WELCOME TO CAPCO'S

REGULATORY MONITORING NEWSLETTER

2018 2ND ISSUE

CAPCO
THE FUTURE. NOW.

SECTION 1: INTRODUCTORY NOTE

Capco continuously monitors the scope of regulations, prepares newsletters on major regulatory developments in the financial industry and develops 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 while providing 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. This helps our clients to manage strategy, business models and operating procedures – while at the same time addressing fundamental issues around profitability and future plans.

This Newsletter contains references to the most important regulatory changes and forthcoming 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.

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CURRENT REGULATORY DEVELOPMENTS FOR FINTECH

For many decades, innovative technologies have been developed and applied to support the provision of financial services. However, over recent years, the range of financial innovations, the prevalence of their use and their pace of evolution have increased substantially. Considering these developments, there is a challenge for regulators and supervisors to allow opportunities presented by FinTech to be fully and properly realized without undermining consumer protection, the level playing field, the integrity of the financial markets, and the stability of the financial system taken. During the last months the European Banking Authority (EBA) and the European Central Bank (ECB) published two major papers that aimed at harmonizing supervisory practices for FinTech and assuring a level-playing field in the industry.

EBA - ROADMAP ON FINTECH

In August 2017, the EBA published a Discussion Paper on its approach to FinTech, which requires the EBA to contribute to enhancing consumer protection, promote a sound, effective and consistent level of regulation and supervision, prevent regulatory arbitrage, and promote equal competition. The EBA then published in March 2018 a Roadmap on FinTech outlining its priorities for 2018/2019.

This Roadmap also sets out the establishment of a FinTech Knowledge Hub to enhance knowledge sharing and foster technological neutrality in regulatory and supervisory approaches.

The EBA's FinTech Roadmap summarizes and shows an indicative timeline on the work carried out by the EBA for each aspect and applies it to the European Supervisory Authorities (ESAs: EBA, European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA)).

The six main areas of EBA's expectations in the Guidelines are:

CRITERIA	GUIDELINE
Authorization and regulatory perimeter	The EBA will monitor the regulatory perimeter, including assessing current authorization and licensing approaches to FinTech firms, and analyses regulatory sandboxes and innovation hubs.
Impact on institutions' business models and prudential risks and opportunities	The EBA will monitor emerging trends and analyses the impact from the use of FinTech. Further, the EBA may also analyses how institutions are responding to these risks and how they adopt their internal governance, control and risk management frameworks.
Cybersecurity	The EBA will promote best supervisory practices on assessing cybersecurity and promoting a common cyber threat testing framework.
Consumer protection	The EBA will address consumer issues arising from FinTech, in the areas of unclear regulatory status of FinTech firms and related disclosure to consumers.
Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT)	The EBA will identify and assess AML/CFT risks associated with regulated FinTech firms, technology providers and FinTech solutions.
FinTech Knowledge Hub	The EBA will form a FinTech Knowledge Hub that will provide an overarching forum bringing together competent authorities (CAs).

CURRENT REGULATORY DEVELOPMENTS FOR FINTECH CONTINUED

ECB - GUIDE TO ASSESSMENTS OF FINTECH CREDIT INSTITUTION LICENSE APPLICATIONS

Because the European Central Bank (ECB) has received an increased number of applications, one of ECB's objectives is to provide a general understanding of the criteria for granting licenses to Fintechs. The ECB published in March 2018 a guide describing the main areas Fintechs are assessed on during the license application process. In addition, this guide intends to align the requirements for Fintechs to the requirements outlined in the general guide applicable to all other license applicants to become credit institutions (license extensions, bridge banks, etc.).

The guide highlights the term "fintech banks" that denotes a business model in which the production and delivery of banking products and services are based on technology-enabled innovation. This general definition captures the different activities of a credit institution. For instance, new fintech subsidiaries of existing and authorized banks or new market participants that use innovation to compete with banks throughout the value chain.

The application procedure integrates both the ECB and the national competent authorities (NCAs) in a joint assessment process, which can be summarized as follows:

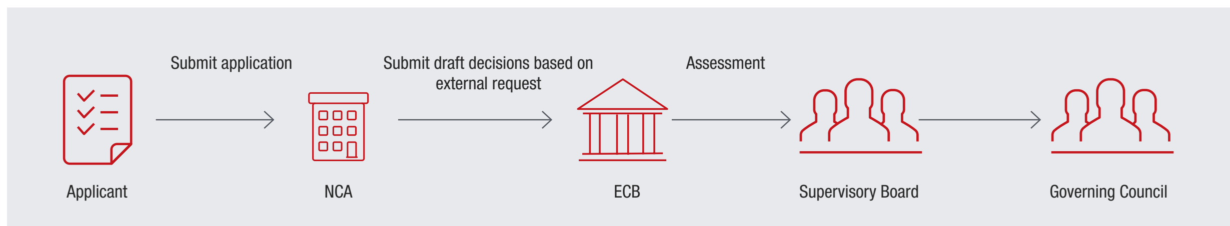

Figure 1: The authorization process (Source: ECB)

Fintech banks are treated as any other credit institution. This means that the assessment criteria is the same as the ones used for other entities such as banks. Something particularly important is the criteria outlined in the latest Capital Requirements Directive (CRD IV), which provides detailed descriptions of the various elements credit institutions need to meet (e.g. ratios, risks measures, etc.). The NCAs have committed to interpret national laws and develop procedures aligned with the ECB polices as much as possible. The four pillars of the CRD IV and the respective particularities assessed in the licensing processes for FinTechs tabled on the next page.

