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“Giving into reform fatigue could erode the willingness of G20 members to rely on each other’s systems and institutions and, in the process, fragment pools of funding and liquidity, create inefficiencies and frictions, reduce competition, and diminish cross-border capital and investment flows. The net result would be less and more expensive financing for households and businesses, and very likely lower growth and higher risks across the G20. There is, however, another path that involves working together through reinforced, voluntary, international regulatory cooperation grounded in agreed international standards.”

Mark Carney, FSB Chair’s letter to G20 Leaders July 2017

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Foreword

Uncertainty unclarified

Another year has passed, so what has changed?

This time last year we expected 2017 to be a period of uncertainty for financial services regulation. Financial services firms were challenged by the continuing lack of clarity over the final shape of post-crisis reforms, the implications of Brexit and a new US political administration. We also saw significant pressures on the banking and life insurance sectors from sluggish economic growth and low interest rates in Europe and the US, and competition from new entrants (particularly “FinTechs”). Looking ahead to 2018, most of these challenges and uncertainties remain.

Economic growth, but how robust?

Global growth prospects improved through 2017 and continue to be broadly positive, albeit more subdued than in the period before the financial crisis. China, Europe, and Japan have all been outperforming expectations, and although India’s economy has slowed lately, the long-term

outlook is upbeat. There are now signs that the extraordinary monetary easing of the last ten years is starting, slowly, to unwind in Europe and the US, although this stands in contrast to the situation in China and Japan.

There are reasons for caution. Asset markets and prices have seemed impervious to the prospect of tighter monetary conditions and geopolitical tensions. This has left many commentators worrying that markets are in the grip of a bout of irrational exuberance. There are also signs of price bubbles in commercial and residential property markets, as well as leveraged finance markets, and of elevated levels of consumer indebtedness, particularly in the advanced economies.

Supervisors across the globe are very alert to the financial stability risks posed by the political and economic climate, and we expect them to focus on the ability of financial institutions in all sectors to deal with the downside risks of an abrupt shift

in market sentiment and any increase in asset price volatility, irrespective of the trigger. Boards are expected to keep their risk appetites under review, and will also need to engage closely with stress testing, whether prompted by supervisors or carried out internally.

What does this mean for the regulatory agenda?

Last year we predicted that there would be no wholesale rolling back of the post-crisis regulatory framework, and this remains our view. The consensus in the US is that there will be some meaningful adjustments to the Dodd-Frank Act, but no large-scale repeal or re-write. In the EU there remains a considerable volume of legislative work ongoing; and even where there is no new legislation, there is a great deal of “fine tuning” of existing rules. The Asia Pacific region faces a long tail of implementation work, and must also deal with the impact of regulation from outside the region.

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At the international level, the FSB has shifted its primary focus towards a post-implementation evaluation framework, which will be “progressively applied” in the coming years.¹ This is part of a rebalancing away from introducing new rules towards assessing the effectiveness of what has been done over the past decade. Boards will need to be ready to demonstrate to supervisors that they have embedded change and that this is leading to the desired outcomes.

One major area in which there remains a number of significant unanswered questions is bank capital requirements. Although the BCBS has until now been unable to complete the Basel III package, final agreement on the open issues seems within reach. This will be a significant achievement. But it will not provide banks and their investors with certainty about the “final” shape of the rules, given that much depends on national and regional implementation of international standards.

We do not see any major economies as being in a hurry to introduce yet-more legislation, and we also see those economies being more willing to depart from the letter of global standards where they conclude it is in their interest to do so.

As a consequence, financial services firms need to be prepared to deal with the challenges of diverging regulatory frameworks. At a minimum they will need globally coordinated approaches to understand overlaps, incompatibilities and potential synergies.²

Supervisors are turning more attention to long-term structural issues

Technological innovation, ageing populations, and climate change have all caught the attention of the regulatory and supervisory community as emerging risk areas. We expect some supervisors to begin to challenge boards, risk committees and senior management to demonstrate that they understand the impact on their customer bases, business models and risk profiles, and are set to take effective mitigating actions where needed.

“Technological innovation, ageing populations, and climate change have all caught the attention of the regulatory and supervisory community as emerging risk areas.”

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- **FinTech:** while new technologies present opportunities, regulators want to understand the potential risks and the likely impact on incumbents' business models. The FSB has a clear interest in the subject. The European Commission is expected to deliver a FinTech "Action Plan" in January. Similarly, US regulators are considering the implications of new technologies, including third-party relationships among FinTechs and banks, and are even exploring special purpose bank charters for FinTechs.
- **Climate change:** the FSB has taken the lead internationally with its Task Force on Climate-Related Financial Disclosures, which made its final recommendations in June 2017. A number of regulators in the Asia Pacific region are instituting policies to encourage green finance. The BoE is also researching climate change and the EU recently proposed to integrate environmental risks into the mandates of the ESAs as part of its Action Plan on sustainable and green finance.

- **Ageing populations:** ageing populations worldwide will create a widening pool of potentially vulnerable customers and influence demand for different types of financial services, as well as the way in which financial institutions engage with their customers. At the international level, IOSCO is taking forward work on ageing populations.

Leadership changes

Lastly, we note that by the end of 2018, the most senior leadership of many of the world's most important regulatory bodies will be starkly different from what it has been for the majority of the post-crisis regulatory reform era. Mark Carney's term as Chairman of the FSB has been extended through to December 2018, lending some additional continuity to reform efforts, but this will be his final year at the top of the FSB. We expect Stefan Ingves to stand down as Chair of the BCBS in the near future. There is also a great deal of

change in senior leadership across national and regional regulatory bodies, particularly in the US. It remains to be seen how far new leaders will uphold the key tenets of the international supervisory agenda of the last decade, particularly its emphasis on cross-border coordination, or whether supervisory priorities will tilt more towards promoting the competitiveness of individual jurisdictions.

On balance we think that these new leaders will emphasise practical supervisory initiatives over (new) rule-making, as well as the need for firms to demonstrate that they are financially and operationally resilient to a range of threats, both old and new. New leaders will be keen to consolidate the outcomes and achievements of the prudential policy agenda that has dominated the last ten years and focus their tenures on continuing structural challenges as well as emerging risks and issues.

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Acting in the face of uncertainty

While we expect some greater clarity about the regulatory outlook to emerge in 2018, the overriding challenge for firms remains coping with uncertainty, including from the global impacts of Brexit and how markets in Europe and elsewhere will be reshaped



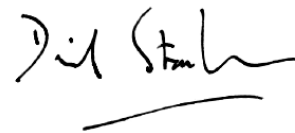
Kevin Nixon
Centre for Regulatory Strategy
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by MiFID II. This will put a premium on firms maintaining strategic flexibility, while at the same time adopting new technologies to react to the threat from “challengers”, improve their customer service and outcomes, better manage their risks, and help control costs. With yields and income levels, and hence



Christopher Spoth
Centre for Regulatory Strategy
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return on capital, still under pressure, cost control will continue to be important: even though interest rates rises are under way, they will be neither quick enough nor big enough to alleviate pressure on incumbents’ business models.



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The defining regulatory issues of 2018 for financial services firms of all stripes

Regulatory strategy in 2018

The European financial services industry faces considerable strategic challenges in 2018. There is a large volume of implementation work being carried out, alongside uncertainties around the future shape of regulation. And though many initiatives have their roots in the financial crisis (now ten years past), others – such as work to address cyber resilience, Brexit, and Open Banking – reflect more recent concerns.

Looking at the breadth of topics covered in this year's Regulatory Outlook, we are struck by a number of common threads that emerge from the detail:

- The industry faces many **resource constraints** and numerous competing priorities. With business models already under pressure, it can be difficult for regulated firms to do the bare minimum, let alone invest to become best in class.
- There is **considerable uncertainty** across the board: the outcome of Brexit remains unknown, there are important regulatory technical standards outstanding in several areas, and the impact of new rules on markets will take time to play out.
- The **ecosystem of financial services is changing**. MiFID II will intentionally overhaul the trading landscape, but old and new players will forge different types of connection, particularly through technological innovation and third party service providers. The shape of markets is changing, and with this the nature of risk in the system.
- **Technology provides opportunities** to do old things better and to introduce new products, services and ways of working. **But it also creates risks** for firms whose business models will be challenged, and risks for consumers where its use is not well understood or controlled.
- **Customers' relationships with firms are changing**. Firms are looking to use customer data in novel ways, but customers are also set to gain stronger rights over how their data is used, while new technologies are enabling new types of interactions between customers, firms and third parties.

How individual firms respond to these issues will dictate who will succeed and who will struggle in the years ahead.

Our Regulatory Outlook for 2018

We have identified seven cross-sector issues of strategic significance for all sectors of the European financial services industry in 2018, alongside a number of additional sector-specific issues.

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Our **cross-sector** issues span a wide range of issues. 2018 is a year of multiple regulatory deadlines, including MiFID II, PSD II and GDPR, and our first theme examines industry's efforts to "get over the line" in terms of compliance. Our second theme is Brexit, and we set out what industry will need to do against a backdrop of political and regulatory uncertainty. Third, we look at the business model challenges posed by the macro-economic environment, competition initiatives, and regulatory change. Fourth, we examine whether and how industry efforts to utilise customer data in novel ways can be reconciled with new data protection rules and supervisory expectations of the fair treatment of customers. Fifth, we observe significantly higher supervisory expectations and approaches regarding the treatment of vulnerable customers. Sixth, we consider the ever-present threat posed by cyber attacks, and the increasing supervisory emphasis on cyber resilience. Last, but not least, we assess the evolving landscape for model risk management in an environment in which a

large proportion of assets in the financial system, and the level of capital supporting them, are managed using approved internal models.

Beyond our cross-sector themes, we also highlight a number of issues we consider to be "**supervisory constants**". These remain the core priorities and activities of supervisors. Although we do not see major new formal policy initiatives emerging in 2018, these issues should nevertheless be given the attention they deserve by firms owing to the high importance placed on them by supervisors.

Supplementing these, we present our views of a number of strategically significant **sector-specific issues**:

- **Banks** must contend with slow progress on the prudential framework, the intersection of IFRS 9, stress testing and other requirements, evolving resolvability expectations, and the instigation of the "Open Banking" era.

- **Capital markets** will respond to and be shaped by the introduction of MiFID II, particularly in terms of the trading landscape, data and reporting, and best execution.
- **Insurers** are grappling with continuing regulatory change in the context of technological disruption, a persistent soft market and a continued low yield environment that is necessitating changes in asset strategies, business models and risk appetite. They also face challenges in delivering the product innovation needed to meet changing customer needs.
- **Investment managers'** business models are being scrutinised, with the margin between passive and active fund fees set to be squeezed. They also face the prospect of continuing supervisory review and potential intervention to address systemic risk concerns.

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Regulatory Outlook 2018



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We have identified seven cross-sector issues of strategic significance for all European financial services sectors operating in 2018, alongside a number of additional sector-specific issues.



Meeting multiple regulatory deadlines

The focus on meeting multiple regulatory deadlines in 2018 will come with a significant opportunity cost – firms will not have been able to exploit synergies to the full, will have diverted resources from other strategic priorities and will likely have to undertake significant remediation work post-deadline to make compliance efficient and effective.



Preparing for Brexit

Firms and supervisors will continue preparing for Brexit in a world of uncertainty, where the detail of both political and regulatory developments will be unveiled during the course of the negotiation period.



Supervisory spotlight on business models

The macro-economic environment, competitive forces and regulatory change continue to put pressure on traditional business models across the financial services industry, and in some cases are driving changes to business models and risk appetite.



Data protection, innovation and good customer outcomes

Against a backdrop of increasing concerns about the use of personal data and data privacy, firms can expect to experience greater scrutiny by regulators of their approaches to their use of, and controls over, personal data.



Customer vulnerability – broadening the perspective

Regulators are increasingly recognising that legislation, products and services are often built for the “average” consumer, and that while these work satisfactorily for many, supervisors nonetheless need to focus on certain consumer groups whose situational vulnerability may leave them less able to secure their own interests and hence at greater risk of suffering poor outcomes.



Cyber risk and resilience

The regulatory focus on the heightened cyber risks created by technological change and increasingly digital business models is not new. In 2018, however, we will start to see regulators flex their muscles and begin to articulate clearer priorities for what firms need to do to prepare for cyber threats.



Managing risks from internal models

2018 will see a concerted push from national and supranational regulators on the risks posed by capital and other models to firms and the financial system.

Banking



The prudential framework: slow progress



IFRS 9, stress tests, NPLs and disclosure



Resolvability: yet to be resolved



The Open Banking era begins

Capital Markets



Trading landscape and market structure



Data and reporting



Best execution

Insurance



Continuing regulatory and capital change



Profitability and low interest rates



Profitability and soft markets



Disruption and innovation

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Business models and new regulation



Systemic risk concerns

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Cross-sector issues



The defining cross-sector regulatory issues for 2018.

In the year ahead we see seven issues of strategic significance for all sectors of the European financial services industry in 2018:

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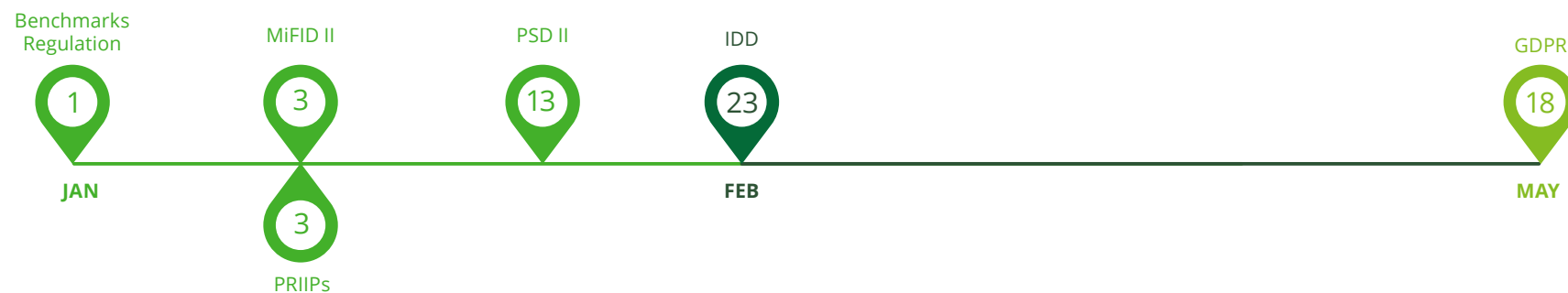
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Meeting multiple regulatory deadlines

The focus on meeting multiple regulatory deadlines in 2018 will come with a significant opportunity cost – firms will not have been able to exploit synergies to the full, will have diverted resources from other strategic priorities and will likely have to undertake significant remediation work post-deadline to make compliance efficient and effective.

- Some implementation work will overrun regulatory deadlines, with firms having to adopt tactical approaches to compliance due to resource pressures. Firms need to act swiftly to identify areas where they may be at risk of not being fully compliant and plan accordingly.
- Firms should not assume that regulators and supervisors will refrain from early use of enforcement powers across all regulations that go live in 2018, notwithstanding indications from a small number of regulators that they will adopt a pragmatic approach to early post-implementation supervision of MiFID II.
- Firms will have to make ongoing changes to implementation plans in 2018 to ensure that they are working towards strategic solutions that will deliver optimal operating models

Timeline of regulations (2018)



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Meeting multiple regulatory deadlines

The first half of 2018 will see a concentration of far-reaching regulations taking effect.

