

Ten years on from the crisis

Financial Markets

Regulatory Outlook 2019

“So where do we stand on the tenth anniversary of the collapse of Lehman? The bottom line is this: we have come a long way, but not far enough. The system is safer, but not safe enough. Growth has rebounded, but is not shared enough.”

Christine Lagarde, Ten Years After Lehman – Lessons Learned and Challenges Ahead, September 2018

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Foreword

Nearly ten years after the financial crisis, the long shadow it has cast has started to fade. Most post-crisis prudential policies have now been decided, and banks in particular are now much better capitalised and more liquid than before the crisis. Amid varied approaches and timetables to national implementation of agreed prudential reforms, attention is now more acutely focused on culture and governance, the challenges of new technology, and emerging economic, market and operational risks. Firms need to be prepared to respond to this shifting focus and the new demands that it will place on them.

Lifting of accommodative monetary policy

Globally, monetary easing and low interest rates are slowly giving way to interest rate “normalisation”, although rates are expected to settle at levels significantly below historical norms. The US has led the way with a series of rate rises and the Federal Reserve has begun to shrink its balance sheet. The Bank of England has tentatively begun to raise rates, and the European Central Bank is bringing an end to the expansion of its balance sheet.

In Australia, interest rates remain on hold but are expected to begin rising. Japan is the major exception to this trend, with rates expected to remain low in the near future. Given the number of headwinds to the global economy (e.g. high levels of debt, elevated levels of geopolitical risk and trade protectionism), the pace of any interest rate rises is likely to be slow.

Higher interest rates may be beneficial in net terms to certain firms: banks may enjoy higher net interest margins and insurers could benefit from rising asset yields. However, interest rate normalisation may also lead to falls in some asset values and rising credit defaults as well as revealing structural weaknesses in both the global economy and individual firms. It is unclear what the overall effect of these opposing factors will be, especially at the level of individual firms and sectors.

An uncertain economic environment

Meanwhile, a period of accommodative monetary policy has contributed to a build-up of debt, with global debt levels now at \$247tn¹, significantly higher than their pre-crisis peak.

In many commentators’ eyes, this represents a key systemic vulnerability². Low rates also contributed to a sustained search for yield that may have led many lenders and investors to move down the credit quality curve. Further, comparatively higher capital requirements for banks have paved the way for a rise in non-bank lending, which means that exposure to credit markets now extends to a much wider variety of firms. Both the leveraged loan and real estate markets are likely to be vulnerable to higher interest rates, whilst consumer credit expansion and the resulting high levels of personal debt may have left many consumers vulnerable to interest rate rises, especially after such a prolonged period of low rates.

Looking at the wider global economic picture, we see a mixed outlook. Economic growth continues to be strongest in parts of Asia, although Chinese growth has slowed, while the outlook for emerging and developing economies is uneven. Recoveries in both the UK and US are now close to a decade long, while Eurozone expansion – although weaker – is also well embedded. Historically, downturns or recessions have

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occurred at least once each decade, suggesting that such an event may be overdue³.

Some commentators⁴ consider that the global economy has reached its “late cycle” phase, most evident in asset valuations that appear stretched on historic bases. In the EU, close to €731bn⁵ of non-performing loans continue to act as a major risk to some banks’ resilience and profitability, while globally, increasing trade protectionism and political uncertainty also weigh heavily on the minds of many in the industry. Brexit continues to be a major political and regulatory uncertainty, and both regulators and politicians will attempt to mitigate its risks and effects throughout 2019. Nevertheless, if there is a disorderly Brexit, leading potentially to new political strategies and approaches, the implications for how a number of these regulatory predictions unfold in the UK could be profound.

Against this background, we expect regulators across sectors to remain highly vigilant to the risks of economic downturn and market shocks. They will likely want to use stress testing extensively to assess firm vulnerability

and resilience, recognising that during a period of unprecedentedly low interest rates some business models have grown up in relatively benign conditions and have yet to be tested in a sustained downturn.

A retreat from global coordination

The global regulatory approach is changing. The aftermath of the financial crisis saw a globally coordinated response to draw up a series of new regulations which would underpin a more robust and stable financial system. However, there is starting to be a move away from global policy making and a reduced appetite for cross-border regulatory cooperation. As a result there are increasing signs of regulatory divergence, including geographical and activity-based ring-fencing, as different regions and countries look to tailor regulations to their own needs. Global firms are, therefore, having not only to comply with these divergent rules in the different jurisdictions in which they operate, but also to optimise their local governance structures, operating models, legal entity structure, and booking models.

A shift to supervision

We do not expect regulators to embark on a path to wholesale unravelling or reversing the post-crisis reforms implemented since 2008. But it seems that, absent a significant unexpected event, there is little prospect of major new regulation, especially in relation to bank and insurance capital. Regulators’ key priorities are to consolidate and safeguard and – in some jurisdictions – refine the reforms of the past decade. What we do expect is a sharp tilt away from a period of regulatory re-design and innovation, to one of operating and embedding the reformed supervisory system.

As a result, firms in many countries are seeing rising supervisory expectations, reflecting the growth of principles-based supervisory approaches that emphasise the importance of firms’ governance, culture and management approach and the outcomes, both prudential and conduct, these are delivering. Firms’ conduct and the treatment of their customers are also receiving increased focus in numerous countries, driven by political and regulatory concern over the perceived poor conduct of firms across all financial sectors⁶.

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Supervisors are also adopting more intrusive practices, including greater use of on-site supervisory visits. This reflects global leading practice and the increasing need for supervisors to engage directly with firms in order to understand their strategies and business models, risk profiles and appetites, risk management frameworks and approaches, and to hold boards and senior management accountable for the outcomes these deliver.

New technologies

Firms, regulators, and their customers are considering the opportunities and risks associated with new technologies. For example, due to the rapid development of artificial intelligence, machine learning, and FinTech solutions, once “new” technologies are quickly becoming mainstream. The powerful impact these technologies will have should not be underestimated, not only on consumers, but also on regulation and supervision, too. The pace of technological change, therefore, demands deep thinking about the appropriate regulation of processes, products, and institutions to avoid regulatory gaps and

to ensure financial stability and consumer protection.

These technology developments and disruption have triggered a debate around the perimeter of financial services regulation. Many incumbent firms worry that new technology-driven entrants offer services that lie outside the boundaries of existing financial services regulation and which incumbent firms find more costly to deliver because of a “compliance leakage” from the regulated activities that they are undertaking. We do not expect regulators to “come to the rescue” of incumbents, who will have to look to their own resources to rise to the challenge of competition. However, we expect that these level playing field concerns, along with worries about the role of technology in society more generally, will drive increasing interest in how FinTech firms and crypto assets are regulated - or rather, at present, how they are not.

We expect clarification of the regulatory treatment of crypto assets, especially in the areas of investment by retail consumers, money laundering and prudential capital for systemically important banks.

Acting in the face of uncertainty

While the current regulatory environment appears more settled compared to the recent past, regulators across the world continue to set high expectations intended to maintain a strong, resilient financial sector through firms having robust financial and operational resilience, supported by strong risk management and compliance capabilities. In our view, this may provide an opportunity for leading financial firms to pivot from having to build frameworks to reflect a barrage of new regulations to optimising through taking advantage of new technologies and operating models.

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The world changes and regulation changes with it

The debates around the regulatory perimeter and potential fragmentation of the financial system mean that firms' operational resilience, as well as their susceptibility to cyber and financial crime, are becoming much greater issues for regulators. As part of this, we also expect a sharpening supervisory focus on how boards and senior management teams control

the risks posed to them by their exposure to outsourced providers and other third parties.

The past decade has seen profound and lasting changes in the structure of the economy, employment, and society. The providers, consumers, and regulators of financial services are all changing. Ageing populations and new millennial consumers are demanding different types of

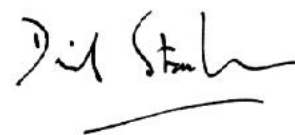
financial services and products, distributed in different ways. This changing and challenging background makes it essential to consider the future of regulation holistically, rather than in a piecemeal manner. All sectors and stakeholders have an important role here, and we hope that this year's outlook from our Regulatory Centres will both inform and stimulate this discussion.



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We have identified six cross-sector themes of strategic significance for the FS industry in 2019, alongside a number of sector-specific issues.

2019 cross-sector themes:



Shift from implementing new regulations to ongoing supervision
2019 will see a shift away from regulatory reform and policy initiatives, with regulators and supervisors looking to assess how new regulatory requirements have been implemented. Firms will need to ensure that regulations have been suitably embedded and should look to optimise their approaches where possible.



Preparing for Brexit
Firms will lack certainty over the terms of the UK's withdrawal from the EU and its future relationship with it. Any agreement is only likely to be ratified at the very last moment. In the meantime, firms should continue to prepare for a "no deal" scenario.



IBOR transition
Pressure to transition away from LIBOR will grow, with greater supervisory scrutiny of whether firms are reducing their exposure to LIBOR. More immediately, firms will also need to prepare for a transition away from both EONIA and, possibly, Euribor.



Climate change and sustainability
Global, EU and national regulators are in the process of defining their expectations for climate change risk management. Amidst rising investor pressure and industry action, central banks and regulators will increasingly focus on the financial risks that arise from climate change, and expect firms to work towards managing them.



Building resilience to operational disruptions
Firms' increasing exposure to both IT and cyber risks, as well as increasing awareness of the harm that operational issues can cause, will see regulators scale up their activity on operational resilience in 2019. Firms will need to show they understand their risk exposures and have the capability to deal with any potential disruptions.



Value for money
Conduct regulators are putting a growing emphasis on the economic consequences that poor value products and services have on consumers. Regulators will continue to focus on firms' fees and charges across customer groups, and on the transparency and comparability of products, and will expect firms to apply clear and fair charging structures.

Banking sector themes



Prudential



Resolvability



ICAAP, ILAAP, SREP and stress testing



Financial crime

Capital Markets sector themes



Capital markets landscape



Algorithmic and electronic trading



Payment for research



Transaction reporting



Traded risk



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Alongside our six cross-sector themes, we have also identified six supervisory constants – although not new, these will be important areas of supervisory focus in 2019.

2019 supervisory constants:



Governance and culture

To address the root causes of prudential failure and misconduct, supervisors will intensify their oversight of firms' culture and their governance and risk management frameworks. They will focus increasingly on diversity and inclusion at board/senior management level, especially as a way of avoiding group-think and ensuring effective challenge.



Scrutiny of firms' business models to the changing risk environment

As a decade of accommodating monetary policy comes to an end, political uncertainty increases, and technological innovation disrupts and transforms the way financial services are delivered, supervisors will step up their scrutiny of how firms are responding to these risks.



Firms' protection and use of data

As firms seek to make greater use of consumers' personal data, both they and supervisors will be keen to prevent a "Cambridge Analytica moment" given the harm it could do to consumers' trust. With GDPR and PSD2 in place, supervisors will have both the basis and the tools to take a closer look at firms' use of data.



Access and vulnerable customers

Concern about financial exclusion, particularly as a result of growing digital distribution, will mean that supervisors will continue to scrutinise the levels of access that more "vulnerable" groups have to FS products/services. Supervisors will also focus on firms' policies and practices to ensure that vulnerable consumers are not put at risk by poor firm conduct.



Testing for cyber vulnerabilities

As technological change and the rise of digital business models continue, cyber-related risks have risen up the regulatory agenda, and supervisors across Europe will step up their scrutiny of firms' cyber resilience in 2019.



Model risk management

Supervisors will continue to want firms' senior management and boards to improve their understanding of the strengths and weaknesses of internal models that are used for regulatory capital, strategic decision making and other areas; as well as their governance and oversight of such models.

Insurance sector themes



Business model challenges



Changing role of insurers and insurance



Pricing and distribution



The Solvency II review

Investment Management sector themes



Value for money



Payment for research



Fund governance



Product governance and distribution



Fund liquidity and leverage

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Cross-sector themes



The defining cross-sector regulatory themes for 2019.

In the year ahead we see six issues of strategic significance for all sectors of the FS industry in EMEA in 2019:

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- 3 IBOR transition
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Shift from implementing new regulations to ongoing supervision



- The focus of activity for supervisors will shift to examining how key regulatory reforms and associated new requirements have been implemented. Implementation of MiFID II is likely to be at the vanguard of this scrutiny, in particular transaction reporting, payment for research and inducements.
- Faced with this scrutiny, boards will need to satisfy themselves that regulations have been adequately embedded within their firms. Firms will need to increase resources dedicated to understanding and responding to supervisory priorities.
- Firms should turn their attention to optimising their operational strategy and business model in the new regulatory environment, in order to progress cost reduction targets and enhance customer outcomes.

A decade on, sweeping changes to the global regulatory framework driven by the financial crisis are largely in place. The focus of activity for supervisors has shifted to examining how effectively requirements have been implemented, and to supervisory priorities beyond the implementation of regulatory change (the most significant of those priorities are explored elsewhere in this paper).

2019 will be an important milestone in this trend as it is the first calendar year following deadlines for the implementation of several major pieces of regulation. After an informal “grace period” for firms through 2018, supervisors will scrutinise the implementation of PRIIPs, MiFID II, PSD2, IDD and GDPR. In a similar vein, resolution authorities are planning to assess the resolvability of banks and (in the UK) the implementation of bank ring-fencing.

Key to understanding what this entails is the hypothesis supervisors will want to test (borne out by experience). Namely, whilst firms may have taken adequate steps to comply with the letter of requirements, there will inevitably be more to do to ensure governance, processes

and systems are sufficiently robust and embedded in the business in order to deliver compliance in the spirit intended.

For example, by early 2018 only 15% of organisations surveyed by Deloitte expected to be fully compliant with GDPR by the May deadline, with the majority instead targeting a “risk-based, defensible position”⁷. A starker illustration of the potential gap between meeting deadlines and fulfilling regulatory expectations is provided by international standards for banks’ risk data (BCBS 239). G-SIBs had to comply with the requirements by January 2016, yet reports published by the BCBS and ECB in mid-2018 emphasised there remains much more work to do.

MiFID II is likely to be at the vanguard of post-implementation scrutiny. There will be variations between jurisdictions in the topics that supervisors examine, but we expect most to prioritise transaction reporting, payment for research and inducements. By contrast, GDPR implementation is likely to receive less proactive attention as national authorities are hampered by a lack of resources.

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Scrutiny, however, may be generated by supervisory activity in other areas. In the UK, for example, the FCA has committed to highlight to the ICO problems concerning data privacy identified through its supervisory work. In other countries, prudential supervisors plan to capture data privacy in the ICAAP by asking firms to consider potential risks from associated compliance and reputational issues. Moreover, if a firm does experience a data protection breach, the political, public and regulatory backlash is likely to be severe, extending well beyond the individual firm affected by it.