CURRENT REGULATORY DEVELOPMENTS FOR FINTECH CONTINUED

CRITERIA	GUIDELINE
Management Body	Management bodies must have the knowledge, the skills, and the experience to adequately fulfill their responsibilities, including practical and theoretical experience in banking as well as in financial business. Also, because fintech banks have technology-driven business models, the ECB requires that the management possesses technical knowledge as this is equally important as banking knowledge. Under the CRD IV, fintech banks must appoint a Chief Technology Officer as member of its executive board.
Shareholders	As part of the licensing procedure, shareholders are assessed as in any other credit institution. In the case of Fintechs, ECB acknowledges that shareholders may include venture capital entities and, in some cases, "business incubators". Thus, according to CRD IV, shareholders must have management and technical competence in relation to financial activities including financial services. The assessment of shareholders will focus on their financial soundness by evaluating their willingness and ability to provide capital over and above the initial requirements.
Structural Organization	The ECB and NCAs will assess Fintechs' approaches and procedures to: a) identify and prevent frauds, b) evaluate clients' ability to repay considering income and debt, and c) determine clients' willingness to repay based on their past performance. For such effect, Fintechs' end-to-end credit process will be assessed considering credit policies, periodic documentation, type of data used for approving loans, assessment of non-performing loans, credit scoring processes, among others. In addition, the assessment will also pay close attention to the IT-related procedures regarding cyber risks. For instance, it will be assessed, if Fintechs have specialized staff for detecting and responding to cyber incidents.
Program Operations	The guide pays special attention to the business plan of the Fintechs applying for a license. Such business plans should forecast in detail the envisaged operations including start-up losses in the first years of operations as well as the period up to the break-even point. As part of the business plan, Fintechs must include their exit plan. This requirement intends to understand how applicants plan to unwind its business and cease their operations without affecting depositors.
Capital, liquidity, and solvency	ECB and NCAs will assess Fintechs' capital, liquidity, and solvency particularly considering the start-up phase. For such effect, the guide encourages to carry out this assessment based on potential scenarios depending on the business nature of each entity.

Table 2: General Criteria assessed in the licensing processes for Fintechs (Source: Own representation based on the information from the ECB)

IMPACTS

- Having a guide for assessing Fintechs is an important step towards the regularization of fintech business models. Many have wondered whether Fintechs had an advantage over banks, as it was not clear if Fintechs would have less stringent rules as banks.
- With this guide, it is now clear that Fintechs and banks will be equally assessed. Fintechs need to be financially solid supported by shareholders, not only with experience in the financial sector, but also with the financial means to provide capital above the requirements. Client protection remains in the core of the guide by ensuring that deposits and savings are protected in case of unforeseeable events.

JOINT COMMITTEE REPORTS ON RISKS AND VULNERABILITIES IN EU FINANCIAL SYSTEM

In April 2018, the Joint Committee has issued a report on Risks and Vulnerabilities in EU Financial system considering

(I) valuation risks and potential for sudden risk premia reversals,

(II) uncertainties around the terms of the UK's withdrawal from EU,

(III) highly escalating threat of cyber risks and

(IV) climate change and the transition to a lower-carbon economy.

All these factors raise concerns about the sustainability and stability of the European financial system and overall market confidence.

Today's volatility remains very low by historical standards in 2007, which reflects to some extent expectations of continued monetary policy support. The relative absence of market reaction to adverse events also potentially increased investor complacency and the probability of sudden risk repricing. Implied volatility in 2017 was also particularly low in historical terms when the shortest option maturity is taken into account. Compared to the mid-2000 pre-crisis period, the second half of 2017 displayed a larger difference between short and long term implied volatilities and such larger differences indicate expectations that volatility may increase in future periods. Low interest rates coupled with low volatility and sufficient liquidity may have led to a build-up in excessive risk and an increase of medium-term vulnerabilities. The expectation based on potential policy changes as well as the materialisation of risks in European financial markets may trigger significant increase in yields, volatility spikes, and losses in asset prices. The major consequences of the risk to valuations and repricing of risk premia are:

(i) Negative effect on bank profitability and asset quality due to low yields that leads to higher investing into riskier assets and easing of credit standards,

(ii) Retail consumers are affected by a replacing of risk premia through their portfolio holdings – significant market turmoil can reduce household's consumption through wealth effect and realised losses,

(iii) The prolonged low interest rate environment provides an incentive for insurers to search for yield through increased exposure to lower credit quality bonds, non-listed equity and loans and less liquid asset classes.

Until now, the impact of Brexit that was observed varies across financial sectors. For example, for securities markets the structural impact of the UK's withdrawal seems to be limited. Some insurance companies that are more substantially exposed to UK assets might be affected in the short to medium term due to the drop in the value of some asset classes, which can negatively affect their solvency position. The most possible consequence of the Brexit is the relocation of financial service activities. It becomes important to ensure a consistent EU supervisory approach to potential relocations of financial institutions to protect the integrity of the Single Market.

The European Banking Authority (EBA) has already published an opinion providing guidance to ensure the consistent application of EU legislation for the banking sector. Regarding the insurance sector the European Insurance and Occupational Pensions Authority (EIOPA) has issued an opinion to national supervisory authorities setting out principles to ensure consistency in the authorisation process related to the relocation of insurance undertakings from the UK. Another risk for market participants is the reduction of access to market infrastructure and contract continuity upon Brexit.

