

Insight: Capital Markets

Autumn 2013

Financial Regulatory Update

This newsletter provides an overview of some of the main EU and UK banking, securities and derivatives markets regulatory developments during the period 1 June to 30 September 2013. For a copy of our last newsletter, click [here](#).

Banking Regulation

Basel III

The Bank for International Settlements' Basel Committee on Banking Supervision (the **Basel Committee**) has published various consultation papers and reports on aspects of the Basel III regulatory framework. These include:

[The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper](#)

This paper, published in July, discusses the reasons behind the evolution of the current Basel regulatory framework, and outlines the potential benefits and costs that arise from a more risk sensitive methodology. It discusses ideas that could possibly be explored to further reform the framework with the objective that it continues to strike an appropriate balance between complementary goals of risk sensitivity, simplicity and comparability. Click [here](#) to view a copy of the discussion paper.

[Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement](#)

In July, the Basel Committee published its methodology for assessing and identifying global systemically important banks (**G-SIBs**). The published framework also describes the additional loss absorbency requirements that will apply to G-SIBs, the phase-in arrangements for these requirements and the disclosures that banks above a certain size are required to make. The measures are intended to enhance the going-concern loss absorbency of G-SIBs and reduce the probability of their failure.

Assessment methodology for G-SIBs is based on an indicator-based approach and comprises five broad categories: size, interconnectedness, lack of readily available substitutes or financial institution infrastructure, global (cross-jurisdictional) activity and complexity. Applicable additional loss absorbency requirements will range from 1% to 2.5% of Common Equity Tier 1 (**CET1**) depending on a bank's systemic importance. There is a potential upper requirement of 3.5% CET1, which is intended to discourage banks from becoming more systemically important.

The higher loss absorbency requirements will be introduced in parallel with the capital conservation and countercyclical buffers between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019. Click [here](#) to view a copy of the methodology.

This publication is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.



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Revised Basel III leverage ratio framework and disclosure requirements – consultative document

Implementation of the leverage ratio requirement has already begun, with bank level reporting to supervisors of the leverage ratio and its components from 1 January 2013. Public disclosure will commence on 1 January 2015. Final adjustments to the definition and calibration of the leverage ratio will be made by 2017, with a view to applying the capital requirements on 1 January 2018. This June consultation paper proposes revisions to the leverage ratio framework, primarily to the denominator of the leverage ratio, the so-called Exposure Measure. Click [here](#) to view a copy of the consultation.

Capital treatment of bank exposures to central counterparties – consultative document

This joint consultation of the Basel Committee, in conjunction with the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) published in June seeks views on potential changes to the capital treatment of banks' exposure to central counterparties (CCPs). The Basel Committee published an interim standard on bank exposure to central counterparties in July 2012. Previously, such exposures had not attracted a regulatory capital charge. The proposed changes to the interim standard seek to improve on it by establishing a capital treatment that ensures banks' exposures to central counterparties are adequately capitalised while also preserving incentives for central clearing. Click [here](#) to view a copy of the consultation.

Regulatory consistency assessment programme (RCAP) – Analysis of risk-weighted assets for credit risk in the banking book

This July report presents the findings of the Basel Committee's initial analysis of Risk Weighted Assets (RWAs) outcomes for banks that have adopted the Internal Ratings Based (IRB) approach for credit

risk in the banking book. It complements the preliminary findings for RWAs in the trading book published by the Committee in January 2013 and the on-going work on RWAs for operational risk. Collectively, these findings on RWA variations will inform other work streams of the Committee including those on how to increase the robustness of the risk-based capital framework and the fundamental review of prudential requirements for the trading book. Click [here](#) to view a copy of the report.

Subsequently, in August, the European Banking Authority (EBA) published the second interim report on the consistency of risk-weighted assets in the banking book of EU banks. The report illustrates the outcomes of the next stage in EBA's review into RWA consistency in sovereigns, institutions and large corporate exposures, generally referred to as low default portfolios. The analysis is closely aligned with the work of the Basel Committee. Click [here](#) for a copy of the report.

Capital requirements for banks' equity investments in funds – consultative document

These Basel Committee proposals published in July revise the prudential treatment of banks' equity investments in funds and seek to address some of the risks associated with banks' interactions with shadow banking entities. The proposals are based on the principle that banks should apply a look-through approach to identify the underlying assets whenever investing in schemes with underlying exposures such as investment funds. However, the paper recognises that a full look-through approach may not always be feasible and that a staged approach based on different degrees of granularity of the look-through is warranted, with incentives for improved risk management practices. The proposals are due to be finalised by the end of the year. Click [here](#) to view a copy of the consultation.

Liquidity coverage ratio disclosure standards- consultative document

In July, the Basel Committee issued liquidity coverage ratio (LCR) disclosure standards for consultation. The standards contemplate a common disclosure framework and disclosure template. Click [here](#) to view a copy of the consultation.

The non-internal model method for capitalising counterparty credit risk exposures – consultative document

In June, the Basel Committee launched a consultation on the non-internal model method for capitalising counterparty credit risk exposures, outlining a proposal to improve the methodology for assessing the counterparty credit risk associated with derivative transactions. The proposal would, when finalised, replace the capital framework's existing methods, namely the Current Exposure Method and the Standardised Method.

The Basel Committee will conduct a quantitative impact study to inform the final formulation of the non-internal model method and to assess the difference in exposure and overall capital requirements under this proposal as compared to other measures of counterparty credit risk under the Basel framework. In addition to replacing the Current Exposure Method and the Standardised Method, the non-internal model method may also be used with respect to the leverage ratio, large exposures, and exposures to CCPs. Click [here](#) to view a copy of the consultation.

