SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY GROUP NEWSLETTER

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Financial Regulatory Developments Focus

In this week's newsletter, we provide a snapshot of the principal US, European and global financial regulatory developments of interest to banks, investment firms, broker-dealers, market infrastructure providers, asset managers and corporates.

Click here if you wish to access our Financial Regulatory Developments website.

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Bank Prudential Regulation & Regulatory Capital

EU Extends Transitional Measures for Exposures to CCPs Again

EU ExOn December 7, 2017, a Commission Implementing Regulation on the extension of the transitional periods related to own funds requirements for exposures to CCPs set out in the Capital Requirements Regulation and European Market Infrastructure Regulation was published in the Official Journal of the European Union. Thirty-two third-country CCPs have been recognized by the European Securities and Markets Authority to date. However, there are still third-country CCPs that are awaiting recognition status. Without an extension of the transitional periods, banks and investment firms in the EU (or which are subject to consolidated supervision in the EU) would need to increase their own funds requirements for their exposures to those CCPs that are not yet recognized. The Implementing Regulation extends the transitional period to June 15, 2018.

The proposals to amend the CRR include an amendment to these transitional provisions. The proposed amendment would remove the need for the European Commission to continuously extend the transitional period by basing the transitional deadline instead on the timing of an application for recognition by a third-country CCP.

The Implementing Regulation is available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2241&from=EN.

European Banking Authority Proposes Revised Technical Standards on the Mapping of External Credit Ratings

On December 7, 2017, the Joint Committee of the European Supervisory Authorities published a final report setting out revised draft Implementing Technical Standards for the assessment of credit quality under the CRR. Under the CRR, firms that use the Standardized Approach to credit risk (rather than the internal ratings based approaches or internal models) can use external credit assessments to determine the credit quality of exposures. Credit quality can be determined by reference to the credit assessments of External Credit Assessment Institutions. The corresponding risk weight to which an exposure's credit quality should be mapped to establish the credit risk of that exposure is set out in an Implementing Regulation published in October 2016. ECAIs are defined as credit rating agencies registered or certified in accordance with the Credit Rating Agency Regulation or any central banks issuing ratings that are exempt from the application of the CRA Regulation.

The ESAs' proposals make amendments to Annex III of the Implementing Regulation to reflect the fact that there have been some changes to the ECAI population. Since the Implementing Regulation entered into force, five additional ECAIs have been recognized and one ECAI has been de-registered. The revised draft ITS therefore amend Annex III of the Implementing Regulation to include mappings for the five newly established ECAIs and to remove the mapping for the deregistered entity. The mappings for the 25 ECAIs comprising the remainder of the ECAI population are unchanged.

The revised draft ITS have been submitted to the European Commission for endorsement, following which they will be published in the Official Journal of the European Union. The ITS will enter into force 20 days after publication.

Revised draft ITS have also been published to reflect the equivalent change under the Solvency II legislation for insurance and reinsurance business.

The final draft ITS under the CRR is available at: https://esas-joint-committee.europa.eu/Publications/Reports/Final%20Joint%20Revised%20Draft%20ITS%20Mapping%20CRR%20(JC%202017%2061).pdf, the final draft ITS under Solvency II is available at: https://esas-joint-committee.europa.eu/Publications/Reports/Final%20Joint%20Revised%20Draft%20ITS%20Mapping%20Solvency%20II%20(JC%202017%2067).pdf and the press release is available at: https://esas-joint-

committee.europa.eu/Publications/Press%20Releases/Press%20release%20on%20amended%20Joint%20ITS%20on%20mapping%20of%20ECAIs.pdf.

UK Regulator Proposes Update to Pillar 2 Reporting Requirements

On December 6, 2017, the Prudential Regulation Authority published a consultation paper proposing updates to the Pillar 2 reporting requirements. The PRA is proposing a new data item to capture stress testing data currently included in firms' Internal Capital Adequacy Assessment Process documents. The purpose is to enhance transparency and comparability in stress test data provided alongside ICAAP documents and to decrease the operational risks associated with capturing stress test data manually. The PRA is also proposing to reduce the frequency of reporting of the data items in the Reporting Pillar 2 part of the PRA Rulebook for some firms to take a more proportionate approach. In addition, the PRA proposes to consolidate the definition of several reporting parts of the PRA Rulebook into the Glossary.