Technological innovations provide a lot of opportunities in the financial sector for consumers and investors. In such an environment, cyber risks have become a significant and increasingly escalating threat to investor protection and financial markets stability worldwide. Because financial institutions continue to outsource their systems and processes that support regulated activities to cloud services – these risks become even more challenging end severe. Moreover, cyber risks tend to threat data integrity, data confidentiality, data protection and business continuity. The risk is significant because it can cause high legal costs, and mostly because of multiplier effects that lead to further risks such as supply chain risks, and reputational risks. As

JOINT COMMITTEE REPORTS ON RISKS AND VULNERABILITIES IN EU FINANCIAL SYSTEM

CONTINUED

mentioned above, new challenges arise with the increased outsourcing to cloud service providers. Cloud computing offers many benefits, but at the same time such activities pose risks beyond those of traditional IT outsourcing.

The next concern is about climate change and transition to a lower carbon economy risk. This risk is relatively new, however seems to be of relative importance for large parts of the financial sector. Even though climate risk is receiving increased attention amongst supervisors, general knowledge about the impact of these risks on the financial sector is still relatively limited. It is known that rising global temperature is expected to cause an increase in severe weather events, such as droughts, floods and storms. When it comes to the financial markets, if such events are secured, they can directly affect financial positions of insurance companies which are involved in such transactions. If those risks are uninsured, all burdens to cover potential losses fall on the government, thus to households and corporations. The transition to a lower-carbon economy also provides new opportunities around sustainable finance.

IMPACT

Looking at the potential effects of valuation risks on the European Financial systems, it becomes clear how important the proper development and the regular use of stress test evaluation tools across all sectors that will help to analyse and mitigate the consequences of the risk premia seems. With Brexit, it becomes important that EU financial institutions and their counterparties together with investors and retail consumers prepare appropriate mitigation actions in time to be fully prepared. Supervisors should continue to encourage financial institutions to improve the robustness of their IT systems and address concerns about connectivity and outsourcing to third-party providers. Considering potential climate changes, financial institutions should be encouraged to take a more forward-looking approach to include sustainability risk in their governance and risk management frameworks, and to develop responsible, sustainable financial products.

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EMIR: MEASURING RESILIENCE – ANALYSIS OF THE RECENT HEALTH-CHECK FOR EU CCPS

ANNOUNCEMENT IN SHORT

On 2 February, 2018, the European Securities and Markets Authority (ESMA) published the results of its 2017 2nd EU-wide stress test for clearinghouses. By doing so, the supervisory authority exercised its mandate to conduct EU-wide stress tests for clearinghouses and acted in accordance with two of ESMA´s Founding Regulation policies, EMIR Art. 6b and Art. 32. The 1st stress test in 2016 focused on credit risk, and revealed no shortcomings. In its 2nd stress test, ESMA broadened the scope to include liquidity risk and reported two findings for BME and ICE Clear Europe.

FUNCTION OF A CLEARING HOUSE

A clearinghouse serves as an intermediary between buyer and seller. For each ETD and standard OTC derivative contract subject to the clearing obligation, a clearinghouse becomes a counterpart for both sides of a transaction. Originally, clearinghouses were mainly responsible for settling trading accounts, netting opposing transactions before settlement, and providing settlement guarantee. Today, the main function of a clearinghouse is to provide risk management via the collection of margins and default fund contributions, thus reducing systemic risk.

BACKGROUND AND REGULATORY FOCUS OF CCP STRESS TESTS BY ESMA

In the aftermath of the financial crisis, both banks and clearinghouses are believed to be able to fail under extreme market conditions. With growing importance of central counterparties (CCPs), the relevant regulatory framework continues to transform and develop. In addition to the prudential requirements, laid down in EMIR with respect to normal market conditions, there is a set of measures which focus on extreme market conditions.

One of those measures is a requirement for a recovery and resolution mechanism of CCPs, which is looking to come to fruition in the near future. Another measure according to EMIR, is a daily stress test conducted by each EU CCP as part of its own risk management. An additional measure is the implementation of EU-wide stress tests. These tests are to be conducted by the EU-authority on an annual basis to prove the resilience of EU-authorized CCPs as an interconnected system.

Whereas recovery and resolution requirements deal with extreme, residual market scenarios, stress tests are being designed to cover extreme, but plausible market conditions. An applicable description of both instruments, in the context of the risk management framework for CCPs, has been recently provided by Steven Maijoor, chair of ESMA.

Both individual daily stress tests by CCPs, and annual industry-wide stress tests conducted by the EU authority, are focused on proving the CCPs´ resilience against multiple counterparty defaults[1] combined with market price shocks. Individual CCPs rely on their daily stress tests to assess the adequacy of their prefunded financial resources, and to regularly calibrate the size of their default funds. In doing so, CCPs use individual stress test scenarios. ESMA, on the other hand, uses harmonized market and default scenarios, considering interconnectedness of European clearinghouses and that multiple clearing members are clients of several CCPs.

RELATED INITIATIVES OUTSIDE THE EU

There are equivalent stress tests outside the EU which are gaining significance after the last global financial crisis. They are based on an international standard methodology by the Committee on Payments and Market Infrastructures (CPMI), and the International Organization of Securities Commissions (IOSCO) - the Principles of Financial Market Infrastructures ("PFMIs").Though both are used to shape these alternative stress tests, these contributors noticeably differ in detail. In the US, stress testing is being conducted by the Commodity Futures Trading Commission (CFTC), the local supervisor, which oversees the derivatives clearing organizations (DCOs). The latest stress test in the US included a reduced participant number (3) and covered exclusively the liquidity risk aspect.

