Realigning the rules

Delivering Capital Markets Union – a summary of progress

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What should be the priorities for financial regulation?

This is not an opportunity to abandon regulations, rather a targeted recalibration to address unanticipated effects.

Capital Markets Union (CMU) represents an opportunity for Europe to rebalance provision of financial services in the economy and grow capital markets, while maintaining the role of banks as both providers of credit and intermediaries between investees and alternate providers of debt and equity finance.

Financial stability is vital. Measures taken over recent years to achieve stability must be balanced with those that are necessary to remove the barriers and disincentives which are preventing a greater flow of investment across borders within Europe and inward investment from other parts of the world.

Achieving growth means businesses recognising and embracing the risk/reward ratio. However, this will require increased levels of transparency, control and oversight to be accepted by businesses.

Within the context of CMU the European Commission is taking stock of all financial regulation introduced since the financial crisis; looking at where rules are creating constraints are imposing unnecessary burdens or have created inconsistencies on the wider economy. There has been a change in tone and acceptance of the need for more flexibility – but on the condition that it is backed by evidence. What is unclear is how actual changes to the rules will be made and over what timescales.

KPMG member firms have submitted a response to the European Commission along with three hundred other market participants, public bodies and private citizens. An initial summary published by the European Commission[1] shows wide-ranging concerns by industry. This paper summarises our position and also provides analysis of the key themes emerging.

Early signals from the European Commission appear positive. In recent speeches[2] Commissioner Hill has indicated action will be taken to address many key areas of concern including:

- Taking a more proportionate approach to different business models and smaller banks on reporting, capital requirements and derivatives clearing.
- Ensuring financing of the economy is maintained by further amending capital requirements for insurers investing in infrastructure assets and reviewing the passporting barriers for investment funds.
- Reducing the compliance burden to help market liquidity by adjusting calibrations in the revised Markets in Financial Instruments Directive (MiFID II) and assessing the impact of Basel measures including the revisions to the market risk framework.

Further work and answers are required. This paper summarises the current position. Progress will be made during 2016.

[1]European Commission summary of contributions to the 'Call for Evidence' May 2016.
[2]Commissioner Jonathan Hill at the EUROFI High Level Seminar, Amsterdam, April 2016 and Call for Evidence hearing, Brussels, 15 May 2016.
[3]KPMG Pulse of Fintech Q1'16 Report.

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Why are changes being considered?

The prize of boosting capital markets would see growth in alternative financing options for business and more opportunities for investors. Compared to the US capital markets, those in Europe are less diverse and highly dependent on bank finance, when for some higher risk businesses alternative sources of debt or equity would be more appropriate. Funding of FinTech highlights the limits of Europe's capital markets, in Q1 2016 Europe's FinTechs raised USD0.3 billion in venture funding compared to USD1.8 billon in the US and USD2.6 billion in Asia, a KPMG report shows[3]. Un-necessary barriers on FinTech has a knock-on effect on the role alternative finance can play in SME funding, the European Commission's recent report on crowdfunding shows Europe lagging behind both the US and Asia on volumes.

The Commission has recognised that post-crisis regulations could be dampening the operation of markets and so acting against the goals of building stronger capital markets.

A combination of regulation, incentives and investor confidence are holding European potential back. By developing the pool of investible assets, more investors could benefit from the opportunities and the wider market would benefit from the increased liquidity and greater risk dispersion. In parallel the EU is also looking at how personal pensions could be extended across more countries to meet the challenges of the retirement savings gap. Despite the challenges, the benefits could be considerable.

Regulation is undoubtedly having a significant impact on the functioning of capital markets and therefore change is required. The pressures on banks' balance sheets are ranging from capital, liquidity and leverage requirements to the complexity of reporting and transparency requirements on buy- and sell-side firms. Leaving banks unwilling and indeed unable to be part of the solution.

An inflection point in regulation?

The process of change begun with a 'call for evidence' request on EU financial regulation, which closed in January 2016. Industry and other stakeholders were asked to provide concrete examples of how regulations are causing detriment.

