

КРМБ

Top 10 regulatory challenges

10 key regulatory challenges facing the Australian Banking & Capital Markets industry in 2017

With the arrival of 2017, KPMG has outlined 10 key new and ongoing regulatory themes that we expect will demand the attention of the Banking & Capital Markets industry in the coming year.

Financial institutions (FIs) in Australia and internationally will continue to see a focus on governance and conduct, while the implementation of new capital requirements and technology will provide both challenge and opportunity. Political changes in the United States and Europe have introduced uncertainty into an international regime that had previously, for the most part, provided a reasonably clear regulatory program.

Here are the key regulatory issues that are likely to impact the industry through 2017.



Political uncertainty – Brexit, Trump and EU dynamics

The post global financial crisis world has largely seen a globally consistent and coordinated response to regulation. Global bodies such the International Organization of Securities Commissions (IOSCO) and Basel Committee on Banking Supervision (BCBS), together with Australian regulatory bodies – APRA, ASIC and the Reserve Bank of Australia have provided stable and predictable regulatory frameworks. Banks have been able to plan regulatory response over the medium term and adjust business models accordingly.

In June 2016, the British people voted to leave the EU, placing Europe's largest financial market into a state of uncertainty.

In the United States, Donald Trump was elected as President with a mandate that included eliminate or significantly change the Dodd-Frank Act, abolish the Consumer Financial Protection Bureau and a temporary freeze on new regulations. While. Trump provided few specific or detailed plans for the financial services industry, a great deal of uncertainty remains. Public statements by Trump and his aides since the election indicate there will be reforms to replace elements of the regulation with new policies to encourage economic growth and job creation. So far, specifics on what might be changed are unclear, but there appears to be a theme of less regulation and enforcement.

In the EU, elections are scheduled in 2017 in a number of the largest economies – Germany, France and Holland. In November 2016, we witnessed the European Commission publish amendments to the Capital Requirements Regulation (CRR2), which in effect delayed global capital reforms and introduced a phased implementation to enable local banks to adjust.

While international uncertainties do not directly impact Australian regulation, it would be fair to assume that APRA and ASIC are closely monitoring developments. Domestic regulators may wait until US and European positions are more settled before pushing ahead with local regulatory change.

A move away from harmonising global regulatory standards introduces risk, inefficiencies and the opportunity to arbitrage jurisdictions.

For Australian banks this makes planning difficult. Implementing change at large FIs is expensive and takes time. Banks want to act on reliable information, including regulation, to form the basis of decision making.



O2 Governance, culture and conduct

At KPMG, we distinguish between a bank's governance, culture and conduct. The responsibilities and accountabilities for each are different, but taken together, they were the dominant theme for 2016.

In 2017, we expect the focus to further extend with an increase in investigations, remediation programs and the introduction of sophisticated monitoring capabilities.

Despite heightened attention from regulators and external stakeholders to strengthen governance structures and risk control frameworks across the industry, instances of misconduct (i.e. professional misbehaviour, ethical lapse, compliance failures and breach of codes of conduct) continue to be frequently reported.

Regulators have come to see shortcomings in culture and conduct as the root cause. They are looking to Boards of Directors and Senior Executives to drive organisations towards cultural and ethical change. Boards and Senior Executives are now expected to define the culture within their organisations, to establish values, goals, expectations and incentives for employee behaviour consistent with the stated organisation culture, and to set a 'tone from the top', by exhibiting their commitment to the stated values and expectations through their own words and actions.

Line and middle managers, who are frequently responsible for implementing organisational changes and strategic initiatives, and who interact daily with staff, are expected to be similarly committed to adopting and manifesting the desired organisational culture to ensure the 'mood in the middle' is reflective of the 'tone from the top'.

The regulatory focus also extends to how organisations implement their business strategies. Regulators expect firms to place the interest of all their customers and the integrity of the market ahead of profit maximisation. Further, they will consider the business practices firms utilise and the associated customer costs relative to both the perceived and demonstrable benefit of a product or service to the customer.

Following significant market conduct failures such as FX and Libor rate-rigging scandals and misselling of financial products, the Financial Conduct Authority (FCA) in the UK has introduced the Senior Managers Regime which holds senior management personally accountable for misconduct caused by poor organisational culture. Meanwhile ASIC is considering criminal sanctions for poor bank organisational culture.

Investigations and remediation

In Australia there has been a dramatic increase in the number and scale of investigations across banking and capital markets. Over the last 5 years, international banks have paid over \$US260bn in legal settlements and fines. While Australian banks have been largely immune from large settlements and fines, the response to the investigation has been costly and time consuming for senior management.

