Developments on the EU Financial Services Legislative agenda

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Dr. David P. Doyle
Policy Adviser – EU Financial Services Legislation

Heavy ongoing EU Agenda in Financial Services Legislation

Cultural shift in Regulatory reform

- Regulating **capital markets** and **market actors**
- ‘Safety first’ approach
- Filling in the gaps between European and national regulation
- Fast track model: **Less directives – more regulations**
- More elevated and Pan-EU centralised supervision
- Assertive powers vested with the EU Parliament

- Capital requirements Directive/Regulation IV
- Remuneration and bonuses
- Banking Union: ECB supervisory powers, Bank Resolution, Deposit Guarantee
- Alternative Investment Fund Management
- EMIR: OTC derivatives, CCPs, trade repositories, short-selling
- Insurance Mediation Directive
- Solvency II
- Packaged Retail Investment Products Regulation
- UCITs IV + Asset Management
- Credit rating agencies
- Shadow Banking
- Bank Structures
- MiFID II
- Market Abuse Directive
- EU Mortgage Credit Directive
- Pensions
- Corporate governance reform within financial institutions

Regardless of costs, regulatory reform is here to stay

All that is of systemic importance should be regulated and supervised

To restore trust, investors and consumers should encounter clearer, more coherent and more effective safeguards

Supervisory bodies should have the right tools to grasp the complex, interconnected and globalised financial nature of activities

There is a need for a better capitalised finance industry with less leverage

Perverse incentives in the financial sector should be tackled and reduced

Greek EU Presidency agenda

◆Key legislative texts prioritised before the end June 2014…

- Completing the banking union: Single Resolution Mechanism + new Single Supervisory Mechanism
- Long-term financing of the economy and SMEs' facilitation of access to financing
- MiFID/MiFIR package
- Revised legal framework for payment services (SEPA)
- Directive on the comparability of fees related to payment accounts, payment account switching and access to payment accounts
- Private and occupational insurance sector: transparency and supervision

EU Bank Resolution and Recovery Regime (Directive)

The main resolution measures would include:

- the sale of (part of a) business
- establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity)
- asset separation (the transfer of impaired assets to an asset management vehicle)
- bail-in measures (the imposition of losses, with an order of seniority, on shareholders and unsecured creditors

Cascade of loss-absorbing bank liabilities - the bail-in hit list:

- \- Shareholders
- \- Junior creditors
- \- Senior creditors, large corporate deposits – above € 100,000
- \- deposits above € 100,000 of individuals + SMEs to "*benefit from a preferential treatment ensuring that they are do not suffer any loss before all other secured creditors' claims are absorbed*".
- \- "If additional resources are needed, these will be taken from the national, prefunded resolution fund".

Deposits less than € 100,000 exempted

Diluting the link between collapsing banks and sovereigns -

The EU Single Resolution Mechanism (SRM)

- •Targeting largest 130-150 SSI banks (85% of Eurozone banks)
- • SRM to establish a single resolution Board to carry out resolution of any bank (EC, ECB + national agency)
- • Size of Resolution funding: national funds to reach 1% of all authorised deposits of each credit institution within 10 years
- • "Responsibility of covering bank losses on private investors in banks and the banking sector as a whole".
- • Deposit guarantees excluded for now
- • Cooperative and savings banks excluded

- Maximum amount of a bank's total liabilities in public funds/resolution funds that can be used: 5%
- National flexibility in using resolution fund allowed once losses equal to 8% of bank's total liabilities

- Implementation: The bail-in tool will apply as from 1 January 2016.

Exemptions to bail-in

- covered bonds
- secured liabilities including covered bonds
- liabilities to employees of failing institutions, such as fixed salary and pension benefits
- commercial claims relating to goods and services critical for the daily functioning of bank
- liabilities arising from a participation in payment systems which have a remaining maturity of less than 7 days
- inter-bank liabilities with original maturity of less than 7 days

The European Central Bank – the new sheriff in town

The Single Supervisory Mechanism – what powers will it have?

