WELCOME TO CAPCO'S

REGULATORY MONITORING NEWSLETTER

2018 1ST ISSUE

CAPCO

SECTION 1: INTRODUCTORY NOTE

Capco continuously monitors the scope of regulations, preparing newsletters on major regulatory developments in the financial industry and developing technical notes on specific rules.

Implementation of complex changes over extended timescales is forcing businesses to change the way they operate while pressure from the market and the competition is already driving change.

The Capco Regulatory Monitoring Newsletter compiles regulatory developments and anticipates major changes in regulations and provides insights of new rules put forward by global, regional and national policy setting bodies.

Capco established the Regulatory Monitoring Newsletter to translate policy, legislative and regulatory developments into actionable intelligence for our clients to manage strategy, business models and operating procedures – at the same time addressing fundamental issues around profitability and future plans.

This Newsletter contains references to the most important regulatory changes; forthcoming publications, providing details of documents and summarizes relevant publications.

For regulations that have the biggest impact, we issue technical notes that seek to synthesize these regulations, put them into context and explain some of their potential impacts.

NON-PERFORMING LOANS (NPLS) FRAMEWORK

Although NPLs have started to decline, several banks in Member States across the Euro area are still experiencing high levels, which ultimately have a negative impact on bank lending to the economy. That being said, in July of 2017, the European Council derived an Action Plan to tackle NPLs in Europe to assist in preventing the emergence and accumulation of new NPEs on banks' balance sheets.

According to this Action Plan, the European Central Bank (ECB) published Final Guidance to banks on NPLs with the goal of developing a consistent supervisory approach (supervisory expectations) regarding the identification, measurement, management, and write-off of NPLs in March 2017.

Further, in March 2018 several documents were published regarding NPLs. The ECB then published the final Addendum to the ECB Guidance to banks on NPLs, specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for Non-Performing Exposures (NPEs). The European Banking Authority (EBA) published a Consultation Paper (CP) with Guidelines (GL) on the management of NPEs and FBEs which specifies, among others, sound risk management practices for managing NPE and Forborne Exposures (FBE). The European Commission (EC) then published a proposal for a regulation to amend the CRR as regards minimum loss coverage for NPEs. This aims to ensure banks set aside sufficient funds to mitigate the risks associated with future loans could potentially become NPLs.

The content of the NPL framework includes references to the ECB Guidance to banks on NPLs and Addendum to the ECB Guidance on NPL, the EBA CP on GL on management of NPE and FBE, and the EC Proposal for a Regulation on amending the CRR about minimum loss coverage for NPEs.

SUMMARY

The ECB Guidance on NPLs and the EBA CP GL on NPE and FBE cover recommendations on NPLs. Further, the ECB Addendum provides information about the prudential provisioning expectations, whereas the EC Proposal aims at ensuring sufficient loss coverage.

AREA OF APPLICATION

The ECB Guidance and the Addendum on NPLs are addressed to significant institutions, the EBA CP GL on NPE and forbearance is addressed to all credit institutions, and the EC Proposal applies to all CRR institutions.

MAIN CONTENT

ECB Guidance on NPL vs EBA CP GL on NPE and forbearance.

This guidance covers:

- NPL strategy (e.g. assessing the operating environment, developing the NPL strategy, and implementing the operational plan).
- Governance and operations (e.g. steering and decision-making, NPL operating model, and control framework).
- Forbearance (e.g. forbearance options and viability).
- NPL recognition (e.g. application of NPE definition, and link between NPE and forbearance).
- NPL impairment measurement (e.g. individual and collective estimation of provisions, and other aspects of impairment).
- Collateral valuation for immovable and movable property (e.g. governance, procedures and controls).
- Supervisory reporting and evaluation of management of NPLs.

The ECB Addendum to the ECB Guidance on NPL sets out definitions to be considered, such as new NPEs, NPE vintage, eligible credit protection to secure exposures, etc. Further, it also provides information on prudential provisioning expectations (e.g. minimum level).

The EC Proposal for a Regulation on amending the CRR about minimum loss coverage for NPE introduces amendments to the CRR regarding the definition of NPE, forbearance measures, the deduction of NPEs, the introduction of a principle of prudential backstop, etc.

SUPERVISORY EXPECTATIONS AND DRAFT GUIDES TO THE ICAAP AND ILAAP

The CRD IV requires institutions to have in place an internal capital adequacy assessment process (ICAAP); and an internal liquidity adequacy assessment process (ILAAP). These processes are key risk management instruments for institutions, and competent authorities (CAs) review them as part of the Supervisory Review and Evaluation Process (SREP).

In the EU, the ECB assumed responsibility for the supervision of significant institutions (SIs) within the Single Supervisory Mechanism (SSM) from November 2014 onwards. Thus, the ECB is responsible for carrying out the SREP with respect to these institutions.

In November 2016, the EBA published the Final Guidelines (GL) intended to ensure convergence of supervisory practices in the assessment of ICAAP and ILAAP as required by the SREP. In January 2016, the ECB published its expectations on ICAAP and ILAAP, together with a description of what ICAAP and ILAAP-related information institutions should submit; and in March 2018 the ECB launched a public consultation on its Draft Guide to the ICAAP and on its Draft Guide to the ILAAP.

SUMMARY

In November 2016, Final Guidelines on ICAAP and ILAAP information that supervisors should collect for SREP purposes. Further, In March 2018, the ECB published Draft Guides to the ICAAP and to the ILAAP for SIs according to the SSM framework.

AREA OF APPLICATION

The EBA GL on ICAAP and ILAAP information are applicable to credit institutions and investment firms as defined in the CRR / CRD IV, whereas the ECB supervisory expectations and Draft Guides to the ICAAP and ILAAP are applicable to significant institutions within the SSM, as defined in the Guide to the banking supervision.

MAIN CONTENT

EBA GL on ICAAP and ILAAP general information:

The GL contains general considerations related to operational procedures, the proportionality principle, additional information and cross-border banking groups. A ‘reader’s manual’ shall be included providing an overview of the documents submitted to the CAs and their status.

- Information common to ICAAP and ILAAP (e.g. business model and strategy, risk governance and management framework or risk appetite framework).
- ICAAP-specific information (e.g. overall ICAAP framework, risk measurement, assessment and aggregation, capital planning or stress testing in ICAAP).
- ILAAP-specific information (e.g. liquidity and funding risk management, funding strategy, strategy on liquidity buffers or cost benefit allocation mechanism).
- Conclusions and QA (i.e. conclusions of the ICAAP and ILAAP and their impact on the risk and overall management, quality assurance and internal audit reports).

ECB SUPERVISORY EXPECTATIONS:

The ECB supervisory expectations include: harmonized collection of information (e.g. specifications on dates, format and content), supervisory expectations on ICAAP (e.g. governance, definition of internal capital, assumptions and key parameters, or stress tenting), and supervisory expectations on ILAAP (e.g. general definition of the ILAAP).

ECB Draft Guides to the ICAAP and to the ILAAP: these Draft Guides set out seven principles on ICAAP and seven principles on ILAAP (e.g. governance, management framework, continuity of the institution, or material risks).

Capco compiles new regulations published in recent weeks by different regulatory and supervisory authorities with a focus on the financial industry.

RELEVANT PUBLICATIONS

MARKET RISK

BCBS – Consultative document on revisions to the minimum capital requirements for market risk (23 March 2018)

The Basel Committee on Banking Supervision (BCBS) has published a Consultative document on revisions to the minimum capital requirements for market risk. This aims at addressing those issues that have been identified while monitoring the implementation and impact of the standard published in 2016. Amendments are proposed to the following sections: i) standardized approach, ii) internal models approach, iii) scope of market risk capital requirements; and iv) simplified alternative to the standardized approach.

PILLAR 3

BCBS – Technical Amendment on Pillar 3 disclosure requirements: regulatory treatment of accounting provisions (22 March 2018)

The BCBS has issued a Technical Amendment on Pillar 3 disclosure requirement to provide users with disclosures that fully reflect any transitional effects for the impact of expected credit loss (ECL) accounting on regulatory capital. Additionally, it provides further information on the allocation of accounting provisions in the regulatory categories of general provisions and specific provisions for standardized exposures during the interim period. This document introduces amendments to two templates (KM2 and CR1) and one table (CRB) of the Pillar 3 standard.

CREDIT RISK MITIGATION

EBA – Report on CRM framework (19 March 2018)

The EBA has published a Report on credit risk mitigation framework (CRM), which assesses the current framework as part of its work on the review of the IRB approach. This Report clarifies the application to the different credit risk approaches of the provisions currently laid down in the CRR regarding CRM. Further, this document provides a quantitative overview of the institutions' use of the CRM framework, as well as a series of policy proposals for the consideration of the European Commission, with a view to ensuring a proper and harmonized application of the current CRR and CRM framework provisions.

FINTECH

EBA – Roadmap on FinTech / Q&A on FinTech Roadmap (16 March 2018)

The EBA has published a Roadmap on FinTech setting out its priorities for 2018/2019 as well as the establishment of a FinTech Knowledge Hub to enhance knowledge sharing and foster technological neutrality in regulatory and supervisory approaches. These priorities focused on: i) authorization and regulatory perimeter issues relating to FinTech; ii) impact on incumbent institutions' business models and prudential risks and opportunities arising from the use of FinTech; iii) cybersecurity; iv) consumer protection; and v) anti-money laundering and countering the financing terrorism (AML/CTF).

BIG DATA

ESAs – Final Report on Big Data / Big Data Factsheet (15 March 2018)

The European Supervisory Authorities (ESAs) have published a Final Report on Big Data analyzing its impact on consumers and financial firms. Overall, the ESAs have found that while the development of Big Data poses some potential risks to financial services consumers, the benefits of this innovation currently outweigh these. This Report shows that Big Data is related to, among others, more tailored products and services, improvements on fraud analytics, or the efficiency of organizational internal procedures.

RELEVANT PUBLICATIONS CONTINUED

NON-PERFORMING LOAN (NPL)

ECB – Addendum to the ECB Guidance to banks on non-performing loans (15 March 2018)

The ECB has published the final Addendum to the ECB Guidance to banks on NPLs, specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for non-performing exposures (NPEs). This Addendum aims at avoiding an excessive build-up of non-covered aged NPEs on banks' balance sheets in the future, which would require supervisory measures.

