Horizons

The outlook for financial services regulation

January 2019

kpmg.com

Seven regulatory challenges in 2019 and beyond

Welcome to the January 2019 edition of Horizons from the KPMG EMA Financial Services Risk & Regulatory Insight Centre – your 'go to' read for insights on financial services regulation from the perspective of the EMA region.

At the beginning of a new year, and over ten years on from the global financial crisis, what is the regulatory outlook for financial services firms in 2019 and beyond? Who and what will be driving the regulatory agenda? How might rules and supervisory priorities develop?

In this edition of Horizons, we offer some pointers to the evolving regulatory landscape. We have identified seven challenges for 2019 and beyond. Most immediately, however, firms need to take practical steps to plan for a range of **Brexit** outcomes, including "no deal", and time is running out. Firms also need to plan for industry adoption of the new **risk-free benchmarks**. See page 12 for further details.

1. Geo-political and macro-economic risks

Financial services regulators around the globe need to respond to macro-economic policy and trade issues under their financial stability and consumer protection remits. Brexit is one example. The persistent low interest rate environment is another – in addition to balance sheet impacts, it has increased the focus on the impact of costs on investment product returns.

2. Systemic risk

The systemic risk agenda now encompasses resolution, asset volatility, non-bank finance and climate change (linked to challenge 6 below), and is therefore focussing increasingly on the insurance and asset management sectors. Stress testing is a focus for all sectors (see page 6 for the latest results for banks and insurers). The changing tides of wider geo-political debates may influence the priorities and outputs of the Financial Stability Board (FSB) – see page 4 for more thoughts on this.

3. Operational resilience

Regulators and supervisors are concerned about all aspects of the ability of firms to prevent, respond to, recover and learn from operational disruptions. This extends beyond cyber security and data protection to a spotlight on interconnectedness, outsourcing and concentration in the financial system.

4. Technological change

Regulators continue to encourage fintech but are concerned that technological developments may heighten cyber and other risks – linked to operational resilience. They also continue to assess whether existing rules, originally designed in a paper and person-to-person world, are fit-for-purpose in the digital age.

5. Governance, accountability and conduct

Governance structures are a perennial focus of regulators and a small, but increasing number, of regulators are focusing on individual accountability within regulated firms in an attempt to constrain excessive risk-taking and to improve standards of conduct and culture. Diversity is also beginning to emerge as an area of increased supervisory focus.

6. Social objectives

Regulators are having to take into account a range of social objectives. In particular, all types of financial services firms and investing institutions are under increasing regulatory pressure to evidence their approach to environmental, social and government (ESG) issues, in order to help

> The next four months might bring some greater clarity for firms but will as likely give rise to new regulatory issues.

governments meet climate change agreements – see page 8. There may be tensions where these aims conflict with the long-standing bulwarks of financial stability and consumer protection.

7. Institutional change

The debates on increased powers for the European Supervisory Authorities (ESAs) and whether the European Banking Authority (EBA) should have a greater role in anti-money laundering compliance may result in firms needing to establish new or expanded relationships with different supervisors. Embedding such supervisory changes could be challenging for both firms and their supervisors.

Meanwhile...

We are less than four months away from the last session of the European Parliament, ahead of the elections in May. The co-legislators have reached agreement on some legislative proposals in the last three months, but a number are outstanding. **Reform of the ESAs**, progress with **Capital Markets Union** (CMU) and completion of **Banking Union** and the **Banking package** (capital requirements and resolution) remain priorities of this Commission to progress, as does the suite of proposals on **sustainable finance**. Also expected to be completed are reform of capital requirements for investment firms, the pan-European personal pension product (PEPP), removing barriers to cross-border fund distribution and revisions to EMIR.[1]

The regulatory focus on **delegation** practices continues. There are proposals to introduce a bonus cap on fund management companies and their delegates, for instance, and to tighten up rules for third countries. Given the large volume of portfolio management activities delegated by EU27 firms to UK asset managers, this could have significant implications for the post-**Brexit** landscape.

The heightened possibility of a "no-deal" scenario has caused regulators to spring into action. The UK regulators have issued further details on the Temporary Permissions Regime (TPR) for inbound firms and funds, and draft rules under the Financial Services Contracts Regime (FSCR). The FSCR will provide a limited period of time during which EEA passporting firms can continue to service UK contracts entered into prior to exit day. France, Germany and the Netherlands are proposing some form of FSCR, but with different scopes and durations, and a number of regulators are encouraging firms to make full preparations for a no-deal outcome.

