THE NEW UK REGULATORY FRAMEWORK

Impact and Implications on Financial Institutions
# Table of contents

03..........................................................................................................................................................The New UK Regulatory Framework  
03..........................................................................................................................................................What has changed!  
04..........................................................................................................................................................A Service Provider Point of View on the New Regulatory Regime  
07..........................................................................................................................................................Considering Capabilities  
07..........................................................................................................................................................Beyond the Twin Peaks  
08..........................................................................................................................................................Conclusion  
09..........................................................................................................................................................About the Authors  
09..........................................................................................................................................................About Wipro
The New UK Regulatory Framework

As of April 1 2013, UK has a new regulatory regime – the twin peaks of the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA). The introduction of this new regime has been surprisingly quiet, given the potential for profound implications for UK Financial Institutions. The new structure is seeking to close gaps in regulatory information gathering and legal powers, and has raised expectations regarding its performance from political areas. Regulators wish the UK to continue to be a centre of excellence for the financial services industry, hence their interest in ensuring financial institutions deliver more data, reports and controls – all to a higher standard and increased frequency. Firms require a new approach, which is more integrated and holistic and includes both operational changes and new technology infrastructure. Failure to have such plans in place, soon, is highly likely to attract regulatory attention.

What has changed

The PRA will be responsible for the day-to-day supervision of financial institutions that manage significant risk on their balance sheet. It will adopt a more judgment-focused approach to regulation so that business models can be challenged, risks identified and action taken to preserve financial stability.

An independent conduct of business regulator, the Financial Conduct Authority (FCA), will take a tough approach to regulating how firms conduct their business. It will have a strong mandate for promoting confidence and transparency in financial institutions and to give greater protection to consumers of financial services. It will also have a strong role in promoting competition.

The creation of the two new regulators has been used as an opportunity to clarify mandates for all parts of the regulatory process. Regulators are therefore confident that gaps in regulation and legal powers will reduce as we go forward under the new regime.
Banks, insurance companies and strategically important financial institutions in the UK have faced an unprecedented volume of regulations since the Global Financial Crisis (GFC) of 2008. Coping with regulatory demands, while also seeking to rebuild balance sheets and (in some instances) capabilities has been a significant management challenge. We are now beginning to see clear distinctions between the responses of banks, with the most capable starting to emerge. Many financial institutions have raised the hope that the regulatory demands will soon end, partly as a response to the great progress made in some significant areas since the GFC.

Unfortunately, we see no end to the regulatory waterfall for the largest global financial institutions. Regulators have themselves been going through significant change programmes, including validation of skills, recruitment in key areas, model building and extending the data they are able to collect. Political will to reform banks remain high; the enhanced confidence in their own skills, increased resources and undoubted backing means regulators remain ambitious. Further, they have a clear lack of tools in their regulatory portfolio to comprehensively monitor the global financial system and identify emerging risks at an early stage.

Our point of view remains that there will be a continued flow of regulatory requests for data supporting increased analysis. This process is likely to produce new controls and reports, justifying further data requests. As such, financial institutions should plan for a continuing regulatory waterfall running for at least 3 years globally, but likely to be much longer in Europe.

To meet the demand for data - both regulatory and for senior management, technology investments will be required. The litmus tests will be:

- **Ad hoc reporting** – is it accurate, complete and timely?
- **Stress testing** – do firms still retain effective risk controls under both financial stress and physical disruption? This may include network security and privacy controls
- **Risk Culture** – has this improved and how can it be demonstrated – risk technology spend being a key, but not an exclusive, indicator of progress
Financial Conduct Authority

The FCA was formed in April 2013 as part of the re-organisation of financial regulation in the UK following the Global Financial Crisis. The key objectives of the FCA are:

- Delivering Consumer Protection – giving an appropriate level of protection to consumers
- Enhancing Market Integrity – ensuring the integrity of the UK Financial System
- Building Competitive Markets – promoting effective competition in the interest of consumers

The FCA differs in a number of respects from the FSA - it has a much more focused mandate and objectives, which will be backed up with a more rigorous approach and stiffer penalties for non-compliance. Also, in 2014, the FCA is likely to take over the responsibilities for Consumer Credit from the Office of Fair Trading (OFT) and the regulation of second charge mortgages. This would make the remit of the FCA similar to the US Consumer Financial Protection Bureau (CFPB).