NON-PERFORMING LOAN (NPL) / ASSET MANAGEMENT COMPANY (AMC) / RECOVERY OF COLLATERAL

The European Commission (EC) – Proposal for a Regulation on amending the CRR about minimum loss coverage for non-performing exposures / Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral / Blueprint on the set-up of national asset management companies (AMCs) / Second progress report on the reduction of non-performing loans (NPLs) (14 March 2018)

The European Commission (EC) has published a comprehensive package of measures to tackle NPLs in Europe. In particular, this package sets out a comprehensive approach with a mix of complementary policy actions focused on: i) ensuring banks set aside funds to cover the risks associated with loans issued in the future that may become non-performing; ii) facilitating debt recovery; iii) encouraging the development of secondary markets where banks can sell their NPLs to credit servicers and investors; and iv) assisting Member States in the restructuring of banks, by providing non-binding guidance (i.e. a blueprint) for establishing Asset Management Companies (AMCs) or other measures dealing with NPLs.

COMPENSATION PRACTICES

FSB – Supplementary Guidance to the Principles and Standards on Sound Compensation Practices (12 March 2018)

The FSB has now published the Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices that provides firms and supervisors with a framework to consider how compensation practices and tools can be used to reduce misconduct risk and address misconduct incidents. This document sets out 8 recommendations on better practice regarding the following aspects: i) governance of compensation and misconduct risk; ii) effective alignment of compensation with misconduct risk; and iii) supervision of compensation and misconduct risk.

NON-PERFORMING EXPOSURES (NPE) AND FORBEARANCE EXPOSURES (FBE)

EBA – Consultation Paper on Draft Guidelines on management of non-performing and forborne exposures (09 March 2018)

The EBA has now published a Consultation Paper (CP) on Guidelines (GL) on management of NPEs and forborne exposures (FBE). These guidelines specify sound risk management practices for credit institutions for managing NPE and FBE; set out requirements on processes to recognize NPEs and FBEs, as well as a forbearance granting process with a focus on the viability of forbearance measures; establish requirements for competent authorities' (CA) assessment of credit institutions' NPE management activity as part of the SREP; and ask for views on the threshold for assessing high NPE banks whose NPL ratio is 5% or above.

MONITORING REPORT

BCBS/EBA – Basel III Monitoring Report / CRD IV – CRR Monitoring exercise (06 March 2018)

The BCBS has published the results of its latest Basel III monitoring report. In parallel with this report, the EBA has conducted its thirteenth report of the CRD IV - CRR / Basel III monitoring exercise on the European banking system. These exercises allow gathering aggregate data on capital, leverage ratio (LR), liquidity coverage ratio (LCR) and net stable funding ratio (NSFR).

RELEVANT PUBLICATIONS CONTINUED

FUNDS TRANSFER IN USA

Fed – Proposed Rule on Regulation J on collection of checks and other items by federal reserve banks ad funds transfers through Fedwire (06 March 2018)

The Fed has published a proposed rule on amendments to Regulation J on collection of checks and other items by Federal Reserve banks ad funds transfers through Fedwire, with the aim at simplifying it and making it conform more closely with Regulation CC on availability of funds and collection of checks. This proposal rule removes obsolete provisions, and improves consistency between Regulation J and Regulation CC, among other aspects.

ICAAP AND ILAAP

ECB – Draft Guide to the internal capital adequacy assessment process (ICAAP) / Draft Guide to the internal liquidity adequacy assessment process (ILAAP) / FAQ (05 March 2018)

The ECB has launched a public consultation on its Draft Guide to the ICAAP and on its Draft Guide to the ILAAP with the aim at developing a more detailed set of supervisory expectations regarding these two processes. These Draft Guides include seven principles for the ICAAP and seven principles for the ILAAP, which are defined in parallel considering each risk's specifications, regarding several aspects such as internal governance, management, continuity of the institutions, and material risks. These Draft Guides are relevant for any credit institution which is a significant supervised entity according to the SSM Framework Regulation.

SOLVENCY II

European Insurance and Occupational Pensions Authority (EIOPA) – Second and final set of advice to the European Commission on specific items in the Solvency II Delegated Regulation / Annex to section 6: Natural catastrophe risks - Zonal Calibration / Frequently Asked Questions (FAQs) (01 March 2018)

The EIOPA has published the second and final set of advice to the European Commission on specific items in the Solvency II Delegated Regulation. This advice covers, among other aspects, the recalibration of standard parameters of premium and reserve risks, volume measure for premium risk, recalibration of mortality and longevity risks, man-made catastrophe risk, natural catastrophe risk, interest rate risk, market risk concentration, unrated debt, unlisted equity, simplification of the look-through approach, risk margin, and capital instruments only eligible as tier 1 up to 20% of total tier 1.

DATA POINT MODEL (DPM)

EBA – New DPM data dictionary tools (01 March 2018)

The EBA has established the tools to access its data point model (DPM), which compiles the harmonized data requirements included in its technical standards and guidelines. The role of this data dictionary is to enable the harmonization of the banking regulatory framework by providing a clear interpretation of data exchange requirements. The data dictionary also includes a query tool, a navigation tool, a table with data categorization and a database.

EUROPEAN MARKETS INFRASTRUCTURE REGULATION (EMIR)

ESMA – Validation Rules regarding the European Markets Infrastructure Regulation (EMIR) (01 March 2018)

The ESMA has updated its validation rules regarding the European Markets Infrastructure Regulation (EMIR), for the reports submitted under the revised technical standards. This update allows for the reporting of exchange-traded derivatives in products for which the effective date may be earlier than the date of execution and clarifies how the identification of the product should be validated in the reports submitted on or after 3 January 2018.

RELEVANT PUBLICATIONS CONTINUED

DISCLOSURE

BCBS – Consultative document on Pillar 3 disclosure requirements – updated framework (27 February 2018)

The BCBS has issued a Consultative document on Pillar 3 disclosure requirements that sets out proposals from the third phase of the Pillar 3 review. These proposals include new or revised requirements arising from the Basel III reform as well as new disclosure requirements on asset encumbrance and on capital distribution constraints (CDC).

CREDIT CARDS

FCA – Policy Statement 18/4. Credit card market study: persistent debt and earlier intervention (27 February 2018)

The Financial Conduct Authority (FCA) has published the Policy Statement (PS) 18/4 that responds to the feedback received to Consultative Paper (CP) 17/43 on credit card market study. This PS includes final measures to address persistent credit card debt and to require credit card firms to use the data available to them to identify customers at risk of financial difficulties.

CORRESPONDENT BANKING

FSB – Correspondent Banking Data Report – Update (06 February 2018)

The FSB has published a Report with updated information on correspondent banking using data provided by SWIFT to address the decline in correspondent banking relationships. The Report shows the effects of this decline in terms of its impact on, the volume and value of payments, the length of payments chains, concentration in correspondent banking.

OTHER PUBLICATIONS OF INTEREST

EXPOSURES TO CENTRAL GOVERNMENTS

EBA – List of EU regional governments and local authorities treated as exposures to central governments (22 March 2018)

The EBA has published an updated list of regional governments and local authorities that, in accordance with the CRR, may be treated as central governments for the calculation of capital requirements. Compared to the last published version, the list includes changes to the regional governments and local authorities in Finland.

ECONOMIC BULLETIN

ECB – Economic Bulletin, Issue 2/2018 (22 March 2018)

The ECB has published the Economic Bulletin 2/2018 which provides a comprehensive analysis of the economic and monetary developments, including an evaluation of macroeconomic projections by Euro-system experts. This document covers the following aspects: i) external environment, ii) financial developments, iii) economic activity, iv) prices and costs, v) money and credit, and vi) fiscal developments.

SOLVENCY II

EIOPA – Solvency II tools with macroprudential impact (21 March 2018)

The EIOPA has published a document on Solvency II tools with macroprudential impact, which is the second in a series of papers with the aim of contributing to the debate on systemic risk and macroprudential policy. This document identifies, classifies, and provides a preliminary assessment of the tools or measures already existing within the Solvency II framework (e.g. volatility adjustment, transitional measure on technical provisions, or prohibition or restriction of certain types of financial activities), which could mitigate any of the systemic risk sources that were identified in the first document of the series.

INFRASTRUCTURE FINANCING

FSB – Survey on financing and regulation over the life cycle of infrastructure projects: Survey / Instructions for completing the survey / Background note (15 March 2018)

The FSB has launched a voluntary survey on the trends, drivers, and potential effects of regulatory reforms on infrastructure financing. They invite relevant institutions and firms that are actively involved in infrastructure financing by providing investments and sponsorship, insurance against financial and non-financial risks and transactional advice to participate. The aim of the survey is to assess the effects of the G20 regulatory reforms on financial intermediation, carried out under the FSB's evaluation framework.

RCAP

BCBS – RCAP Handbook for Jurisdictional Assessments / RCAP summary of post-assessment follow-up actions as of end-December 2017 (12 March 2018)

The BCBS has published, under the Regulatory Consistency Assessment Program (RCAP), the Handbook for jurisdictional assessments, which contains guidance and principles for RCAP assessment teams, assessed jurisdictions and experts; and describes the process and methodologies used by the BCBS to assess the completeness and consistency of domestic prudential regulations with the Basel framework. The Handbook includes specific guidance on the assessment of the NSFR and large exposures framework.

VOLATILITY MANAGEMENT

IOSCO – Consultation report on mechanisms used by trading venues to manage extreme volatility and preserve orderly trading (07 March 2018)

The International Organization of Securities Commissions (IOSCO) has published a consultation report on mechanisms used by trading venues to manage extreme volatility and preserve orderly trading. This report includes eight recommendations to assist trading venues when considering the implementation, operation, and monitoring of volatility control mechanisms (e.g. control mechanisms should be appropriately calibrated and monitored).

OTHER PUBLICATIONS OF INTEREST CONTINUED

SHADOW BANKING

FSB – Global Shadow Banking Monitoring Report 2017 (05 March 2018)

The FSB has published the Global Shadow Banking Monitoring Report 2017, which presents the results of the annual monitoring exercise that assesses global trends and risks in the shadow banking system (e.g. maturity/liquidity mismatches, leverage, etc.).

SUPERVISED ENTITIES

ECB – List of supervised entities (02 March 2018)

The ECB has published the annual list of supervised entities. This list displays the significant, a total of 118 (part A), and less significant credit institutions (part B) which are supervised by the ECB. The list is compiled based on significant decisions adopted and notified by the ECB and refer to events that became effective up to 1 January 2018.

FINANCIAL EDUCATION

EBA – Financial Education Report (01 March 2018)

The EBA has published its first Report on financial education in 2017 and 2018. It is based on a repository of more than 80 financial education initiatives carried out by the national authorities supervising banking products and services across the 28 EU Member States. This report presents a general view of the most common approaches used by the national authorities and focuses on four key characteristics of the related initiatives: subject matter, format, target group and type of output produced.

