



Horizons

The outlook for financial
services regulation

May 2019

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Regulatory reality check

Twelve years after the beginning of the global financial crisis the pace of regulatory reforms has slowed, but by no means halted.

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Twelve years after the beginning of the global financial crisis the pace of regulatory reforms has slowed, but by no means halted.

Basel 4 was completed through the finalisation of the market risk framework in January 2019, but EU implementation has still to catch up and the treatment of sovereign risk remains to be resolved.

Some amendments to Solvency II remain under discussion, including the treatment of long-term guarantees and infrastructure investments. The International Association of Insurance Supervisors (IAIS) international capital standard remains a long way off.

The EU legislative framework for asset management is largely in place, but disclosure and reporting are not working well.

The remits and agendas of regulatory bodies continue to evolve and expand (see the article on pages 4 and 5 and firms need to continue to implement post-crisis reforms, such as the change to risk-free rates.

Even as these regulatory frameworks trundle forwards, new or enhanced areas of regulatory focus have emerged.

As discussed in KPMG's recent paper on the regulation and supervision of fintech, and in the article on crypto assets on page 10, the regulation of fintech is slowly taking shape. Recent developments include the call from the Joint Committee of the ESAs for the regulation (preferably under global standards) of cloud computing providers, and the ethics guidelines for trustworthy artificial intelligence issued by a high level working group established by the European Commission. The article on page 8 discusses how these guidelines might be applied in the financial sector.

Regulators are also focusing increasingly on climate change and sustainability, including the recent EU agreement on low-carbon

benchmarks and the first report from the central bank Network for Greening the Financial System. But the lack of an agreed taxonomy remains a concern, along with wider questions about how much the financial sector (and its regulation) can deliver in the absence of optimal fiscal measures (carbon taxes and direct government interventions).

Debates on the magnitude of systemic risk in the insurance and asset management sectors rumble on. The IAIS is due to consult in June on its framework for addressing systemic risk in the insurance sector, and to implement the framework in 2020. Meanwhile, recent regulatory reports have revealed no material concerns about the levels of liquidity or leverage in EU investment funds.

As discussed in KPMG's report on Resolution, the authorities remain cautious about the resolvability of major banks. Progress remains to be made by these banks on issuing sufficient loss-absorbing capacity, and in making adequate preparations for valuation, restructuring, funding and management to support a resolution. Very little progress has been made in developing a resolution regime for major insurers.

In the EU retail markets, the costs and performance of retail investment products is under scrutiny (see the article on page 6.



The recent FCA and PRA business plans show that Brexit will continue to remain high on the agenda for 2019. ”

The greater focus on the impact of the implementation of EU legislation may also lead to regulatory changes, although reviewing each piece of legislation individually is unlikely to address wider questions about the overall impact of regulatory reforms.

Ahead of the European Parliament elections and appointment of a new Commission, the EU struggled to reach the finishing line in some areas.

Some major EU initiatives remain incomplete or ineffective.

Completion of Banking Union depends on agreement to create a European Deposit Insurance Scheme. There remains reluctance in some quarters to take this step, reflecting concerns over the implications of mutualising EU-wide risks at a time when risks (as proxied by banks' non-performing loans and sovereign risk exposures) remain high in some countries, and in the absence of a common insolvency framework. Completion of Banking Union may not be sufficient to stimulate cross-border banking business or cross-border bank mergers and acquisitions. National fragmentation may prove to be deeply entrenched.

Similarly, and despite the passage of related EU legislation such as for pan-European personal pensions, overall progress on Capital Markets Union (CMU) remains slow. Legislation alone

will not create a thriving pan-European capital market, not least given the low level of ownership of equities in continental Europe and the continuing preference for national insolvency regimes and securities laws.

Securitisation provides an example within CMU of limited progress in market outcomes, even once legislation is in place. Banks are keen to use securitisations to manage their balance sheets, but policymaker and regulator caution (on capital treatments, disclosures and notifications) is holding back the development of a well-functioning securitisations market, apart from for covered bonds.

And there is still Brexit.

The delay to agreeing a withdrawal agreement has provided a breathing space, but the underlying uncertainties about the end result remain.

EU and UK authorities, and financial institutions operating in the EU, have put in place a high level of preparedness for the possibility of the UK leaving the EU without a deal. The recent FCA and PRA business plans show that Brexit will continue to remain high on the agenda for 2019.

Further ahead, questions will need to be addressed over the EU and UK regulatory frameworks, as the EU reduces its dependence on what will become a third-country financial centre, and the UK looks to serve other financial markets.