The FCA has highlighted five areas as a continuation of their research into emerging risks in the market. These include:

- The design of products and services to meet consumer needs
- Lack of transparency in distribution channels
- Over reliance on payment and product technology
- Shift towards more innovative, complex or risky funding strategies posing a risk to market integrity
- Consumers taking on inappropriate risk due to poor understanding of risks and returns

The FCA has designed a new Conduct Risk supervisory framework called the Firm Systematic Framework (FSF). This will include assessments of financial institutions conduct risk processes as depicted in the figure below:

**Figure 2: Firm Systematic Framework**

The initial focus in 2013 will be on the largest retail deposit takers with the intention of extending the scope to all banking and insurance firms with both a retail and wholesale focus.

The FCA enforcement regime will be built around market abuse, transaction reporting and market surveillance, Systematic Anti-Money Laundering Programme (SAMLP), which will also include anti-bribery and corruption, and redress. Much of this has been inherited from the FSA, however, penalties and accountability are likely to be much higher than under the replaced regime. As new legislation comes into force such as the EU AML Directive IV, the SAMLP process will be updated. Financial Institutions will need to take a much more holistic and integrated approach to compliance to ensure that they are in line with the expectations of the FCA.

**Inherent Factors** include lack of relevant, clear information for consumers, lack of understanding of complex financial products, mismatches between the needs of consumers and the available products & services, and potential lack of inertia for consumers to act.

**Structures and Behaviors** include in-built conflicts of interest, inappropriate cultures & incentives, and ineffective competition.

**Environmental** priorities include regulatory and policy changes, new technological developments, economic and market trends.
**Prudential Regulation Authority**

The PRA became responsible for regulatory activities on 1st April 2013, having been created by the Financial Services Act in 2012, alongside the FCA. It is part of the Bank of England as is the Financial Policy Committee and Special Resolution Unit.

Around 1,500 banks operate in the UK with around 200 more firms categorised as building societies, credit unions, insurers etc.

The PRA is charged with the statutory objective of promoting safety and soundness, which is defined in terms of avoiding harm to the stability of the UK financial system. Stability is defined in terms of the continuation of critical financial services.

Critical financial services were defined by the FSA in one of the last major pieces of work it undertook – Recovery & Resolution Planning. This was structured as a data gathering exercise intended to enable the FSA to judge the state of preparedness of banks to meet Recovery and Resolution, as well as to understand what functions they viewed as economically critical.

Phase 2 of this exercise is due in Q4 2013 and will be one of the first major pieces of regulation put forward by the PRA. This will take the form of individual instructions to G-SIBs and G-SIFIs based in the UK, advising them of the new data they must report to the Bank of England to support its monitoring of critical economic functions. The primary focus will be on retail deposits and payment services, though there are mechanisms to extend the definition of critical economic functions, which currently includes:

- Facilities for accepting deposits or other payments into an account
- Facilities for withdrawing money or making payments from such an account
- Overdraft facilities in connection with such an account

It is widely assumed that a de minimis exemption will apply for UK institutions with less than GBP 25 billion in retail deposits. In addition, building societies are not regarded as “ring-fenced bodies” or otherwise subject to the legislation, although the Treasury is empowered to pass similar rules for these institutions.

The Bank of England historically has taken a more quantitative approach than the FSA to regulation, reflecting the skills and training of its staff. Given the recent EBA and BIS commentary on the dearth of data available on key banking sector macro-economic risks, it is to be expected that the next 18 months will see the PRA issue a number of calls for additional data. As this is analyzed, banks should then expect pointed discussions on levels, monitoring and control of risks.

The FSA participated in a regulation waterfall between 2008 and 2012. The PRA is likely to reduce this slightly. Banks should expect continued requests for data, with relatively short lead times, as the PRA seeks to build its monitoring capabilities. Meeting these requirements will be easier for banks with:

- High data quality
- Agile systems
- Strong technology programme management
- Good integration between risk, finance and compliance systems
- Strong corporate memories
- Good communication between regulators, risk, finance and technology professionals

While the PRA’s role is relatively narrow, it operates in an environment where it has to work well with international regulators both in developing legislation and as part of the supervision of the Home / Host regulatory framework. It has published the Financial Stability Report, which covers the Global Financial Environment as well as the medium and short term risks. There is an increasing body of material which indicates future areas of regulatory interest and activity.