In the first quarter of 2018, the BCBS consultative document on revisions to the minimum capital requirements for market risk stood out. In Europe, the EC, the EBA and the ECB published several documents on NPLs. Further, the EBA published the scenarios

SUMMARY

GLOBAL PUBLICATIONS

- At international level, the BCBS published a consultative document on revisions to the minimum capital requirements for market risk. This document introduces amendments, a standardized approach, an internal models approach, the scope of market risk capital requirements, and more.
- The BCBS also published a consultative document on Pillar 3 disclosure requirements, arising from the Basel III reform.
- Lastly, the BCBS released the results of its latest Basel III monitoring report. In parallel, the EBA conducted its report of the CRD IV-CRR / Basel III monitoring exercise on the European banking system.

EUROPEAN PUBLICATIONS

- The European Commission (EC) published a comprehensive package of measures to tackle NPLs in Europe, including a proposal for a regulation on amending CRR about NPLs' minimum loss coverage. Further, the EBA published a consultation paper with guidelines on the management of NPEs and forborne exposures, which specifies sound risk management practices. Finally, the ECB published an addendum to the ECB Guidance to banks on NPLs, focusing on quantitative supervisory expectations concerning the minimum levels of prudential provisions.
- The EBA published the macroeconomic scenarios for the 2018 EU-wide stress test that banks are required to consider estimating the potential impact on profits and capital. Further, the EBA published final guidelines on disclosures of IFRS 9 transitional arrangements. These guidelines specify a uniform disclosure template to be applied by institutions to ensure consistency and comparability of data disclosed during the transitional period.
- The EBA also published a Roadmap on FinTech setting out its priorities for 2018/2019 and a timeline for the completion of these tasks.
- The ECB launched a public consultation on its draft guides for the ICAAP the ILAAP with the aim at developing a more detailed set of supervisory expectations for these two processes.
- The EIOPA published the second and final set of advice on specific items in the Solvency II Delegated Regulation, which covers the recalibration of standard parameters of premium and reserve risks.

LOCATIONS PUBLICATIONS

- In the US, the FED published a supervisory guidance on management of business lines and independent risk management and controls for large financial institutions. This guidance clarified the FED's supervisory expectations regarding risk management for these institutions.
- The FED also published the instructions as well as the stress testing scenarios to be used by banks and supervisors for the 2018 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act Stress Test (DFAST) exercises
- In the UK, the Prudential Regulation Authority (PRA) published a consultation paper on credit risk mitigation and the eligibility of guarantees as unfunded credit protection. This paper helps to clarify its expectations on the eligibility of these guarantees under the credit risk mitigation (CRM) framework of the CRR.

SECTION 3: REGULATORY OUTLOOK

REGULATORY PROJECTIONS

At European level, the General Data Protection (GDPR) and the guidelines on the assessment of the suitability of members of the management body and key function holders of the EBA and the ESMA will be applicable. In the US, the FED will publish the 2018 CCAR and DFAST results.

REGULATORY PROJECTIONS

1. Quarter 2

(Europe) May 2018: General Data Protection Regulation (GDPR) will be applicable.

(Europe) June 2018: the EBA Guidelines on internal governance and the EBA and ESMA Guidelines on the assessment of suitability of the management body and key functions will be applicable.

(USA) June 2018: the FED will publish the 2018 CCAR and DFAST results.

2. 2018 – 2019

(Europe) To be determined: The European Parliament (EP) and the Council are expected to approve the reform package of the financial system proposed by the EC, amending several legislative acts (CRD IV, CRR, BRRD, SRMR and EMIR).

(Europe) September 2018: Institutions are expected to start reporting under AnaCredit.

(Europe) October 2018: The EC's withdrawal agreement with UK is expected.

(Europe) November 2018: The EBA will publish the 2018 EU-wide stress test results.

(Europe) November 2018: The EBA will publish the 2018 EU-wide stress test results.

(Global) December 2018: The FSB will publish the new list of G-SIBs.

REGULATORY PROJECTIONS CONTINUED

(UK) December 2018: The BoE will publish the 2018 stress test results.

(Global) January 2019: G-SIBs not headquartered in an emerging market economy will be required to comply with a minimum TLAC requirement of 16% of risk-weighted assets and 6% of the LR exposure, in accordance with the FSB.

(Global) January 2019: The BCBS's large exposure framework will be applicable.

(Europe) January 2019: The EBA Final Guidelines on the treatment of connected clients will come into force.

(Europe) January 2019: The ECB Final Guides to the ICAPP and to the ILAAP will be applicable and considered according the SREP framework.

(Europe) January 2019: The ECB Guidelines on management of NPLs and forborne exposures will be applicable.

(USA) January 2019: The new requirements on Long-Term Debt (LTD) and TLAC will be applicable.

(UK) January 2019: The ring-fencing rules will be implemented.

(UK) January 2019: The BoE rules on operational continuity in resolution will enter into force.

3. More than a year

(Global) December 2019: The BCBS assessment methodology for G-SIBs will be applicable.

(Global) December 2019: The FSB is expected to conduct a review of the technical implementation of TLAC.

(Global) December 2020: The BCBS Guidelines on step-in risk will be applicable.

(Europe) January 2021: The EBA Guidelines in IRB parameters estimation will be applicable.

(Global) January 2022: The revised SA for credit risk, the revised IRB framework, the revised CVA framework, and the revised operational risk framework published by the BCBS will be implemented. The LR framework (using the revised exposure definition) and the G-SIB buffer will also be applicable.

(Global) January 2022: the BCBS revised market risk framework will be applicable, and the regulatory information required in this regard will be disclosed for the first time.

(Global) January 2022: The majority of the new disclosure requirement of the BCBS Pillar 3 updated framework will be implemented.

(UK) January 2022: The PRA will require firms to comply with an end-state Minimum Requirement for Own Funds and Eligible Liabilities (MREL).

(Europe) December 2022: The application of IFRS 9 transitional arrangements, which have been in place since March 2018, will conclude.

(Global) January 2027: An output floor of 72.5% will be applicable according the Basel III reform.

ECB LAUNCHES PUBLIC CONSULTATION ON DRAFT GUIDES FOR BANKS ON THEIR CAPITAL AND LIQUIDITY MANAGEMENT

INTRODUCTION

On 2 March 2018, the European Central Bank (ECB) started a public consultation on draft guides for banks on their capital and liquidity management. There will be a public hearing on 24 April 2018 and the consultation will run until 4 May 2018. Being subject to this consultation, the ECB published a draft ECB guide to the internal capital adequacy assessment process (ICAAP) and one to the internal liquidity adequacy assessment process (ILAAP).

This consultation is the next step of the ECB's multi-year plan to promote the banks' ICAAP and ILAAP. As stated in the Single Supervisory Mechanism (SSM) supervisory priorities of 2018[1], the ECB aims to finalize both guides, which had already been presented last year and updated based on the feedback received2.

The final documents will give an overview of ECB's expectation of a sound ICAAP and ILAAP. From early 2019 on, they will be used as a starting point of discussion during supervisory assessments of SSM in the 118 current3 significant supervised entities. Having this character, they will constitute not only new obligatory, but good-practice guidelines enriching articles 73 and 86 of CRD5 IV, respectively.

APPROACH TAKEN IN THE GUIDES

As the content of the draft guides was already discussed in the consultation 2017, this paragraph gives a brief overview of them:

Both guides are following the same approach each giving seven principles on ICAAP or ILAAP. For the most part, both sets of principles are in parallel with each other, as only slight adjustments to the types of risks and legal bases considered are needed.

The seven principles are listed below and differ only slightly from last year's drafts:

1. The management body is responsible for the sound governance of the ICAAP
2. The ICAAP is an integral part of the overall management framework
3. The ICAAP contributes fundamentally to the continuity of the institution by ensuring its capital adequacy from different perspectives
4. All material risks are identified and considered in the ICAAP
5. Internal capital is of high quality and clearly defined
6. ICAAP risk quantification methodologies are adequate, consistent and independently validated
7. Regular stress testing is aimed at ensuring capital adequacy in adverse circumstances

MAIN DIFFERENCES TO THE 2017 VERSIONS

In comparison to the 2017 draft guides, the content remained generally the same as far as wording, however the display of the drafts changed to a more structured presentation. Most changes that were made can be viewed as a shift in emphasis of the text of the guides, some of those are:

- The inclusion of back-testing and performance measurement of the ICAAP/ILAAP assumptions in Principle 1's internal review and validation
- The emphasis that the legal authority, which signing the capital adequacy statement, is chosen by the institution "in the light of national regulations and relevant prudential requirements and guidelines. "(Principle 1)
- The weight on the short and medium-term assessments has declined to the 2018 version, having the medium-term view linked to the normative perspective in its definition.
- Changes to more generalizing statements covering more cases were made. This includes for example the change from the "treatment of hidden losses and hidden reserves" of the 2017 guide to the ICAAP to a formulation, that the institute shall take a prudent approach to define its internal capital (Principle 5)

[1] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisory_priorities_2018.en.pdf?3b4a89e9ad114ff7dbdaf156d0f0f564

[2] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/170220letter_nouy.en.pdf

[3] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.list_of_supervised_entities_201802.en.pdf

ECB LAUNCHES PUBLIC CONSULTATION ON DRAFT GUIDES FOR BANKS ON THEIR CAPITAL AND LIQUIDITY MANAGEMENT CONTINUED

The only less light adjustment to the guides can be seen within Principle 2 – "The ICAAP is an integral part of the overall management framework". In the 2017's drafts the ECB mainly gave the technical components of ICAAP and ILAAP, e.g. the limit system, but now it asks the supervised banks to provide documentation of their ICAAP and ILAAP architecture. This should describe the parts of the respective processes and how they link to each other, as well as to other parts of the institute's management framework. The ECB then asks its assessors to review for a formalized link of the risk appetite framework and other strategic processes, especially the ICAAP and ILAAP.

IMPACT

After finalization, both guides are targeted as ECB's view on sound processes on institution's capital and liquidity management processes and guidance for its Joint Supervisory Team (JST) on the assessment of ICAAP and ILAAP. The SSM supervised entities may already revise their processes using the principles given - if this did not happen already. As stated in their press release about the consultation in 2016, the ECB saw significant differences in the approaches taken and a need for improvements at all reviewed institutions. Having set out their expectations, one might expect a focus of the supervisory authority in 2019 on assessing ICAAP and ILAAP.