Margin requirements for non-centrally cleared derivatives- final document

In September, the Basel Committee and IOSCO released the final framework for margin requirements for non-centrally cleared derivatives. These require all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives to exchange initial and variation margin commensurate with counterparty risks, subject to some exceptions. The framework is designed

to reduce systemic risks related to over the counter (OTC) derivatives markets, as well as to provide firms with appropriate incentives for central clearing while managing the overall liquidity impact of the requirements.

The requirement to collect and post initial margin on non-centrally cleared trades will be phased in over a four-year period. Click [here](#) to view a copy of the final document and [here](#) to see a copy of our recent client alert on this topic.

Report to G20 Leaders on monitoring implementation of Basel III regulatory reforms

This report published by the Basel Committee in August updates G20 Leaders on progress in adopting the Basel III regulatory reforms since the previous Committee Report in April 2013. It also includes the findings of the Committee's work on banks' calculation of risk-weighted assets. Click [here](#) to view a copy.

Capital Requirements Directive IV (CRD IV)

The European Union's legislative package known as CRD IV, implementing the Basel III regulatory proposals and containing prudential rules for banks, building societies and investment firms, entered into force on 17 July 2013. The bulk of the rules contained in the legislation will apply from 1 January 2014. Click [here](#) for the text of the Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and [here](#) for the Regulation containing detailed prudential requirements for credit institutions and investment firms.

EBA launches new Single Rulebook Q&A tool

In July, EBA launched a new online "Single Rulebook Q&A" tool allowing institutions, supervisors and other stakeholders to submit their questions on the CRD IV package, including the related Technical Standards developed by EBA. Click [here](#) for a link to the Q and A tool.

EBA publishes a Recommendation on the preservation of capital

EBA has published a Recommendation on capital preservation addressed to supervisory authorities in all EU Member States. The Recommendation aims to preserve the enhanced capital base that banks built by 30 June 2012, in response to the EBA's 2011 recapitalisation Recommendation. Click [here](#) to view a copy of the Recommendation.

EBA publishes final draft technical standards on supervisory reporting requirements

EBA has published final draft Implementing Technical Standards (**ITS**) on supervisory reporting. They set out reporting requirements related to own funds, financial information, losses stemming from lending collateralised by immovable property, large exposures, leverage ratio and liquidity ratios. Click [here](#) to view a copy of the draft ITS.

EBA publishes first final draft technical standards on own funds and credit risk adjustment

EBA has published its final draft Regulatory Technical Standards (**RTS**) and final draft ITS on own funds, as well as its final draft RTS on credit risk adjustment (**CRA**). Click [here](#) to view a copy of the final draft RTS and [here](#) for the draft ITS on own funds. Click [here](#) to view the final draft RTS on CRA.

EBA consults on draft technical standards in relation to credit valuation adjustment risk

In July, EBA launched a second consultation on draft RTS for credit valuation adjustment risk (**CVA**) to further specify how a proxy spread should be determined for the calculation of own funds requirements and to provide additional details on a limited number of smaller portfolios. Click [here](#) to view a copy.

EBA consults on draft technical standards on own funds requirements for investment firms

EBA has consulted on RTS on own funds requirements for investment firms based on fixed overheads. Click [here](#) for a copy of the consultation.

EBA consults on draft technical standards on the hypothetical capital of a central counterparty

This consultation relates to draft ITS on the reporting of the hypothetical capital of a CCP. Click [here](#) to view a copy.

EBA consults on draft technical standards on methods for identifying the geographical location of relevant credit exposures

EBA is consulting on draft RTS setting out criteria for identifying the geographical location of all relevant credit exposures, namely credit risk, trading book and securitisation exposures. Click [here](#) to view a copy of the consultation which runs until 1 November.

EBA consults on draft technical standards on close correspondence for own-issued covered bonds

EBA has launched a consultation on draft RTS on close correspondence between the fair value of an institution's covered bonds and the fair value of its assets. Click [here](#) to view a copy.

EBA consults on draft technical standards on prudent valuation

EBA has consulted on draft RTS setting out the requirements related to prudent valuation adjustments of fair valued positions. The objective is to determine prudent values that can achieve an appropriate degree of certainty while taking into account the dynamic nature of trading book positions. Click [here](#) to view a copy.

Consultation on guidelines on technical aspects of the management of interest rate risk arising from non-trading activities (IRRBB)

EBA has consulted on amendments and additions to CEBS Guidelines on IRRB published on 3 October 2006. The proposed changes are aimed at improving the management of IRRBB risks by institutions, and to promote the convergence of supervisory practices in reviewing and evaluating institutions under the Pillar 2 assessment process. Click [here](#) to view a copy of the consultation.

EBA consults on draft Technical Standards on closely correlated currencies and on appropriately diversified indices

In June, EBA published two consultation papers on draft ITS to identify (i) a list of relevant closely correlated currencies for the purposes of calculating the capital requirements for foreign-exchange risk; and (ii) a list of relevant appropriately diversified indices for the purposes of calculating the capital requirements for equity risk. Click [here](#) and [here](#) to view copies.

EBA consults on draft technical standards on supervisory disclosure

In July, EBA launched a consultation on draft ITS specifying the format, structure, contents list and annual publication date of the supervisory information to be disclosed by competent authorities in the banking sector. Click [here](#) to view a copy.

EBA consults on draft technical standards on information exchange between home and host competent authorities

Two public consultations were launched in July on draft ITS and draft RTS relating to how competent authorities collaborate and exchange information regarding institutions operating via passport arrangements. Click [here](#) and [here](#) to view a copy of the consultations.

EBA launches discussion on possible treatments of unrealised gains measured at fair value

EBA has published a discussion paper on possible treatments of unrealised gains of assets and liabilities measured at fair value,

other than including them in Common Equity Tier 1 without adjustment. The input gathered from the discussion paper will assist the EBA in providing its technical advice to the European Commission on the topic. Click [here](#) to view a copy of the discussion paper.

