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Banking and Capital Markets Insight

Welcome to the September 2011 edition of Banking and Capital Markets Insight, which includes areas as diverse as the revisions to the tax and regulatory treatment of banking capital, the adoption of the US Foreign Account Tax Compliance Act (FATCA), and the expected approach to conduct regulation of the Financial Conduct Authority (FCA).

Our detailed articles are as follows:

- Jeff Lyne on the expected **tax implications of new capital instruments**, such as contingent convertibles (CoCos) and 'bail-in' capital, created to meet the forthcoming Basel Committee requirements;
- Paul Leech on the **emerging Auditing Practices Board (APB) guidance on client money and asset reporting**, which applies to 30 September year-ends onwards;
- Clifford Smout on the **FCA's approach to Conduct Regulation**, which is likely to continue the Financial Services Authority's (FSA) existing intrusive and proactive product based focus to their regulatory oversight;
- Eric Wooding on the **non-Basel III aspects of CRD IV**, principally the single European Union (EU) rulebook but also its proposals on corporate governance, reducing reliance on external ratings and sanctions for rule breaches;
- Martin Killer on the **US FATCA provisions**, which do not come into force until 1 January 2013, but will require significant changes to client take-on and aggregated reporting of US and non-US assets to the Internal Revenue Service (IRS);
- Kush Patel on the changes to the basis to, and disclosure of **consolidations under International Financial Reporting Standards (IFRS) 10 and 12**, which apply to years beginning on or after 1 January 2013, and change the basis solely to control; and
- James Polson on **recovery and resolution planning** and the need for all large FSA regulated firms to deliver a significant part of their planning to the FSA by June 2012, raising challenges around how firms run a complex project to implement their plans while at the same time meeting the expectations of the regulators on a timely basis.

We look forward to your comments on the current edition and your suggestions for future articles.

Mike Williams
mikewilliams@deloitte.co.uk

The tax treatment of new capital

The Basel Committee on banking supervision has proposed regulatory reforms that are focused on enhancing the quality and quantity of bank capital. The priority is to make bank capital fit for purpose by ensuring that it is fully loss absorbing on both a going and gone concern basis, ahead of the need for government intervention.

The result is a new lexicon of bank capital such as CoCos, 'bail-in' capital, high/low triggers and write down features, all of which are increasingly familiar from the ongoing debate, if not yet widely seen in practice.

But what is, or perhaps more appropriately, what should the tax treatment of new capital be? What do the much stricter loss absorption and coupon flexibility characteristics mean for tax deductibility under current rules?

This is an important question as the overall cost to banks of new, higher levels of capital is part of the equation in balancing a more stable banking system, less prone to shocks, with the supply of credit and economic growth. A tax shield for coupons may help ease the burden for issuers of new capital, provided there is no compromise on quality, and may directly affect the viability of any fledgling market.

The UK Government has recognised the need for a tax regime which provides certainty of tax treatment for new capital and an informal consultation is under way between HM Revenues & Customs and industry, with a view to amending existing tax rules in next year's Finance Act. This is very much to be welcomed, not least because London must remain competitive as a centre for issuing bank capital with, as ever, the need to keep an eye on the international tax landscape.

Below we provide some thoughts on the tax treatment of new capital to help inform the ongoing debate.

Importance of the consultation on tax treatment

There is clearly some way to go before the regulatory landscape and design of new capital instruments is settled, with Basel moving away from contingent capital in its consultative document on global systemically important banks (July 2011). The UK's Independent Commission on Banking (ICB) however, recommended that banks should have primary loss absorbing capacity of 17%-20% which could potentially include 'bail-in' bonds and contingent capital.

As a general matter, the cost of new instruments will be fundamental to the viability of any new market, and clearly tax deductibility - as well as the need for instruments that appeal to a wide universe of investors to ensure a deep and liquid market - will be important if banks are not to revert to common equity and retained earnings in order to meet new capital standards.

Certainty and transparency of tax treatment may therefore ultimately assist in the development of a market that, most commentators agree, has the potential to reduce the probability and impact of future bank failures.

Link regulatory purpose and tax treatment

We think there is a clear logic in linking a capital instrument's regulatory purpose or function to its tax treatment, i.e. whether loss absorbent on a going or gone concern basis, or whether it acts as buffer capital. This is no more than redefining the debt/equity divide in the context of new bank capital and the detailed Basel III criteria. Relative position in the capital structure has always mattered to the tax treatment of instruments and this should continue.

For instance, it would seem uncontroversial to say that as a general principle, core tier 1 at the bottom of the capital structure should not be tax deductible and tier 2 subordinated debt at the top end should be. A similar policy decision could also be made regarding additional tier 1 capital, perhaps taking into account the European competitive landscape to ensure a level playing field for UK banks (although at only 1.5% of RWA, it is not the most important component).

Impact of accounting uncertainty

UK tax has traditionally followed the GAAP accounts and we would only reluctantly move away from this approach. We don't think the ongoing uncertainty in the accounting treatment of new capital instruments is insurmountable and would caution against too radical an approach in terms of a separate regime that looked directly at the regulatory classification in determining tax treatment, bypassing the GAAP accounts.

The IFRS or UK GAAP audited accounts should remain the starting point in terms of measurement of taxable profit in order to ensure the benefits of consistency, transparency and compliance are retained. Where bank taxpayers are concerned this is doubly important given their importance to the financial system and wider public interest.

We would therefore suggest that the existing framework of Loan Relationship rules, based on accounting principles but with specific tax rules where necessary, are amply able to cope with the taxation of new capital instruments. Building on an existing robust and well understood framework, we would argue, offers the best solution and would recommend that the consultation looks at where the tax treatment of new instruments might need to depart, for good policy reasons, from GAAP accounting. There are already many instances of this approach, i.e. "Rules differing from Generally Accepted Accounting Policy".