The proposals are relevant to banks, building societies and PRA-designated investment firms. The proposed changes would impact the PRA rules, the Supervisory Statement on Pillar 2 Reporting (SS32/15) and the Statement of Policy on the PRA's methodologies for setting Pillar 2 capital.

The consultation closes on March 6, 2018. The PRA intends its final policy to take effect from October 1, 2018.

The consultation paper is available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2017/cp2517.pdf.

UK Prudential Regulation Authority Consults on Principles for Assessing Stress Test Model Risk Management Practices

On December 6, 2017, the PRA launched a consultation on model risk management principles for stress testing. The PRA is proposing a set of four principles which are intended to assist firms in developing and implementing policies and procedures to identify, manage and control the risks inherent in the use of stress test models. The principles will be set out in a new Supervisory Statement entitled "Model risk management principles for stress testing," a draft of which is provided in the annex to the consultation paper. The Supervisory Statement would present the PRA's expectations on the model risk management practices firms should adopt when using stress test models. The four proposed principles are that:

1. Banks have an established definition of a model and maintain a model inventory.

2. Banks have implemented an effective governance framework, policies, procedures and controls to manage their model risk.

3. Banks have implemented a robust model development and implementation process, and ensure appropriate use of models.

4. Banks undertake appropriate model validation and independent review activities to ensure sound model performance and greater understanding of model uncertainties.

The proposed principles would apply to firms participating in the annual concurrent stress test in full and to other firms on a proportionate basis, taking into account their size, complexity, risk profile and the relevance to them of using stress test models. The PRA's proposals are relevant to PRA-authorized banks, building societies and PRA-designated investment firms. The PRA is not currently proposing to extend the principles to insurance or reinsurance firms.

The PRA proposals reflect similar steps being taken by the European Banking Authority, as well as authorities outside of the EU, such as those in the US and Canada. The EBA is proposing new detailed guidance for firms designing and conducting a stress testing programme. The new Guidelines will replace the existing 2010 Guidelines on stress testing published by the Committee of European Banking Supervisors. The proposed Guidelines cover the organization of

stress testing, the types of stress test exercises, the reverse stress testing process for regular stress testing and recovery planning purposes, business models, data aggregation, risk and litigation costs, FX lending risk and the interaction between solvency stress tests and liquidity stress tests. The EBA aims to finalize these guidelines during the first quarter of 2018 and intends for the application date to be in the second quarter of 2018.

The PRA invites feedback on its proposals by March 6, 2018. It is particularly interested in feedback on the proposal to apply the proposed principles to firms not participating in the BoE's annual concurrent stress test. The proposed implementation date is June 1, 2018. The PRA proposes that firms should assess their stress test model risk management practices against the principles and report the findings from January 1, 2019. Firms participating in the annual concurrent stress test would be required to assess their stress test model risk management practices from Q3 2018 onwards.

The consultation paper is available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2017/cp2617.pdf.

The EBA's consultation paper is available at: http://www.eba.europa.eu/documents/10180/2006781/Consultation+Paper+on+Guidelines+on+institution%27s+stress+testing+%28EBA-CP-2017-17%29.pdf.

UK Financial Stability Report Published

On November 28, 2017, the Financial Policy Committee of the Bank of England published the latest UK Financial Stability Report. The FPC notes that the UK banking system is resilient and that UK banks are stronger than they were ten years ago. The results of the stress test show that no bank needs to improve its capital position. However, as a result of the stress test, the FPC has decided to raise the UK countercyclical buffer rate from 0.5% to 1% from November 28, 2018. In addition, the Prudential Regulation Committee will set capital buffers for individual banks. The FPC will reconsider the countercyclical buffer rate during the first half of 2018.

The FPC continues to assess the risks posed by Brexit and concludes that Brexit presents a material risk to the provision of financial services to customers in both the UK and the EU. Three main risks are discussed: risks associated with bringing EU legislation into UK law through the Great Repeal Bill, risks to the continuity of outstanding cross-border contracts and risks presented by barriers to cross-border financial services provision.