The next two to four months might bring some greater clarity for firms but will as likely give rise to new regulatory issues. Keep tuned to further editions of Horizons and our other publications to help you navigate the difficult flight path ahead.

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

[1] European Market Infrastructure Regulation

FSB evolving focus

Ten years on from the financial crisis and with a new chair, how might the FSB's evolving focus influence future regulation?

The outgoing Chair of the Financial Stability Board (FSB), Mark Carney, has set out the FSB's shifting focus from developing post-crisis reforms to monitoring and evaluation. It will be interesting to see what difference will be made by the new Chair, Randal Quarles (NY Fed), given the view of the US Treasury that the FSB has gone beyond its core mission of enhancing global financial stability.

The new agenda

As emphasised in Mark Carney's report to the G20, the FSB is shifting its focus from developing post-crisis regulatory reforms to:

1. finalising and operationalising post-crisis reforms;
2. monitoring the implementation of post-crisis reforms;
3. evaluating the effects of post-crisis reforms and adjusting them where necessary; and
4. addressing new and emerging vulnerabilities in the financial system.

This will be challenging:

Some post-crisis international standards remain a long way from completion, not least the development of an international capital standard for insurers and the response to systemic risks in the insurance sector.

The timing and substance of the implementation of international standards continues to be uneven across jurisdictions. Moreover some reforms have so far resulted in very little by way of national implementation, for example the FSB's key attributes for the resolution of insurers (which date back to 2011).

Evaluations of post-crisis reforms have generally resulted in very little adjustment to standards, even in response to concerns about the impact of regulatory reforms on the availability of correspondent banking.

There remains a potentially long list of areas where the FSB may develop further reforms, even if not all of them relate back to the financial crisis a decade ago. This includes the systemic risks arising from non-bank finance, and in particular the structural vulnerabilities associated with asset management; cyber security; a range of risks to financial stability arising from fintech; and climate change (through the work of the Taskforce on Climate-related Financial Disclosures).

In the view of the US Treasury, the FSB has gone beyond its core mission of enhancing global financial stability (for example in its work on conduct and culture, governance, remuneration and climate change) and has not followed best practice in consultation and cost benefit analysis. Given these comments, we may find the FSB's agenda changing further over 2019.

Recent FSB reports

Recent FSB reports have reflected its increasing focus on implementation and evaluation.

The FSB published its fourth annual report on the implementation and effects of the G20 financial regulatory reforms at the end of November 2018.

More detailed FSB reports in the final quarter of 2018 covered:

- measures to address the decline in correspondent banking;
- progress in the implementation of resolution regimes, noting the fundamental lack of progress in introducing resolution regimes for systemically important insurers, the absence of comprehensive resolution regimes for central counterparties, and the challenges that still remain in the banking sector;
- progress in reforming major interest rate benchmarks; and
- lengthy evaluations of the effects of regulatory reforms on incentives to centrally clear OTC derivatives and on infrastructure finance.

> "The timing and substance of the implementation of international standards continues to be uneven across jurisdictions."

The FSB has also published changes in its processes and procedures to increase its transparency and effectiveness.

Contributors

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

Julie Patterson
Director
EMA FS Risk & Regulatory Insight Centre
KPMG in the UK
T: +44 20 73115261
E: julie.patterson@kpmg.co.uk

Mostly positive results from bank and insurance stress tests

The latest results need to be viewed in the wider context of continuing regulatory reform and evolving external risks

The European Banking Authority (EBA), the Bank of England and the European Insurance and Occupational Pensions Authority (EIOPA) have published the results of their 2018 stress tests for major banks and insurers. The results are generally encouraging, with the high starting points for most firms' capital and solvency ratios providing a substantial cushion from which to absorb the impact of adverse stress scenarios.

EBA

In the EBA stress test the "fully loaded" (full implementation of the Capital Requirements Regulation, Capital Requirements Directive 4 and IFRS 9) aggregate CET1 (common equity tier 1) capital ratio fell under the adverse stress scenario by almost 4 percentage points, from 14.0 percent to 10.1 percent, driven mostly by credit risk losses and increases in risk exposure amounts. The average leverage ratio declined from 5.1 percent to 4.2 percent.