Potential approach to new instruments

In summary, we would suggest the following three steps as a possible approach in formulating the policy towards new instruments, in conjunction with the impact assessment:

- review new types of instrument and determine their function in the capital structure, intended regulatory treatment and benefit both before and after any trigger event that results in write down or conversion;

- having established the underlying economic function of the capital, align the tax treatment with existing tax principles regarding debt and equity as far as possible, having regard to compound instruments which contain features of both; and

- where the accounting treatment does not accord with the underlying function of the capital or is uncertain or creates tax base volatility, provide for adjustments to be made to the GAAP accounting treatment within the Loan Relationship and Derivative Contract rules.

We briefly outline how this approach might be applied to going concern CoCos and gone concern 'bail-in' instruments.

Going concern contingent convertibles

Going concern CoCos are designed to operate well before resolution mechanisms are relevant - they are pre-emptive recapitalisation or a 'pre-pack recap' intended to trigger where the bank is under stress but some way off being non-viable. Their utility lies in helping banks comply with core tier 1 capital requirements under stress scenarios whilst it is a going concern, and such instruments may in some jurisdictions form part of the buffer capital above Basel III minimum requirements. Proponents also argue that they create an incentive for more proactive action by ordinary shareholders to prevent risky behaviour so as to avoid being diluted by a trigger event.

In terms of the underlying economics, the bank issuer may have raised subordinated debt prior to a conversion and at an objective trigger point (either capital or market based), is able to put shares to investors in full satisfaction of the debt. The maximum number of shares is likely to be capped and on issue worth significantly less than the face value of the debt.

In other words, the bank is paying interest on subordinated debt and a premium to investors willing to take the risk that their debt claim will convert into low value ordinary shares when the bank is under stress but still a going concern. There are thus both debt and equity features which may be reflected in the tax treatment.

One approach would therefore require such an instrument to be treated as a compound instrument, consisting of a subordinated debt host and a purchased equity put option. The host debt finance expense ought to be tax deductible; on the other hand, the premium paid for the put right is clearly related to the issue of shares and should be a non-deductible capital expense. To the extent the accounting treatment differs (e.g. the instrument is bifurcated into a derivative and debt host), Loan Relationship and Derivative Contract rules should provide for an adjustment. For instance, this may require fair value movements on the derivative to be ignored for tax purposes.

The benefit of this approach is twofold: the bank would continue to obtain a deduction at its plain vanilla subordinated debt rate prior to conversion and secondly, the approach would help achieve a level playing field between different banks, i.e. banks that are required to or choose to issue high levels of going concern CoCos should not be able to achieve an additional tax deduction over their normal debt costs compared to a non systemically important financial institution.

Loss absorption via write down

Possible loss absorption mechanisms may potentially be structured as a permanent or temporary write down of all or a part of an instrument at a pre-defined trigger point. There appears to be some uncertainty as to whether an instrument with a permanent write down feature is a viable market instrument outside of the highest quality institutions given the inversion of the capital structure: post the trigger event there is no upside for holders, potentially making such an instrument more risky than common equity.

A temporary write down loss absorption mechanism may be more palatable to investors, although not to regulators, e.g. post a write down event the instrument might accrete up to par *parri passu* with returns to common equity. In this case, a consistent tax treatment with convertible instruments would be desirable given the similar underlying economics.

Gone concern or 'bail-in' capital

Gone concern or 'bail-in' capital is a very different animal to going concern CoCos. There is perhaps greater uncertainty around these instruments and the future legal framework which makes the tax analysis harder to establish in advance of more regulatory work, particularly on recovery and resolution.

Whereas going concern CoCos represent a preventative measure, 'bail-in' capital is a resolution tool to be used when the firm is at the point of non-viability or insolvency. Such capital should therefore be viewed in the context of the wider resolution mechanism to be employed to allow a bank to fail safely, allowing restructuring to take place and a core business to be rescued in accordance with a living will without wider systemic impact.

The focus of these instruments is on reducing the impact of failure by ensuring losses fall on equity and certain creditors rather than taxpayers. A general right to 'bail-in' capital may exist as part of the statutory resolution mechanism or it may be built into the terms of the capital. Some form of hybrid could also be envisaged where a conversion would occur at a low trigger point, in addition to the existence of a general 'bail-in' right of the resolution authority. In the round, it's uncertain what this type of capital will look like. In addition, it's possible that there will be a range of instruments on a scale between high trigger going concern CoCos and 'bail-in' capital.

One possible tax approach is to ignore any 'bail-in' feature which is fundamentally part of the resolution mechanism (i.e. where 'bail-in' is at the regulator's discretion), whether delivery of this is through statutory authority or under the instrument's terms. This is on the basis that the new rules are essentially making gone concern capital fit for purpose, i.e. correcting market driven and resolution framework weakness that became apparent in the crisis and which undermined the ability of non-equity capital to absorb losses.

Compound treatment of 'bail-in' capital as debt host and equity does not appear all that sensible given the difficulty in measuring the separate value of a write down or conversion feature where this is at a regulator's discretion.

Therefore our suggestion would be that tier 2 subordinated debt and other debt capital that may potentially be subject to a bail-in by regulators (as opposed to an objective CoCo trigger) should continue to be tax deductible in full, subject to the impact assessment. This would require appropriate amendments to the distribution rules.

Tax implications of 'bail-in'

Tax consequences for the issuer upon a conversion or write down should be neutral: this is purely a balance sheet transaction that ensures losses are shared across all capital holders, and, as we know, there is unlikely to be an economic gain for anyone at this point. To the extent an accounting profit & loss credit did arise, this should be ignored for tax purposes which would be consistent with existing tax rules on debt for equity swaps.

Conclusion

The foregoing are some of our initial observations on the tax treatment of new capital instruments. In summary, our view is that the tax treatment of new capital instruments can be accommodated by amending the Loan Relationship and Derivative Contract rules, for example to ignore fair value movements on embedded derivatives which in this context are more akin to equity transactions. This would represent a reasonably simple and expedient approach for which there is some precedent.