EBA consults on draft Guidelines on retail deposits subject to different outflows for the purpose of liquidity reporting

EBA has consulted on draft Guidelines on retail deposits subject to different outflows aimed at providing greater harmonisation in the reporting of retail deposits in the EU banking sector. Click [here](#) to view a copy of the consultation paper.

EBA consults on draft technical standards related to the specific risk of debt instruments in the trading book

EBA is consulting on draft RTS assessing the minimum materiality needed to implement internal approaches for calculating own fund requirements related to risks associated with debt instruments in the trading book. Click [here](#) to view a copy of the consultation.

EBA publishes its 2012 Annual Report

In June, EBA published its 2012 Annual Report, providing an overview of the activities performed by the Authority in its second year of existence. Click [here](#) and [here](#) to view a copy of the report and a summary of the report.

The UK's Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) Consult on CRD IV

In August, the UK's Prudential Regulation Authority published a consultation paper on the changes to the PRA's rules to implement the Directive and relevant discretions provided in the Regulation. Click [here](#) to view a copy of the consultation paper.

The UK's FCA published its own consultation paper relating to CRD IV in July. Click [here](#) for a copy.

Banking Union in the EU

Macro-prudential policy

European Systemic Risk Board (ESRB) – Advisory Scientific Committee reports on the consequences of the single supervisory mechanism for Europe's macro prudential policy framework

This paper, published in September, focuses on the implications of the SSM for the macro prudential policy framework in Europe. It considers how macro prudential policy can be organised within the SSM and also the implications of the SSM for the role of ESRB. The paper argues for a centralised model for the application of macro prudential tools, that is, with the European Central Bank (**ECB**) directly applying such tools in co operation with national competent authorities (**NCA**s). NCAs must also provide information to the ECB on macro prudential issues such as national business and housing cycles. The paper argues that the ESRB should then make its recommendations to the ECB. The paper further argues for measures to prevent conflicts of interest between the ESRB and ECB (for example, the need for separate Presidents) to allow the ESRB to make recommendations on macro prudential policy to the ECB freely. Click [here](#) to view a copy of the paper.

Single Supervisory Mechanism

Progress has been made towards achieving banking union in the EU, with the first pillar of banking union, namely the adoption of a single supervisory mechanism (**SSM**) for Eurozone banks being approved by the European Parliament on 12 September 2013. The package adopted by the Parliament comprises a Council Regulation to give specific tasks related to financial stability and banking supervision to the ECB, along with a regulation to align the role of the EBA to the modified framework for banking supervision. The texts won political agreement in March 2013 and will come into force after adoption by the Council of Ministers and publication in the Official Journal, although the details are still to be finalised.

The ECB will exercise its new role under the SSM in full one year from publication of the legal texts in the Official Journal, with, initially, approximately 30 of the Eurozone's largest banks being directly regulated by the ECB. Transitional arrangements are expected.

Under the new rules, the ECB will authorise and withdraw authorisation of all credit institutions in the Euro area; assess the acquisition and disposal of holdings in banks; ensure compliance with EU prudential banking rules; directly supervise the largest Eurozone banks; and become the home supervisor for Eurozone banks and the host for non Eurozone banks active in the Euro area.

The ECB will not supervise non EU bank branches in the EU or non EU banks providing cross border services into the EU. NCAs will continue to supervise such entities, along with maintaining supervision over less significant Eurozone banks.

Click [here](#) for a copy of the EU press release and [here](#) for the accompanying FAQs.

Single Resolution Mechanism

On 10 July, the European Commission proposed a Single Resolution Mechanism (**SRM**) for the Banking Union. The intention is to reach agreement on the mechanism by the end of 2013 so that it can be adopted before the end of the current European Parliament term in 2014. This would enable it to apply from January 2015, together with the Bank Recovery and Resolution Directive.

In a recent speech, Financial Services Commissioner Michel Barnier expressed the view that the SRM for banks could be set up without a treaty change. Germany has hitherto expressed reservations relating to the SRM, believing that Treaty changes would be necessary before the SRM could be adopted. Commissioner Barnier has, however, indicated openness to improving the mechanism through treaty changes at a later stage.

It is envisaged that the Single Resolution Mechanism will work as follows:

- The ECB, as the bank supervisor, would signal when a relevant bank is in severe financial difficulties and needs to be resolved;
- A Single Resolution Board (**SRB**), consisting of representatives from the ECB, the European Commission and relevant NCAs, would prepare the resolution of a bank. The Board will have powers to analyse and define the approach for resolving the bank, which tools to use, and how the European Resolution Fund should be involved. National resolution authorities will be closely involved;
- On the basis of the SRB recommendation, or on its own initiative, the Commission will decide whether, and when, to place a bank into resolution and would set out a framework for the use of resolution tools and the fund. For legal reasons, the final say may not be with the Board;
- Under the supervision of the SRB, national resolution authorities would be in charge of the execution of the resolution plan;
- The Single Resolution Board will oversee the resolution. It would monitor the execution at national level by the national resolution authorities and could directly address executive orders to the troubled banks; and
- A Single Bank Resolution Fund would be set up under the control of the SRB to ensure the availability of medium-term funding support while the bank was restructured. It would be funded by contributions from the banking sector, replacing the national resolution funds of the euro area Member States and of Member States participating in the Banking Union, as set up by the draft Bank Recovery and Resolution Directive (**BRRD**).

Click [here](#) to view a copy of the proposal.

Bank Recovery and Resolution Directive

In late June at ECOFIN, finance ministers reached broad political agreement on the future BRRD. Trilogues with the European Parliament will finalise the rules and a Presidency compromise text was published on 27 September 2013. It is also intended that proposals to enhance the deposit guarantee framework, as proposed by the European Commission in 2010, will be finalised.

The BRRD will require member states to set up "ex ante" resolution funds to ensure that the resolution tools can be applied effectively. These national funds must reach at least 0.8% of covered deposits within 10 years. Member states may choose whether to merge or keep separate their funds for resolution and deposit guarantee purposes.