Implementation programmes of all the major inflight wholesale and retail markets regulations such as MiFID and its accompanying regulation MiFIR, Markets Abuse Regulation (MAR), Securities Financing Transaction Regulation and Packaged Retail Investment and Insurance-based Products Key Information Document (PRIIP KID), to name but a few, will have to continue to meet deadlines. This means that program implementation – including strategic, operational and system considerations – will need to allow for flexibility to anticipate potential change and avoid costly re-work.

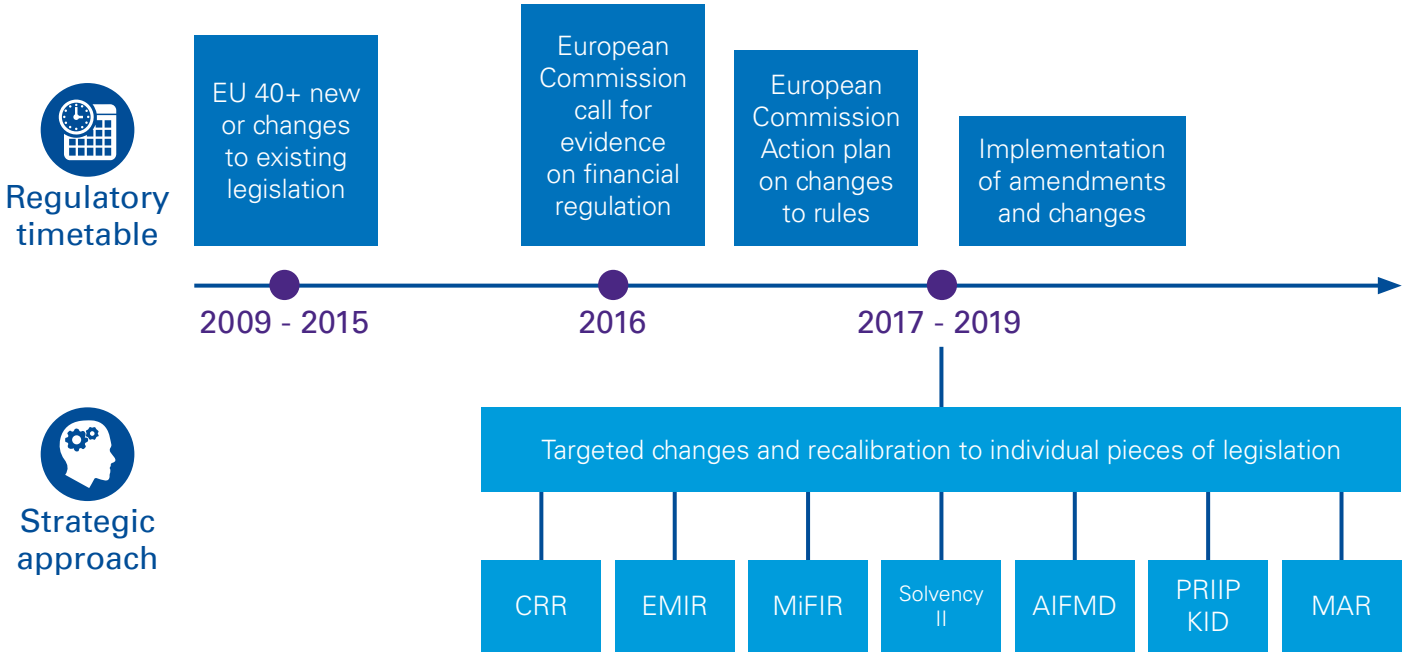
What will happen and when?

The difficult balancing act will be to strengthen market confidence through strong stability and appropriate investor protection measures without placing excessive costs and complexities on the operations of firms.

The Commission has begun the process to review what has been done and, where credible evidence is presented, has a commitment to make necessary changes. How this will be implemented isn't clear. The hope is that when the Commission reports back later in 2016 there will be a coherent overall plan outlining where adjustments can be made through existing review clauses within legislation. Early indications are that targeted changes will be made and reviews of transversal issues such as reporting and passporting barriers will be addressed.