Jeff Lyne
jelyne@deloitte.co.uk

Client Assets – a new focus

In late March 2011, the FSA issued its Policy Statement PS 11/5 entitled 'Auditor's Client Assets Report'. Much of the content of this Policy Statement (PS) is aimed specifically at the reporting accountants who prepared the Client Assets Report but many of the changes affect the regulated firms themselves. The rule changes on PS 11/5 came into force for reporting periods ending on or after 1 June 2011 but with most firms adopting the transitional arrangements, the new requirements do not have effect until periods ending on or after 30 September 2011.

To assist reporting accountants and to some extent regulated firms, within the PS the FSA indicated its intention to work with the APB to update and where appropriate, develop additional guidance on Client Assets Reports following these rule changes. Such guidance is proposed in the format of an APB Bulletin (the Bulletin), incorporating relevant material from the APB's Practice Note 21 on 'The audit of investment businesses in the United Kingdom (Revised)'. The Bulletin though is a significant new document in its own right. Subject to approval, the Bulletin 'Providing Assurance on Client Assets to the Financial Services Authority' is expected to be issued at the end of September 2011.

Through its work in 2009 and 2010, the FSA identified a number of concerns about the way regulated firms were complying with the Client Assets (CASS) rules and the contents of Client Assets Reports prepared by reporting accountants. A key element of these concerns was that client assets would not be adequately protected in the event of insolvency. The APB Bulletin recognises this and emphasises that a key objective of the CASS rules is the keeping of client assets separate from the assets of the regulated firm, so that if the regulated firm becomes insolvent there are no legal impediments preventing the beneficial owners from recovering their assets.

This approach is consistent with experience from the financial market crisis which points to the need for regulated firms and reporting accountants to have an insolvency mind-set with respect to client assets. Indeed, the Bulletin states that it should be assumed that insolvency of the firm will occur when evaluating the regulated firm's client asset procedures.

In turn, insolvency law has application to legal entities rather than to businesses or groups that may encompass a number of regulated legal entities. This will be particularly important for another document, the CASS Resolution Pack (CASS RP), which is being proposed by the FSA in Consultation Paper CP 11/16 'Recovery and Resolution Plans'. While much of CP 11/16 is aimed at large financial institutions, one section, chapter 6, sets out proposals for regulated firms that hold client money (excluding insurance monies under CASS 5) and/or custody assets to put in place a Client Money and Custody Assets Resolution Pack. The proposals envisage that each regulated entity will have its own CASS RP, which may present challenges for some group structures.

The Client Assets Report is required to be in the form of a reasonable assurance report where the regulated firm holds client money and custody assets. A limited assurance Client Assets Report is required for those firms that do not hold client money or custody assets. A combined reasonable and limited assurance report is required for firms which hold one but not the other, for example, a firm that holds client money but not custody assets would require a reasonable assurance report on the client money and a limited assurance report on custody assets. The Bulletin provides reporting accountants with updated guidance as to the processes they are expected to go through to obtain the necessary evidence for such reports.

The FSA has made it clear that materiality is not a relevant consideration when determining if a CASS rule has been breached. The FSA wishes to have all breaches that both the regulated firm and the reporting accountant identifies reported to it in the breaches schedule attached to the Client Assets Report.
The reporting accountant is required to deliver a draft of the Client Assets Report to the regulated firm, so that the firm has an adequate period of time to consider the breaches set out in the schedule and can then provide comments explaining the circumstances that gave rise to each of the breaches identified and any remedial actions that it has undertaken or plans to undertake.

The timescale of four months for the Client Assets Report to be submitted to the FSA becomes a rule rather than guidance. While most regulated firms and reporting accountants already work to this four month timescale, the need for the reporting accountant to have formal discussions with the regulated firm on the breaches schedule will put additional pressure on timing.

As indicated earlier, the FSA does not regard materiality as a relevant consideration when determining if a CASS rule has been breached. If a firm has breached the CASS rules, the FSA expects the reporting accountant to assess the firm's systems in light of the CASS breaches to determine whether to express a qualified or an adverse opinion in the Client Assets Report. The APB Bulletin therefore concludes that unless there have been no breaches, a Client Assets Report will express either a qualified or an adverse opinion. The option of ignoring minor breaches is no longer a possibility.

Thus, for those regulated firms holding client money and/or custody assets, a qualified or adverse opinion in the Client Assets Report is likely to become the norm. The reporting accountant needs to consider whether the rule breaches indicate that there has been a systemic or pervasive failure to comply with the principle of protecting client assets. If so, an adverse opinion is likely to be given. If the system generally works but there are isolated breaches, an 'except for' qualification is likely to be more appropriate.

Other recent changes to the client asset requirements of the FSA include:

- CASS medium and large firms are required to complete a monthly Client Money and Asset Return (CMAR) from October 2011.

- CASS small firms are required to notify the FSA of their highest client money balance and value of client assets.

- CASS medium and large firms must have an individual approved for the CASS operational oversight function (CF10a).

- CASS small firms must allocate a director or senior manager (carrying on "significant influence function") to have CASS operational oversight.

- Implementation of a 20% limit on the placing of client money deposits with a group entity (or combination of such entities).

- Prohibition on general liens in custodian agreements (see further consultation on this set out in CP 11/15).

- Mandates (CASS 8) have been brought within the scope of the Client Assets Report.

- The opinion in the Client Assets Report must be signed in the name of the individual with primary responsibility for the report within the practitioner firm.

- The regulated firm's governing body is provided with the findings of the 'auditor's' Client Assets Report. This does not have to be completed ahead of the report's submission to the FSA but does have to be done promptly after the firm receives the report.

The FSA's Client Asset Unit is expected to transfer to the FCA and to continue the new focus on client assets. For those involved in this area of regulation and reporting, the focus is likely to be sharpened further.