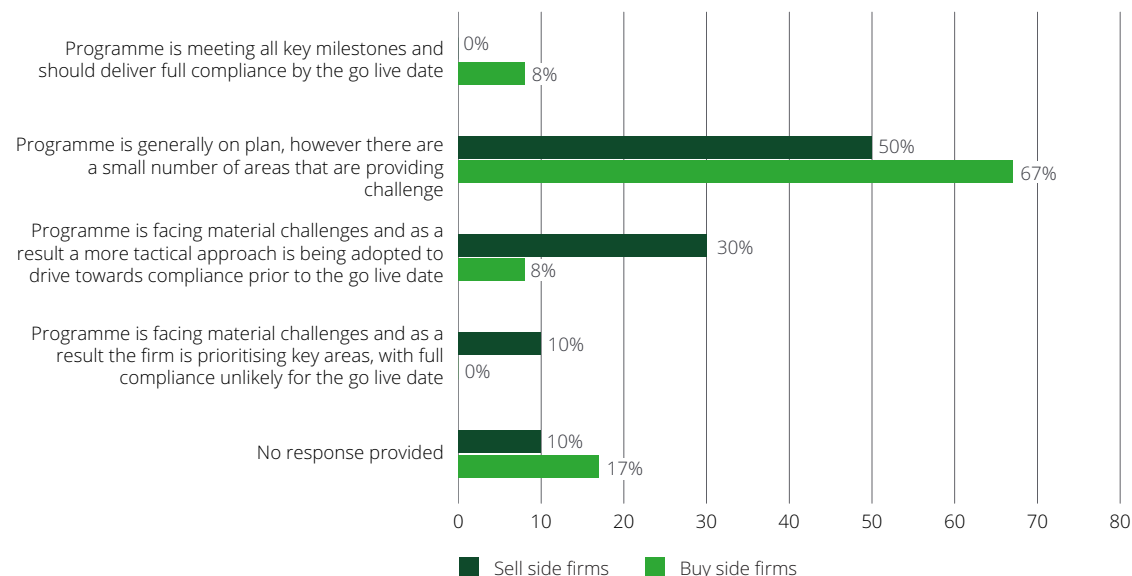
Firms have been investing considerable resource into their implementation programmes, but the process has been riddled with challenges, not least of which is uncertainty over the interpretation of legislation due to delays in the finalisation of regulatory guidance and standards. It has proven virtually impossible for firms to adopt an integrated approach to implementing these regulations, given their breadth, resource pressures, and the relatively short window of time in which they all go live.

Firms have focused on establishing systems and controls which allow them to meet regulatory requirements, but in some cases to no more than a minimum level. Two-thirds of the buy-side firms we interviewed in late 2017, with total AUM of \$6.1 trillion, said that, while they are generally on track with their MiFID II implementation programmes, they have tactical overruns built into their plans.

Implementation challenges are evident across many major regulatory change programmes. For GDPR it is the sheer scale of changes involved that creates difficulty. The challenges involved with IDD are proving so extensive that the European Commission is coming under intense pressure to delay its application to October 2018. Some firms are also struggling

with PRIIPs, particularly the calculation of transaction costs and interpretation of the rules for derivatives. There is some respite for benchmark administrators, however, many of which will be able to rely on transitional arrangements for authorisations, which ESMA has clarified will extend through to 2020.

MiFID II programmes: firms' readiness ahead of the implementation deadline



Source: Deloitte MiFID II Buy-Side & Sell-Side Forum Survey Results (2017)

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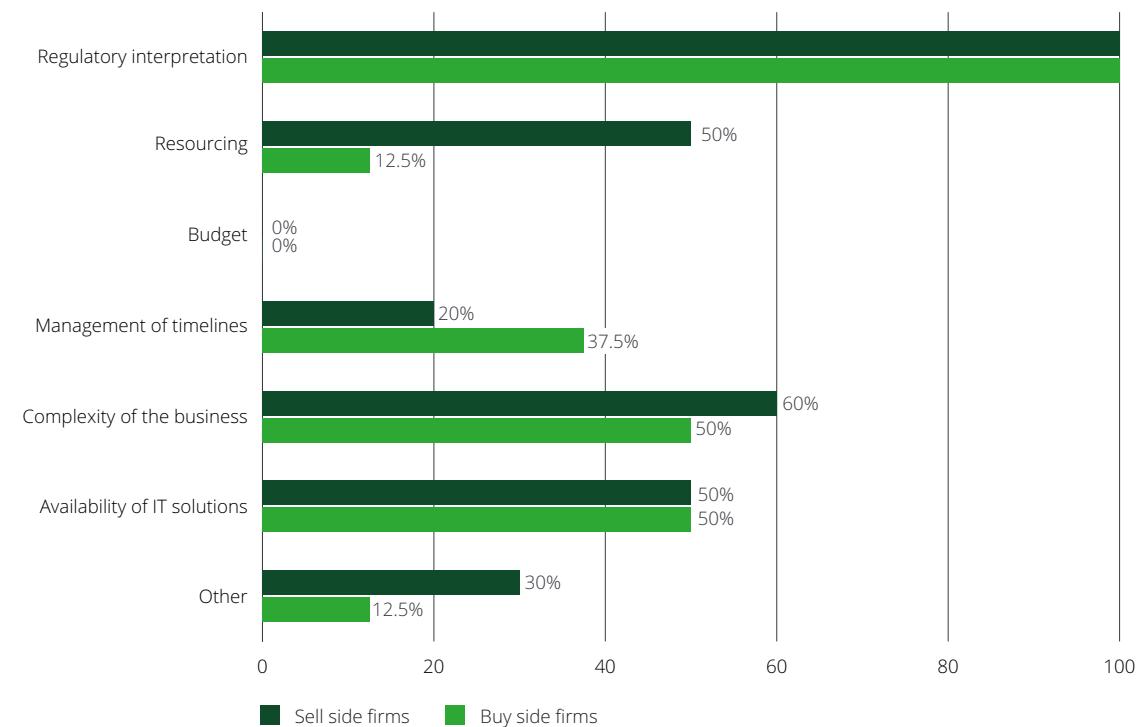
Meeting multiple regulatory deadlines

Our expectation is that implementation work will continue beyond deadlines.

We therefore expect firms to continuously review implementation programmes over the course of the year. This will also allow them to adapt their solutions as they go. Supervisors are likely to monitor progress and identify areas for remediation.

Firms need to act swiftly to identify areas where they are at risk of not being fully compliant and plan accordingly, including documenting how and by when they will achieve full compliance. Although UK FCA has said that it has “no intention of taking enforcement action against firms for not meeting all MiFID II requirements straight away”,³ this is conditional on evidence of “best efforts” and the existence of a priority programme to reach full compliance. Danish and Finnish regulators have also indicated that they are aware of implementation challenges and may take a pragmatic approach to initial supervision,⁴ but other EU regulators have not been forthcoming about their intentions towards MiFID II.

Root cause(s) behind firms' MiFID II programme challenges



Source: Deloitte MiFID II Buy-Side & Sell-Side Forum Survey Results (2017)

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Meeting multiple regulatory deadlines

Moreover, it is not obvious that any pragmatism towards MiFID II will also be displayed towards other directives and regulations. There are no grounds for complacency. This is especially true in areas which are likely to be high priority for regulators, such as transaction reporting, best execution, investor protection, costs and charges transparency, and data protection.

Many of the new rules will require information to be obtained from customers at various stages of the customer journey. As these customer journeys become more complex, firms would do well to put themselves in their customers' shoes and examine all the linked requirements, where appropriate. For example, firms will need information from customers periodically to comply with the product governance rules and the suitability and appropriateness regime under MiFID II. They will also need to pass on enhanced disclosures to clients (under MiFID II and PRIIPs), and seek

approvals in respect of data retention (under GDPR). The more integrated and streamlined these information requests are made, the better the customer's experience.

In some areas, coordinated implementation is a necessity.

In particular, GDPR and PSD II programmes should be coordinated to help determine integral issues such as which party will be responsible for obtaining consent from customers, to allow banks to share their payment data with TPPs under PSD II.

Success more broadly will mean identifying and exploiting non-obligatory synergies between regulations, such as MiFID II, IDD and PRIIPs overlaps around costs and charges or the conflict of interest requirements of MiFID II and IDD. Some regulators are already considering these links (for instance, the UK's FCA is proposing to develop supplementary guidance

around the disclosure of costs and charges under MiFID II and PRIIPs).⁵ Identification of overlaps and linkages between regulations and investment in building or updating IT infrastructure, particularly automated solutions, is crucial.

“As these customer journeys become more complex, firms would do well to put themselves in their customers' shoes and examine all the linked requirements.”

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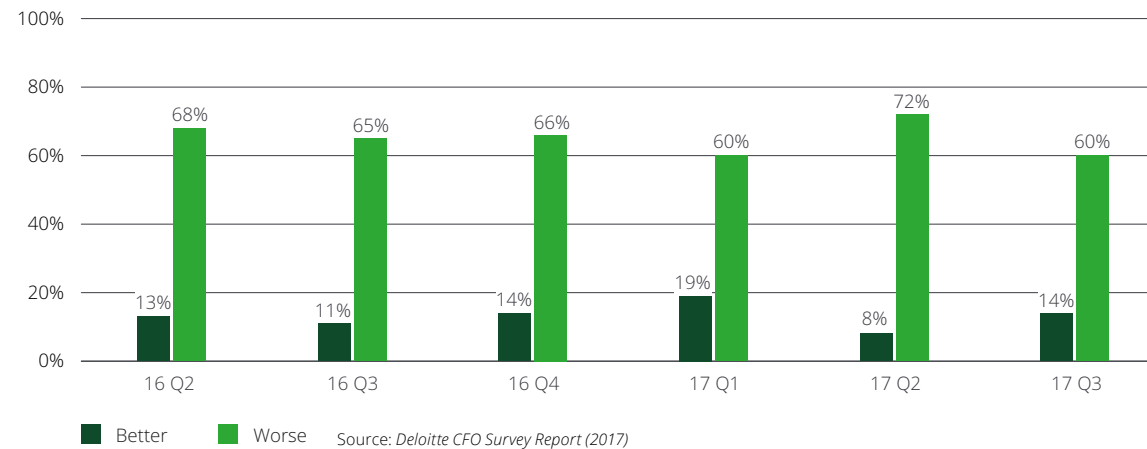
Preparing for Brexit

Firms and supervisors will continue preparing for Brexit in a world of uncertainty, where the detail of both political and regulatory developments will be unveiled during the course of the negotiation period.

- Those firms operating in the UK that need to ensure continued EU market access will start building their presence in EU27 countries on a sliding scale of intensity throughout 2018.
- It remains unclear whether a transitional period will be agreed; even if one is, we expect firms to press ahead with aspects of their plans, including new authorisations and model approvals.
- We expect legislative (or equivalent) solutions to the issue of cross-border derivative and insurance contracts in order to maintain financial stability and consumer protection.
- In the UK, we expect the PRA and FCA to clarify their approach to the treatment of branches of EEA firms in the UK post-Brexit.

Long term impact of Brexit

Percentage of CFOs who think the overall environment for business in the long term will be better/worse if the UK leaves the EU (excludes "little changed")



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Preparing for Brexit

With March 2019 rapidly approaching, we expect firms to begin building their presence in EU27 countries on a sliding scale of intensity throughout 2018.

Restructurings will not be completed in 2018, but will occur in waves over a number of years, depending on the final terms of any market access agreement between the UK and the EU. The first wave will cover the minimum structures and resources needed to continue offering regulated services to affected clients and to meet supervisory expectations.

It remains unclear whether a transitional period will be agreed, but to have a significant impact on firms' contingency plans, a legally binding agreement would need to be concluded early in the year. Even with such an agreement in place, we expect firms to press ahead with new entity authorisations, internal model approvals, infrastructure and technology build, and more.

“It remains unclear whether a transitional period will be agreed, but to have a significant impact on firms' contingency plans, a legally binding agreement would need to be concluded early in the year.”

Number of applicants: PRA and ECB

As a direct result of Brexit, the PRA expects 130 applications for authorisation in the UK, and the ECB has so far received around 20 applications.

130



The number of applications for UK authorisation expected by the PRA⁶

20



The number of banks that have applied to the ECB for European banking licences⁷

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For many firms, their ability to execute their contingency plans will depend on the timely receipt of regulatory licences. As more firms submit applications, regulators' resources will come under pressure and we expect them to take a "first come, first served" approach. Given time pressures and the risk of process logjam, firms should be proactive in anticipating and responding to likely areas of supervisory review and enquiry.

We expect to see a continuing strong pan-European drive for consistent supervisory treatment of restructuring firms, led by the ESAs and the ECB. There will be a strong element of "learning by doing" such that supervisors' expectations will evolve as they understand better the specific challenges in relation to restructuring work and related authorisations.

We see two fundamental industry wide issues in need of early resolution: the treatment of derivative contracts and of cross-border insurance contracts with durations beyond the UK's exit date. EU27 and

UK regulators will ask firms to demonstrate how these contracts can be serviced without customer and counterparty detriment in a "hard" Brexit scenario. Although there are measures the industry can take to deal with such issues, there are limits to what firms can practically achieve by March 2019. We expect legislative (or equivalent) solutions in the UK and EU.

Firms continue to work through the complex implications of regulation. One example is the interplay between booking model supervision and MiFID II, particularly in light of the tougher best execution requirement and broader trading obligation, including for some derivatives. Post-Brexit, EU entities using an execution venue based in a non-EU jurisdiction (such as the UK) will still have to demonstrate to supervisors that they are providing best execution for client orders, including where they are hedging the transactions on a back-to-back basis. It will be essential for firms to apply their first year of MiFID II operational experience to post-Brexit execution of client orders.

"Post-Brexit, EU entities using an execution venue based in a non-EU jurisdiction (such as the UK) will still have to demonstrate to supervisors that they are providing best execution for client orders."

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Meanwhile, there continues to be legislative and regulatory change in the EU. Banks and capital markets firms will have to keep a close eye on several major legislative processes, including revisions to EMIR relating to the supervision of CCPs, the IPU proposals in CRD V/CRR II, the new prudential framework for investment firms, and what – if any – revisions are proposed to MiFID II. It is impossible for firms to “future proof” their current plans entirely, but they should stress test them against the most adverse outcomes.

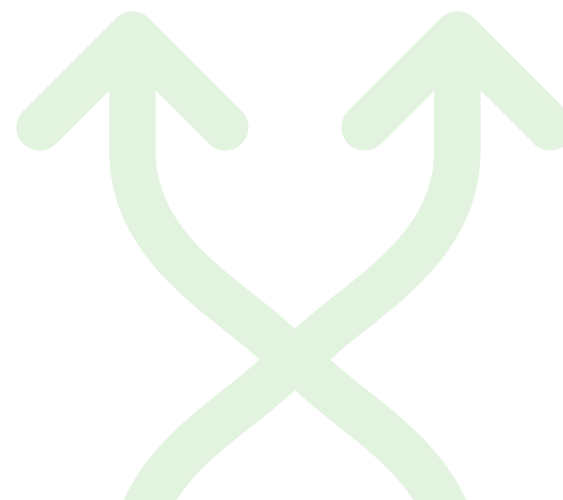
Insurers will need to focus on Solvency II. The UK will not depart from Solvency II in 2018, but the PRA will examine ways of streamlining its implementation, for instance in relation to data collection and model change approval. The PRA will give serious consideration to a unilateral early change to the calculation of the risk margin for UK firms, given that EIOPA’s review does not seem to have delivered this.

Investment managers should closely monitor any movement on the issue of delegating portfolio management to non-EU countries in the UCITS and AIFMD reviews.

The treatment of branches also remains a major unanswered question, with EEA firms currently operating in the UK through branches still seeking clarity on their post-Brexit regulatory status. We expect the FCA to opt for an “interim authorisation regime” for FCA-regulated firms while applications for post-Brexit authorisation are assessed.

The PRA’s stance on branches remains more complex, but we expect clarity around the turn of the year. The PRA’s preference for retail deposit-taking to be carried out in subsidiaries rather than branches is well established, and we expect this model to be replicated for EU27 retail banking branches in the UK. We also expect the PRA to press for subsidiarisation where material volumes of retail insurance business are concerned, particularly on the life side.

Less clear is the treatment of wholesale banking and insurance business. The PRA’s current openness to branches of third country firms conducting wholesale business relies on supervisory equivalence, cooperation, and resolvability considerations. As such, if agreements on regulatory cooperation between the PRA and EU27 supervisors are not in sight by the time of PRA’s announcement, the possibility of branches being required to subsidiarise cannot be discounted. We do not expect the PRA to entertain a time-limited authorisation regime akin to the FCA’s expected approach, or any other form of “tolerance period”.



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The macro-economic environment, competitive forces and regulatory change continue to put pressure on traditional business models across the financial services industry, and in some cases are driving changes to business models and risk appetite.

- Supervisors will expect the board and senior management team to demonstrate tangible improvement in the quality of debate and discussion on business strategy and its risk implications, and the quality of data supporting that debate
- Business strategy will become an important lens through which supervisors will view the competence and effectiveness of the board and senior management.

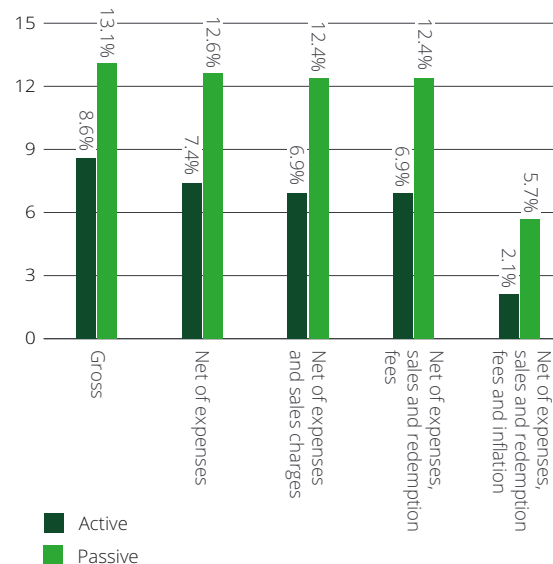
The sources of business model challenges are varied.

