



# Horizons

The outlook for financial  
services regulation

October 2018

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# All change ahead, but no let-up

**Welcome to the first edition of Horizons from the KPMG EMA Financial Services Risk & Regulatory Insight Centre. This publication replaces our Monthly Update. We hope it will become your 'go to' read for insights on financial services regulation from the perspective of the EMA region.**

**Please send us your feedback.**

## In this edition:

Risks and vulnerabilities in the EU financial system

EU toughens up on AML

Towards a risk-based global Insurance Capital Standard?

ECB's booking model expectations post-Brexit

Round-up – recent insights and alerts

We are now just seven months away from the next European parliamentary elections and a new set of Commissioners will follow. We are likely to see a very different dynamic from the second half of 2019, not least because the UK will no longer be present. Meanwhile, time is running out for the co-legislators to reach agreement on a number of open proposals.

Debate on **reform of the ESAs** (the European Supervisory Authorities) has revealed entrenched differences of view: from the need for a few tweaks to the proposals, to rip them up and start again.

Views are similarly mixed on the progress of **Capital Markets Union** (CMU). Successes include revised capital incentives, simplified prospectuses and securitisations, but questions remain as to whether the original plans have gone far enough to tackle the key barriers to boosting investments, and Brexit is a game-changer.

Many regulators and firms want **Banking Union** to be completed as soon as possible, but the political sticking points look as difficult as ever.

Other open files include the need to increase long-term institutional investment in the EU, the ongoing tension between seeking to encourage market-based financing and concerns about systemic risks, the harmonisation of national insolvency regimes and taxation of financial activity.

Meanwhile, monitoring the EU financial markets for potential systemic risks continues to be a priority. Supervisors are watching closely the introduction of **risk free rates** and the implementation of other new rules. Alongside new legislative initiatives such as **sustainable finance**.

**Operational resilience** is universally seen as a top three priority. Despite

the EU banking system being more resilient than in the past, profitability challenges remain due to heterogeneity of business models, legacy assets, cost inefficiency and competitive/overbanking capacity.

**Data privacy** and related themes are moving up the agenda everywhere, together with **cybersecurity**, which regulators are increasingly emphasising as a key plank of operational resilience.

Regulators are wishing to encourage **fintech** but are concerned that technological developments may heighten cyber and other risks.

They are also considering whether existing rules, which were originally designed in a paper and person-to-person world, are fit-for-purpose in the digital age.

## **Brexit negotiations nearing final stage**

With the UK due to leave the EU in under six months, there is growing realisation that Brexit is far more complicated than most had anticipated – and time is running out. A number of Europe's economies remain fragile and the self-harm arising from a "bumpy Brexit" is politically unacceptable – all the more so in the run-up to the elections.



Now, more than ever, firms need to be aware of the overall direction of regulation and to assess potential financial and operational impacts, acting now to re-assess business models and operating structures.



Central banks and supervisors are actively thinking through the ramifications of a no-deal outcome, while the Commission accepts there may be some contractual issues, but is questioning the scale of the problem.

In order to mitigate potential risks of a no-deal outcome, HM Treasury, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are consulting on a “temporary permissions regime” for inbound EEA firms and funds ([see further insights](#)).

Ultimately, the UK’s departure from the EU leaves considerable scope for regulatory divergence.

Despite calls from some for a ‘bonfire of red tape’, UK financial regulation is unlikely to become easier post-Brexit – read more in [The Future Shape of UK FS Regulation](#).