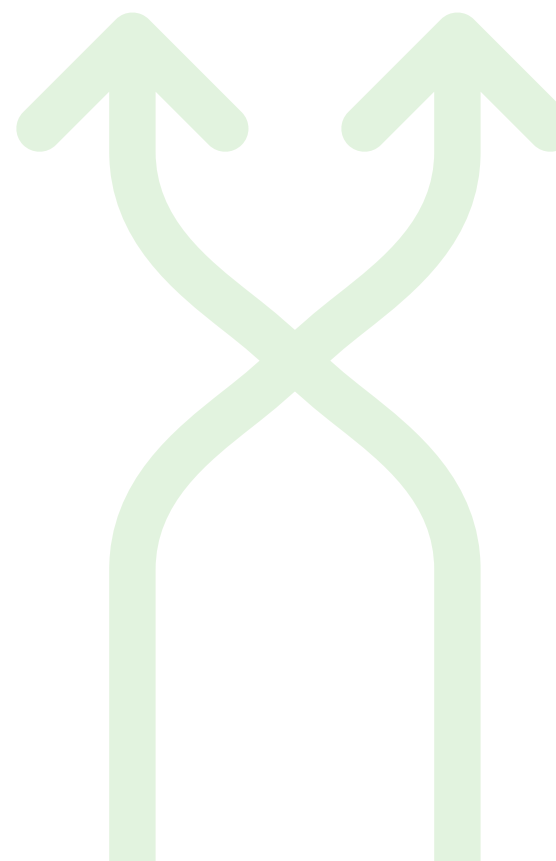
For supervisors, the shift in focus will go beyond examining implementation, with more time being spent on business as usual supervision. Focusing on “gateways” to firm resilience, supervisors will examine business models and strategy, governance and culture, and individual and corporate accountability. There will be an emphasis on operational resilience in parallel to financial resilience, and increasing attention paid to the impact of new technologies.

We will also see supervisors deploy “SupTech” solutions, initially focusing on data collection and data analytics. A legislative pause at the EU level in 2019 during European Parliamentary elections and the subsequent Commission appointment process may mean ESAs in particular have more time to focus on supervisory convergence rather than regulation.

Firms need to satisfy themselves that regulations have been adequately embedded. Internal Audit has a key role to play here. Boards should challenge senior management to ensure that requirements have been fully met (and that outstanding remediation work has not been forgotten as change delivery teams have been re-deployed).

Irrespective of the push from supervisors, firms should turn their attention to optimising their operational approach. Firms have experienced a build-up in compliance costs from various regulatory programmes and now have the opportunity to streamline processes and systems, reducing costs and creating the capabilities to deliver better customer

and market integrity outcomes, although this should not come at the cost of reduced compliance or ongoing monitoring activities.



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Preparing for Brexit



- Firms will have no legal certainty on the Withdrawal Agreement as we expect it to be ratified at the very last moment in both the UK and EU.
- EU authorities will maintain pressure on outgoing firms from the UK to demonstrate they have taken all steps possible to deal with any remaining cliff edge risks rather than depend on emergency fixes.
- However, in extremis, we expect the EU to choose emergency fixes over disorder if there is no implementation period and we expect other EU national authorities to follow the path taken in Germany, France and the Netherlands in preparing emergency powers for relevant authorities in case they prove necessary.
- Due to EU supervisory expectations and loss of “passporting”, firms will start to shift trading and clearing of more Euro denominated products to the EU. If there is an implementation period agreed in sufficient time, we expect outgoing firms from the UK to transfer less capital and people to the new EU entity on Day 1.

Successful execution of Brexit plans will remain a critical cross-sectoral priority for firms. At the time of publication, we do not expect firms to have legal certainty on the Withdrawal Agreement and the associated implementation period until the very last moment once all the respective legislative processes have been completed. The ratification process will require debate in the two Houses of the UK Parliament, approval by the House of Commons in a vote set to take place on 11 December, a successful passage of the European Union (Withdrawal Agreement) Bill through the UK Parliament, a vote in the European Parliament and approval by at least 20 of the other 27 EU states at the Council of the EU before 29 March 2019.

This lack of certainty will be particularly challenging for outgoing firms from the UK, as the EU authorities have not yet offered anything akin to the UK’s proposed TPR enabling EU firms and funds to continue their activities in the UK for at least three years after exit day.

We expect EU authorities to continue to insist that outgoing firms from the UK execute a plan based on a “no deal” scenario where the UK becomes a third country on 29 March and there are no public sector solutions beyond what has already been announced by the Commission with regards to temporary and conditional equivalence decisions for UK-based CCPs and by the ESAs on the bilateral margin requirements and clearing obligation under EMIR. We do not expect any further public sector solutions to be agreed until the last possible moment.

There is no sign of any comprehensive solution to an important cliff edge risk - that of the UK’s position in relation to the GDPR - and whether UK will benefit from some form of temporary adequacy assessment in the event of a no deal. As the Commission does not see any need for EU-level action related to data and contract continuity for uncleared derivatives, in particular to allow UK-based firms to undertake lifecycle management activities with EU27-based clients or on insurance contracts, we expect EU national authorities to follow the path taken in Germany, France

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and the Netherlands in preparing emergency powers for relevant authorities in case they prove necessary, and to choose emergency fixes to minimise disruption and harm faced by EU businesses and consumers in a no deal scenario. While action taken at a national level is preferable to no action, UK firms will be left to deal with a patchwork of national EU27 regimes and measures on the remaining cliff edge issues.

Due to EU supervisory expectations and loss of “passporting”, both UK firms and incoming EU27 firms that use London as a trading hub will start to shift trading and clearing in relation to transactions with EU clients and an increased number of Euro denominated products to the EU. However, if an implementation period is agreed in sufficient time, we expect outgoing firms from the UK to transfer less capital and people to the new EU entity on Day 1. Instead they will reduce their business/execution risk and adopt a more phased approach by transferring business product-by-product over the course of the implementation period.

Both the UK and EU have agreed that the future relationship on market access for financial services will centre on an equivalence framework. Both sides will aim to conclude assessments under their respective frameworks before the end of June 2020, and there will be transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions. However, we are unlikely to get more granular detail on how this new “close and structured” relationship will operate in practice beyond further high-level statements until after the European Parliament elections and a new European Commission in 2019. Full details of how the UK’s equivalence regime will operate need to be announced.

We do not expect equivalence assessments in relation to the MiFIR third country regime for investment services to start until the PRIF legislation is finalised as the PRIF proposals include some important provisions in relation to third country equivalence decisions by the Commission. Even then, it is not clear if the outcome of an equivalence assessment will be positive for the UK. Likewise, we expect the

temporary and conditional decisions for UK-based CCPs to act as a “bridge” to the tougher equivalence regime in EMIR 2.2. We expect this process to remain highly politicised and intertwined with negotiations on the future relationship.

While most large UK insurers have executed plans to ensure cross-border contracts can be serviced post-Brexit, this is not universally the case. Repapering or transfer of all affected regulated legacy contracts (insurance and non-insurance) to a new EU-based entity ahead of 29 March 2019 may not be an option for all firms concerned with only a few months left before exit date. If no solution is proposed by national authorities in a no deal scenario, this issue will be brought to head on the exit date as some firms may not be able to service legacy contracts in some EU jurisdictions without public sector/regulatory forbearance action or by taking on legal risk, potentially leading to consumer detriment.

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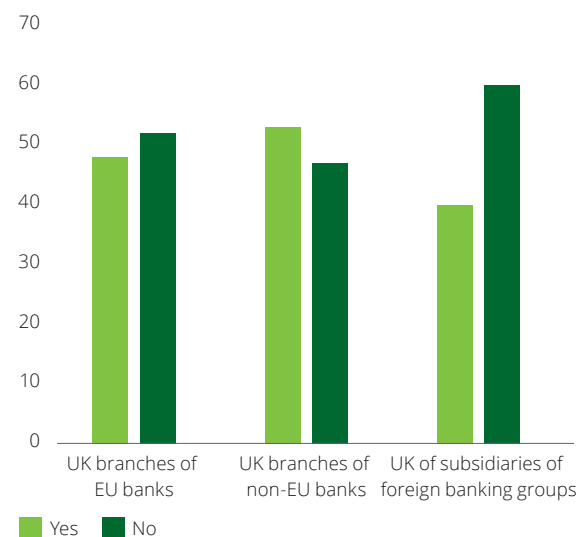


In the asset management sector, following ESMA's Opinion of July 2017, we expect EU ManCos to come under greater scrutiny in 2019, particularly in relation to the amount of resources they have in the EU and their ability to exercise independent oversight of their delegates, especially where they are delegating to third country entities. We expect supervisory cooperation arrangements between the UK and EU regulators to be signed before the end of March 2019, but firms may not have legal certainty on this until late in the day.

The asymmetry in the approach taken by UK and EU authorities means outgoing firms from the UK will in some cases face a significant challenge in successfully executing their plans. Where there is a high probability that a firm may not be able to execute its plan without assistance from public sector authorities, for example in relation to contracts, these firms should continue to engage strongly with EU and national member state authorities in explaining the challenges and potential effects on consumers and financial stability if a solution is not found. In parallel, firms

should however diligently execute their plans to demonstrate they continue to take all action within their powers to mitigate any risks.

Figure 1: Where you have pan-European/global operations, are you reviewing your booking models?



Source: Association of Foreign Banks/Norton Rose Fulbright



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- The pressure to transition away from LIBOR will grow, with greater supervisory scrutiny of whether firms are reducing their dependencies on, and exposures to, LIBOR.
- 2019 will see an increase in issuances of RFR-linked products, as banks and other market participants start to drive activity in them.
- Firms' management of conduct risk will move up the agenda as supervisors take greater interest in firms' accountability and oversight, conflicts of interest controls and disclosure practices to manage these risks.
- Early in 2019 firms will "wake up" to the risks of a failure to transition away from EONIA, and possibly Euribor, in time.
- Even if authorities offer some flexibility in respect of the 1 January 2020 EU BMR deadline for critical, and/or non-critical benchmarks (including third-country benchmarks), EU regulators will become more vocal about firms' transition plans in 2019.

LIBOR underpins contracts affecting banks, asset managers, insurers and corporates estimated at \$350tn globally on a gross notional basis. While there is no strict legal mandate, the official sector has said that firms should undertake a market-led transition from LIBOR to alternative overnight RFRs. In 2017, Andrew Bailey, Chief Executive of the FCA, announced that by the end of 2021 the FCA would no longer seek to persuade or compel panel banks to contribute to LIBOR. This made clear that reliance on LIBOR beyond then could no longer be sustained.

In the Eurozone, outstanding interest rate derivative instruments referencing EONIA and Euribor are valued at €22tn and €109tn, respectively. A further €4.4bn and €1.6tn of interest debt securities are linked to EONIA and Euribor. These benchmarks are not currently compliant with the EU BMR. The administrator has indicated that EONIA will not meet the requirements of the Regulation; it is, however, planning to apply for authorisation in respect of Euribor and has proposed changes to the methodology. Without compliance, firms will not be able to use these benchmarks

in new contracts from 1 January 2020 when EU BMR transitional provisions expire. Use in legacy contracts may be permitted by the Competent Authority. The deadline also applies to other non-compliant benchmarks, including third-country benchmarks.

Supervisors will enquire about firms' plans for EONIA and Euribor. Given the short timeframe, an extension to the EU BMR deadline may be offered, but even if this were to happen there would still be no room for complacency.

In a similar vein, while LIBOR is currently authorised under the EU BMR, in a "no deal" Brexit scenario where the UK is deemed a third country with no equivalence, LIBOR could become a third-country benchmark for the purposes of EU BMR. In these circumstances, and in the absence of equivalence, the administrator of LIBOR would need to re-apply under the recognition or endorsement options within the Regulation before 1 January 2020. Otherwise, EU-supervised entities could be prohibited from using LIBOR. Firms will need to monitor developments closely.

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2019 will see firms make real progress in benchmark transition against a backdrop of uncertainty, with major issues such as term RFRs still outstanding. It is likely to be one of the biggest transformation projects firms will have undertaken, affecting almost every business unit, with huge financial and operational implications.

The largest firms will receive the greatest scrutiny. The FCA and PRA have already written to major banks and insurers to ask that they identify a Senior Manager to take responsibility for oversight of transition programmes and a board-approved assessment of the firm's key risks relating to LIBOR transition. In 2019, they will continue to question firms on their financial exposures and management of conduct risks. Supervisors will also turn their attention to the next tier of firms, and to buy-side firms.

Boards need to establish a co-ordinated, senior Steering Committee to manage and oversee transition and put in place the key activities that will drive the transition programme. Firms will need to assess

their financial exposures to LIBOR, EONIA and Euribor as early as possible. This includes identifying which contracts require renegotiation and how they will manage exposures and reduce these over time. They should decide when to issue RFR-linked products to help build liquidity (some have already done so) and discontinue their issuance of IBOR-linked products (whilst monitoring developments regarding Euribor). Operational and systems changes will also be required.

Firms should identify all delivery risks and implement mitigants early. In particular, moving legacy products to RFRs could create winners and losers, with one party paying or receiving more or less because the methodologies for calculating RFRs are different. If the process is not managed appropriately, customers could file complaints or claims against firms arguing that they were treated unfairly. This risk is heightened by potential information asymmetries.

Moreover, firms that continue to issue new contracts linked to "vulnerable" benchmarks which mature past 2020 and 2021 may be increasing their conduct risk, and with it, the potential for mis-selling claims, particularly if there is a sudden or disorderly withdrawal of a benchmark (e.g. due to the withdrawal of panel banks). Firms will need a clear strategy on when to stop issuing these contracts and will need to undertake regular monitoring and oversight of their exposures. A clear client communication strategy, underpinned by rigorous programme controls, documentation and management of conflicts of interest will be vital in managing conduct and operational risk.

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Figure 2: Key dependencies
Benchmark transition is a complex undertaking and its success will depend on active collaboration between a range of different market participants and the official sector, as illustrated here.



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Climate change and sustainability



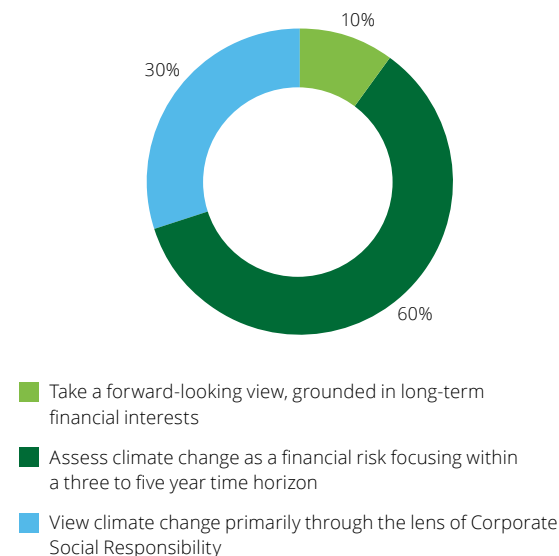
- The prescriptiveness of any EU-wide regulatory actions over a one to two year horizon will depend in part on how well firms engage with voluntary initiatives and demonstrate that they are on top of climate-related financial risks.
- Boards will need to review and define the relevant roles and responsibilities for managing financial risks from climate change.
- Increasingly banks will integrate climate-related financial risks into their loan origination processes, insurers will introduce more sophisticated modelling of physical risks, and asset managers will treat them as investment risks and influence corporate responses to climate change through board targeting.

The regulatory response to a transition to a greener economy has accelerated rapidly. Against a backdrop of institutional investor pressure and industry actions, central banks and regulators are focusing on the financial risks that arise from climate change, including physical risks, transition risks and liability risks, and expect firms to work towards managing them.