Recently, CPMI-IOSCO has produced a new methodology

[1] "Cover 2" requirement in the EU

EMIR: MEASURING RESILIENCE – ANALYSIS OF THE RECENT HEALTH-CHECK FOR EU CCPS CONTINUED

for multi-CCP stress testing. Although not legally binding, standards published by international bodies like CPMI-IOSCO or BCBS are being used by national supervisors in their oversight practice or upon transition into national law.

TEST RESULTS ANALYSIS

For the recent ESMA´s stress test, all (16) EU-authorized clearinghouses had provided data on their actual positions and financial resources for the stress test reference date in March 2017. CME Clearing Europe was a participant at one point but had wound down its subsidiary in Europe and was not included in the March 2017 stress test.

A major side benefit of the stress test is an overview of the clearing market. The clearing market has had a clear increase in default resources since the 1st stress test, growing from 150 bn euros to 270 bn euros[2], and thus gaining in systemic importance. Another remarkable observation is the top 5 CCPs holding over 90% of the required margin amount and default fund contribution. London Clearing House was the leading top CCP, with the rest coming far behind. This proved to be an observation especially notable during Brexit and EMIR 2.2[3], this because the amount of default resources corresponds to the exposure of clearing members.

The main test result is the overall confirmation of the CCP resilience in the EU, with two shortcomings in one of the credit stress tests. In the reverse credit stress tests ("cover-2 groups"), market stress scenario one[4], and minor increases in shock magnitude (20%, 50%, 50% in combination with only one defaulting group, or baseline price shock in combination with three defaulting groups) would lead to "material" shortfalls (0.7 bn, 2.0 bn, 0.6 bn, and 0.4 bn euros respectively). This is due to the presence of either BME Clearing or ICE Clear Europe, the latter responsible for the main part of the shortfall. Thus, ESMA concludes that especially ICE Clear Europe is subject to "high sensitivity to small increases of shocks".

In the case of ICE Clear Europe, not only the prefunded resources of the 20 non-defaulting clearing members (CMs) would have been depleted, but also the non-defaulting CMs would be asked for non-prefunded resources (assessment

[2] Initial margin less excess margin plus default fund contribution

[3] EMIR 2.2 proposal deals with strengthening of supervision powers to maintain control over EU-relevant CCPs outside the EU.

[4] Market scenario 1 (shock originating in the CDS market), as described in ESRB´s methodology

EMIR: MEASURING RESILIENCE – ANALYSIS OF THE RECENT HEALTH-CHECK FOR EU CCPS CONTINUED

powers). This means a higher risk of losses for non-defaulting CMs in case of a default. On the other side, an ex-ante increase of defaulting resources before someone defaults, would mean higher clearing costs for all CMs.

Consider also the fact that ICE Clear Europe is a UK CCP and one of top 5 in the EU. However, at this point in time this stress test finding seems to be not politically exploited in the Brexit discussion – the EU Parliament votes against the EU Commission´s proposal regarding forced relocation of euro-denominated clearing.

Unlike credit stress test outcomes, liquidity stress test results and evaluation of the EU CCPs´ interconnectedness showed no reason for concerns.

WHAT COMES NEXT

ESMA stress tests are not to prove the regulatory compliance of an individual CCP or to test the effectiveness of the CCP´s risk management. In case of shortcomings, ESMA will issue recommendations according to Art. 21 EMIR in conjunction with Art. 16. of ESMA´s Founding Regulation: the affected financial institutions "shall make every effort to comply" and, if required by that recommendation, "shall report, in a clear and detailed way" on their compliance.

The next iteration for 2018 is in preparation. The new test methodology, though, has not yet been published. As stress test methodology evolves, further aspects may be included in future stress tests, affecting default fund and margin requirements in the long run, and thus, the costs of clearing. One such development has been a „cover-2 enough" (as an approach for a default fund adequacy) discussion in the market.

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MIFID II: ESMA UPDATES ITS DOUBLE VOLUME CAP REGISTER

On April 10th, 2018, the European Securities and Markets Authority (ESMA) updated its public register regarding the double volume cap (DVC) mechanism under the Markets in Financial Instruments Directive (MiFID II).

The updates included DVC data and calculations for the period between March 1st 2017 and February 28th 2018, commonly referred as the **March 2018 publication**.

BACKGROUND

The purpose of the DVC mechanism is to limit the amount of trading under certain equity waivers, which then ensures that the use of such waivers do not harm price formation for equity instruments. More specifically, the DVC limits the amount of "dark trading" under the reference price waiver and the negotiated transaction waiver.

The DVCs refer to the total volume of financial instruments, with an International Securities Identification Number (ISIN), that is traded across all EU venues. The basis for the calculation of those caps is as follows:

- For any ISIN, the average **trading on a single venue is capped at 4% of the total trading volume** over the previous 12-month period.
- For any ISIN, the average trading **on all EU venues is capped at 8% of the total trading volume** over the previous 12-month period.

Based on this, a financial instrument in a specific venue may breach the cap of 4% but still can be traded on other venues across the EU until the market reaches 8%.

On a regular basis, ESMA publishes the results of the DVC mechanism on its website in the Double Volume Cap Register.