For firms managing complex implementation programmes, any further uncertainty of where changes will be made and by when would not be helpful and could be counter-productive to the goals of boosting capital markets. We are likely to see proposals to revise rules during 2016 – 2017.

Timeline and strategic approach



How should firms respond...

Given the potential for changes, level of uncertainty and need to meet challenging regulatory deadlines firms should consider:

Strategic considerations

Under what conditions would business or product areas be viable? Given a range of potential outcomes, which businesses should be:

- Scaled back pending potentially favourable changes?
- Rebased to lower costs through technology and efficiency to remain viable with only moderate changes?
- Exited altogether as non viable even in the face of a range of outcomes?

Operational considerations

Potential technical changes could have implications for process, data and systems:

- How can data sources and governance be constructed to ensure changes flow effectively upstream and downstream?
- Can key processes embed flexibility to allow requirements to be switched on or off as rules change?
- Can you design program traceability to allow for robust change ownership and management?

KPMG member firms approach to regulatory transformation embeds flexibility, accountability and traceability to help clients embed optionality given the changing landscape.

What needs to happen?

The financial industry is trying to cope with multiple new rules across capital markets. Management focus on regulation in Europe is inhibiting strategic thinking and innovation. Banks in Asia Pacific have been more focused on transformative strategies including the digital agenda, perhaps because they were focusing less senior management time on delivering regulatory change.

Global monetary policies are beginning to change and the current 'new normal' of near-zero percent interest rates will come to an end. Europe needs to be in a strong position to fund its growth through dynamic capital markets. The aim is for Europe to be seen as an attractive investment opportunity for global investors and therefore a longer term plan for the financial system is needed – the CMU initiative is an essential pre-requisite for this.

Financial services would benefit from a comprehensive roadmap of regulations including those still being discussed by international bodies such as the Financial Stability Board (FSB), the Basel Committee, International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). This could then be used to identify where the key interactions are and where future adjustments could be made to make the framework more appropriate within the context of growing and effective capital markets. It would help identify unanticipated consequences and allow balanced recalibration between financial stability and innovation.

The complexity continues...

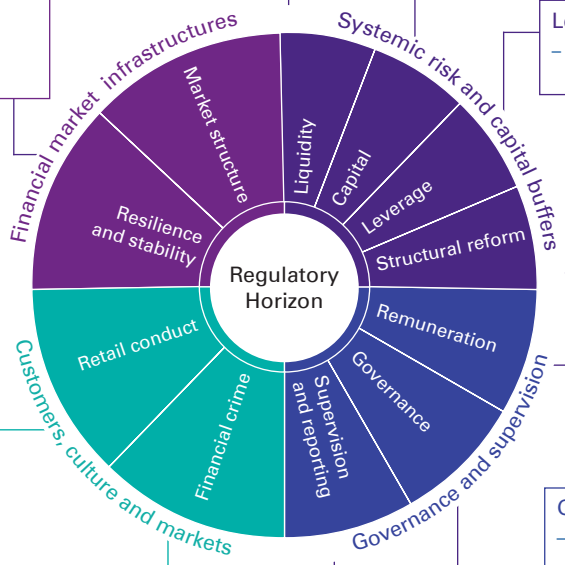
Market structure
- CMU
- MiFID II/MiFIR
- European Market Infrastructure Regulation (EMIR)
- EU Benchmarks
- Fair & Effective Markets Review (FEMR]
- Financial Transactions Tax (FTT)
- Markets Abuse Regulation (MAR)
- Single European Payments Area II (SEPA)
- Target2Securities
- CSD, CRAs, haircuts on securities financing
- UK AM Market Study
- Wholesale Sector Competition Review
- Payment Services Directive II
- Securitisation
- EC Call for evidence on financial regulation
- STS Securitisations
- Prospectus Directive Review
- Covered Bonds Regulation

Liquidity
- Short term liquidity (LCR) + long term liquidity (NSFR) + US capital charge