We expect a number of developments in 2017:

- The volume and complexity of the investigations will grow. Investigations will move from reviewing the action of individuals (traders, salespeople and advisors), to more sophisticated review activity such as algorithmic and electronic trading.
- As seen in the UK and US, a move beyond financial corporate penalties to action against

individuals such as criminal prosecutions.

 The role of senior management will be increasingly in focus.
Were managers aware or should they have been aware of activity conducted by their staff? How did management respond to perceived inappropriate activity at the time of the incident?
Was the response consistently applied across the business?
Did the bank seek to perform wider internal investigations once misconduct was recognised?

The current crop of investigations are likely to highlight weaknesses within banks' control, operating processes and systems. Banks will need to implement remediation programs to respond to the findings. The remediation may take several courses – upgrade in codes of conduct, increased training, further resourcing in compliance/ oversight, and technological enhancements to prevent and/or report inappropriate activity.

The implementation of remediation programs will be of significant interest to management, regulators and auditors.

Monitoring

Global banks have significantly invested in conduct monitoring and surveillance.

The surveillance is increasingly shifting from 'look-back' to real time, near real-time and even forwardlooking behavioural analytics.

Data capture is vast – including trade/transaction reporting, voice, email, instant messaging and chat-rooms.

While many banks have improved the capture and storage of the information, the greater challenge is to collate and provide comprehensive analysis of the information and to take demonstrable action based on the outputs. While banks need to ensure compliance to codes of conduct, money laundering, financial crime, insider trading, front-running, and other market manipulations, etc., it will be essential for banks to employ a systematic and comprehensive approach to better manage known and emerging regulatory and legal risks. They will need to proactively respond to market structure reforms and new forms of misconduct.

The largest Australian banks must understand and manage regulatory mandates across more jurisdictions and services. Regulatory obligations and crossborder pressure points include:

- BSA/AML (Bank Secrecy Act/ Anti-Money Laundering)
- Commodity Futures Trading Commissions' (CFTC) data record keeping and reporting requirements

- The EU's second Markets in Financial Instruments Directive (MiFID2) which legislates firms who provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded. MiFID1 is currently in effect. The enhanced MIFID2 is expected to come into force on 3rd January 2018.
- EMIR/Dodd Frank: OTC mandatory clearing, margining of non-cleared OTC derivatives and transactional reporting.

Together with other financial crime requirements, these obligations continue to challenge local banks that operate in global locations. Given their size and complexity, banks need to move beyond reactionary mode, to a more coordinated and strategic deployment approach to tackling high-impact regulatory change. To address these challenges, banks will need to consider implementing a regulatory change management framework that is capable of centralising and synthesising current and future regulatory demands. This would incorporate both internally developed and externally provided governance, risk management, and compliance (GRC) regulatory change tools.

This change framework will enable institutions to improve coordination across their operating silos (business and location) and gain new insights that can improve overall performance, ensure risk management frameworks and compliance controls are integrated into strategic objectives, avoid redundancy and rework, and better address regulatory expectations.



Digital transformation

In 2016 we highlighted the emergence of fintech (finance technology) as one of the key regulatory challenges. The last 12 months has seen a significant evolution in the digital agenda. We see a number of specific components playing out this year:

 Regtech – The UK regulator FCA describes regtech as "the adoption of new technologies to facilitate the delivery of regulatory requirements." Given the stringent requirements and increased oversight, together with the availability of massive volumes of underlying data, the rapidly evolving fintech sector has led firms to target technology solutions to meet regulatory compliance. The objectives are to improve accuracy in compliance and reporting, find synergies across the organisation and drive down costs.

Artificial intelligence and robotics - Intelligent automation and robotic processing has been a cornerstone of modern manufacturing for a number of decades. The technology is quickly developing within the service sector, including banking. The technology, collectively 'digital labour', enables the analysis of massive amounts of data, automation of process, and analysis and decision making. Advances have enabled the technology to learn and adapt as new situations arise. This has enabled banks to reduce costs and improve accuracy.

The developments have come from a variety of sources – entrepreneurs outside of mainstream banks, in-house developments by banks – both organic and acquisition – and industry collaboration.

The challenge to banks' approach to regulation is two-fold:

- Embracing the technology to drive down costs, improve analysis to enable better decision making and improve accuracy
- Evolving operating models, policy and processes to take account of the automation of previously manual processes. This will require regulatory, compliance and risk managers to enhance their understanding of the new technologies and the developing business models.



Capital and liquidity

"Unquestionably Strong" is APRA's ultimate benchmark when assessing capital and liquidity requirements. This was the clear response of the Financial Services Inquiry to set capital standards for Australian authorised deposittaking institutions.

Enhanced Prudential Standards for large domestic banks, foreign banking organisations and other non-bank financial companies have brought capital planning and liquidity risk management to the forefront, as regulators have sought to restore both public and investor confidence in the aftermath of the financial crisis.