As stated above the drafts only slightly changed from their 2017's versions, and the main impacts on the supervised entities will remain the same as they have already been discussed in the 2017 consultation phase among different contributors. The main impacts are listed below

1. Higher coherence in supervision leads to an adjustment effort for individual institutes' ICAAP and ILAAP, especially to groups with diversified sub-entities that are being spread among different states. The new expectations may lead to the need of the institution to:

    a. Further integrate ICAAP and ILAAP to their management framework

    b. Enhance its IT architecture for scenario calculation for management support

    c. Monitor upcoming regulatory and supervisory changes more intensified

2. As both ICAAP and ILAAP mirror each other and are targeted to complement each other in interplay with other processes, a further integration of both into a common framework is enforced.

The new spin, which came in by this year's draft, is the demand for the formalization of point 1a) above, with a documentation of the overall ICAAP or ILAAP architecture and formalizing links to the risk appetite framework.

BREXIT: CURRENT SITUATION AND MAJOR CONCERNS

Brexit is one of the hottest topics today. London has been a leading international financial centre and major banking hub since the 19th century. Today, almost all international banks operate their EU business from the London offices. However, this situation may significantly change after the UK leaves European Union. In a nationwide referendum on June 23rd, 2016 the majority of participated British citizens voted for the United Kingdom to leave the European Union. On March 29th, 2017, the UK government invoked Article 50 of the treaty of European Union, and thus, The UK must leave the EU two years later on March 29th, 2019.

In the beginning of Brexit, it was still unclear to what extent the UK and EU would save their economic relationships. There were two possible scenarios: "hard" and "soft" Brexit. "Soft Brexit" approach would leave the UK's relationship with EU as close as possible to pre-Brexit situation. The UK would no longer be a part of the European Union and would not have any place in European Council, however, will still have an unlimited access to European single market. This approach was preferred by many "no-Brexit" voters because it would significantly reduce the overall impact of Brexit. However, in December 2017, the UK Prime Minister Theresa May and EU's leaders have confirmed that sufficient progress was done in the Brexit negotiations and the next step will be the discussion of future trading relationship between UK and EU. The UK will leave the European single market after a 2-year transition phase[4]. That means that all affected institutions must prepare for the Hard Brexit scenario. For Financial Institutions in London, that means that from EU perspective they will become third country Institutions without "European Passport" and will have to comply with a number of EU-wide and country specific regulations aimed on third country firms.[5]

After Brexit became a real issue, and third country investment firms were told to comply with particular MiFID II requirements – major investment banks started to search for new trading hubs within European Union. Two major cities that are still under consideration are Frankfurt, Germany and Paris, France. Some investment banks have already announced where they are going to dislocate their businesses. According to Bloomberg: Morgan Stanley, Citigroup Inc., Standard Chartered Plc and Nomura Holdings Inc have picked Frankfurt for their EU headquarters to ensure continued access to the single market and HSBC Holding Plc opts for Paris[6]. According to The Guardian, Goldman Sachs has stepped back from identifying a single European city as its post-Brexit EU home and has instead chosen to split its business between Frankfurt and Paris.[7]

The next important question is, to what extent do banks want to transfer their activities from London to Europe? There are two probable variants: either banks will establish full functioning independent legal entity that will completely take over the whole aspects of business from the UK, or banks will create an entity that will act as an intermediate between European clients and UK based banks. The first solution seems more plausible for European regulators because it guaranties higher stability, brings more economic benefits due to higher tax income additional working places, and more. However, there is a high probability that banks will prefer the second solution because it will be easier and less costly to implement. Using the intermediate entity in the EU, UK based banks will be able to use already existing infrastructure and SMEs in the UK. One of the major European bank supervision authorities, the European Central bank, has announced that "some elements in a number of banks' plans do not fully meet the ECB's expectations and requirements of banks operating in the euro area." According to the ECB, many banks have indicated their wish to transfer all market risk to a third country group entity. It is highly unlikely that the ECB will allow such an approach because it creates obstacles for proper supervision, and could create additional risks during the crisis where local capabilities may be crucial to continue operations. The ECB in particular, as a final approver for bank licence, has stated that it won't approve a creation of empty shells or letter box banks.

If a bank decides to move to Frankfurt, first it should understand that German bank regulation is quite complex, and it includes a number of requirements, based on UK requirements, that can be new for the banks. In order to establish a legal entity in Germany, a bank will have to receive an approval from the major German regulator: the "Bundesanstalt für Finanzdienstleistungsaufsicht" (BaFIN). One of the biggest concerns of the German regulator is an appropriate level of risk control. So, it will be extremely hard for banks to convince BaFIN that they can provide a high quality of risk control by outsourcing it to the third country entity. Based on the lastest guidelines and publications of

[4] https://www.theguardian.com/politics/2017/dec/15/brexit-talks-eu-next-phase-brussels-theresa-may
[5] https://uk.reuters.com/article/uk-britain-eu-financials/eu-holding-line-against-passporting-for-british-banks-after-brexit-idUKKBN1FK116
[6] https://www.bloomberg.com/news/articles/2017-08-23/paris-or-frankfurt-bofa-executives-debate-trading-hub-location
[7] https://www.theguardian.com/politics/2017/nov/20/its-frankfurt-and-paris-goldman-sachs-names-post-brexit-hubs

BREXIT: CURRENT SITUATION AND MAJOR CONCERNS CONTINUED

ECB[8] it is clear that some strategic approaches that were used by banks in the past, will be hardly accepted by Regulators. For example, to keep the German Entity risk flat, some banks have decided to use "beack2back" models. Under these models, trading positions that will be created on the German entities will be hedged against the UK Entity or even trade base. In this case, at the end of trading day there will not be any outstanding positions and thus no market risk that is needed to be managed. However, the ECB seems to have another view on what the business processes in Germany should look like. German entities will be required to manage at least part of the risk locally and thus banks will not be able to outsource the whole risk. The ECB assumes that such approach can create a concentration risk because all risk will be outsourced to one entity that is ultimately located in the third country.

Coming back to outsourcing, the majority of banks would like to outsource as much as possible back to the UK in order to use existing infrastructures and to avoid investing in building a new one in the EU. However, the "Mindestanforderung an das Risikomanagement" (MaRISK), whose purpose is to ensure that in the case of crisis situation, provided detailed outsourcing guidelines[9] to ensure that a Germany located entity has enough local operational resources to react and remain stable.

IMPACT

It is very important for UK banks to anticipate the current situation and to begin working on the solutions that will suit the regulators' requirements. There are less than 13 months left until Brexit, and banks who cannot manage to establish a functioning entity in the EU will not be able to continue their business within European Union. There will be an additional 20 months of transition phase, but this time will be mostly being used for polishing the final adjustments to European regulation framework.

A MEASURED APPROACH TO FINTECH – KEYNOTE ADDRESS

On February 27th, 2018, Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), delivered a keynote speech at the Afore Consulting's Second Annual Financial Technology (FinTech) and Digital Innovation Conference.

This annual conference is held to discuss challenges and opportunities within the financial services industry, and the impact of FinTechs.

Due to its fast growth and potential impact, ESMA is taking a measured approach to assess and to monitor FinTechs. This, however, can be challenging as the technology used in financial markets is evolving rapidly. To measure and monitor FinTechs, ESMA has implemented an analytical framework called Financial Innovation Scoreboard.

This framework helps to monitor innovation based around economic functions. According to Mr. Maijoor, ESMA is aiming at how to best monitor trends and technologies, while factoring in the risks and benefits that these may bring in.

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[8] https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl180214.en.html
[9] https://bankinghub.de/banking/steuerung/auslagerung-statt-outsourcing

A MEASURED APPROACH TO FINTECH – KEYNOTE ADDRESS CONTINUED

WHAT ARE THE MAIN STRUCTURAL FEATURES OF FINTECHS?

STRUCTURAL FEATURES OF FINTECHS	DESCRIPTION
Information technology	• Information technology (IT) has been changing economies, societies, and, through virtual collaboration and remote work, has even changed the face of the workplace. • FinTech relies on information technology, like for example, a retail investor managing his investment portfolio online.
Innovation spiral	• Innovation spiral can be described as a pattern of an innovation which lays the foundation for another innovation. Even a failed innovation can lead to new innovations and products. An example of this process is the distributed ledger technology, known as Blockchain. • Another situation where innovation spiral has been seen is in the Initial Coin Offerings (ICOs). In ICOs, companies raise capital by offering “tokens” or “coins” using blockchain technology, thus exemplifying an innovation being built on top of a recent innovation.
Regulatory dialectic	• Regulatory dialectic is described when market participants take existing rules and regulations into account as they innovate. In some cases, new technologies, which are not included in the current regulation, prompt amendments to be added to regulatory frameworks. • On the other hand, when market participants try to innovate to frustrate the intended effects of a regulation, this is then known as negative regulatory dialectic. An example of this is shadow banking. • ESMA is supportive of the regulatory dialectic with firms within the Regulatory Technology (RegTech) sphere. As seen with the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive (MiFID), both regulations were lacking proper supervision during the recent financial crisis. RegTech has enabled automated reporting and streamlined processes, leading to lowering costs and improving efficiency.

Table 1: Structural features of FinTechs (Source: own representation)

WHAT IS THE ECONOMIC FUNCTION WHEN MONITORING FINTECHS?

As mentioned before, ESMA’s intention is to assess FinTechs to understand how they transform innovation maturity, how they transfer risk, and how they create economic value. Some technologies and innovations evolve over time increasing their complexity. This situation brings some degree of opacity, such as the use of machine learning by asset managers, also described as a “black box” technology. Another example is the use of algorithms, which learn through trial-and-error without following a transparent inferential process.

Here, the Financial Innovation Scoreboard helps to understand and identify the core economic functions, as well as thei risks and benefits which relate to each of ESMA’s objectives: financial stability, market integrity, and investor protection.

A MEASURED APPROACH TO FINTECH – KEYNOTE ADDRESS CONTINUED

WHAT ARE THE CHALLENGES AND OPPORTUNITIES FOR REGULATORS?

To have sufficient support, the European Commission (EC) proposed an enhancement on the mandate of ESMA and two other European Supervisory Authorities (ESAs) to harness potential opportunities, while addressing possible risks that may arise from FinTechs.