Paul Leech
pleech@deloitte.co.uk

Conduct regulation – some questions of balance

Much of the debate over regulation in recent years has centred on prudential issues – how much capital do firms need, and how many 'safe' and liquid assets should they hold? But there is also a recognition that the need for financial stability must co-exist with a continued supply of credit to the rest of the economy, particularly during the transition to higher standards. In other words, there is a trade-off between security and return, both for individual firms and society more generally.

Similar questions arise in the area of conduct regulation. At the launch of the FCA, the FSA Chief Executive, Hector Sants, identified five themes that in each case, raised questions on where society should strike the balance.

The five issues were:

- **Responsibility and suitability** – should consumers be free to make their own decisions, albeit perhaps on the basis of disclosure mandated by the regulator? Or given the asymmetry in information and knowledge between some consumers and some producers, should a regulator substitute its own judgments on suitability, even though – in Sants' words – "The consequence of this will be to diminish personal freedom and to a degree undermine the concept that we all take responsibility for our own actions".

- **Intervention and innovation** – in order to prevent customer detriment, the FCA might be allowed to ban products judged harmful in themselves, or alternatively likely to be mis-sold. But this could reduce innovation, choice and competition, and raise the cost of regulation (because of the need to hire people to make these judgments). So if, for instance, certain mortgages were banned on affordability grounds, how many people would be saved from future distress, and how many prevented from owning a house and getting a mortgage that in practice they could have repaid?

- **Transparency and efficiency** – the balance to be struck here is between a general presumption in favour of disclosure (to reduce uncertainty and aid decision-making by consumers) and the risk that publicising concerns about particular firms could exacerbate their plight.

- **Cost and effectiveness** – in Sants' words "a more interventionist and proactive regulator offers the prospects of greater success but comes with the certainty of extra cost". He also cautioned that an extra £200m spent on supervision was unlikely to result in a £200m reduction in the costs met by the Financial Services Compensation Scheme.

- **Accountability and judgment** – while regulators needed to be accountable for their judgments, politicians and commentators had to accept that, with hindsight, some of these judgments would not produce the desired result (and in any case not all firm failures necessarily implied regulatory failure).

These are fundamental issues, relating as they do to the cost and availability of financial services, the ability to discover what is going on in firms (and at regulators), and notions of personal responsibility and freedom. Understandably, therefore, Sants concluded that these were not for the regulator to decide: instead it was for society to set the regulatory mandate, having struck the balance it desired on these matters.

This will not be easy. Many commentators have noted that the job of a monetary authority requires it to remove the punchbowl just as the party gets going: an inherently unpopular role. But recently many have argued that a prudential regulator should also act in this way, hence the interest in 'macro-prudential' tools, under which standards would be tightened in a counter-cyclical fashion.

Less attention has been paid to conduct regulation. But there are similar pressures here, too. Again, the mandate for such a regulator needs to be truly robust, i.e. set in such a way that means that during a boom, regulators are not pressured to accept innovations that in the event do not stand the test of time (or more particularly the test of a downturn). Drafting such a mandate will be difficult. And in that context, having powers to ban products may be a double-edged sword – if an unbanned product should eventually prove detrimental there will be calls for regulators to be fired and governments (rather than firms) to pay compensation. Such instances demonstrate how closely some of these themes can interact – in this case raising issues related to suitability and accountability as well as product intervention. The challenge involved in balancing this myriad of forces is a very real one.

A further complication is the sheer range of products and consumers to be covered. Wholesale players, for instance, are much better equipped than retail customers to make their own decisions, and may well put more emphasis on the benefits of innovation and relative cheapness. Any conduct regime must reflect such differences. It also needs to respond to the international nature of the London market, and to the increasingly international scope of regulation, particularly within the EU.

At present there is little doubt about the direction of travel for conduct regulation in the UK. It is towards a more assertive, proactive and expensive approach, with less freedom for retail consumers to make their own mistakes and less opportunity for firms to exploit these. But this is all a matter of degree. The mandate set for the regulator must be set in a way that balances the various forces noted by the Chief Executive of the FSA; otherwise there is a risk that its legitimacy will come under challenge as economic circumstances change.

Clifford Smout
csmout@deloitte.co.uk

The Commission's proposals for CRD IV – not just transposing Basel III

Although the original motive for CRD IV was to transpose Basel III into EU law, the Commission has also treated it as an opportunity to advance its harmonisation objective. Its main step in this direction is to propose a single EU-wide rulebook for most of the detailed capital and liquidity framework. In addition, new EU minimum requirements are proposed in three main areas: sanctions (i.e. penalties) for violations of EU prudential requirements, corporate governance and reliance on external ratings.

This article provides a brief overview of these four, 'non-Basel III', aspects of CRD IV which will of course apply not only to 'credit institutions' (banks and building societies), but also to BIPRU investment firms, whether full scope, limited activity or limited licence.

The Single Rule Book

The proposal would repeal the current prudential directives for 'institutions' (banks, building societies and BIPRU investment firms) and replace them with a package consisting of two different types of legal instrument: a directive, which must be transposed into national rules, and – the new feature – a regulation which would take effect in all Member States in the same way as a national instrument, without any further action by national authorities, and would therefore be a single EU-wide rule book.

The Commission has decided which parts of the rules go into the directive and which go into the regulation based on degree of prescription and the importance of links to national administrative laws. So matters involving the exercise of power by national authorities, such as authorisation and on-going supervision (including Pillar 2), are in the proposed directive, while the Pillar 1 capital framework (with the exception of the requirements for capital buffers) and detailed liquidity and leverage rules are in the proposed regulation.

The uniform application of the regulation is reinforced, and the scope for national divergences in the implementation of the directive is narrowed, by requiring the European Banking Authority (EBA) to develop technical standards and guidelines to help national authorities determine what is required by over 100 areas of the rules.