They include the potential loss of market share and restructuring of value chains owing to new entrants using new technologies; failure to deal with legacy problem assets; overcapacity or intense competition (leading to the compression of spreads or margin, most evident with respect to active and passive fund management costs); and regulatory-mandated business model changes (such as MiFID II rules in relation to investment research).

The persistent combination of regulatory change and low interest rates has generally eroded profitability and the capacity of firms to weather further challenges, and has provided strong incentives to pursue higher yielding asset strategies. In the insurance sector especially this is leading to an on-going shift into alternative and often less liquid asset classes as well as lower rated bonds, creating in turn new challenges for the sector in the areas of credit risk assessment and management. Furthermore, conduct rules aimed at enhancing consumer protection will affect product distribution: revenue streams will come under pressure as provisions on

inducements, conflicts of interests, and remuneration of salespeople come into effect. Product ranges will be scaled back in response to tougher product governance requirements on complex products, and distribution networks (particularly for insurance broking) may diminish in some countries as smaller intermediaries struggle with the weight of regulatory requirements.

Average rate of return on investment - active vs. passive



Source: ESMA, Report on the impact of charges on mutual fund returns (2017)

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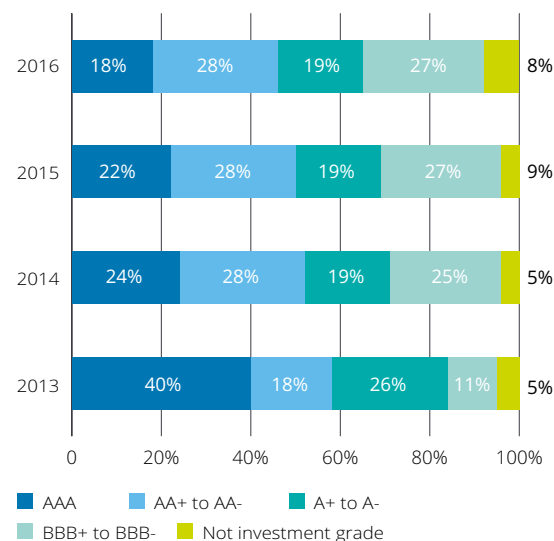
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Supervisory spotlight on business models

Although supervisory methodologies for assessing business models have not always been transparent to firms, this analysis has played a more prominent role in supervisory activity in 2017 and this will intensify in 2018. Analysis carried out in 2017 is set to translate into supervisory actions. There are three broad dimensions on which supervisors are focused:

Bond investments of European insurance groups by rating (%)



Source: EIOPA, Investment Behaviour Report (2017)

- Viability and sustainability:** supervisors are concerned that some firms are unable to make sufficient returns on capital within risk appetites for their business model to be sustainable. The BoE, ECB, and others are pursuing work in this area. Efforts by the ECB to deal with legacy assets (including NPLs) in the Banking Union should also be seen in this context.
- Financial stability:** diversification away from traditional activities, and the increasing prevalence of technology-oriented new entrants, will increase and change the nature of interconnectedness within the financial system. For example, issuance of ILS under the UK's incoming ILS regime will increase interconnections between insurers, asset managers and capital markets.
- Conduct:** analysis of strategy and business model performance is being used to find areas where there may be an inherent or heightened risk of consumer detriment. Highly profitable products or newer and non-traditional products (such as lifetime mortgages) will be scrutinised. The FCA's strategic reviews of retail banking and general insurance business models, in which cross subsidisation is a critical focus, are clear examples of this.
- Supervisors are not in the business of directing firms' business strategies or models** but the insights they have gained through business model analysis are leading them to challenge extensively on these fronts, as well as prompting supervisory work across a range of other areas. Individual firms whose business models are under such pressure that the firm is at, or close to, the point of failure should clearly expect intervention (including the use of resolution powers), and for banks in particular an unsatisfactory SREP score may well trigger microprudential intervention.

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Supervisory spotlight on business models

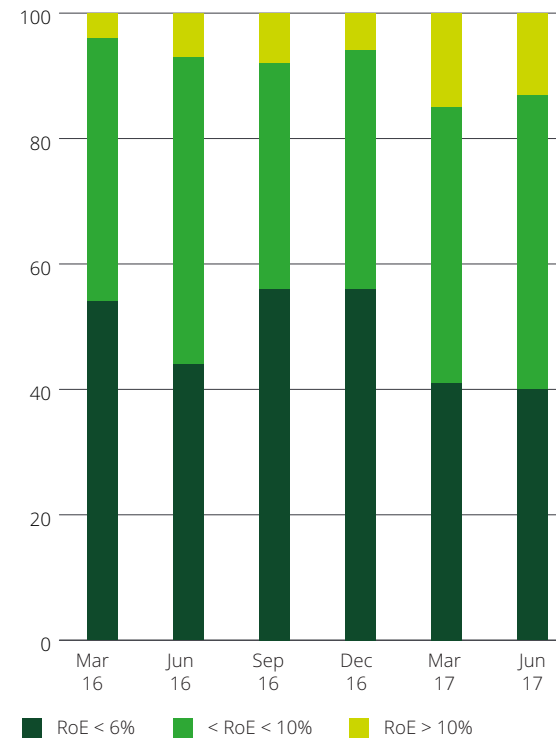
The more supervisors understand regulated firms' business models, the more targeted their interventions will be across the board. Increases in their understanding presage higher expectations of senior management and boards as the business model lens is used progressively to form broader views on management capabilities and governance. And although supervisors are not looking to force fundamental changes to firms' strategies or product offerings, they will intervene at the level of individual legal entities within group structures (for instance in relation to booking model concerns).

On a practical level, firms need to develop their own internal capacity to analyse their business model and its vulnerabilities, including by drawing on analysis carried out for supervisory exercises such as stress testing. They also

need to continue to facilitate supervisory investigations: the ECB's 2017 horizontal review of business models created substantial data requests for multiple functions and business lines. Internal coordination is critical to ensure timely and accurate data provision, as well as consistency with other supervisory submissions, such as for recovery plans or stress tests.

Handled badly, these exercises can undermine supervisors' confidence in the overall competence of the board and senior management team. Supervisors will look to the board and senior management team to improve the quality of debate and discussion on business strategy. Specifically, they will expect boards to offer robust justification for decisions, promote strong control and cultural environments, and demonstrate that strategy is effectively cascaded throughout the organisation.

Distribution of EU bank profitability (% of banks)



Source: EBA Risk Dashboard for Q2 2017

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Data protection, innovation and good customer outcomes

Against a backdrop of increasing concerns about the use of personal data and data privacy, firms can expect to experience greater scrutiny by regulators of their approaches to their use of, and controls over, personal data.

- GDPR will serve as a catalyst for regulators to increase scrutiny of wholesale automated processing of customers' personal data.
- To be in a defensible position by GDPR's May 2018 implementation deadline, firms need to complete Data Protection Impact Assessments and, if necessary, have a remediation plan in place.
- GDPR will require a gear shift in relationships with data protection authorities, both at firm and industry level.

Firms are increasingly using advanced analytics and AI solutions to design tailored services and products that better suit customers' needs, and also to determine customers' individual risk profiles more effectively

We have seen these developments across the spectrum of financial services offerings, from simple lending decisions through to robo-advice services and connected insurance products. In all cases, being able to leverage these technologies is predicated on the availability of large sets of relevant customer data, whether privately held or publicly available. As GDPR goes live, firms' ability to use customers' data while remaining compliant with data protections requirements will be tested. Fulfilling GDPR requirements in relation to automated processing from a compliance perspective will be challenging, and firms will also need to understand if and how these requirements will affect their innovation strategy and their customer relationships.

GDPR will give consumers additional rights to understand and take control of how firms are using their personal data. These rights will include the option to request an explanation for, and object to, decisions based on fully automated processing, which have a legal effect on them. Firms whose business models rely on wholesale processing of customers' personal data will need to prepare appropriately before May 2018. This means being able to satisfy supervisors once supervisory programmes start, and importantly, also to respond to customers' enquiries in a meaningful, transparent and understandable manner. This is particularly difficult where AI involves deep learning or neural network models, given that these can be very difficult to understand in terms of what drives outcomes.

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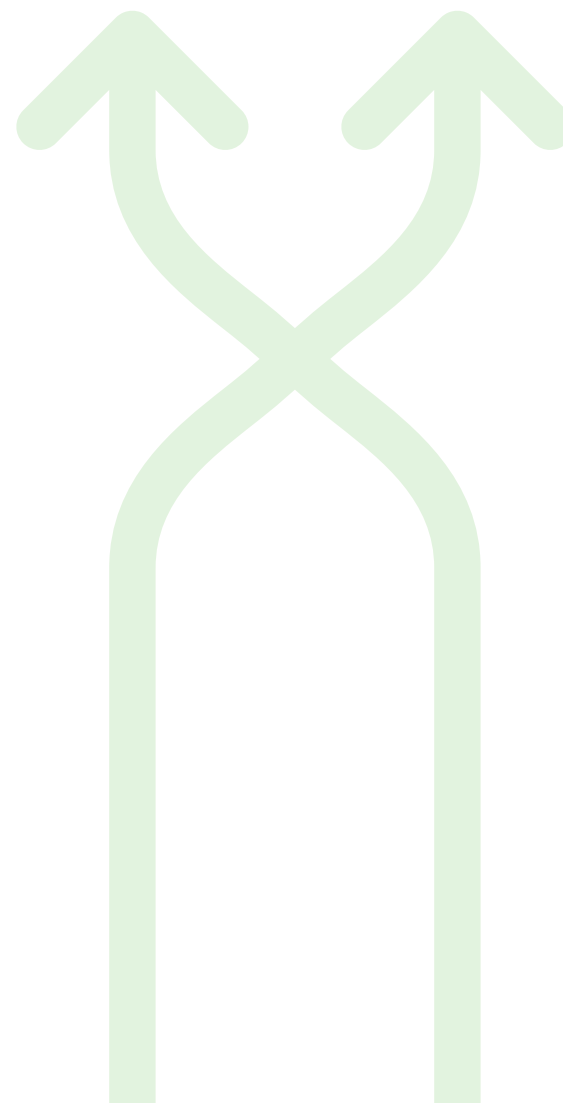
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Data protection, innovation and good customer outcomes

As a starting point, for firms to be in a defensible position by May they will need to complete a documented Data Protection Impact Assessment for any high-risk automated processing using customers' personal data and, if needed, have a remediation plan in place. More generally, they should adopt the principles of algorithmic accountability and auditability – these require firms to have organisational and technical processes in place to demonstrate, and for third parties to be able to check and review, that an algorithm is compliant with data protection requirements. Last, but not least, firms will need to ensure the data used for the processing meets the test of being lawful to use and free of bias.

In several EU jurisdictions, GDPR will also require a gear shift in relationships with data protection supervisory authorities. In the UK, for example, firms will need to establish more structured and appropriately funded regulatory affairs teams to conduct regular briefings with the ICO to discuss their organisational data privacy strategy and any high-risk automated data processing being planned. As the ICO will also need to build its resources rapidly in response to GDPR, it is likely to respond positively to efforts from the industry to make engagement as effective as possible, for example, by establishing industry groups to liaise with the ICO collectively on shared issues.

“Last, but not least, firms will need to ensure the data used for the processing meets the test of being lawful to use and free of bias.”



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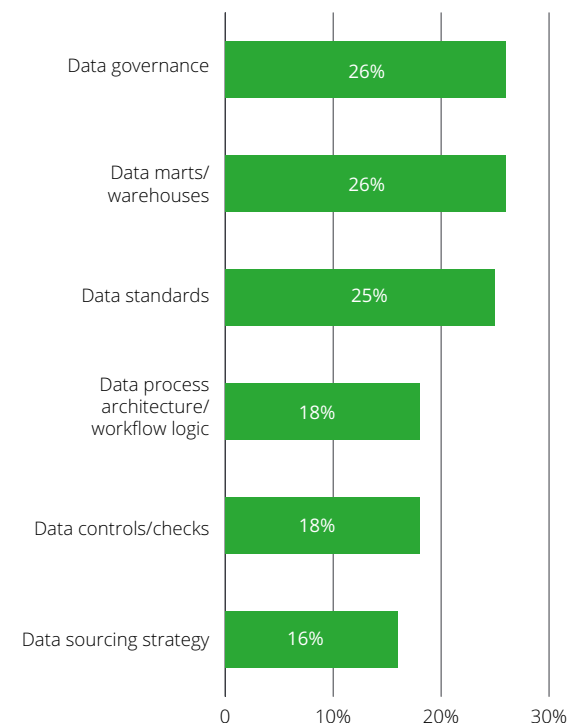
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However, compliance with GDPR is not the end of the story. The risks associated with large-scale processing of consumer data is also on the radar of financial services policy makers and supervisors, and we have already seen evidence of supervisors looking to investigate firms where they believe poor data practices may put customers at risk. The European Commission has stressed that in order for innovations in financial services to be delivered safely, appropriate policies, including on personal data protection, will need to be put in place, although it remains to be seen how this will feature in its 2018 FinTech action plan. The ESAs have also been looking at these issues and the EBA concluded that, while specific regulations may not be required yet, competent authorities should continue to monitor developments closely, and co-operate with data privacy supervisory authorities. Supervisory collaboration may also present firms with an opportunity to use their existing relationships with financial services regulators to accelerate the process of building similar relationships with data privacy authorities.

Proportion of firms rating themselves as “extremely or very effective” in aspects of risk data strategy and management



Source: *Deloitte Global risk management survey, 10th edition (2017)*
Note: Based on responses from 77 global financial institutions

Data protection issues provide practical examples of how FinTech is blurring the lines between financial services regulation and other policy domains. The effective supervision of GDPR requires close and formal collaboration between financial services and data privacy authorities. Financial services supervisors should and will pay particular attention to any unintended consequences of the automated processing of large sets of data, such as the potential that it could lead up to unintentional financial exclusion or discrimination. Regulatory affairs teams should be prepared to discuss their firms' use of customers' data from perspectives both of financial services supervisors and data privacy authorities.

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Customer vulnerability – broadening the perspective

Regulators are increasingly recognising that legislation, products and services are often built for the “average” consumer, and that while these work satisfactorily for many, supervisors nonetheless need to focus on certain consumer groups whose situational vulnerability may leave them less able to secure their own interests and hence at greater risk of suffering poor outcomes.

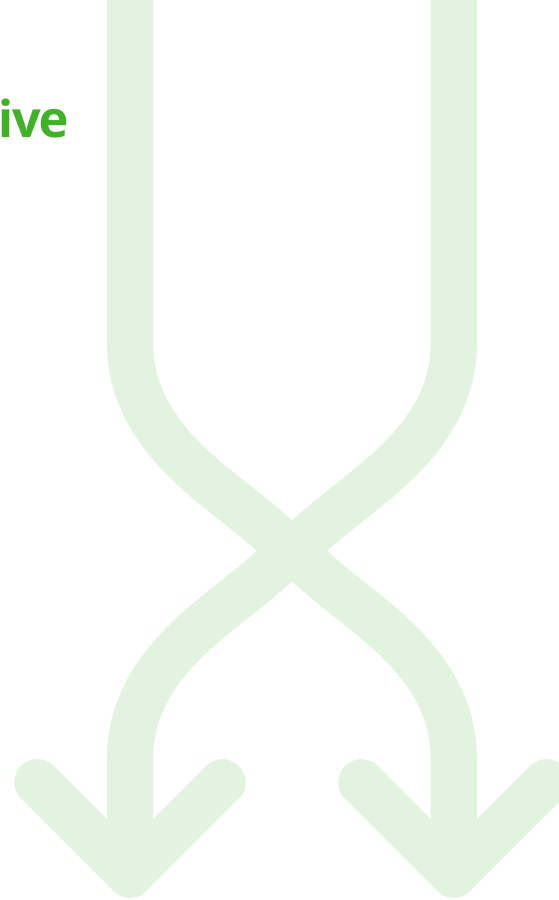
- Regulatory understanding of customer vulnerability is broadening to recognise that vulnerability is dynamic and a function of many variables.
- Firms need to adapt to this broader definition of vulnerability and factor it into their governance and interactions with customers.

