on recent Handbook developments
- other publications (consumer publications, Guidance Consultations and Finalised Guidance)
- updated timetable for forthcoming publications.

Firms should review FSA's publication plans to anticipate developments relevant to their business. We also

provide a consolidated list of regulatory developments in the Calendar.

FSA publishes Handbook Notice 120

The FSA published Handbook Notice 120 on 28 May 2012, setting out instruments recently passed by the FSA Board. This Handbook Notice includes three instruments (effective dates in brackets):

- *Periodic Fees (2012/2013) and Other Fees Instrument 2012 (FSA 2012/26)*. The instrument makes changes to the FSA Glossary and Fees Manual (FEES) to reflect the new periodic fees that FSA is charging firms to meet the FSA annual funding requirement (effective 1 June 2012).
- *Compensation Sourcebook (Deposit-Taking Firms' Disclosure Requirements) Instrument 2012 (FSA 2012/27)*. The changes to the Compensation Sourcebook (COMP) aim to increase consumer awareness about deposit protection by increasing the disclosures made by deposit-takers (effective 31 August 2012).

- *The Periodic Fees (Unauthorised Mutual Societies Registration) (2012/2013) Instrument*. This instrument reflects only a change in the date when the fees are applicable (effective 1 June 2012).

The FSA included a summary of industry feedback to the underlying policy proposals in the Handbook Notice.

FSA publishes service standards

The FSA published their latest service standard results on 16 May 2012, on meeting its voluntary and statutory obligations for the period 1 October 2011 to 31 March 2012.

Against 46 metrics measured, FSA met its standards in 63% (29) instances. FSA described ten further missed targets as “challenging 100% targets,” and was only one or two cases off-target in most areas.

However, FSA’s two largest failings related to areas that directly impact firms. FSA achieved only 61% (33 out of 54) of its target to provide a draft letter of findings and recommendations to firms within 10 weeks after a full ARROW or Light ARROW plus Capital

Assessment visit. For Light ARROW visits, the FSA managed to meet its six week target in only 29% of cases (2 of 7). Somewhat surprisingly, FSA only conducted 61 ARROW visits in total during the six month period covered.

FOS publishes annual review of customer complaints

The FOS published its *annual review of customer complaints* on 22 May 2012, discussing major trends in FOS complaints. The report covers the 12 month period ending March 2012.

The review highlighted the FOS’s increasing workload, as the number of complaints increased 25% from 2010/11 year. The FOS has set in motion plans to double its complaint handling staff by August 2012, whilst also seeking to improve its efficiency and the time required to settle a claim.

Payment protection insurance (PPI) mis-selling claims rose dramatically, representing over 60% of claims. The review also highlighted a demographic shift in the profile of claimants, with the number of unskilled claimants rising from 3% to 10%. The report links this to the wide range of PPI products sold, and the diversity of PPI

customers. The report noted that commercial claims management companies account for a significant part of the increase, representing 70% of PPI claims.

To address the increased PPI workload, the FOS is introducing a charge of £350 per for each PPI case, applicable to all firms that are the subject of 25 or more PPI claim referrals to FOS in a year.

Pensions

FSA and FRP consult on pension and non-MiFID product data and illustrations

FSA and the Financial Reporting Council (FRC) published a joint consultation ‘Product projections, transfer value analysis and Statutory Money Purchase Illustrations’ *CP12/10* on 31 May 2012. In addition to product providers, this paper is of interest to life insurers and other firms that provide or advise on personal pensions.

The proposed changes are designed to make FSA rules for personal pensions more consistent with the FRC assumptions, as well as update the assumptions used for non-MiFID

product projections and transfer value analysis (TVA).

The proposed changes, and implementation dates where provided, include:

- updating the mortality assumption to be used when illustrating a personal pension (from 21 December 2012)
- introducing a separate CPI assumption for a transfer value analysis when benefits under a defined benefit pension scheme are compared with benefits under a personal pension scheme
- changing the investment return assumptions (projection rates) in the FSA Conduct of Business sourcebook
- changing the FRC assumptions used for Statutory Money Purchase Illustrations, to make them more consistent with the FSA’s assumptions in the Conduct of Business sourcebook (from 6 April 2013).

The consultation period relating to the proposed changes to mortality

assumptions ends on **29 June 2012**. The comment period for the remainder of proposals closes on **31 August 2012**.

Prospectus Directive

FSA and HMT finalise implementation of Amending Directive

The FSA and HMT published *UK implementation of Amending Directive 2010/73/EU* (PS12/9) on 19 May 2012. This legislation amends aspects of the Prospectus Directive (2003/71/EC) and Transparency Directive (2004/109/EC).

PS12/9 sets out the feedback the FSA and HMT received to their joint Consultation Paper (CP11/28), the changes to be made to the FSA rules and HMT's draft statutory instrument that will be laid before Parliament.

The draft statutory instrument will clarify that either the issuer or person responsible for drawing up the prospectus (if a different entity) must consent to the use of the prospects in a retail cascade. Some respondents felt the original draft suggested that both entities needed to consent, contrary to

the technical advice that ESMA gave the EC.

The policy statement notes changes to certain definitions:

- the definition of a 'Qualified Investor' will include the ability for such an investor to opt-out of being a professional investor (consistent with MiFID rights)
- 'key information' and the content of the prospectus summary have been changed to more closely copy out the wording in the Amending Directive.

The FSA is also making some conforming changes to the Disclosure Rules and Transparency Rules Sourcebook.

These changes will be noted in the final impact assessment that HMT submits to the Government. An updated impact assessment is not included within PS12/9, but HMT will include a higher revised estimate of implementation costs that firms will bear.

Regulatory Reform

FSB May plenary meeting reviews progress

A *FSB Plenary meeting* took place on 29/30 May 2012. The FSB discussed regulators' progress in strengthening global financial regulation.

The FSB discussed its ongoing workstreams:

- *Systematically important financial institutions*. The FSB released a consultation paper on the methodology for assessing the global systemic importance of insurance companies will be published prior to the next G20 summit
- *OTC derivatives*. The FSB recognised that much work remains to be done to complete the reforms by the end 2012 deadline agreed by the G20. In the coming weeks standard setters will issue consultation papers on margining requirements for bilaterally cleared derivative transactions and on the resolution of CCP and other financial market infrastructures
- *Shadow banking*. The FSB issued an initial set of policy recommendations to strengthen the regulation of shadow banking will be published by the end of 2012
- *Legal entity identifier (LEI)*. The FSBs recommendations to support the establishment of a global LEI system that will provide a unique global identifier for parties to financial transactions will be submitted to the next G20 summit. Launch of the global LEI system is planned by March 2013.
- *Monitoring implementation and adhering to standards*. The FSB's focus is turning from policy development to timely and consistent implementation. It will release reports on Basel III and compensation practices around the time of the next G20 summit
- *Emerging markets*. The FSB will release a study (which it commissioned) on the effects of agreed reforms for emerging market and developing economies at the next G20 summit.

The FSB's update anticipates the next G20 summit, which will take place on 18/19 June 2012 in Los Cabos, Mexico.

TSC opens inquiry into BoE macroprudential tools

The TSC published on 30 May 2012 the *terms of reference for an inquiry into the macroprudential tools* that are set to be handed to the FPC of the BoE.

The Financial Services Bill 2012 proposes giving the FPC powers of direction over PRA and FCA and the power to make recommendations to a wide range of parties. Taken together, these constitute the macroprudential tools.

The interim FPC has requested powers of direction in respect of the countercyclical buffer, sectoral capital requirements and a leverage ratio. The TSC's inquiry includes consideration of what tools the FPC should have and what transparency and accountability framework is necessary in respect of these tools.