UPDATE ON CAP BREACHES

According to March 2018 publication, the following breaches have occurred:

- The 8% cap exceeded 668 instruments (Jan 2018: 727 / Feb 2018: 633)
- The 4% cap exceeded 15 instruments (Jan 2018: 17 / Feb 2018: 10)

It is important to note that for most of the flagged instruments, the caps were already breached previously. Thus, the net number of new breaches which occurred in March 2018 was as follows

- 8 equities for the 4% cap (applicable to individual trading venues)
- 47 equities for the 8% cap (applicable to all trading venues across EU)

ACTIONS TO BE TAKEN BY ESMA AND NCAS

To maintain financial soundness of the system, ESMA takes measures in relation to the instruments that presented a breach. The instruments which breached the DVC thresholds during March, but also presented a breach in previous periods, will continue to be suspended from trading.

For the instruments newly added to the instruments in breach, National Competent Authorities (NCAs) must suspend the use of waivers within two working days. The suspension will last 6 months from April 13th, 2018 to October 13th, 2018.

ESMA highlighted that some trading venues have corrected prior trading data, and that amendments were submitted subsequently. Hence, the previous DVC publications have been affected. For some instruments, the suspension of trading under the waivers will be lifted.

MIFID II: ESMA UPDATES ITS DOUBLE VOLUME CAP REGISTER CONTINUED

IMPACT

Although substantial progress has been made through the combined efforts from trading venues, NCAs, and ESMA, the data received by trading venues is still not 100% complete. This affects the data accuracy, which in turn results in delays of the information published by ESMA.

The periodic report of cap breaches is essential because it helps to maintain a healthy financial environment. Both applicable caps (4% and 8%), in partnership with the suspension of instruments, reduce the risk of "dark trading" across EU venues.

Market participants should have mechanisms already in place to avoid trading in suspended securities.

REFERENCE

https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-double-volume-cap-register

CAPITAL MARKETS UNION: BREAKING DOWN BARRIERS TO CROSS-BORDER INVESTMENTS AND ACCELERATING DELIVERY

In March 2018, the European Commission (EC) published a set of proposals which will foster the comprehensive development of the Capital Markets Union (CMU) by 2019. To improve the European economic well-being, the EC took further steps to speed up the implementation of the Action Plan for a Capital Markets Union, by presenting proposals aiming to:

1. promote covered bonds as a solution for a cost-efficient source of funding across Member States;
2. remove regulatory barriers to increase cross-border distribution of funds within the European Union (EU);
3. encourage cross-border transactions in claims and securities by strengthening the legal certainty as to which national law applies.

BACKGROUND

In the last three years, there has been a substantial progress in building a single market for the barrier-free and transparent movement of capital across the EU. As the economic development varies among Member States, the EC intends to create new opportunities for cost-efficient funding as well as to foster risk-sharing for encouraging the participation of the less developed member countries in the EU market. These legislative proposals, if accepted by respective EU institutions, together with the planned upcoming changes, are to be implemented by 2019.

COVERED BONDS MARKET

The EU has a strongly developed covered bonds market, where investors (mostly institutional, i.e. banks) benefit from a stable cost-efficient source of funding. However, because covered bonds are regulated at national level, there is a fragmentation that results in an unequal prevalence of quality across the Member States. Therefore, the EC has seen the opportunity to lower the borrowing costs for all Members by proposing an integrated framework for covered bonds.

A harmonized treatment of covered bonds across the EU has been proposed by introducing a Directive and a Regulation. The Directive specifies the common definition of covered bonds by:

a. defining their structural components such as quality of the backed assets, as well as transparency and liquidity requirements,

b. defining the rules for their supervision, and

c. setting the rules for allowing the use of the 'European Covered Bonds' label.

The proposed Regulation, on the other hand, adds new requirements to the Capital Requirements Regulation (CRR) with the intention to improve the conditions in case preferential capital treatment is triggered.

CAPITAL MARKETS UNION: BREAKING DOWN BARRIERS TO CROSS-BORDER INVESTMENTS AND ACCELERATING DELIVERY CONTINUED

THE CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

The asset management industry has undergone an enormous regulatory change in the last decade which resulted in the establishment of a robust framework for investment opportunities for both private and institutional investors. Investment funds have been one of the main vehicles in the EU for efficient allocation of capital, which have led the economic development of the EU, as private savings are channeled to the productive use. The EU institutions have made significant efforts to boost the cross-border distribution of funds by taking actions such as introducing passports and reducing regulatory barriers for both UCITS and AIFs. Substantial work has been done to achieve transparency, to increase the investor protection, and to reduce the costs of investing so that this market can reach its maximum potential.

Considering both that investment funds are still sold mostly domestically, and that these are not evenly popular among Members, the European Commission has proposed:

1. Regulation to align the national regulatory requirements among the EU Members in terms of marketing and regulatory fees, while streamlining the approval process of marketing documentation by the domestic authorities. With this, European Securities and Markets Authority (ESMA) is granted better conditions to monitor the fund industry.
2. A Directive to streamline the conditions for exiting the market, as well as for the pre-marketing activities.

THE CROSS-BORDER TRANSACTIONS IN CLAIMS AND SECURITIES

The barriers for the efficient cross-border capital movements can be seen in the differences in the national laws which handle the third-party effects of assignment of claims, among Member States. The uncertainty, in terms of which laws apply to participants, results in a less integrated market, as the domestic market is preferred due to lower legal risks.