The BoE, a founding member of the global NGFS, and the FCA have already taken steps to consult on their supervisory expectations of firms' management of financial risks from climate change. There will be increasing supervisory focus on UK firms' governance, risk management, scenario analysis and disclosure of sustainability risks. As a first step, firms will need to assign clear responsibilities to manage the financial risks from climate change, and aim to address them through their existing risk management framework in line with their risk appetite. The PRA has proposed that banks' ICAAPs and insurers' ORSAs should include any material exposures relating to the financial risks from climate change, while the FCA has made clear that

investment managers must consider the impact these risks have on the valuation of underlying investments as part of exercising stewardship.

Figure 3: PRA Survey of UK Banking Sector's Response to Climate Change



Source: PRA, *Transition in thinking: The impact of climate change on the UK banking sector, September 2018*

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While the first FSB TCFD progress report has highlighted that few firms have quantified and disclosed the financial implications of climate change, UK regulators have signalled that this will become an imperative for firms. To tackle the shortage and inadequacy of historical data on the impact of climate change, firms will require technical solutions to inform their risk assessment and modelling of potential future trends and risks. They can begin their risk identification process through high-level, and largely qualitative scenario analysis and stress testing, before establishing quantitative metrics and tools to measure short- and long-term risks.

Other EMEA supervisors will follow the PRA and FCA's approaches with interest, and may also set out detailed expectations on climate change risk management. Olli Rehn, Governor of the Bank of Finland, has called climate change "the biggest market failure of all times"⁸. In his view supervisors will increasingly ask firms to manage their own climate-related risks - and indeed the ECB has already cautioned that banks should take action to manage their exposures to the most

vulnerable business sectors - followed by possible balance sheet adjustment. Over the course of 2019, as EU Member States and the ESAs continue examining how sustainability risks and sustainability factors can be incorporated into MiFID II, IDD, Solvency II and SREP, the prescriptiveness of any EU-wide regulatory responses will depend in part on how well the industry positions itself against climate-related financial risks, and how well private-public partnerships fare in terms of mitigating those risks.

The primary example of such partnerships is the TCFD, which requires the many firms committed to the initiative to assess the resilience of their strategy in different medium- to long-term scenarios. Leading industry players will make their first TCFD disclosure in 2019 alongside their annual financial results. This will not only exert pressure on other firms to commit to the TCFD, but also give investors and analysts more clarity about how the climate-related risks faced by these firms might inform their corporate valuations.

The most committed industry players have already started making concrete changes: some banks have started analysing the impact of climate change on their corporate loan portfolios, and at least one bank is actively steering its lending strategy to meet the Paris Agreement's global temperature goal. Leading insurers are improving risk reserving to account for more severe and frequent weather-related insured losses, as well as increasingly measuring the impact of climate change on their investment portfolios. Leading investment managers are holding corporates to account by disclosing the best and worst performers in mitigating climate change, and will increasingly deploy divestment strategies, particularly if they detect long-term devaluation risks. We expect adoption of these leading practices to broaden.

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Building resilience to operational disruptions



- Firms will increasingly be challenged by rising regulatory expectations for their resilience to operational failures, including cyber attacks.
- The ECB will roll out maturity-based expectations for the cyber resilience of SSM-supervised Eurozone banks.
- Recent high-profile IT outages will prompt UK authorities to accelerate the development of their “impact tolerance” framework for firms’ operational resilience.

Regulators are in the midst of significantly increasing their activities in relation to firms’ resilience to operational disruptions. This is being driven primarily by the increasing exposure of firms to cyber and IT risks. Indeed, in the UK, the FCA found that technology-related outages in financial services firms jumped by 138% in the last year alone. As they observe these trends, authorities are becoming more aware that operational incidents can cause significant harm to customers, market participants and potentially even endanger the stability of firms or the markets in which they operate.

2019 will see important strides in the design and early implementation of regulatory initiatives addressing operational and cyber resilience that are already in development by UK and Eurozone authorities.

In the UK, the BoE and the FCA will press ahead with the development of their “impact tolerance” framework for operational disruptions. The UK Treasury Committee’s recently launched investigation into a number of high-profile IT outages at FS firms will only

enhance the mandate for the authorities to accelerate the pace of their work. Although the implementation of the framework will likely not begin in 2019, the clear direction of travel places pressure on firms across the financial sector to begin preparatory work on identifying and mapping their critical services, articulating their risk appetite for large-scale disruptions in the form of impact tolerance statements, and investing in improving their ability to recover from disruptions when they do occur.

We believe that UK authorities will opt to strengthen their impact tolerance work by developing a set of regulatory leading practices in operational resilience, identifying expected levels of maturity in a number of capability areas. We believe that these expectations will emphasise the role that boards should play in overseeing operational resilience activities, including setting risk appetite, ensuring appropriate controls are put in place, and reviewing incident response and recovery plans.

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In the EU, the ECB will step up its existing efforts to roll-out a cross-border framework for the regulatory assessment of firms' cyber resilience. The 2018 CROE for FMI will be applied in 2019 to large FMI that the ECB directly oversees. We expect the SSM to develop an assessment framework on cyber resilience similar to the CROE for those banks that it directly supervises. This means that large banks operating in the Eurozone can eventually expect to be subject to a similar degree of scrutiny as their counterparts in the UK, although the focus in the Eurozone will be more trained on cyber risks rather than broader operational ones.

As supervisors make further progress on setting the level of operational and cyber resilience they expect firms to demonstrate, firms will increasingly be challenged to show that they have a sufficient understanding of their risk exposures and have invested in capabilities that enhance their resilience to disruptions. We expect that this will be particularly difficult for firms to do in areas where the risk landscape is rapidly evolving.

One such area for many FS firms is outsourcing to cloud service providers. While cloud providers will have their own security and resilience procedures, early regulatory work (including standards set by the ECB and EBA) has made clear that firms are nevertheless expected to take responsibility for the security of data put in the cloud and any outsourced processes that may be seen as critical for the functioning of key services the firm provides to its customers. Supervisors will continue to be reluctant to allow systemically important firms to move core functions onto the cloud, particularly given supervisors' limited ability to oversee and intervene with cloud service providers. An expansion of supervisory powers, such as FINMA's legal authority in Switzerland to carry out on-site inspections of third party outsourcing partners, may give authorities more confidence in allowing this transition. We also expect authorities to become increasingly wary, from a macroprudential perspective, of the concentration risk presented by the growing trend of outsourcing given the small number of cloud service providers.

In most of the work on operational resilience, international standard-setting bodies such as the FSB, BCBS, IOSCO or IAIS, will play a less prominent role than they have in the development of rules for financial resilience or market conduct. While some international standards do exist, new rules addressing operational and cyber resilience will derive from a more bottom-up process. If, as we expect, countries design their own approaches, these are very likely to diverge from approaches taken in other countries. Firms will have to monitor developments in this area closely and determine where cross-border business models or integrated services might be threatened by regulatory fragmentation. The trend that has emerged since the crisis for geographical and activity-based "ring-fencing" may soon extend to operational ring-fencing in some countries.

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Value for money



- 2019 will see a growing emphasis by conduct regulators on the economic consequences for consumers of poor value products and services.
- There will be continued reliance on information and disclosure to enhance the transparency and comparability of products, particularly in relation to costs, charges and performance.
- Where disclosure alone will not improve value for money, regulators in some jurisdictions will be increasingly willing to consider stronger remedies, including pricing interventions.
- Providers will need to demonstrate that their charging structures are clear and fair, and that their products and services represent value for money.

Regulators are increasingly looking to ensure that financial products and services deliver value for money. In the UK, this is a clear focus for the FCA. Regulators across Europe are also stepping up their scrutiny of investment fund fees, reflecting their concerns that performance does not always correlate with the level of fees charged.

2019 will see continued reliance on information and disclosure to enhance the transparency and comparability of products, particularly in relation to costs, charges and performance. Initiatives will include the publication of studies to increase investors' awareness of the impact of fees and charges on retail investment, insurance and pension products; and clarifications to PRIIPs disclosures. ESMA's work on closet-indexing may also include policy changes to improve investor disclosures. Increased consumer awareness should lead to stronger competition amongst providers and may put pressure on fees and charges as consumers learn to consider these factors in their decision making.

The impact of fees and charges on investment funds will remain a key area of focus. This will be especially true for performance fees. ESMA will produce guidance to address concerns about divergent practices across the EU in relation to performance fees, while in Ireland, UCITS funds will have to take action to remedy instances where performance fees have been improperly paid. In the UK, the FCA is consulting on requiring performance fees to be calculated net of all other charges.

Firms will need to demonstrate that their costs and charges are clear and fair and that their products deliver value for consumers. In particular, where firms charge performance fees, regulators will expect that these have been fairly calculated and the impact of them adequately disclosed to consumers. Firms should, as a first step, revisit their costs and charges disclosures as a whole and consider how they present them in a way that is helpful to consumers and allows them to make an informed choice.

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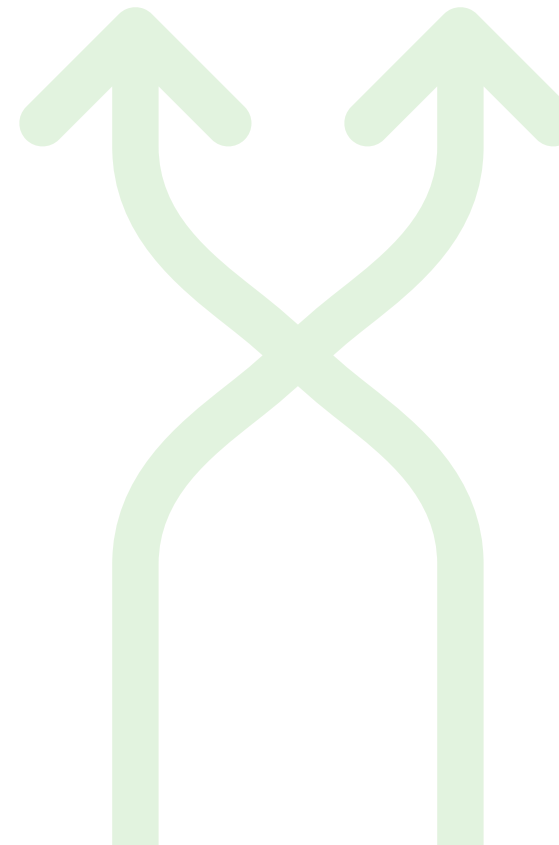
Where information and disclosure alone will not produce the outcomes they desire, regulators will be increasingly willing to reach for stronger remedies to correct poor value. Some of the strongest interventions will take place in the UK, reflecting the fact that the FCA has an objective to promote competition. Notably, in late 2019, AFMs will have to appoint a senior individual with prescribed responsibility for the assessment of value for money and publish these assessments annually. Following on from its high cost credit review we expect the FCA to introduce a price cap on rent-to-own products and to make further reforms to overdraft fees and charges. In the cash savings market it favours the introduction of a basic savings rate, which will require cash savings providers to set a default rate of interest on all savings products open for longer periods of time, whilst its review of GI pricing practices could also lead to pricing related interventions in the household and motor insurance markets. Experience of similar interventions in the UK has shown that they can radically alter the way a market operates.

Firms, particularly those heavily reliant on these products, should be modelling the impact of these potential changes on their profitability and considering whether proactive action is necessary.

Whilst we do not expect pricing interventions to be considered other than in the UK (and then only in very limited circumstances), firms offering products with demonstrably poor value may, nevertheless, struggle to justify their offering and will come under pressure to reduce charges, improve their service or move consumers to better performing products.

To be able to defend the value of their products firms will need to demonstrate, including through MI, that they are adequately overseeing the value of their products on an on-going basis and that potential harm from poor value is addressed. This will be particularly important for those with the aforementioned prescribed responsibility who will need to set out the “reasonable steps” they took to ensure that the AFM carries out an assessment of value. Certain business model features such as cross-subsidisation or price

discrimination are also likely to attract sharp regulatory scrutiny. Where these exist, firms will need to demonstrate that they do not result in certain groups of consumers being harmed.



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Supervisory constants



At the heart of supervision.

Alongside our six cross-sector themes, we have identified six supervisory constants – although not new, these will be important areas of supervisory focus in 2019.

- 1 Governance and culture
- 2 Scrutiny of the resilience of firms' business models to the changing risk environment
- 3 Firms' protection and use of data
- 4 Access and vulnerable customers
- 5 Testing for cyber vulnerabilities
- 6 Model risk management

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Governance and culture



- In their continued drive to address the root causes of prudential failure and misconduct, supervisors will focus increasingly on meaningful diversity and inclusion as a way of avoiding group think and ensuring adequate challenge within decision-making.
- Firms will need to demonstrate that their governance, risk management and control frameworks are sufficiently robust, both to identify emerging risks, and to cope with these and other risks which crystallise.
- Boards will be expected to demonstrate that they take culture seriously, that they have defined and communicated their target culture, and that they have incentivised the right behaviours at all levels throughout the firm.
- Regulatory appetite for greater board and senior management accountability is growing. Future episodes of misconduct or excessive risk-taking will lead more regulators to pursue measures to achieve this accountability

Despite concerted efforts by supervisors globally, scandals and episodes of severe misconduct continue to arise. Consequently firms' governance and culture remain top priorities for conduct and prudential supervisors who expect boards to exert clear, proactive leadership in these areas.

As part of their overall assessment of board effectiveness and firm culture, supervisors will sharpen their scrutiny of firms' approaches to diversity and inclusion. They will want to ensure that boards are not dominated by one or two individuals and that key decisions are subject to rigorous, collective debate and challenge. To guard against group think, and tokenism, firms will be expected to ensure that the board and senior management, together with the succession pipeline, are comprised of individuals from a range of substantially different backgrounds, experiences and outlooks.

Firms will need to demonstrate, at an increasingly detailed level, that their governance is sufficiently robust to identify emerging risks, and deal with these to the extent that they crystallise. Supervisors will look for evidence of a strong, independent reporting line between the board and internal control functions, and of the latter being given sufficient status and resource to perform their functions.

Supervisors, mindful of public trust issues, will look to boards to ensure that the use of technology and in particular, customer data, is subject to robust oversight and challenge, as well as being grounded in strong principles including clarity of purpose, ethical and legal oversight, and clear communication with customers.