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



Changing regulatory powers and agendas

Implementation reviews, new social imperatives, fintech developments and the pursuit of common standards are causing regulatory agendas to evolve and remit to expand.

In the January edition of Horizons we commented on the evolving focus of the Financial Stability Board. It is now the turn of IOSCO and the ESAs, with the release of reports on their forward agendas and the market risks on which they are focussed. Meanwhile, the debate in the European Parliament and the Council about increased powers for the ESAs has reached its final stage, with only the official “rubber stamps” awaited.

It remains to be seen what impacts these changes will have on the market place at large or on individual firm’s operating models. The reports clearly indicate, though, both significant shifts in regulatory agendas and the importance assigned to implementation reviews in determining next steps.

IOSCO’s first annual work programme

To enhance the effectiveness of IOSCO and the impact of its policy work on global securities markets, IOSCO’s board published in March 2019 its first annual work programme, which highlights five priority issues that will be examined:

- The regulation of **crypto** trading platforms and of investment funds with crypto exposures.
- The supervision of market intermediaries, including asset managers, that use **artificial intelligence and machine learning** and ethical challenges that may arise from their use in securities markets.

- Potentially harmful **market fragmentation**, including that attributable to cross-border regulation, and members’ progress in assessing and deferring to foreign regulatory regimes.
- The impact of **passive investing** on markets – price discovery process, the allocation of capital and corporate governance – and the role of index providers in asset management. Passive asset management strategies were estimated to represent USD 8 trillion globally in 2017, 20 percent of assets under management.
- The use of social media and the **digitalisation of investment product distribution**, by both regulated entities and new types of financial intermediaries.
- Collaboration with the FSB on potential financial stability risks arising from the possible impact on market liquidity of exchange-traded funds and high frequency trading.
- Practical “use case” applications of distributed ledger technology in securities markets.
- The benefits and challenges of adopting machine-readable rule books.
- National regulators’ experiences in designing innovation support frameworks (such as sandboxes).
- Consistency reviews of suitability requirements for complex financial products, business continuity plans for intermediaries and trading venues, and money market fund and securitisation reforms.

The programme also includes work on:

- Consistent measures of leverage in investment funds.

Risks and vulnerabilities in the EU

The ESAs individually and collectively issued risk reports in March and April.



EBA's risk [dashboard](#) confirms improved asset quality and stable capital ratios, but that bank profitability is still below long-term sustainable levels. In 2018, the ratio of non-performing loans (NPLs) to total loans continued to trend downward, reaching 3.2 percent, due to both a reduction in NPLs and new loans. CET1 ratios were slightly down on 2017 but remained above 11 percent for all countries in the sample. The liquidity coverage ratio reached 152 percent and leverage was stable. Return on equity increased from 6 percent to 6.5 percent.

EIOPA's risk dashboard classified all seven risk categories as medium but said that risk exposures in the European insurance sector remained stable overall.

ESMA's report found that market, credit and liquidity risks all remain high, due to various factors, including ongoing Brexit uncertainty, weakening growth prospects and deterioration in outstanding corporate debt ratings. A negative outlook for operational risk, due to cyber threats and Brexit-related risks, remained a major concern.

Investor risks persisted across a range of products – ESMA renewed its restrictions on the provision of contracts for differences and the prohibition on the provision of binary options to retail investors.

The report also included the results of examinations and analyses of:

- The use of technology by supervised entities and supervisors.
- EU alternative investment funds sold to retail investors.
- The impact of the double volume cap mechanism on EU equity markets.
- Potential financial stability risks posed by money market funds.

The ESAs' report picked up the various sector themes and highlighted two key areas of risk:

- Brexit (relocation activity and manner of the withdrawal).
- Asset valuation, repricing of risks premia and a less favourable macroeconomic environment.

“IOSCO work increasingly cuts across the mandates of different policy committees.”

Ashley Alder,
Chair of the IOSCO Board

The ESAs' remits grow

At the time of writing, publication of the final texts of the legislation enhancing the powers of the ESAs was awaited.

It is understood that a number of the original European Commission proposals – which covered governance, funding, new authorisation and supervision powers, and new powers to countermand the agreement by national regulators of firms' delegation and outsourcing arrangements – have been watered down during the legislative debate. The plans to give EBA increased anti-money laundering powers was adopted, though.

It will be sometime before the new modus operandi are fully up and running, and perhaps longer still before the impacts on individual firms or the Single Market are revealed.