The proposal addresses the question regarding which country's law will govern the third-party effects of the assignment of claims in a cross-border transaction. The Commission has proposed a general rule that the law of the country of the habitual residence of the creditors, known as "assignors", will apply; noting that certain exceptions may apply. On this matter, the EC foresees that borrowers (i.e. small and medium companies), together with creditors (i.e. banks), and financial intermediaries (i.e. funds), will tend to get more involved in cross-border transactions due to a more stable legal framework.

The same conflict has been observed in case of transactions in securities, where currently only few Directives address the applicability of national laws. The EC has issued a Communication to determine which country's law should apply in which cases.

IMPACT

By harmonizing the legal framework within the EU, the cross-border economic activities are likely to rise. Participants will engage more in transactions by having more knowledge on the rights and duties of all involved parties. The alignment on the treatment of covered bonds and cross-border funds distribution will play a significant role in accelerating the economic growth in both the developed, and the less developed Member States.

The mentioned proposals are particularly important for smaller entities, such as retail businesses or smaller investment funds, as these can now get more involved in cross-border operations. This will result in increased competition among creditors, whilst achieving an efficient and integrated market safeguarding debtor.

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JOINT COMMITTEE FINAL REPORT ON BIG DATA

On March 15th, 2018, the European Securities and Markets Authority (ESMA), and the European Banking Authority (EBA), published their Joint Committee Final Report on Big Data. This report summarized the responses to the Discussion Paper on the use of Big Data, where stakeholders were asked to provide their opinions on March 2017.

BACKGROUND

The European Supervisory Authorities (ESAs), composed of the EBA, the ESMA, and the European Insurance and Occupational Pensions Authority (EIOPA), have noted an increased use of Big Data. This is particularly noticeable in the processes related to monitoring consumer protection developments across banking, insurance, and securities industries, as well as across different EU member states.

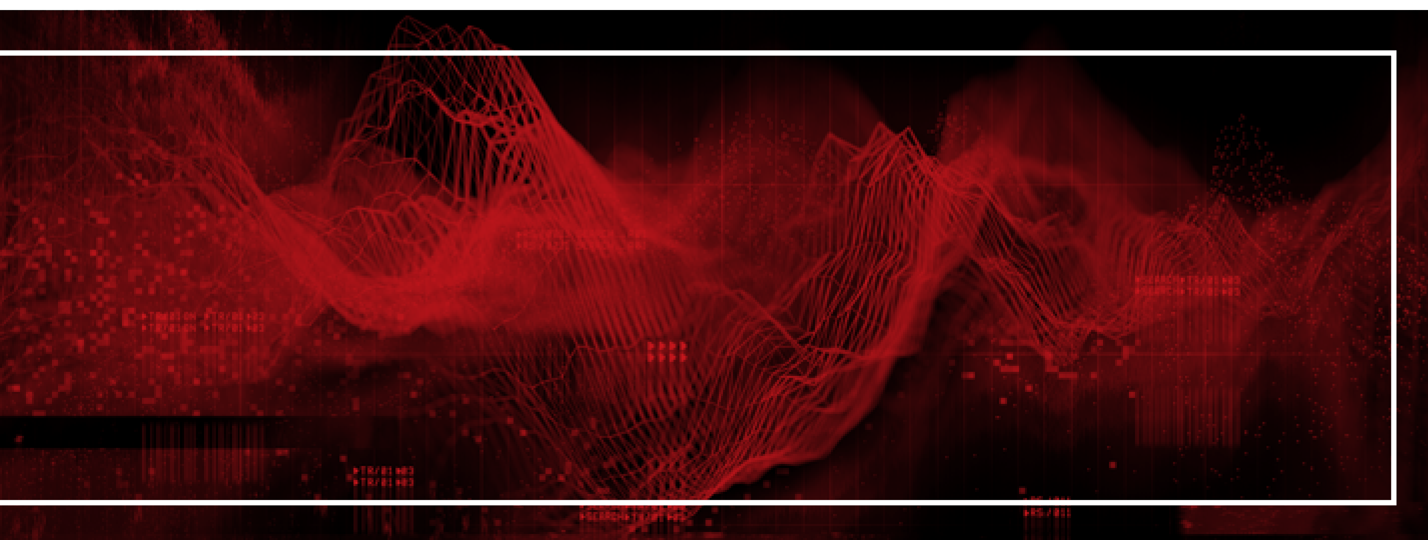
In ESMAs public consultation regarding the Discussion Paper on the use of Big Data, stakeholders highlighted various benefits, challenges, and opportunities arising from this Discussion Paper. They stressed the importance of having accuracy in the data that is gathered and used, as this can have a significant impact on future business decisions. For instance, many participants agreed that the use of Big Data techniques could help financial institutions develop tailored products by better considering the needs of their target market. Others see the potential of Big Data through enhancing the efficiency of their internal procedures while improving efforts in fighting fraudulent activities, or even enabling better customer-client interactions.

The received feedback confirmed and reinforced the need for regulators and supervisors to continue closely monitoring the development of Big Data, and the use of it by financial institutions.

Big Data

Big Data refers to processing of data sets so large and complex that they cannot be handled by traditional data processing software. Big Data is commonly referred as the 3 “Vs”, standing for “Volume”, “Variety” and “Velocity”. Some include 2 additional “Vs” for “Veracity” and “Value”.