FIs are required to demonstrate their ability to develop internal stress-testing scenarios that properly reflect and aggregate

the full range of potential stressed impacts on their business activities and exposures, as well as the effectiveness of their governance and internal control processes. Large FIs must also provide information that will allow regulators to perform sensitivity analyses on their ability to manage their funding sources, signalling a step up in the scrutiny of FIs' liquidity management and how they would fare under system wide financial stress. Efforts to formalise the link between capital, funding and liquidity management include:

- The Fundamental Review of the Trading Book (FRTB). Perhaps the most significant change to capital requirements for capital markets, FRTB will set a new market risk framework for determining the amount of capital required to support financial and capital markets activities. The changes in capital will be significant and will require banks to assess their business structures. The implementation programs are large. Banks will need to invest considerably in 2017/18 to meet implementation timelines in 2019/20.
- An extensive refresh of standardised credit risk regulatory capital standards

(SA-CCR) comes into force in January 2018, with reduced reliance on external credit ratings; enhanced granularity and risk sensitivity; updated risk calibrations and providing more comparability with Internal Ratings Based categorisation.

 Total loss absorbing capacity (TLAC) held by systemically important banks. The key objective is to ensure that G-SIBs have sufficient 'loss absorbency' to enable authorities to implement an orderly resolution without impacting the stability of the broader financial markets. While Australia has no G-SIBs, the Australian Government's response has endorsed APRA's recommendation to implement a domestic TLAC framework.

- Basel III capital and liquidity minimum standards, namely the Net Stable Funding Ratio (NSFR) and the 30-day liquidity ratio (LCR). LCR was introduced into Australia in 2015. Both measures are complementary, with LCR focused on the short term and NSFR on the medium and long term. NSFR is expected to come into effect in 2018.



In our 2016 top 10, we nominated the 'cost effectiveness and sustainability of compliance' as a key challenge. For 2017 we have evolved our thinking with the 'Risk Function of the Future'.

Risk must innovate its operations, challenge traditions, push boundaries, be more forward focused and step into a leadership role in order to steer organisations through immense challenges in a technology powered world.

After years of boosting resources to meet continual regulatory compliance, all eyes are now on Risk to add deeper value. It must help protect strategy and goals against a volatile economy, disruption, competition and globalisation – as well as mitigating the threat of poor culture, conduct and cyber risk. Of course, compliance remains essential. But Risk must embrace the power of technology, rethink its approach to assessing culture, and up-skill to position itself as a leader. It must add a strong competitive edge to its organisation.

We discuss all of these aspects in our <u>Risk Function of the Future</u> <u>insights series</u>, demonstrating how transformation will bring immense benefit to organisations.



The new financial instruments standard becomes effective from the first financial year after January 2018. The commercial impact to larger banks are wideranging. Upgrades to systems and processes will be necessary to meet the changes. Key aspects include:

Expected credit loss model

- IFRS 9 introduces a new forward looking impairment model, requiring banks to provide for expected credit losses (ECLs).
- The ECL model is more complex and significantly more subjective. Application of the new model is not prescriptive and there are a range of approaches and outcomes.

 Banks will need to be able to make robust estimates of ECLs and determine when significant changes in credit risk occur – for example, by assessing external data and predicting future conditions.

Classifying financial assets

- Classification of financial assets is based on the contractual cash flows and the business model for managing those assets.
- This new principles-based approach will require judgement to ensure that financial assets are classified appropriately.

Hedge accounting

- Banks may choose to switch to the IFRS 9 hedging model or continue to hedge in accordance with IAS 39.
- The new model is more principles based and is aligned more closely with risk management strategies. It may offer some simplifications to hedge accounting but will require a more judgemental approach when assessing, qualifying, rebalancing and discontinuing hedge accounting.

Global banks expect provisions for bad debts to be bigger under the

new impairment requirements. At the same time, the new requirements are likely to have an adverse impact on regulatory capital positions.

Internal and external stakeholders, internal and external – such as analysts and investors, will need to be educated through the process.

A recent European Banking Authority report included an impact assessment, which revealed that surveyed banks on average estimated an 18% increase in provisions and a 59 bps decrease in CET 1 ratios – but for some the impacts could be much larger.

Prudential and securities regulators, together with auditors, will be involved. They will be expecting robust, high-quality implementation of the new requirements and transparent disclosure of the impacts.

For KPMG's insights on IFRS 9, visit our <u>IFRS – Financial instruments</u> webpage.

And visit our <u>IFRS for Banks</u> webpage for the latest on IFRS developments that directly impact banks, and the potential accounting implications of regulatory requirements.



The NPP is being developed collaboratively by a number of financial institutions in Australia. It will comprise a basic infrastructure, which all FIs, and through them businesses and consumers, connect. The NPP will enable payments to be made quickly between financial institutions and their customers' accounts, and will enable funds to be accessible in almost real-time, even when the payer and payee have accounts at different banks.