The FPC considers that the extent and nature of the changes to be brought in through the Great Repeal Bill will depend on the terms of the UK's withdrawal agreement and there is a tight timeframe in which it all needs to be achieved. In addition to the Great Repeal Bill, secondary legislation is needed, and the regulators will need to change their rulebooks. Firms will also need to make changes to comply with the amended legal framework.

The FPC views UK and EU legislation as necessary to ensure the continuity of existing cross-border insurance and derivatives contracts. HM Treasury is considering all of the options for mitigating the risks to the continuity of these, and other financial contracts.

The FPC states that the provision of cross-border financial services may be impacted by restrictions on transferring personal data between the UK and the EU. Firms could insert new clauses in contracts to permit such data transfer; however, the FPC notes that there may not be time to do this and that such clauses would be subject to legal challenge. Therefore, the FPC agrees with the Government's position paper on the exchange and protection of personal data which proposes that the UK and the EU should recognize each other's data protection frameworks as "adequate" to provide legal certainty.

Furthermore, the FPC states that, in the event of a "no deal" Brexit, EU incorporated banks currently operating in the UK through a branch will need authorization to continue to do so after Brexit. The PRA intends to set out its approach to those authorizations before the end of the year.

In addition, the FPC observes that there are material risks to the provision of clearing services in the EEA by UK CCPs if access to cross-border clearing services is not maintained. Migrating clearing services would be complex and difficult to achieve. The FPC notes that the BoE is working with CCPs and their clearing members to develop their contingency planning.

The Financial Stability Report is available at: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/november-2017.pdf?la=en&hash=8CB2A5526478872DE14D531254B948BB6FD47793#page=9 and the results of the 2017 stress test are available at: https://www.bankofengland.co.uk/stress-testing/2017/stress-testing-the-uk-banking-system-2017-results.

Basel III Finally Finalized

On December 7, 2017, the Basel Committee on Banking Supervision published the last part of the Basel III reforms. The revisions are to the standardized approach and the Internal Ratings-Based approach for credit risk, the Credit Valuation Adjustment risk framework, the leverage ratio framework, including the introduction of a leverage buffer for Global Systemically Important Banks, the operational risk framework and the new output ratio floor. The revised standards will take effect from January 1, 2022 and will be phased in over five years.

The revisions to the standardized approach to credit risk include, among other things, recalibrating the risk weights for rated exposures to banks, a specific risk weight for exposures to small and medium-sized enterprises, a standalone treatment of exposures to project finance, object finance and commodities finance, more risk-sensitive approaches for exposures for residential and commercial real estate, subordinated debt, equity exposures and unrated exposures to banks. There is also a new standalone treatment for covered bonds.

The IRB approach for credit risk has been amended by: (i) removing the option to use the advanced IRB approach for certain asset classes, including for exposures to large and mid-sized corporates, banks and other financial institutions and for exposures to equities; (ii) adopting "input" floors; and (iii) providing more specification of parameter estimation practices to reduce risk-weighted asset variability.

The CVA framework has been revised to enhance its risk sensitivity by taking into account the exposure component of CVA risk. The framework has been made more robust by removing the use of an IRB approach, leaving a standardized approach and a basic approach, which have been recalibrated to align with the revised market risk framework: the standardized approach is based on fair value sensitivities to market risk factors and the basic approach is benchmarked to the standardized approach. In addition, the revised CVA framework allows banks with an aggregate notional amount of uncleared derivatives less than or equal to EUR100 billion to calculate their CVA capital charge as a simple multiplier of its counterparty credit risk charge.

The operational risk framework revision replaces the existing advanced measurement approach and three standardized approaches with one standardized approach that must be used by all banks. The operational risk capital components will be based on a measure of a bank's income and a measure of a bank's historical losses. There is discretion granted to regulators not to set a bank's capital requirements for operational risk by reference to historical losses. However, all banks will be required to disclose their historical operational risk losses, even if this discretion is exercised.