The TSC welcomes comments and the deadline for the submission of written evidence is **22 June 2012**.

BoE to review lessons learned since the financial crisis

On 21 May 2012, the BoE announced that it is *commissioning three*

independent reviews into its performance during the financial crisis. This development may be seen as a u-turn by the BoE, given that Mervyn King, Governor of the Bank, recently stated that any review 'has to be an inquiry into everything, not just the Bank of England but what ministers did, what Treasury officials did, what bankers did and what everyone else was recommending was the right policy before 2007'.

BoE has come under significant pressure to undertake a full and transparent review of its role. The TSC has vociferously called for the BoE to review its role in the financial crisis, particularly in its report on the *Accountability of the Bank of England* in October 2011, because the BoE will take on a more powerful financial oversight and regulatory role under the Government's proposals to reform the UK regulatory bodies. Andrew Tyrie, Chairman of the TSC, commented that 'the conclusions of a comprehensive review of bank performance could, and should, have been available to inform the legislation currently before parliament to reform financial regulation'.

The three reviews will focus on:

- *The provision of Emergency Liquidity Assistance (ELA) in 2008/9*. This is focusing on governance within the BoE for providing ELA, the structure and terms of each ELA, the impact of providing ELA to institutions and the basis of the decision to provide ELA to an institution.
- *The BoE's framework for providing liquidity to the banking system as a whole*. This review is looking at the operation of the Special Liquidity Scheme, the BoE's 'Red Book' and the operation of the framework since it was reformed in 2008.
- *The Monetary Policy Committee's (MPC's) forecasting capability*. This will review the accuracy of the MPC's growth projections since 2008, the MPC's process and analysis in producing them, the MPC's processes to produce projections and the capability of the BoE to support the projections.

The reviews commissioned by the BoE will not focus on the run on Northern Rock in 2007 because the BoE states

these lessons have already been learnt 'The Run on the Rock' Treasury report was published in 2008.

The BoE expects the conclusions of the review to be presented to it in October 2012. The conclusions will be published more widely soon after.

BoE and FSA announce PRA firm designations

The BoE and FSA published a joint note on 17 May 2012. The BoE and FSA published a *joint note* on 17 May 2012, in response to a request from Government to assist with the Parliamentary scrutiny of the Financial Services Bill. The note sets out the BoE and FSA's initial views on how the PRA will determine which firms it will prudentially supervise.

The FSA states that their internal twin peaks split includes those firms it considers "most likely" to be regulated by the PRA, but does not include thresholds or formal parameters. It reiterates HMT's previous policy statements, and broadly confirms that the PRA will supervise firms that have permission to deal in investments as principal and are a BIPRU 730k firm or higher capital requirement. However,

the PRA may pull other firms under its supervision where it is desirable based on its risk analysis of other factors, e.g. the firm's assets, the status of any other group firms and whether the firm could impact on the PRA's objectives.

After the PRA designates a firm as being under its supervision, that designation will apply for a minimum period, even if the firm drops below any relevant thresholds, before it is transferred to FCA for supervision.

The BoE and FSA also mention that the FPC has the power to recommend that HMT bring create new regulated activities under FSMA, which could bring additional firms within the scope of PRA regulation, such as firms engaged in shadow banking activities.

Consumer Panel lobbies for publication of firms' regulatory performance

The Consumer Panel issued a *report* on 11 May 2012 which recommends that the Government gives the new financial services regulators the power to publish certain firm violations. The Consumer Panel has previously published research on using transparency as a regulatory tool.

FSMA currently restricts the FSA from publishing information about firms' performance and behaviour, but the Consumer Panel argues that this hinders consumers from making informed choices. They recommend making public the nature of complaints against firms, firms' records in complaints handling, and the results of mystery shopping where poor performing firms should be 'named and shamed'. The Consumer Panel believed that greater transparency would drive improved firm behaviour.

Kay Blair, the Consumer Panel's Vice Chair commented: 'The new Financial Services Bill presents the Government with a once in a lifetime opportunity to create a new generation of informed consumers through greater regulatory transparency'.

The Panel noted that, in contrast to the financial services industry, the Food Standards Agency has the power to publish such information at its discretion under the Food Standards Act 1999, subject to certain narrow exceptions. This transparency is viewed as having helped restore consumer

confidence in the industry following the BSE crisis.

The report recommends publication of the following types of information:

- complaints data
- financial promotions violations
- mystery shopping findings
- comparison of retirement annuities and the open market option (which would require the FCA to capture new types of information).

The Joint Committee expressed a similar view in its comments on the draft Financial Services Bill. The Financial Services Bill 2012 is in late stage Parliamentary Committee debates and should be passed this summer. The PRA and the FCA, the new financial services regulators, are expected to commence operations in 2013.

BIS sets out timing for transfer of consumer credit regulation to FCA

The BIS has outlined on its *Consumer credit regulation* webpages the timetable and methodology for the transfer of consumer credit regulation from the OFT to the FCA.

The Government intends to design a model of FCA regulation that reflects the particular characteristics of consumer credit, and is proportionate for the different segments of the market according to the risk they pose to the consumer. Once the model for FSA regulation has been designed, the transfer will be then be subject to an impact assessment and approval by both Houses of Parliament.

The Government plans to confirm the intention to make the transfer by the end of 2012. It also plans to publish the impact assessment in early 2013 and obtain approval by both Houses of Parliament by the summer of 2013. OFT would then transfer consumer credit regulation to FCA in April 2014.

Government proposes Enterprise and Regulatory Reform bill

The BIS published its proposed *Enterprise and Regulatory Reform Bill*, which was presented to Parliament on 23 May 2012.

Vince Cable, the Business Secretary, says that the proposed measures will help grow Britain's economy out of the crisis by 'encouraging investments and exports, boosting enterprise,

supporting green growth and building a responsible business culture’.

New measures to encourage long-term growth include:

- improving the employment tribunal system
- replacing the Competition Commission and the Office of Fair Trading with a new Competition and Markets Authority
- establishing the UK Green Investment Bank to support private sector investment in Britain’s transition to a green economy
- giving shareholder binding votes on directors’ pay.

The bill also aims to facilitate entrepreneurship and job creation by reducing the cost of doing business in Britain and certain regulatory burdens. The second reading is scheduled to take place in June 2012.

Reporting

FSB encourages improved risk disclosures

The FSB is aiming to improve market confidence in financial institutions’

disclosures by establishing the private-sector led Enhanced Disclosure Task Force (EDTF). The FSB *announced* the formation of the EDTF on 10 May 2012. Bob Sullivan, PwC's Global Banking and Capital Markets Leader, will serve as a member.

The EDTF will address recommendations raised at an FSB roundtable event held in December 2011. The event identified key areas for improvement in qualitative and quantitative risk disclosures:

- improving the relevance of disclosures about firms’ governance and risk management strategies
- creating executive summaries for key risk categories and making risk disclosures specific to each firm
- enhancing disclosure of firm credit risk, including disclosing off-balance sheet and joint venture structures and counterparty exposures
- improving liquidity and funding risks transparency
- disclosing the firm’s earnings resilience, particularly in the current low interest rates environment

- increasing comparability and reconcilability between unaudited Pillar 3 information and the audited financial statements of firms
- disclosing stress testing results in financial reports and indicating whether or not the external auditor had reviewed these results.

The EDTF plans to develop common principles by consulting with existing standard-setting bodies, such as the Basel Committee, the IASB, the FASB and IOSCO. The FSB expects findings from the EDTF to be published in October 2012.

RRPs

EBA consults on recovery plans

The EBA published a *discussion paper on a template for recovery plans* on 15 May 2012. National legal frameworks on RRP differ between the EU member states, so the EBA is currently reviewing best practices with the aim of harmonising standards.