For a copy of our previous note on the proposed BRRD, please click [here](#).

Deposit Guarantee Fund

Imminent adoption of a single deposit guarantee scheme currently appears unlikely.

Shadow Banking

Financial Stability Board (FSB)

The shadow banking, or non-bank credit intermediation, system has been estimated to account for approximately 25 – 30% of the total financial system, being roughly half the size of the bank credit intermediation system. Accordingly, the focus of international regulators has been on addressing both size of the shadow banking system and its interconnectedness with the regular banking system.

In August 2013, the FSB published three documents relating to shadow banking in furtherance of these regulatory concerns: an *Overview of Policy Recommendations for Shadow Banking*, a *Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* and a *Policy Framework for Strengthening Oversight and*

Regulation of Shadow Banking Entities. The FSB's proposals were endorsed by the G-20 meeting of Government leaders on 5 and 6 September, with the FSB due to finalise policies aimed at mitigating the systemic risks of the repo and securities lending market (key funding sources for shadow banks) in 2014. The Basel Committee is also due to finalise proposals to address the risks from banks' interactions with shadow banks in 2014.

Separately, the FSB has created a monitoring framework to track financial sector developments outside the banking system. There is now an annual monitoring exercise to assess the global trends and risks of the shadow banking system, including jurisdictions covering 90% of global financial system assets. The third global shadow banking monitoring report will be published in November 2013.

The overview document sets out the FSB's approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and the next steps. Key elements of the proposals relate to:

Mitigating the spill-over effect between the regular banking system and the shadow banking system

Proposals are being developed by the Basel Committee to ensure that all banks' activities, including interaction with the shadow banking system, are appropriately captured in prudential regimes; to limit banks' large exposures to single counterparties (including to shadow banking entities); and to introduce risk-sensitive capital requirements for banks' investments in the equity of funds.

The Basel Committee will finalise its proposed supervisory framework for banks' large exposures and its proposed capital treatment for banks' investments in the equity of funds by the end of 2013. It will review the capital treatment of back-up lines to funds as necessary in 2014. Work on the scope of prudential consolidation will also be completed in 2014.

Reducing the susceptibility of money market funds (MMFs) to "runs"

MMFs provide a deposit-like instrument to investors, especially when they are redeemable at short notice and at par. They are, as such, susceptible to contagious investor runs.

Final policy recommendations were developed by IOSCO last year, providing the basis for common standards of regulation and management of MMFs across jurisdictions. G20 countries should have a variety of "tools" to contain risk. The tools should enhance the ability to slow down or suspend redemptions in distressed funds, limit investments in illiquid assets, impose liquidity buffers, limit leverage, impose capital requirements, apply curbs on the use of customers' money and demand tougher collateral standards.

The EU and the United States are already moving ahead with reform (see below, re the EU) and a peer review process of national implementation will be launched by IOSCO in 2014.

Securitisation

IOSCO will review the effectiveness of EU and US reforms, including risk retention (the so-called "skin-in-the-game") requirements, in 2014. Regulatory impediments to a resumption of orderly and sustainable securitisation markets will continue to be reviewed and the FSB will review how to revive the securitisation market in an orderly way.

Repos and Securities Lending

The FSB paper considers ways to dampen financial stability risks and pro cyclical incentives associated with securities financing transactions. It proposes enhanced transparency, regulation of securities financing, and improvements to market structure.

There are consultative proposals on proposed fixed minimum haircuts on transactions that have not passed through a clearing house backed by a default fund. Haircuts are to be finalized by spring 2014 after the FSB conducts an impact study in 2013. Implementation will depend on market conditions and time needed for adjustments to systems.

Standards and processes for data collection and aggregation at the global level on securities financing markets are to be finalised by the end of 2014. Data is to be aggregated monthly by the FSB.

Assessing and mitigating systemic risks posed by other shadow banking entities and activities

The Policy Framework seeks to allow authorities to capture innovations that occur outside the bounds of bank regulation and to adopt regimes for taking actions on non-banks that pose a threat to financial stability from shadow banking. A new system for regulators to share information on shadow banking will commence by March 2014. The FSB will start assessing how G20 members apply the new framework by 2015.

To view a copy of the Overview of Policy Recommendations click [here](#), the Policy Framework for Securities Lending and Repos, click [here](#) and the Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, click [here](#).

EU

On 4 September 2013, the European Commission published a Communication on Shadow Banking. This ties in with the FSB's work and aims to limit the emergence of risks in the system of credit intermediation outside the regular banking system. The policy intention is to ensure that the potential systemic risks to the financial sector are covered and that the opportunities for regulatory arbitrage are limited in order to strengthen market integrity.

The Commission envisages a package of measures to address the risks arising from shadow banking. These include:

- **a proposed new regulation on MMFs.** This proposal, also launched on 4 September, covers MMFs that are domiciled or sold in Europe and aims to improve their liquidity profile and stability:

- *Liquidity management and exposures:* MMFs should have at least 10% of their portfolio in assets that mature within a day and another 20% in assets maturing within a week. This is so that MMFs can repay investors wishing

to withdraw funds at short notice. In order to avoid a single issuer bearing undue weight in the net asset value (NAV) of an MMF, exposure to a single issuer is to be capped at 5% of the MMF's portfolio (in value terms). For standard MMFs, a single issuer may account for 10% of the portfolio.

- *Stability*: these should be a predefined capital buffer in order to tackle the issue of needing sponsor support to stabilise redemptions at par. This buffer will be activated to support stable redemptions in times of decreasing value of the MMFs investment.

- **transparency of the shadow banking sector**: detailed, reliable and comprehensive data is to be compiled on this sector in order to monitor risks and intervene where necessary.