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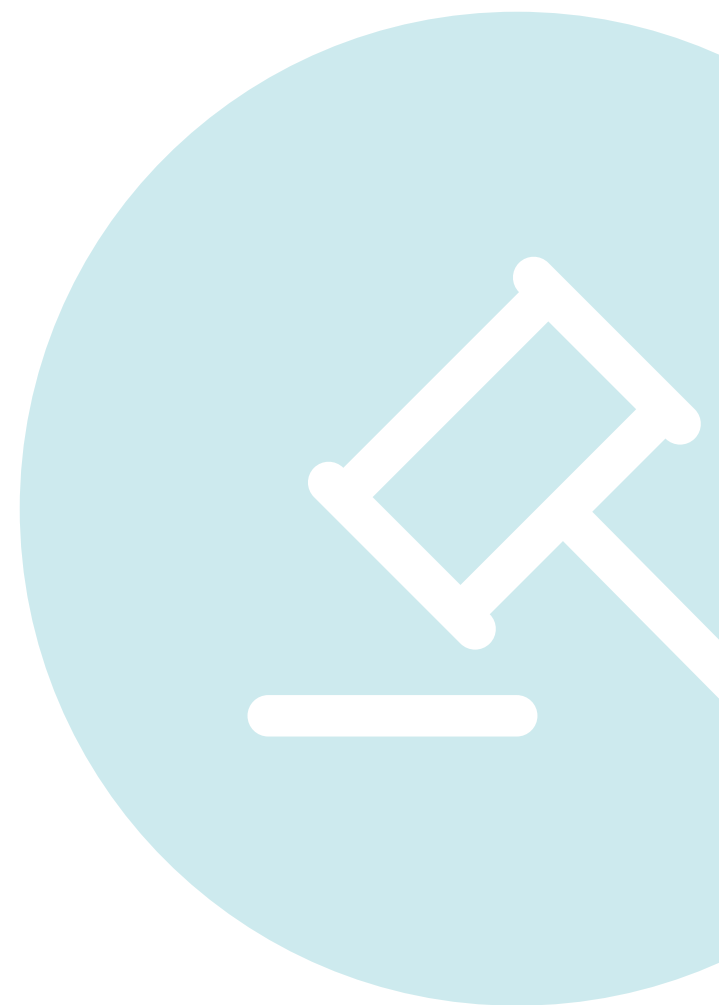
Governance and culture



Regulators look to boards to provide cultural leadership for the firm. This has been a longstanding emphasis in jurisdictions such as the UK and the Netherlands and it is gaining traction more broadly, with regulators in Ireland, Belgium, Germany and South Africa increasingly focused on firm culture. Accordingly, boards will be expected to demonstrate, including through MI, that they have defined and communicated a target culture, linked to a clear sense of the firm's purpose; and that desired behaviours are in evidence throughout all levels of the organisation, driven by appropriate incentives.

Regulatory appetite for enhanced individual accountability is growing. In the UK, the SM&CR is being extended to all firms in December 2019. In Ireland, the CBI is proposing an Individual Accountability Framework which promises to go “significantly beyond the current requirements”; while the FSB has recently published a toolkit for firms and regulators to identify key responsibilities and functions and assign them to individuals. To prepare themselves for this shift towards greater accountability, firms will need to clarify

and document the roles and responsibilities of senior managers and other key individuals, and identify significant functions. Boards should also communicate their expectations on accountability and conduct to all levels of the firm.



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Scrutiny of the resilience of firms' business models to the changing risk environment



- Vulnerabilities are building in the real economy and financial system. Supervisors exploring how these risks might crystallise will challenge firms on a range of “what-if” assumptions, focusing on idiosyncratic risks.
- Firms also face several structural risks, including from technological innovation, cyber and climate change. These risks are not new, but in 2019 we expect to see a step-up in activity as supervisors demand evidence of firms taking concrete steps to assess and address the risks.
- In light of these developments, firms should review the effectiveness of their risk management frameworks and the quality of their strategic thinking and management. Supervisors will expect to see continuing evidence of firms proactively managing risks to their balance sheets and business models. As well as posing a threat, technological innovation presents an opportunity for firms to enhance their management and monitoring of risks.

As a decade of accommodating monetary policy comes to an end and political uncertainty increases, the risk environment may be at a turning point. Vulnerabilities are building in some housing markets; household indebtedness is rising; and in some regions of the EU NPLs remain persistently high. In financial markets, there are indications of stretched valuations and increasing risk-taking - evidenced for instance by recent rapid growth in leveraged lending.

The implications of these risks will vary across firms. For example, whilst the prolonged low yield environment poses a challenge for insurers, for banks it is unclear whether higher rates will be a net benefit (due to higher revenues) or not (because of higher loan default rates). Asset managers, for which macroeconomic risks are borne by investors, need to be alert to the suitability of products, particularly illiquid assets, as performance becomes more volatile.

Financial resilience of firms has improved substantially over recent years and in general firms are well positioned for any change in the risk environment. Supervisory stress testing of capital - for example, by the EBA and EIOPA - indicates that large banks and insurers are well placed to withstand severe but plausible stresses. Stress testing of liquidity is less widespread, but the ECB plans to run a test in 2019 for the banks that it directly supervises. There are no system-wide exercises for asset managers, but some national supervisory authorities have published guidance to improve practices at the level of individual firms.

Concern has shifted to idiosyncratic risks. Supervisors expect boards to attend to risks that are not or may not be fully captured in supervisory-led exercises and firms will increasingly be challenged on a range of “what-if” assumptions.

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Scrutiny of the resilience of firms' business models to the changing risk environment



Supervisors' expectations of risk management frameworks, monitoring of risks and the involvement of the board will continue to evolve. Supervisors will examine the effectiveness of risk management frameworks and the quality of strategic thinking. Above all, supervisors will emphasise the quality of debate within firms about risks and their response to them. They will expect to see continuing evidence of firms proactively managing risks to their balance sheets and business models.

Firms also face several structural risks. These risks have been debated for several years, but in 2019 we expect to see a step-up in activity as supervisors demand evidence of firms taking concrete steps to assess, address and respond to them. Cyber and climate change risks are discussed elsewhere in this report. There are also structural risks from technological innovation - both the risk from competition, and execution risk from the adoption of new technologies as firms transform their operations and adopt digital strategies.

At the same time, technology also presents an opportunity for firms. For example, various RegTech tools being developed could be used to enhance firms' management and monitoring of risks, and in turn improve their resilience..



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Firms' protection and use of data



- Preventing loss of trust over firms' use of consumer data is a top priority for supervisors, particularly in the context of technological innovation.
- GDPR and PSD2 will give supervisors both the reasons and the tools to take a closer look at firms' use of consumer data.
- Firms should focus on embedding data risk management fully into their digital and innovation strategies, in line with the letter and the spirit of GDPR and other relevant consumer protection rules.

Monitoring the use (and misuse) of data will continue to be a priority for EU and UK policy makers and supervisors. They have made clear that the scrutiny of wholesale processing of consumer data will only continue to intensify in 2019, especially in the context of innovative data-driven technologies and business models.

The increasing focus on firms' use of data is not new, but there will be two major changes in 2019.

First, GDPR and PSD2 will give supervisors compelling reasons, as well as the tools, to take a much closer and more systematic look at firms' use of consumer data. Scrutiny will come from both FS supervisors and data protection authorities, but in many EU countries data protection authorities are still gearing up for post-GDPR supervision and are not operating at full capacity yet. Partly to address this, in the UK, the FCA and the ICO are re-doubling efforts to coordinate and cooperate effectively, but this is not the case in most other EU Member States.

Overall, supervisors will want to understand the impact of AI and other Big Data technologies on data protection, competition, pricing, fair customer outcomes, vulnerable customers, and financial exclusion.

Second, particularly in the UK, FS supervisors are keen to prevent a "Cambridge Analytica moment"⁹. Loss of trust over the FS sector's use and protection of consumer data would inflict significant damage to the reputation of both firms and supervisors, and could undermine regulators' support for beneficial FinTech innovation.

Trust should be considered as a strategic asset by firms and be at the heart of any sustainable data-driven business model. In 2018 the focus has been mostly on minimum GDPR compliance. In 2019 firms should focus on embedding both the letter and the spirit of GDPR – specifically leading practices in data mapping and management – into their digital and innovation strategies.

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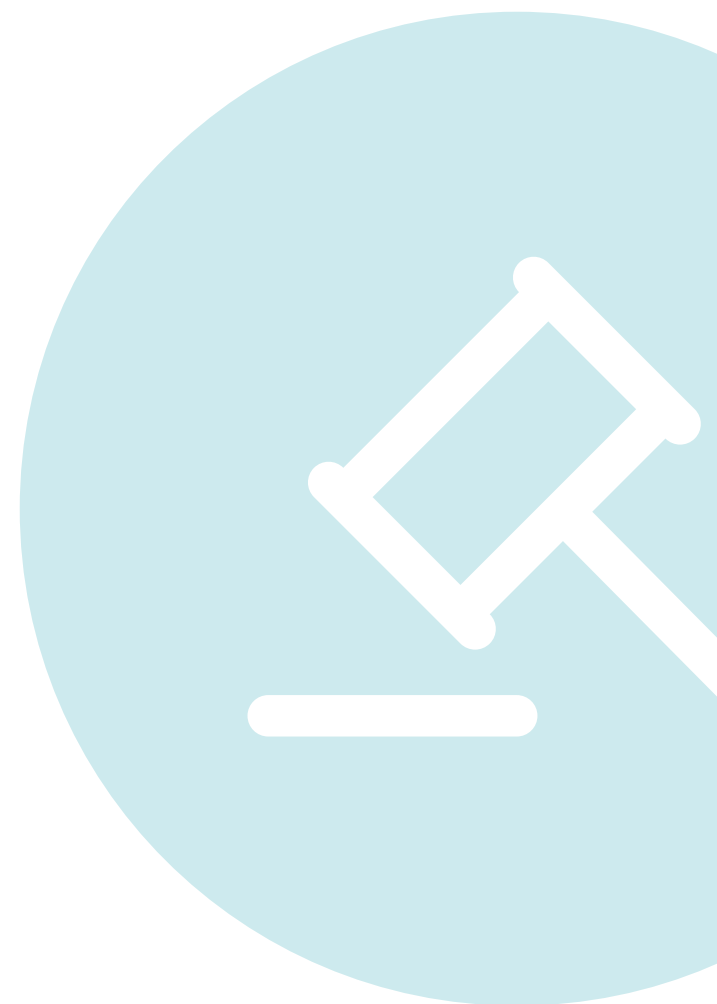
Data risk management is therefore key. As firms develop new “digital journeys” supported by Big Data/AI applications, they will need to understand how the use of these technologies affect their overall risk profile. This includes ensuring that the existing governance and controls in relation to gathering, using, storing and protecting data are delivering the right outcomes. For example, firms should have a clear view of the risks of using external data sources (e.g. social media) for profiling consumers or metadata (e.g. location information). Firms should also consider the implications for vulnerable consumers of using these technologies, and take steps to ensure they do not lead to a loss of access or financial exclusion.

This risk should be considered in the firms' risk appetite framework and risk measurement, including for regulatory capital purposes.

Where genuine challenges exist in identifying, measuring, or mitigating data risks – including outstanding challenges in reconciling PSD2 and GDPR requirements, supervisors will be prepared to listen. In the UK, the ICO

is consulting on the creation of a new regulatory sandbox to support firms using data in innovative ways, although we do not see signs of other EU data protection authorities following suit. Nevertheless, proactive engagement with supervisors about industry-wide challenges, as well as individual firms' approaches, will be essential for firms to develop an appropriate data management strategy.

Finally, as policy makers and regulators increasingly consider data usage from an ethics perspective, firms too will need to consider the ethical implications of using consumer data throughout the lifecycle of the development and delivery of products and services.



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Access and vulnerable consumers



- As firms' use of new technologies and digital distribution grows, regulators' focus on conduct and consumer protection will mean they become increasingly concerned about the potential for these developments to lead to financial exclusion amongst certain consumer groups.
- We expect the FCA's new guidance on vulnerable consumers to provide firms with a steer on how to identify and categorise them based on their different vulnerabilities, and highlight what sort of actions firms can take to ensure they are treated fairly.
- A variety of EU supervisors will look to assess firms' steps to safeguard elderly and vulnerable consumers as part of their MIFID II suitability assessments.

While the term "vulnerable consumer" is mainly used in the UK and Ireland, where the FCA and CBI have incorporated vulnerability into their consumer protection frameworks and business as usual supervision, other EU regulators often share similar concerns, even if they do not use the term "vulnerability".

Concern about financial exclusion will mean that regulators will continue to scrutinise the levels of access that more "vulnerable" groups of consumers have to FS products and services. Supervisors will also focus on firms' policies and practices to ensure that vulnerable consumers - whom the FCA defines as those who are "especially susceptible to detriment" - are not put at risk by poor firm conduct.

A number of regulators have expressed concern that less digitally savvy consumers may struggle to access FS products as firms continue to adopt new technologies and embrace digitisation. In Finland, concerns about digitally-driven financial exclusion led the Finnish Parliament to extend EU directive 2016/2102 to cover FS firms. The directive,

which ordinarily only applies to public sector bodies, aims to ensure that all websites and mobile phone applications are designed to be universally accessible, including to those with disabilities. The Finnish FSA will consequently be looking to ensure firms' websites and mobile applications are easily accessible by those with disabilities.

These concerns around technology-driven exclusion are not only related to how consumers access services, but also to firms' use of new technologies. Both EIOPA and the FCA are looking at firms' use of Big Data in general insurance markets, and we expect them to voice concerns about the potential for data-driven price discrimination to lead to financial exclusion and access problems. These studies could also lead to new requirements for firms to be more transparent in how data drives their prices, and possibly restrict some types of non-risk-based pricing.

In the UK, the FCA will expect firms to look at the needs of vulnerable consumers when developing their digital offerings, and ensure that any automated tools and AI-

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driven systems are capable of detecting, and delivering fair outcomes for, vulnerable consumers. The UK's Treasury Committee has also launched an inquiry into the level of access consumers have to financial services, with a particular focus on vulnerable customers. This will report in 2019.

The FCA has said it will publish new guidance on vulnerable consumers early in 2019. We expect the guidance to give firms a steer on how to identify vulnerable consumers; categorise them

based on their different vulnerabilities; and highlight what sort of actions firms can take to ensure they are treated fairly. We also expect the FCA's market studies and wider supervisory programme to continue to scrutinise firms' business models for features and structures that may lead to the unfair treatment of vulnerable consumers, and for the treatment of vulnerable consumers to feature more holistically across the FCA's forthcoming work. The CMA is also incorporating vulnerability into its programme of work.

ESMA's adoption of updated MiFID II suitability requirements guidance in June 2018 will prompt supervisors across the EU to assess firms' application of these guidelines in 2019. The guidance stipulates that firms should collect more information on "potentially vulnerable clients (such as older clients could be) or inexperienced ones" and supervisors will look to test whether firms take appropriate steps to safeguard these consumers.

Figure 4: Firms should be aware of a wide variety of factors which may make consumers vulnerable. In Europe:



There are 10.5 million people living with dementia¹⁰



1.3 million people die of cancer every year¹¹



28% of people aged 15-64 reported a longstanding health problem or a basic activity difficulty, or both¹²



19% of the population is aged over 65, expected to grow to 29% by 2060¹³

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- Cyber “red-team” testing will become more widespread in 2019, with more jurisdictions beginning to adopt the practice.
- The rollout of red-team testing in the Eurozone will follow the ECB framework, but national authorities will implement it unevenly across geographies and sectors.
- UK authorities will extend their existing CBEST red-team testing programme to a broader group of firms, potentially including more insurers and asset managers.
- Pressure will grow for more international coordination in the cyber risk testing of financial firms, potentially prompting the G7 to produce high-level principles.

Authorities are moving to embed cyber red-team and scenario testing into their approach to supervising firms. While these tests have, thus far, been piloted in many jurisdictions, 2019 will see important work to normalise them, extend their scope to additional firms, and increasingly coordinate their delivery across jurisdictions.

In 2019, we expect some national authorities in the EU to begin conducting the first tests under the ECB’s new threat intelligence-based ethical red-team testing (TIBER-EU) framework. Since the TIBER-EU framework is optional for national authorities and can be applied to any kind of firm, the scope of these tests will not be immediately clear and firms will have to keep close track of which EU jurisdictions lead with the first tests and how. Although we expect FMIs and large banks to be the first in line, all firms should now see this as a leading practice.

In the UK, where the initial phase of the BoE’s CBEST cyber vulnerability testing is mostly complete, the next iteration of these tests will be more closely aligned with the ongoing supervisory work of the PRA and FCA.