The EC enhancement included four task areas:

TASK AREA	DESCRIPTION
License requirements	• Convergence on license requirements for FinTech companies would lead to a close cooperation, as well as a thorough understanding of the different FinTech businesses. • This can help ESMA and the national competent authorities (NCAs) to provide a standard, measured basis to monitor and assess FinTechs.
Outsourcing framework	• Update outsourcing frameworks such as cloud services. • This would enable faster data processing, as well as access data remotely, reduce extensive on-site hardware and reduce cost of data storage.
Coordination of national technological innovation hubs	• The EC proposes that ESAs coordinate national technological innovation hubs. For this, it is advisable to develop convergence measures regarding innovation hubs and regulatory sandboxes (i.e. testing grounds for new business models) for fostering the attractiveness towards financial businesses. Such measures would serve to motivate businesses to innovate and build their business within Europe.
Cybersecurity	• ESAs and EC are working together to pursue convergence of IT risk management and to contribute to developing cyber stress testing modalities. Furthermore, ESMA is working to achieve state-of-the-art supervision of credit agencies and trade repositories to ensure detection of evolving cyber risks.

Table 2: EC enhancement - Four Task areas (Source: own representation)

All four areas will give a clear roadmap towards ensuring a secure and safe ground for all participants within the financial sector. In parallel, these will promote innovation and will enable grasping opportunities arising from FinTechs.

IMPACT

All the outlined topics are important to safeguard innovation within financial sectors. Therefore, ESMA needs to establish a measured approach to monitor technologies which are used and developed by FinTechs. Firstly, this is required to foster an understanding of the new technologies. Secondly, this is approach will be used to promote innovations in terms of economic functions. This will lead to a balanced interaction between regulators and FinTechs, allowing risks and benefits to be considered. FinTechs are already, and will continue to, reshape the financial sector by bringing innovation, risks, and opportunities to the industry.

Please find the (Keynote) Second Annual Fintech Innovation Conference Document here.

EMIR: ESMA PUBLISHES GUIDELINES ON CCP CONFLICT OF INTEREST MANAGEMENT

INTRODUCTION

The European Securities and Markets Authority (ESMA) has published the final version regarding the guidelines on Central Counterparty (CCP) conflict of interest management. This paper follows a consultation paper issued by ESMA in June 2017.

The purpose of the guidelines is to provide clarification of the requirements regarding the management of conflicts of interest by CCPs, stated in Article 33 of the European Market Infrastructure Regulation (EMIR). This details that CCPs are required to have written organizational and administrative arrangements to identify and manage any potential conflicts of interest. The final version of the guidelines can be divided into the following four main areas:

- Concept of conflicts of interest
- Organizational arrangements to avoid or mitigate any conflicts of interest
- Additional measures for CCPs belonging a group
- Impact

Within two months of the publication of the translations, each National Competent Authorities (NCA) will be required to confirm whether it complies, or intends to comply, with these guidelines.

CONCEPT OF CONFLICTS OF INTEREST

Chapter 5.1.15. from the above guidelines defines the existence of a conflict of interest in which a stakeholder's own interest interferes with a CCP's interest, or other parties, in its objectivity to make a decision or in the decision-making processes. The paper stresses that CCPs should consider potential conflicts in various relationships, e.g. between a CCP, broker and their clients or with related firms, payment and securities settlement systems, trade repositories, or trading venues. Also, persons with close relationships to the CCP, e.g. respective staff or someone who is involved in the CCPs' business, should be covered. In this case the duty of the CCP is to set up a period of time during which the potential or real conflict is presumed to continue. Depending on the type of conflict or relationship, different timelines may be considered.

ORGANIZATIONAL ARRANGEMENTS TO AVOID OR MITIGATE CONFLICTS OF INTEREST

The second part of the final version of the guidelines addresses the requirement to implement written organizational and administrative arrangements to identify and manage any potential conflicts of interest. The CCPs should consider a need-to-know principle, which ensures that confidential information is only shared on a need-to-know basis among selected persons. Apart from that, support from Chinese walls and a secure IT-infrastructure guarantee a clear separation of workstreams and protect access to the different systems in use.

The rules of conduct apply for the CCPs' staff or anyone involved in the business, and which aim to act in the interest of the CCP with impartiality and good faith, in a transparent manner. Moreover, the CCPs should limit the number of contracts or mandates of board members and executive directors in line with the applicable law.

Further policies regarding the acceptance of gifts and/or the ownership of financial instruments by its staff, such as shares, bonds or other securities, aim to prevent any area of potential conflicts of interest. To manifest these principles within the organization, each CCP is required to train their staff adequately on their obligations. In order to monitor the efficiency of the arrangements, the Chief Compliance Officer (COO) should report to the board of any material cases in a timely manner.

EMIR: ESMA PUBLISHES GUIDELINES ON CCP CONFLICT OF INTEREST MANAGEMENT CONTINUED

ADDITIONAL MEASURES FOR CCPS BELONGING TO A GROUP

The third part of the paper refers to the case where a CCP belongs to a group, e.g. as a parent undertaking or a subsidiary. As a result of such structures, further conflicts of interest may occur and should be taken into account.

In the context of a group, the role of each board member should be clearly defined to prevent overlapping competencies. Additionally, independent board members should be appointed by the CCP to counterbalance the number of representatives within the group entities. Where senior management is shared with another group entity, material decisions should be approved by the board. A close monitoring of potential conflicts should be undertaken by the Chief Compliance Officer (CCO), the board, or independent board members.

IMPACT

By implementing those guidelines of how to manage conflicts of interest within a CCP, the impact refers mainly to organizational changes on a personal and operational level, as well as to the governance policies of the CCP.

On a personal level, the role and accompanying duties of the Chief Compliance Officer is extended. This means, if any potential conflict of interest appears, the CCO should be informed and empowered immediately to take action. If the CCO is not charged to solve the issue, he should provide a report with recommendations to the decision makers.

Further organizational impact refers to a clear definition of responsibilities regarding making decisions on potential or real conflicts of interest. The decisions should be made by a person who acts independently and with authority, such as the CCO, line managers, or independent board members.

Moreover, the processes and procedures within the organization of a CCP should be established. An escalation procedure must be implemented in any case of disagreements. A conflict of interest register should be set up to track and record any areas of potential conflicts, including the respective resolution, status, and performed training by staff.

The change in policies of the CCP should contain the monitoring of conflicts, the disclosure, exclusion, or restriction of the affected party in terms of sensitive information.

EMIR: ESMA PUBLISHES RESULTS OF SECOND CCP STRESS TEST

INTRODUCTION

On February 1st, the European Securities and Markets Authority (ESMA) published the details of the 2017 stress test exercise on Central Counterparties (CCPs). The objective was to rate the resilience and security of the EU's CCPs from a systemic viewpoint.

The second stress test builds on the previous CCP stress test, published in 2016. The focus of the previous test was counterparty credit stress through the assessment of CCP's resources adequacy to absorb losses under scenarios combining clearing members defaults, and simultaneous extreme shifts of risk factor prices. To improve the definition of the scenarios and the validation of the results, ESMA has extended the scope to include liquidity risk (liquidity stress test).

The stress test exercise covered 16 European CCPs, and in which ESMA tested such CCPs resilience with approximately 900 clearing members EU-wide. On the test date, the aggregated amount of collateral held by CCPs was approximately €270bn, being expressed in the form of margin requirements and default fund contributions.

This year's exercise enabled ESMA to highlight individual CCP-specific results for the credit stress test. They suspected the default of the top-2 groups of clearing members selected for each individual CCP. The 16 CCPs included in the scope of the exercise provided detailed data on their exposures and resources. This data was utilized to run the credit and liquidity stress tests.

DESCRIPTION

CREDIT STRESS TEST

The Credit Stress Test's objective is to evaluate the sufficiency of CCPs' resources to absorb losses under a combination of market price shocks and member default scenarios. The CCPs reported for each clearing member, and default fund the losses they would have in case of the member's default under specific market stress scenarios and the amount of resources, that could be used to cover those losses. To identify the entities with the top exposures, the ESMA then compared the reported losses to the resources that are available to cope with the default, based on different member default scenarios.

The results of the Credit Stress Test state that all CCPs could cover the calculated losses with the already provided prefunded resources under the simultaneous default of the two groups of clearing members. Such action would cause the largest losses above the defaulting members' collateral at an aggregate EU-wide level.

Under an adverse scenario for one CCP, BME Clearing, there would be a marginal shortfall, of less than €1 million, over and above the available pre-funded resources, if the largest two clearing members default. The shortfall is with no systemic impact, considering that the CCP had access to surplus collateral of the defaulting members in other default funds, and excess margin that could be used to cover this.

For another CCP, ICE Clear Europe, all the pre-funded resources (97%) would be required to cover the simulated losses. The excess margin held on top of the minimum required could also significantly reduce the consumption of prefunded resources. That means that the ICE Clear Europe would be vulnerable to any changes of defaulting or market stress scenarios.

REVERSE CREDIT STRESS TEST

The objective of the Reverse Stress Test is to verify the sensitivity of the credit stress results to small changes by increasing the number of defaulting entities, in addition to the level of market shocks, to identify at which point resources are exhausted.

The analysis showed that one CCP, ICE Clear Europe, would have a depletion of the prefunded resources if there would be small increases of the number of defaulting groups (3 groups) or market shocks (to 120% of the baseline stress shocks). Overall, only this CCP demonstrated a high sensitivity to small increases of shocks.

EMIR: ESMA PUBLISHES RESULTS OF SECOND CCP STRESS TEST CONTINUED

LIQUIDITY STRESS TEST

The Liquidity Stress Test is aimed at assessing the resilience of EU CCPs to market wide and liquidity stress events under a combination of market price shocks, member and liquidity provider default scenarios. This enables ESMA to identify potential shortcomings and issue recommendations to address those.

The results of the liquidity stress test demonstrate that EU CCPs could achieve sufficient capacity to meet their liquidity needs by assuming the default of two relevant clearing members. CCPs are using a variety of tools to meet their liquidity needs.

Some large CCPs require access to the short-term FX markets to cover requirements in some major currencies. Other CCPs make use of its access to highly reliable central bank repos or otherwise. In assuming the default of two EU-wide groups of entities, one of the CCPs had moderate liquidity needs if ESMA assumed delayed settlement. Some CCPs would need undisrupted access to markets and the ability to settle immediately.

CCPs use different tools to cover their liquidity needs. Some are highly reliable as central bank repos and other less, but ESMA found no particular deficiency in the management of liquidity risks by EU CCPs.

IMPACT

The results are based both on a series of validation tests carried out by the individual national competent authorities (NCAs), and on the data provided by the CCPs.

For this reason, all stress testing exercises with this scope have limitations. Additionally, the granularity of the published results is limited to the liquidity stress test section as the stress tests and assumptions for the liquidity stress scenarios were first tested. This has led to some remaining uncertainties.

ESMA is ready to further improve the scope of CCP stress tests and methodology, and is prepared to address remaining limitations in future exercises.