Contact



Julie Patterson

Director
EMA FS Risk & Regulatory
Insight Centre

T: +44 20 73115261

E: julie.patterson@kpmg.co.uk

Retail investment products: performance and costs

The wide range of products and data deficiencies in some sectors make comparative analysis difficult; clear conclusions remain elusive.

The European Commission mandated the three ESAs to provide recurrent reports on the performance and costs of retail investment products, motivated by the key objective of Capital Markets Union: to foster retail investor participation in EU capital markets.

The reports evidence the wide variety of the level and transparency of costs between and within the sectors, and between member states, and the inconsistent approach to past performance disclosure. MiFID II, the Insurance Distribution Directive and the PRIIP KID Regulation have recently harmonised pre-contract disclosures to an extent, but some disclosures and presentations are less consistent, including past performance.

More fundamentally, though, the reports demonstrate the difficulty of obtaining comprehensive market data for some types of retail investment products and therefore of drawing comparative conclusions.

Insurance-based investment products

EIOPA's [report](#) covers 21 member states, with data sourced from the larger insurance undertakings over the period 2013-2017. Insurance-based investment products (IBIPs) and, to a limited extent, certain personal pension products were in scope. On the latter, EIOPA was able to source data only from 10 providers in three member states – too small a sample for conclusions to be drawn.

EIOPA found a wide range of costs based on product type and risk categorisation, and significant variations by member states and by premium. However, concerns about data comparability – and the consequent limitations of conclusions drawn – are highlighted throughout the report.

Asset management costs appear to be the primary driver for cost differences, followed by insurers' administrative and distribution costs. Only 20% of IBIPs offered passively-managed products and ESG (environmental, social, governance) products were not mainstream.

The report also highlights the variance in transparency of costs and information about product performance. It notes that retail investors need to understand costs and returns in the context of risk but also in relation to the term of the product. EIOPA observes that reporting on short-term market returns for IBIPs does not necessarily equip customers to make an informed decision about the suitability of that product to meet their requirements.

Investment funds and structured products

ESMA's report (the largest) covers UCITS, retail alternative investment funds (AIFs) and structured retail products (SRPs), considering each of these products against member state of domicile and underlying assets, for the period 2008 to 2017.

UCITS made up three-quarters of the market and is described as "the most transparent market in terms of cost and performance disclosure". ESMA notes that retail AIFs have not been as transparent as UCITS, and SRPs even less so, but the PRIIP KID is beginning to change that. For SRPs in particular, performance data were not generally available and ESMA observes that, to the extent that they become available in future, they may be hard to interpret given the nature of the products.

For investment funds, the report found a high degree of heterogeneity between member states, including for UCITS (e.g. in relation to performance fee disclosures). This made comparative analysis difficult, but ESMA notes that over the period studied, ongoing costs had the greatest impact on fund performance. Overall costs remained broadly stable, but costs in money market funds halved in the period 2008 to 2011.

Key findings include that there is no significant sign of liquidity mismatch for funds that are 100%-held by retail investors, and that actively-managed funds outperform passive funds on gross returns, but underperform net of costs.

Structured deposits

The only products falling to the EBA to consider were structured deposits. Again, the report (by far the smallest) notes that procuring comprehensive data had proved challenging. Given the size of the EU structured deposits market – estimated to comprise about 6,000 credit institutions – the EBA believes that additional efforts to collect data from all providers would be disproportionate at this stage. It suggests that its understanding of the market will improve over the next few years, allowing it to reassess whether the size of the market justifies the effort required to provide a comprehensive analysis, on proportionality grounds.

Contact



Julie Patterson

Director
EMA FS Risk & Regulatory
Insight Centre
T: +44 20 73115261
E: julie.patterson@kpmg.co.uk

Next steps?

The ESAs' reports will likely set the broader context for the new Commission's review of the costs and charges section of the PRIIP KID and of cost disclosures under MiFID II, IDD and the UCITS KIID. Given the varying quality and depth of the analyses, it is not obvious how useful the reports will prove to be. They will, though, underline to the new European Parliament that one of the significant barriers to achieving Capital Markets Union is the absence of comprehensive data.



Taking account of the ethical dimensions of data and AI

Financial institutions across all sectors are under pressure to take account of the ethical dimensions of the use of data and artificial intelligence (AI).

This pressure seems sure to increase, so firms should be considering how to incorporate this into their data analytics capacity. Demonstrating fairness and transparency will be a key element in generating and maintaining trust.

Regulatory response

One response to these concerns at EU-level has been the creation by the European Commission of a high-level expert group on AI, which has recently published a set of ethics guidelines for trustworthy AI. This covers all firms, not just financial services.