## Divergence of global regulatory agendas

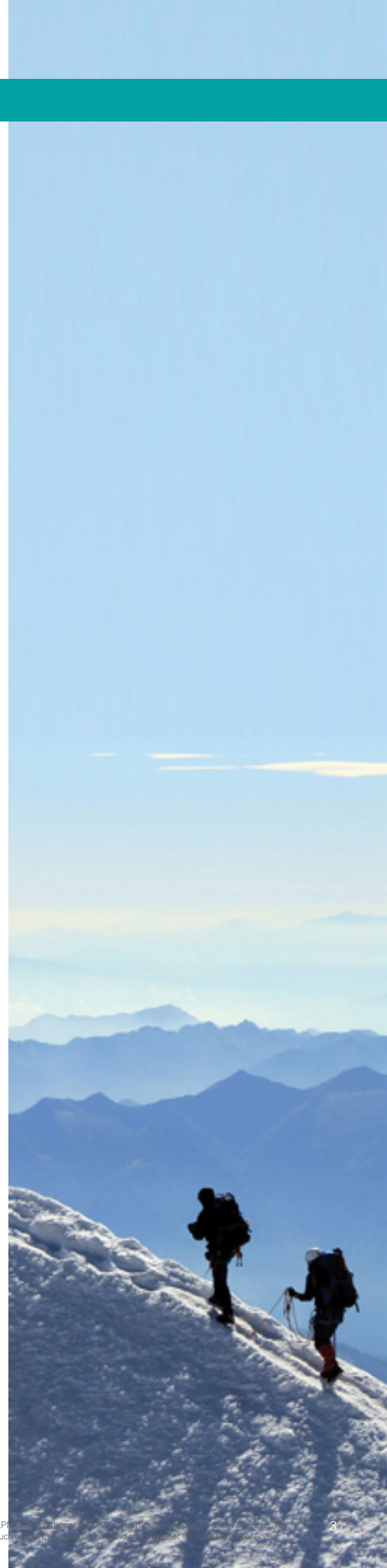
Regulators and industry around the globe broadly agree on the need for open markets and that cross-border activity should not be constrained. Financial services are inherently international.

Ten years on from the 2008 financial crisis, though, the unified global response is fracturing. The US is reviewing all post-crisis regulation, while Europe has indicated no intention of rolling back on the reforms.

Moreover, new regulation and reforms to existing rules can bring cross-sector implications and unintended consequences. Now, more than ever, firms need to be aware of the overall direction of regulation and to assess potential financial and operational impacts, acting now to re-assess business models and operating structures.



**James Lewis**  
Head of EMA Financial Services Risk & Regulatory Insight Centre



# Risks and vulnerabilities in the EU financial system

## Three reports from EU institutions highlight the continuing monitoring of systemic risks.

The Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA) has published its latest [assessment](#) of the risk and vulnerabilities in the EU financial system, ESMA has issued its first annual [statistical report](#) on the EU derivatives market and the European Systemic Risk Board (ESRB) has issued its third [EU Shadow Banking Monitor](#).

### The ESAs identify three main risks to financial stability

#### An abrupt increase in yields

The report warns that this imminent and high risk could generate substantial asset price volatility and lead to losses across asset classes. Market volatility could be reinforced by investment repositioning of market participants and portfolio reallocations. The return of volatility puts additional pressure on bank profitability, as shown by decreasing net trading income in early 2018.

#### Rising interest rates and risk premia

Rising interest rates might represent a return to normality, following an extended period of ultra-low interest rates. However this could pose challenges to the stock of non-performing loans in the EU, while the potential for sudden risk premia reversals remains a major concern for insurance companies and pension

funds. Retail investors may also be affected by valuation risks through their portfolio holdings.

#### Uncertainties around the UK's withdrawal from the EU

Brexit could expose the EU27 and the UK to economic and financial instability, particularly if negotiations end in a disorderly fashion. The report focuses on:

- i. the relocation of financial services activities and the need for new authorisations;
- ii. reduced access to financial market infrastructure;
- iii. the rights and obligations under existing contracts, where the ESAs continue to place responsibility solely on financial institutions (not on the authorities) to take any necessary actions to amend existing contracts and to communicate clearly to their customers; and
- iv. the solvency position of insurers and reinsurers, as covered in an earlier EIOPA Opinion.

### Supervisory responses

In response to these risks the Joint Committee advises:

- Stress test exercises across all sectors. The EIOPA and EBA 2018 stress tests already embedded these risks, while ESMA is reported to be progressing on the development of its approach to stress testing of investment funds.
- Banks to accelerate addressing non-performing loans and adapting business models to improve sustainability; all financial institutions to manage their interest rate risk; and investors to consider the risks in moving into higher yielding, leveraged products.
- Macro- and micro-prudential authorities to address possible contagion risks, and to continue to monitor lending standards and asset quality.
- EU financial institutions and their counterparties, investors



and retail consumers to plan appropriate mitigating actions in a timely manner, to prepare for the UK's withdrawal from the EU. Financial institutions should inform their supervisors about the actions they are taking and be clear about implementation timelines. Supervisors should monitor the contingency plans that financial institutions have in place and encourage the speedy implementation, where required, of adequate contingencies.