In the light of past episodes of widespread misconduct, we see a general shift in conduct supervision strategy:

whilst emphasising firms’ obligations to treat all customers fairly as a starting point, conduct supervisors increasingly look to focus their resources on groups of customers at greatest risk of potential detriment. “Consumer vulnerability” is more overtly used as a notion and operating principle in certain jurisdictions (such as the UK), but the shift is taking hold more broadly.

The scale of the operational challenge facing industry is a function of the number of consumers considered potentially vulnerable. This number could be very large: a recent FCA study found that as many as 50% of consumers display characteristics of potential vulnerability, with the proportion rising steadily further among older age groups.⁸ And vulnerability is seen as a dynamic factor; it depends on an individual’s situation and circumstances, which will change over time. Conduct supervisors will increasingly see vulnerability less as a function of simple

factors such as income and more a function of many variables, including financial capability, financial resilience, health, age, and life events. Firms will be expected to assess their customer base specifically in this light, so as to identify customer groups at heightened risk of loss. They will also need to keep track of these factors over time, given that changing life circumstances can create vulnerability later in the customer journey.



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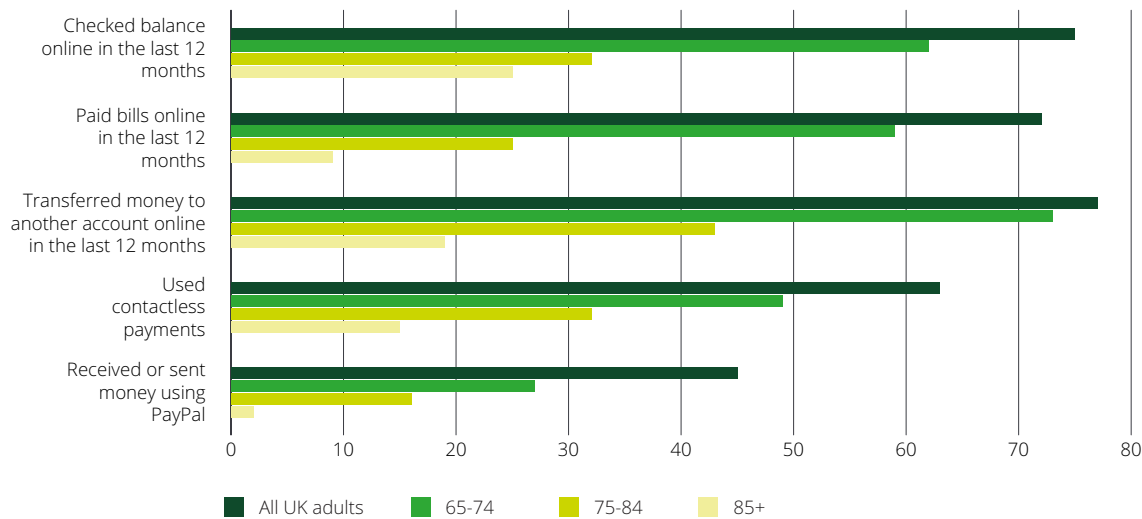
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Online banking activity and use of contactless payments by overs 65s relative to all UK adults



Source: FCA Financial Lives Survey (2017)

Regulatory initiatives to protect vulnerable consumers will vary between countries and span a diverse range of customer segments and issues. Most immediately, the focus will be on older customers and heavily indebted customers, as well as the potential for financial exclusion.

For example:

- Through its Committee on Retail Investors, IOSCO is examining the vulnerability of older investors in 27 jurisdictions and bringing together examples of best practice.

- In the UK, the FCA has highlighted a general concern that older people's financial services needs are not being fully met, resulting in exclusion, poor customer outcomes and potential harm.
- In the Netherlands, supervisory concern has arisen over interest-only mortgages and the risk that older borrowers in particular may be unable to repay or refinance as mortgages approach maturity.
- The ESRB has highlighted the level of household indebtedness in 20 EU countries and the risk that these economies are consequently vulnerable to shocks.
- EIOPA will be undertaking work to ensure that digitisation of products and services and the increasing use of customer profiling does not result in some consumers being excluded from insurance and pension products.

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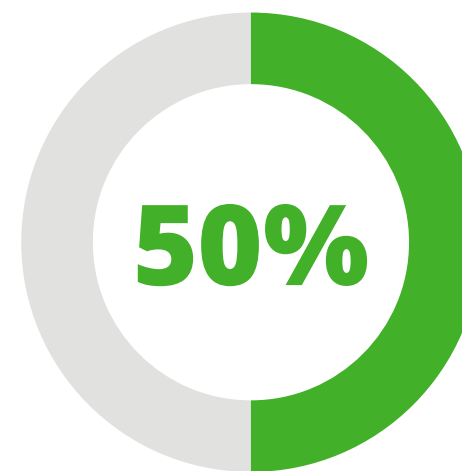
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Customer vulnerability – broadening the perspective

Deep dive reviews of individual product and business areas and the development of MI to capture the results will be needed. But point-in-time reviews will be seen only as a first step: supervisors will expect firms to review and enhance their processes for the design, distribution and monitoring of their products and services. In particular, supervisors will expect firms to consider the roles of systems, processes and controls to address risks of consumer detriment across product design and approval, communications, systems, monitoring and MI, training, and documentation. Building in the capability to monitor vulnerability factors over time, ensuring clear communications and ease of access, and maintaining records evidencing the reasoning behind decisions, will be crucial.

Strong board and senior executive engagement will also be needed. Robust discussion on how vulnerability is identified and addressed will be expected. Vulnerability will feature with increasing prominence in supervisory dialogue with boards and senior management, with an emphasis on how firms' strategies are being reviewed and adjusted in response to changes in customers' behaviour and needs. The needs of specific customer groups and risks of exclusion should be considered explicitly by firms when developing new distribution strategies or new technology.

Enhanced data analytics will help firms respond to this supervisory challenge by providing powerful new capabilities to identify, analyse and respond to the risks and causes of vulnerability. In particular, data and voice analytics will allow firms to analyse their customer interactions at a detailed level provided they remain on the right side of the evolving framework for data privacy and protection.



The number of adults displaying one or more characteristics of potential vulnerability⁹



The age at which signs of vulnerability increase significantly beyond the national average⁹

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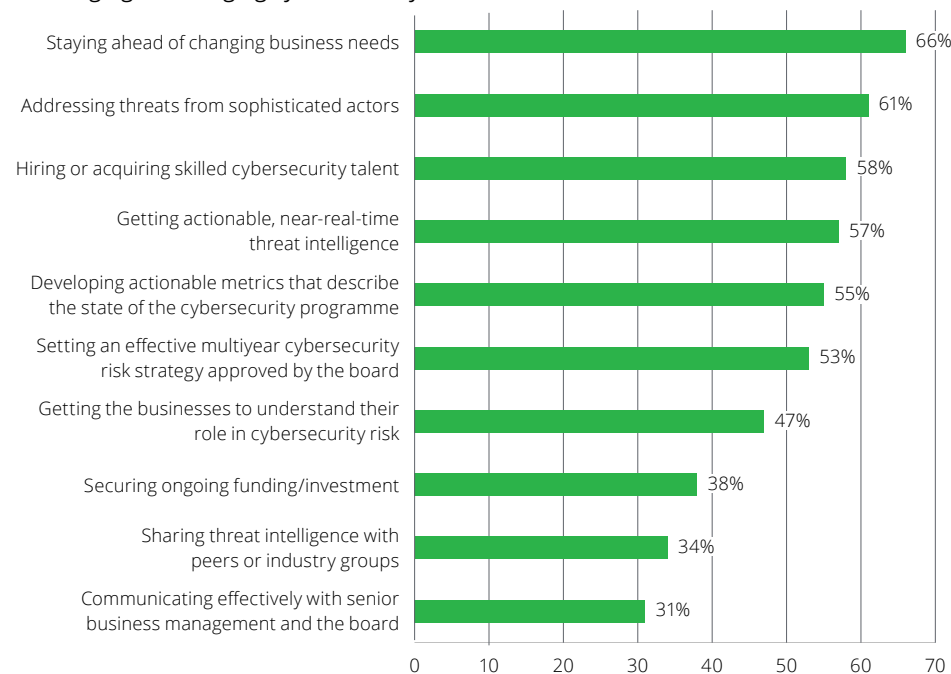
Cyber risk and resilience

The regulatory focus on the heightened cyber risks created by technological change and increasingly digital business models is not new. In 2018, however, we will start to see regulators flex their muscles and begin to articulate clearer priorities for what firms need to do to prepare for cyber threats.

- 2018 will see regulators, most notably the BoE and ECB, issue a range of new standards on cyber security in financial services, building on earlier pilot programmes around resilience testing, and expanding into newer areas such as threat intelligence sharing.
- European banking supervisors will increasingly make firm-specific interventions where deficiencies in cyber risk identification or management are found; fines and even capital charges will be part of a growing supervisory toolkit.
- Insurance supervisors will be alert to the potential risks arising from cyber insurance underwriting practices.

Cyber security challenges

Percentage of global financial institutions that rated each issue extremely or very challenging in managing cyber security risk



Based on responses from 77 global financial institutions
Source: *Deloitte Global risk management survey, 10th edition (2017)*

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Cyber risk and resilience

A successful cyber attack on a systemically important bank or financial market infrastructure could threaten financial stability,

and the heightened risk of such an event is prompting a new level of regulatory and supervisory scrutiny. With almost three quarters of FSB members planning to launch new cyber standards and initiatives for the financial sector, the dangers posed by cyber risk are widely recognised.¹⁰

In 2018, a number of European regulators will pivot from exploratory activities to embedding and expanding testing regimes and better integrating cyber risk into routine supervision. EU authorities will develop a so-called “red team” testing framework in 2018 for significant FMIs. The application of the EBA’s new Guidelines on ICT risk within the SREP may result in additional (Pillar 2) capital requirements for unaddressed deficiencies in cyber risk management as part of operational risk assessments. Additional capital may do little to protect a firm against cyber risk or shorten its recovery times, but it will prompt board action to deal with underlying

deficiencies. In the UK, we expect the BoE to expand its cyber resilience testing scheme, (“CBEST”) and to release clearer principles-based “baseline standards” for cyber resilience for the first time.

Firms in all sectors will face increased pressure to show that their controls and individual recovery plans have been robustly developed and thoroughly tested against sufficiently severe scenarios, requiring them to build on existing investments in cyber defences. All firms should expect supervisors to carry out enhanced reviews of, and initiate enforcement in relation to, any cyber resilience deficiencies that they identify, potentially resorting to firm-specific interventions, fines or other disciplinary measures where those deficiencies are not appropriately addressed.

With rising supervisory concerns around the systemic consequences of individual cyber incidents, supervisors will adopt a broader perspective than that of individual firms, which have typically been focused on their own resilience and protection of their customers.

The increasing interconnections between financial services firms and their outsourcing partners – particularly technology partners – will change the nature of the cyber threat and its systemic risk implications, raising questions about how to deal with potentially jointly owned systemic risks, especially in a cross-border context. In that vein, we expect more work from the EU, particularly following the European Commission’s proposal to strengthen the mandate of ENISA, the EU’s cybersecurity agency, as part of a broad cross-sectoral package of measures set out in September.

Insurance supervisors, although moving in a similar direction, are generally at an earlier stage in developing their approach to cyber resilience. EIOPA has indicated that it will look to incorporate qualitative elements relating to cyber risk in its 2018 stress test. The implicit terms of many general business continuity policies, often written in an era when cyber attacks were rare, carry substantial practical exposure to adverse cyber outcomes.

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Additionally, the insurance sector is explicitly exposed to cyber risk through its increasing underwriting of cyber risk insurance policies – a market that Lloyds of London estimates to be worth between \$3 billion and \$3.5 billion.¹¹ As this remains an immature market, there are concerns about the quality of underwriting standards and the clarity with which coverage and exclusions are communicated. Underwriting and reserving are likely to come under closer scrutiny from prudential supervisors, while conduct supervisors, on the other hand, will be alert for signs, either from complaints or from litigation, that policyholders have concerns about having been sold policies which did not cover them adequately for the cyber events to which they were subject.

Finding people with the right experience in both IT resilience in general and cyber resilience in particular will continue to be challenging for financial institutions. As part of the solution to establish clear accountability for cyber resilience within their governance structures, firms should be able to articulate

the relationship between the CRO, CISO and the board in planning for and dealing with threats. Firms should expect to demonstrate to supervisors that their boards have expertise and/or access to expert advice to provide effective challenge on cyber risk issues.

One of the lessons drawn from the various public-private resilience tests conducted to date has been the challenge of managing cyber risk within financial institutions with global footprints. This can be exacerbated by the lack of coordination between national authorities in the development of their regulatory frameworks. Internationally active firms headquartered in a jurisdiction with more stringent standards may feel pressured to apply those standards globally, even if these go beyond local expectations. Where firms do opt for a differentiated approach between jurisdictions, it becomes crucial that they benchmark the different demands they face across their global operations and devise responses to areas where gaps and overlaps in those demands may exist.

“Firms should expect to demonstrate to supervisors that their boards have expertise and/or access to expert advice to provide effective challenge on cyber risk issues.”

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Managing risks from internal models

2018 will see a concerted push from national and supranational regulators on the risks posed by capital and other models to firms and the financial system.

- Supervisors over 2018 will increasingly expect boards and executive management to demonstrate understanding of the uses, limitations and potential adverse incentives of models.
- Fieldwork for the ECB's TRIM will be largely complete by the end of the year, and some banks may have to undertake remediation work.
- The use of hard floors or “guard rails” on model results is likely to be considered for the insurance sector, and EIOPA will also develop quantitative benchmarking and limits to help identify outlying model results.
- Given exhaustive model approval processes in both the banking and insurance sectors, firms should expect a high bar for approval of model changes. Supervisors will give serious consideration to whether overall model re-approvals are needed where multiple non-material changes have been made.

“Supervisors over 2018 will increasingly expect boards and executive management to demonstrate understanding of the uses, limitations and potential adverse incentives of models.”

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Internal models are used to calculate a substantial proportion of the capital requirements of financial services firms.

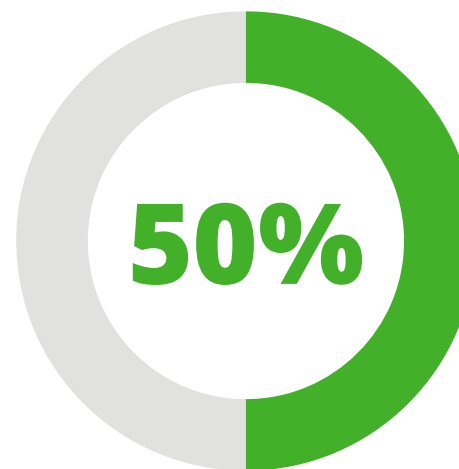
In the banking sector around half of credit risk capital requirements in the EU are generated through IRB approaches. Many insurers have applied for supervisory approval of internal capital models since the 2016 introduction of Solvency II. In the UK – where the uptake has been highest – around two thirds of the aggregate industry SCR is now determined by insurers using internal models, fully or in part. In Germany this is around one half, and in France around one quarter. And capital models are not the only models of interest to supervisors: the implementation of IFRS 9, for example, requires extensive application of internal model approaches.

Regulators in EMEA continue to see value in modelling as a part of the regulatory framework, albeit with differing levels of enthusiasm. But there are concerns as to whether models are fulfilling their intended role in adequately capturing and calibrating risks, and whether they are creating inappropriate incentives for firms. There are also concerns

as to whether these risks are well understood and managed by boards and senior executives. These concerns have two prongs:

- The ever-increasing computational power and complexity of internal models call into question whether firms (especially at the board and senior management level), and supervisors, have the skills and understanding needed to manage and evaluate models, outside of specialist modelling centres of expertise. Firms need to demonstrate that they have considered the inherent limitations of their models and that they understand the circumstances in which key model assumptions and dependencies might break down. This concern is at its strongest at the board and senior management level.
- Models are also seen to produce different results for similar risks between firms. Both the ECB's TRIM, and EIOPA's comparative studies into internal model consistency cite high output variability as a driving factor behind these initiatives.

TRIM fieldwork will be substantially completed by the end of 2018, and some banks will be expected to carry out remedial work. EIOPA will also issue further guidance in 2018 on internal model convergence, helping to set methodological and quantitative expectations for insurers' approved internal models.