13 banks suffered a decline in their CET1 capital ratios of at least five percent. However, none of the 48 banks in the EBA sample fell to below a CET1 capital ratio of 5.5 percent (a minimum acceptable post-stress result, based on the 4.5 percent minimum CET1 capital ratio and a one percent capital surcharge for a systemically important bank), although five banks fell below a leverage ratio of 3 percent.

Banks in some countries (in particular Germany and the UK) performed worse than others, partly as a result of the severity of the macroeconomic scenario for their countries. UK banks also suffered from significant loan exposures, and German banks from low levels of profitability.

Bank of England

All seven UK banks "passed" the Bank of England stress test, even though the minimum hurdle rate for post-stress capital ratios was higher (at around 8 percent) than in previous tests. The hurdle rate included the minimum CET1 capital ratio, the systemic buffers that apply to UK banking groups with ring-fenced retail banks, and Pillar 2A capital requirements.

The average CET1 capital ratio for the sample fell from 14.5 percent to 9.2 percent as a result of the stress scenario (before conversion of Additional Tier 1 (AT1) instruments, which takes the post-stress average CET1 capital ratio up to 9.7 percent). The average leverage ratio fell from 5.7 percent to 4.6 percent.

Two banks would have fallen below their hurdle rates on a fully loaded IFRS 9 basis, but this was avoided by triggering the conversion of AT1 capital instruments into CET1 capital.

EIOPA

EIOPA published the aggregate results of its 2018 stress test for 42 major European insurers, representing approximately 75 percent of the European market. Only four insurers gave permission to EIOPA to publish their individual results. The sample began with a pre-stress (end-2017) assets over liabilities (AoL) ratio of 109.5 percent and solvency coverage ratio (SCR) of 202 percent.

In the three stress scenarios:

1. a "yield curve up" shock of a sudden and sizeable repricing of risk premia and a significant increase in claims resulted in the excess of assets over liabilities (eAoL) falling by approximately one third and the SCR falling to 145 percent. Six groups reported a post-stress SCR below 100 percent.

2. a "yield curve down" shock of a protracted period of extremely low interest rates and an increase in life expectancy resulted in the eAoL falling by nearly 30 percent and the SCR falling to 137 percent. Seven groups reported a post-stress SCR ratio below 100 percent.

3. a series of natural catastrophes results in a decrease of less than half a percent in the AoL ratio, as the main impact is transferred to reinsurers.

Overall, EIOPA concludes that the sector is vulnerable to both of the first two stress scenarios. EIOPA will conduct further analysis of the results and issue recommendations where appropriate. It will also evaluate and discuss in future publications the responses to the cyber risk questionnaire that accompanied the 2018 stress test.

Implications for banks

The results will feed into the Supervisory Review and Evaluation Process, and in particular the setting of Pillar 2 capital requirements.

Banks that remain vulnerable to adverse stresses despite having improved their pre-stress test capital ratios in recent years may face pressure from supervisors and market analysts to bolster further their capital positions.

The EBA and the Bank of England also focus on qualitative aspects of how well banks manage their stress testing, in particular governance and modelling, which could also feed into Pillar 2 capital requirements.

The results need to be assessed in the wider context of continuing regulatory reform, which could have an adverse impact on banks' measured starting positions. EBA analysis has shown that the revised Basel Committee standards for credit, market and operational risk and the output floor will reduce major EU banks' measured regulatory capital ratios on average by nearly 3 percentage points (albeit with full implementation not expected until 2027).

Contributors

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

Matt Francis
Director
KPMG in the UK
T: +44 207 311 5506
E: matthew.francis@kpmg.co.uk

Regulation responds to climate change

There is increasing pressure on regulators to assist governments in meeting climate change commitments

With legislative proposals on sustainable finance and regulatory pronouncements that stress testing exercises should take full account of climate change risks, this topic is now firmly in the regulatory mainstream.

Sustainable finance

In May 2018, the European Commission issued a legislative package on sustainable finance, aimed at asset managers, investment funds, investing institutions (including insurance companies and pension funds) and intermediaries. It includes:

1. **harmonised criteria** (a taxonomy) for determining whether an economic activity is "environmentally-sustainable";
2. **disclosure requirements** for institutional investors and intermediaries;
3. the creation of new categories of **low-carbon benchmarks;** and
4. amendments to MiFID II[2] and IDD[3] to integrate sustainability preferences into financial advisers' **suitability tests**.