The Commission's proposal to create an EU-wide single rule book for much of the prudential regulation of banks and investment firms is intended to reduce the scope for regulatory arbitrage within the EU and to facilitate amending the rules to cater for market developments.

While it would largely deprive national authorities of their current freedom to impose tighter Pillar 1 requirements than those specified in EU law, it would still allow a national authority:

- on financial stability grounds, if justified by default experience and forward-looking developments, to set a higher risk weight, or impose tighter criteria, than those specified in the regulation on residential and commercial mortgages located in its jurisdiction;
- to continue to use the Pillar 2 provisions to impose additional capital requirements or other measures on individual institutions, or a type of institution, that might be exposed to higher-than-normal risk or pose such risk to the financial system; and
- to impose a countercyclical capital buffer to dampen excessive credit growth in its jurisdiction.

Given that it contains 457 articles which fill 544 pages, and will replace much of BIPRU and GENPRU, a practical matter that firms should not overlook is the challenge of navigating and generally familiarising themselves with the new regulation.

Sanctions

The Commission's rationale for action to increase harmonisation in this area is that in the banking sector "national sanctioning regimes are divergent and not always appropriate to ensure deterrence" of breaches of EU law. Accordingly, it proposes requiring Member States to comply with minimum standards concerning the administrative (but not criminal) sanctions to be applied for violations of a wide range of requirements of the directive or the regulation. These include, but are not limited to, those relating to corporate governance, financial reporting to the supervisory authority, large exposures limits, retention of a minimum proportion of a securitisation by the originator or sponsor, public disclosure (Pillar 3) and liquid asset buffers.

The minimum standards address the types of sanction that must be available to national authorities, the level of fines they may impose, the criteria they should use to determine the type of sanction and level of fines to be imposed, mechanisms to encourage reporting of breaches to the authorities (e.g. protection of whistleblowers) and mandatory public reporting of sanctions imposed for breaches of requirements. The proposal requires the EBA to issue guidelines to national authorities regarding the determination of sanctions to be applied and the level of fines to be imposed.

Corporate governance

The Commission's aim is to strengthen corporate governance in institutions across the EU and thereby to contribute to a reduction in excessive risk-taking by individual institutions and in the financial system as a whole. Its proposals in this area include requirements for:

- the governance of risk management, including Board approval and periodic review of risk strategies and policies, the need for a risk committee of appropriately skilled Non-Executives (may not be required depending on the nature, scale and complexity of the firm), and the need for an independent risk function;
- the separation of the functions of Chairman and CEO "unless justified and authorised by the competent authorities";
- the appointment of a nomination committee of Non-Executives (may not be required depending on the nature, scale and complexity of the firm);
- limits on the number of other directorships they may hold; in particular either one Executive directorship and two Non-Executive directorships or four Non-Executive directorships (but national authorities may authorise exceptions);
- adequate resources for the induction and training of Board members; and
- diversity to be one of the criteria for selecting Board members.

The EBA is also required to develop technical standards on various aspects of these proposals. The draft technical standards must be submitted to the Commission for approval by the end of 2015.

Reducing reliance on external ratings

The Commission's proposals aim to reduce reliance on external ratings in two areas: the calculation of capital requirements and the assessment of credit risk.

Calculation of capital requirements

It is proposed that institutions must develop internal rating based approaches for determining capital requirements for credit risk (and likewise must develop internal models based approaches for determining the specific risk requirement for debt securities held in the trading book) "where exposures are material in absolute amount and they have at the same time a large number of material counterparties." The EBA is required to develop by the beginning of 2014, technical standards which define "material in absolute amount" and the threshold for determining large numbers of material counterparties.

In addition, the Commission proposes that where capital requirements are based on external ratings or the fact that an exposure is unrated, institutions must use their own internal methodologies to check the ranking of credit risks implied by the external ratings and take the result into account in allocating internal capital.

Credit risk assessment

The Commission proposes that institutions must have internal methodologies to assess the credit risk of individual borrowers, issuers and counterparties and to assess credit risk at the portfolio level.

Summary

While the transposition of Basel III is the raison d'être of CRD IV, the European Commission has also used it as a means of achieving a significant increase in harmonisation by proposing an EU-wide single rule book for the detailed prudential requirements for banks and investment firms and by adding EU directive requirements, to be buttressed by EBA guidelines, regarding sanctions, corporate governance and reduced reliance on external credit ratings.

Eric Wooding
ewooding@deloitte.co.uk

Foreign Account Tax Compliance Act – where are we?

The provisions of FATCA, enacted on 18 March 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, impose new information reporting and withholding requirements on non-US financial institutions (Foreign Financial Institutions or FFIs) which receive with-holdable payments (see below for definition of with-holdable payments). Through FATCA, the IRS seeks to identify US taxpayers with accounts at FFIs and asks the FFIs to report those account holders to the IRS under the threat of punitive measures of withholding tax. The FATCA rules apply in addition to existing US withholding tax rules, including those applying to Qualified Intermediaries (QI), and will significantly affect foreign financial intermediaries, non-financial foreign entities, and other payers of US source income.

FFIs will be required to enter into compliance agreements with the US Treasury as well as identify and report information on all accounts held by specified US persons on an annual basis. Other non-US entities which do not fall under the definition of a FFI (Non-Financial Foreign Entities or NFFEs) will be required to report substantial US owners or certify that they have no substantial US ownership.

Failure to comply with the FATCA rules will result in the imposition of a 30% withholding tax on with-holdable payments of both the institution and its account holders. A with-holdable payment includes any US source payment of interest, dividends, compensation, and other fixed, determinable, annual or periodic gains, profits and income. The definition is extended to include any US source gross proceeds from the sale or other disposition of any capital or income that can produce interest or dividends.

Initial guidance was issued on 27 August 2010 (Notice 2010-60) which provided preliminary guidance regarding the scope of obligations exempt from FATCA withholding, the definition of a FFI, the scope of identifying US persons and collecting information by FFIs, and the information on US accounts that FFIs must report to the IRS pursuant to a FFI agreement.