- **securities law and the risks associated with securities financing transactions** (principally securities lending and repurchase transactions). These transactions can contribute to an increase in leverage and strengthen the pro-cyclical nature of the financial system, which then becomes vulnerable to bank runs and sudden deleveraging. The Commission will consider securities law reform to address issues such as property rights and transparency, aimed at limiting risks in securities financing transactions.

- **provision of a framework for interactions with banks**. The Commission proposes to address the issue of interconnectedness and contagion risk by tightening the prudential rules applied to banks in their operations with unregulated financial entities.

- **supervision of shadow banking entities**. Particular attention will be paid to the supervision arrangements of shadow banking entities/activities in order to ensure that specific risks are adequately addressed. Related areas such as the set-up of resolution tools for non-bank financial institutions and structural reform of the banking system are to be addressed separately.

Click [here](#) for a copy of the Communication and [here](#) and [here](#) for the proposed MMF regulation and FAQs.

Payment Services

On 24 July 2013, the European Commission adopted a legislative package in the field of the EU payments framework. This package proposes a revised Payments Services Directive (**PSD2**) and a Regulation on Multilateral Interchange Fees (**MIFs**) to help the payments framework better serve market needs. Competition, innovation and security have been key concerns in formulating the new package.

Click [here](#) to view a copy of the proposal on PSD2, [here](#) for the proposal on MIFs and [here](#) for the Commission FAQs.

Mortgage Lending

Mortgage insurance: market structure, underwriting cycle and policy implications – Basel Committee final document

This Basel Committee report published in August examines the interaction of mortgage insurers with mortgage originators and underwriters, making a set of recommendations directed at policymakers and supervisors aimed at reducing the likelihood of mortgage insurance stress or failure. Click [here](#) to view a copy of the report.

EBA Opinions

On 26 June, EBA published two Opinions on good practices for (i) responsible mortgage lending and (ii) for the treatment of borrowers in mortgage payment difficulties. Both Opinions are addressed to competent authorities and aim at promoting common practices, with the ultimate view of enhancing consumer protection and contributing to the stability, integrity and effectiveness of the financial system. Click [here](#) for the Opinion on responsible lending and [here](#) for the Opinion on the treatment of borrowers in mortgage payment difficulties.

Separately, on 10 September, the European Parliament approved in principle the new Mortgage Credit Directive. The text is still to be finalised.

Banking – Money Laundering

In June 2013, the Basel Committee issued a consultative paper to support countries' implementation of the Financial Action Task Force (FATF) standards with respect to their banks and banking groups, by exploring complementary areas and leveraging the expertise available in both organisations. The Basel Committee guidelines are intended to be consistent with and to supplement the goals and objectives of the FATF standards and cross refer to the FATF standards. Click [here](#) for a copy of the consultation.

Cross sectoral

Remuneration

ESMA and EBA

In June, ESMA published Guidelines on remuneration policies and practices for relevant staff of investment firms, credit institutions and fund management companies when providing (**MiFID**) investment services, and to national securities regulators enforcing those rules. Click [here](#) to view a copy of the guidelines.

In July, EBA published a report featuring data on the remuneration of EU bank staff who received one million Euro or more in total in 2010 and 2011. The report focuses on the gathering of numerical data and provides a first analysis of remuneration structures across the EU. Click [here](#) for a copy of the report.

Also in July, ESMA made available EU translations of its Guidelines on sound remuneration policies under the AIFMD.

UK

In September 2013, the British Government launched a legal challenge to the new remuneration rules within the CRD IV package at the European Court of Justice. The challenge argues that the new rules increase the potential for systemic uncertainty by effectively raising the fixed component of bankers' remuneration. It also raises issues of legal certainty, wrongful application outside the EU and potential contravention of data protection laws.

Also in September, the UK's FCA published draft guidance on the remuneration code for alternative investment fund managers under the AIFMD, including on: timing for implementing the AIFMD remuneration code, the application of the proportionality principle to the remuneration payment process; the treatment of payments to partners or members of AIFMs established as partnerships or limited liability partnerships; requirements of the remuneration code to be applied to delegates; and the requirement for a Remuneration Committee.

Separately, as part of the UK Government's response to the Parliamentary Commission on Banking Standards (see further below) the Government has asked regulators to consider certain further reforms relating to pay.

Supervisory Decision

In June, the joint Board of Appeal of the European Supervisory Authorities, being EBA, ESMA and EIOPA (together the **ESAs**) decided an appeal brought by an Estonian company against a decision of EBA, allowing the appeal.

The issue concerned the question whether the suitability of the managers of a significant branch of a bank may be a matter within EU law, and not just national law. The Board of Appeal interpreted the Banking Consolidation Directive consistently with EBA Guidelines on the assessment of the suitability of members of management bodies and key function holders. It came to the conclusion that the "fit and proper" requirement is not restricted to the persons which direct the business of a credit institution. Click [here](#) to view a copy of the Decision.

Joint Committee of the ESAs Reports on Risks and Vulnerabilities in the EU Financial System

The Report, published on 5 September, identifies cross-sectoral risks to the stability of the European financial system. Click [here](#) to view a copy.

Point of sale disclosure in the insurance, banking and securities sectors – Basel Committee consultative report

This Basel Committee report, published in August, considers whether regulatory approaches to Point of Sale disclosure need to be further aligned across sectors, and it makes a number of recommendations, mainly to policymakers and supervisors, to assist them in considering, developing or modifying their POS disclosure regulations. Click [here](#) to view a copy of the consultation, which closes on 18 October 2013.

EBA, EIOPA and ESMA publish RTS on the consistent application of calculation methods under the Financial Conglomerates Directive (FICOD)

The Joint Committee of the ESAs has published draft RTS on the consistent application of the calculation methods described in FICOD covering the assessment of the financial situation of credit institutions, insurance undertakings and investment firms which are part of a financial conglomerate. Click [here](#) for a copy.