Capital
- Basel III/CRDIV
- CRD IV + Harmonising Basel RWAs & Stress Testing
- TLAC/MREL
- Fundamental Review of Trading Book
- RWA, buffers, large exposures/ intragroup exposures
- Solvency II
- IAIS global insurance capital standard (2020)
- FSB initiatives – G-SIB/G-SII
- IAIS global insurance capital standard (ICS)
- EC Call for evidence on financial regulation

Resilience and stability
- Non-bank/CCP
- EU Cyber Security Strategy

Leverage
- Country specific leverage rules



Structural reform
- BRRD (Recovery & Resolution)
- National reforms (e.g. Retail Ring fence)
- Focus on entity viability and sustainability
- Shadow Banking (including MMFs)
- EU Structural Reform

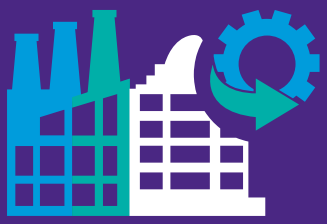
Retail conduct
- EBA & EIOPA Product Oversight and Governance guidelines
- Dodd-Frank Act (DFA)
- MiFID II/IDD
- Mortgage Credit Directive
- European Deposit Guarantee Scheme
- PRIIP KID
- Interchange fees
- EU Digital Single Market Strategy
- Money Market Funds (MMFs)
- AIFMD
- UCITS V
- ELTIFs, EuSEFs, EuVECAs
- EC Green Paper on Retail FS & Insurance
- IORDD II
- EC Review of Barriers of Cross Border Funds Distribution
- EC Call for evidence on financial regulation

Remuneration
- FSB Guidance
- CRD IV
- MiFID II
- UCITS V
- EBA opinions
- ESMA guidelines
- National codes

Governance
- FSB Governance, Risk Appetite and Culture
- CRD IV
- MiFID II
- National reforms (e.g. retail ring fence)
- Personal Accountability (e.g. UK SMR/SIMR)/ UK Senior Manager and Certification Regime
- BCBS 239 (Data Governance)
- EU Personal Pensions

Financial crime
- EU Fourth Anti-Money Laundering Directive
- MAR
- Know your customer (KYC)
- EU Bank Accounts
- G20 Transparency on beneficial ownership
- Cross Border Taxation
- National thematic exercises
- FSB on assessing risk culture
- Remuneration
- Mortgages Directive
- Austerity-led pensions and other welfare reforms

Supervision and reporting
- FSB guidance for SIFIs
- FINREP/COREP, revised Pillar III disclosures, Securities Financing
- IASB and FASB convergence, IFRS 9 etc.
- Shareholders Right Directive



Industry perspectives

Significant common themes across reporting, implementation and operational impacts.

Looking at the published responses of the industry to the European Commission's call for evidence, there are varying levels of detail and quality of evidence. The European Commission's short summary paper shows that most responses focused on constraints on financing, compliance costs and overlaps/inconsistencies. Regulations cited as being most problematic were CRD IV/CRR, MiFID II/MiFIR and EMIR. There are some significant common themes across reporting, implementation and operational impacts, including:

Multiple reporting requirements

Clear concerns about the cost of new rules and also the usefulness of data produced, including:

- Some banks state a more proportionate approach is required; "single-sided" reporting would be one example. This would be in line with jurisdictions such as the US, Singapore and Australia and reduce operational complexity, particularly for less sophisticated entities. "Dual-sided" reporting (DSR) creates unnecessary operational complications for both firms and end-users and in practice duplicates existing EMIR rules for portfolio reconciliation and dispute resolution.
- CRR reporting requirements are unnecessarily burdensome, overlap with national regulatory reporting requirements and require numerous updates due to validation rule errors, interpretation issues and regulatory changes.
- Duplicative disclosure requirements are burdensome. SFTR requires firms to provide clients with information relating to the risks and consequences associated with a transfer of ownership of collateral under title transfer collateral arrangements (TTCAs). However, such disclosures duplicate what is currently already provided under industry standard legal agreements.

