

REGULATORY DEVELOPMENTS IN Q3 2010

A TRAINING AND COMPETENCE PAPER

October 2010

CONSULTATION PAPERS

10/15 6 July Quarterly Consultation No. 25

The 193 page consultation invites comments on miscellaneous amendments to the Handbook including:

- **Changes to FSCS' exit levy** – When firms cease to carry out certain permitted activities the FSCS would be able to charge an exit levy in anticipation of industry-wide claims in respect of that line of business, rather than just when the firm exits the scheme.
- **Fees for deposit takers** – Technical clarification to fee calculation on banks that accept deposits from the public. The tariff base of 'protected deposits' will continue to apply for all accounts that are excluded from the Single Customer View.
- **BIPRU liquidity assessments** – A simplified liquidity regime to apply to firms that are not complex and to introduce additional guidance to BIPRU TP 30 clarifying how the liquidity floor for mismatch banks is intended to operate.
- **Disclosure of firms' commitment to the Stewardship Code** – Amendment to require institutions that are authorised to manage assets for others to disclose clearly on their websites or in another accessible form the nature of their commitment to the Stewardship Code or their alternative business model.
- **Title Transfer Collateral Arrangements** – Amendments to (TTCA) rules and the money due and payable to the firm provisions in the Client and Assets Sourcebook (CASS), to strengthen protection for retail clients who place money and assets with investment businesses, as well as to ensure a consistent application of the FSA's client money and asset rules

10/16 13 July Mortgage Market Review - Responsible Lending

Reflects the FSA's enhanced consumer protection strategy and intensive day-to-day supervision for mortgage lenders so as to ensure that borrowers can afford their debt.

Some of the key proposals in this 185 page document include:

- Imposing affordability tests for all mortgages and making lenders ultimately responsible for assessing a consumer's ability to pay;
- Requiring verification of borrowers' income in every case to prevent over inflation of income and to prevent mortgage fraud;
- Extra protection for vulnerable customers with a credit-impaired history.

The FSA found that:

- 46% of households either had no money left, or had a shortfall after mortgage payments and living costs were deducted from their income;
- Almost half of new mortgages between 2007 and the first quarter of 2010 were provided without a customer having to verify their income;
- The share of interest-only mortgages has been increasing. At the peak of the market, over 30% of all mortgages were interest-only;
- Many consumers with no repayment vehicle count on future house price rises or uncertain life events to repay their mortgage and some have no plan at all;
- Borrowers with a credit-impaired history are particularly vulnerable.

The mortgage rules require arrears charges to be based on a reasonable estimate of the cost of the additional administration required as a result of the customer being in arrears.

10/17 23 July Strengthening Capital Standards 3

The latest chapter in the continuing dialogue between FSA and the industry in relation to introduction of the EU Capital Requirements Directive 2 is a 332 page document proposing policy in relation to:

Hybrid Capital – Firms to obtain a legal opinion about cross-border risk potential on Special Purpose Vehicles.

Large Exposures – Consultation deferred on amendments to the 0% risk weighting of intra-group exposures for credit risk purposes.

Securitisation Provisions – Now that the Directive has been agreed FSA intends to make final Handbook text available for feedback and re-consultation.

Trading Book – Looking forward to when CRD 3 has been agreed, FSA will in due course provide some general guidance on implementing a stressed Value-at-Risk (VaR) measure, implementing the Incremental Risk Charge (IRC) and the all price risk measure requirements.

10/18 23 July Implementing aspects of the Financial Services Act 2010

Publishes final rules and guidance, including a new Handbook module, the Financial Stability and Market Conduct sourcebook. The 115 page document includes new rules and guidance covering:

- Use of the power to impose financial penalties or public censure on those who breach short-selling rules;
- Disclosure of significant net short positions (these will go in a new part of the Handbook covering financial stability and market confidence and the current provisions on short selling in the Code of Market Conduct will be deleted);
- Use of the power to suspend firms or individuals by stopping them undertaking some or all of the activities which they are permitted to carry on for a period of time;
- Use of the power to impose financial penalties on individuals who have carried out controlled functions without the necessary approval from the FSA;

- FSA’s policy on the use of the power to gather information in relation to financial stability from specified categories of both authorised and unauthorised persons to help identify potential threats to the UK financial market;
- Making alterations to the FEES manual to reflect amendments made by the Act in relation to the Financial Services Compensation Scheme’s (FSCS) contribution to the costs associated with resolutions under the Banking Act 2009.