We also expect that CBEST will be extended in 2019 to cover a larger group of firms, which may mean that some insurers and asset managers not previously included in the CBEST exercise could be brought into the fold.

The most interesting new addition to the cyber testing landscape in 2019 will be the introduction of the FPC’s scenario-based cyber stress test. The FPC has announced that the pilot-phase of this test in 2019 will be done with a scenario, jointly-developed with the UK National Cyber Security Centre, which simulates a cyber attack interfering with the UK’s payments infrastructure. Although authorities have good cause not to reveal publicly any vulnerabilities identified by these tests, firms should nevertheless expect the pressure that supervisors place on them to increase substantially as these tests begin to show a more granular picture of where they can improve.

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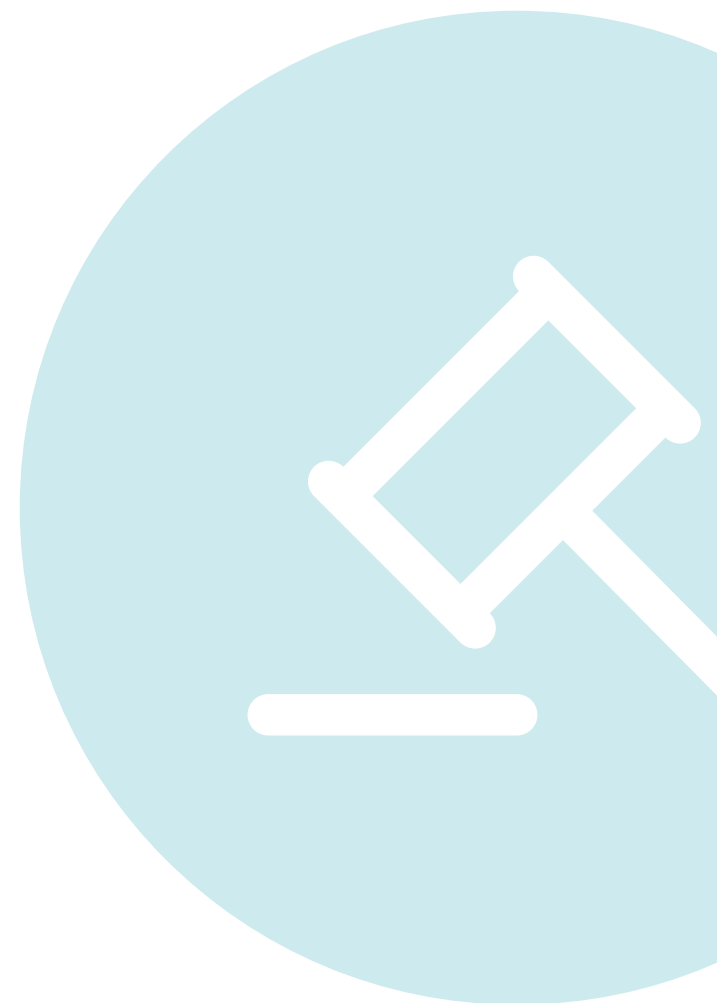


In parallel to the deepening engagement of supervisors in addressing cyber vulnerabilities, firms should also expect growing interest from the market, which will be aware of the ongoing tests even if the results are not disclosed. Any suspicion that a firm is ill-equipped to protect itself or its customers from a cyber-attack could prompt investor pressure or action from credit rating agencies, which have indicated their growing interest in the cyber resilience of the firms they rate.

At the international level, few standards exist to ensure consistency between cyber testing regimes in different jurisdictions. This is clearly sub-optimal as cyber attacks do not stop at national borders and neither do many of the core functions or services provided by cross-border firms. In 2019, we expect the G7 to make an effort to address this through the publication of high-level guidelines for the development and use of cyber vulnerability testing in financial institutions.

This framework may also include a mechanism, similar to the TIBER-EU process, whereby national authorities conducting such a test on a cross-border firm can recognise the results of a similar test carried out by an overseas authority on that same firm using a common set of standards and practices.

On a much more limited basis, we expect growing awareness of the importance of international coordination to prompt financial authorities in key jurisdictions, including the US, EU and UK, to carry out cross-border cyber attack simulations, similar to the UK-US Operation Resilient Shield exercise in 2015. This will not only allow authorities to assess the cyber resilience of firms better, but also to improve cross-border coordination between supervisors and security agencies in the event of a large-scale cyber incident.



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Model risk management



- Supervisors continue to want firms to improve their understanding of the strengths and weaknesses of models used for regulatory capital calculations and strategic decision making; and the governance and oversight of such models.
- Firms will need to demonstrate continuous improvement in senior management and board understanding of models, and ongoing improvements in the processes and teams conducting oversight and challenge of both the models and their outputs.
- Firms will need to apply model risk standards, oversight and governance to a broader range of existing financial models such as IFRS 9 and IFRS 17 reserving models, as well as other model-like algorithms and approaches to managing non-financial risks.

Figure 5: Benefits of model approval for banks - PRA data



Source: Policy Statement: The PRA's methodologies for setting Pillar 2 capital, December 2017

Model risk management remains a priority for supervisors and a challenge for firms.

Supervisors want firms to demonstrate that senior management and boards properly understand the strengths and weaknesses of models and how these affect the use of model outputs in decision making.

Supervisors expect firms to have rigorous review, challenge and governance processes, and apply a sceptical view of models and their outputs. A particular area of focus for supervisors is the governance of model changes, and ensuring that model outputs do not “drift” toward lower capital requirements¹³. In order to achieve these supervisory aims, supervisors in the EU are likely to issue further clarifying standards.

On the banking side, the TRIM programme will continue, with the emphasis shifting toward lower-default portfolios in 2019, and there will be further updates to the ECB's guide to internal models, leading to further systems and model revision work for banks subject to the TRIM.

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On the insurance side, EIOPA is committed to undertaking ongoing consistency reviews of internal models, and to completing such exercises more quickly in future. EIOPA's reports and recommendations to national authorities will increase pressure for more rigorous consistency measures (similar to Basel III) to apply to Solvency II insurers.

In order to meet stakeholder expectations that poor understanding of model processes, weaknesses or outputs does not lead to outcomes that result in further regulatory sanctions, and in the face of ongoing cost pressures on all functions, firms are seeking to standardise and achieve economies of scale in their model risk management functions.

To meet supervisory and wider stakeholder expectations, we believe firms will need to:

- continue to enhance senior management's and boards' levels of technical understanding of the models that drive both regulatory requirements and strategic decision making;
 - apply model risk standards, oversight and governance to a broader set of existing models (e.g. IFRS 9 and IFRS 17 reserving models, in particular the expert judgement aspects) and a wider set of operational processes and approaches, for example AML processes, or asset allocation algorithms;
 - demonstrate continuing improvements to the challenge and governance of both models and their associated outputs;
 - expand the role of model risk management teams/functions to cope with the broader range of algorithms and allow for improved efficiencies of scale; and
- standardise approaches to model development, validation and oversight, so that the most material models are most closely governed, but also so all models that give rise to material risks (and associated supervisory scrutiny) are subject to appropriate challenge.

Industry leaders are already implementing these changes: bringing in specialists to join or advise the board and increase the challenge to models at the highest levels in the organisation; widening the definition of a model, and broadening model oversight and governance; and setting up centralised model risk management functions, allowing for scale efficiencies and ensuring consistency of standards. 2019 will see these trends become more widely adopted.

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Relative ranking

The chart to the right aims to show the likely impact of our cross-sector and banking-specific themes on a hypothetical large, multi-business line bank operating on a cross-border basis. We considered the impact these themes would have across two dimensions - corporate strategy and operations - giving each a score on a five-point scale. The chart indicates the extent of change on each of these dimensions. The impacts on any individual bank will vary significantly. However, our view is that presenting the impacts in this way will prompt debate among boards and senior management about what they mean for their firm and the extent their firm differs from the average.



When two or more regulatory themes are very close to each other, these regulatory themes are ranked the same

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- The EU's CRD V/CRR II banking package will be finalised in 2019, clarifying the implementation of many prudential initiatives; progress will be made on plans to complete Basel III in the EU, but legislation will not be proposed until 2020.
- The BoE will continue to push banks to be more resolvable, including using public disclosure of resolvability assessments.
- Despite finalisation of the BRRD in 2019, firms will lack clarity on the implementation of MREL and TLAC standards.
- The ECB will push Eurozone banks to incorporate their Pillar 2 assessment methodologies into internal risk management.
- The EBA will prepare to take on EU-wide authority to police AML in banks, although formal authority may not come until 2020.
- The inclusion of virtual currencies in AMLD V will bring some clarity to the market and help make the EU more competitive as an innovation hub.

European banks continue to face significant pressures in relation to their profitability; despite improving macroeconomic conditions the gap in their performance relative to their US counterparts remains wide. There is broad consensus that the European market would benefit from a degree of consolidation. The Banking Union was expected to foster consolidation, but it is notable that Eurozone M&A activity, particularly cross-border, has been on a steady downward trend since the crisis. This calls into question the continent's competitive landscape, and whether the institutional and regulatory structure of the Eurozone's banking market is working as anticipated.

While European banks have continued to improve their capitalisation and addressed long-leftover vulnerabilities from the crisis, their profitability continues to make implementing new (capital) regulation a challenge. Perhaps motivated by the competitive threat from foreign banks, European policy makers are more cognisant of this problem than before.

It will fall to them to carry out a balancing act between applying Basel III in full, while simultaneously trying to avoid derailing the recovery of the sector.

Prudential

2019 will see progress in the finalisation of the post-crisis bank capital framework, albeit many implementation dates will extend beyond 2021/2022.

We expect the EU to put the finishing touches to the nearly-agreed CRD V/CRR II banking risk reduction package in early 2019.

The EU will also make progress in developing the next legislative proposal on bank prudential rules, CRD VI/CRR III, implementing the package of measures agreed by the BCBS in December 2017.

Although this will not be proposed until 2020, the European Commission must make many of the key decisions in 2019 over how far it is willing to diverge from the Basel framework to accommodate EU market specificities. As we

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have seen in the EBA and BCBS 2018 Basel III assessments, the package has a greater effect on European banks than their US peers, with an estimated Tier 1 capital increase for EU G-SIBs of 25.4%.

This will lead to significant industry and potentially political pressure to diverge from Basel standards, with the SMA for operational risk and output floors likely to be particular targets.

The EU has shown willingness to diverge from Basel, as is being demonstrated by its likely decision not to adopt a binding capital framework in CRR II for the FRTB. Work scheduled in 2019 by both the EBA and the ECB to address inconsistencies in bank risk modelling may mitigate the need for EU authorities to apply fully the BCBS measures that target these issues, particularly the standardised output floor. We expect to see indications of the EU's likely areas of divergence in implementing Basel III in the EBA's mid-2019 response to the Commission's Call for Advice on the matter.

As clarity on the EU's approach to Basel III implementation emerges, firms will need to

respond by ensuring their regulatory change programmes are set up to deliver against the evolving requirements.

Resolvability

Ten years on from the financial crisis, public and political tolerance for providing funding to bail out troubled banks remains low, and expectations of resolvability plans will be high.

In the year ahead, the BoE will begin public disclosure of banks' resolution plans and its own assessment of UK banks' resolvability. This will drive renewed interest in how clearly and credibly banks are embedding resolvability in their businesses and operations.

The PRA's rules on OCIR apply from January 2019, and there will be significant interest in overlaps between OCIR and operational resilience. We anticipate the PRA will be looking to firms to ensure they are developing the flexibility to facilitate joined-up planning for recovery, resolution and resilience purposes. Strengthening an end-to-end understanding of systems, operational processes and

critical services will be key to enhancing a firm's capacity to plan for a wider range of contingencies.

The SRB will continue to develop its resolution capabilities alongside beginning a detailed exercise to identify impediments to resolvability in banks. The SRB has expressed concern in particular about the impediment that retail holdings of MREL pose to bail-in. The SRB – or other resolution authorities – may consider imposing MREL add-ons to mitigate this risk. Given, in addition, the complexity of the amendments made to the CRR II and BRRD during negotiations, we expect uncertainty around the interpretation of the new MREL requirements to continue into 2019.

In 2019 work will continue on developing valuation capabilities to support resolvability, ahead of the need for firms to comply with the BoE's valuation policy by January 2021. We expect there to be two areas of focus.

First, firms' enhancement of their existing valuation capabilities to produce the four resolution bases, building on what has been

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developed for IFRS9, solvent wind-down or prudential valuation. Second, assessment of the scope of valuation work required for specific business types. In addition, we expect co-ordination between supervision and resolution staff to increase, in order to maintain pressure on banks whose efforts are seen as inadequate.

ICAAP, ILAAP, SREP and stress testing

The ECB's new guidelines on the ICAAP and ILAAP will emphasise the need to embed and integrate the ICAAP and ILAAP into banks' wider risk management and business decision-making processes.

Meeting the ECB's expectations in this regard will be more complicated than it may initially seem, as many banks separate the activities of running the balance sheet and managing risk. Bringing these two functions together will require banks to re-think the governance structure of their internal risk management activities. With this in mind, we expect the ECB to launch a horizontal review of how banks

embed the ICAAP and ILAAP in their wider risk management frameworks. In particular, we believe that supervisors will challenge boards to show that they have engaged on this topic.

Despite the progress made by the European Commission in 2018 on introducing legislative measures on minimum provisioning requirements for new NPLs, we do not expect the package to be passed prior to the 2019 European Parliament elections.

However, banks will still need to adjust to the ECB's new Pillar 2 provisioning expectations for new NPLs. In addition, we expect the ECB to propose Pillar 2 provisioning expectations for existing stocks of NPLs, which will maintain European banks' focus on their NPL reduction programmes.

Financial crime

Recent high profile AML/CFT failings affecting a small number of banks in the EU are a stark reminder of how financial crime remains a risk for firms and a focus for supervisors and legislators.

The intensification of AML/CFT efforts in the EU will also be seen in the Middle East, where FATF reviews are scheduled for the UAE, Qatar, Oman and Kuwait in 2019, which will in turn drive national risk assessments and industry wide AML reviews across these countries.

At the EU level the coming year will see two critical developments. First, in 2018, the EC proposed a number of legislative and non-legislative measures to entrust AML/CFT responsibilities to the EBA. As a result, the EBA, as a last resort, will gain the authority to investigate and give direct instructions to banks to take action on financial crime. However, due to an already busy legislative agenda and upcoming elections for the European Parliament, measures for entrusting these responsibilities to the EBA are unlikely to be adopted quickly.

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Second, virtual currency exchanges and custodian wallet providers will be brought into AMLD V. At the international level, we also expect the FATF to agree AML/CFT standards for virtual currencies and crypto assets. AMLD V's extension to virtual currencies will provide some clarity about the regulatory framework. This may encourage more financial firms to add virtual currencies and crypto assets to their product offerings. The transparency created by AMLD V in virtual currencies may also enhance the EU's competitiveness as an innovation hub.

In the UK, the joint HMT, FCA and BoE Crypto assets Taskforce published its final report in October 2018. Under the proposals set out in the report, in 2019 the UK government will legislate on a comprehensive response to the use of crypto assets for illicit activity, which promises to go significantly beyond the requirements set out in AMLD V. Clarification of the regulatory perimeter for crypto assets, which is expected imminently, will support firms' management of these requirements.