## ESMA's first annual EU derivatives market report reveals 10 percent growth and UK dominance

In response to the 2008 financial crisis, the European Markets and Infrastructure Regulation (EMIR) introduced mandatory reporting of derivative contracts to a Trade Repository (TR) and an obligation to clear contracts via Central Counterparties (CCPs)

The impact of regulatory intervention will be seen beyond central clearing. Contracts for Difference (CFDs) constituted less than one percent of gross notional outstanding, but the number of contracts doubled during 2017, representing 60 percent of all outstanding contracts. This indicates the widening use of this type of contract among retail investors. From 1 August 2018, ESMA imposed a restriction on the marketing, distribution and sale of CFDs to retail investors, under its product intervention powers. The impact of this will be seen in next year's report.

### Key findings of ESMA's report are:

- At end-2017, a total of 74 million transactions with gross notional outstanding of around EUR 660 trillion, up 10 percent on 2016.
- Interest rate derivatives (IRDs) totalled 69 percent of total amount outstanding.
- Swaps were the most common contract type (50 percent).
- 61 percent of contracts had less than one year to maturity.
- USD was the main currency (33 percent), followed by EUR (28 percent) and GBP (11 percent). However, there were marked differences between segments, with 91 percent of EEA commodity derivatives denominated in USD.
- Over-the-counter contracts still dominated, but exchange-traded derivatives increased from 13 percent to 17 percent.
- Central clearing rates increased from 40 percent to 58 percent for IRDs but only from 25 percent to 27 percent for credit derivatives (CDs).
- Investment firms and credit institutions accounted for 95 percent of trading activity, with the UK dominating and with increased interconnectedness between parties. However, these facts must be interpreted carefully as firms may act on behalf of end clients who may be domiciled in a range of jurisdictions.
- Alternative investment funds accounted for six percent of CDs and three percent of IRDs. UCITS were minor players with a share of over two percent in only CDs and equity derivatives.
- Concentration among the top five market participants was highest for commodity derivatives at 67 percent, but for other contract types was 50 percent or less.

### ESRB identifies no new “shadow banking” risks

The ESRB defines the shadow banking system as all financial sector assets except those of banks, insurers, pension funds and CCPs. Investment funds represent about one-third of the system, with other financial institutions (OFIs) including securitisation vehicles.

At end-2017, total assets stood at over EUR 42 trillion, around 40 percent of the total EU financial system. The report considers a range of risks and vulnerabilities, including those related to interconnectedness, liquidity and leverage. It does not identify new risks but notes that data gaps continue to prevent a more comprehensive risk assessment.

The share of bank funding to the sector (mainly loans and debt securities) represented eight percent in the Euro area, having fallen from a high of 9.4 percent in 2011. Conversely, the wholesale funding of banks by “shadow banking” entities increased by two percent to EUR 2.2 trillion, following a period of contraction. The increase was primarily due to increases in investment fund holdings of bank debt.

The ESRB notes that EU bond funds have increased their liquidity transformation, credit and interest rate risk-taking activities in recent years, but recognises that OFIs are typically more engaged in such activities than investment funds. The report focuses on three specific areas: potential liquidity risks and market functioning implications of exchange-traded products and funds; cross-border and cross-sector links between non-domestic investors and sponsors of non-securitisation special purpose entities; and that seven percent of UCITS use credit default swaps.

### A global debate

This debate is not solely a EU preoccupation. A recent Financial Stability Board (FSB) [report](#) does not identify new risks and vulnerabilities in the financial system, like the ESRB, but it now refers to non-bank financial intermediation rather than “shadow banking”.

The FSB continues to be concerned about previously identified risks, but its emphasis is shifting to the effects of post-crisis regulatory reforms and a small number of continuing or new initiatives, including recovery from a cyber incident.

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...data gaps continue to prevent a comprehensive risk assessment.

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# EU toughens up on AML

## EU's AML roadmap may hit speed bumps

Following recent money laundering scandals in some European banks, the European Commission has published a suggested roadmap to increase the effectiveness of supervisory interventions relating to anti-money laundering (AML) and countering the financing of terrorism (CFT).

However, despite wide-spread support for taking action, progress may not be as fast as anticipated.

Produced in cooperation with the European Central Bank, the Commission's roadmap focuses on the interplay between financial supervision and AML oversight. It also addresses the allocation of powers and cooperation between authorities.

The additional powers for the EBA to oversee national supervision of AML rules is a significant development. It seeks to address concerns that not all EU countries are enforcing the existing rules sufficiently.

However, the Commission's quick-fix to add the EBA's new powers into the ongoing review of the ESAs has met with some resistance from both MEPs and member states.