- Monitors capital, liquidity and leverage requirements
- Authorises and revokes ban licence
- Enforces recovery plans
- Conducts stress tests
- Approves bank mergers & acquisitions (domestic and cross-border)
- Supervises early intervention in case of breaches of prudential rules (recovery plans, intra-group financial support arrangements, etc.)
- Empowered to request information **directly** from banks, conduct office visits, investigate.
- Impose restrictions on bank lending

2014 launch of Asset Quality Review of Eurozone banks to "help dispel concerns over deterioration of asset quality due to macro-economic conditions in the EU"

Fine-tuning the ECB Rules

Coordination between supervisors is vital but the crisis has shown that mere coordination is not enough" **(Council Regulation, May 2013)**

- Banks with assets in excess of €30bn (£28bn) assets in excess of €30bn (£28bn)
- Banks receiving support under the European Stability Mechanism (ESM) bail-out fund and employing state-aid
- Banks whose total assets exceed 20% of its country's GDP
- Exemptions for small banks with assets less than €5bn (£4bn) –national supervision

- At ECB initiative, intervene with bank of significant relevance where it has banking subsidiaries in more than one participating EU State and its cross-border assets or liabilities represent a significant part of its total assets or liabilities

- Non-participating Member States: MOU relating to ECB decisions impacting on subsidiaries or branches in these States, whose parent undertaking is established in a participating Member State (Council Regulation, May 2013

- Supervision at the consolidated level, of financial holding companies and supervision of mixed financial holding companies, excluding insurance undertakings

Restructuring the bank sector

The Liikanen Report (2012)

- Separation of activities based on an assessment of a firm's recovery & resolution plans or a mandatory separation of proprietary trading and other high risk activities.

Scope

- All bank's with assets held for trading and available for sale exceeding :

(i) a relative examination threshold of 15-25% of the bank's total assets or
(ii) an absolute examination threshold of EUR 100bn (US$ 129bn, £80.7bn).

► Supervisors would determine the need for separation based on the share of assets to which the separation requirement would apply

Arlene MacCarthy MEP Resolution (2013)

- Separate balance sheets
- Non-linked funding of retail and trading businesses
- Mandatory separation of bank's retail and investment activities
- Strict limits on intra-group transactions and exposures of the retail entity arising from the investment entity
- Independent decision-making and governance for each entity: separate executive and non-executive board members
- Separate capital, leverage and liquidity rules

Restructuring the bank sector

« The Barnier Rule »

Key proposals

- **National supervisors to have wider discretionary powers in applying the banking reforms and deciding, in the final analysis, which bank in its jurisdiction should be subject to ring-fencing .**

- **A EU version of the Volcker Rule: prohibits proprietary trading by EU banks – to be decided by national regulators**

- **Small and medium sized exempt from any separation between lending and trading functions and proprietary trading bans**

The EU Capital Requirements Directive - Regulation IV

- Bankers' remuneration:
- 1:1 ratio - 1:2 with shareholder approval – possible extension to "material risk takers" at 1:2 ratio (EBA proposal).
- 76% risk weightings for SME financing above €1.5m
- Liquidity coverage ratio:
- Easily available money within 30 days: the Liquidity Coverage Requirement needs to be implemented for 60% in 2015, and 100% in 2018 or 2019.
- Net Stable Funding Requirement will not become fully defined and implemented before 2018.
- Leverage ratio:
- defines how banks should calculate their leverage ratio, which banks do not need to disclose to regulators until 1 January 2015; probably not fully to the public.
- Supervisors to assess the risks of the leverage ratio of the bank. Commission report in 2016 and possibility of separate law for binding leverage ratio as of 2018.

CRD IV – « europeanisation of Basel III »

New disclosures

- G-SIFIs and O-SIFIs required to report the following to EU Commission by **July 2014** on country-by-country basis:
  - - Profits made
  - - Taxes paid
  - - Subsidies received
- New disclosures – all other banks to report:
  - - Number of employees per institution
  - - Net banking income
  - e

Agenda in the retail investment space

- Insurance Mediation Directive (IMD)
- Packaged Retail Investment Products (PRIPS)
- Reform of the EU Pensions Regime
- Markets in Financial Instruments Directive (MiFID)

- *" European consumers deserve better. They need reassurance that their savings, investments or insurance policies are protected no matter where in Europe they are based "* (Commissioner Barnier, 2010)

European Markets Infrastructure Regulation (EMIR)

- **Summary of measures agreed:**

  - **Compulsory central clearing**
  - **Standardised contracts eligible for clearing**
  - **Counterparties subject to the clearing obligation**
  - **Risk management/margin requirements for non-cleared contracts**
  - **Reporting Requirements**
  - **Requirements for CCPs and Trade Repositories.**

Scope

All eligible OTC derivatives trades are subject to central clearing and reporting to trade repositories.

Exemptions to central clearing and margin requirements granted to:

- **Intra-group transactions subject to the opinion that such transactions are not capable of significantly increasing systemic risk**
- **Pensions (for 6 years) but subject to the reporting and bilateral collateralisation requirements during that time**
- **Corporates (up to a transaction ceiling to be determined by ESMA and ratified by the EC)**
- **Covered bonds issued by a non-bank special purpose vehicle may be exempt, within certain parameters**
- **Central banks**

Markets in Financial Instruments Directive (MiFID) – review and update

What has changed?