The leverage ratio framework introduces a further leverage ratio buffer for G-SIBs, which must be met with Tier 1 capital. The buffer is set at 50% of a G-SIB's risk-weighted higher-loss absorbency requirements. The buffer does not apply to non-G-SIB banks. Capital distribution restraints will be imposed on a G-SIB that fails to meet its leverage ratio

buffer requirement. In addition, amendments are made to the leverage ratio exposure measure, including changing the way in which derivatives are reflected in the measure.

Finally, the Basel III reforms replace the existing Basel II floor with a new output floor ratio based on the revised Basel III standardized approaches. The output floor provides a risk-based backstop that limits the extent to which banks can lower their capital requirements by using internal models. It will not be possible to reduce the capital charge associated with risk-weighted assets to below 72.5% of the charge that would arise under the standardized approach. It is expected that this requirement will become capital limiting for 20% of banks, many of them located in Europe. Banks will be required to disclose their RWAs based on the revised standardized approaches. The specific details of these disclosure requirements will be set out in an upcoming consultation paper. The output floor requirements will be phased in from January 1, 2022 until January 1, 2027. Regulators will have a discretion to apply a transitional cap during the phase-in period.

The Basel Committee has also decided to change the implementation date for the revised market risk framework, which was published in January 2016, from January 1, 2019 to January 1, 2022. The revised implementation date will allow firms further time to develop their systems. The Basel Committee will also have time to consider certain issues related to the market risk framework and to conduct a review of the calibrations of the standardized and internal model approaches.

The Basel Committee notes its commitment to review the impact of the Basel III reforms. In particular, it will assess the impact of the Basel III leverage ratio requirements on the provision by banks of clearing services to clients.

The full report is available at: https://www.bis.org/bcbs/publ/d424.pdf, the summary of the reforms is available at: https://www.bis.org/bcbs/publ/d424_hlsummary.pdf, the impact assessment is available at: https://www.bis.org/bcbs/publ/d426.pdf, previous versions of the revised areas and related consultation papers are available at: https://www.bis.org/bcbs/publ/d424.htm and the revised market risk framework is available at: https://www.bis.org/bcbs/publ/d352.pdf.

Competition

UK Competition & Markets Authority Consults on Upcoming Focus Areas

On December 4, 2017, the UK Competition & Markets Authority launched a consultation on its proposed focus areas for 2018/2019. The consultation paper sets out the CMA's draft plans and priorities and a number of key commitments and initiatives across the areas of: markets and mergers, CMA development and resources, enforcement and preparing for the UK's exit from the EU. The CMA proposes, among other things, to deal with a higher volume of enforcement cases, advance consumer protection, support business compliance, consider specific markets or practices, enhance its processes around assessing mergers, improve the effects of remedies by conducting evaluations of previous projects, enhance its operational effectiveness by establishing a new digital team and to continue its preparation for Brexit. The CMA has secured additional funding for the 2017/2018 financial year to enable it to prepare for the anticipated increase in cases that will fall within the CMA's remit post-Brexit. The CMA notes that the additional £2.8 million funding per year from 2018/19, allocated in the Autumn budget, will enable it to initiate more enforcement cases against companies allegedly acting unfairly.

The consultation closes on January 14, 2018. The CMA intends to publish its final Annual Plan in March 2018.

The consultation paper is available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/664451/annual-plan-consultation-2018-2019-web-accessible.pdf.

Consumer Protection

UK Regulations on Packaged Retail and Insurance-based Investment Products Published

On December 5, 2017, the Packaged Retail and Insurance-based Investment Products Regulations 2017 were published and will enter into force on January 1, 2018.

The Regulations implement in part the EU Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs Regulation). From January 1, 2018, the PRIIPs Regulation will introduce requirements on manufacturers of PRIIPs to produce a standardized Key Information Document in an official language of all EU countries into which offerings are made. It also requires those advising on or selling PRIIPs to provide retail investors with KIDs in good time before the investor enters into the investment.

This legislation has major implications for many parts of the financial sector, since PRIIPs as defined are likely to include most financial instruments (other than shares). For example, for bonds and exchange traded derivatives, new selling restrictions or disclosures are needed for many financial products.