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Practical implementation challenges

Multiple rules targeting similar or inter-related issues is causing challenges, including:

Legislation

- A more interconnected set of rules could help avoid inconsistency and duplication of effort which undermine the effectiveness of the rule. Level 2 and 3 rules are in some instances viewed as inconsistent with the intentions of level 1.
- A more harmonious framework on a European level, which is able to better reflect specific circumstances in each of prudential, conduct and market structure rules could help achieve alignment, clarity and legal certainty.
- In addition to a call for a more harmonious framework on a European level, a global co-ordination of rules as well as a consideration of cross-border implications, could facilitate a better approach to third country recognition.
- Many individual measures may work in isolation but not in parallel. Just as financial institutions are interconnected, so must be regulation. It should not lead to multiple measures which often have the same or a slightly nuanced intention e.g. incoming Country-by-Country tax rules are already in CRD IV, so potentially causing further changes to reporting systems.
- There is a risk of unintelligibility of the whole legislative framework and the accumulation of procyclical regulations. Some banks believe that the requirements from host regulatory authorities related to recovery planning pose duplication of effort and risk undermining the effectiveness of the group resolution plan.

Significant inconsistencies

- CRR, BRRD, EMIR rules have multiple inconsistent definitions of intragroup exposures across leverage, RWA, CVA and large exposure rules. Some banks have identified contradictions in the EU legislation with regards to Pillar 1 and 2 capital requirements.
- There is a discrepancy between CRD IV and the ECB/EBA about the calculation of the Maximum Distributable Amount (MDA), where CRD IV does not include pillar additional capital requirements. In addition, bail-in exclusions for non-EU financial market infrastructures (FMIs) BRRD gives contradictory messages as regards to the inclusion of non-EU financial market infrastructures (FMIs) in the scope of bail-in.

Operational and business model impacts

Changes which result in specific challenges to particular services, including:

- The lack of predictability of the legal framework can have a negative impact. Strict deadlines in review clauses undermines legal certainty, which is detrimental to investments, businesses and economic growth.
- Incentives for activities to be based in third country jurisdictions with a lighter regime or one that is stable and easier to predict. MiFID II Ancillary Activity Exemptions and MiFID II Position Limits are a prominent example of rules likely to drive this behaviour.
- Not enough consideration is given to the timetable for the implementation of rules.
- MiFID II Firms are not in a position to access or report on the commodity derivatives positions of clients of their clients for commercial, privacy, or data protection reasons, creating a potential risk of non-compliance for firms.
- CRR treatment of short-term secured funding leads to significantly higher capital requirements than the risk-based capital requirements (LR).
- Multiple prudential rules and disclosures create costs on business models with knock on impacts on overall market liquidity.

Priorities for change

KPMG member firms have long argued that the design of individual pieces of legislation was well-intentioned, but practical experience has shown that the cumulative effect of multiple interconnections and duplications is limiting the role that the financial industry can play in supporting economic recovery.

A summary of the key points made in our submission to the European Commission are below.

Banking regulation

Revise the CRDIV/CRR capital and liquidity requirements

- The trend for liquidity requirements is being met by an increase in retail deposits. However, the aim should be for more savers to become investors.
- As the leverage ratio limits balance sheet growth, banks may restore profitability by investing in riskier assets and by further increasing the cost of credit.

Assess the impact of 'Basel 4' requirements

- Once liquidity needs have been met, there is a strong perverse incentive for banks to reduce their holding of less risky assets, including sovereign debt, other highly rated securities, prime mortgage lending, high quality corporate lending and fully secured exposures.
- Banks also need to respond to the data and systems implications of capital, liquidity and leverage requirements, not least in calculating (and disclosing) the revised standardised approaches and the leverage ratio; and in undertaking a range of stress-tests.
- Consider the 'parallel tracks' of regulation that have an impact on banks' capital and liquidity requirements, including capital surcharges for systemically important banks (including TLAC), the use of macro-prudential instruments, resolution and structural separation within banking groups.