The discussion paper introduces a template on recovery plans and discusses key elements of the plans:

- A general overview which provides a summary of the plan, a description of the institution, and governance arrangements with regards to the plan.
- The core of a recovery plan, which provides information on options available in a crisis situation and how these are identified, and the execution and impact of these options.
- A follow-up section which identifies measures to facilitate the plan drafting and its further governance.

In short, the EBA is requiring banks to conduct a strategic analysis of their core businesses, set out a ‘menu’ of possible recovery measures and then assess the feasibility of such measures.

The EBA will propose EU legislation which will establish a framework for RRP later this year. This legislation will also further define the role of the EBA and national authorities. The consultation closes on **15 June 2012**.

FSA provides further guidance on RRP

The FSA published a *Feedback statement on recovery and resolution*

plans (FS12/1) on 10 May 2012, together with draft core rules, a revised draft information pack, and FAQs for firms.

FS12/1 provides an update on developments since CP11/16 was published in August 2011, and sets out the proposed next steps on RRP. It is relevant to all UK incorporated deposit takers and investment firms.

In summary:

- Given significant developments and recent initiative on resolutions, the FSA has decided to delay the publication of the final rules to ensure they are consistent with the proposed European Recovery and Resolution Directive and the FSB's Key Attributes of Effective Resolution Regime.
- The 'draft information pack' sets out detailed informational requirements, which are expected to form the basis of the final rules.
- The FAQ document provides answers to questions on general issues, the information requirement for international groups, recovery plans, and resolution information.

- Large firms that are involved in the pilot exercise are expected to submit their recovery and resolution plans by 30 June 2012. Small and medium sized firms will agree individual deadlines with their supervisors.

The final rules will be published no later than autumn 2012. FSA has also indicated it will consult on extending RRP rules to UK branches of non-EEA firms.

Shadow Banking

ECB scopes European shadow banking

The ECB estimated that the European shadow banking industry was approximately half the size of the European banking sector, based on data from the second half of 2011. In contrast, ECB estimated that during this period the assets of the US shadow banking industry were equal to 100% of the US banking sector. This ECB published these findings on 1 May 2012 in its occasional paper *Shadow Banking in the Euro Area: an overview*. This follows the EC's recent *green paper* on shadow banking and demonstrates the increasing European focus on shadow banking activities.

The ECB's paper also discusses the interconnectedness of the regulated and non-bank regulated segments of the financial sector. The ECB believes the interconnectedness is increasing, because banks are relying more on short-term funding from the financial sector (instead of central banks), increasing the risk of contagion. The ECB sees this funding coming from three main shadow banking vehicles:

- securitisations
- money market funds
- sale and repurchase agreements

The ECB noted that several European initiatives will regulate and limit certain aspects of shadow banking activities, such as AIFMD and CRA regulatory reforms.

The ECB expressed concern that its tracking of European shadow banking activity is imprecise due to insufficient reporting and data collection. The paper concludes with some preliminary considerations for addressing data gaps and regulatory options.

Accounting¹

FRC publishes its priorities and funding for 2012/13

The FRC published its *Plan and budget 2012/13* on 23 May 2012. The FRC will focus on four objectives:

1. *Monitoring the health of corporate governance and reporting in the UK.* This is making sure its code and standards remain fit for purpose and that planned changes are introduced at the right time
2. *Ensuring that the UK's approach to corporate governance and reporting is properly understood and appreciated in the EU and internationally.* This involves working with the BIS, the FRC will press for EU policies on governance and audit that serve the interests of investors.

¹ This section includes accounting developments with a direct or potential impact on the financial services industry only. For a complete update on accounting developments in the UK visit http://www.pwc.co.uk/eng/services/ifrs_services.html

3. *Ensuring that the FRC is responsive to emerging risks – i.e. that it is joined up, transparent and proportionate.* The FRC will review further the scope of its conduct work and seek to enhance the speed and effectiveness of its disciplinary work, including its sanctions.
4. *Ensuring that the final decisions on reform of the FRC are introduced effectively.*

The FRC's overall budget for 2012/13 is £22.4m (2011 £22.1m).

UK GAAP

The future of UK GAAP

Firms presently reporting under UK GAAP will all be impacted by the ASB project on the Future of UK GAAP.

On 30 January 2012, ASB published financial reporting exposure drafts (FREDs) setting out revised proposals for the future of financial reporting in the UK and Republic of Ireland. At the core of these proposals is a single new Financial Reporting Statement (FRS), applicable in the UK and the Republic of Ireland, that will replace the existing suite of FRSs and statements of standard accounting practices. The

ASB's website and our *Straight Away* publication summarise the proposals.

At the same time the ASB also issued a *discussion paper* on the options for the future of insurance accounting in the UK and Republic of Ireland which is considered in our *Hot Topic* publication. ASB proposed that the new requirements will apply from 1 January 2015 (with early adoption permitted). The period for comment on ASB's proposals closed on 30 April 2012 and responses are available on *ASB's website*. See our responses - *PwC response to ASB on the future of UK GAAP - FRED 46 to 48* and *PwC response to ASB on the future of UK GAAP - Insurance accounting*. The ASB is now considering the responses to the Exposure Drafts and Discussion Paper.

Tax

EC proposes VAT reforms

A consortium of six banking and insurance industry bodies published a *joint statement* on the EC's proposals to reform the application of the value added tax (VAT) rules on insurance and financial services on 3 May 2012. The statement expressed concern at the lack of progress and reiterates the importance of the proposals. The industry

The EC proposals seek to reform VAT regime for insurance and financial services that was adopted in November 2007. The reforms are designed to modernize and simplify the legislation and to provide greater harmonisation among Member States.

Government amends CFC provisions in Finance Bill 2012

The Government tabled proposals on 25 May 2012 to amend the draft controlled foreign companies (CFC) rules in Schedule 20 of the Finance Bill 2012. The amendments create more circumstances in which insurance groups will be able to take advantage of

the new finance company regime in the CFC rules.

Without these amendments, finance companies would not have qualified for the 5.5% finance company tax regime when making loans to companies that then loaned these funds to another party, including insurance companies that acquire corporate bonds as portfolio investments in the ordinary course of their business.

The current draft CFC regime includes a limitation on finance company lending; a loan does not qualify for the preferential tax treatment if it is funded (directly or indirectly) by funds received from a UK bank or insurance company. Despite this limitation, insurance groups still have a significant opportunity to take advantage of the 5.5% finance company tax regime.

These proposals are expected to be debated in Parliament on or around 19 June 2012.

HMRC publish second consultation on unauthorised unit trust tax

The HMRC published its *Second consultation into the taxation of unauthorised unit trusts* (UUTs) on 23

May 2012. The consultation sets out the Government's proposals to simplify the rules and reduce administrative burdens, whilst at the same time removing tax avoidance opportunities.

The first consultation considered the tax avoidance risks associated with UUTs. HMRC acknowledged that whilst the tax at risk from such avoidance is significant, the vast majority of UUTs are set up for legitimate investment and commercial purposes wholly unrelated to tax. HMRC also recognised that stakeholders want simpler tax rules to reduce tax complexity and compliance burdens for UUTs.

A summary of responses together with draft legislation and guidance will be published in autumn 2012, with a view to introducing legislation under the Finance Bill 2013. The consultation closes on **20 August 2012**.