The Regulations designate the Financial Conduct Authority as the competent authority for the purposes of the PRIIPs Regulation and confer enforcement powers on the FCA. The FCA will be empowered to make orders prohibiting persons from marketing PRIIPs or requiring them to suspend marketing. The FCA will also have the power to issue statements on contraventions of the PRIIPs Regulation and/or to impose penalties.

The Regulations (S.I. 2017 No 1127) are available at: http://www.legislation.gov.uk/uksi/2017/1127/pdfs/uksi_20171127_en.pdf, Correction Slip published on December 11, 2017 is available at: http://www.legislation.gov.uk/uksi/2017/1127/pdfs/uksics_20171127_en.pdf and the Explanatory Memorandum is available at: http://www.legislation.gov.uk/uksi/2017/1127/pdfs/uksiem_20171127_en.pdf.

Financial Crime

EU Final Draft Technical Standards on Mitigating Money Laundering and Terrorist Financing in Third Countries

On December 6, 2017, the Joint Committee of the European Supervisory Authorities published a final Report and final draft joint Regulatory Technical Standards on the measures that financial institutions should take to mitigate the risks of money laundering and terrorist financing where a third country's laws do not permit the application of group-wide policies and procedures. The Fourth Money Laundering Directive, which entered into force on June 26, 2015, requires a financial institution to put policies and procedures in place to mitigate and manage the money laundering and terrorist financing risks to which it is exposed. Where a financial institution is part of a group, the policies and procedures must be implemented at group level. Additional policies and procedures must be implemented where a financial institution has a branch or majority-owned subsidiary in a third country whose laws do not allow the implementation of group-wide policies.

The final draft RTS set out the minimum steps that a financial institution within a group that has entities in a third country should take, such as assessing the risk to the group, ensuring the risk is reflected in group policies and procedures and providing training to relevant staff in the third-country establishments.

Where the third country's laws limit an institution's ability to identify and assess money laundering or terrorist financing risks associated with a business relationship or transaction due to restrictions on access to customer and beneficial ownership information, or prohibit or restrict sharing or processing of customer data or the disclosure of information related to suspicious transactions or the keeping of records, a financial institution should inform its national regulator and take steps to obtain legal consent from its customers to overcome those restrictions. The RTS set out additional measures that must be taken by a financial institution where that is not feasible. These include measures, such

as restricting the nature and type of financial products and services provided in the third country to those that present only a low ML or TF risk and ensuring that other entities in the same group do not rely on the customer due diligence carried out by the group entities situated in the third country.

Finally, where an institution cannot effectively manage the risks by applying the minimum steps and additional measures, it must, depending on the specific circumstances, terminate the business relationship or not proceed with the transaction or close down some or all of the operations provided by the group entities in the third country. However, the extent to which such measures need to be taken can be determined on a risk-sensitive basis. Financial institutions will need to demonstrate to their national regulator that the measures are appropriate in view of the specific ML or TF risks.

The final draft RTS have been submitted to the European Commission for endorsement, following which they will be published in the Official Journal of the European Union. It is proposed that the RTS would apply three months after the RTS entered into force to allow financial institutions to adjust their policies and procedures.

The final Report and final draft RTS are available at: https://esas-joint-committee.europa.eu/Publications/Reports/Final%20Report%20on%20Joint%20RTS%20on%203rd%20countries.pdf.

Financial Services

UK Financial Conduct Authority Publishes Measures to Improve the UK Financial Advice Market

On December 8, 2017, the FCA published a Policy Statement setting out new Handbook rules and guidance to implement some of the recommendations arising from the Financial Advice Market Review launched by the FCA jointly with HM Treasury in August 2015.

The final report of FAMR made a number of recommendations aimed at addressing barriers to consumer access to advice in markets for retail, investments, protection and retirement income planning. The Policy Statement relates to three of those recommendations, namely:

(i) Following a recommendation from FAMR, HM Treasury has amended the definition of regulated advice in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, so that it includes only advice involving a personal recommendation. The change to the definition will mean that, from January 2018, most authorised firms will only be providing financial advice to the extent that they provide a personal recommendation. Informal guidance from firms to support customers making an investment decision will not amount to or be regulated as financial advice. The policy statement sets out the revisions to FCA Handbook rules necessary to effect this change.