As a next step, ESMA will make the necessary recommendations in line with the mandate of the European Market Infrastructure Regulation (EMIR). Currently, they are reviewing whether recommendations are needed, and in which forms the recommendations should take.

ESMA TO ANALYZE IMPACT OF INTERVENTION MEASURES ON CONTRACTS FOR DIFFERENCES AND ON BINARY OPTIONS

ESMA CALLS FOR RESPONSES TO ITS CONSULTATION PAPER

On January 18th, 2018, the European Securities and Markets Authority (ESMA) has issued a "Call for evidence" directed to all stakeholders involved in the sale, distribution, or marketing of contracts for differences (CFDs) and binary options (BOs). The consultation paper contains ten questions on the suitability of the intervention measures with respect to CFDs and BOs.

ESMA welcomed responses until February 5th, 2018. However, results have not yet been published.

BACKGROUND – RISKY PRODUCTS FOR RETAIL INVESTORS

Marketing, distribution, and sale of CFDs and BOs have increased over the last years, particularly through online channels. ESMA and national supervisors consider both product classes to have a high risk of loss, and a lack of informational transparency (see Figure 1). Furthermore, companies offering such products often use aggressive marketing techniques to incentivize retail investors to enter into those contracts, a situation which has led to investor protection concerns. Studies conducted by National Competent Authorities (NCAs) find that between 74% and 89% of the clients trading in CFDs and BOs lose money.

Contracts for differences are made between a buyer and a seller, in which the seller pays the buyer the (positive) difference between the current value (or opening price) and the value at contract time (or closing price) of a certain underlying asset. If the difference is negative, the buyer pays the respective amount to the seller. Possible underlying assets are shares, currencies, commodities, indices, etc.)

Binary Options (also digital options or all-or-nothing options) pay either a fixed amount if the underlying meets one or more predetermined conditions, or they pay nothing if the underlying does not meet one or more predetermined conditions.

Figure 1: Contracts for differences and binary options explained (Source: ESMA Investor Warning and ESMA Call for ESMA Evidence)

In responding to the latent risks between 2013 and 2016, ESMA and National Competent Authorities (NCAs) intervened through several initiatives, including:

a. Q&As to collect and address publicly questions from stakeholders
b. a closer supervision of firms distributing CFDs and BOs,
c. bans of the distribution of certain derivatives,
d. bans of certain marketing measures,
e. and the imposition of leverage limits for CFDs.

Even with those measures in place, ESMA remained concerned about the sufficiency of investor protection. For that reason, in June 2017, it considered the possibility to intervene through prohibitions and/or restrictions of financial instruments, or activities under Article 40 of Regulation (EU) 600/20142 (Markets in Financial Instruments Regulation (MiFIR)). The law became applicable with the implementation of MiFIR on January 3rd, 2018.

ESMA TO ANALYZE IMPACT OF INTERVENTION MEASURES ON CONTRACTS FOR DIFFERENCES AND ON BINARY OPTIONS CONTINUED

INTERVENTION MEASURES CURRENTLY UNDER REVIEW

ESMA proposes several restrictions on the marketing, distribution, or sale of CFDs to retail clients. Table 3 summarizes the restrictions.

RESTRICTION	DESCRIPTION
Leverage limits	To vary with respect to the underlying from ratios of 30:1 for major currency pairs to 5:1 for equities
Margin close-out rule	Shall be on a position-by-position basis: Clients should not lose more than they have invested; if the value of the underlying falls below 50% of the initial margin, the position is closed out
Negative balance protection	Shall be on a per account basis, to limit aggregated losses to any retail client
Restrictions on incentivization of trading	Shall be established by a CFD provider; for example, the provision of retail clients with payments (apart from profits on CFDs) or non-monetary benefits related to marketing, sale or distribution of CFDs
Standardized risk warnings	Shall be required by CFD providers; standardized "warning in any communication to, or published information accessible by, a retail client relating to the marketing, distribution or sale of a CFD"

Table 3: Proposed CFD restrictions (Source: Own representation)

ESMA is very aggressive with respect to BOs, for which restrictions are expressly not found to be sufficient for retail clients, but a prohibition is necessary. Thus, marketing, distribution, and sale of BOs shall remain only for professional clients, and not for retail clients.

For collecting feedback, ESMA issued ten questions asking to provide further data on the impact of the proposed restrictions. It has welcomed responses from stakeholders stressing the importance of having not only qualitative information, but also quantitative information.

IMPACT

The impact of the new regulation is what ESMA focuses on uncovering. It is hoped that the responses will reveal both qualitative and quantitative data. Assuming the measures proposed above for both product classes are implemented, the identification of retail and professional clients will be necessary and must be determined by (potential) distributors. This categorization implies a target market assessment as required under the updated Markets in Financial Instruments Directive (MiFID II), especially Article 16, regarding its rules on product governance. There is a risk that new products may be created with features similar to BOs or CFDs, but which appear under a different label to try to circumvent the prohibition or the restrictions.

For CFDs, business processes need to be adapted to the new rules, leading to systems needing to be modified to reflect such adaptations. For example, leverage ratios are different for CFDs of different product classes, for example those of different underlyings, and must be considered accordingly. The trading volume is also likely to decrease due to an effect of filtering out retail clients who do not have the risk profile to enter into a CFD or into a BO.

Moreover, ESMA is also analyzing CFDs on cryptocurrencies. Those currencies have a high price volatility which requires the protection measures, such as leverage ratios or prohibitions, to be determined. Additionally, it is not certain whether those products can be classified as financial instruments under the MiFID II framework.

ANTI-MONEY LAUNDERING REGULATION: THE CHALLENGES FACED BY FINANCIAL INSTITUTIONS AND REGULATORS

"The central problem of anti-money laundering regulation is to design a system of procedures and incentives that induces the agent, that is, the financial institution, to act effectively with regard to the production of the information required by the principal, that is, the competent authority" (Azevedo 2008, pg. 69)

Anti-money laundering (AML) regulation has always been problematic for financial institutions. On the one hand they face the regulator, who will fine and shame non-compliant institutions, thus hurting their reputation. On the other hand, being compliant is expensive for banks and perhaps uncomfortable for clients. Some clients wish to keep their information as private as possible (for example ownership structures in foundations, family offices, investments in other companies, among others). Moreover, customer relationship managers (CRMs) are put in an uncomfortable position where they must ask and chase the client for information to be able to conduct business with them. Knowing how to approach clients regarding background checks is not an easy task and is increasing costs due to stricter regulation, hurting the bank's profitability.

Market conditions influence the effectiveness of regulation. While a risk-based approach (RBA) is better under efficient market conditions, a holistic review must be enforced with asymmetric information. That is the case when it is unclear to the regulator whether a bank will cooperate with AML efforts. Under such cases, it is important that institutions are forced to conduct thorough checks on clients, and try to avoid simplified due diligence (Azevedo, 2008).

Money launderers have two kinds of costs: a technical cost, which is the cost of physically laundering money, and the effort cost. The effort cost correlates with regulation, as stricter regulation makes money laundering more expensive. If the launderer must launder a positive fraction of his money, the costlier it becomes, and thus leaving less money after laundering. This laundered money will flow back into the economy and have a multiplier effect. According to Masciandro (1999) there is a strong correlation between bank deposits and GDP-growth (the legal economy) in Italy, but there is an even and stronger correlation between bank-deposits and the per capita number of crimes (as a proxy for the illegal economy). These statements exemplified that if banks do not have proper mechanisms in place to combat money laundering, there will be a multiplier effect of money laundering on the illegal economy, and thus on criminal activity.

AML CHALLENGES FOR FINANCIAL INSTITUTIONS

There are several tools to help banks with background checks and Know-Your-Customer (KYC) processes. Nevertheless, financial institutions are still facing challenges. Although banks have automated processes, KYC and AML teams are still too expensive. Moreover, new regulation has increased on-boarding times of clients, thus postponing the date at which a bank can start offering services and further forgoing revenue, or being exposed to loosing clients to other banks with faster onboarding processes.

According to a survey published by Thomson Reuters (2017), it takes around 26 days to on-board a client. This means that for almost a month, CRMs are not allowed to conduct any official business with clients. A longer onboarding time is not only an issue for CRMs, but is also a burden on costs. The longer the onboarding time, the more effort and time AML teams must put in onboarding clients, thus affecting efficiency, and ultimately making AML departments costlier.

Onboarding times are not the only KPI on the rise. With new AML regulation, costs of KYC-related procedures have increased, head-count of AML teams have grown, and expenditure on KYC/AML technologies have gotten more expensive. Even with the number of employees working in AML related activities rising, financial institutions still claim that they are understaffed, and that teams cannot cover the full amount of work assigned. With increased regulation, increased compliance pressure, and stricter procedures, the increase in workforce alone will not suffice to fill this gap.

Additionally, banks feel that clients are not helping them to meet compliance requirements. Over 50% of institutions feel that clients try to avoid handing in, or providing

ANTI-MONEY LAUNDERING REGULATION: THE CHALLENGES FACED BY FINANCIAL INSTITUTIONS AND REGULATORS CONTINUED

new, information regarding whether there are changes in management, or changes in ownership. Furthermore, CRMs are reluctant to chase clients as they feel this has a negative impact on their relationship with them.

IMPACT

Even though the challenges for financial institutions seem to be clear, there is no straightforward solution. However, with a tow sided approach, a simple solution can be defined. First, institutions must be willing to comply and assume the costs of stricter regulations. This seems to be the case, since in the past years, the amount spent by financial institutions in KYC and AML-related activity has increased (Mui, 2017). Second, member states and regulators must prepare the market to facilitate the compliance of institutions. This encompasses incentivizing institutions (moving from blame and shame culture to a congratulating culture for those who comply), and ensuring that organizations which wish to be part of the financial market make it easier for banks to perform their AML process. Since these regulations are an international requirement, the latter seems more difficult. It is specifically to this point where new technologies come in handy.

According to the 4th AML Directive (Articles 30, paragraph 5), which came into effect on June 26th, 2018:

“Member states shall ensure that the information on the beneficial ownership is accessible in all cases to:

- Competent authorities and FIUs, without any restrictions;
- Obliged entities, within the framework of customer due diligence in accordance with Chapter II;
- Any person or organisation that can demonstrate a legitimate interest”

It is the regulator’s duty to make available information for AML procedures to those who need it, or at least to ensure institutions can find providers of reliable and accurate information. This information may include commercial registers, articles of association, ownership structure, and information on legal representatives. Moreover, this information must be reliable, transparent, and in some cases, come from a statutory authority, to avoid loss of validity. Since the regulator must ensure access of information to people who need it, ownership of information becomes critical. Blockchain technology may offer a solution to share needed information between clients and institutions.