In order to prepare for these developments, banks that are developing new offerings relating to virtual currencies and crypto assets should perform risk assessments to tailor their policies and procedures to ensure they can fulfil AML/CFT obligations. Given the rapidly-growing scope and costs in this area, banks have a renewed impetus to develop a better understanding of their customer's financial crime risks. New technologies, including AI, may be particularly powerful tools to this end.



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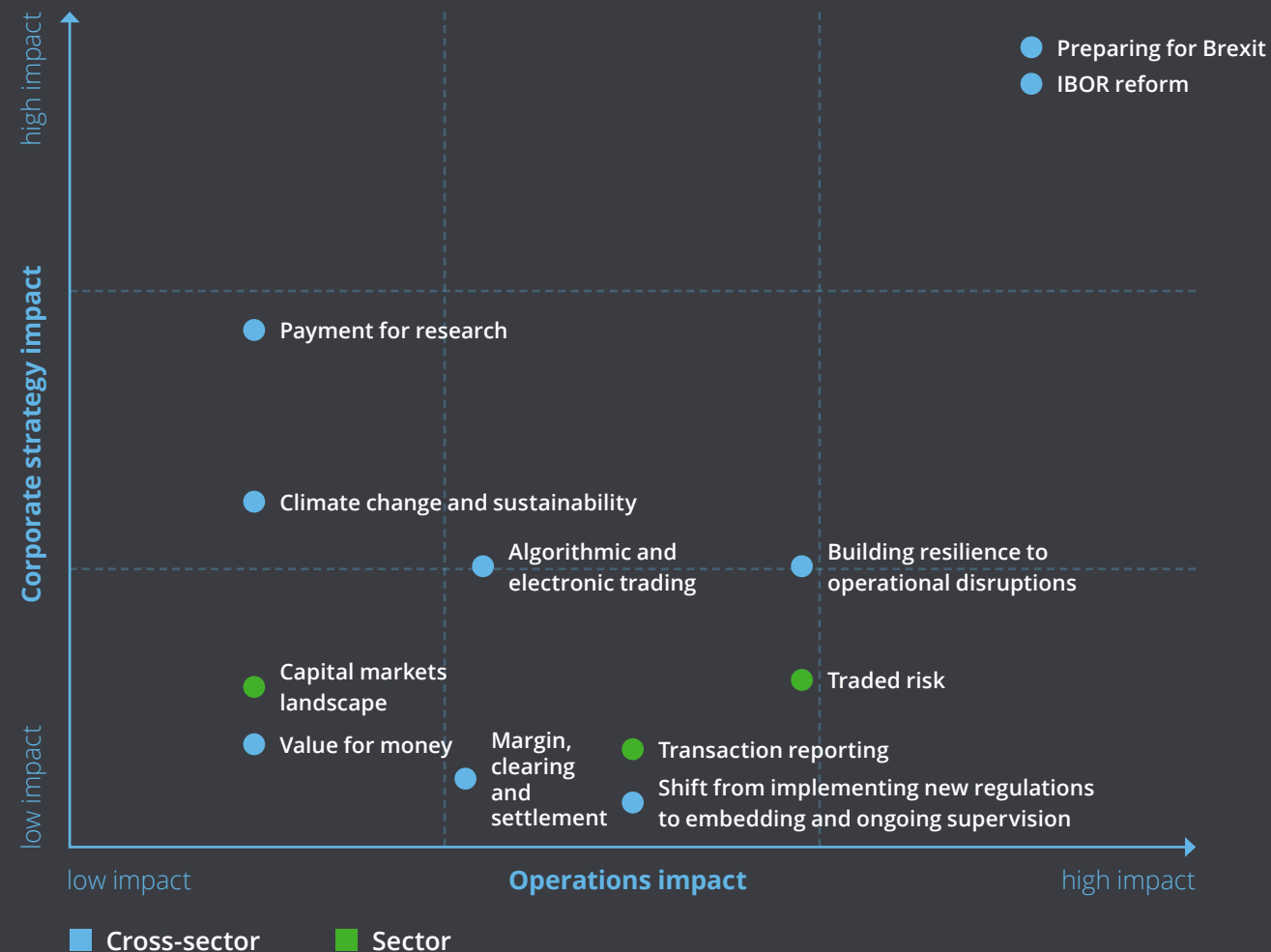
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Relative ranking

The chart to the right aims to show the likely impact of our cross-sector and capital markets-specific themes on a hypothetical large, multi-business line capital markets firm operating on a cross-border basis. We considered the impact these themes would have across two dimensions - corporate strategy and operations - giving each a score on a five-point scale. The chart indicates the extent of change on each of these dimensions. The impacts on any individual capital markets firm will vary significantly. However, our view is that presenting the impacts in this way will prompt debate among boards and senior management about what they mean for their firm and the extent their firm differs from the average.



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- The full benefits of the increase in market data post MiFID II have not yet been realised. Despite this, supervisors will focus on how firms use the increased data to achieve best execution.
- We expect algorithmic trading to increase as more trading moves onto venues and firms focus on reducing costs. Given the detailed rules and expected supervisory scrutiny in this area, firms should focus on algorithm governance and controls.
- The MiFID II inducement rules for investment research will lead to some research providers reducing their research coverage or exiting the market
- Supervisors will require remediation work on MiFID II transaction reporting in 2019. Effective governance and controls are essential so that as businesses evolve they ensure complete and accurate reporting.
- It is almost certain that the FRTB will be implemented in the EU as a reporting requirement first and firms will need to consider what a two-phase

FRTB introduction means for their implementation plans.

- Firms will need to start preparing for the final stage of IM phase-in under EMIR, which will bring far more counterparties into scope.

Capital markets landscape

The CMU was launched in 2015 with the aim of achieving a deeper, more integrated, and more diversified capital market in the EU. Despite a delivery deadline of 2019, we do not expect the majority of initiatives to have entered into force before the European Parliament elections (see figure 6).

MiFID II aims to increase market transparency, but its full benefits have not yet been realised. First, no CTP has yet emerged. MiFID II provides ESMA with the ability to appoint a CTP under certain conditions and we expect this work to kick-off in 2019. Second, there are concerns about the high costs and poor availability of market data. We expect ESMA to address this in 2019.

Despite these limitations, we expect supervisors to look at how firms are using the increased data, particularly in relation to fixed income, to enhance best execution. Firms should use the available data to assess a number of risk areas, such as price, execution quality, market impact, and market liquidity. Firms will invest in enhancing order management systems to utilise their own data, as well as data from APAs, and will look at vendor services, for example, on TCA. In addition, we expect supervisors will scrutinise the next round of Top 5 Execution Venue (RTS 28) reports due in April 2019. While last year's reports were on a best efforts basis, already they have shown that many firms execute via closely-linked parties or with a small number of brokers per asset class. Firms should review the execution venues they use regularly and consider any unexpected trends, and analyse competitors' reports.

Algorithmic and electronic trading

MiFID II has increased venue trading, meaning more electronic trading and more opportunity for algorithmic trading. We expect this trend to

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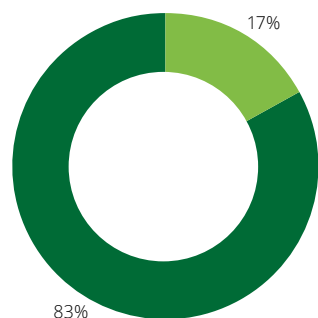
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Figure 6: CMU legislative initiatives and priority actions



Proposed or in-progress work:

- Common Consolidated Corporate Tax base
- Restructuring, insolvency and discharge proceedings
- Pan-European Personal Pension Product
- ESA's review
- Prudential Requirements for Investment Firms
- Third-party effects of cross-border assignments of claims
- Sustainable finance
- FinTech
- Covered Bonds
- Cross-border distribution of collective investment funds
- Credit servicers, credit purchasers and the recovery of collateral
- SME markets
- EU support for local capital markets
- Intra-EU cross-border EU investments

Adopted legislation:

- European Venture Capital Funds Regulation
- Prospectus Regulation
- Securitisation Regulation

Source: *Completing the Capital Markets Union by 2019 – time to accelerate delivery, March 2018 (updated as of October 2018)*

continue as firms focus on reducing costs and achieving best execution.

MiFID II introduced extensive rules on algorithmic and high-frequency algorithmic trading, based on existing ESMA guidance. We expect algorithmic trading to be a supervisory focus area in 2019, especially for the PRA, FCA and Spain's CNMV.

To address the risks, firms will have to focus on the governance and controls of algorithms and be able to demonstrate to regulators that they understand the algorithms they use, have stress tested each individual model and subjected them to a robust approval process.

Payment for research (also covered in the Investment Management section)

The changes in inducement rules for investment research brought about by MiFID II have led investment banks to turn their research divisions from cost centres to profit centres. This increased commercial focus will necessitate strategic decisions about the

banks' areas of coverage, and some banks may choose only to maintain research capabilities in their areas of strength. With a reduction in the overall volume of research consumption by investment managers, some research providers may choose to exit the market, which could dampen competition.

Transaction reporting

Transaction reporting was a key focus in MiFID I. Twelve firms were fined £33m for breaches in reporting by the FCA and further fines were levied across the EU. With the greatly expanded rules under MiFID II, there are even more pitfalls. Our survey of ten EU regulators revealed that six are currently undertaking or planning supervisory activities on MiFID II transaction reporting. We expect that supervisors will require remediation work in 2019. Firms should undertake reviews as soon as possible to ensure compliance and focus on the root causes of poor data quality. They should ensure they have a strong governance framework and process to manage exceptions, as well as effective MI.

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We expect EMIR 2.1, which makes revisions to reporting rules, to enter into force in Q1 2019. While the proposal to remove the requirement to backload transactions will be welcomed, the much anticipated proposal that CCPs, rather than counterparties, would report exchange-traded derivatives is not likely to be taken forward.

Following delays, we expect the Technical Standards under the SFTR to have entered into force by the start of 2019. Credit institutions and investment firms will then have only a year to comply with the rules and preparation will begin in earnest (other SFT counterparties will be phased in over 21 months). Firms will need to conduct a data assessment and build new infrastructure and processes to source and capture the data internally. SFTR reporting is built on the regulatory framework laid down by EMIR and thus the two regulations share similarities. Therefore, firms should consider the lessons learned from EMIR when implementing SFTR, such as communicating effectively with counterparties to match report contents, ensuring oversight of delegated reporting, and embedding sufficient skills and knowledge in support functions.

Traded risk

The emerging CRR II deal looks set to implement the FRTB in the EU initially as a reporting requirement, through a Delegated Act published by the end of 2019. Firms will be expected to start reporting their market RWs under the FRTB SA one year thereafter. EU banks may have to move more quickly than their international peers to implement the reporting requirement, while still facing uncertainty throughout 2019 over the future shape and economics of the binding capital requirements for market risk, which are likely to be delayed by a number of years.

As many banks have been planning substantial upgrades to risk and data infrastructures for the FRTB, and for some the process may already be underway, they will now need to consider how to incorporate the early reporting requirement into their overall FRTB programmes. Doing this early will allow them to implement the framework more strategically and potentially limit the overall cost of the programmes.

As there will be a relatively short lead time to the onset of the SA reporting requirement, banks should use 2019 to start addressing the quality of their trading data, and consider what can be done to achieve better data standardisation.

Finalising CRR2 will also clarify the stable funding treatment in the EU of derivatives and repo activity under the NSFR. This will enable EU banks to start assessing their liquidity risks early and strategically plan how to adjust their funding structure. We expect the EU will seek to adopt lower stable funding requirements for these products than BCBS standards.

Margin, clearing and settlement

In the continued phase-in of EMIR IM, some new counterparties will be brought into scope by 1 September 2019. However, it is the final phase-in in 2020 that will capture nearly ten times more counterparties, even though the proportional increase in activity caught will be limited (as illustrated in figure 5 below). Industry groups have called on international standard-setting bodies to raise the threshold

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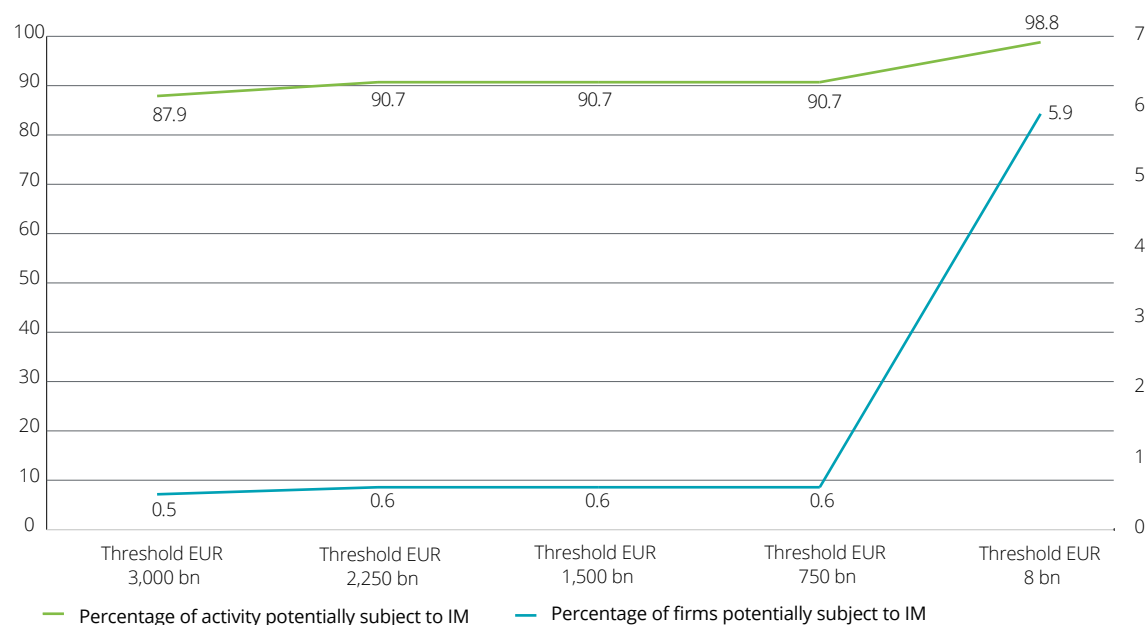
triggering compliance. Assuming no change, newly in-scope counterparties, as well as existing counterparties and custodians, will need to start preparing in 2019 for this final phase-in. Activities include establishing custodial relationships, preparing regulatory IM calculators, and negotiating and executing documentation.

We expect EMIR 2.1 to enter into force in Q1 2019 and to lead to some substantial revisions to EMIR. For example, one key proposal is the introduction of a small financial counterparty category, which we expect to be carved-out from the current Category 3. Category 3 firms falling within the small financial counterparty category would likely be exempted from the

clearing obligation that they would otherwise have needed to comply with by 21 June 2019, but would still remain subject to the margin requirements. Another key proposal is on requirements around the accessibility and affordability of clearing services. These requirements would create a greater burden for clearing service providers, which would have to adhere to specified principles, while other firms would benefit from greater access to, and potentially cheaper, clearing services.

Settlement discipline measures, which require firms to pay penalty fees and conduct a mandatory buy-in in case of security settlement delay or failure, will apply from September 2020. In 2019, banks and brokers should conduct assessments on their settlement failures and the responsible counterparties to help them understand what they must implement to minimise cost increases that could arise from the introduction of the rules.