Banking and capital markets

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Regulation

Capital and liquidity

EBA announces recapitalisation progress and 2013 stress tests

Overall, the EBA is satisfied with progress in the fulfilment of banks' July 2011 stress tests. The tests were conducted to ensure that banks have put appropriate mitigating actions in place to meet Core Tier 1 ratios close to or below its 5% target. In its *Report on the fulfilment of the EBA Recommendation following the 2011* on 30 April 2012, the EBA indicated that since last year's stress test, banks on the margin of the target ratio had taken action to strengthen their balance sheets. They accomplished this increasing their capital levels and amortizing loan impairments. In addition, those banks identified as having significant weaknesses have undertaken restructuring processes and should be in better shape now. Some of the banks, particularly those in Greece, are subject to more stringent measures under pre-agreed EU/IMF assistance programmes, which the EBA is carefully monitoring.

Looking ahead, The EBA is developing its approach to the next EU-wide stress test exercise, taking place next year.

Consumer protection

FSA updates deposit protection disclosure rules

The FSA published its policy statement *Deposit Protection: raising consumer awareness* (PS 12/10) and feedback to consultation *CP11/29* on 24 May 2012. PS12/10 is applicable to all FSA authorised deposit takers.

The FSA's new rules aim to complement and strengthen the existing compensation disclosure requirements in Chapter 16 of the FSA's Compensation sourcebook. These disclosures are intended to increase consumer awareness and help to maintain financial stability by reducing the likelihood of a run on a deposit taker.

In 2009 the FSA introduced a two-tier strategy aimed at raising consumer awareness, consisting of: 1) an awareness campaign run by the FSCS and 2) six monthly disclosures from firms to depositors. The FSA recently reviewed this disclosure regime and in

December 2011 it published enhanced disclosure proposals in CP11/29.

At the EU level, proposals to amend the *Deposit Guarantee Schemes Directive 94/19/EC* may require deposit takers to make disclosures to potential account holders and to existing holders via account statements or internet banking. The FSA is monitoring developments related to these proposals.

All deposit takers are expected to be compliant with the rules by **31 August 2012**, with the exception of Northern Ireland credit unions, which will have to comply when they become subject to other FSA disclosure rules.

Financial stability

BoE's Bailey speaks on UK banking challenges

Andrew Bailey, Executive Director of the BoE and Deputy Head of the FSA Prudential Business Unit, gave a *speech* on 24 May 2012 outlining some of the challenges ahead in maintaining a stable UK banking sector.

In addition to risks to stability and the cost of adjustment arising from the euro area turmoil, he noted:

- *Low interest rates and competition for retail deposits leading to low margins.* Risk managers should take a cautious view and assume that low interest rates will subsist for the foreseeable future, which will continue to squeeze interest margins.
- *A stronger regulatory regime will cause a drag on the profitability of the banking system.* The speed of transition affects the level of cost to the banking system. In addition, there is a need to minimise the uncertainty over the pace of change by ensuring that FSA/BoE is clear about the speed of transition to the new CRD IV capital requirements. An accelerated path may have adverse implications for the economy. In addition, the FSA/BoE should take account of the state of the economy and BoE's role in providing liquidity insurance.
- *Industry restructuring may impede the provision of services to the real economy.* The success of the ICB ring fence proposal lies in providing resolution options that are consistent with the public interest of

providing continuous access to critical financial services. However, more debate and assessment of what comprises critical services is needed.

Bailey also reiterated the need for intervention to curtail free in-credit banking, to promote competition and eliminate distortion in the supply of banking services. He believes this issue must be tackled before retail banking reform can move ahead.

Other regulatory

DWP encourages development of credit unions

The DWP issued its Credit Union feasibility *study* on 10 May 2012. This report will inform the Government's legislative proposals and the FCA's regulation of credit unions from the next year. The DWP observed that credit unions play an important role in providing access to financial services for people on lower incomes. It also noted that there is a big demand for credit unions' services, with a potential market that could be as high as seven million people. Currently UK credit unions have around 953,000 members in aggregate.

However, the study noted that more should be done to facilitate the expansion and modernisation of credit unions to make credit unions more sustainable and better able to serve more people. The study suggested that to achieve these objectives credit unions should:

- complete major programmes of business and cultural change
- reduce the operating cost by introducing automated systems
- introduce modern financial services solutions for customers and attempt to attract a balanced mix of customers.

The report suggests ways for credit unions to serve additional 1 million members and become sustainable. The DWP encouraged the Government to support the development of the credit unions, but stressed that only credit unions that are ready to make the changes should be developed. The DWP also called the industry and stakeholders for views on how credit unions' can develop further.

FSA publishes credit union fact sheet

FSA published a *fact sheet* stating the FSA's risk scoring for various credit unions, covering prudential standards, long-term sustainability, and governance.

The FSA used data including credit unions' financial returns, complaints returns and data on the timeliness and accuracy of firms' FSA submissions. To help to identify and mitigate potential risks, the FSA recommended that credit unions gather and analyse more management information.

Product rules

EC publish guidelines on APR

The EC published a *staff working document* on 8 May 2012 giving guidance on disclosure of the cost of credit and the Annual Percentage Rate (APR) of charges under the Consumer Credit Directive (CCD). While not legally binding, the guidelines seek to help harmonise the implementation of the CCD across Member States.

The guidelines cover:

- the role of the APR, as distinct from the borrowing rate

- the rules relating to disclosure of the APR and
- clarification of elements to be included in both the APR calculation and total cost of credit.

The guidelines address the role and design of representative examples, and disclosure of certain loan characteristics and time intervals in the calculation of APR.

During the original CCD negotiations, Member States disagreed on APR approaches and calculations. As a result, during implementation some Member States have applied CCD requirements to other forms of borrowing – such as mortgage credit – while other Member States have maintained distinct approaches to secured and unsecured lending.

The guidelines may help to encourage a more harmonised approach to the disclosures which will be required under other related initiatives, such as the European *proposal for a directive on credit agreements relating to residential property*, also known as the Mortgage Credit Directive.

Regulatory reform

EC Expert Group consults on banking sector reform

The EC High-level Expert Group (the Expert Group) published a consultation on *Reforming the structure of the EU banking sector* on 3 May 2012.

The Expert Group was set up by Michael Barnier, Commissioner for EU Markets and Services, in February 2012. The Expert Group's mandate is to consider structural reform of the EU banking sector, while having regard to the other financial sector reform.

Where appropriate, the Expert Group will make proposals to the EC with the objective of establishing a safe, stable and efficient banking system.

Particular focus areas will include:

- reducing the risks posed by the banking system as a whole and by individual firms to the financial system
- promoting competition
- reducing moral hazard, by making market exit viable even for the largest and most complex firms,

thereby reducing government guarantees

- maintaining the integrity of the internal market.

The consultation doesn't contain any specific proposals but poses a few questions aimed at three groups - banks, corporate customers and retail customers. The consultation closes on 1 June 2012. The Expert Group is due to report to the EC by the end of the summer 2012.

FSA's Wheatley speaks on rebuilding trust in banks

Martin Wheatley, Managing Director of FSA's Consumer and Markets business unit and CEO designate of the FCA, gave a speech, *'Rebuilding trust and confidence in banks and bankers'*, at the Chartered Institute of Bankers on 04 May 2012.

Noting that confidence in the financial services industry came out at the bottom of an international cross-sector survey, Wheatley said that to make regulation work that regulators need to better understand what motivates consumers and firms, and to focus on current banking conduct issues.

Wheatley noted that consumers struggle with complicated products and financial decisions, and many firms have failed to treat customers fairly. Therefore he believes that product regulation is necessary and should concentrate on the firm's business model and achieving good outcomes for customers. The FSA (and ultimately the FCA) intend to build on their 'intrusive approach' in assessing new product development, as well the sales and distribution processes. Firms need strong governance in place to achieve good outcomes for consumer and the regulators will continue to oversee the appointment of experienced and effective boards and senior management.