Compliance is not an easy task, and it will not get simpler. Just as new technologies help banks become more compliant, new technologies also help criminals find new ways to launder their money. Even banks are facing higher costs and fines. Last year, the US branch of Deutsche Bank was fined $41 million for not having the appropriate AML practices (Hamilton and Arons, 2017). With the 5th AML Directive in progress, institutions must find a way to comply and save costs through means of automating processes, outsourcing, or implementing new technologies in order to meet compliance with AML regulation.

Regulators need to unify their demands and try to agree in the treatment of high risk factors. Are bearer shares going to be considered high risk for institutions that are regulated by financial authorities (such as BaFin, FMA, FCA, etc.)? Will regulators continue the blame and shame culture they have exposed the financial sector to, or will they take a more proactive approach in helping banks achieve compliance and combat money laundering? And more importantly, how willing are banks to break secrecy to expose financial crime, from tax evasion all the way up to terrorist financing?

Note: on March 15th, 2018, the BaFin published a draft which gave suggestions how to treat fictitious beneficial owners. Particularly, companies that are listed on regulated markets do not have fictitious beneficial owners. This indicates that many of banks’ listed clients, which were previously considered high risk due to their fictitious beneficial owner being a politically exposed individual, are no longer high risk due to the exposure of the nonexistent fictitious beneficial owner. This further proves, even to regulators, that it is not yet clear what changes will come in the near future. Banks must remain ready to adapt to these new standards quickly, and most importantly, try to keep their costs under control.

ANTI-MONEY LAUNDERING REGULATION: THE CHALLENGES FACED BY FINANCIAL INSTITUTIONS AND REGULATORS CONTINUED

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NEW INITIATIVES TO COMBAT MONEY LAUNDERING AND TERRORIST FINANCING IN HONG KONG

In March of 2018, an enhancement to the Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) Ordinance took effect as an amendment to Hong Kong's principal AML legislation. A new licensing regime for trust or company service providers (TCSPs), and new requirements on the keeping of Significant Controllers Registers by companies, were introduced.

The "new regimes are in line with international requirements as promulgated by the Financial Action Task Force. The initiatives will safeguard the integrity of Hong Kong as an international financial center and add to our credibility as a trusted and competitive place for doing business," the Registrar of Companies said.

The primary objectives of the amendments are to:

1. introduce a licensing regime for TCSPs to require them to apply for a license from the Registrar of Companies and satisfy a so called "fit-and-proper" test before they can provide trust or company services as a business in Hong Kong
2. apply statutory customer due diligence (CDD) and record-keeping requirements to i. a. TCSPs
3. make amendments to the existing requirements relating to financial institutions

IMPACT

Four key implications of the new AML Ordinance for corporate trustees:

Licensing

TCSPs are required to apply for a license within a four-month transition period by June 28 th, 2018, and maintain up-to-date information on beneficial ownership.

The licensing requirement does not apply i. a. to a Securities and Futures Commission of Hong Kong (SFC) licensed corporation that operates a trust or company service business, which is ancillary to the corporation's principal business.

Complying with AML/CTF Requirements

TCSP licensees are required to comply with AML/CTF requirements. This means that they will need to conduct CDD to identify their customers, and keep records of the identification data, and account and business correspondence for a minimum of at least five years – compared to the previously required six years.

Duties extended to outside Hong Kong

TCSP licensees need to ensure that their branches and subsidiaries in a place outside Hong Kong, have policies and procedures in place to ensure compliance with requirements similar to the AML/CTF Requirements of the AMLO.

Measures include, but are not limited to:

- Incorporating a group AML/CTF policy to ensure that branches and subsidiaries which carry on the same business as the licensee in a place outside Hong Kong, comply with the CDD and record-keeping requirements similar to those imposed of the AMLO to the extent permitted by the law of that place.
- If a branch or subsidiary of a TCSP licensee outside Hong Kong is unable to comply with requirements which are similar to those imposed of the AMLO because such is not permitted by local laws, the licensee must:

  o inform the Registrar of such failure; and

  o take additional measures to effectively mitigate risks faced by the branch or subsidiary undertaking as a result of its inability to comply with the AMLO requirements.

Sunset provision rescinded

The time limit to appoint a Hong Kong registered trust company to act as intermediaries in carrying out CDD measures, is removed. Financial institutions may hence continue to rely on such companies.

Sources: https://www.tcsp.cr.gov.hk/tcspls/

OUTCOMES OF THE FATF PLENARY MEETING

The Financial Action Task Force (FATF) is the most influential inter-governmental body in the fight against financial crime. It sets global standards for the implementation and enforcement of regulatory and operational standards in the international fight against money laundering, terrorist financing, and other financial crimes. The FATF is a standard-setter and a supervisory body of sorts, as it monitors jurisdictions' implementation of the FATF Recommendations[10]. The FATF members and observer jurisdictions meet in a plenary three times per year. This is where decisions are made, and various topics of interest discussed.

The last plenary session took place between February 21th and 23th, 2018, and aside from the usual change in country categorization in terms of presenting "strategic Anti-Money Laundering (AML)/Counter Terrorism Financing (CTF) deficiencies", a number of other topics of interest were addressed, such as Counter Proliferation Financing (CPF), the push to further align data protection rules to AML/CTF regulation, and de-risking.

PRIVATE SECTOR RESPONSIBILITY IN COUNTER PROLIFERATION FINANCING (CPF)

The FATF recently issued a Guidance on Counter Proliferation Financing aimed at "[t]he implementation of financial provisions of United Nations Security Council resolutions to counter the proliferation of weapons of mass destruction."[11]. The document provides direction on the implementation of effective counter-proliferation measures, and in so doing, the FATF Recommendations 2 and 7 on targeted financial sanctions related to proliferation. The Guidance acknowledges that such implementation is not risk-based, but rule based, and explicitly does not require a proliferation risk assessment. However, it mentions that "Participation by all relevant stakeholders from both public and private sectors in such assessments would be beneficial.". This indicates a push, albeit soft, from FATF for jurisdictions, regulatory bodies, and Financial Institutions (FIs) to increasingly understand proliferation financing as a risk to account for in their fight against financial crime.

Sanctions can be issued for a multitude of reasons, for example, proliferation of weapons of mass destruction or terrorism financing. And whilst compliance with sanctions is not a risk-based space, there is no reason why proliferation financing risk should not be also understood as a risk to be managed, as it is the case for terrorism financing. Adopting such an approach and explicitly raising standards in this regard could enhance the comprehensiveness of existing financial crime controls. For example, FIs would have to include detection scenarios specifically targeting proliferation financing behavior as part of their transaction monitoring solutions, which in turn would require investigation teams to handle proliferation financing cases. Starting with the assumption that anti-financial crime controls are commensurate with the risk that a given bank is facing (i.e. risk-based approach), adding proliferation explicitly to the typologies to account for, when performing risk assessments, should lead to a better counter proliferation financing controls and widen the net.

MAKING DATA PROTECTION AND AML/CTF COMPATIBLE

The FATF revised Recommendation 2 pertaining to national cooperation and coordination to include information sharing, in order to encourage member jurisdictions to make their data protection law compatible with AML/CTF regulation. The expectation of the FATF is that this change will also benefit Financial Institutions (FIs)as they often encounter obstacles in exchanging information within their corporate structure.

Data privacy and financial crime risk have become increasingly intermingled topics in the past few years, as multinationals struggle to balance their obligations on both front and as inefficiencies are created when processes are decentralized due to data sharing restrictions. Making data privacy and the fight against financial crime compatible has been an important lesson learned by policy makers and regulatory authorities. That said, how to successfully combine the implementation of this amendment and the General Data Protection Regulation (GDPR) remains unclear.

[10] http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf
[11] http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-Countering-Proliferation-Financing.pdf

OUTCOMES OF THE FATF PLENARY MEETING CONTINUED

DE-RISKING IS NOT THE SOLUTION

Following the exit of Tier 1 banks of large portions of their correspondent banking and money service business portfolio, the FATF and its member jurisdictions increasingly recognized the potential negative impact of banks adopting a strict cost-benefit approach to AML/CTF regulatory compliance. Indeed, the FATF acknowledged that "[linappropriate de-risking undermines financial resilience and inclusion and promotes underground financial channels that can be misused by criminals and terrorists."[12]. The proposed approach is to provide further guidance to FIs on the implementation of a risk-based approach, enabling them to competently manage their money laundering and terrorism financing risk, as the Fourth EU Money Laundering Directive aimed to do. This reinforces the message that FIs need to assess, understand, own, and manage their own risk rather than simply getting rid of the risk altogether. This is an area where the execution of a simple cost-benefit analysis will no longer suffice for FIs justifying the exiting of large amount of relationships. Instead, increased expectations that banks should be able to implement cost-efficient, risk-based controls are instated.

IMPACT

The outcome of the FATF plenary provides insight on what is to come in the anti-financial crime space from a regulatory perspective, pushing the industry to shift from being reactive to being proactive. Both the public and private sectors are gaining a more comprehensive understanding of the fight ahead of them. Meanwhile, the legislative process is slow and large organizations struggle to implement a change. In general, FIs still focus on compliance risk management, rather than on managing their actual financial crime risk through the implementation of a sound risk-based approach grounded in consistent minimal global standards, strong governance, operationally sound execution and a concrete understanding of financial crime typologies.

[12] http://www.fatf-gafi.org/publications/fatfgeneral/documents/outcomes-plenary-february-2018.html

TRANSPARENCY AND MARKET STRUCTURES: ESMA UPDATES ITS MIFID II Q&AS

On February 7th, 2018, the European Securities and Market Authority (ESMA) published an update to its Questions and Answers (Q&As) on transparency and market topics under the second Markets in Financial Instruments Directive (MiFID II).

The Q&A mechanism is a tool designed to promote common supervisory approaches and practices under Article 29 (2) of the ESMA Regulation No. 1095/2010. Although answers are not formally consulted on, ESMA may circulate them for review with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group, or, if necessary, with external parties.

Q&As are periodically reviewed by ESMA and updates are made when required. In certain cases, some of the material in the Q&As may need to be transferred to ESMA Guidelines and recommendations.