### Key proposed measures include:

- Giving the European Banking Authority (EBA) overarching control of AML and CFT supervisory issues;
- Putting in place memoranda of understanding on cooperation between AML authorities and the ECB, by early 2019;
- Mapping of money laundering and financing terrorism risks and identifying the best supervisory practices to address them, by summer 2019;
- Preparing and issuing common guidance on how to factor AML/CFT related aspects into supervisory processes;
- Ensuring effective cooperation between prudential supervisors, AML supervisors and Financial Intelligence Units, by end 2019;
- Clarifying of the relation between AML/CFT practices and the withdrawal of authorisation, by mid 2019;
- Harmonising the prudential and AML frameworks, by 2023.

There is a concern that giving the EBA additional powers over national authorities could be politically sensitive. This risks slowing down progress on the already political proposals to strengthen the powers of the ESAs.

With European elections in 2019 fast approaching, some quick wins on AML are needed. The Commission's roadmap indicates that scrutiny and increased enforcement action will be high on the next Commission's agenda.



Scrutiny and increased enforcement action will be high on the next Commission's agenda.



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# Risk-based global Insurance

## Towards a risk-based global Insurance Capital Standard?

The International Association of Insurance Supervisors (IAIS) is [consulting](#) for the third time on the development of an Insurance Capital Standard (ICS) for internationally active insurance groups (IAIGs).

### Timetable

The IAIS's original intention, announced in 2013, was to develop an ICS by 2016, as part of ComFrame (the Common Framework for the Supervision of IAIGs). In practice, however, this has turned into an extensive consultation and development process, involving three rounds of consultation and four years of quantitative field testing to date. This third consultation includes 198 specific questions that will require some careful consideration.

### Not quite global?

While the current round of field testing focuses on the "reference ICS", the alternative GAAP Plus valuation continues to be assessed as a potential alternative 'outcome equivalent' approach.

During the five-year monitoring period, the ICS to be reported will be the reference ICS, but it will not act as a Prescribed Capital Requirement (PCR).

The reporting on a GAAP Plus basis will be at the option of the group wide supervisor and would be additional to reporting on a reference ICS basis. Due to the timing of accounting developments, GAAP Plus (for IFRS and US GAAP) will be subject to a three-year monitoring period commencing in 2022. For Japanese GAAP, the full five year monitoring from 2020 will apply.



During the five-year monitoring period, the ICS to be reported will be the reference ICS, but it will not act as a Prescribed Capital Requirement (PCR).





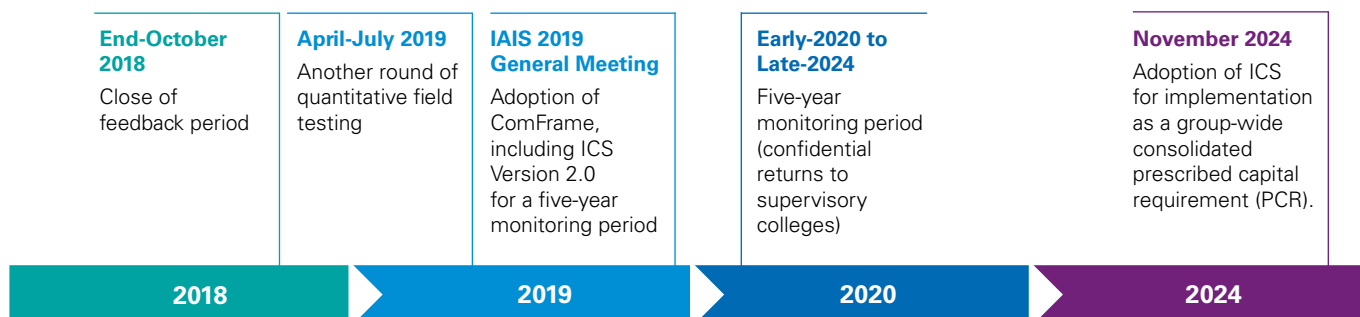
## Implications for firms

There are around 50 IAIGs globally, which will need to have the data and systems ready to meet the reporting requirements during the extended monitoring period, beginning in early 2020.

Further changes to the detailed components of the ICS can be expected before it becomes a binding PCR. In addition, the IAIS has yet to opine on some matters of key importance to some insurance groups, such as the use of internal models and the linkages with other existing group supervision standards.

It is therefore important that potentially affected groups continue to engage with both field tests and industry consultations to shape the final design of this group-wide solvency standard.