Figure 2: Definition of Big Data (Source: ESMA)



PRELIMINARY CONCLUSIONS OF THE EUROPEAN SUPERVISORY AUTHORITIES (ESAS)

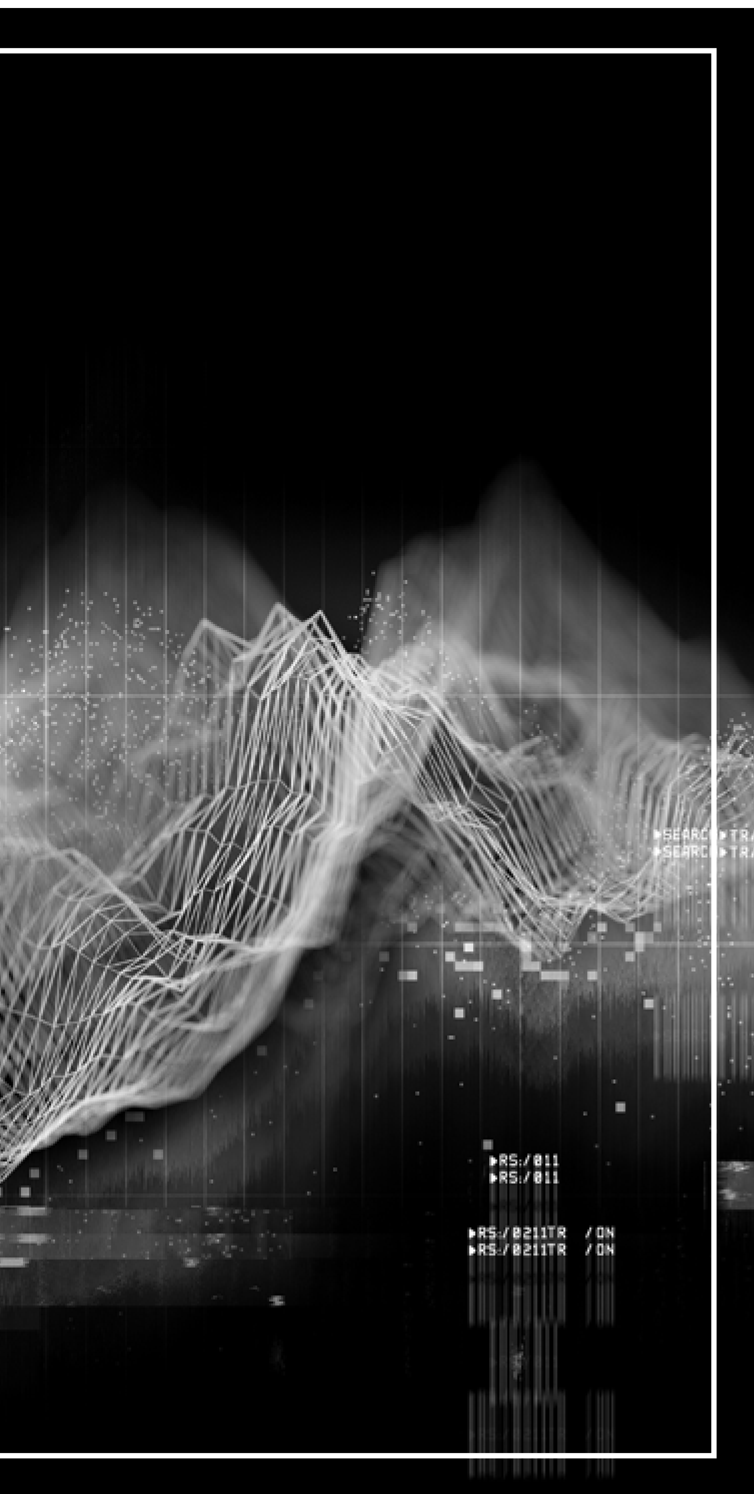
In its final report, the ESAs concluded the following.

TOPICS	CONCLUSIONS OF THE ESAS
Requirements in the European data protection, cybersecurity and consumer protection legislation	The ESAs consider that there is already a notable number of legal requirements for data protection, cybersecurity and consumer protection. The most important ones are: General data protection regulation (GDPR), E-Privacy Directive, Unfair commercial practices Directive (UCPD), Directive on Distance Marketing of financial services.
Requirements under the sectorial financial legislation	The ESAs stressed the importance of having solid operational processes considering the implementation of Big-Data-related procedures. The following elements were highlighted: **Organizational and prudential requirements** • Entities should strengthen their risk assessment as well as their information processing systems • Entities must assess and monitor potential operational risks arising from the implementation of Big-Data-related processes. For instance, mechanisms to identify errors when there is a manual step in the processes, as it is in the case of data loss due to data migration activities. **Conduct of business requirements** • Entities must act honestly, fairly, and professionally to enable fair and non-discriminatory practices while using Big Data • Manufacturing and distribution of products and services must meet the legal requirements when using Big Data tools • Information, including marketing communications, must be fair, clear and not misleading • Interests of consumers must be preserved even when purchasing bundled or tied packages of products
Good practices for financial institutions using Big Data	The ESAs acknowledge that the use of Big Data is beneficial not only for financial institutions and customers, but also for the market of financial services and products. Therefore, significant risk mitigation is needed to avoid damaging the trust of clients in financial institutions. ESAs promote the development of good practices such as: • Periodical monitoring of Big Data algorithms • Periodical assessment of Big-Data-based products to confirm these are aligned to customer's interests • Ensure a high level of transparency towards customers concerning the use of Big Data technologies to process their data

Table 5: Preliminary conclusions of the ESAs (Source: Own representation)

PRELIMINARY CONCLUSIONS OF THE EUROPEAN SUPERVISORY AUTHORITIES (ESAS)

CONTINUED



IMPACT

Big Data is a topic that is taking more and more relevance due to its scalability. The use of information is becoming crucial as it can reveal new business opportunities. The Joint Committee Final Report on Big Data depicts the status of the current dialogue on Big Data among the ESAs. This details the intention to foster the innovation and use of Big Data technologies, while putting close attention to fair treatment of customers' data, as outlined by the GDPR.