UPDATE ON QUESTIONS THAT HAVE BEEN ADDED AND ANSWERED

Between December 2017 and February 2018, the following Q&As were added to ESMA's framework:

QUESTIONS POSED BY STAKEHOLDERS	ANSWER FROM ESMA
Should subscription rights be treated as equity instruments or non-equity instruments?	Subscription rights must be treated as an extension of the shares category and therefore as equity instruments. This means that subscription rights should be subject to the pre- and post-trade transparency regime for equity instruments.
What is the process followed by Systematic Internalisers (SIs) to waive the obligation in Article 18 (2) of MiFIR?	A National Competent Authority (NCA) may allow any SI within its jurisdiction to waive the obligation in Article 18(2) of MiFIR, so long as it complies with the relevant requirements and conditions set out in Article 9(1) of MiFIR. Nevertheless, an NCA may also allow SIs in its jurisdiction to waive the obligation based on individual applications.
How will the reference price waiver be applied for shares listed on multiple venues and traded in different currencies?	The reference price is to be derived from the trading venue where the financial instrument was first admitted to trading or the most relevant market in terms of liquidity. Therefore, it is possible to transact in currencies other than the currency that is used on the trading venue from which the price is derived.
Are "pre-arranged" transactions permitted for transactions in non-equity that are subject to the MiFIR trading obligation?	Although MiFIR does not have specific provisions for "pre-arranged" transactions for non-equity instruments, ESMA considers it possible to formalise "pre-arranged" transactions on a trading venue, subject to meeting the conditions for the respective waivers from pre-trade transparency set out in Article 9 (1) of MiFIR.
How should the minimum size of orders held in an order management facility of a trading venue pending disclosure be calculated for non-equity instruments?	This should be calculated according to Table 4 of Annex II of RTS 2 except for emission allowances and emission allowance derivatives for which the notional number of traded contracts should be used.

Table 4: Updated Q&As as of February 7th, 2018 (Source: Own Representation)

TRANSPARENCY AND MARKET STRUCTURES: ESMA UPDATES ITS MIFID II Q&AS CONTINUED

IMPACT

As banks continue to implement MIFID II transparency requirements, further uncertainty and questions will arise surrounding the extent of their obligations. The answers provided by ESMA in recent months will help guide financial institutions, those of which have the instruments and trading venues applicable to the MIFID II regime. This will ensure that trades are reported in the correct timeframes and in accordance with the rules of the regulator, improving market transparency and rebuilding trust in banks and financial institutions in general.

Please find the consultation paper here

EBA RISK INDICATORS METHODOLOGICAL GUIDE

On February 8th, 2018 the European Banking Authority (EBA) released the final update of the "EBA Risk Indicators Methodological Guide". The revised document will serve the EBA compliers and internal users with the specification of Risk Indicators (RI) and Detailed Risk Analysis Tools (DRAT) that are part of EBA's new uniformed reporting requirements framework to ensure data availability and comparability. Furthermore, the guide provides transparency on the underlying concepts, data sources, calculation techniques, and methodological issues relevant for an appropriate interpretation. The indicators have been allocated to eight categories based on the underlying risk, and are presented in the first part of the guide.

The liquidity risk, defined by the EBA as the inability to fund asset increases and meet financial obligations, can have a significant impact on earnings (e.g. Net Interest Income) and capital (e.g. Economic Value of Equity). It is considered a systemic risk due its heavy impact on the transformation role of banks, their interconnectedness and the general performance correlation within the financial services sector. The 17 RI (LIQ 1 to 17[13]) and 1 DRAT, sourced mainly from the EBA's standardized reporting frameworks (CoRep and FinRep) for the Capital Requirements Directive (CRD), aim to enable a direct comparison of certain types of assets and liabilities holdings, and the identification of cross-regional weaknesses in liquidity position and potential shortfalls.

The funding risk, defined by EBA as the inability to access sufficient funds in efficient manner to meet its obligations when they fall due, can have a severe impact on the creditworthiness and credit standing (and if prolonged on the credit rating) of a financial institution. The level of asset encumbrance (in relation to the ability to handle funding stress) and the so-called funding profile (the composition and the quality of funds) are the two main risk drivers defined by EBA. The 34 RI and 1 DRAT are be divided correspondingly in two general groups – FND[14] 1 to 7 and FND 33 handle asset encumbrance whereas FND 8 to 32 and FND 34 handle balance sheet structure (funding profile). Due to this segmentation, these RI should be analyzed and interpreted jointly to enable covering the full picture of the associated gunning risks.

The asset quality risk, defined by EBA as the reflection of existing and potential credit risk on and off the balance sheet, needs to be closely monitored and maintained within the borders defined by the banks risk appetite to allow the maximization of the bank's risk-adjusted rate of return. As the most critical and heavily supervised area of bank's business model, it is no surprise that EBA has identified as many as 158 RI and 5 DRAT to cover the different aspects of the asset quality concept broadly structured in seven categories – non-performing exposures (AQT[15] 1 to 5, 20, 37, 41, 48 to 51, 54), impaired assets (AQT 6 to 10,19, 25, 29, 36, 40, 44), fair value asset methodology (AQT 22), level of forbearance (AQT 24, 38, 39, 42, 47, 52, 53), value adjustments and write-offs of defaulted exposures (AQT 11, 12, 16, 17, 43), and detailed information on defaulted exposures (AQT 13 to 15, 18, 23). The DRAT has been divided in two groups – NPE-based country ranking (DRAT

[13] EBA's liquidity risk indicator reference number LIQ 1 to LIQ 17
[14] EBA's funding risk indicator reference number FND 1 to FND 34
[15] EBA's asset quality risk indicator reference number AQT 1 to AQT 158

EBA RISK INDICATORS METHODOLOGICAL GUIDE CONTINUED

25, 26) and default metrics (DRAT 29 to 31).

The profitability risk, defined by EBA as the outcome of cyclical factors (interest rate and yield curves, asset price bubbles, economic factors, etc.) and structural reasons (economic adequacy of the business model and internal governance structures, flexibility to changes in business environment, etc.), can materialize with adverse outcomes like shrinking equity or the inability to generate new equity. The 43 RI can be divided in two main groups – an overview perspective (PFT[16] 21 to 33) and a deep dive in the profitability sources (PFT 1 to 20, 34 to 43). The second group covers five broad topics – cost structure and administrative expenses, geographical structure of costs and revenues, structure of interest income, structure of fees and commissions income, and follow-the-money approach on the balance sheet (DuPont Analysis).

The concentration risk, defined by EBA as the excessive loss due to the default of a single or a small set of counterparties, is one of the risks needing very close monitoring and governance on a micro and macro level. This is due to its ability, in an extreme outcome, to lead to insolvency (e.g. the crash of the US housing market and the extreme exposure concentration in mortgage derivatives at Lehmann Brothers and the interconnectedness with many other banks). Furthermore, this section provides guidance on the interpretation of the term "exposure". The 11 RI (CON[17] 1 to 11) tracks exposures relative to size and type of the counterparty. The 24 DRAT aims to give an overview of assets and exposures by country, sector, etc. (COREP and FINREP breakdowns), and to visualize the interconnectedness of countries and sectors – this done by including the EEA Member States alongside the 16 countries with highest exposure, as well as a corresponding sectoral breakdown facilitating comparison.

The solvency risk, defined by EBA as the inability of an institution to absorb losses or earnings decreases, is considered critical enough to justify the integration of some RI into legal and regulatory requirements. The 30 RI can be generally divided into 2 broad categories. The measurement of the solvency risk and of the composition of the institution's risk profile are covered by the first group (SVC[18] 1 to 11 and 26 to 28), whereas specialized topics such as regulatory leverage ratios, own funds to supervisory capital, core components composition, and transitional adjustments to regulatory capital, are covered by the second group.

The operational risk, defined by EBA as the result from inadequate internal processes, failed systems, human error or external sources, reflects the loss potential due to a variety of events types – internal/external fraud, employment practices, business practices, damage of physical assets, business/system failures, execution and process management. The 10 RI covers two broad areas: the relative importance of operational risk exposures compared to other risks (OPR[19] 1 to 4, 9, 10), and the loss size across different event types (OPR 5 to 8). Regarding the first group, operational risk is not a main risk source in the normal business model of a bank; it is a complementary risk that cannot be avoided, and only transferred in certain cases. The second group provides insights to where controls are needed, and guidance as to the remedial actions which should be put in place.

The market risk, defined by EBA as the potential losses on- and off-balance sheet arising from adverse movements of the market, stems mainly form the bank's trading book positions, and sometimes forms commodity and foreign exchange in the banking book. The recent financial crisis highlighted the strong relationship between market risk with most of the other risk categories and emphasized the importance of an appropriate risk monitoring framework. The 10 RI covers the risk-weighted exposure amount (MKR[20] 6 to 9, 11, 13), time-decomposition (MKR 4, 5, 14), marketability of trading book (MKR13), trading of commodity or derivatives (MKR 1 to 3), validity of internal VaR model (MKR 10), and foreign exchange risk relative to the total market risk (MRK 8).

In accordance with the Regulation (EU) No 1093/2010, a final specialized risk category is set with focus on monitoring and assessment of small and medium-sized enterprises (SME) and their specifics (the precise definition of SME is thoroughly covered in CRD IV/CRR). The 14 RI covers lending trend indicators (SME 1, 2, 4), asset riskiness (SME 6 to 13), and credit protection dependency (SME 14).

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[16] EBA's profitability risk indicator reference number PFT 1 to PFT 43

[17] EBA's concentration risk indicator reference number CON 1 to CON 11

[18] EBA's solvency risk indicator reference number SVC 1 to SVC 30

[19] EBA's operational risk indicator reference number OPR 1 to OPR 10

[20] EBA's market risk indicator reference number MRK 1 to MRK 10

EBA RISK INDICATORS METHODOLOGICAL GUIDE CONTINUED

The second and last part of the guide encompasses the diverse methodological issues regarding the compilation of the RI. It serves as a “deep dive” into the risk indicators covering the scope of data, negative value interpretation, statistical metrics, reporting and data flow issues, the “follow-the-money” approach, and a peer group analysis.

IMPACT

With this guide the EBA aims to achieve a major enhancement on the coverage, operational effectiveness, transparency, and comparability of its monitoring activities over the EU financial sector through to a transition towards a comprehensive and uniform requirements framework, built upon predefined and standardized metrics (RI) and tools (DRAT). This framework is aimed to be integrated into the Implementing Technical Standards (ITS), already introduced by EBA, serving as the “backbone” for the collection and compilation of EU supervisory statistics. The integration of this framework within the bank-wide governance, risk and compliance structures is essential for the future operating model, due to its interconnectedness with a multitude of other regulations.

SECTION 5: CONTACT US

If you would like to find out more about Capco's Regulatory expertise around the subject areas discussed within these articles, or if you have any other questions related to our Regulatory Monitoring Newsletter, please contact the Regulatory Monitoring team: CE_CM_RegMonEditors@capco.com

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