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basel III: Capital</td>
<td>BIS / EBA</td>
</tr>
<tr>
<td>Basel III: Liquidity</td>
<td></td>
</tr>
<tr>
<td>Risk Data Aggregation</td>
<td></td>
</tr>
<tr>
<td>Best practice risk management</td>
<td>Forthcoming PRA Risk Management Symposium, July 2013</td>
</tr>
<tr>
<td>Re-engineering risk frameworks and governance towards a new risk culture</td>
<td></td>
</tr>
<tr>
<td>Strengthening risk controls</td>
<td></td>
</tr>
<tr>
<td>Risk based pricing</td>
<td>EBA</td>
</tr>
<tr>
<td>Stress Tests</td>
<td></td>
</tr>
</tbody>
</table>
Considering Capabilities

Few firms have invested in objective challenge (an independent review) of their cultures, risk frameworks and controls. This remains as a crucial cornerstone of leading practice. Leaving such a review to the regulators, especially a new one with incentives to ‘flex its muscles’, has scope to leave Boards critically exposed.

The reporting requirements create the need for data agility. We define this as the means to report completely, accurately and timely to multiple users (in flexible formats) in a cost effective and efficient manner. Most firms will need to enhance their data quality and database structures to meet this challenge. Regulators expect strategically important firms to meet higher standards – we interpret this as meaning strategic goals need to be based around intraday reporting capabilities including capture of material valuation and position movements.

Analytic capabilities need to be extended to protect the Board. If the regulator is more quantitative - driven by data and analysis, it makes sense to be at least one step ahead. Once data agility is achieved then analytic and reporting capabilities can be extended. Risk Governance and Culture will need attention too. At a minimum, Boards should establish a baseline for the Risk Culture and objectively measure progress across several dimensions over time.

Beyond the Twin Peaks

Solvency II has many overlays with Basel III legislation. To date, the new UK regulators have been silent on activity, continuing the direction and timetable set out by the FSA. It is clear that European Regulators are working to a different timetable, leading to some industry frustration as ably expressed by the Head of Lloyds of London insurance market (March 27, Financial Times). The insurance markets remain a strategically important part of the financial sector and such firms should expect to be included in data collection and analysis sponsored by the PSA. Timing of such inclusion remains uncertain and may well not be until 2014.

Twin peaks references captures the collaboration between the FCA and PRA. Many industry commentators have overlooked the other two parts of the Bank of England’s Regulatory approach. However, the Bank of England also runs the Financial Policy Committee and Special Resolutions Unit. It is worth considering these units roles, especially as they will work closely with the PRA going forward.

Financial Policy Committee

The FPC was established under the Financial Services Act 2012. The FPC is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective of supporting the economic policy of the UK Government. The committee is responsible for the Bank of England’s bi-annual Financial Stability report – published in June and November each year.

The FPC has two main powers. The first is to make recommendations, specifically on a comply or explain basis to the PRA and FCA. The second power is to direct those regulators to adjust specific macro-prudential tools. These tools are the Countercyclical Capital Buffer (CCB) which aligns the UK with the EU as set out in the Capital Requirements Directive and Regulation paper (CRD4/CRR). The FPC may also set Sectorial Capital Requirements (SCR). It is planned that from 2018, the FPC will also have direction power over a time-varying leverage ratio.

The CCB tool would allow the FPC to change capital requirements above normal levels for all banks in the UK. The SCR tool is intended to be more targeted and will address concerns relating to specific sectors, which have scope to pose risks to the system as a whole. Initially, this will focus on residential property, commercial property and other parts of the banking sector. More granular sub-sectors may also be impacted such as high loan to value mortgages.

The combination of the two factors brings the UK into line with international regulatory practice. Banks will have a common playing field against their peers in the UK, however, there is scope for significant differences to emerge between UK and EU bank capital requirements.

Specialisation in specific sectors will still be allowed but will only fall outside of the regulation i.e. be exempt from SCR add ons, for banks with balance sheets of less than £25billion. High margin lending or areas of strong demand are no longer likely to see universal and long-term support from banks as the CCB and SCR will be used to smooth such bubbles and modify exposure of the banks. Banks would therefore benefit from being able to conduct their own sectorial analysis and identify trigger points for exit or reduction in exposure. Discussing such initiatives with the PRA is also likely to be valuable.