At a minimum, firms need to be diligent in their application of laws and regulations, including confidentiality, broader privacy rules and data protection. In addition, these guidelines focus on the importance of trustworthy AI being ethical and robust.

Four ethical principles are applied to how firms should develop, deploy and use AI systems:

Respect for human autonomy – people interacting with AI systems must be able to keep full and effective self-determination over themselves. AI systems should not deceive or manipulate people, but should be designed to empower people, leaving them meaningful opportunity for choice.

Prevention of harm – AI systems and the environments in which they operate should be safe and secure, technically robust and not open to malicious use. Particular attention should be paid to vulnerable

customers and to situations where AI systems can cause or exacerbate adverse impacts due to asymmetries of power or information between providers and customers.

Fairness – individuals and groups should be free from unfair bias and discrimination, and should not be deceived or unjustifiably impaired in their freedom of choice.

Explicability – processes need to be transparent, the capabilities and purpose of AI systems should be openly communicated, and decisions should be explainable to those directly and indirectly affected. The data and mechanisms through which an AI system makes decisions should be capable of being described, inspected and reproduced, so that a decision can be properly challenged. Where this cannot be achieved, other measures (traceability, auditability by a third party and transparent communication on system capabilities) may be required

Business developments

Data analytics, including intelligent and autonomous systems, are playing an increasing role in financial services, as reflected in the growing volumes of customer data, access to and storage of data, and data flows (often across national borders) between financial institutions and third party service providers.

Financial institutions are actively considering how they can use data, machine learning and AI to increase their efficiency (for example by automating processes, and improving the detection of fraud and money laundering) and effectiveness (taking better decisions on credit, insurance and market risks, and providing improved outcomes and experiences for customers).

Contact



Clive Briault
Senior Advisor
EMA FS Risk & Regulatory
Insight Centre
T: +44 20 76948399
E: clive.briault@kpmg.co.uk



Guidelines focus on the importance of trustworthy AI being ethical and robust.



Concerns

Data analytics will not necessarily lead to fair, transparent and explainable outcomes. Firms may struggle to identify the limitations of their data and systems, and to ensure that their outputs are free from unfair bias and prejudice (whether deliberate or otherwise).

For example, a 'black box' AI application could be designed to lead consumers towards pre-specified outcomes that benefit the provider rather than the customer, or data

sets may have limitations that make it difficult to validate outcomes or to avoid discrimination or bias.

Financial institutions also need to protect themselves against the types of misuse of data and data analytics that have already emerged in social media contexts, including the unauthorised sharing of data, the resale of customer information by data brokers, and bias within algorithms.

Implications for firms

Firms should consider how they could demonstrate they meet the evolving ethical principles for data and AI, including:

- Respecting customers' ability to make their own free choices, by not misleading or manipulating customers to act against their own interests, or unduly constraining customers' access to information.
- Enabling customers to recognise or check when they are engaging with AI or automated decisions, providing an appropriate level of human control over these systems, and enabling customers to challenge automated decisions.
- Treating customers fairly and respecting their basic rights, including for privacy.
- Identifying and addressing risks of unfair bias and discrimination that can occur through the data themselves or through programming an AI algorithm.
- Taking a 'glass box' approach to the transparency of data analytics and AI, focusing on the intelligibility, explicability and verifiability of the data and any actions taken on the basis of the data.
- Understanding the decisions being taken through AI and being able to explain these decisions to customers, auditors and supervisors.
- Developing processes and frameworks to test, monitor and govern the ethical use of data and AI.
- Taking an organisation-wide and top-down approach to data and AI ethics, with governance frameworks that provide the necessary transparency, communications, culture and defined business and data ownership.
- Establishing clear principles of accountability, not least to resolve any ambiguities, including around liability, if any issues or ethical breaches should arise.

Crypto-assets: what are they?

There is regulatory scepticism over the nature of crypto-assets, and debate about whether and how they should be regulated.

Regulatory responses vary significantly from jurisdiction to jurisdiction, as a recent report by Cambridge University’s Centre for Alternative Finance (CCAF) shows.¹ New rules are rapidly being developed around the globe, but with differing scopes and terminology.

KPMG’s report on the regulation and supervision of fintech called out that the regulatory perimeter might widen to capture crypto-activities. Some regulators are moving to treat crypto-assets as financial instruments and to regulate crypto-exchanges.

Regulated and unregulated firms operating in this space need to navigate the patchwork of regulatory approaches and to keep a close eye on rapidly evolving requirements around the globe. Even within the EU, a common approach seems some way off.