The innovations are exciting for banks and their customers, but as implementation comes closer, regulations and risk management will need to adapt to a near realtime world.

Challenges will include:

 Fraud detection – analytics to identify possible fraudulent activity almost instantaneously.

- Anti-money laundering upgrading practices and procedures designed to prevent illegal transactions/ income being processed through bank accounts.
- Liquidity and treasury management – with significant flow of funds moving from T+2 to intra-day.
- Credit limit management that can measure and action instantaneous draw-downs of credit lines.



OTC clearing and margining – call to arms

The largest FIs have been heavily involved in OTC reforms – central clearing, initial and variation margin and transaction reporting – for several years. To date, OTC reforms have largely been limited to the inter-bank/broker market and large highly sophisticated financial counterparties.

Through 2017, global regulators including Australia will require a new wave of participants to meet central clearing and daily margin requirements.

In order to meet the requirements, counterparties will be required to negotiate new legal agreements, implement new processes, increase the frequency of payments, reduce the processing time to T+1 and introduce new controls on liquidity.

For banks, the challenges are twofold:

- Meeting their own obligations with a significant increase in margin volumes, reduced T+1 schedules and reengineering collateral, valuation and cash management processes.
- Assisting less sophisticated clients through the changes, many of whom lack experienced internal legal and operational support.

There is a risk that the OTC derivative market may struggle to cope with the change. This may result in a significant dislocation, as the market adjusts to the changes.



Data – sharing, quality, aggregation and reporting

It has been almost 3 years since the start of comprehensive credit reporting (CCR), a voluntary system in which lenders can share more detailed customer credit histories. To date very little, if any, credit data has been shared between the major banks. Through 2016, calls to make the regime mandatory were made during the banking parliamentary enquiry, by competition authorities and fintech firms.

While pressure mounts, the initiative lacks a regulatory framework providing a mandate that includes scope of data use, means of access, privacy and a response to security concerns.

Although a long standing industry problem, many FIs continue to struggle with improving their risk data aggregation, systems and reporting capabilities. Banks working to comply with the Basel Committee on Banking Supervision Principles (BCBS) 239 are particularly pressured, as regulators continue to lack confidence in the industry's ability to produce accurate information on demand. Enhancing process controls, data tracing and risk reporting requirements are also top of mind for broker-dealers and investment banks. Compliance to AML and AUSTRAC threshold transaction reporting (TTR) continue to cause significant difficulties.

Globally, anticipated new requirements and regulation, such as the pending single-counterparty credit limit (SCCL) rule, which would likely require organisations to track and evaluate aggregate exposure to a single counterparty across the consolidated firm on a daily basis, further fuel the industry's data concerns.

Quality remains an ongoing challenge, with data integrity continually compromised by legacy technologies, inadequate or poorly documented manual solutions, inconsistent taxonomies, inaccuracies, and incompleteness.

Management will need to consider both strategic-level initiatives that facilitate better reporting, such as a regulatory change management strategic framework, as well as more tactical solutions, such as conducting model validation work, tightening data governance, and increasing employee training. By implementing a comprehensive framework that improves governance and emphasises higher data quality standards, FIs should realise more robust aggregation and reporting capabilities, which, in turn, can enhance managerial decision making and ultimately improve regulatory confidence.



Cyber security, on-boarding and privacy

Cyber security

Cyber security has become a very real regulatory risk distinguished by increasing volume and sophistication. Failures in cyber security have the potential to impact operations, core processes, and reputations, but in the extreme can undermine the public's confidence in the safety of the financial services industry as a whole.

Fls are increasingly dependent on information technology and telecommunications to deliver services to their retail and business customers, which, as evidenced by recently publicised cyber hacking incidences, can place customer-specific information at risk of exposure.

On-boarding

FIs have invested heavily in client on-boarding, yet many processes remain manual, error prone, time consuming and risky in terms of compliance with global regulations and contradictory to the desired client experience. Australian banks need to comply with both domestic and international AML, KYC and FATCA/GATCA regulations.

We expect that banks will need to implement new or extend technology-based on-boarding solutions that can:

- enhance and reshape customer experience
- reduce operational costs, while improving operational efficiencies and controls

- address gaps in (global) regulatory compliance
- use metadata to model policies for complying with regulation
- establish consistency in policy and data quality across the organisation and geographic regions
- advance data quality and governance.

Privacy

Some firms are responding to this linkage between cyber security and privacy by harmonising their approach to the two challenges. Protecting the security and confidentiality of customer information and records is of paramount concern to institutions and regulators alike. Areas of regulatory concern related to privacy include: data access rights and controls, data loss prevention, vendor management, training, and incident response.



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