10/19 29 July Revising the Remuneration Code

The 112 page document updates the Remuneration Code to reflect rules required by the Capital Requirements Directive (CRD 3) and the Financial Services Act 2010. The FSA is required to make some changes to ensure full alignment. In particular, the Code will be strengthened in the following ways:

- **Scope of the Code** – As the scope of the Code is expanded, the FSA states that it is committed to applying a proportional approach to implementation and will ensure that ‘institutions shall comply with the principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities’.
- **Application** – the FSA is consulting on the group of employees to which the Code applies (‘Code staff’). These will include senior management and anyone whose professional activities could have a material impact on a firm’s risk profile. The consultation paper sets out examples of the key positions in firms that the FSA believes should be subject to the Code. The onus will be on firms to identify their Code staff in the first instance, but their lists will be subject to review and challenge by the FSA.

High-level category

Suggested business lines (This list is not exhaustive)

Heads, including regional heads, and any individuals or groups within their control who have a material impact on the firm’s risk profile.

Fixed Income, Commercial Banking, Foreign Exchange, Equities, Commodities, Structured Finance, Securitisation, Lending Quality, Sales Areas, Trading Areas, Investment Banking (incl. Mergers & Acquisitions advisory)

Heads of support and control functions and other individuals within their control who have a material impact on the firm’s risk profile.

Credit/Market/Operational Risk, Compliance, Legal, Internal Audit Treasury Controls, Investment Research, Human Resources, Information Technology

- **Deferral** – at least 40% of a bonus must be deferred over a period of at least three years for all ‘code staff’. At least 60% must be deferred when the bonus is more than £500,000.
- **Proportion in shares** – at least 50% of any variable remuneration components must be made in shares, share-linked instruments or other equivalent non-cash instruments of the firm. These shares will need to be subject to a minimum retention policy.

- **Guarantees** – firms must not offer guaranteed bonuses of more than one year. Guarantees may only be given in exceptional circumstances to new hires for the first year of service.
- **Strengthening of capital base** – firms must ensure that their total variable remuneration does not limit the ability to strengthen their capital base. Total variable remuneration must be significantly reduced in circumstances where the firm produces a subdued or negative financial performance.
- **Voiding provisions** – a new rule will be introduced which defines instances where breaches of the code may render a contract void and/or require recovery of payments made.
- **Severance payments** – should reflect performance over time and failure must not be rewarded.
- **Pensions** – CRD3 states that enhanced discretionary pension benefits should be held for five years in the form of shares or share-like instruments.

10/20 27 September Improving the auditor's report on client assets

This 59 page document announces steps to improve the quality and consistency of auditors' reports on client assets. The FSA had reviewed the quality and consistency of auditors' reports in relation to client assets.

The review identified the following material failings and weaknesses in a number of reports:

- auditors providing 'clean' reports, despite the firm having committed significant breaches of the client asset rules;
- auditors' reports covering the wrong chapters of the Client Assets Sourcebook (CASS);
- failure to provide the report on client assets because the auditor was not aware of, or did not understand, the reporting requirements;
- auditors failing to provide adequate detail on the issues and exceptions identified in their report;
- auditors submitting their reports several months late (in some instances, they were submitted years after the period they relate to); and
- some auditors' reports had 'simple errors', such as the auditor not signing or dating the report, quoting the wrong FSA firm reference number, or referring to another firm within the body of the report.

The consultation paper (CP) sets out ten proposals that aim to drive improvements in the quality and consistency of auditors' reports on client assets. The proposals will be applicable to firms and their external auditors. In summary, these proposals aim to:

- Confirm and clarify the standards required for the auditors' reports on client assets in order to provide clear focus of accountability;
- Make consistent and increase the information provided in the report so that the FSA can better utilise it to undertake both firm and thematic reviews; and

- Improve firms' governance oversight of both their auditors and their compliance with the client assets rules.

10/21 27 September Consumer complaints - The ombudsman award limit and changes to complaints-handling rules

The 60 page document proposes changes to FSA's complaints handling rules as part of a package of measures to drive up standards of complaints handling within the industry.