He then discussed the ongoing conduct issues that the FSA is seeing with 'core' banking activities and how banks treat their customers in their day-to-day transactions. Worryingly, certain firms fail to comply even on simple banking activities, e.g. payment by the next business day. Those banks need to take action seriously if they want to increase their customers' confidence, especially with increasing competition from new

entrants (including non-bank operators).

Finally, Wheatley talked about the need for banks to tackle complaints on Payment Protection Insurance directly, as a more proactive engagement on this issue would reduce consumer need for claims management companies.

Banks have a considerable way to go to rebuild customers' trust and confidence and, like the regulators, they should focus on understanding consumer behaviour and constructing business models where fair treatment of customers is central.

FSA's Wheatley speaks on regulating building societies

Martin Wheatley, Managing Director of FSA's Consumer and Markets business unit and CEO designate of the FCA, gave a *speech* at the Building Societies Association's Annual Conference on 9 May 2012. Wheatley encouraged the industry to see the regulatory reform as an opportunity to solve conduct issues that cause problems to customers. He reminded the industry that protecting customers should remain pivotal to building societies' management.

Wheatley predicted that the FCA will learn from the FSA's mistakes. Staff will focus more on the build up of risks, rather than past risks, and will focus on business model reviews – both in individual firms and review reaching across sectors. Also, FCA staff will assess if achieving good outcomes for customers stays at the heart of each firm's business.

The FCA will expect building societies to fully implement the regulations which are already in place, such as those for crediting money into people's accounts or those dealing with unauthorized transactions. Firms must accept being supervised by both conduct and prudential authorities whose staff will often ask similar questions, but for different purposes.

Wheatley stressed the importance of the board who together with the other senior managers are responsible for fully understanding the risks posed to building societies' members. He also highlighted that all firms, including banks and building societies, will be held to the same high standards.

RRPs

BoE's Tucker speaks on RRP

Paul Tucker, Deputy Governor of the BoE and leader of the FSB's RRP work programme, believes that banks have "nowhere to hide" in the post crisis era. They must take whatever steps are necessary in future to survive financial stresses without relying on government support.

In a [*speech*](#) at the Institute for Law and Finance Conference, Frankfurt, on 3 May 2012, Tucker said banks need two plans, one for recovery and one for resolution. The recovery plan would come into play when the bank begins to struggle to meet prudential norms. The resolution plan would be triggered when the bank no longer meets the criteria for being authorised, and has 'no reasonable prospect' of meeting the regulatory criteria again.

Tucker believes that RRP should reduce the direct hit to public finances, and they should also seek to contain system-wide contagion. Moreover, RRP should contribute to better managed firms, create stronger market discipline, improve risk management

practices and result in less stability-threatening imprudence.

Tucker thinks that financial institutions' intense focus on bail-ins is mistaken. All resolution tools place losses on to debt holders and creditors "because that is the only place they can go". The bail-in tool only differs from other tools because it applies losses up front and based on a valuation, rather than at the end when assets are liquidated. As such, he believes that bail-in "prospectively avoids an unnecessary destruction of value".

Asset management

See Cross sector announcements for this month's asset management news.



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Regulation

Consumer protection

OFT refers private motor insurance market to Competition Commission

The OFT announced that it was provisionally referring the motor insurance market to the Competition Commission for a market investigation in a [press release](#) on 31 May 2012. This step follows the OFT's announcement of its findings from its [report on private motor insurance](#). The report concludes that insurers compete in a dysfunctional way which the OFT believes may push up premiums for drivers by £225 million a year.

The market study was launched because the information gathered during the call for evidence gave the OFT reasonable grounds for suspecting that certain features of the market for private motor insurance in the UK are preventing, restricting or distorting competition. The evidence produced showed that private motor insurance premiums paid in the UK rose by around 12 per cent between 2009 and 2010, and by a further nine per cent in the first three quarters of 2011.

After a road traffic accident, the at-fault driver's insurer is responsible for meeting the cost of repairs and replacement vehicles for the not-at-fault driver. However, the OFT's study found evidence that insurers of at-fault drivers have little control over the way in which these repairs and vehicle replacement services are carried out or the associated costs.

Instead, the OFT believes that insurers of the not-at-fault driver and others, such as brokers, credit hire organisations and repairers, can take advantage of this lack of control as an opportunity to generate revenues through rebates and referral fees. This conduct inflates the costs of insurers of at-fault drivers. In the OFT's view this is an inefficient way for the sector to operate, raising the total costs for providing private motor insurance which all drivers end up paying.

The OFT is consulting on its decision to refer this market to the Competition Commission. The consultation closes on **6 July 2012**. The OFT expects to reach a final decision by October 2012.

Regulatory Reform

Identification of Global Systemically Important Insurers

The International Association of Insurance Supervisors (IAIS) released its proposed assessment [methodology](#) for consultation on 31 May 2012. The methodology seeks to identify global systemically important insurers, or G-SIIs. The FSB endorsed the consultation, which is coordinating measures designed to reduce the moral hazard posed by G-SIFIs. Supervisors, insurers and other interested parties are encouraged to submit comments on the proposed methodology by 31 July 2012.

The IAIS has proposed an indicator-based assessment methodology similar to the Basel Committee's approach to identifying global systemically important banks. But there are important differences reflecting particularities of the insurance business model. The IAIS' proposed assessment methodology involves three steps: the collection of data, an indicator-based assessment of the data, and a process of supervisory judgment and validation. The supervisory process specifies 18

indicators under five categories: size, global activity, interconnectedness, non-traditional insurance and non-insurance activities and substitutability. In developing the insurer-specific proposed methodology, the IAIS took account of its November 2011 report [Insurance and Financial Stability](#). This report concluded that there is little evidence that traditional insurance either generates or amplifies systemic risk within the financial system or in the real economy.

The IAIS plans to publish its proposed policy measures on G-SIIs for public comment later this year. The IAIS anticipates that its policy measures will generally follow the FSB's framework, which includes:

- more intensive and co-ordinated supervision of G-SIFIs
- strengthening the authorities' ability to resolve G-SIFIs in an orderly manner, without destabilising the financial system and exposing the taxpayer to the risk of loss
- higher loss absorbency for G-SIFIs to reflect the greater risks that these

institutions pose to the global financial system

- other prudential measures which will be contemplated by the IAIS.

Stakeholders expect the FSB to publish an initial list of G-SIIs in the first half of 2013.

Solvency II

Solvency II is a fundamental review of the prudential regulatory requirements for the European insurance industry. It will apply to all insurance firms with gross premium income exceeding €5m or gross technical provisions in excess of €25m. The proposed implementation date of Solvency II is 1 January 2014.

Omnibus II updates

The Omnibus II Directive will amend Solvency II to set the implementation date and to specify areas for further Solvency II legislation. It also incorporates new powers for EIOPA and makes a number of other technical amendments.

Following ECON's approval of the draft Omnibus II legislation on 21 March 2012, trialogue discussions have been taking place between the EC, ECON

and the Council. These discussions aim to iron out the differences between the EC's original proposals (published in January 2011), the Council's position (reached in September 2011) and ECON's position (as reflected in the most recent published *text* dated 28 March 2012). See our Hot Topic publication, '*Entering the final countdown towards Solvency II*' for a summary of the most relevant aspects of ECON's proposals and comparison with the Council's position.

After EU policymakers reach agreement, the EP will hold a plenary vote, *scheduled* on 10 September 2012, to finalise the Omnibus II Directive and this will set Solvency II's primary, or level 1, text. The plenary vote is the last stage required to pass Omnibus II, and its passage will enable regulators to begin the consultations required to develop the Solvency II supporting Level 2 and Level 3 legislation.