Regulatory Reform in Europe – state of play

The European Commission has published a high level document entitled "A new Financial System for Europe: financial reform at the service of growth state of play 25.07.2013". The title is self explanatory. Click [here](#) to view a copy.

Regulation of Investment Firms

MIFID 2 and MIFIR

Dialogue discussions are under way between the European Parliament, Council and the Commission. The Parliament has announced that it will consider the Markets in Financial Instruments 2/Markets in Financial Instruments Regulation proposals at its 9 to 12 December 2013 plenary session. Final rules may not come into effect until 2015 or 2016.

Change of Control under MiFiD

In July 2013, ESMA proposed draft RTS in relation to the MiFiD change of control rules (that is, the rules applying where a person seeks to acquire or increase certain holdings in a MiFiD firm). The paper consults on the information to be given in relation to proposed changes of control and consults on new requirements to be applied to: non-EU controllers; sovereign wealth funds and state-owned controllers; and the reputation of significant influence shareholders. It also asks whether special information requirements should apply to, e.g., partnership controllers. The paper proposes that the requirements should be applied on a proportionate basis. It is not clear whether the information requirements will also be applied to firms reporting in their regular controllers reports.

The paper has attracted comment that it lacks clarity and potentially opens up the scope for differential information requirements applying to bank and other investment firm controllers. However, it is possible that, once finalised, the proposed measures will be applied to other EU financial sectors. To view a copy of the consultation, click [here](#).

Market Abuse and Insider Dealing

Dialogues relating to the revised Market Abuse Directive (**MAD 2**) and the Market Abuse Regulation (**MAR**) started in January. Political agreement between the European Council and the Parliament has been reached on MAR and was endorsed by the Parliament in September. Dialogues on MAD 2 continue.

New features of MAR include: the introduction of a safe harbour for certain market soundings; new provisions for insider lists; new requirements for issuers to make insiders and Persons Discharging Managerial Responsibility (**PDMRs**) aware of their responsibilities under MAR; a lower financial threshold triggering disclosure of dealings by PDMRs to EUR5,000 in a calendar year (although competent authorities may choose to increase this); closed period for PDMR transactions; and LIBOR/benchmark manipulation and OTC derivatives are brought within scope.

As the MAD 2 package is related to, and to some extent dependent on, the MiFID 2 proposals (e.g. the definitions), the MAD package is not expected to be formally adopted until MiFID 2 and MiFIR are agreed. Accordingly, implementation before 2015 or 2016 is unlikely.

Energy Markets

In July, ESMA and the Agency for the Cooperation of Energy Regulators put in place an agreement for cooperation and exchange of information. The Memorandum of Understanding establishes a system for exchanging information when the regulatory responsibilities of both EU bodies coincide in relation to wholesale energy markets, encompassing trading in commodity and derivatives contracts.

Short Selling

Short Selling Regulation

In June, ESMA published Technical Advice evaluating the impact of the Regulation on short selling and certain aspects of credit default swaps (the Short Selling Regulation) on European financial markets. To view a copy of the paper, click [here](#). Key findings were that:

- there were mixed effects on the liquidity of EU stocks, with a slight decline in volatility, a decrease in bid-ask spreads and no significant impact on traded volumes. Price discovery speed seems to have decreased;
- overall, settlement discipline has improved; and
- no compelling impact on the liquidity of EU single name CDS and on the related sovereign bonds markets could be noticed (except in a few countries). The liquidity in European sovereign CDS indices has reduced.

Key recommendations for change were:

- *Transparency and reporting requirements:* the current reporting and disclosure thresholds are broadly appropriate, but some technical improvements are to be considered in relation to the method for calculating net short positions in shares and the method of calculation

of net short positions in sovereign debt, particularly the duration-adjusted approach; also, a review of the thresholds for notification;

- *Restrictions on uncovered short sales in shares and sovereign debt:* adjustments to the regime are to be considered to allow internal locate arrangements within the same legal entity and revisiting the definition of "liquid shares" for the purpose of locate arrangements;
- *Shares exempted on the basis of turnover:* an alternative approach is to be considered;
- *Exemption for market-making activities:* clarifications are needed
- *Emergency measures for temporary bans:* the approach to be reconsidered with a view to greater simplicity and consistency.

Guidelines Compliance

Also in June, ESMA published a Compliance Table in relation to its Guidelines on the exemption for market making activities and primary market operations under the Short Selling Regulation. The table indicates which NCAs have declared that they comply or intend to comply with the Guidelines and which do not comply. ESMA has also published the explanations provided by those NCAs which have indicated their non-compliance. Click [here](#) for a link to the compliance table.

Recovery and Resolution for non-banks

The UK Government produced a consultation on secondary legislation for non-bank resolution regimes in September. Click [here](#) to view a copy.

European Market Infrastructure Regulation

The European Market Infrastructure Regulation (**EMIR**) entered into force in August 2012 and sets out a range of new requirements affecting derivatives markets, including, amongst other things, certain mandatory clearing, reporting and risk-mitigation requirements as well as a new regulatory regime for CCPs.

Central clearing: In July, ESMA launched a Discussion Paper to prepare the RTS which will implement provisions of EMIR regarding the obligation to centrally clear OTC derivatives. Click [here](#) for a copy. The consultation was aimed at assisting ESMA to develop its approach to determining which classes of OTC derivatives need to be centrally cleared and the phase-in periods for the counterparties concerned.

OTC transactions by non-EU

counterparties: Also in July, ESMA launched a consultation on draft RTS aimed at implementing the provisions of EMIR relating to OTC derivative transactions by non-EU counterparties in certain cases, and aimed at preventing attempts by non-EU counterparties to evade EMIR's provisions.