The recent efforts to ban former Directors who supported excessive growth (Vince Cable comments on former HBOS Directors, 7th April 2013) may also act as an incentive for Boards to develop their own viewpoints in this area.
Special Resolution

The Banking Act 2009 created a Special Resolution Regime which acts as a framework for dealing with failing UK banks. These powers and tools have now been passed to the Bank of England. The PRA, in conjunction with HM Treasury, will make the decision to place a bank under SRR. The Bank of England will then decide which tools to use to implement the resolution. The SRR powers allow authorities to:

- Transfer all or part of a bank’s business to a private sector purchaser (Transfer)
- Transfer all or part of a bank’s business to a bridge bank (Bridge)
- Place a bank into temporary public ownership
- Apply to put a bank into the Bank Insolvency Procedure (BIP), which is intended to support rapid payments under the Financial Services Compensation Scheme
- Apply for the use of the Bank Administration Procedure (BAP) to deal with parts of a bank that are not transferred

To meet regulatory requirements and the new focus of the FCA and PRA, financial institutions face several challenges – all of which will be explored by the regulators over the next 18 months. Firstly they must be able to provide comprehensive valuation and risk data to support SRR and Board efforts. Secondly, such frameworks must continue to be effective even when part or all of the businesses have been sold, and of course meet both home and host regulator reporting requirements. Finally, risk culture needs to be objectively measured across several dimensions to ensure progress is made.

Few banks have invested in the necessary technology to fully meet such requirements. A long term programme looking at data, reporting and controls will be required to be successful. Operations are also impacted, for example in collateral management. Leading players have started integrated programmes, while, weaker players are trying to tie together siloed efforts and are making piecemeal progress.

We believe we can help accelerate and leverage investments made across risk and finance areas so that financial institutions can better meet the likely challenges emerging from the new UK regulatory structure.

Conclusion

Citations

Bank of England – Prudential Regulation Authority website: http://www.bankofengland.co.uk/pra
HM Treasury website: http://www.hm-treasury.gov.uk
‘Prudential Regulation – Challenges for the future’, speech by Andrew Bailey, 04.10.12
‘The future of UK Banking – Challenges ahead for promoting a stable sector’, speech by Andrew Bailey, 24.05.12
About the Authors

Michael Daniels has 20 plus years of experience of Risk Management gained with G-SIBs and international regulators. He worked extensively on Basel II and the implementation of Economic Capital frameworks, covering modeling, data collection and reporting. He has led bank and Board responses to regulatory reviews. He has supported Boards in evaluating provision and capital requirements – especially for troubled portfolios. He is currently helping many clients, globally, to develop their Recovery and Resolution plans.

Richard Thornton has 30 years of experience in Financial Services and has worked in Risk and Compliance for 20 years. He has delivered large-scale change programmes covering Basel II, MiFID, KYC, Sarbanes Oxley. Currently he is driving change to support global KYC initiatives, FATCA, Dodd Frank and EMIR.

About Wipro Risk & Compliance Practice

Wipro has delivered 95+ Risk and Compliance (R&C) engagements and has over one thousand people engaged in projects with clients in this area. The R&C practice brings over 3,000 person years of experience with a team of expert industry practitioners who partner with clients to help them meet their risk & compliance obligations. Wipro has also been the winner of Financial Times / ‘The Banker’ magazine’s "Risk Management Award" for developing an enterprise-wide Operational Risk Management Solution for a global bank.

About Wipro Finance Solutions

Finance Solutions is Wipro’s biggest business in terms of revenue and includes clients in the banking, insurance and securities & capital market industries. We strive to bring transformational change to our clients. Our banking practice has partnered with over 50 of the world’s leading banks including four of the top five banks worldwide and leading banks in the Asia Pacific region. Our insurance practice has been instrumental in delivering success for our Fortune 100 insurance clients through our solutions accelerators, insurance IP, end-to-end consulting services and flexible global delivery models. We have partnered with leading investment banks and stock exchanges worldwide, providing state-of-the-art technology solutions, to address business priorities including operational efficiency, cost optimization, revenue enhancement and regulatory compliance.

About Wipro Technologies

Wipro Technologies, the global IT business of Wipro Limited (NYSE:WIT) is a leading Information Technology, Consulting and Outsourcing company, that delivers solutions to enable its clients do business better. Wipro Technologies delivers winning business outcomes through its deep industry experience and a 360 degree view of “Business through Technology” – helping clients create successful and adaptive businesses. A company recognized globally for its comprehensive portfolio of services, a practitioner’s approach to delivering innovation and an organization wide commitment to sustainability, Wipro Technologies has over 140,000 employees and clients across 54 countries. For more information, please visit www.wipro.com