Figure7: Aggregate impact of the margin requirements for different thresholds (FCA, 2018)



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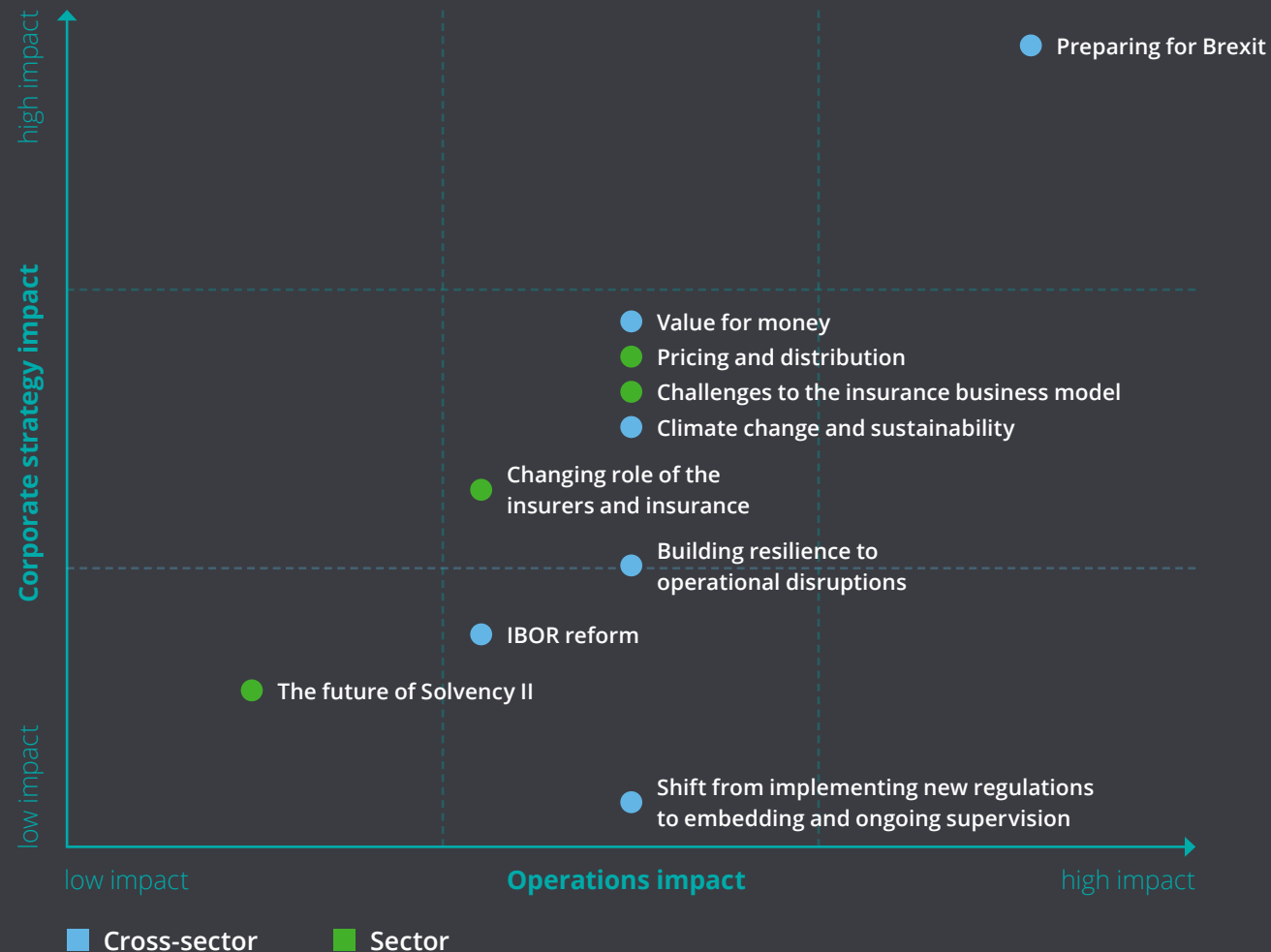
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Non-life Insurance



Relative ranking

The chart to the right aims to show the likely impact of our cross-sector and insurance-specific themes on a hypothetical large, multi-business line non-life insurer operating on a cross-border basis. We considered the impact these themes would have across two dimensions - corporate strategy and operations - giving each a score on a five-point scale. The chart indicates the extent of change on each of these dimensions. The impacts on any individual non-life insurer will vary significantly. However, our view is that presenting the impacts in this way will prompt debate among boards and senior management about what they mean for their firm and the extent their firm differs from the average.



When two or more regulatory themes are very close to each other, these regulatory themes are ranked the same

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Life Insurance



Relative ranking

The chart to the right aims to show the likely impact of our cross-sector and insurance-specific themes on a hypothetical large, multi-business line life insurer operating on a cross-border basis. We considered the impact these themes would have across two dimensions - corporate strategy and operations - giving each a score on a five-point scale. The chart indicates the extent of change on each of these dimensions. The impacts on any individual life insurer will vary significantly. However, our view is that presenting the impacts in this way will prompt debate among boards and senior management about what they mean for their firm and the extent their firm differs from the average.



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- The low interest rate environment and technological innovation will continue as the main business model challenges and drivers of change in the insurance sector.
- Supervisors will scrutinise conduct, prudential and systemic risks, heightened by changing activities and sources of profitability for insurers, including shifts into higher risk, less liquid investments and activities.
- Regulators will develop new policy responses to the changing role of the insurance sector in society in areas such as infrastructure investment, pension and care provision, and releasing housing equity for retirement funding.
- Regulators will scrutinise pricing and distribution, including InsurTech developments, and will materially strengthen their expectations in areas such as price discrimination and cross-subsidy in support of good consumer outcomes.
- The Solvency II review will sceptically re-examine the Long-Term Guarantees package and the macro-prudential features

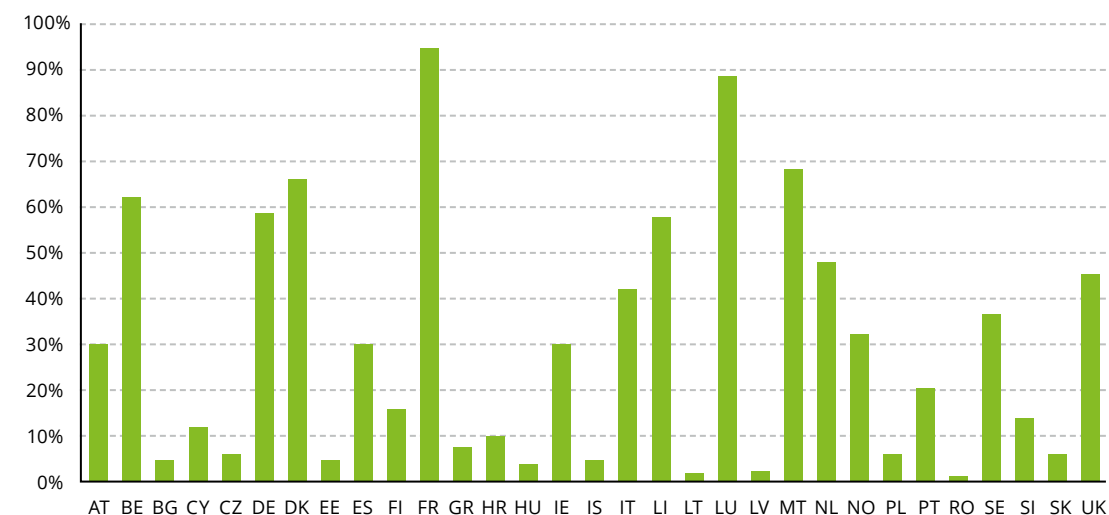
of Solvency II. In parallel, EIOPA will focus on differences in national implementation and the long-term rationale for maintaining multiple regulatory and valuation bases for insurance.

2019 will see the continuation of gradual but profound shifts for the insurance industry and its regulators. While we do not expect 2019 itself to bring fundamental changes in regulation, this should not obscure the long-term importance of

the changes underway in the sector.

Many of these changes in 2019 will turn upon the twin drivers of the low interest rate environment and technological innovation. These present the most important challenges to the profitability and business model of “traditional” insurance, and are pushing insurers increasingly towards non-traditional and innovative activities, potentially increasing credit, operational and even reputational risks

Figure 8: Insurers’ investment portfolio to GDP in % in Q4 2017



Source: EIOPA financial stability report, Spring 2018

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Business model challenges

Current low interest rates are making the core underwriting business far less profitable than in the past, while technological innovation and societal trends are changing consumers' needs and expectations of their insurers.

This is driving many in the industry to move towards alternative business models. For life business in particular, we will see a continuation of the trend of insurers competing for less capital intensive asset management-type business such as ISAs and SIPPs, and with further consolidation in some parts of the industry, in particular annuities.

For general insurance, profitability is increasingly driven by add-on and service products rather than core underwriting results. We expect this trend to be of prima facie concern for conduct regulators, which will place significant focus on topics such as the effect of the cross-subsidies generated and value for money.

The PRA has communicated with concern analysis that suggests that underwriting standards in the UK non-life sector have been progressively weakening and has given a strong indication that it will step up scrutiny of firms which continue to exhibit weak standards.

The equity release sector will continue to receive priority regulatory attention. As well as prudential challenge to firms' valuation assumptions and risk management approaches (challenges that will also be applied to other illiquid asset classes such as commercial property), we expect conduct regulators to start to turn attention back to risks such as the potential for poor disclosure and sales practices, and a lack of understanding of costs and charges particularly on the part of vulnerable consumers.

We expect 2019 to be another strong year for bulk DB pension scheme transfers and, in the absence of reform of the risk margin, to the associated off-shoring of longevity risk through reinsurance. The development of "superfund"

pension consolidators, though significant, is unlikely to affect the flow of deals for insurers in 2019.

Changing role of insurers and insurance

Regulators will need to respond to how insurance business models and products are adjusting to social change in areas such as retirement and care provision and employment patterns. We expect continuing thematic and market review activity as regulators debate policy responses, with a particular focus on vulnerable customers and the risks of their exclusion from essential products and services.

Increasingly individualised, telematics-driven and shorter-term underwriting will erode the principle of mutualised risk-pooling. At face value, this will create winners and losers among consumers. Regulatory and government policy will need ultimately to find a way to accommodate this trend whilst minimising risks of consumer detriment.

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Insurers will increasingly be viewed by governments and policy makers as a source of long-term investment capital, whether in social infrastructure or, increasingly, start-up seed funding. Regulators will remain under pressure to encourage such investments through, for example, favourable capital treatment, but will sharpen their scrutiny of insurers' management of the associated market, concentration and credit risks. Risks of systemic disruption and shadow banking will also come to the fore as the deployment of insurance capital becomes progressively less distinct from traditional bank capital.

These trends are incremental, and as such we do not expect fundamental shifts in 2019. However, insurers which are not already planning strategically for these trends risk being left behind by competitors and the market.

Pricing and distribution

We expect significant regulatory focus in 2019 on insurance pricing and distribution, in particular for non-life business, and

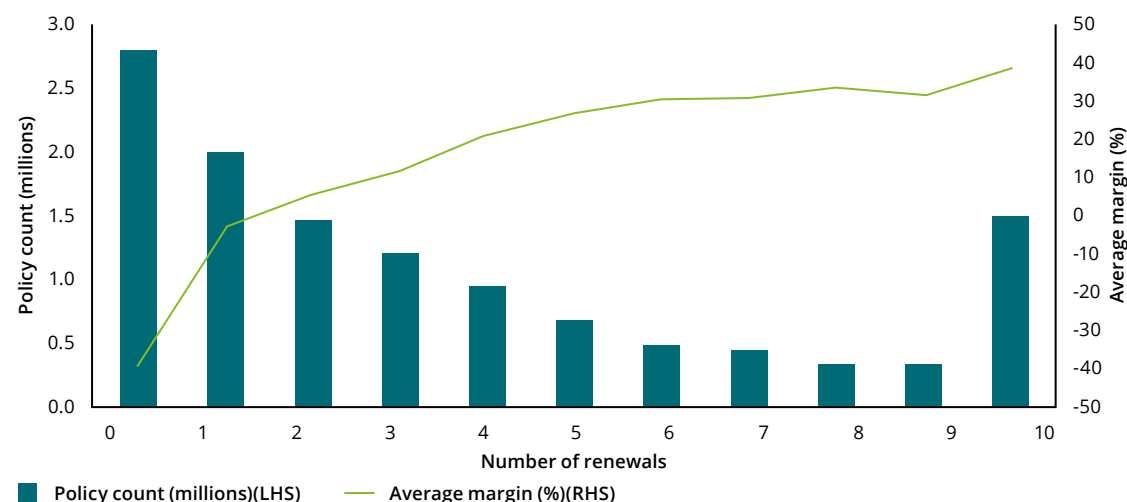
especially for as long as the low interest rate environment continues to put pressure on investment returns and increases the importance of dwindling underwriting returns.

In the UK, the FCA has already initiated thematic and market review activities on general insurance pricing, and we expect other regulators in EMEA to follow these reviews with substantial interest.

Overall we expect a material strengthening of supervisors' expectations for distribution processes and governance, with differential or discriminatory pricing, and treatment of long-standing customers, being areas of particular focus.

This scrutiny will also encompass developments in InsurTech, and how innovation is changing the interactions between consumers and insurers.

Figure 9: Policy count and average margins by number of renewals



Source: Source: David Rule, Speech, A "D to Z" of current issues in Insurance Supervision

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Supervisors will consider the impact of innovative pricing, distribution and policy lifecycle processes on consumer outcomes, including value for money compared to traditional insurance products.

On pricing, in the face of continued soft market conditions, supervisors will focus increasingly, including through stress testing, on underwriting, reserving and policy term discipline. We do not expect a turn in the pricing cycle in 2019 absent sharply higher interest rates or exceptional and unanticipated losses affecting the supply of alternative capital, keeping pricing and reserve adequacy a consistent focus of practical supervisory activity.

Whilst the IDD was formally implemented in 2018, we expect remediation work to achieve full compliance with the regulations to continue throughout 2019.

The Solvency II review

The Solvency II delegated acts have already been reviewed, and a review of the Solvency II directive is scheduled for 2020. However, its scope is proving much broader than expected, as Vice-President Valdis Dombrovskis stated in a speech in 2018:

“Turning now to the 2020 review of the Directive, this was supposed to focus on the long-term guarantee measures. But we will in fact review it more broadly. We know that the sector wants us to take a deeper look, and we will do so.”⁴

The European Commission is highly likely to issue a public call for input on the Solvency II review, and this will provide a good indication of its attitude to the future of Solvency II. In particular, we expect the Commission, post Brexit:

- to be sceptical about how well aspects of the Long-Term Guarantees package are operating, in particular, the Matching Adjustment; and

- to consider the macro-prudential features of Solvency II, although we do not expect the Commission to carry out any substantive work on recovery and resolution for the insurance sector in 2019.

We also expect to see further discussions, involving EIOPA, on how to achieve greater convergence in Solvency II implementation.

We also expect both regulators and industry to question how Solvency II, and other frameworks, will accommodate, adapt to, or interact with the IAIS’s ICS. The ICS’s five year monitoring phase, starting in 2019, should defer the need to answer these questions in the short term. However, variations between the ICS, Solvency II, other regulatory frameworks, and indeed the IFRS 17 insurance contracts standard, will be highlighted in the remaining field testing and monitoring. It will be logical for firms to question the value of maintaining multiple different regulatory and accounting valuation bases for insurance.