## The next steps include:



## Key elements of the ICS

The latest consultation asks a series of specific questions about key elements of the ICS, based in part on the results of the quantitative field testing undertaken to date, including on:

- Market-adjusted valuation (MAV);
- A single discounting approach, based on adjustments to a risk-free yield curve spanning a liquid segment (segment one) based on available market information, an extrapolation/gradation between the first and third segments, and a long term forward rate determined using a macro-economic approach (segment three);
- Two options for setting margins over current estimates (MOCE) of insurance liabilities, with a seeming preference for the introduction of a consistent and comparable MOCE (CC-MOCE) method;
- Definitions of tier 1 and tier 2 capital resources;
- Detail of the approaches to determining the capital resources required to meet unexpected changes, events or other manifestations of insurance, market, credit and operational risks;
- The treatment of tax (in particular deferred tax assets) in the ICS calculation; and
- Reporting of additional GAAP-based data and of the use of internal models during the extended monitoring period.

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# Supervisory expectations on booking models

## ECB's booking model expectations post-Brexit

The European Central Bank (ECB) has published a presentation setting out its “supervisory expectations” on banks’ booking models.

These expectations build on the European Banking Authority’s October 2017 Opinion on internal governance, outsourcing, risk transfer and “empty shells” in relation to Brexit.

### Implications for firms

The ECB will assess the impact that booking models can have on a bank’s risk management and control framework, and its operational resilience in a crisis. The main focus will be on banking groups that undertake capital markets operations, and the supervisory expectations will be applied in a proportionate manner, taking into account the materiality and complexity of each bank’s capital market activities.

### Further detail

The ECB expects banks it supervises directly to have sufficient substance “onshore” (in the EU27 post-Brexit) to manage their business, including:

**Supervisory board** – collectively, the members of the supervisory board should have sufficient geographical presence within the EU27, knowledge (of local market and regulatory frameworks), skills and experience, available time (in particular with regard to dual-hatting and travel time) and independence to provide effective oversight.

**Senior management** – banks should have adequate onshore-based senior management (in terms of capacity and suitability), with a clear understanding of the bank’s booking model, risks and associated control environment, effective decision-making powers regarding issues related to the booking model, and full control of the bank’s balance sheet (including transactions booked to it).

**Risk governance and risk management** – banks should be adequately staffed with sufficient knowledge, experience, capabilities and technology to manage both the existing and relocating business and associated risks.

**Independence from third country risk hubs** – a bank should manage its market and counterparty risks independently and have independent trading capability. When accessing financial market infrastructure (FMI) from another group entity or branch, the bank should consider alternatives in the event that it loses access to that third country FMI. Cost synergies should not be the sole determinant for using third-country risk hubs.

### The ECB encourages banks to put in place:

- An implementation plan to take these expectations into account, including clear milestones;
- A dedicated booking model policy and related controls;
- A dedicated policy around marketing practices and the related control environment;
- Updated recovery and crisis management capabilities that incorporate Brexit risks and preserve the continuity of hedging and market access; and
- Enhanced hedging and market access capabilities.

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### **Booking model and hedging strategies**

– banks are expected to have in place booking models and hedging strategies that enable ECB supervised entities to have full control of their onshore exposures. They should identify clearly their hedging strategies, procedures, controls and governance, and should have a proven ability to hedge their material risks with a diversified set of external (third party) counterparties. They should not be overly reliant on intragroup back-to-back hedging strategies with, or on remote booking to/from, third-country entities or branches in third countries.

EU products and transactions with EU clients should be booked onshore and the risk management capabilities related to these products should also be located onshore.

**Outsourcing** – outsourcing arrangements should not result in the bank having the characteristics of an “empty shell”.

### **Operational continuity in a crisis**

– banks’ business continuity plans should provide comfort that they will be able to carry out their business independently from another third-country group entity or branch in a third country; have sufficient onshore risk management key function holders (with the appropriate level of knowledge and authority) and processes to identify, manage and monitor material onshore risks; and ensure access to necessary operational assets through adequate contractual provisions.

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# Recent alerts and insights

**Recent insights published by the EMA Financial Services Risk & Regulatory Insight Centre (RRIC) and others include:**



## **The future shape of UK Financial Services regulation**

September 2018

This paper describes the current and changing dynamic of policy influences, and what they are likely to mean for the shape of UK FS regulation beyond Brexit. The paper considers how the interplay of external and domestic drivers might shape UK financial services regulation. Read our new [report](#) to find out more.