Further guidance was issued on 8 April 2011 (Notice 2011-34) which supplemented guidance issued in Notice 2010-60, as well as superseding some of the guidance issued in Notice 2010-60. Notice 2011-34 included required procedures for identifying accounts held by US individuals, as well as focusing on additional procedures for an FFI's private banking customers and accounts with a value in excess of USD $500,000. In addition, Notice 2011-34 also outlined the pass through percentage calculation method, certain deemed compliant FFI categories and the requirement for the FFI's Chief Compliance Officer (CCO), or equivalent, to sign a certification that the "FFI management personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding the identification of their accounts as US accounts". The IRS also requires the CCO to backdate this certification to 9 May 2011.

The most recent guidance note was released on 14 July 2011 (Notice 2011-53) and gives transitional relief to FFIs. In particular, it states that an FFI must enter into an FFI agreement with the IRS by 30 June 2013 in order to be identified as a participating FFI and give sufficient time to US withholding agents to refrain from withholding beginning on 1 January 2014. FATCA withholding will begin for US source fixed or determinable annual or periodical income (FDAP) payments on 1 January 2014 and FATCA withholding for FDAP and gross proceeds will begin on 1 January 2015. In addition, withholding on pass through payments will not be required until 1 January 2015 at the earliest; therefore, participating FFIs will not be required to calculate and publish their pass through payment percentages until the first calendar quarter of 2014. Notice 2011-53 states that draft regulations will be published by 31 December 2011, with the final regulations, FFI agreements and reporting forms being published in summer 2012. It is anticipated that further guidance on implementing FATCA will be released by the IRS before 31 December 2011.

Why is becoming compliant a challenge?

FFIs face a major challenge across a number of areas and this is magnified by the number of jurisdictions within which they operate and the variety of products offered. The impact to the FFI goes far beyond the obvious tax and reporting obligations. Large institutions may be required to undertake significant systems and process changes alongside other ongoing change programmes.

Some of these areas include:

- modifying the client take on process to capture additional information regarding US status and searching information obtained during the account opening process;
- performing electronic searches on existing client accounts, as well as paper reviews in certain cases to determine the US status of existing account holders;
- building reporting processes to aggregate information across different businesses and report details annually to the IRS;
- implementing procedures to collect withholding taxes on all US sourced and pass through payments; and
- analysing US and non US assets held by the FFI in order to calculate a pass through payment percentage on a quarterly basis.

A key concern is how to quantify the investment and effort required to become compliant, particularly given the current uncertainty associated with FATCA.

How have organisations responded appropriately to the uncertainty?

The first step is to perform an impact assessment to understand the compliance challenge as it applies to the FFI and its affiliates. This should provide a high level estimate of the level of investment and effort likely to be required to become compliant. FFIs are having to build flexible programmes to deal with the level of uncertainty whilst being in a strong position to deliver compliance within a tight timeframe. To achieve this many FFIs are:

- prioritising the compliance requirements, analysing the likelihood that requirements will change and assessing the effort required to deal with the changes;
- making broad assumptions across the wider group to ensure consistent approaches are taken to the programme;
- analysing the impact of possible regulatory changes so that the direction can be changed if new guidance or regulations dictate a change of approach;
- monitoring activities in the market, including those of competitors and industry bodies, to ensure new information is brought into the programme;
- identifying synergies with other programmes to accelerate FATCA implementation and ultimately reduce costs.

Most organisations have delivered FATCA programmes using a combination of resources across the business as the solution is cross functional. This includes a mixture of tax, legal, systems, anti-money laundering and programme and change management specialists feeding into a steering committee with strong Executive sponsorship.

With less than two years to go until FFIs are required to sign up to agreements to minimise the impact of FATCA withholding, there remains significant uncertainties that institutions need to be able to manage the transition effectively whilst retaining sufficient flexibility to deal with possible changes arising from further guidance and draft regulations.

Martin Killer
mkiller@deloitte.co.uk

Consolidation and Special Purpose Entities

Background

In May 2011, the International Accounting Standards Board (IASB) issued a new standard, 'IFRS 10 Consolidated Financial Statements', governing when an entity should be consolidated into consolidated (or 'group') financial statements. The primary reason for the development of IFRS 10 was to enhance comparability by replacing the current requirements cited in 'IAS 27 Consolidated and Separate Financial Statements' and 'SIC-12 Consolidation – Special Purpose Entities' with a single standard.

The reason behind the two sets of consolidation requirements is because IAS 27, issued in 1989, was not designed with special purpose entities (SPEs) in mind. Its consolidation requirements, based on the concept of control, were written primarily for operating entities. Such entities typically issue equity shares with voting rights attached where a majority of the voting rights give the holder control over the entity's operations, for example by giving them the ability to appoint a majority of the Directors on the Board. The guidance in IAS 27 was not suited for assessing control over SPEs which tend to be more structured in nature and set up to for a narrow and limited purpose, for example to raise finance by issuing securitised notes. As a result, SIC-12 was issued in 1998 with specific guidance on what constitutes control for SPEs. However, as practice developed, inconsistencies in application of the control concept under IAS 27 and SIC-12 emerged.

This is in part because IAS 27 defined control as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities" whereas SIC-12 focused on in-substance control determined by assessing the exposure to risks and the rights to rewards.

Hence IFRS 10 was issued to set out a basis for consolidation centred on the control concept that is applicable to both operating and special purpose entities. To accompany IFRS 10, an additional new standard, 'IFRS 12 Disclosure of Interests in Other Entities', was issued to address disclosures for subsidiaries, joint arrangements, associates and unconsolidated structured entities. One of the drivers behind the disclosures for unconsolidated structured entities was to enhance transparency of an entity's exposures to such entities, which was found to be lacking during the recent financial crisis.