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Relative ranking

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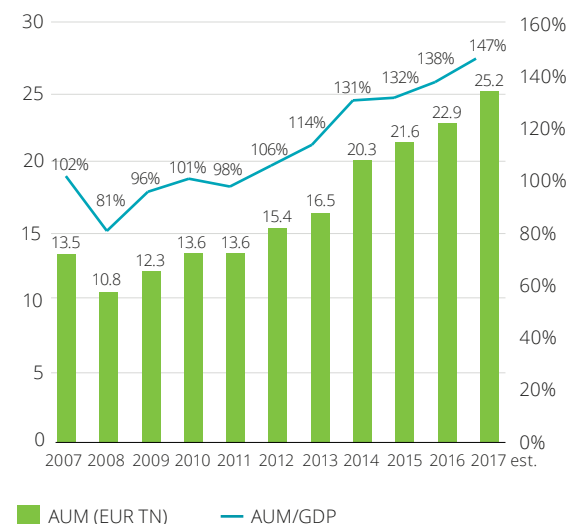
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- Transparency in fees and charges and value for money will continue to be overarching regulatory themes.
- Investment managers will apply strong scrutiny to the value of the research they receive, but will continue to want broad coverage.
- EU supervisors will expect UCITS and AIFMD firms to show greater independence in their oversight of investment managers.
- As the quality of the MiFID II target market data received from distributors matures, investment managers will be able to draw out useful commercial insights.
- Regulators will increase their scrutiny of fund liquidity management, and impose more restrictions on fund leverage, particularly for open-ended funds investing in illiquid assets.

The investment management sector is attracting increasing political and regulatory attention in line with its rising societal importance. The value of assets managed by the sector has steadily increased relative to GDP over the past decade (see Figure 10), due to a shift from bank financing to capital markets financing and an increase in asset prices driven in part by low interest rates. The growth of the sector has sharpened regulators' focus both on the value for money the sector delivers to consumers and on whether consumers invest in suitable products. It has also raised questions about whether the sector could pose systemic risks, particularly in view of the size of the biggest firms.

For example, looking at firms headquartered in the US or Europe, the three largest investment managers collectively manage assets equivalent to almost twice the collective balance sheet assets of the three largest investment banking groups. While regulators recognise that "big" does not automatically equal "systemic", and that the assets are under management rather than on balance sheet, they will continue to scrutinise whether systemic risks arise.

Figure 10: European Assets under Management (EUR TN)



Source: *Asset Management in Europe*, EFAMA, September 2018

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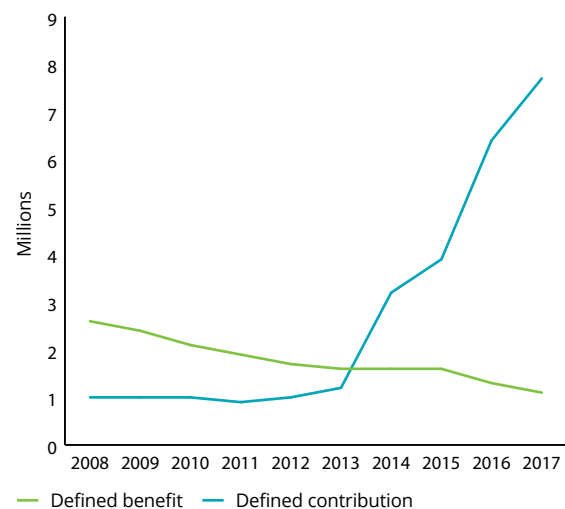
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Figure 11 illustrates the dramatic increase in the number of active members of occupational DC pension schemes in the UK, accelerated by the introduction of automatic enrolment in 2012. This has naturally led to a greater supervisory focus on value for money and investor protection.

Figure 11: Active membership of private sector occupational pension scheme by benefit structure



Source: UK Office for National Statistics

We see the key areas that supervisors will focus on in 2019 as follows.

Value for money

Value for money in retail investment products is an overarching theme. At EU level, this has translated into new investor disclosure requirements under MiFID II and PRIIPs, unbundling of execution fees under MiFID II, and scrutiny of performance fees and closet-indexing. ESMA is also assessing retail investment product disclosures. In the UK, the FCA has set out new rules on assessing the value of investment funds. For more detail, please see our chapter on **value for money**.

Payment for research (also covered in our Capital Markets section)

The investment research market is a key focus area for EU regulators following implementation of the MiFID II payment for research rules. The European Commission has issued a call for tender on a study on the impact on research relating to fixed income products and small and medium-sized enterprises. The FCA is conducting a multi-firm review of the research market. The AMF is assessing the impact of the rules as one of

its 2018 strategic priorities. Regulators want to assess both compliance and whether the outcomes they are seeking are being delivered.

MiFID II has led to a large fall in the price of research as investment managers apply greater scrutiny to its value¹⁶. Although many investment managers have significantly reduced their research consumption, we expect them to continue to want broad coverage, albeit keeping quality under continuous review.

Due to competitive pressures and the administrative burden of managing research payment accounts, the majority of large investment managers have absorbed the cost of research. Smaller investment managers, however, enjoy fewer economies of scale when purchasing research, so have had to make a difficult choice between absorbing significant costs and asking their customers to pay. This new burden for smaller firms, along with other regulatory costs and competitive pressures, is likely to reinforce the trend of consolidation in the market.

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Firms managing funds investing in small cap stocks may need to review where they source their research from as some larger sell-side firms are reducing their coverage. This can lead to reduced liquidity and increased market volatility, but may create new market inefficiencies and hence investment opportunities.

Supervisors are likely to scrutinise pricing models to ensure research is not being accepted on terms which could be considered an inducement. For example, the FCA has signalled that so-called “all you can eat” models, where a fixed price is paid for an unspecified amount of research, are more likely to be considered non-compliant.

Supervisors are also likely to look closely at how firms determine what constitutes research, and at their arrangements for sharing research across group entities in different jurisdictions where different rules may apply.

Fund governance

The delegation of investment management functions by UCITS and AIFMD firms has attracted increased scrutiny by EU regulators in the context of Brexit. In 2017, an ESMA opinion set out heightened regulatory expectations on the reasons for delegation, the amount of resources in the EU, independent oversight of the delegate, and protections for UCITS funds. In 2018, the CSSF and the CBI responded by strengthening local requirements. UCITS and AIFMD firms can expect increased supervisory scrutiny of delegation, and will need to evidence robust due diligence and independent oversight of their delegates.

In parallel, the FCA set out concerns in its asset management market study about AFMs – i.e. UCITS or AIFMD firms managing authorised funds – lacking independence from the investment manager to which they delegate. The FCA’s concerns are similar to some of ESMA’s concerns.

The FCA is requiring AFM boards to appoint at least two independent directors and for them to comprise at least 25% of the total board membership from September 2019. The FCA is also requiring AFM boards to assess whether their funds provide value for money, which will require them to reach their own, independent conclusion. Finally, the FCA is introducing a prescribed responsibility under the SM&CR for these new obligations from December 2019. Overall, the FCA wants to see AFM boards becoming more independent and evidencing robust challenge. There will be significant demand for credible independent directors, so firms should start their recruitment early.

Product governance and distribution

In 2018, investment managers started receiving target market data from distributors under the MiFID II product governance rules. To date they have mainly focussed on ensuring they receive the right level of data, but in 2019 we expect them to focus on how they can use this data to obtain useful insights on issues

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such as a product's investor base and whether the distribution strategy remains appropriate.

Several EU regulators have identified MiFID II inducements rules as a key area of supervisory focus in 2018-2019. We expect to see a particular focus on whether firms receiving inducements are providing appropriate additional services to clients and whether those services are proportional to the level of inducements received.

The Commission has reportedly supported postponing the introduction of the PRIIPs KID regime for UCITS funds from the end of 2019 to the end of 2021. The ESAs have also consulted on targeted changes to some of the rules, including performance scenarios. The ESAs are expected to submit draft RTS to the Commission in January 2019.

We expect supervisors to continue to scrutinise high-risk, complex investments. In 2018 ESMA used its new product intervention powers to suspend sales of binary options and restrict sales of contracts-for-difference to retail investors,

and it will continue to monitor the market. The FCA is expected to report on its work on high-risk, complex investments in late 2018. IOSCO recently published a report on the risks associated with retail OTC leveraged products. ESMA recently published guidelines and a supervisory briefing on the MiFID II suitability requirements, an area which several EU regulators have identified as a supervisory priority. Investment managers providing complex products should review their distribution strategy and marketing materials in the light of these developments.

The FCA has said it plans to assess the impact of the UK's FAMR and RDR in 2019. It is unlikely to row back on the main elements of these reforms, but the review will be an opportunity to consider progress against narrowing the "advice gap". The FCA continues to support firms developing solutions to deliver lower cost advice and guidance. However, in its 2018 review of automated investment services it found failings relating to disclosures, suitability assessments, client information, vulnerable customers and governance. The FCA has said that it intends to feed back on its outcomes

testing on automated advice in Q1 2019. ESMA is also continuing to monitor the development of the automated advice market following its 2018 report on risks and benefits. Overall, regulators support innovation to provide lower cost advice but are not willing to lower their standards. Consequently, for innovators compliance needs to be front of mind in formulating their overall strategy.

The FCA has said that it plans to publish a final report on its investment platforms market study in Q1 2019. The FCA is considering, inter alia, the extent to which disclosures on platforms drive competition between investment managers, and how arrangements with investment managers to secure the best fund prices affect competition. Investment managers may need to consider their pricing strategy in light of the FCA's findings and measures.

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Fund liquidity and leverage

In 2018 the ESRB published a Recommendation on liquidity and leverage risks in investment funds, following the FSB's work on potential systemic risks in this area. ESMA is expected to publish guidance on fund liquidity stress testing and leverage limits in 2019, and the European Commission is expected to propose legislation on fund liquidity management by 2020. Work at EU level is likely to take account of IOSCO's updated recommendations on fund liquidity risk management and recent consultation on fund leverage measures. The FCA is also consulting on rules to protect retail investors in open-ended funds investing in illiquid assets.

Although we are unlikely to see an EU-wide ban on open-ended retail funds investing in illiquid assets, EU regulators will increase their scrutiny of liquidity management processes and tools in such funds. They are also likely to impose more restrictions on fund leverage, particularly for open-ended funds investing in illiquid assets. To meet supervisory

expectations, firms will need to demonstrate strong governance processes, particularly in the areas of product design, fund stress testing, leverage monitoring and contingency plans for stressed market conditions.

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AFMs

Authorised Fund Managers

AI

Artificial Intelligence

AIFMD

Alternative Investment Fund Managers Directive

AMF

Autorité des Marchés Financiers (French regulator)

AML

Anti-Money Laundering

AMLD

Anti-Money Laundering Directive

APA

Approved Publication Arrangement

AUM

Assets under management

BCBS

Basel Committee on Banking Supervision

BMR

Benchmarks Regulation

BRRD

Bank Recovery and Resolution Directive

BoE

Bank of England

CBI

Central Bank of Ireland

CCP

Central Counterparty

CFT

Counter Financing of Terrorism

CISO

Chief Information Security Officer

CMA

Competition and Markets Authority

CMU

Capital Markets Union

CNMV

Comisión Nacional del Mercado de Valores (Spanish regulator)

CQS

Credit Quality Step

CRD

Capital Requirements Directive

CRR

Capital Requirements Regulation

CROE

Cyber Resilience Oversight Expectations

CSSF

Commission de Surveillance du Secteur Financier (Luxembourg regulator)

CTP

Consolidated Tape Provider

DB

Defined Benefit

DC

Defined Contribution

EBA

European Banking Authority

ECB

European Central Bank

EIOPA

European Insurance & Occupational Pensions Authority

EMEA

Europe, Middle East and Africa

EMIR

European Market Infrastructure Regulation

EONIA

Euro OverNight Index Average

ESAs

European Supervisory Authorities (the EBA, ESMA and EIOPA)

ESMA

European Securities & Markets Authority

ESRB

European Systemic Risk Board

ESTER

Euro Short-Term Rate

EU

European Union

Euribor

Euro Interbank Offered Rate

FAMR

Financial Advice Market Review

FATF

Financial Action Task Force

FCA

Financial Conduct Authority

FMI

Financial Market Infrastructure

FPC

Financial Policy Committee (part of the Bank of England)

FRTB

Fundamental Review of the Trading Book

FS

Financial Services

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FSA

Financial Services Authority

FSB

Financial Stability Board

GBP

British pound sterling

GDP

Gross Domestic Product

GDPR

General Data Protection Regulation

G-SIB

Global Systemically Important Bank

HMT

Her Majesty's Treasury (the UK's finance ministry)

IAIS

International Association of Insurance Supervisors

IASB

International Accounting Standards Board

IBOR

Interbank Offered Rate (for the purposes of this paper, the term "IBOR" is used to describe LIBOR, Euribor and EONIA)

ICAAP

Internal Capital Adequacy Assessment Process

ICO

Information Commissioner's Office

ICS

Insurance Capital Standard

IDD

Insurance Distribution Directive

IFRS

International Financial Reporting Standards

ILAAP

Internal Liquidity Adequacy Assessment Process

IM

Initial Margin

IOSCO

International Organization of Securities Commissions

IPU

Intermediate Parent Undertaking

IRB

Internal Ratings Based (approach)

ISA

Individual Savings Account

IT

Information Technology

JST

Joint Supervisory Teams

KID

Key Information Document

LEI

Legal Entity Identifier

LIBOR

London Interbank Offered Rate

LTV

Loan to Value

M&A

Mergers and Acquisitions

MI

Management Information

MiFID

Markets in Financial Instruments Directive

MiFIR

Markets in Financial Instruments Regulation

MoU

Memorandum of Understanding

MREL

Minimum requirement for own funds and eligible liabilities

MTF

Multilateral Trading Facility

NGFS

Network for Greening the Financial System

NPL

Non-performing Loan

NSFR

Net Stable Funding Ratio

OCIR

Operational Continuity in Resolution

ORSA

Own Risk and Solvency Assessment

OTF

Organised Trading Facility

OTC

Over the counter

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PRA

Prudential Regulation Authority

PRIF

Prudential Regime for Investment Firms

PRIIPs

Packaged Retail Investment and Insurance Products (Regulation)

PSD2

Revised (second) Payment Services Directive

RDR

Retail Distribution Review

RFR

Risk-Free Rate

RTGS

Real Time Gross Settlement

RTS

Regulatory Technical Standard

RW

Risk Weight

SA

Standardised Approach

SFTR

Securities Financing Transactions Regulation

SI

Systematic Internaliser

SIPP

Self Invested Personal Pension

SM&CR

Senior Managers and Certification Regime

SONIA

Sterling Overnight Index Average

SRB

Single Resolution Board

SREP

Supervisory Review and Evaluation Process

SSM

Single Supervisory Mechanism

TCA

Transaction Cost Analysis

TCFD

Task Force on Climate-related Financial Disclosures

TIBER

Threat Intelligence-based Ethical Red Teaming

TLAC

Total Loss-Absorbing Capital

TMP

Transitional Measure on Technical Provisions

TPP

Third-Party Provider

TPR

Temporary Permissions Regime

TRIM

Targeted Review of Internal Models

TRR

Temporary Recognition Regime

UCITS

Undertakings for Collective Investments in Transferable Securities

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