►Escalation of Scope of MiFID I to include fixed income, OTC derivatives and commodities

► Introduction of maximum harmonisation' framework with little or no scope for derogations, gaps, re-interpretations, or Member State gold-plating.

► Investor Protection is taken to a new level of authorisation, supervision and enforcement under MiFID II.

Key characteristics

- **Scope: all banks, investment firms, certain non-financial institutions, intermediaries, tied-agents, independent financial advisers, etc**
- **Conduct of business obligations**
- **Investment advice**
- **Informing clients on complex products**
- **Client classification:**
  - **- eligible counterparty**
  - **- professional client**
  - **- retail client**
- **Execution quality & best execution**
- **Fit and proper criteria**
- **EC abolishing national options and discretions in MiFID I: A "Single Rule Book" applicable to all market players.**

MiFID review – and outcome…"less betting, more investment"

- The retention of OTFs for non-equity trades only, ie, bonds and derivatives)
- client facilitation applies to non-equities only to " bring together two or more potentially compatible trading interests in a transaction"
- HFTs: checks, reporting and filters on orders introduced: 'circuit breakers'
- Commodity derivatives - position thresholds i.e., maximum net positions traders can hold/enter into over specified period
- Dark pools: reference price waiver and negotiated trade waiver retained, but subject to Council exemptions for trading platforms to publish pre-trade quotes capped at 4% per stock/per venue + 8% per stock/EU-wide basis - alternatives being considered
- Retention of ban on commissions – when providing investment advise on independent basis + with explicit upfront disclosures:
  - 3rd party payments prior to investment advice is given
  - If advice is given on the basis of a limited number of instruments.
  - Commitments on frequency of assessment on suitability of investments.
- New obligation: when designing new products, specify a target group within retail or professional category with offerings meeting their needs and 'marketed to clients within the target group'.
- Non-discriminatory clearing access between CCPs and trading venues
- Access requirements for ETDs likely to face a 3-year delay

Packaged Retail Investment Products (PRIPS)

- **Pre-contractual product disclosure**
- **Sales practices**

KID Key Information Document:
must provide:

- ***What is this investment?***
- *What is it for?*
- *Could I lose money?*
- *What are the risks and what might I get back?*
- *What are the costs?*
- *How has it done in the past?*
- *What might I get when I retire?*

- Scope proposed by the EC:
  - Structured term deposits
  - Retail Investment (or mutual) funds
  - Closed and open-ended funds
  - Investments packaged as life insurance policies
  - Retail structured security products
  - Unit-linked insurance contracts
  - ‘Complex’ products

…and the MEPs want:

- Shares
- Bonds
- Bank products (term deposits, Euro-denominated life insurance)
- Voluntary pension savings’ products, DC schemes
- Investment products with yield linked to interest rates
- Tax implication’s review

UCITS V

- Clarification of the UCITS depositary’s functions and liability in circumstances where assets are lost in custody

- Rules governing remuneration policies

- Harmonisation of the minimum administrative sanctions regime across Member States

- CRD IV bonus-cap narrowly avoided on all fund management companies running a UCITS-approved fund (EP July 2014)!

- Compromise: requires managers to substantially cut variable pay when the performance of the fund has "subdued or negative financial performance“.

- Powers vested with EU Member State regulators to scrutinise bonus levels of UCITS management companies to ensure consistency with the principles of sound and effective risk management and appropriate levels of risk taking.

- Remuneration rules for UCITS managers:

- At least 50% of any variable remuneration must consist of units of the UCITS;

- At least 25% of the variable remuneration must be deferred, over a period of at least three to five years (unless the life cycle of the relevant UCITS is shorter).

- Scope: fund managers, other persons who take investment decisions that affect the risk position of the fund or persons with the power to exercise influence over staff, senior managers, risk takers and persons in control functions

- New requirement: UCITS management companies to disclose details of remuneration policies in the key investor information document (KID)

Thank you!

- dpdoyle@free.fr
- Mobile: +33 628 69 40 40

- Published material:

- *Cost Control - A Strategic Guide* (CIMA/Elsevier: London, 1994/2002)
- EU chapter to *The Future of Finance after SEPA* (Wiley: London, 2008)
- EU chapter to *A Practical Guide to Corporate Governance* (Sweet & Maxwell: London, 2010).