EC proposes directive amending Solvency II dates

Following its April announcement, the EC published a *proposal* for a Directive to amend the Solvency II Directive dates of transposition and application

and the date of repeal of certain Directives on 16 May 2012. This measure will delay the Solvency II's deadline for transposition into Member States' law until 30 June 2013. It also delays the effective date for companies until 1 January 2014. The EC had to separate these proposals from Omnibus II and bring them forward to ensure that the changes are made prior to Solvency II's original implementation date of 1 November 2012.

EIOPA updates Solvency II timeline

EIOPA has revised the Solvency II *timeline* on their website to reflect that they expect to have the legal powers to consult on standards and guidelines from late autumn 2012. Following consultation EIOPA plans to submit final standards to the EC and finalise its guidelines in the spring of 2013. EIOPA plans to consult on:

- internal models, solvency capital requirements, own funds, technical provisions, valuation of assets and liabilities
- group supervision

- supervisory transparency and accountability, reporting and disclosure
- governance, ORSA
- supervisory review process, capital add-ons, extension of recovery period ("Pillar 2 dampener"), finite reinsurance, special purpose vehicles, repackaged loan investments.

Meanwhile, EIOPA is engaging with its Insurance and Reinsurance Stakeholder Group to prepare draft guidelines and technical standards. EIOPA also aims to support supervisors and undertakings in specific areas. For example, to ease Solvency II capital supervision, EIOPA may introduce a proposal to allow supervisors to accept pre-applications for internal model during 2012.

EIOPA opines on external models and data for Solvency II capital requirements

EIOPA published an *opinion* on 7 May 2012 on the use of external models and data for the calculation of Solvency II capital requirements. The opinion was

addressed to supervisors and stated that:

- supervisors may request any additional information on external models/data, to assess the insurers' compliance with the Solvency II requirements
- supervisors should reject an insurer's internal model application if it uses an external model/data that fails to provide mandatory information for an appropriate assessment of its application
- an insurance company cannot use contractual conditions with its vendors of models/data to justify refusing to demonstrate that its external model/data fulfil the necessary requirements.

EIOPA's Bernadino speaks on role of loss adjusters

Gabriel Bernadino, EIOPA Chairman, delivered a speech on 11 May 2012 to the General Assembly of the European Federation of Loss Adjusting Experts. He discussed three main issues:

1. What is EIOPA?

2. How Solvency II can contribute to the improvement of risk management
3. The loss adjusting profession and its relevance for the insurance market and the overall society.

Bernardino concluded that the role of loss adjusters is key to the practical implementation of Solvency II requirements relating to risk management, particularly reserving.

EIOPA's Bernadino speaks on stability and consumer protection – the EIOPA view

In this speech to the Central Bank of Ireland Stakeholder Conference on 27 April 2012, Gabriel Bernadino, EIOPA Chairman, considered the future of financial regulation with a particular emphasis on insurance (Solvency II) and pension stability (the proposed revision of the IORP Directive) and consumer protection.

Industry concerned over Solvency II reporting requirements

Following its consideration of EIOPA's proposals for public and private reporting under Solvency II, Insurance Europe has published a position paper

on the Solvency II reporting package. This paper highlights areas of industry concern over the content, frequency and deadlines of the proposed reporting requirements.

FSA's Adams speaks on Solvency II and the London Market

The FSA continues to encourage firms to prepare for the existing Solvency II implementation deadlines. In a speech to the Insurance Day Summit on 15 May 2012, Julian Adams, FSA Director of Insurance, discussed the model approval process and the FSA's views on the internal model review.

Adams confirmed that the internal model pre application process was coming to an end and that FSA intends to receive the first model approval applications imminently. These will only be draft applications, because the FSA will not have the legal powers to grant internal model approvals until at least mid 2013. However, the FSA are keen to have the submission phase shadow the final application process as much as possible. This approach aims to minimise the work required during the formal application process, but ultimately the work involved in

preparing and reviewing final applications will depend on how significantly the final policies differ from current proposals.

He also spoke about weaknesses identified in the internal model review:

- *Setting methodology, assumptions and materiality.* This looks at weaknesses including setting the same assumptions across different scenarios or including too much complexity in a model.
- *Model scope.* Firms failed to identify all material sources of risk to the business
- *Documenting materiality.* Firms were not able to clearly demonstrate how they made choices based on materiality and how judgements based on materiality were linked to the level of complexity used in the model.
- *Aggregation and dependency assumptions.* Firms were not able to adequately explain, validate and carry out sensitivity testing on the choices and assumptions they made in relation to diversification of risk;

Insurers' work on diversification was not as advanced as expected.

- *Validation and validation policies.* The FSA expected firms to better articulate and make decisions on validation materiality thresholds. In some cases policies were too vague to provide assurance and the governance processes were not challenging enough. The governance around model validation should be robust, rather than a box-ticking exercise.
- *Use-test.* Some firms were not able to demonstrate that their models were fully embedded within their businesses. The FSA expects to see evidence of this in the application process.
- *Emerging catastrophe risks.* The FSA believes that the increasing importance of emerging markets will change the nature of catastrophe exposure. As a consequence, firms need to keep un-modelled catastrophe risk under review. Insurers must also continue to monitor current catastrophe models, to ensure they capture new risks and/or territories.

For further information on these findings see the FSA's *letter to firms* dated 14 May 2012, detailing themes from the FSA's review and is assessment work with firms in developing the internal model approval process. The FSA hopes this guidance will help firms to make a satisfactory submission during their allocated submission slots, although the guidance does not supersede instruction that the FSA has already given to individual firms.

FSA's Gvero speaks on capital issues

The ABI hosted two Solvency II implementation seminars on 25 May 2012. Slavko Gvero, FSA Solvency II Implementation Manager, presented the following sessions:

- *'Implementation challenges for standard formula firms'.* He emphasised the choice firms take to use the standard formula to reflect their risk profile and urged firms to maintain progress on implementation, updating any assumptions as and when more information became available.
- *'Implementation challenges for internal model firms'.* Gvero

confirmed the need for firms to maintain momentum in their Solvency II preparations. He set out the process for firms using internal models in the run-up to implementation.

Where to go for more information

PwC's Solvency II UK web pages are available at www.pwc.co.uk/solvencyII.

Accounting²

IFRS

IASB insurance contracts project

The IASB is working alongside the FASB to develop a harmonised IFRS for insurance contracts. For background information on this project please see our *webpage*. A review draft, or revised exposure draft (ED), is timetabled for

² This section includes accounting developments with a direct or potential on the financial services industry only. For a complete update on accounting developments in the UK visit http://www.pwc.co.uk/eng/services/ifrs_services.html

the second half of 2012. In their *joint note* on accounting convergence, the Board indicated that on the basis of their current plan the final insurance contract standard could be issued in 2013. The final standard is not expected to be effective before 1 January 2015.

In May the IASB updated their high level summary of the *current status* of the project, their *summary* of how tentative decisions of the IASB are reflected in the ED and their *presentation* on IASB and FASB's tentative decisions, showing where those decisions would affect the proposals in the ED.

At their board meetings of 22-24 May 2012 the IASB and BASB boards held education sessions to discuss a number of topics, including:

- unbundling and disaggregation
- use of other comprehensive income for discount rate liability changes
- acquisition cost presentation
- IASB risk adjustment and residual margin.

See PwC *observer notes* for details of the decisions reached, including:

- requirements to unbundle and distinct investment components
- requirements to use Other Comprehensive Income (OCI) for reporting changes in the insurance liability arising from changes in the discount rate
- the IASB's requirement that deferred acquisition costs must be netted against the insurance contract liability (the FASB would only accept netting against the margin component of the liability)
- IASB's reaffirmation of its previous decision to include an updated explicit risk adjustment, with changes in risk adjustment taken through profit and loss.