See KPMG alert: *EU strategy on sustainable finance* for more details[4]. The regulation on low-carbon benchmarks is already at "trilogue" stage (discussions between the European Parliament, Council and Commission), but the core Taxonomy regulation is progressing much more slowly. It remains to be seen whether the full package will be agreed before the European Parliamentary elections in May, despite the attendant pressures to finalise as many outstanding proposals as possible.

The European Insurance and Occupational Pensions Authority (EIOPA) is consulting until 30 January 2019 on the integration of sustainability risks and factors in Level 2 regulations under IDD and the Solvency II Directive. And the European Securities and Markets Authority (ESMA) is consulting until 19 March 2019 on:

- Integrating sustainability risks and factors in MiFID II. Firms will need to take into account environmental, social and governance (ESG) preferences in the context of assessing clients' investment objectives and to consider ESG factors in the context of product classification;
- Requiring UCITS and AIF to incorporate sustainability risks into their internal procedures and investment processes, and to identify and manage conflicts of interest; and
- Guidelines on minimum disclosure requirements in press releases on credit ratings, including whether and how ESG factors were considered as key underlying elements of the rating.

Meanwhile, the Commission issued on 4 January 2019 draft amendments to the IDD and MiFID II Level 2 Regulations to provide the legal basis for how ESG considerations must be taken in account in advice given by investment firms and insurance intermediaries. The rules will come into play only when the fourth element of the main legislative package has been agreed.

Potential ESG requirements for banks

ESG considerations are extending into other legislative proposals, too. We understand that the trilogue on revisions to the Capital Requirements Regulation (CRR2) may be finalised soon and may lead to:

1. The European Banking Authority (EBA) to assess the potential inclusion of a credit institution's ESG risks in the Supervisory Review and Evaluation Process (SREP) and possibly to develop guidelines.
2. A requirement for (larger) credit institutions with listed securities to disclose their ESG risks.
3. The EBA to investigate options for reflecting ESG considerations in the risk weighting of exposures.

[2] Markets in Financial Instruments Directive II

[3] Insurance Distribution Directive

[4] https://home.kpmg/xx/en/home/insights/2018/06/eu-strategy-on-sustainable-finance.html

Stress testing by banks and insurers

Meanwhile, there is already increasing pressure for banks and insurers to incorporate the full panoply of climate change risks in their stress testing exercises. EIOPA is to deliver by 30 April 2019 recommendations on how existing regulatory frameworks might incorporate sustainability risks and factors, and an opinion on the impact of Solvency II on insurers' sustainable investment and underwriting activities.

National regulators are also increasingly focussed on the issue. The UK's Prudential Regulatory Authority, for example, is consulting on its expectations for regulated firms to draw up credible plans to protect themselves from financial risks associated with climate change. Firms will need to embed climate change within the existing governance framework and assign board-level accountability for oversight. CROs will need to consider long-term scenario testing to inform the firm's strategic response to climate change and build climate change risk into risk management processes.

What it means for firms

It is clear that this topic is now firmly on the regulatory agenda. Until the various new rules are finalised, the impact on regulated firms and their clients cannot be precisely calibrated. It is certain, though, that regulatory and client pressures will be at the forefront throughout 2019 and beyond. Firms will need to incorporate ESG considerations across their business. For further information, please visit the KPMG Global Sustainability Institute page.

Contributors

Julie Patterson
Director
EMA FS Risk & Regulatory
Insight Centre
KPMG in the UK
T: +44 20 73115261
E: julie.patterson@kpmg.co.uk

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

Recent alerts and insights

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

Recovery planning: Playbooks and Dry-runs

October 2018

This paper from KPMG's ECB Office responds to the ECB benchmark analysis of recovery plans of significant institutions, which found that their complexity inhibits the ability of banks to implement recovery plans quickly and effectively. This paper outlines how banks can improve the usability of complex recovery plans, with playbooks and dry-runs evolving as best practice.