In this article we take a closer look at the core elements of what drives the consolidation requirements (i.e. what constitutes control) and also consider some of the new disclosure requirements.

The Control Concept

IFRS 10 uses control as the single basis for consolidation. This eliminates the current mixed model approach of focusing on voting rights when applying IAS 27 and risks and rewards when applying SIC-12. The standard sets out the following three conditions, all of which must be met, for an investor to have control over an investee:

- power over the investee;
- exposure, or rights, to variable returns from involvement with the investee; and
- the ability to use power over the investee to affect the amount of the investor's returns.

The standard provides detailed guidance and examples on the application of these conditions. It is noteworthy that the standard requires an investor to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three components of control. These three components are discussed in more detail below.

Power
IFRS 10 defines power as "existing rights that give the current ability to direct the relevant activities" and adds that the relevant activities are those that significantly affect the investee's returns. This component of control is likely to be the most complex and judgemental aspect of the control assessment. This is because it requires a thorough understanding and assessment of:

- the purpose and design of an investee;
- the relevant activities of the investee and how decisions about those activities are made; and
- whether the rights of the investor give it the current ability to direct the relevant activities.

For example, in a securitisation structure, the most relevant activities may be managing or working out the receivables upon default (i.e. restructuring the terms with the borrower, seizing collateral or managing the foreclosure process). Even though these activities are contingent on a future event, these activities may still be determined to be the only relevant activities of the entity.

Variable returns
IFRS 10 clarifies that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the substance of the arrangement and not the legal form. Variable returns are not limited to arrangements where the cash flows under the arrangement are contractually variable. For example, for an investor holding a bond with fixed interest payments, the fixed interest payments are considered variable returns because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability depends on the credit risk of the bond.

Power over variable returns
The third and final component of the consolidation assessment considers the interaction between the first two components. Specifically, can the investor use its power to influence its returns from its involvement with the investee. This section of the standard introduces guidance on whether an entity is acting in the role of principal or agent (i.e. a decision maker engaged to act on the behalf, and for the benefit of, other parties and therefore does not control an investee). The remuneration paid to the decision maker must be both commensurate with the services provided and include only terms, conditions or amounts customarily present in other similar arrangements negotiated on an arm's length basis.

In assessing the exposure to variability of returns, a decision maker is required to consider that the greater the magnitude of, and variability associated with, its overall economic interests (including the remuneration), the higher the likelihood the decision maker is a principal. Additionally, if the exposure to variability of returns is different from that of other investors (i.e. because of subordination of interests), the decision maker should consider how that may influence their actions as decision maker.

The standard highlights that the subordination of interests may increase the exposure to variability. Financial institutions may often either be required to hold a portion of the 'equity' tranche or other subordinated interest in a securitisation or other structured entity, or may choose to do so in order to better align their own interests with those of the investors in the structure. The consideration of the exposure to variability associated with investments in the equity tranche or other subordinated interest of managed structured entities, may impact the consolidation assessment for those investment managers who hold significant interests in their managed structures. Financial institutions which provide guarantees or credit facilities to SPEs also have exposure to variability which would need to be considered in determining whether the financial institution is acting in the role of principal or agent.

Disclosures
As mentioned earlier, the intention of the disclosure requirements of IFRS 12 is to improve disclosures around the nature of, and risks associated with an entity's interests in other entities and their impact on the financial statements. For interests in unconsolidated structured entities, IFRS 12 requires disclosure of information about the nature and extent of an entity's interests in unconsolidated structured entities and the nature of, and changes in, the risks associated with those entities.

For example, the entity is requried to disclose:

- the carrying amounts and line items in the statement of financial position where the assets and liabilities related to its interests in unconsolidated structured entities are recognised;
- an estimate of the entity's maximum exposure to loss from its interests in unconsolidated structured entities; and
- a comparison of these two amounts.

In addition, if an entity has provided any financial or other support (whether contractually required or not) or intends to provide support, it is required to disclose information about this. For any unconsolidated structured entities that the entity sponsors but no longer has an interest at the reporting date, the entity is also required to disclose how it determined it was the sponsor, what income it received during the reporting period and the carrying amount at the time of transfer of all assets transferred to the structured entity during the reporting period. The standard also provides examples of other information that may be necessary to comply with the overall disclosure objectives including terms of arrangements that could require providing financial support (such as liquidity arrangements or guarantees), information on gains and losses recognised during the period, whether an obligation exists to absorb losses before other parties and information on the funding duration of the entity.

Taken together, these disclosure requirements could represent a significant data gathering exercise and the presentation of such information in a meaningful and appropriately aggregated way could also be challenging.

Effective date and implementation

The effective date for IFRS 10 and IFRS 12 is for accounting periods beginning on or after 1 January 2013, with earlier application permitted[1]. However, EU reporting entities will have to wait for the standards to be endorsed for use in the EU which is currently pending.

Assuming the standards are endorsed, it is clear that these two standards could have a significant impact on financial reporting for financial institutions in particular. The impact could be very broad, resulting in changes in the size of balance sheets, and in all cases will introduce a further disclosure burden. For example, it could lead to consolidating SPEs not consolidated under IAS 27 and SIC-12, or conversely lead to deconsolidation of SPEs consolidated under IAS 27 and SIC-12. Hence, implementation of the requirements will need careful planning with advanced consideration of the potential knock-on effects on key performance indicators and regulatory capital.

Kush Patel
kupatel@deloitte.co.uk

Recovery & Resolution Plans

On 9 August 2011, the FSA published its much awaited Consultation Paper[2] (CP) on Recovery and Resolution Plans (RRP). The RRP requirements will apply to all UK incorporated deposit takers and significant investment firms defined as full scope BIPRU 730k investment firms with assets exceeding at least £15bn and first submissions are due in June 2012[3].