The next Insurance Working Group meeting will be held in London on 25-26 June 2012 (see [Agenda](#)).

IASB/FASB re-deliberate lease treatment

The IASB and FASB met in May to discuss the results of recent consultations with users, preparers and auditors on how a lessee should measure a right-of-use asset arising under a lease. See our [Straight Away](#)

publication for the key points from this meeting.

IASB publishes 'annual improvements' to six standards for 2013 year ends

See our [Straight Away](#) publication for details of the more significant changes to standards arising from the 2009 to 2011 annual improvements project, and their implications for management.

IASB publishes proposed amendments to 11 IFRS under annual improvements project 2012

The IASB published its *exposure draft* containing proposed amendments to 11 IFRSs under its annual improvements project. The proposed amendments reflect issues discussed by the IASB in the project cycle that began in 2010.

The IASB proposes that these amendments take effect in the annual accounting periods beginning on or after 1 January 2014, with the exception of the amendment to IFRS 3, 'Business combinations', and the proposed consequential amendment to IFRS 9 'Financial instruments'. These changes are effective for annual periods beginning on or after 1 January 2015, but early adoption is permitted for all the proposed amendments.

The comment period closes on **5 September 2012**. See our [Straight Away](#) publication for more detail.

Following the publication of these proposed amendments, we have added a section on the improvements project to our [Practical guide to new IFRSs for 2012 year ends](#) (first issued on 26 March 2012). This is a guide to the new IFRS standards and interpretations that come into effect for 2012 year ends.

Accounting briefing - May 2012

Our Accounting briefing newsletter provides you with a quarterly technical update, focusing on the practical implications of recent developments and topical issues in UK GAAP and IFRS.

The [May 2012 issue](#) looks at:

- pensions: auto-enrolment only months away
- budget changes to corporation tax
- audit exemption – are you affected?
- restructuring at the FRC.

IFRS news

IFRS news is our monthly newsletter highlighting developments at the IASB. Articles in [IFRS news – May 2012](#) include:

- second exposure draft on revenue recognition
- new IFRSs applicable for 2012 year-ends
- IFRS quiz: test your knowledge of embedded derivatives and hedge accounting.

Monthly calendar

Open consultations

Closing date for responses	Paper	Institution
11/06/2012	<u><i>Automatic enrolment: career average schemes as qualifying schemes</i></u>	DWP
12/06/2012	<u><i>Commission services working document: Consultation on bank accounts</i></u>	EC
15/06/2012	<u><i>Assessment methodology for the principles for FMI's and the responsibilities of authorities</i></u>	IOSCO
15/06/2012	<u><i>Disclosure framework for financial market infrastructures</i></u>	IOSCO
15/06/2012	<u><i>Green Paper on Shadow Banking</i></u>	EC
15/06/12	<u><i>Discussion paper on recovery plans template</i></u>	EBA
20/06/2012	<u><i>Recommendations for the security of internet payments</i></u>	ECB
24/06/12	<u><i>ESMA call for evidence on transaction reporting</i></u>	ESMA
25/06/2012	<u><i>Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options</i></u>	ESMA
27/06/2012	<u><i>Principles for the Regulation of Exchange Traded Funds: Consultation Report</i></u>	IOSCO

Closing date for responses	Paper	Institution
29/06/12	<u><i>CP12/10: Product projections, transfer value analysis and Statutory Money Purchase Illustrations</i></u>	FSA
03/07/12	<u><i>Review of absolute return sector</i></u>	IMA
09/07/12	<u><i>Consultation on internal controls at credit rating agencies</i></u>	IOSCO
13/07/2012	<u><i>Revisions to the UK Corporate Governance Code and guidance on audit committees</i></u>	FRC
18/07/12	<u><i>Consultation Paper on draft Guidelines for assessing the suitability of members of the management body and key function holders</i></u>	EBA
31/07/2012	<u><i>Arch cru funds –redress for mis-selling (CP 12/9)</i></u>	FSA
02/08/2012	<u><i>Principles of Liquidity Risk Management for Collective Investment Schemes</i></u>	IOSCO
13/08/12	<u><i>Consultation on response to call for evidence on the review of FICOD</i></u>	ESAs
17/08/12	<u><i>Consultation on future regulation of authorised professional firms</i></u>	SRA
20/08/12	<u><i>Consultation on the taxation of unauthorised unit trusts</i></u>	HMRC
07/09/12	<u><i>Basel Committee on Banking Supervision fundamental review of trading book</i></u>	BCBS

Forthcoming publications in 2012

Date	Topic	Type	Institution
Accounting			
Q2 2012	Insurance Contracts Standard – re-exposure / review draft	Consultation paper	IASB
Banking Structure			
Q3 2012	Report from the high-level expert group examining the structural aspects of the EU banking sector	Discussion paper	EC
Q4 2012	Large exposures regime		
Capital and Liquidity			
Q2 2012	EBA Capital Requirements Directive Common Reporting Application	Consultation paper	FSA
Q2-Q4 2012	Capital Requirements Directive IV	76 regulatory technical standards, 32 implementing technical standards and 20 guidelines	EBA
Consumer protection			
Q3 2012	Directive on misleading and comparative advertising (2006/114/EC)	Communication	
Q3 2012	Mortgage Market Review: Proposed package of reforms	Policy statement	FSA
Q3 2012	Packaged bank accounts: New ICOBS rules for the sale of non-investment insurance contracts	Policy statement	FSA
Q4 2012	Bank accounts	Legislative proposals	EC
Q4 2012	FSCS funding model review	Consultation paper	FSA

Date	Topic	Type	Institution
<i>Financial crime, security and market abuse</i>			
Q3 2012	European terrorist finance tracking system	Legislative proposals	EC
Q3 2012	Financial message data transfer from the EU to the USA for the purposes of the Terrorist Finance Tracking Program	Report	EC
Q4 2012	Market Abuse Review	Technical advice	ESMA
Q4 2012	An EU framework for collective redress	Legislative proposals	EC
Q4 2012	Securities Law Directive	Legislative proposals	EC
Q4 2012	Review of Financial Conglomerates Directive	Legislative proposals	EC
TBC 2013	Revision of Financial Conglomerates Directive (FICOD II)	Legislative proposals	EC
TBC 2012	Third Anti-Money Laundering Directive	Legislative proposals	EC
<i>Insurance</i>			
Q3 2012	Revision of the Insurance Mediation Directive (2002/92/EC) (IMD)	Legislative proposals	EC
Q3 2012	Institutions for Occupational Retirement Provision	Legislative proposals	EC
Q4 2012	Tracing employers liability insurers	Consultation paper	FSA
<i>Market Infrastructure</i>			
Q2 2012	Delegated Regulation amending the Prospectus Regulation (Regulation 809/2004)	Consultation	EC
Q2 2012	Regulating bidding for Emissions Allowances	Policy statement	FSA

Date	Topic	Type	Institution
Q2 2012	OTC Derivatives, CCP Requirements, Trade Repositories and CCP Interoperability (EMIR)	Technical standards	ESMA
Q2 2012	OTC Derivatives, CCP Requirements, Trade Repositories and CCP Interoperability (EMIR)	Technical advice	ESMA
Q3 2012	OTC Derivatives, CCP Requirements, Trade Repositories and CCP Interoperability (EMIR)	Guidelines	ESMA
Q4 2012	Limitation period and further procedures for fining credit rating agencies	Regulation	EC
Q4 2012	Credit Rating Agencies III Regulation	Technical advice	ESMA
Q4 2012	Revision of the Transparency Directive	Discussion papers	ESMA
TBC 2012	Investor Guarantee schemes- revision	Legislative proposals	EC
TBC 2012	Close-out netting	Legislative proposals	EC
Products and investments			
Q2 2012	Alternative Investment Fund Managers Directive – remuneration standards	Technical standards	ESMA
Q3 2012	Packaged Retail Investment Products	Legislative proposals	EC
Q3 2012	Undertakings For The Collective Investment Of Transferable Securities V	Legislative proposals	ESMA
Q4 2012	Implementation of Alternative Investment Fund Managers Directive	Consultation paper	FSA
Q4 2012	Non-mainstream investments	Consultation paper	FSA