(ii) The final report from the FAMR recommended that the FCA set up a dedicated team to provide regulatory feedback and support to firms that are developing mass-market automated advice models. The FCA established its Advice Unit in May 2016. The Policy Statement sets out new guidance based on the experiences to date of the Advice Unit.

(iii) The FAMR also recommended that the FCA should develop guidance on what constitutes a personal recommendation. The Policy Statement states that the FCA will be issuing a further policy statement in early 2018 which will contain finalized perimeter guidance on personal recommendations, following further development of the draft guidance to address issues raised by stakeholders during the consultation process.

The Policy Statement also sets out guidance for firms on how to comply with their Handbook obligations when dealing with “insistent clients.” The term “insistent client” has been used to describe an individual who has received a personal recommendation and chooses to do something other than follow that recommendation.

The Policy Statement is also consulting on retiring two pieces of non-Handbook guidance which are likely, for most firms, to be superseded from January 3, 2018 by the requirements of the revised Markets in Financial Instruments Directive. These are the FCA's non-Handbook guidance on inducements and conflicts of interest and on independent and restricted advice. Firms or individuals who believe this guidance will remain relevant for them following MiFID II implementation should provide feedback to the FCA by January 19, 2018.

The Handbook rules and guidance take effect from January 3, 2018.

The Policy Statement (PS 17/25) is available at: https://www.fca.org.uk/publication/policy/ps17-25.pdf.

Upcoming Events

January 16, 2018: EBA consultation on Pillar 2 draft Guidelines

January 22, 2018: EBA public hearing on draft RTS on the methods of prudential consolidation under the CRR

Upcoming Consultation Deadlines

December 19, 2017: EBA consultation on significant risk transfer in securitization

January 2, 2018: BoE consultation on its approach to setting internal MREL for groups

January 2, 2018: PRA consultation on changes to the PRA's large exposures framework (CP 20/17)

January 2, 2018: EBA consultation on draft Implementing Standards on the provision of information for the purpose of resolution plans

January 4, 2018: PRA consultation on Groups policy and double leverage (CP 19/17)

January 12, 2018: PSR consultation (CP17/2) on authorized push payment scams

January 14, 2018: UK Competition & Markets Authority consultation on its 2018/2019 annual plan

January 15, 2018: ESMA consultation on proposed Guidelines on the position calculation under EMIR

January 16, 2018: European Commission legislative proposals for enhanced powers for European Supervisory Authorities and the European Systemic Risk Board

January 19, 2018: FCA consultation on removing non-Handbook guidance superseded by MiFID II

January 25, 2018: ESMA consultation on amendments to Systematic Internalisers' quote rules under RTS 1 of MiFID II

January 26, 2018: UK Banking Standards Board consultation considering what good banking outcomes look like for consumers

January 29, 2018: European Commission proposed Regulation moving the EBA to Paris due to Brexit

January 29, 2018: European Commission legislative proposals for enhanced powers for the ESAs and the European Systemic Risk Board

January 31, 2018: EBA consultation on Pillar 2 draft Guidelines

February 2, 2018: BoE consultation on the procedure for the Enforcement Decision Making Committee

February 2, 2018: FSB consultations on proposed guidance on principles of bail-in execution and on the funding strategy elements of an implementable resolution plan

February 5, 2018: FCA consultation: Industry Codes of Conduct and Discussion Paper on FCA Principle 5

February 9, 2018: EBA consultation on draft RTS on the methods of prudential consolidation under the CRR

February 15, 2018: Comments due on the Federal Reserve's proposed guidance on supervisory expectations for boards of directors and its proposed new rating system for large financial institutions

February 28, 2018: European Commission consultation on supervisory reporting requirements

March 6, 2018: PRA consultation on proposed updates to the Pillar 2 reporting requirements

March 6, 2018: PRA consultation on model risk management principles for stress testing

This newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. If you wish to receive more information on the topics covered in this publication, you may contact your usual Shearman & Sterling representative or any of the following:

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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