Bank capital requirements generated through internal models in the EU¹²

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Managing risks from internal models

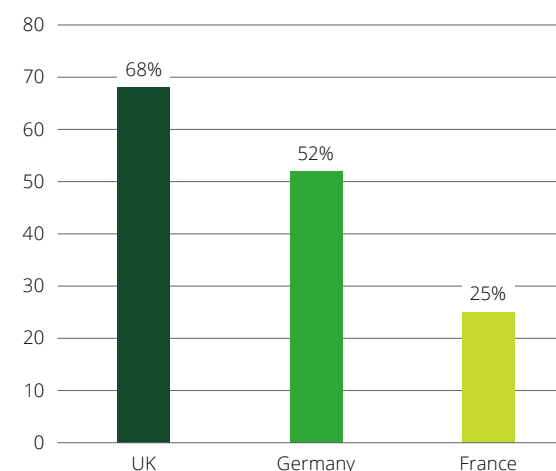
SSM benchmarking and Solvency II reporting data will provide extensive information for supervisors, enabling them to analyse the results of internal models across the industry and to target differences in model treatment. The use of hard floors or “guard rails” on model results is likely to be considered for the insurance sector; these are similar in concept to the output floor currently being so hotly debated in the BCBS. EIOPA will also develop quantitative benchmarking and limits to help identify outlying model results.

Supervisors will be particularly concerned by asymmetric incentives for model builders to devise only model improvements that reduce capital requirements. Robust, risk-based justification will be needed to secure approval for model changes. Firms should expect a high bar for approval of model changes, and supervisors will consider whether overall model re-approvals are needed where multiple non-material changes have been made.

Firms’ broader model risk management frameworks will also come under increased scrutiny. Firms will need to demonstrate that they have identified all models generating material risk, and that they have a clear understanding of risks posed to their organisations by their models, including those outside the scope of regulatory approval. This includes models used for algorithmic trading, particularly in light of the entry into force of MIFID II in 2018.

To prepare for this regulatory drive, firms using internal models should focus on effective governance and oversight, particularly the sufficiency of information provided to boards and risk committees. A lack of transparency around how conclusions have been reached will raise serious supervisory concerns. Expectations of the level of understanding of model methodologies and use will vary by position, but all directors will be expected to have, at a minimum, a sound conceptual understanding of model limitations and of judgmental factors, particularly those that “shift the dial”.

Proportion of aggregate insurance industry Solvency Capital Requirement determined by insurers using internal models



Sources: PRA; ACPR; BaFIN; and Deloitte calculations

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Regulatory and supervisory constants



At the heart of supervision.

There are innumerable more regulatory and supervisory issues for financial services firms and their boards and senior management teams than we have space to do justice to in this document. This is, emphatically, not to diminish their importance, either for supervisors or for firms. In this section we draw out core supervisory issues that will continue to form a crucial part of “business as usual” supervision.

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Regulatory and supervisory constants



Governance and culture: previous episodes of repeated and severe misconduct will sustain regulatory momentum and focus on improving the culture and governance of financial services firms. Beyond the UK's Senior Managers and Certification Regime, the FSB is prioritising ways to increase individual accountability of senior managers, prevent the "rolling of bad apples", and promote governance frameworks that address cultural risk with a view to developing a toolkit for supervisors and firms. Indeed, regulatory initiatives on individual accountability are in place or under development in a number of jurisdictions. New guidelines from ESMA and the EBA will improve firms' internal governance and the suitability assessments of senior managers. Supervisors will look to ensure that the right values and cultural attitudes are in place at all operating levels within a firm, starting with the board itself, and that remuneration and incentives underpin this. Firms will need to define how their corporate culture and values foster responsible behaviour, and demonstrate that they have robust governance and internal control functions to prevent excessive risk taking.

There will remain a strong emphasis on board effectiveness and "tone from the top" to ensure that governance and remuneration arrangements directly reinforce the culture the board wants to deliver.

“Supervisors will look to ensure that the right values and cultural attitudes are in place at all operating levels within a firm, starting with the board itself, and that remuneration and incentives underpin this.”



Conduct risk: conduct supervision will continue to proceed under its overarching themes of fair treatment of customers and ensuring that products are sold in a way that is clear, fair and not misleading. This entails a continuing focus on product governance, design and marketing. Competition perspectives will inform reviews of charges, as is currently the case in the UK for asset management, platforms, wealth management and the banking sector. There will also be increased appetite for direct product intervention where supervisors judge that market failure is occurring such that consumers are unable to make reasonable decisions. Prudential supervisors have also cemented their interest in conduct issues, most obviously in their treatment of conduct risk in stress testing.

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Data and reporting: despite significant pressure from supervisors and effort by industry to improve the quality and timeliness of data and associated reporting, this area remains a work in progress for many firms. We expect supervisors to keep up the pressure in 2018. Part of this will stem from new data initiatives covered elsewhere in this document (principally MiFID II and GDPR, but also the BoE's proposed approach to valuation capabilities in resolution), and part will be from the continuing drive by supervisors for more granular and higher quality data to support stress testing and other initiatives. Insurers will have to submit Solvency II returns within four weeks of the due date as opposed to last year's six weeks – a significant challenge for some. There is also a need for greater confidence in the quality of data to enable firms and supervisors to take best advantage of the “big data” analytical techniques that are increasingly prevalent.



Disclosure: we continue to await the PRA's discussion paper on possible disclosures of elements of banks' and insurers' regulatory returns; depending on the proposed approach this could set a new direction across EMEA. For banks, the BCBS timetable calls for additional Pillar 3 disclosures, particularly concerning the composition of capital, to be made by the end of 2018. Asset managers in the UK will need to tackle any new disclosure requirements stemming from the FCA's Asset Management Market Study, which may supplement the requirements already contained in PRIIPs and MiFID II. Investors will see the first full-year IFRS 9 disclosures by banks at the end of the year, but we expect interim numbers from some banks at mid-year, giving an indication of the impact on banks' capital ratios. In November, the market will have to digest the results of the EBA's 2018 stress test, and reconcile the results with the IFRS 9 disclosures. EIOPA will also publish the results of its stress test at the back end of the year. The Taskforce on Climate-Related Disclosure will also continue its work through to September 2018, and will look to encourage adoption of its recommendations.

“There is a need for greater confidence in the quality of data to enable firms and supervisors to take best advantage of the big data analytical techniques that are increasingly prevalent.”

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Remuneration: remuneration continues to be in the spotlight, with much of the focus shifting to ensuring the appropriate application of rules, rather than the introduction of new frameworks. However, new remuneration rules under MiFID II and European guidelines on variable pay for customer-facing staff in retail banking come into force in 2018, which may lead to remuneration policy changes in some firms across Europe. Regulatory expectations on pay structures continue to evolve, in particular in relation to risk adjustment, malus and clawback. The requirement for financial services firms to carry out independent internal reviews into compliance with remuneration policies is also now baked into legislation and regulatory guidance across sectors, which needs to be reflected in internal audit plans.



Risk appetite: we expect the supervisory focus on risk appetite in financial services firms to continue. This will cover the articulation of risk appetite by the board: how it is cascaded and then monitored by the board throughout the organisation, and the extent to which it is embedded, including within strategic decision-making and business planning. Supervisors will be looking to firms to make progress in integrating what are often referred to as “non-financial risks”, such as conduct risk and cyber risk, and to consider inherently “unquantifiable” risks (including reputational) into their risk appetite and “own” risk and solvency assessments. Supervisors increasingly view a fully implemented RAF as a prerequisite for effective governance and proper translation of strategy into business activity. Firms’ dialogues with supervisors in these and other areas will need to be rooted firmly in the implications for risk appetite.

“Supervisors increasingly view a fully implemented RAF as a prerequisite for effective governance and proper translation of strategy into business activity.”

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Banks continue to face the brunt of regulatory reform initiatives.

The European banking sector continues to look anaemic – returns are underwhelming, and cost control remains a persistent challenge despite years of focus. The post-crisis regulatory framework is yet to hit steady-state, particularly on the prudential side of things, while new issues continue to find their way onto the agenda, particularly as technology develops. The volume of change, coupled with cost pressures, means that the industry is close to maximum operational stretch.

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The prudential framework: slow progress

Further progress will be made in finalising the post-crisis prudential framework, but the slow speed of negotiations and variable implementation around the world will mean that uncertainty over its long-term impact on banks' business models and product lines will persist.

- The BCBS will agree on the finalisation of Basel III but the implementation timeline in the EU will remain unclear.
- Negotiations on the EU's CRD V/CRR II banking package will proceed slowly and will not be finalised in 2018.
- Regulatory fragmentation in the implementation of prudential rules will become an increasing concern for many internationally active banks.

We expect the BCBS to reach a deal to finalise the Basel III framework, but the impact of these rules on industry will remain unclear as the EU will not propose legislation for them until 2019 at the earliest. The EU continues to negotiate its "Risk Reduction Package" (which includes CRD V/CRR II) and is unlikely to conclude those negotiations in 2018. This will lengthen the delays in implementing already-agreed elements of the Basel framework, such as the NSFR and FRTB. Beyond a divergence from the timing associated with implementation of the Basel standards, EU legislators are also showing a growing willingness to depart from them in terms of the content, sometimes by proposing substantial discounts to capital requirements, such as those for market risk.

This will lead internationally active banks to become increasingly concerned in 2018 over the impact that regulatory fragmentation could have on their compliance activities. A more uneven regulatory environment will create additional costs and complexity, and designing regulatory capital models based on Basel

standards will become more difficult as those models will run a greater risk of falling out of alignment with the rules that are eventually implemented by EU and national regulators.

"We expect the BCBS to reach a deal to finalise the Basel III framework, but the impact of these rules on industry will remain unclear as the EU will not propose legislation for them until 2019 at the earliest."

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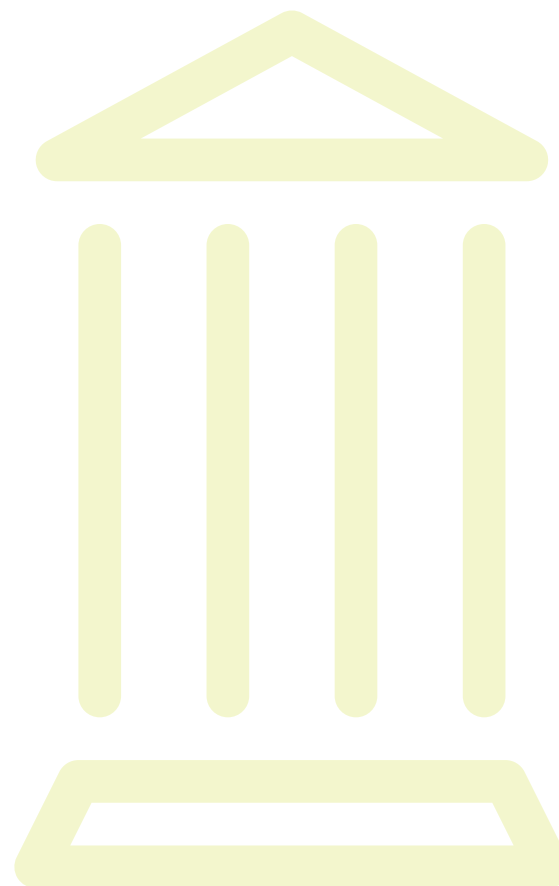
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Banks need to respond to the challenge of fragmentation in the prudential agenda by designing solutions that enhance their ability to meet regulatory demands flexibly and understand their impact quickly. One (and perhaps the only) upside from the delays that are becoming apparent for many parts of the Basel agenda are that they give banks the opportunity to refine their implementation programmes and to invest in capabilities and technologies that support these efforts. For instance, regarding the implementation of the FRTB, EU banks can take advantage of the likely two-to-three year delay beyond the BCBS's January 2019 effective date to focus on being better prepared to meet supervisory tests for the use of the Internal Models Approach.

More broadly, banks should be thinking about investments that will help them better cope with a long and difficult period of prudential rules implementation that is due to stretch well into the next decade. Efficiently implementing these rules is only one part of the challenge. The other is being able to form a granular and forward-looking view of their impact on various product lines and geographies. This will enable better business sustainability decisions, and the development of the business model agility needed to respond successfully to the challenges technological innovation will bring about. In this respect, banks should waste little time in driving forward the integration of their risk and finance teams for capital planning purposes. Banks should also re-assess the role their strategy function plays in this structure, taking note of industry best practices in using regulatory strategy teams to direct and leverage regulatory-driven investments and change in order to find capital, liquidity and business model efficiencies.



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IFRS 9, stress tests, NPLs and disclosure

Banks are having to deal with the simultaneous introduction of new accounting rules, an intensifying focus on asset quality and NPLs, an evolving stress testing framework, and a possible hardening of supervisory attitudes towards the use of internal models.



- IFRS 9 goes live on 1 January 2018 and will have a negative impact on banks' capital ratios, albeit mitigated by transitional arrangements, agreed by the EU at the 11th hour.
- Investors will take some time to come to terms with the impact of IFRS 9, and banks can expect significant interest in, and challenge of, their disclosures by analysts.
- The integration of IFRS 9 into stress testing and the ICAAP will be challenging, with stressed impairment putting further pressure on capital requirements.
- Work to address the Banking Union's legacy NPLs will intensify, with the European Commission set to introduce a package of measures on an ongoing basis throughout 2018.

2018 is the first year in which banks are required to use IFRS 9. The new accounting standard will have significant knock-on implications for a variety of prudential issues, most notably capital requirements and stress testing. Its introduction sits alongside intensifying work to address NPL stocks in the Banking Union, and the business end of the ECB's TRIM exercise.

The consensus is for an IFRS 9 impact on capital numbers in the region of 40bps CET1 reduction (although this will vary significantly in between banks), albeit mitigated by the transitional arrangements that have been fast-tracked through the EU legislative process just in time to be applied from January. The capital impact of IFRS 9 will also vary significantly depending on variations in the economic cycle, and will introduce new volatility into capital numbers owing to the way ECL are measured. Indeed, as the BoE has recognised, the novelty of ECL provisioning means that its practical functioning will become clear "only in the light of experience."¹³

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40 bps

The fully loaded average negative impact on CET1 ratio for SSM significant institutions¹⁴

59 bps

The fully loaded average negative impact on CET1 ratio for SSM less significant institutions¹⁴

With this in mind, investors will take some time to come to terms with the impact of IFRS 9, and banks can expect significant interest in, and challenge of, their disclosures by analysts, ramping up the pressure to ensure clear and transparent disclosure and communications. These disclosures require explanations of the drivers of movements between reporting dates – more detail than has previously been communicated to the market.

Feeding IFRS 9 numbers into stress tests and the ICAAP will also increase the demand side of the capital equation. Stress testing will become even more analytically challenging, and all other things being equal, stress testing results are likely to worsen due to the treatment of IFRS 9 impairments which are expected to increase significantly in a stress. Banks will also need to generate “point-in-time” forecasts during hypothetical stress scenarios, a complex task which essentially requires them to produce forecasts of a forecast.

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Work to address the significant stock of NPLs in the Banking Union has transformed from a supervisory concern into a political priority. Banks with above average levels are expected to address NPLs proactively, and failure to do so will lead to supervisory intervention via the SREP. The European Commission will bring forward a package of initiatives starting in early 2018 to address NPLs, including a “blueprint” for national asset management companies to which impaired loans could be transferred, and plans for the further development of a secondary market for such loans. Further work is also expected from both the EBA and ESRB, including on enhanced disclosure and data production requirements on asset quality and NPLs.

Definitions of Stages 1, 2, and 3 in IFRS 9 will be critical for investors and analysts to understand book quality. The trigger for movements from Stage 1 to Stage 2 is within banks’ remit to define, and while reporting may be consistent, the variability in triggers will make benchmarking and comparison of book quality (including overall capital adequacy) difficult. ECB guidance makes clear that “at least all” of

banks’ Stage 3 exposures under IFRS 9 will be in the scope of its framework for addressing NPLs¹⁵ and markets are eagerly awaiting the ECB’s update on progress on managing the current stock which is anticipated by the end of Q1. For banks that are currently finalising the introduction of IFRS 9, focus will move from the underlying models to the business impact and we expect to see significant attention given to the early stage prevention or mitigation of transition from Stage 1 to Stage 2. And while the introduction of IFRS 9 is in part explicitly designed to prevent the build-up of impaired loans by forcing earlier recognition of credit losses, within Stage 2 in particular, the effectiveness of this objective will vary by firm, jurisdiction and asset class.

The ECB’s TRIM exercise remains ongoing. With many on-site inspections already having been carried out, many firms have received or will soon receive feedback on the findings, which will give an indication of the remediation work needed. In general, we anticipate the TRIM to result in tightening of conditions attaching to the use of internal models, which may push up the demand for capital.