The Consultation Paper clarifies the conditions where EMIR's provisions regarding central clearing or risk mitigation techniques would apply to OTC derivatives between two non-EU counterparties which have a direct, substantial and foreseeable effect in the EU. The proposed RTS would only apply when two counterparties to the same transaction are established outside the EU, their jurisdictions' rules are not considered equivalent to EMIR, and where one of the following conditions are met:

- one of the two non-EU counterparties is guaranteed by an EU financial counterparty for at least €8 billion of the gross notional amount of OTC derivatives entered into and for an amount of at least 5% of the OTC derivatives exposures of the EU financial counterparty; or
- the two non-EU counterparties execute their transactions via their EU branches.

Click [here](#) for a copy of the consultation.

ESMA standards on cross-border

application of EMIR: Originally due by 25 September, the European Commission has extended the deadline by which ESMA must deliver its draft technical standards on the cross-border application of EMIR. The new deadline is 15 November 2013.

Reporting to trade repositories – exchange traded derivatives:

In August, ESMA sent the European Commission a Final Report proposing an amendment to the ITS on reporting relating to the format and frequency of reporting to trade repositories under EMIR. The amendment relates specifically to the reporting of exchange traded derivatives (ETDs) and proposes postponing the reporting start date by one year to January 2015. A delay in the reporting date for ETD transactions will allow sufficient time for the development of the relevant guidelines and their implementation by counterparties, trade repositories and regulators.

Equivalence: In early September, ESMA published its advice to the European Commission on the equivalence of the regulatory regimes for OTC derivatives clearing, CCPs, and trade repositories (TR) of non-EU countries with EMIR. The third-country rules were compared with EMIR requirements for central clearing, reporting, CCPs, TRs and non-financial counterparties as well as risk mitigation techniques for uncleared trades. Third-country regimes were considered equivalent where the legal provisions and the level of supervision and enforcement is similar to that of EMIR.

ESMA found the regulatory regimes of Australia and Switzerland for CCPs equivalent to EU rules.

Conditional equivalence was proposed to the following regimes:

- Hong Kong, Japan, Singapore, and the US for CCPs;
- the US and Japan for central clearing, requirements for non-financial counterparties and risk mitigation techniques for uncleared trades; and
- the US for TRs.

The European Commission is expected to use ESMA's technical advice to prepare possible equivalence decisions. Where it adopts such a decision, certain provisions of EMIR may be disapplied in favour of equivalent third-country rules and, depending on the specific area determined to be equivalent, ESMA may:

- recognise within the EU a CCP which is authorised outside the EU; or
- recognise within the EU a TR which is authorised outside the EU;

ESMA's advice is based on a factual assessment of the rules of each jurisdiction but has also taken into account possible consequences for the stability and protection of EU entities and investors that an equivalence decision would have. ESMA's advice has also considered upcoming regulations in several jurisdictions that may impact the equivalence assessment.

Exemptions: In July 2013, the European Commission adopted a Delegated Regulation to include the central banks and debt management offices of Japan and the United States in the list of exempted entities under Article 1(4) of EMIR.

Timetable: In September, ESMA published an updated version of its EMIR implementation timetable. The key change in the implementation timeline relates to the registration of the first TRs which was expected to occur in late September. ESMA now expects to make those first registration decisions not before 7 November. Consequently, counterparties' reporting to trade repositories is not expected to start before February 2014. Click [here](#) to view the revised timetable.

Benchmark Regulation

ESMA and EBA Principles

In June, ESMA and EBA published their final report setting out their Principles for Benchmark-Setting Processes in the EU. Click [here](#) for a copy of the Report.

European Commission proposal on Benchmarks

On 18 September, the European Commission proposed new legislation relating to financial benchmarks. The proposal is in line with the principles recently agreed at international level by IOSCO and covers a broad variety of benchmarks, including interest rate benchmarks such as LIBOR; commodity benchmarks and all benchmarks used to reference financial instruments admitted

to trading or traded on a regulated venue, such as energy and currency derivatives; benchmarks used in financial contracts, such as mortgages; and those used to measure the performance of investment funds.

The proposal seeks to address possible shortcomings at every stage in the production and use of benchmarks. The ultimate objective is to ensure the integrity of benchmarks by guaranteeing that they are not subject to conflicts of interest, that they reflect the economic reality they are intended to measure and are used appropriately. Click [here](#) for a copy of the proposal.

Sale of complex products to retail financial consumers

In July, ESMA published a research report on Retailisation in the EU, which examines the growth in the sale of complex financial products to retail financial consumers in the EU. Click [here](#) to view a copy.

ESMA Trends, Risks and Vulnerabilities

In September, ESMA published its semi-annual paper on Trends, Risks, Vulnerabilities (TRV) Report and quarterly Risk Dashboard for the second quarter of 2013. Click [here](#) and [here](#) to view copies.

Capital Markets

Financial Transaction Tax

A paper from the EU Council's legal division produced in September 2013 has significantly challenged the scope of the Financial Transaction Tax (FTT) proposals. The paper concluded that one of the main provisions of the proposed FTT is discriminatory, overreaches national jurisdiction and infringes the EU treaties. Although the European Commission is not in agreement with the views expressed in the paper, it is quite likely that the next iteration of the FTT will be much watered down.

Prospectus Directive

In June, ESMA published a report on the Comparison of liability regimes in Member States in relation to the Prospectus Directive. The report is the first of its kind and provides a comparison of liability regimes covering the EEA and is aimed at providing clarity for market participants about the different regimes in place. It contains an overview of administrative, criminal, civil and governmental liability. It does not cover how the regimes, or sanctions, are applied. Click [here](#) to view a copy.

Listing

In July, ESMA launched a consultation on Guidelines on the enforcement of financial information published by listed entities in EU. The Guidelines aim to strengthen and promote greater supervisory convergence in existing enforcement practices amongst EU NCAs. They establish the principles to be followed in the enforcement process, and will apply to all competent authorities and any other bodies from the EU undertaking enforcement responsibilities under the Transparency Directive, and IFRS Regulation.