Date	Topic	Type	Institution
Q4 2012	Consumer redress scheme for Arch cru funds	Policy statement	FSA
Q4 2012	Alternative Investment Fund Managers Directive – cooperation agreements	Technical standards	ESMA
Q4 2012	Markets in Financial Instruments Directive II	Technical advice	ESMA
Q4 2012	Markets in Financial Instruments Directive II	Guidelines	ESMA
Q4 2012	Markets in Financial Instruments Directive I-financial consumer protection	Guidelines	ESMA
Q4 2012	Markets in Financial Instruments Directive I- supervisory convergence	Guidelines	ESMA
Q4 2012	Packaged Retail Investment Products	Technical standards	ESMA
Q4 2012	Prospectus Directive	Technical advice	ESMA
Q4 2012	Social Investment Funds	Technical advice	ESMA
Q4 2012	Venture Capital	Technical advice	ESMA
Q4 2012	Undertakings For The Collective Investment Of Transferable Securities V	Technical advice	ESMA
<i>Recovery and Resolution</i>			
Q3 2012	EU framework for recovery and resolution plans	Technical advice	EBA
Q3 2012	Recovery and resolution plans	Policy statement	FSA
Q4 2012	Rescue and restructuring of financial institutions in Europe	Guidelines	EC

Date	Topic	Type	Institution
<i>RDR</i>			
Q2 2012	Accredited Bodies	Feedback statement	FSA
Q2 2012	Changes to Training and Competence Sourcebook	Feedback statement	FSA
<i>Solvency II</i>			
Q2 2012	Draft Level 2 delegated acts	Level 2 text	EC
Q2 2012	Transposition of Solvency II- Part 1	Feedback statement	FSA
Q2 2012	Solvency II and linked long-term insurance business	Policy statement	FSA
Q4 2012	Solvency Level 3 measures finalised	Level 3 text	EC
<i>Supervision, governance and reporting</i>			
Q2 2012	Remuneration- EBA Data Collection	Consultation paper	FSA
Q3 2012	Corporate reporting	Guidelines/ recommendations	ESMA
Q4 2012	EU corporate governance and company law	Action plan	EC
Q4 2012	Storage of regulated information at ESMA	Discussion paper	ESMA
Q4 2012	Supervisory convergence	Discussion paper	ESMA
Q4 2012	Revision of Enforcement Standards	Consultation paper	ESMA
Q4 2012	Corporate Governance (proxy advisors, empty voting)	Discussion paper(s)	ESMA
Q4 2012	Remuneration and supervisory co-operation arrangements	Guidelines/ recommendations	ESMA

Main sources: ESMA 2012 work programme; EIOPA 2012 work programme; EBA 2012 work programme; EC 2012 work programme; FSA policy development update (Issue 147)

Education – Conferences and event (June and July)

Date	Topic	Institution
14/06/12	Data protection and privacy conference	BBA
14/06/12	FCA update briefing	FSA
15/06/12	Introduction to derivatives	BBA
19/06/12	MiFID II and AIFMD interactions	BBA
20/06/12	Summer lecture	BBA
25/-6/12	Introduction to operational risk	BBA
28/06/12	Financial Conglomerates Directive conference	EC
29/06/12	Introduction to bribery and corruption	BBA
02/07/12	Enforcement conference	FSA
03/07/12	Annual Public Meeting	FSA

PwC insights

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Solvency II: Pillar 2 - Challenging your risk culture

Pillar 2 requires companies to place risk management at the heart of their business models. Are you ready for the new framework for risk management?

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Cross Financial Services

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Summary of the European and UK regulations that financial services firms are facing in respect of their remuneration and reward arrangements

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Glossary

ABI	Association of British Insurers
AIFMD	Alternative Investment Fund Managers Directive
AIMA	Alternative Investment Management Association
AMICE	Association of Mutual Insurers and Insurance Cooperatives
ASB	UK Accounting Standards Board
Basel Committee	Basel Committee of Banking Supervisors
BBA	British Bankers' Association
BIBA	British Insurance Brokers Association
BIS	Bank of International Settlements
BoE	Bank of England
CCPs	central counterparties
CEA	European Insurance and Reinsurance Federation
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CFPB	Consumer Financial Protection Bureau
CFTC	Commodities Futures Trading Commission
CIS	collective investment schemes
Consumer Panel	Financial Services Consumer Panel
Council	European Council of Ministers

CPI	Consumer Price Index
CRAs	credit rating agencies
CRD	Capital Requirements Directive 2006/48/EC
DG MARKT	Internal Market and Services Directorate General
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
D-SIBs	domestic systematically important banks
EBA	European Banking Authority
EC	European Commission
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council of the EU
ECON	European Parliament Committee on Economic and Monetary Affairs
EEA	European Economic Area
EFAMA	European Fund and Investment Management Association
EIOPA	European Insurance and Occupations Pension Authority
EP	European Parliament
EMIR	European Market Infrastructure Regulation COM(2010) 484 final
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority

ESRB	European Systemic Risk Board
FASB	US Financial Accounting Standards Board
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FICOD	Financial Conglomerates Directive 2002/87/EC
FOS	Financial Ombudsman Service
FPC	Financial Policy Committee
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FMI	financial market infrastructure
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
G30	Group of 30
GAAP	Generally Accepted Accounting Principles
G-SIFIs	globally systemically important financial institutions
G-SIIs	globally systemically important insurers
HMRC	Her Majesty's Revenue & Customs
HMT	Her Majesty's Treasury
IASB	International Accounting Standards Board
ICB	Independent Commission on Banking

IFRS	International Financial Reporting Standards
IMA	Investment Management Association
IMD	Insurance Mediation Directive (2002/92/EC)
IMF	International Monetary Fund
IORP	Institutions for Occupational Retirement Provision Directive 2003/43/EC
IOSCO	International Organisations of Securities Commissions
ISDA	International Swaps and Derivatives Association
JMLSG	Joint Money Laundering Steering Committee
MAD	Market Abuse Directive 2003/6/EC
Member States	countries which are members of the European Union
MiFID	Markets in Financial Instruments Directive 2004/39/EC
MiFIR	Markets in Financial Instruments Regulation COM(2011) 652 final
MLD	Money Laundering Directive 2005/60/EC
MoJ	Ministry of Justice
Official Journal	Official Journal of the European Union
Omnibus II	EC proposed Directive 2011/0006 (COD) amending Solvency II
OTC	over-the-counter
PRA	Prudential Regulation Authority
PRIPS	Packed Retail Investment Products
RAO	Financial Services and Markets Act 2000 (Regulated Activities Order) 2001
RDR	Retail Distribution Review

RRPs	recovery and resolution plans
RTS	regulatory technical standards
SCR	solvency capital requirement
SEC	Securities and Exchange Commission
SOCA	Serious Organised Crime Agency
Solvency II	Taking up Pursuit of Business of Insurance and Reinsurance Directive 2009/138/EC
TR	trade repository
TSC	Treasury Select Committee
UCITS	Undertakings for Collective Investments in Transferable Securities
US	United States of America

Contacts

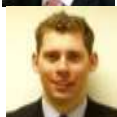


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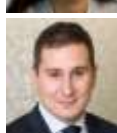
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