This confluence of regulatory interest in internal models and the introduction of IFRS 9 underlines the need for investment in credit risk modelling and related risk management capabilities (including model validation). IFRS 9 requires the development of capabilities which can leverage credit risk modelling techniques used for calculating capital under IRB methodologies, as well as macroeconomic modelling techniques which overlap with the analysis undertaken in stress tests. Banks should look to take advantage of the potential synergies. Banks currently utilising the Standardised Approach to calculating capital should also build on the expertise they have developed and the data work they have carried out to help move them towards gaining permission for IFRS 9 preparation to use IRB models for capital.

However, in general, we observe most firms adopting tactical solutions to IFRS 9 implementation which will ultimately increase complexity and costs. Continued investment in capabilities is therefore a necessity beyond the imminent implementation deadline.

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Resolvability: yet to be resolved

2018 may test whether regulatory and political authorities are fully subscribed to the aims of the resolution agenda.



- Further bank failures are possible in 2018, and the authorities' approach to their resolution will be critical for market perceptions of the credibility of the framework overall.
- Resolution authorities will influence new banking structures, particularly in the context of Brexit relocations, with banks needing to satisfy the ECB, BoE and their home resolution authority that their post-Brexit structures are resolvable.
- Negotiations on the IPU will only progress slowly, as other priority issues dominate CRD V/CRR II discussions, leaving considerable uncertainty over the future of bank structures for third country banks.
- Resolution authorities will be increasingly focused on the practical utility of plans and banks' preparedness to execute them, particularly with respect to carrying out valuations.

In 2017 the SRB successfully deployed resolution tools to deal with the failure of Spain's Banco Popular, but the subsequent use of State Aid in connection with Italy's Veneto Banco and Banca Popolare di Vicenza has dented confidence in the regime. Given the uncertainties surrounding the economic environment, and the continuing concerns about the capital adequacy of a number of EU banks, further bank failures in 2018 are possible. The next case will be critical for market perceptions of the credibility of the framework as a whole.

Lest anyone doubt it, it is in the industry's interests for resolution to work. According to Martin Taylor of the UK's FPC, it is only the credibility of resolution, structural reform and enhanced supervision that stand between the UK banking system and a potential 500bps hike in capital requirements. In his words, "those who consider the present system onerous should reflect on this point."¹⁶

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Consistent with previous years, we do not anticipate significant interventions by resolution authorities in 2018 to mandate structural solutions to improve resolvability – resolvability remains a long-term aim, and one that needs to be achieved alongside significant other operational burdens on the sector. But we do expect continuing work and scrutiny by resolution authorities on the practical utility of plans; the BoE's recent consultation on its expectations of banks' valuation capabilities – which will be followed by a finalised principles-based policy in 2018 – is evidence of this. We do not expect other resolution authorities to follow suit with published standards, but we fully expect them to push on valuation as part of ongoing bilateral resolvability conversations.

And while resolution authorities will not intervene significantly in legacy structures, we do expect them to have much greater influence on new structures. Brexit is a case in point, with the PRA having indicated that it views

Brexit-related restructuring as a complicating factor for resolvability. We are also seeing signs of the SSM and SRB considering the resolvability of new entities that banks are proposing to establish in the EU27, particularly relating to booking models, which are a factor influencing intragroup complexity and cross-border interconnectedness. We expect this to intensify in 2018 as more details emerge about banks' relocation plans. Resolvability adds a new dimension to restructuring decisions, and relocating banks need to articulate their plans in a way that will satisfy the SRB, ECB, BoE, and (for third country firms) their home resolution authority.

Thinking further ahead, the EU's proposed IPU requirement – intended to facilitate the resolvability of third country banks within the EU – will lead to yet-more structural changes in the coming years. But its final shape remains unclear, as does the potential timeline for its implementation. The general slow pace of CRD V negotiations means we may not know a great deal more about the IPU by the end of 2018.

There are however pockets of significant restructuring work being carried out. In particular, the major UK high street banks are on the cusp of completing major structural changes in pursuit of retail ring-fencing, which will go live on 1 January 2019, and will do much to improve their resolvability. We expect the affected banks to be ready in time, but there will be plenty of work left to do to fine-tune their ring-fenced structures.

There is a significant amount of work being carried out to refine resolution plans, to amend contractual terms to remove impediments to resolvability, to restructure liabilities to improve the loss-absorbency of balance sheets, and more. In short, we remain a long way from being able to declare systematically important banks resolvable and will remain so at the end of 2018.

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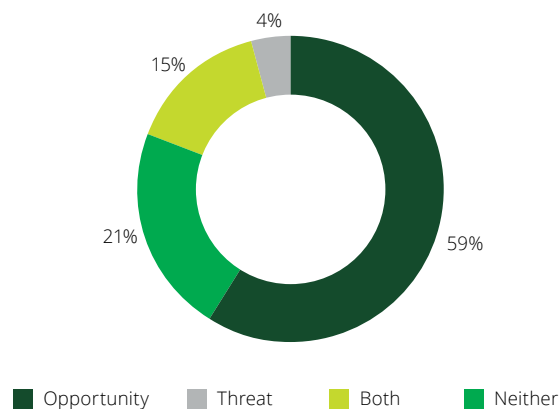
The Open Banking era begins

Open Banking is intended to shake up the payments market by requiring bank to provide TPPs with customers' transactional data and access to customer accounts to make payments on their customers' behalf. But the Open Banking revolution will get off to a slow start while several regulatory questions remain to be answered.

- Most banks will embrace the revised PSD II as an opportunity to drive their digital transformation.
- Regulatory uncertainty will remain a challenge and will make the development and adoption of new services slower.
- Industry players will come together to define a common communication standard for their market.

PSD II will apply from January 2018, but firms' compliance and strategic plans have been hampered by the lack of regulatory clarity, including the absence of a finalised RTS on SCA and CSC between banks and TPPs. This will make the development and adoption of new services and products across the EU slower than expected in 2018, although in the UK, where the Open Banking APIs will go live at the same time as PSD II, things should move more quickly.

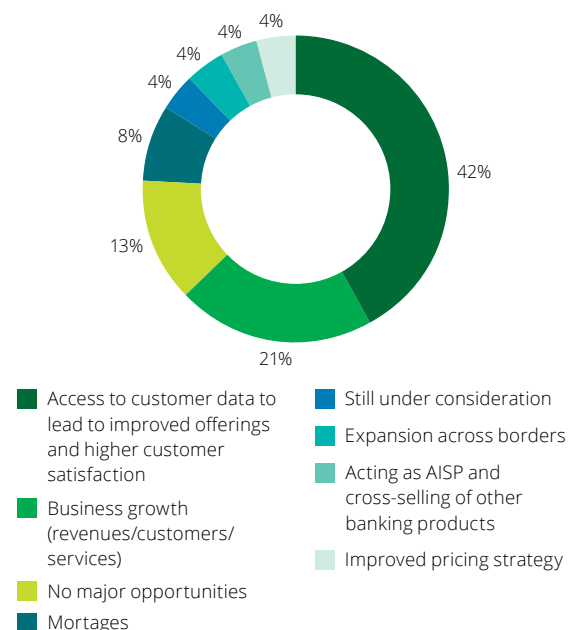
On balance do firms perceive PSD2 to be a strategic threat or opportunity for their organisations?



Source: Deloitte European PSD2 Survey Results Highlights (2017)

Based on responses from 70 banks, building societies and other credit institutions.

What do firms see as the greatest opportunity for their business arising from PSD2?



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Most banks will use PSD II as an opportunity to transform their digital offerings to provide new and better services to their customers. Their brand and financial strength, coupled with wide customer bases, mean they are well positioned, together with established “FinTechs” and “BigTechs”, to succeed. However, while many firms have carried out some form of strategic impact assessment, most resources to date have been spent on compliance programmes, rather than on a strategic response. Indeed, in a recent Deloitte PSD II survey, 59% of respondents stated they considered the regime to be an opportunity for their organisation, but only 32% felt they were ready to respond strategically. In this sense, while the delay in the finalisation of the RTS on SCA and CSC is challenging, it could buy banks some extra time to finalise their Open Banking strategies, as competition is likely to be slower to emerge than previously expected.

Compliance challenges will continue into next year. Banks will be required to support existing solutions, such as screen scraping, from January 2018 until the RTS on SCA and CSC become applicable in September 2019. This places them between a rock and a hard place,

as screen scraping will be difficult to reconcile with the GDPR. The European Commission has signalled clearly to banks that it will take a tough line on competition issues, but banks also risk hefty fines under GDPR. Firms will need to engage closely with the relevant supervisors to explain their concerns and try to obtain clearer guidance on how to balance competition with safety, not only with respect to GDPR, but also with respect to other liabilities under the PSD II Third Party model. Indeed, 58% of respondents to our survey cited issues around customer and third party authentication and the lack of an industry standard of communication as the biggest challenge for developing a third party access solution.

However, we expect banks and TPPs to overcome the lack of a specified common communication standard by coming together to define an industry standard for their market. This will increase interoperability, reduce implementation costs and time, and also ease some of the issues around customers’ consent verification and TPP identification. The UK Open Banking APIs will provide a useful model on which to proceed.

Finally, the FSB and the EBA have already stated they will monitor whether Open Banking will introduce any unintended consequences such as, for example, lower deposit “stickiness” and, in turn, a negative impact on liquidity and lending capabilities. The extent to which this risk manifests itself will depend on the rate of adoption of new products and services by consumers, but banks should make sure that they put in place systems to detect changes in depositor behaviours and their extent.

“Most banks will use PSD II as an opportunity to transform their digital offerings to provide new and better services to their customers.”

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MiFID II is arriving, and is set to redefine the trading landscape.

MiFID II is designed to promote market integrity and investor protection. We see the changes to market structure arising from MiFID II as being among the most significant of all in 2018. The proliferation of trading venues and the increase in the number of SIs will increase competition in the market. Competition will be strengthened further by the newly introduced disclosure requirements on the top execution venues under the MiFID II best execution rules. However, we expect there to be bumps in the road that market participants will have to navigate.

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Trading landscape and market structure

MiFID II goes live on 3 January 2018, and will transform the way in which numerous products are traded in the EU's capital markets.

- MiFID II will transform the market structure for non-equities, with a significant reduction in OTC volumes in favour of transactions on venues, including MTFs and OTFs, and SIs.
- Some large investment banks are set to become SIs, but other market participants will wait for ESMA's market data (due six months into the new regime) before making a decision as to whether to register as an SI.
- Product liquidity and standardisation will be the main influencing factor on where firms choose to execute orders – OTC, SI, or on-venue.

For each asset class, 12 buy-side firms were asked to indicate the approximate split between venue and OTC trading for their firm currently and what they expect the split to be from 1 February 2018. The table contains the average results for each asset class.

	Government bonds	Corp bonds	Interest derivatives	Credit derivatives	FX derivatives
Trading venue (current)	62%	49%	35%	26%	62%
OTC (current)	38%	51%	65%	74%	38%
Trading venue (from 1 Feb)	78%	69%	60%	40%	92%
OTC (from 1 Feb)	22%	31%	40%	60%	8%

Source: *Deloitte MiFID II Buy-Side Forum Survey Results (2017)*

MiFID I brought significant changes in transparency and market structure to the equities market, and MiFID II will have similar effects on what are currently mainly OTC non-equities markets. 2018 will see significant disruptions to the way market participants transact, with a product's liquidity and standardisation set to influence firms' decisions over whether to trade OTC or the types of venues to use.

Market participants will choose to trade more liquid and standardised products, including US Treasury bonds, gilts and some types of FX derivatives, electronically on MTFs. Owing to the increasingly electronic nature of trading and greater product standardisation, volumes on MTFs will increase, while the volume on exchanges is likely to be reduced by the growth of MTFs, OTFs and SIs. In general, the size of the OTC landscape will reduce significantly for non-equities.

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The introduction of a new category of trading venue – the OTF – will bring into regulatory scope a range of facilities that were outside the scope of MiFID I, including broker crossing systems, hybrid electronic and voice broking facilities, and more. OTF operators will have discretion over execution, and must be active in bringing about transactions and follow best execution rules. As a result we expect market participants to approach OTFs for specialised orders or less liquid products. The scope for OTFs to do matched principal trading (prohibited for MTFs) also means that OTFs will appeal to market participants wanting to maintain anonymity in derivatives transactions subject to the trading obligation. To stay competitive, we expect large inter-dealer brokers to provide both MTF and OTF optionality to their clients.

The SI regime is being extended such that it will capture more firms. Investment firms previously had the option to register as an SI for equities, whereas the new regime requires a firm transacting equities and non-

equities (on its own account or bilaterally) above certain quantitative thresholds to register as a SI for the relevant instrument. The rules for SIs touch every stage of the trade lifecycle, and the SI regime will increase price transparency for transactions outside of venues. Some large investment banks are registering as SIs for equities as a result of the trading obligation, and as of late 2017 our survey of sell-side firms also shows a trend towards SI registration for some non-equities. Some firms are already prepared to follow pre-trade transparency and enhanced post-trade reporting rules, and will make a move before the 1 September registration deadline. This will enable them to help their buy-side clients in terms of post-trade reporting. However, we expect some firms to postpone decisions on registration until ESMA's market data from the first six months of MiFID II implementation becomes available. Those with smaller portfolios may opt to reduce trading activities to stay below SI thresholds, thereby avoiding requirements for pre- and post-trade price disclosure.

“2018 will see significant disruptions to the way market participants transact.”



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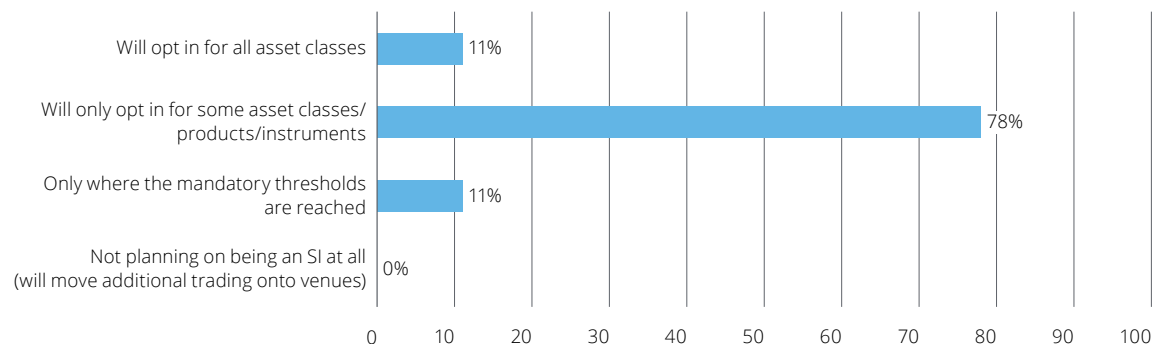
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The implementation of the trading obligation will disrupt current market practices by requiring equities that are admitted to trading on regulated markets or trading venues to be traded on exchanges, MTFs, equivalent third-country trading venues or SIs. Certain interest rate and credit derivatives will also be brought on to exchanges, OTFs, MTFs and equivalent third-country trading venues. Over time, other classes of derivatives deemed sufficiently liquid by the EU will also be required to move on-venue. The trading obligation will enter into force for equities on 3 January 2018, and the trading obligation for derivatives will be phased in from the same date according to counterparty type. Buy-side firms will transact substantially increased volumes on-venue, but not only due to the trading obligation: venues have other attractions, such as providing assistance with post-trade reporting requirements.

Firms' plans to operate as SIs for non-equities



Source: Deloitte MiFID II Sell-Side Forum Survey Results (2017)

The absence of third country equivalence decisions presents a potential stumbling block in relation to instruments subject to the trading obligation, and for intragroup transactions that may otherwise be eligible for exemptions from the trading obligation. The European Commission has adopted equivalence decisions for certain securities exchanges in the US and Switzerland.

The European Commission and the CFTC have also agreed to adopt an equivalence decision for certain derivatives trading venues authorised in the EU and the US. However, if similar arrangements are not agreed with other jurisdictions, firms will not be able to transact those instruments on third-country venues. In particular, we expect that equivalence with APAC jurisdictions will likely be delayed until after 3 January.

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A variety of factors will cause firms to consider how they collate, hold, report, and use data in 2018, with MiFID II set to provide particular challenges.