Proposals include:

- Requiring firms to identify a senior individual responsible for complaints handling;
- Abolition of the 'two-stage' complaints handling rule to incentivise firms to resolve complaints fairly the first time;
- Underlining the requirement for firms to carry out root cause analysis, by identifying and remedying any recurrent or systemic problems with complaints, and to take action where appropriate; and
- Additional guidance in relation to taking account of ombudsman decisions and previous customer complaints and learning from the outcome.

Total consultation pages Q3 2010 - 1056

DISCUSSION PAPERS

10/2 1 July Summary of feedback to the Turner Review Conference Discussion Paper (DP09/4)

A 22 page summary of feedback to an earlier discussion paper focussing on "systemic importance" of banks considering policy in relation to:

- higher capital levels in systemically important banks;
- a greater focus on standalone national subsidiaries;
- action to reduce bank inter-connectedness in trading markets;
- the separation of 'narrow banking' from proprietary trading; and
- recovery and resolution plans (also known as 'living wills').

10/4 25 August The prudential regime for trading activities - a fundamental review

This 126 page document sets out a number of recommendations which are grouped into three key areas:

1. Valuation: FSA recommend an increased regulatory focus on the valuation of traded positions and think there is a need for a specific assessment of valuation uncertainty.
2. Coverage, coherence and the capital framework: FSA recommend changing the structure of the capital framework to bring greater coherence and reduce the opportunities for structural arbitrage within the banking sector and the wider financial system.
3. Risk management and modelling: FSA recommend specific measures aimed at improving firms' risk management and modelling standards, and ensuring that these are aligned with regulatory objectives.

FEEDBACK STATEMENT FS 10/3 13 September

Enhancing financial reporting disclosures by UK credit institutions: Feedback on DP09/5

Of interest to the UK's largest credit institutions this 44 page paper concludes that markets function most efficiently when market participants have sufficient information about risks and returns to make informed investment decisions. High-quality disclosures in firms' financial reports represent a key part of this.

POLICY STATEMENTS

24 Sep PS10/15

Effective corporate governance - Significant influence controlled functions and the Walker Review

This is important as it amends the categories of Significant Influence Function, effectively back-peddalling by restoring Finance, Risk and Internal Audit from the previously merged Systems and Controls Function. In addition Non-executive Directors (CF2) can have a variety of labels:

- CF2a (Chairman)
- CF2b (Senior independent director)
- CF2c (Chairman of risk committee)
- CF2d (Chairman of audit committee)
- CF2e (Chairman of remuneration committee)

Other Policy Statements in the quarter:

- 24 Sep PS10/14 Capital planning buffers - Feedback on CP09/30 and final rules
- 24 Sep PS10/13 Pure protection sales by retail investment firms: remuneration transparency and the COBS/ICOBS election. Feedback on CP10/8 and final rules 10
- Aug 10/12 The assessment and redress of Payment Protection Insurance complaints
- 23 Jul 10/11 A review of the Credit Union Sourcebook (CRED)
- 25 Jun 10/10 Delivering the Retail Distribution Review: Corporate pensions - feedback to CP09/31 and final rules

OTHER PUBLICATIONS AND DEVELOPMENTS

Bribery Act 2010

This was passed into the statute book on 8th April 2010

The Acts defines four new criminal offences:

- offering or paying a bribe
- requesting or receiving a bribe
- bribing a foreign public official. (A specific offence required to comply with the OECD Convention)
- a corporate offence of failing to prevent bribery being undertaken on its behalf.

The act defines 'bribery' in wide terms, to capture the differing ways in which bribes are made or received. It sets out several scenarios, or "cases". The one which is expected to apply to most businesses is the offence of giving a bribe, specifically:

"The defendant offers, promises or gives a financial or other advantage intending to induce another person to perform improperly one of their functions in their position of trust and responsibility, or as a reward for improper performance"

The legislation applies to all companies, partnerships and individuals based in England, Scotland, Wales and Northern Ireland, as well as foreign companies and individuals doing business in the UK. It has a global reach, applying to acts or omissions taking place anywhere in the world.