## **Evolving LIBOR series**

*Dear CEO Letter* – September 2018

The PRA and FCA wrote to CEOs of large banks and insurance companies.

*LIBOR to Risk Free Rate* - [August 2018](#) and [October 2018 Regulatory round-up](#)

*Evolving LIBOR* – June 2018

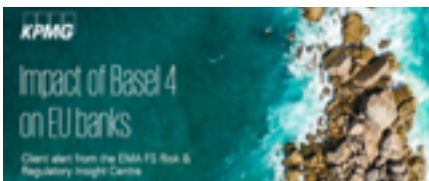
This report provides insight into scenario planning for a successful transition.



## **Individual Accountability**

July 2018

Individual accountability is a global concept and is becoming a regulatory focus area around the world. Firms have taken the shift to greater individual accountability seriously, perhaps not least because of the potential consequences on individual senior managers of a failure to do so. Read our new [report](#) to find out more.



## **Impact of Basel 4 on EU banks**

October, 2018

The European Banking Authority has published an analysis of the impact of Basel 4 on EU banks, showing increases in capital requirements of around 25 percent for large and internationally active banks. The main results are broadly consistent with initial estimates using the KPMG Peer Bank tool.



## **Regulatory focus on funds is relentless**

October, 2018

Under the banner of financial stability and systemic risk, the spotlight on investment funds is intensifying. Enhanced rules and greater supervisory scrutiny of investment funds look set to continue well into 2019 and beyond.



## **KPMG's SSM Insights**

October 2018

The autumn 2018 issue of SSM Insights from KPMG's European Central Bank (ECB) Office is now available to [download](#). KPMG's ECB Office brings you news and insights into issues relating to the Single Supervisory Mechanism (SSM). This quarterly newsletter seeks to cover the key issues that the ECB are talking about, and the questions and topics that KPMG member firms are discussing with banks and others in the industry.

# Brexit perspectives



## **Proposed “no-deal rules” for FCA- authorised firms**

*October, 2018*

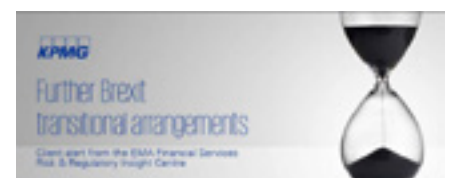
The Financial Conduct Authority (FCA) has published its first consultation paper on proposed changes to the Handbook and EU-derived Binding Technical Standards, and on its post-Brexit approach to EU non-legislative material, such as guidelines and Q&As issued by the ESAs.



## **Brexit Temporary Permissions Regime**

*October, 2018*

The FCA is consulting on how the Temporary Permissions Regime will work. It proposes additional requirements for inbound firms and funds. It seeks comments by 7 December, with feedback and final rules scheduled for Q1 2019, ahead of the day of exit.



## **Further Brexit transitional arrangements**

*October, 2018*

HM Treasury is proposing to introduce a temporary transitional power to be exercised by the Bank of England, the FCA and the PRA. This would enable these regulators to waive or modify (for a limited period) firms’ regulatory obligations that have changed as a result of the ‘onshoring’ of the post-Brexit financial services legislation, in the event of a ‘no deal’ Brexit.



## **Preparing for regulation after Brexit**

*August 2018*

The UK government is making contingency plans for a “no deal” Brexit. This includes the preparation of a statute book that could function from day one post-Brexit. One element of this is a proposed Statutory Instrument covering the Capital Requirements Regulation and related EU legislation covering the prudential regulation of credit institutions and large investment firms.



## **Brexit: UK temporary permissions regime - what it means**

*August 2018*

HM Treasury published on 24 July a draft of the regulations that will enable the FCA and the PRA to operate a Temporary Permissions Regime. The regime will come into effect only if the EU and the UK do not ratify the Withdrawal Agreement.



## **Contract certainty – what are the risks for asset managers?**

*July, 2018*

Most asset managers have undertaken some form of Brexit risk assessment and developed plans to protect their business against the inevitable loss of EU passports, out of and into the UK. Firms now need to turn their minds to the large number of second and third order impacts of Brexit, one of which is the question of contract certainty.

**Please get in touch with your local KPMG contact if you would like any further information.**





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## Further insights:

[www.kpmg.com/regulatorychallenges](http://www.kpmg.com/regulatorychallenges)

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