Depending on the complexity of the organisation, development of the RRP will be an iterative multi-year process which will be expected to have oversight from the highest levels within the organisation. Given the importance being attributed to resolvability, especially in the UK where it will form a cornerstone of ongoing regulation[4] under the Prudential Regulation Authority (PRA), all impacted firms will need to ensure they dedicate appropriate thought and resource to this challenging project.

The proposals in the CP follow extensive work by the UK authorities over the last 18 months, including pilots with the largest banks. As a result of this, we believe it is unlikely that the consultation will lead to significant changes to either the requirements or the proposed timing. With first submissions due in June 2012, all impacted organisations will need to ensure plans are in place to adhere to the published proposals.

The CP takes a modular approach and sets out the following key requirements:

- **Executive Summary (Module 1)** – This will help the authorities understand how the overall RRP preparation process has been conducted and will include details of the governance process followed.

- **Recovery Plan (Module 2)** – Credible options that the organisation could take when faced with stress scenarios, both idiosyncratic and market-wide. The purpose of these would be to address capital and liquidity pressures and bring the organisation back to a stable and sustainable position.

- **Understanding of the Group Structure (Module 3)** – Central to both recovery and resolution planning, an understanding of how the group is structured, how different business activities (Economic Functions) are booked onto different legal entities and the key interrelationships (e.g. funding, capital, hedging, operational) between the entities.

1 If IFRS 10 is applied earlier, an entity is also required to apply IFRS 12 as well as IFRS 11 Joint Arrangements, IAS 27 (revised 2011) Separate Financial Statements and IAS 28 (revised 2011) Investments in Associates and Joint Ventures at the same time. However, if an entity chooses to apply some or all of IFRS 12 early it is not compelled to apply IFRS 10, IFRS 11, IAS 27 (revised 2011) or IAS 28 (revised 2011) early.
2 CP 11/16: Recovery and Resolution Plans, available at http://www.fsa.gov.uk/pages/Library/Policy/CP/2011/11_16.shtml
3 The exception is interbank exposure data which is due to be submitted in March 2012
4 Resolvability is a key element of the PRA's supervisory model as set out in its launch document, which is seen as structural mitigation of the potential risk a firm poses to the stability of the financial system. For more information, please refer to the joint paper issued by the Bank of England and the FSA, 'The Bank of England, Prudential Regulation Authority: Our approach to banking supervision', which was published on 19 May 2011available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/043.shtml

- **Resolution Planning (Modules 4, 5 & 6)** – Metrics to assist the authorities in making a determination of which Economic Functions are critical to the UK economy or financial system. For critical activities, an understanding of how they are conducted and supported operationally in order to assist the authorities in developing their resolution plans. This will include the identification of barriers to resolution and in due course, a plan for how these can be addressed.

Assuming there is no entity in the Group incorporated in the UK which is a deposit taker or a significant investment firm, the RRP requirements do not apply to UK branches of overseas entities (although the FSA would expect access to home state resolution plans for UK branches deemed to carry out critically important functions).

Recovery and, in particular, resolution plans will continue to be refined for a number of years as the issues are better understood by firms and regulators and there is greater international convergence of requirements and practices. The approach to RRPs will also develop as the PRA implements its approach to banking regulation and to take account of any changes which may arise from the possible implementation of recommendations from the ICB in their final report issued on 12 September 2012.

Different organisations will be at different stages in their RRP process and will be facing quite different challenges. Much of the guidance is derived from the pilot exercises that six of the largest UK banking groups participated in and these organisations will benefit from familiarity with the requirements and the work that has already been performed. Next steps for these types of organisations are likely to include refinement and updates to recovery planning, compliance with the additional new requirements in the CP (e.g. derivative and securities financing information and information relating to balance sheet encumbrances) and the completion of analysis for additional critical Economic Functions not covered in the pilot exercise. More broadly, focus will continue to turn to the development of 'business as usual' capabilities, the rectification of known weaknesses in information availability and the consideration of potential solutions to the structural issues identified.

Many non-pilot UK deposit takers are likely to be at very early stages in their RRP planning, whilst for firms which are headquartered overseas, the initial key challenge will be the incorporation of detailed UK requirements into global RRP projects.

There is a clear commitment to the implementation of RRPs globally and the UK proposals are consistent with the international approach to RRPs. The need to cooperate on this topic internationally is clearly acknowledged by the FSA in the CP. The development of proposals in this area to date internationally is being coordinated through the Financial Stability Board (FSB) in which the FSA and the Bank of England are active participants. The FSB recently published a consultation document on effective resolution frameworks for financial institutions[5] and the FSA CP reflects the key elements of this international consultation.

In addition to the CP, the FSA published a Discussion Paper (DP) exploring and seeking comment on different approaches to resolution and to enhancing resolvability. The DP covers:

- The regulatory approach to improving resolvability which includes defining what is meant by "resolvable", access to central bank funding on a collateralised basis in resolution, potential social costs of bank failure and the approach the FSA expects to take in addressing resolvability issues with the firms it regulates.

- Barriers to resolution such as trading books, structural barriers arising from the legal structure of banking groups, operational and financial dependencies which may arise from the way in which services are provided from third parties or other group companies, the impact of booking practices on resolution and the impact on payment, settlement and clearing systems.

- The resolution of trading books which can pose a serious threat to financial stability.

- 'Bail-ins'. This refers to a process of internal recapitalisation of a failing firm by writing down or converting to equity the claims of certain creditors.

5 http://www.financialstabilityboard.org/publications/r_110719.pdf

The DP highlights a number of the challenges and complexities inherent in successfully resolving a failed financial institution which will need to be addressed by both regulators and the industry over the coming years.

Responses to the CP are due to the FSA by 9 November 2011. The FSA and Bank of England have invested a significant amount of time in the drafting of the proposed rules and we do not expect that requirements and guidance as currently drafted will change significantly following the consultation period.

Additional information, including a more detailed summary of the requirements and practical considerations relating to the CP can be found at www.deloitte.com/livingwills

James Polson
jpolson@deloitte.co.uk

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