ESMA expects to publish final guidelines in 2014. Click [here](#) for a copy of the consultation.

Credit Ratings Agencies (CRAs)

CRA Regulation

On 17 June, ESMA published Guidelines and Recommendations on the Scope of the CRA Regulation. The Guidelines clarify certain aspects of the scope of the CRA Regulation for registered CRAs, market participants operating on the perimeter of this sector and national securities markets regulators. Click [here](#) for a copy of the Guidelines.

CRA 3

On 10 July, ESMA published a Discussion Paper dealing with the implementation of the CRA 3 Regulation, which entered into force on 20 June. The Regulation complements the existing regulatory framework for CRAs and requires ESMA to draft RTS on various issues. The draft RTS are to be published for consultation

in early 2014. ESMA must submit the draft RTS to the European Commission by 21 June 2014. There will be:

- *A draft RTS on Information on Structured Finance Instruments.* The aim is to facilitate the provision of adequate information on SFIs, and their underlying assets, to investors, in order to improve their ability to make informed assessments on the creditworthiness of SFIs, reduce reliance on external credit ratings, promote competition between CRAs and facilitate the assignment of unsolicited credit ratings. The draft RTS will specify: the information that issuers, originators and sponsors of structured finance instruments established in the Union must publish; the frequency with which the information is to be updated; and the presentation of the information by means of a standardised disclosure template.
- *A draft RTS on European Rating Platform (ERP).* The Regulation requires ESMA to establish the ERP where CRAs will report up to date ratings and outlooks, together with data on the historical performance of their ratings. This information will be publicly available allowing investors to compare all credit ratings that exist regarding a specific rated issuer/instrument, and assist in their decision-making, thereby contributing to increased investor protection and improving the visibility of smaller CRAs.

The draft RTS will specify: the content and format of ratings data periodic reporting to be requested from registered and certified CRAs for the purpose of on going supervision; and the content and the presentation of the information, including the structure, format, method and timing of reporting that credit rating agencies are to disclose to ESMA.

- *A draft RTS on fees charged by CRAs to their clients.* The draft RTS aims to mitigate conflicts of interest and facilitate fair competition in the credit ratings market by ensuring that CRAs' fees are cost-based, non-discriminatory and not dependent on any result or outcome of the work performed or on the provision of ancillary services.

The Discussion Paper focuses on gathering information on CRAs' fees and cost structure, as well as their pricing policy. The draft RTS will specify the content and the format of periodic reporting on fees charged by credit rating agencies for the purpose of on-going supervision by ESMA.

Click [here](#) for a copy of the Discussion Paper.

Investment Funds

Alternative Investment Funds

The Alternative Investment Fund Managers Directive (AIFMD) came into force on 22 July 2013 and significantly alters the legal foundation on which alternative investment funds are managed and marketed within Europe.

On 1 August, ESMA published an Opinion on arrangements for the late imposition of the AIFMD, seeking to give effect to the Directive and passporting rights under it notwithstanding late implementation in a particular EU member state. Click [here](#) to view a copy of the Opinion.

Also in August, ESMA submitted its formal opinion to the European Commission on draft regulatory technical standards under Article 4(4) of the AIFMD, relating to identifying types of AIFM (open-ended or closed-ended funds). Click [here](#) to view a copy.

International Supervisory Cooperation

At its July meeting, the Board of Supervisors of ESMA approved Memoranda of Understanding (MoUs) with authorities from the Bahamas, Japan, Malaysia, Mexico and the United States, including the Commodity Futures Trading Commission. ESMA has now negotiated 38 agreements on behalf of the 31 EU/EEA national competent authorities for securities markets supervision. The co-operation agreements allow for the exchange of information, cross-border on-site visits and mutual assistance in the enforcement of respective supervisory laws.

European Long Term Investment Funds

On 26 June, the European Commission proposed a new investment fund framework designed for investors wishing to invest in companies and projects for the long term. These private European Long-Term Investment Funds (**ELTIFs**) would only invest in businesses that need money to be committed to them for long periods of time. Investors may be institutional or retail.

To qualify as an ELTIF, funds must:

- only invest in certain types of assets and at least 70% of the money in the fund has to be invested in these assets
- only be offered by a manager which is authorised under the AIFMD
- run for a specified period of time during which investors do not have the right to get their money back
- strictly limit derivative use to currency risks so avoiding their use for speculative reasons
- limit leverage

Click [here](#) for a copy of the proposal and [here](#) for a copy of the FAQs.

UK Regulatory Reform

In July, HM Treasury and the Department for Business, Innovation and Skills published the Government's response to the Parliamentary Commission on Banking Standards. To view a copy of the response, click [here](#).

The Government plans to implement the following major recommendations of the report:

- Strengthening individual accountability by:
 - introducing a new Senior Persons regime governing the behaviour of senior bank staff. This will replace the existing Approved Persons regime;
 - introducing new banking standards rules to promote higher standards for all bank staff;
 - introducing a new criminal offence for reckless misconduct for senior bankers;
 - reversing the burden of proof so that bank bosses are held accountable for breaches within their areas of responsibility unless they can demonstrate that they took all reasonable steps to prevent the contravention occurring;
 - extending the time limit for commencing disciplinary action against senior persons; and

- working with the regulators to implement the Commission's proposals on pay. This will allow bonuses to be deferred for up to 10 years and enable 100 per cent clawback of bonuses where banks receive state aid.

- Asking the regulators to implement the Commission's key recommendations on corporate governance to ensure that firms have the correct systems in place to identify risks and maintain standards on ethics and culture.
- Supporting competition in the banking sector by:
 - providing the PRA with a secondary competition objective to strengthen its role in ensuring banking markets are effective and deliver good outcomes for consumers; and
 - asking the new payments regulator, once established, urgently to examine account portability and payments system ownership.