- Greater confidence in the accuracy of market data will gradually emerge in 2018, driven in part by a concerted effort by regulators for the industry to improve reporting standards.
- This will give rise to better use of the data to inform the price formation process, enhance surveillance system capability at firms and regulators, and improve best execution analysis.
- Improvements in the reliability of data will further drive RegTech solutions, not only for regulatory purposes, but also in market participants' pursuit of competitive advantage.

A variety of factors will cause firms to consider how they collate, hold, report, and use data in 2018. GDPR becomes directly applicable, placing unified data protection obligations on firms operating in the EU (or outside of the EU if dealing with EU resident data), and new reporting requirements under the SFTR – which will be implemented by 2019 – will be developed, bringing a wider range of transaction reporting considerations to bear on market participants.

However, data requirements under MiFID II look set to provide particular challenges in 2018. The industry will face demands to collate and report trade data correctly, and to use the improved data availability to meet heightened regulatory expectations such as best execution and transaction monitoring obligations.

Industry participants have long been preparing for the additional trade (real-time) and transaction reporting (T+1) requirements. The increased number of mandatory fields, the

expanded range of products in scope (non-equity), and the wider range of information relating to counterparties and instruments remain significant operational hurdles for the industry to clear. When set alongside additional challenges such as dual reporting concerns in multiple jurisdictions, cross-border data privacy considerations under GDPR, LEI set-up, and likely discrepancies between buy-side and sell-side reporting in areas such as trade timing, it is inevitable that data submission accuracy will continue to be a focus area throughout 2018.

ESMA has provided early evidence of this focus in its business plan for 2018. The FCA has also signalled its intent, and put the industry on notice of the importance of data integrity with significant fines for transaction reporting failures in 2017.

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Despite this supervisory focus, meaningful transparency envisaged in OTC and derivative markets may be slow to materialise until data reliability can be assured. This will be compounded if early market fragmentation occurs, and the goal envisaged by regulators of more efficient price discovery may take some time to emerge.

The success of innovative RegTech solutions will be partly contingent on the availability of high quality data, which may not be available for some asset classes in the first few months or the regime. Firms will look to upgrade existing systems and processes. Over time, market surveillance systems will benefit from the increased level of source data available, and firms will be better able to demonstrate that they are meeting the “sufficient steps” test of best execution obligations if basing decisions on an expanded and reliable data set.

Supervisors will also look to improve their market surveillance capabilities. Any trends toward cognitive computing and AI will be enhanced by the vastly expanded level of data availability, and rule-based surveillance systems will be supplemented by firm and individual behaviour analysis and anomaly detection.

Post-trade data reporting requirements are intended to improve market transparency and increase competition as firms will be able to compare the execution service received from the sell-side, but they also provide an opportunity for the sell-side to realise competitive advantages by utilising the improved data offering through automation and AI technology. We expect leading market participants to consider where service provision can be improved for clients, for example utilising data to analyse customer trading patterns and target automatic research provision.

“The success of innovative RegTech solutions will be partly contingent on the availability of high quality data, which may not be available for some asset classes in the first few months or the regime.”

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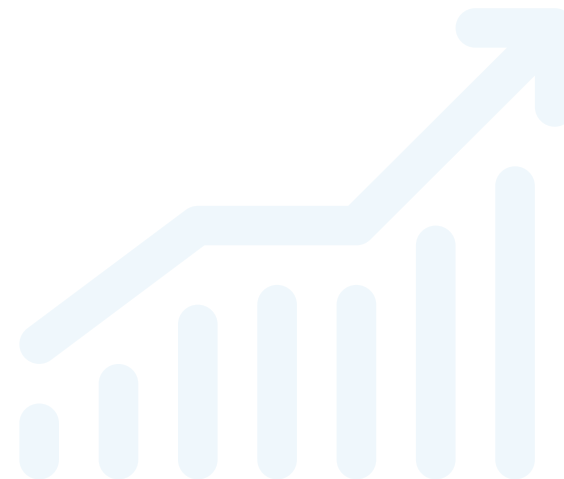
Firms will need to test, monitor and make adjustments to their strategies for overseeing best execution, and continue to evidence that they are taking steps to deliver better client outcomes.

- Firms will need to assess and optimise their execution policy on an ongoing basis.
- Investment firms' publication of top five execution venues will increase competition among venues and incentivise them to improve service quality and lower execution costs.
- Supervisors will be more intrusive in their scrutiny of whether firms are delivering best execution.

Best execution – the requirement that investment firms take all sufficient steps to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order – will undergo testing and ongoing monitoring in 2018.

By the start of the year, firms should have implemented execution strategies that take into account the price of instruments and all costs relating to execution when they trade on behalf of clients. When MiFID II comes into force, firms will need to demonstrate to their clients that they execute orders in accordance with their policies and that they are making decisions on behalf of their clients to deliver better outcomes. As part of this overall strategy, they will need to have identified which venues are relevant for which asset classes and considered whether they need different policies for different asset classes. Firms will have also established monitoring processes to ensure that they can effectively detect deficient trades and trends.

The strategic challenge for 2018 will be that as firms select venues, ways to route their clients' orders and even providers of algorithms, they will need to assess and optimise their execution policy on an ongoing basis. The growth in the choice of venues means that best execution has to be continuously monitored, tested and verified. Firms are expected to be answerable to clients and supervisors when asked why they have chosen a particular way to route an order, and demonstrate that they have considered alternative options.



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By the end of April 2018, investment firms will have published the first set of data from the preceding calendar year on the top five execution venues and execution quality for each asset class. We expect this kind of industry-wide transparency to increase competition among venues and hold them to higher standards of execution quality, as well as incentivise venues to improve the quality of their services and reduce execution costs.

While Transaction Cost Analysis (TCA) aims at improving the entire execution policy, it will pose challenges for fixed income and derivatives. We foresee best execution monitoring in fixed income lagging behind that for equity trading. The lower data quality for these asset classes will cause TCAs to be less reliable in the first few months of MiFID II application. As the use of TCA increases data and reference points, we expect market participants to be able to provide more evidence for best execution.

Deficiencies in NCAs' monitoring of best execution under MiFID I caught the attention of ESMA. Following its 2016 peer review work, ESMA will be alert to any further deficiencies in this area among NCAs, particularly given that the new definition of best execution in MiFID II raises the bar. We expect NCAs to be mindful of their experience during the first ESMA peer review and therefore more inclined to be intrusive in their supervision of whether firms are delivering best execution in 2018 and beyond.

Because buy-side firms will have greater responsibility to ensure that they are receiving best execution (see more in the Investment Management section), they will need to leverage data and statistical analysis on execution quality from their new reporting capabilities. For example, in the UK, the FCA has warned that some investment managers "need to improve current practices" before MiFID II application.¹⁷

We expect that the FCA will look to hold senior managers responsible if a firm fails in its obligation to ensure it consistently achieves best execution, particularly in instances where senior managers have not empowered compliance staff to challenge the front office on execution quality.

"We expect that the FCA will look to hold senior managers responsible if a firm fails in its obligation to ensure it consistently achieves best execution."

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The soft cycle, like regulatory change, is here to stay in 2018 along with many of the challenges that have consumed much time and effort in previous years.

Despite the implementation of Solvency II there will be much discussion of further change to the regulatory regime. Some major new conduct and distribution requirements will materialise in the forms of IDD and PRIIPs. The low interest rate environment and the soft market will continue to constrain insurers' operations and profitability; we expect great supervisory scrutiny of firms' responses and resultant risk profiles, focused on board and senior management understanding and accountability.

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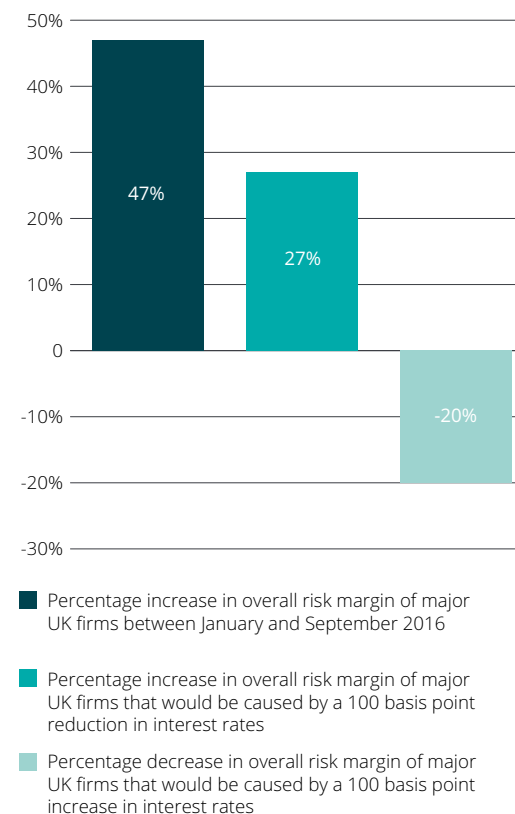
Two years on from the landmark regulatory changes brought about by Solvency II, reform to aspects of the insurance prudential regime is still being debated. However, 2018 will be dominated by discussions about future changes rather than implementation.

EIOPA will finish delivering its advice on the Solvency II review to the European Commission in 2018. This will include topics with potentially significant effects on capital, of which the risk margin and associated cost of capital rate are among the most important. EIOPA will come under intense pressure from those countries and industry participants most affected in 2018 to propose a lower cost of capital rate, having suggested maintaining the current 6% rate in its November 2017 consultation. EIOPA's final position will help to frame both the subsequent debate between the European Commission, Parliament and Council, and, for UK insurers, the UK PRA's own deliberations on the future

of UK insurance regulation. If EIOPA does not shift its position in favour of a lower risk margin, we expect increasing pressure on the PRA to implement unilaterally a UK-specific adjustment to the Solvency II approach.

- The risk margin and associated cost of capital rate are likely to attract fierce debate as part of the Solvency II review, with an increasing prospect of the UK implementing unilateral – and substantial – change in this area.
- Firms should expect a great deal of focus on the impact of Brexit on policy and regulation.
- If the ICS is implemented as agreed at the IAIS's 2017 Annual Conference, it is far from clear that it will succeed in providing a consistent and comparable international standard.
- The implementation of the IDD will affect the business strategies and operations of firms across Europe.

Changes in overall risk margin of major UK firms



Source: David Rule, Bank of England, *Changing risks and the search for yield on Solvency II capital* (2017)

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2018 will also be an important year more broadly for firms based or operating in the UK which are anticipating the regulatory changes that may come about as a result of Brexit. The UK Treasury Committee's October 2017 report on Solvency II provides an important viewpoint on the future direction of insurance regulation in the UK, and the extent to which it may diverge from Solvency II. Substantial change will not take place in 2018 (and may not take place at all), but firms should expect a great deal of debate on future policy and regulation. The PRA's exercise of judgement and flexibility in implementing Solvency II will come under potential scrutiny, especially in relation to internal model approval, regulatory reporting and solvency for long-term insurers (in particular the criteria and process for granting matching adjustment and the rating and treatment of illiquid assets in internal securitisations and models, and the treatment of the volatility adjustment under stress). This scrutiny will likely include whether the PRA's approach in these areas is taking sufficient account of competitiveness issues.

The IAIS will also consult on version 2.0 of the ICS in 2018, the last full year of consultation and testing before its scheduled adoption in 2019. Although the implementation pathway agreed in 2017 has provided some clarity on the ICS timeline beyond 2019, it is far from clear that, if implemented as proposed, the ICS will succeed in providing a consistent and comparable international standard. Nonetheless, internationally-active groups will need to start planning time and resources to report to regulators under the standard on a market-adjusted basis during the five year confidential reporting period. For insurers not already reporting on a market-consistent basis, or if the methodology or calibration of the ICS differs significantly from prevailing national standards and Solvency II, the effort required to do so could be substantial, notwithstanding the fact that firms will not be required to hold capital to the ICS level, or any subsequent alignment to internal model or national approaches.

In conduct and distribution, the implementation of the IDD will affect the business strategies and operations of firms across the EU. In reinforcing a more consumer-centric approach, the IDD will require many firms to rethink their charging and distribution strategies, resulting in pricing and margin pressures. Firms will need to make sure their product governance and approval processes comply with the IDD, particularly the requirement that firms should ensure, on an on-going basis, that products are aligned to the interests, objectives and characteristics of their target market. New sales, disclosure and record-keeping requirements will bear on firms' processes and IT systems, while professionalism requirements will require firms to review their training, development and performance management processes. PRIIPs regulations will require insurers offering certain complex investment products to start providing KIDs in 2018, expanding the information provided to customers at point-of-sale and through the product lifecycle.

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Profitability and low interest rates

The low interest rate environment will continue to be the defining influence on supervisory activity in the insurance sector.



- Insurers will move further into alternative investment classes and products such as infrastructure and equity release mortgages.
- Supervisors will understand the business rationale behind these diversification activities in principle, but will strengthen their challenge to boards and senior management on their understanding of the implications for risk profile and capital strength.
- Firms' conduct will also be placed in sharp focus by supervisors concerned by the risk of customer detriment, particularly amongst customers who are unable to protect their positions, and hence vulnerable, in pursuit of profitability.
- Insurers should expect their resilience to low interest rates to be tested in the 2018 EIOPA stress test.

Commensurate with its pervasive effect across the insurance business model, the low interest rate environment will remain among the greatest challenges facing the insurance sector in 2018 and beyond. Insurers should expect their resilience to this environment to be tested robustly in the 2018 EIOPA stress test.

“Insurers will move further into alternative investment classes and products such as infrastructure and equity release mortgages.”

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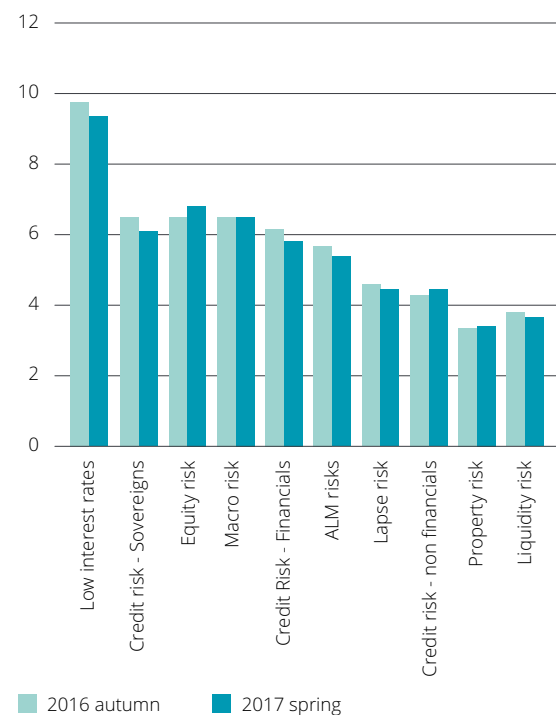
Low returns on “traditional” investments – with the added incentive of the liquidity premium that can be recognised through the Solvency II matching adjustment – will drive insurers further towards alternative investment classes and products such as infrastructure and equity release mortgages. While supervisors, recognising the business rationale, will not seek to rein in these activities in principle, they will strengthen concerted their challenge to boards and senior management on their practical understanding and management of these higher risk activities and their implications for capital strength. The adequacy of sector expertise, credit risk assessment and governance, and recovery preparedness, will come under sharp scrutiny. Particular supervisory focus will attach to the credit ratings firms are assigning to illiquid assets for which there are few, if any, independent market valuation indicators.

Supervisors will be concerned that these strategies are being driven overly by yield considerations alone. They will focus sharply on the risks to solvency that these strategies

will pose in the event of sharp equity or property market crashes. Firms can expect to see their “prudent person” approach expressly challenged in this regard, not least in relation to the rigour and breadth of the stress testing they have undertaken. Reverse stress testing is also likely to be applied with greater frequency. Firms which do not satisfy supervisors on their understanding, management and board engagement with respect to riskier activities are likely to see increasing use of independent reinsurance by regulators.

Firms’ conduct will also be placed in sharp focus by supervisors concerned by the risk of customer detriment in pursuit of profitability. Conduct supervisors will continue to focus on the suitability and marketing of more profitable products and activities (for example, add-on sales, renewals and long-term fee arrangements), and will have particular concern for consumers at increased risk of harm either through a lack of understanding and/or because their circumstances leave them little option but to purchase such products.

Risk assessment for the insurance sector



Note: Risks are ranked according to probability of materialisation (from 1 indicating low probability to 4 indicating high probability) and the impact (1 indicating low impact and 4 indicating high impact). The figure shows the aggregation (i.e. probability times impact) of the average scores assigned to each risk.