Refining the framework: SSM supervisory priorities in 2019

November 2018

What do the 2019 supervisory priorities mean for European banks? KPMG's ECB Office examines the supervisory topics that will be most relevant to EU banks in the coming year, including IT risks, non-performing loans, Brexit and the newly announced liquidity stress test. This paper delves into topics that will impact everything from daily supervision to on-site investigations of EU banks in the coming year.

KPMG's SSM Insights

December 2018

This quarterly newsletter from KPMG's ECB Office covers key issues the ECB is talking about. It also looks at the questions and topics that KPMG member firms are discussing with banks and others in the industry. It highlights both current and upcoming change by identifying potential effects on financial institutions' strategies and operations.

Basel Market Risk framework completed

January 2019

The Basel Committee has finalised its standards for the capital treatment of market risk. Banks are likely to welcome this final version of the market risk framework, which will generally have a much smaller impact on market risk capital requirements than the 2016 version.

RFR Regulation Round-up

January 2019

This update looks at a number of key developments including the results of the benchmark fallback consultation; an update from the EONIA transition subgroup on transition paths; and the ECB consultation on determining an ESTER-based term structure methodology as a fallback for EURIBOR-linked contracts.

Moving to new risk-free rates: Why asset managers need to prepare for the transition from IBORs

January 2019

With European and national regulators focussing on the transition to new risk-free rates (RFRs), this paper highlights the factors impacting the industry, what buy-side firms should consider and where they should start. Given the scale and complexity of this transition, early action should be a priority for firms.

[The systemic risk spotlight turns to leverage]

November 2018

The November edition of Asset Management Regulatory Insights looks at the calculation of leverage. Further to the Financial Stability Board's recommendations of January 2017, IOSCO is consulting on a standardised set of measures of leverage and a proposed supervisory framework. Comments are sought by 1 February 2019.

Ten key regulatory challenges of 2019: Resiliency amidst innovation

December 2018

The financial services industry is experiencing dramatic transformation, challenging both regulators and traditional financial services firms to keep pace. This paper, published by KPMG in the US, highlights the issues we believe will impact financial services firms in 2019, highlighting both the drivers behind these challenges and possible actions firms can take to address them, including pursuing greater agility and resilience.

Are you prepared for a "no deal" outcome?

January 2019

It is not yet certain what will happen as a result of Tuesday's decision by the UK parliament not to accept the EU-UK withdrawal deal. It does, though, underline that firms need to take practical steps to manage a range of outcomes including "no deal", and time is rapidly running out.

PRA Temporary Permissions Regime – BAU, almost

October 2018

On 26 October, the Bank of England and the Prudential Regulation Authority (PRA) published information on the detail of how the Temporary Permissions Regime (TPR) will work in practice. Firms should be aware that if they fail to make the TPR notification before exit day, they will not be able to enter into the regime and will be able to operate in the UK only once they subsequently obtain a full UK authorisation.

Proposed "no-deal rules" for PRA-authorised firms

November 2018

The Bank of England and the (PRA) are consulting on proposed changes to UK requirements and EU-derived Binding Technical Standards, which will be brought into effect in the event of a "no-deal" Brexit at the end of March 2019. The consultations are relevant to all firms authorised and regulated by the PRA (or those that intend to seek authorisation) and to financial market infrastructure providers currently supervised by the Bank of England (or that intend to apply to the Bank for recognition).

FCA proposed 'no deal' rules – part 2

November 2018

The Financial Conduct Authority's (FCA) second consultation paper on the rules that would apply in the event of a 'no deal' Brexit covers: its proposed approach to a wide range of topics where HM Treasury has laid further draft laws; further issues arising from the application of the cross-cutting approach set out in the FCA's first consultation paper; the transfer of the regulation of UK registered credit rating agencies and trade repositories to the FCA; and a series of detailed amendments to Binding Technical Standards.

Coming soon...

Regulation and supervision of Fintech: ever-expanding expectations

Regulatory proposals on fintech turn from a trickle to a stream.

The focus on fintech by regulators is intensifying. The balance between encouraging fintech and regulating appears to be shifting, with new rules as likely to constrain the take-up of such developments as they are to encourage it.

Look out for our forthcoming publication on the ways in which regulation is both responding to fintech and shaping it, and the implications for existing financial services firms and new entrants.

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

Janine Hawes
Insurance
T: +44 20 73115261
E: janine.hawes@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

CREATE | CRT108005 | January 2019

kpmg.com