Crypto and anti-money laundering

The Financial Action Task Force (FATF) called for an effective global response to the AML risks associated with virtual asset financial activities and issued guidelines that must be implemented by June 2019.

In the EU, the 5th Anti-Money Laundering Directive has to be implemented by January 2020. It will bring cryptocurrencies, exchanges and platforms in scope.

An emerging pan-EU approach

ESMA’s paper in January 2019 found that crypto-assets do not give rise to financial stability issues but may pose risks to investor protection and market integrity. It called for crypto-assets to be classed as financial instruments and, given the cross-border nature of such assets, for an EU-wide approach.

The European Commission is therefore considering legislation to address the need for legal certainty for crypto-assets in order to ensure investor protection, market integrity and a level EU regulatory playing field.

National positions vary though

National regulations and approaches vary within Europe. Malta’s Virtual Financial Assets Act, for example, requires crypto-issuers and crypto-exchanges to be licenced.

A French government report concluded that cryptocurrencies should not be directly regulated other than in relation to AML. Instead, banks should be prevented from investing in them, trading platforms regulated and investments by asset managers restricted.

In contrast, the UK’s “Cryptoassets Taskforce” published an assessment of risks and potential benefits. It concluded that strong action should be taken to address the risks associated with crypto-assets falling under existing regulation, and that international coordination is required for crypto-assets that fall outside the current regulatory framework and pose new challenges to traditional financial regulation.

Contact



Julie Patterson

Director
EMA FS Risk & Regulatory
Insight Centre
T: +44 20 73115261
E: julie.patterson@kpmg.co.uk

¹ https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf

Recent alerts and insights

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



Resolution: Pressures build on European banks

April 2019

Resolution poses many challenges for banks. When designing a commercial banking model with operating structures that are capable of facilitating recovery and resolution, it is essential for banks to understand clearly how to navigate regulatory requirements and what to focus on to meet these challenges. This paper looks at eight areas, identified by the FSB, BoE and SRB, where systemically important banks need to take actions to improve their resolvability.



LIBOR to RFR Transition

April 2019

This year will be a significant year for the working groups, industry bodies and firms. The priorities for member firms' clients for 2019 have begun to crystallise and include strategy definition and refinement; client outreach planning; and contracts impact assessment and planning. There have been a number of key regulatory updates over the last couple of months that will help to further drive clients' priorities. In this regulatory round-up you will find the latest regulatory updates from key parties including, ECB, BoE and ARRC.



Regulation and supervision of fintech: ever-expanding expectations

March 2019

Fintech is moving rapidly from 'under the regulatory radar' and is attracting growing regulatory responses and supervisory scrutiny. The list of regulatory and supervisory responses to fintech-related risks continues to lengthen – and will continue to do so as fintech solutions continue to develop and grow, and as the associated risks evolve. Firms entering the fintech space need to factor the ever-changing nature of regulation and supervision into their strategies, business planning, governance and risk management.



ESMA and the FCA agree MoUs

February 2019

ESMA and the FCA have confirmed that they have agreed the substance of a multilateral Memorandum of Understanding (MoU) between the FCA and national regulators (NCAs), covering supervision, enforcement and information exchange. They have also agreed an MoU on the supervision of credit rating agencies and trade repositories. Firms will need to ensure, however, that they have appropriate substance in the EU27 delegating entity.



Resilience and Resolution: EU agrees the banking package

February 2019

The EU has reached political agreement on the "banking package" of measures, first proposed by the European Commission in November 2016. The banking package covers extensive amendments to the Capital Requirements Regulation (CRR), the Fourth Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).



Asset Management Regulatory Insights

February 2019 – April 2019

This quarter we have looked at recent ESMA updates which included a report on the performance and costs of retail investment products, draft guidelines on liquidity stress testing in funds and a report on the PRIIP KID. In March we explored the opportunities and associated costs with the pan-European personal pension product (the PEPP). And in the most recent update, we discuss the impact the new capital requirements will have on the industry.

Useful information...

Contact a member of the EMA Financial Services Risk & Regulatory Insight Centre:

James Lewis

Financial Services

T: +44 20 73114028

E: james.lewis@kpmg.co.uk

Clive Briault

Banking

T: +44 20 76948399

E: clive.briault@kpmg.co.uk

Julie Patterson

Asset Management

T: +44 20 73112201

E: julie.patterson@kpmg.co.uk

Further insights:

www.kpmg.com/regulatorychallenges

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CREATE | CRT113329 | May 2019

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