Source: EIOPA, *Financial Stability Report (2017)*

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Profitability and soft markets

The persistent soft market will continue to challenge insurers and supervisors in 2018, creating a double-edged risk for supervisors as profitability remains squeezed and underwriting standards and policy term limitations potentially deteriorate.

- Despite 2017's active hurricane season, the persistent soft market will continue to challenge insurers and supervisors in 2018. The supply of insurance risk capital is unlikely to dry up in the near term.
- Firms should expect to respond to requests from supervisors on financial resilience and contingency planning; catastrophe modelling and stress testing will be key areas of supervisory scrutiny.
- Supervisors will continue to be concerned by the adequacy of rates and reserving, the risk of a gradual softening of policy terms, and whether adequate allowance is being made for extreme events in capital requirements.
- Cyber underwriting risk will be an area of special focus.
- Resolution planning will remain within the framework of national regulation in 2018. While we do not expect the European Commission to propose legislation on a harmonised EU framework during the life of this Parliament, we do expect a consultation in 2018.

Despite 2017's active hurricane season, the persistent soft market will continue to challenge insurers and their supervisors in 2018. The supply of insurance risk capital is unlikely to dry up in the near term as interest rates remain low and the search for yield creates appetite for insurance risk among an increasingly broad spectrum of investors (for example, pension funds) and attracts new entrants into the insurance capital market. The new UK ILS framework will provide the legal framework for capital markets to assume insurance risk in the UK in 2018, for example through the issuance of catastrophe bonds. We expect further growth in the alternative risk transfer market, adding to the supply of risk capital from outside the traditional sector and leading to further pressure on pricing and margins and, potentially, underwriting standards and policy term scope.

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These factors point to a structural shift in the insurance market. The availability of insurance risk capital in the low interest rate environment has structurally weakened and hence inhibited the insurance market cycle. A prolonged hardening of the market is therefore unlikely without interest rate rises substantially exceeding those currently expected by the market, barring a “market turning event” of truly unprecedented scale.

This creates a double-edged risk for supervisors – on the one side, long-running depressed profitability coupled with a deterioration in underwriting standards and policy terms and on the other, the risk of disruption in a turning market. The watchword for insurance supervisors in 2018 will therefore be ensuring that firms build resilience and manage the risk of failure. Supervisors will continue to be concerned by the adequacy of rates and reserving, the risk of a gradual softening and extension of policy terms, and whether adequate allowance is being made for extreme events in capital requirements.

Insurers will see this translate into requests from supervisors on financial resilience and contingency planning, and further sharp focus on modelling and stress testing (including a 2018 stress test by EIOPA).

Cyber underwriting risk will be an area of special focus, with supervisors concerned that modelling either underestimates the potential scale and impact of cyber exposures or is not capturing the implicit cyber coverage provided by conventional business continuity cover. Supervisors will therefore expect robust scenario testing of potential major cyber events and scenarios from both angles, considering both overt and implied cyber exposures. A major systemic cyber loss event (for example, affecting the clearing or payments systems) would undoubtedly harden long-term pricing in the cyber market, and could plausibly have a major effect on broader market pricing. Supervisors will expect boards to demonstrate in-depth understanding of cyber risks and firms’ own cyber resilience, in addition to evidence of clear leadership on underwriting discipline, reserve strength and capital planning.

Firms will be expected to carry out advance planning for a market-turning catastrophe, including consideration of resolution. Resolution planning for the insurance sector will remain within the framework of national regulation in 2018. The European Commission will consult in 2018 following, particularly in light of EIOPA’s 2017 opinion on recovery and resolution for the insurance sector, but we do not expect a legislative proposal during the life of this European Parliament.



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The rate of product innovation and disruption in general insurance will accelerate in 2018, as firms further explore the potential of data to develop underwriting, pricing and product delivery.

- Pricing practices will be in regulatory focus, in particular where supervisors perceive risks of financial exclusion.
- Innovation will be slow in the life and retirement sector.

Product innovation will provide opportunities for both insurers and consumers for products to be more tailored, relevant and accurately priced. But supervisors will also be strongly alert to the risks of unfair use of consumer data and financial exclusion. 2018 will see a significant level of engagement with supervisors and demand for guidance on the use of data in underwriting and pricing. The implementation of the GDPR will add extra emphasis. Firms and supervisors

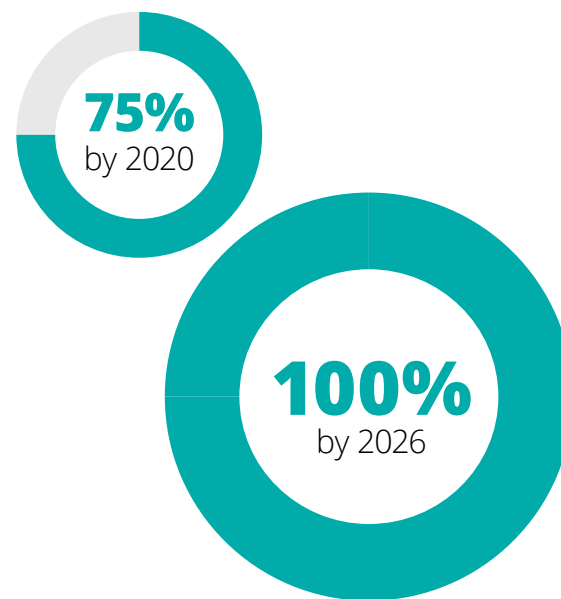
will also consider the use of a broad spectrum of data, such as social media data, in the course of the insurance product and consumer lifecycle. Precedents for acceptable use of different types of data will emerge over time, extending well beyond 2018.

Pricing practices will be a focus for supervisors in 2018, in particular where they see risks of financial exclusion. In the UK, the FCA expects to focus in 2018 on whether certain consumers are systematically affected by pricing practices, whether renewal customers are disadvantaged, and whether information provided to consumers is sufficient to assess the products they are presented with. Firms will need to be able to explain clearly how pricing decisions are made and the types and sources of data used.

In the life and retirement sector, customer retirement preferences will reflect a continued desire for both security and flexibility. However, innovation to meet these needs will remain slow in 2018 as barriers to innovation, including the pace of policy change, uncertainty about how the market will develop, customer inertia and the small sizes of customer retirement funds,

will persist. Supervisors will continue to focus on whether appropriate advice is being provided to consumers at the point of retirement, and on eliminating conflicts of interest in the advice process. The information provided to consumers will be subject to ongoing scrutiny, with a view to its effectiveness in overcoming areas of consumer inertia.

Percentage of new cars that are expected to be connected cars in the UK¹⁸



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Pricing fairness and competition will attract increasing scrutiny, while MiFID II will bite. Systemic concerns about the asset management sector will not go away.

The introduction of new regulatory standards in 2018 will challenge conventional investment management business models. Scrutiny of costs and charges, and increasing investor transparency, will bring about a compression of margins, particularly for non-performing active management strategies. This will reinforce competitive pressures as the search for returns or low cost pricing structures intensifies, and will act as a catalyst for innovative pricing structures and product offerings. The size of AUM and the march of passive investment strategies will continue to drive systemic risk concerns, and this is likely to lead to a focus on fund stress testing, and liquidity and leverage control requirements.

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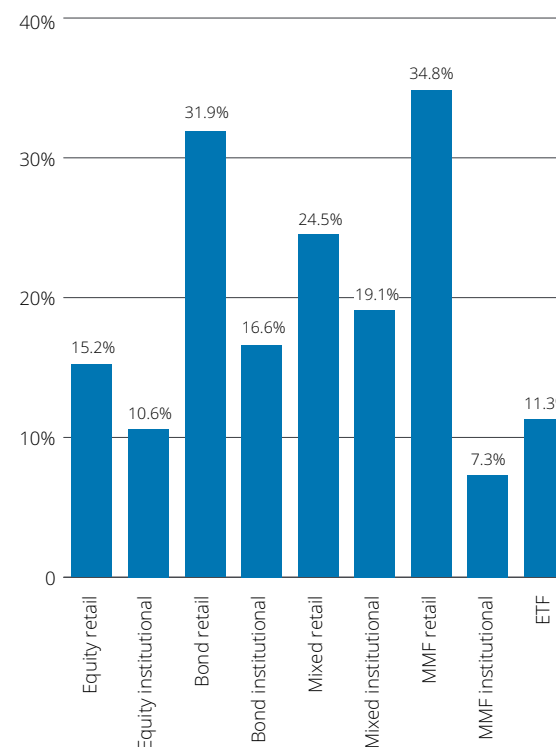
Business models and new regulation

Competitive pressures coupled with heightened regulatory scrutiny will lead to a steady compression of the margin between active and passive fund management costs, particularly for retail funds, and to increased momentum towards consolidation.

- Investment research rules under MiFID II will have an impact on asset managers' business models.
- Collectively, regulatory rule changes and increased expectations will drive down profit margins.
- There is likely to be greater consolidation within the industry as firms face higher costs owing to the multitude of rule changes, the need to comply with enhanced regulatory expectations around transparency, and increased competitive price pressures arising from regulatory scrutiny of costs and charges.

Many rule changes will go live in 2018, including, MiFID II, PRIIPs, and new rules following the FCA's Asset Management Market Study in the UK. ESMA will also undertake a large-scale assessment of the reporting of costs and past performance of retail investment products, in order to increase investors' awareness of the net return on these products and the impact of fees and charges. ESMA has published an initial assessment of the impact of charges on mutual fund returns. Collectively, these measures seek to improve investor protection through market transparency and promoting competition.

Reduction in relative return on investment (net of expenses, sales and redemption fees)



Source: ESMA, Report on the impact of charges on mutual fund returns (2017)

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Competitive pressure, coupled with continued strong regulatory scrutiny from both fairness and competition perspectives, is likely to lead to a steady compression of the margin between active and passive fund management costs, most notably for retail funds. There is an increasing risk of declining market share and reputational damage for those firms that cannot keep up with the many rule changes, enhanced regulatory expectations and increased competition. In particular, this is likely to affect mid-sized asset management firms and incentivise consolidation.

The most efficient and innovative asset managers will be able to use greater transparency around costs and charges, including through the introduction of more innovative, performance-based charging structures, to gain an advantage and increase their market share. Specifically, active managers need to have a coherent business model and pricing response to the growing shift towards low cost passive management. Asset managers that are unable to offer consistently good returns or competitively

priced services are most likely to be at risk of losing market share and suffering reputational damage.

As fee disclosures become more transparent, asset managers need to take a position and explicitly justify their charges to investors, including, for example, where they pass on investment research costs to investors. Some larger asset managers have used the focus on fees to demonstrate that they will absorb costs rather than pass them on to investors, prompting a few firms to change their plans and implement the same approach. However, consideration should also be given to innovative fee structures. One approach could include tying fees, or a variable component within them, more explicitly to investment performance. Some firms have already advanced plans to differentiate themselves in this way.

Product innovation or greater automation through distribution channels should be considered. Opportunities for greater innovation may, for example, be facilitated through the EU Capital Markets Union.

Additionally, there may be scope to develop activities in areas beyond traditional corporate debt markets, to alternative forms of debt finance, such as broadening direct lending to, and investment in, companies.

There are also examples of fierce negotiations over the provision of investment research and this could create opportunities for cheaper research platforms to flourish. Firms might consider whether AI or machine learning solutions could lower costs around research, particularly where research is being produced in-house.

There is more recent evidence that some sell-side firms are lowering their charges or using carve outs to provide virtually “free” research to such an extent that inducement rules might be breached by such subsidies. Asset managers will need to balance the opportunity to negotiate cheaper research costs with the risk of a conflict of interest arising. This is a topic which is likely to continue to attract the scrutiny of supervisors.

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Systemic risk concerns

Calls for more intensive regulation of asset managers due to residual systemic risk concerns will not go away, but we do not expect individual firms to be designated as globally systemically important in the same manner as in the case in banking and insurance.

- Asset managers will need to develop strategic stress testing plans.
- The focus is likely to be on fund leverage monitoring and control requirements.

Global AUM figures have risen substantially since the financial crisis. EFAMA reported that European AUM alone has grown by 77% between 2006 and 2016. It now amounts to a €23 trillion industry.

Driven by a combination of quantitative easing that has inflated asset prices, the increasing prevalence of defined contribution scheme investments, and a low interest rate environment which has fuelled the search for yield, this growth will trigger further regulatory responses to systemic risk concerns. Regulatory interest will be heightened by asset managers increasing their risk-taking activities in response to the retrenchment of banks, and the market instability concerns that arise from the ever growing proportion of global capital flows represented by passive investment and ETFs. The concern is that this growth is creating markets dominated by blocs of funds that can be expected to react in “lock step” to market trends or shocks, potentially leading to disorderly market adjustments and pressure on market infrastructure.

In 2017, the FSB published policy recommendations to address structural vulnerabilities in asset management, and IOSCO is reviewing how national authorities have implemented the recommendations.

Both ESMA and the ECB have also commented on the risks associated with the growing asset management sector, signalling a need for industry preparedness. France’s AMF has recently moved to strengthen the requirements on ETFs, with guidance on monitoring procedures in the event of liquidity reduction, valuation issues, and counterparty default.

“EFAMA reported that European AUM alone has grown by 77% between 2006 and 2016. It now amounts to a €23 trillion industry.”

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Supervisors will develop strategies to guard against systemic risk and instability in the event of a severe market downturn. Asset managers will need to respond with longer-term strategic and governance plans that provide the capability to meet fund stress testing requirements. They will also need to ensure appropriate liquidity management controls are in place.

It is increasingly likely that specific prudential tools will be made available to supervisors in the form of higher capital requirements and liquidity restrictions. Nevertheless, since it is not clear that capital is an effective mitigant of these market stability concerns, we expect the use of such tools to be sparing. Fund leverage will, however, come under scrutiny, and managers will need to satisfy supervisors that they are monitoring and measuring synthetic leverage appropriately.

We expect these systemic issues around the asset management sector to generate continuing debate and practical review. However, regulators do not yet seem poised to designate specific asset managers as globally systemically important.

“It is increasingly likely that specific prudential tools will be made available to regulators in the form of higher capital requirements and liquidity restrictions.”



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**AI**

Artificial Intelligence

AIFMD

Alternative Investment Fund Managers Directive

AMF

Autorité des Marchés Financiers

API

Application Programming Interface

AUM

Assets Under Management

BCBS

Basel Committee on Banking Supervision

BoE

Bank of England

CCP

Central Counterparty

CISO

Chief Information Security Officer

CRD V / CRR II

Capital Requirements Directive V / Capital Requirements Regulation II

CSC

Common and Secure Communication

DPIA

Data Protection Impact Assessment

EBA

European Banking Authority

ECB

European Central Bank

ECL

Expected Credit Losses

EFAMA

European Fund and Asset Management Association

EIOPA

European Insurance and Occupational Pensions Authority

EMIR

European Market Infrastructure Regulation

ENISA

European Agency for Network and Information Security

ESAs

European Supervisory Authorities

ESMA

European Securities and Markets Authority

ESRB

European Systemic Risk Board

ETF

Exchange-Traded Fund

FCA

Financial Conduct Authority

FMI

Financial Market Infrastructure

FRTB

Fundamental Review of the Trading Book

FPC

Financial Policy Committee

FSB

Financial Stability Board

GDPR

General Data Protection Regulation

IAIS

International Association of Insurance Supervisors

ICAAP

Internal Capital Adequacy Assessment Process

ICO

Information Commissioner's Office

ICS

Insurance Capital Standard

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**ICT**

Information and Communication Technology

IDD

Insurance Distribution Directive

IFRS 9

International Financial Reporting Standard 9

ILS

Insurance-Linked Securities

IOSCO

International Organization of Securities Commissions

IPU

Intermediate Parent Undertaking

IRB

Internal Ratings-Based

LEI

Legal Entity Identifier

MI

Management Information

MiFID II / MiFIR

Markets in Financial Instruments Directive II / Markets in Financial Instruments Regulation

MTF

Multilateral Trading Facility

NPL

Non-Performing Loans

NSFR

Net Stable Funding Ratio

OTF

Organised Trading Facility

PRA

Prudential Regulation Authority

PSD II

Payment Services Directive II

RAF

Risk Appetite Framework

RTS

Regulatory Technical Standards

SCA

Strong Customer Authentication

SCR

Solvency Capital Ratio

SFTR

Securities Financing Transactions Regulation

SI

Systematic Internaliser

SRB

Single Resolution Board

SREP

Supervisory Review and Evaluation Process

SSM

Single Supervisory Mechanism

TCA

Transaction Cost Analysis

TPP

Third Party Providers

TRIM

Targeted Review of Internal Models

UCITS

Undertaking for the Collective Investment of Transferable Securities

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