FSA Guidance - http://www.fsa.gov.uk/pubs/anti_bribery.pdf

FSA explored how **insurance brokers** address the risks of becoming involved in corrupt practices such as bribery.

They concluded that broker firms have approached higher risk business involving third parties far too informally and many firms are still not operating at acceptable standards. These firms need to do more to ensure they minimise the risk of becoming involved in bribery or corruption, unwittingly or otherwise. At present, FSA judge that the serious weaknesses identified in some broker firms' systems and controls mean there is a significant risk of illicit payments or inducements being made to, or on behalf of, third parties to win business.

FSA also believe that many firms are not currently in a position to demonstrate adequate procedures to prevent bribery – a defence to the Bribery Act 2010's new criminal offence of 'failing to prevent bribery'. However, FSA are encouraged by the progress of some broker firms over the past year in putting right weaknesses in their systems and controls, particularly through gap analysis against the interim findings of our review and the Final Notice they issued to **Aon Ltd** when they fined them in January 2009 for failing to establish and maintain effective anti-bribery systems and controls. FSA hope broker firms find the examples of good and poor practice in this document a useful tool for improving their systems and controls and raising awareness.

IRAN – RESTRICTIVE MEASURES

On 26 July the EU published a decision concerning further restrictive measures against Iran.

Bank Mellat and the Islamic Republic of Iran Shipping Lines (IRISL), together with all their branches and certain named subsidiaries, have today been designated for an asset freeze by the EU. Detailed guidance on the asset freeze can be found at

http://www.hm-treasury.gov.uk/d/fin_sanctions_iran_270710.pdf

A NEW APPROACH TO FINANCIAL REGULATION – FSA to lose its Objectives

In a Treasury consultation document dated 26 July Chancellor George Osborne stated that FSA "will cease to exist in its current form". A new prudential regulator will be formed that will be a subsidiary of the Bank of England, to be headed by Hector Sants. This will effectively take statutory objective no. 1 (market confidence) away from FSA.

Meanwhile a “Consumer Protection and Markets Authority” is to be established to regulate every firm providing financial services to consumers. This will roughly take away objectives 2 (public awareness) and 3 (protection of consumers) from the FSA.

A new Financial Policy Committee within the Bank of England will be given the power and responsibility to look at the “macro issues that may threaten economic and financial stability and take effective action in response.” This takes objective 5 (financial stability) away from FSA.

The last remaining objective - the reduction of financial crime – will be taken off FSA by the single agency to be created “to take on the work of tackling serious economic crime that is currently dispersed across a number of Government departments and agencies”.

FSA DISCIPLINARY ACTIONS

FSA – fines – 1 July to 30 September 2010 – in £1000s

05/07/2010	Neale Morton	130.00
06/07/2010	Henry Cameron	350.00
07/07/2010	Pace	49.00
08/07/2010	N-Hanced	21.00
09/07/2010	David Head	10.50
15/07/2010	Redstone Mortgages	630.00
19/07/2010	J+J Burley	179.20
27/07/2010	David Jones	320.00
27/07/2010	Ronald Winton	31.50
28/07/2010	David Roberts	14.00
02/08/2010	RBS Group	5,600.00

03/08/2010	Paul Willment	50.00
19/08/2010	Zurich Insurance	2,275.00
25/08/2010	Societe Generale	1,575.00
01/09/2010	Moneywise IFA Ltd	19.60
09/09/2010	Goldman Sachs Intl.	17,500.00
15/09/2010	Robert Yarr	28.00
22/09/2010	Michael Royden	10.50
22/09/2010	Thorntons Law	35.00
27/09/2010	Fabio de Biase	252.24
Total Q3		<u>29,090</u>
1 April to	30 June	50,898
<u>TOTAL since 6 April</u>		<u>79,978.54</u>

Of note is the monetary amount which for the first half of FSA's financial year amounts to more than five times the total annual average for the prior three years. This is a tenfold increase and represents 17.59% of FSA's total budget for the year (35% annualised). At this rate regulated firms can expect a 35% discount on next year's authorisation fees.

A number of other non-financial penalties have been handed out including 4 firms whose authorisation was terminated because they did not inform FSA of an address change. Goldman Sachs' £17.5 million fine was for failing to tell FSA that one of their Approved Persons had received notice that he was to be investigated by an overseas regulator (SEC).