Why is the regulation of Big Data important? Supervisory authorities and regulators play a big role, as they should be able to detect and monitor emerging risks from the use of Big Data. Only those suited with proper tools to use such information will be able to provide products that could be more relevant for clients.

REFERENCE

https://www.esma.europa.eu/sites/default/files/library/jc-2018-04_joint_committee_final_report_on_big_data.pdf

Apart from the Highlights described in Section 2 and 3, the following relevant papers have been published during the last months:

RELEVANT PUBLICATIONS

GLOBAL

IOSCO/CPMI – Framework for supervisory stress testing of central counterparties (CCPs) (April 10th, 2018)

The International Organization of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures (CPMI) have published the framework for supervisory stress testing of central counterparties (CCPs). The supervisory stress testing framework is designed to support tests conducted by one or more authorities that examine the potential macro-level impact of a common stress event affecting multiple CCPs.

FSB – Report on Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors (April 24th, 2018)

The FSB has published a Report on strengthening governance frameworks to mitigate misconduct risk, developing a list of 19 tools, addressed to firms and supervisors, that can be used to tackle the causes and consequences of misconduct and to address three overarching issues identified, namely: i) mitigating cultural drivers of misconduct, ii) strengthening individual responsibility and accountability, and iii) addressing the 'rolling bad apples' phenomenon.

BCBS – Report on frameworks for early supervisory intervention (March 29th, 2018)

The BCBS has published a Report on frameworks for early supervisory intervention, which presents a range-of-practice study on how supervisors around the world have adopted frameworks, processes, and tools to support early supervisory intervention. This Report finds that early supervisory actions taken by supervisors depend not only on the expert judgment of supervisors, but also to a large extent on an organizational infrastructure that sets in place, among other aspects, the reinforcement through both vertical and horizontal risk assessments.

NORTH AMERICA

SEC – Proposed Rule S7-07-18 on Regulation Best Interest (April 18th, 2018)

The Securities and Exchange Commission (SEC) has published a Proposed Rule on 'Regulation Best Interest' with the aim of establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct is to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer.

SEC – Proposed Rule S7-08-18 on Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles **(**April 18th, 2018)

The SEC has published a Proposed Rule with amendments on the acts related to the investment advisers and securities exchanges acts, to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors to inform them about the relationships and services the firm offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events.

RELEVANT PUBLICATIONS CONTINUED

EU

EBA – Risk Dashboard Q4 2017 (April 05th, 2018)

The EBA has published a periodical update of its Risk Dashboard and parameters summarizing the main risks and vulnerabilities in the EU banking sector by a set of Risk Indicators in 4Q17. The main findings identified are, a positive progress for European banks that have strengthened their capital ratios. However, risks remain heightened on sustainable profitability. Following the ESRB recommendation on commercial real estate markets, the EBA's Risk Dashboard has provided additional data on the aggregated real estate exposures referred to real estate activities and the construction sector.

ECB – Guide to assessments of license applications (March 23th, 2018)

Apart from Guidelines governing the licensing requirements for FinTech (see our spotlight in section 2) the ECB has published Guides on the application process and licensing requirements for banks intended to support common supervisory practices and to increase transparency. The Guide explains the general application process and the assessment requirements regarding governance, risk management, capital etc.

ECB – Draft Guide to internal models – General topics chapter (April 03rd, 2018)

The ECB has published a Draft Guide to internal models, which covers the update of the first chapter of the Guide to the TRIM, for consultation. This first chapter is devoted to general topics and contains principles for the following non-model-specific topics: i) overarching principles for internal models, ii) roll-out and permanent partial use, iii) internal governance, iv) internal validation, v) internal audit, vi) model use, vii) management of changes to the IRB approach, and viii) third-party involvement.

EBA – Report on Benchmarking of Remuneration Practices at the European Union Level and Data on High Earners (April 10th, 2018)

The EBA has published its Report on benchmarking of remuneration practices in EU banks for the financial years 2015 and 2016 and high earners data for 2016. This Report shows that in 2016, the number of high earners in EU banks receiving a remuneration of more than 1M € decreased by 10.6%. additionally, for high earners, the average ratio between the variable and fixed remuneration continued to decrease in the last two years.

UK

PRA – Policy Statement 3/18. International banks: the PRA's approach to branch authorization and supervision / Policy Statement 4/18. International insurers: the PRA's approach to branch authorization and supervision (March 28th, 2018)

The Prudential Regulation Authority (PRA) has published the Policy Statements (PS) 3/18 and 4/18 that provide feedback on responses to Consultation Papers (CP) 29/17 and 30/17 on the PRA's general approach to branch authorization and supervision for international banks and international insurers, respectively. These PSs are relevant to all PRA-authorized banks and international investment firms which are operating in the UK , are looking to apply for PRA authorization in the future, as well as all existing and prospective insurance firms carrying out regulated activities, in the UK that are not able to benefit from passporting rights.

SECTION 5: CONTACTS

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

ABOUT CAPCO

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