Review data and reporting requirements

- Data-related regulatory reporting for banks in particular is increasing significantly with multiple requirements coming from different sets of rules. Existing national supervisors, new supervisors, and authorities including the ECB, the European Supervisory Authorities, national and European resolution and macro-prudential authorities, are formulating their own requirements.
- Challenges include: Pillar 3 disclosures and the need to report wholesale market trades and securities financing transactions; revisions to the standardised approach to credit risk that will require use of 'risk drivers' data to determine risk weights.
- Pressure to improve risk data aggregation and reporting is increasing, and is becoming a key element in supervisory assessments of banks' internal risk governance.
- Various authorities are developing approaches that may eventually constrain banks in terms of data privacy, data storage, cyber security, and even the use of data to cross-sell products and services – especially to retail customers.

Capital Markets regulation

Need to understand the impacts of regulation on market liquidity

- Banks are holding significantly less inventory of corporate bonds for market-making purposes, this is likely to be a response to the higher capital, liquidity and other regulatory costs of holding market-making inventory.
- Non-banks are becoming more active on both sides of the market and there has been limited growth of trading platforms to facilitate direct trading.
- Holders of corporate bonds may find them difficult to sell into a falling and illiquid market.

Continued support for crowd-funding

- Crowd-funding is in some countries a growing part of the funding mix for corporates seeking debt or equity financing.
- Ensuring appropriate levels of investor protection is important, but cutting off this alternative channel at a time of reduced bank lending would be the wrong thing to do.
- The UK Financial Conduct Authority has set a limit on the portion of liquid assets that retail investors, excluding sophisticated and high net worth, can invest via equity crowdfunding.

Address inconsistencies that limit professional mobility

- It is difficult to move a statutory auditor registered in one Member State to another Member State for the purpose of becoming the signing partner or Engagement Quality Control Reviewer (EQCR).
- The need to move audit professionals with the right industry skills, experience and capacity, across countries in the EU at the right time will become a main focus for auditors of public interest entities (PIEs) in a new auditor rotation environment.
- The introduction of an EU passport for auditors, which would facilitate greater mobility of both key audit partners and EQCRs across the EU, would be hugely beneficial.

Need for a level-playing field for audit reforms

- Ensuring the consistent interpretation and application of the new audit legislation is critical to help support the audit profession in pursuit of audit quality.
- However, given the numerous options that are available to Member States within the legislation a patchwork of different rules across the EU is emerging. For groups containing an EU PIE operating across the EU, such complexity will undoubtedly increase the cost of doing business in the EU.
- These complexities and costs are further amplified when we consider the international environment in which most groups operate and which are thereby affected by many other regulatory regimes.

Review requirements for trade and transaction reporting

- Multiple trade and transaction reporting requirements are causing considerable challenge for capital markets firms. Although not directly responsible for reporting, investors must still provide personal data to their broker or fund administrators for reporting purposes, adding cost and complexity.
- There is also a significant requirement on supervisors to build and develop their own technical systems.
- Duplications and inconsistencies within MiFIR, and between MiFIR and other sets of requirements – including reporting requirements under EMIR, securities financing transactions and wholesale energy transactions under the Regulation on Energy Market Integrity and Transparency (REMIT) .

Assess the overall complexity of new markets regulations

- The requirements across a series of markets rules such as MiFID, EMIR, REMIT, MAR, CSDR and SFTR require significant changes to systems, processes and organisational structures.
- Rules, investors and securities originators must work together, and where possible closely match global markets.
- To minimise costs and streamline the process, a global consolidated reporting approach is required that brings together the reporting requirements across a whole range of regulations for all market participants.

Insurance regulation

Revisit Solvency II incentives for infrastructure investment

- Insurance pension providers are being encouraged to invest in infrastructure investments, with perceived fit between Europe's long-term funding needs and the long-term nature of life insurance liabilities.
- Insurance sector regulation is focused on ensuring that all risks, including those within investment portfolios, are properly understood and managed. Infrastructure projects can have unpredictable cash outflows, especially during the development phase of the project, and the timing of future cash inflows.
- Need for more certainty on how the potential for consumer detriment could be managed.

Investment management regulation

Reduce restrictions on investors in ELTIFs

- Take-up of European Long Term Investment Funds (ELTIFs) has been low despite the wide range of eligible assets, including unlisted small or medium enterprises (SMEs).
- The restricted investor base and the operational complexity involved in marketing ELTIFs to eligible retail investors is a key problem. Larger institutions can already invest in such assets directly or via alternative investment funds and so do not necessarily wish to invest in funds with constrained investment and borrowing powers.
- The restrictions on retail investors should be revisited. Many "mass affluent" EU citizens could reasonably be allowed to invest smaller sums of money into ELTIFs, especially under the strengthened investor protection rules in MiFID II and the enhanced disclosure regime to be created by the Packaged Retail Investment & Insurance Products Key Information Document (PRIIP KID).

Balance investor protection levels with incentives to invest

- Some of the filters in place to protect investors need careful calibration to balance protection with creating the right incentives to enter into investment.
- Once implemented MiFID II, PRIIP KID and the Insurance Distribution Directive (IDD) will introduce enhanced and more consistent levels of investor protection across products but could lead to higher costs, reduced choice and less availability.
- Getting consistency right is important as currently small savers have varying levels of protection compared to wealthy 'semi-professional' investors.

Conclusion

Success of the capital markets in Europe depends on a stable and adaptable financial regulatory framework that fosters and encourages investors and allows intermediaries including the banks to have viable businesses.

Despite the good intentions behind individual pieces of legislation, when taken as a whole and with the benefit of practical experience, the sheer of volume of new regulations is placing too much restraint on the financial system.

The European Commission should be congratulated for initiating a review of the financial regulatory framework.

This will be an important signal if it is seen to act on the evidence and drive the jobs and growth agenda. For banks, investment managers, insurance and commodity firms already struggling with large and complex regulatory programmes some certainty over how potential changes will be made is essential.

The early signs are very positive with indications from Commissioner Hill of where some targeted changes and wider reviews will happen. The stakes are high and getting the regulatory framework well aligned to supporting Capital Markets Union should be top of the agenda.

Stay connected

KPMG member firms provide a wide-ranging offering of studies, analysis and insights on the evolving regulatory landscape. For more information, please go to www.kpmg.com/regulatorychallenges

Thought leadership

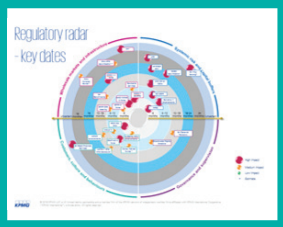
Basel 4 revisited

Two years ago KPMG International published a paper suggesting the emergence of what is commonly referred to as 'Basel 4', even before Basel 3 had been fully implemented. Basel 4 is now part of the regular vernacular.

Regulatory insights

Monthly update

KPMG's financial services regulatory monthly update provides insights into regulatory issues, market developments, supervisory approaches and implementation issues



Online regulatory radar

Prioritising and managing change

KPMG member firms help clients navigate the complex regulatory landscape by tracking, monitoring and prioritising developments. We can advise on planning, implementation and how to manage change programmes with optionality in areas of regulatory uncertainty with the aim of avoiding costly reworking in the future.

Giles Williams
Partner, Financial Services Regulatory
Center of Excellence
EMA region
KPMG International
T: +44 20 7311 5354
E: giles.williams@kpmg.co.uk

Karl Braun
Partner, Head of Markets
EMA region
KPMG International
T: +49 69 9587-1436
E: karlbraun1@kpmg.com

Roderick Devlin
Partner, EMA Head of Quality and Risk
Management
KPMG International
T: +33 155 687 020
E: roddevlin@kpmg.fr

Jon Hogan
Head of Public Policy
Financial Services Regulatory Centre
of Excellence
EMA region
KPMG International
T: +44 20 7694 2258
E: jon.hogan@kpmg.co.uk

kpmg.com/socialmedia

kpmg.com/app

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