



# KPMG Regulatory Horizons

The outlook for financial services regulation

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# The regulatory express

**Regulators remain focused on the resilience of financial services firms and recovery mechanisms but are also pushing ahead on many other issues.**

## In this edition:

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- Financial and operational resilience for banks
- Growing focus on product governance

Policy makers continue to be concerned about potential sources of systemic risk, including market infrastructure, evolution of the banking system and the role of investment funds.

**There is also a strong sense of looking forward and seeking to do things differently and better,** as evidenced in the articles on the European Commission's digital finance package, its retail payments strategy and the second phase of Capital Markets Union. Sustainable finance and consumer protection are also front of stage. The ESAs' latest business plans underline the wide supervisory agenda.

The financial sector has stood up well to the economic shock of the pandemic, but central bank

intervention was needed. Recovery is likely to be hard and possibly 'W'-shaped. It will be a challenge to avoid supporting "zombie" companies, in the real economy and in the banking sector. Some regulators are keen to have a full investigation into the drivers of the "dash for cash" or liquidity shortage in the financial markets in March, before making any changes to the regulatory framework.

Other regulators are more focused on revision of the liquidity risk management framework for investment funds. In countries that provide the full suite of liquidity management tools to managers, funds generally stood up well. Inflows have returned and funds are regarded as an important element in recovery.

The central counterparty (CCP) framework withstood the pressures of market volatility in March, in part due to the EMIR requirements for anti-pro-cyclical measures.

However, industry and regulators have noted areas where the framework may need further fine tuning. The almost finalised CCP Recovery and Resolution Regulation has generally been welcomed by industry, along with the EMIR delegated acts on third-country CCPs, of which the UK will be the first big “use case”. Meanwhile, the MiFID II review is well underway (see page 14) and there are calls for reviews of various other capital markets regulations.

For the banking sector, the pandemic was a purely exogenous shock and banks contributed substantially to supporting emergency responses across the Eurozone. The distinctive feature of supervisory responses was speed, and the most important actions were capital relief and use of buffers. At some point these buffers will need to be rebuilt. The tension for banks is in balancing the need to continue providing support, with concerns around their own profitability.

There is still a risk of an extended severe scenario that would require further support. The issues are not just cyclical, but structural: non-performing loans will increase, transitional relief from IFRS9 will reverse with potential capital headwinds, leverage ratios will lead to expansion of central bank balance sheets, and there is excessive procyclicality around capital ratios and risk-weighted assets. Industry initially supported dividend restrictions, but prolonging these could limit European banks’ funding capabilities and make them less competitive. Regulators will need to offer pragmatic solutions to avoid cliff-edge effects.

Also, the pandemic is increasing the differences between countries: some will recover faster; others will suffer long-term damage. Banking Union is seen as more important than ever. Meanwhile, the Basel Committee is focusing on operational resilience. For the latest developments see page 16.

The ability to insure against costs of future pandemics is key for the recovery and future resilience of the European economy. This includes proper risk assessments, and measures relating to mitigation and adaptation strategies and risk transfers. In its new business plan, EIOPA says it will develop work on shared resilience solutions, to address systemic risks to business interruption not caused by physical damage. It notes that the increase in uncertainty stemming from several geopolitical risks could lead to scenarios such as a sudden substantial increase in risk premiums and a drop in asset prices.

**For more thoughts on moving through recovery, see KPMG’s publication series on regulating the new reality.**



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# ESAs set out their agendas

**EBA, EIOPA and ESMA have each issued extensive work programmes for 2021 and beyond.**

The ESAs' work programmes all refer to the continuing impact of COVID-19 on their activities, protecting consumers and businesses, supporting sustainable finance and technological developments, cross-border business and the ongoing uncertainty of Brexit. They also include commentary about the way in which the ESAs themselves are developing in the face of new and existing challenges.



**EBA** will focus on six strategic areas:

- supporting deployment of the risk reduction package and implementation of effective resolution tools
- reviewing and upgrading the EU-wide EBA stress testing framework
- becoming an integrated EU data hub by leveraging on the enhanced technical capability for performing flexible and comprehensive analyses
- contributing to the sound development of financial innovation and operational resilience in the financial sector
- building the infrastructure in the EU to lead, coordinate and monitor AML/CFT supervision
- providing the policies for factoring in and managing sustainability (ESG) risks

It will also establish a culture of sound and effective governance and good conduct in financial institutions and deal with the aftermath of COVID-19. And the newly established Advisory Committee on Proportionality has recommended enhanced proportionality measures regarding the Investment Firms Directive, SREP guidelines, internal governance guidelines, the cost of compliance study and ESG disclosures template.



**EIOPA** has set two cross-cutting themes and three external-facing strategic objectives:

- Digitalisation and cyber-risks: AI, machine learning and digital ethics; impact of and supervisory response to new technologies and business models; innovative and efficient supervisory systems; ICT governance; cyber risk management practices; cyber insurance terms and conditions; risk mitigation; European data spaces
- Sustainability: firms’ decisions incorporate customers’ ESG preferences; sustainable approach to stewardship of assets; ESG risks managed and mitigated appropriately; tools and methodologies for assessing vulnerabilities to potential adverse market developments; resilience to ESG risks; sustainability risks integrated in risk assessment framework
- Conduct regulation: enhanced regulatory framework (IDD, PRIIPs and sustainable disclosures); implementation of conduct aspects of the pan-European Personal Pension Product (PEPP); a comprehensive risk-based and preventive approach to conduct supervision
- Prudential: Solvency II review; IORPD II implementation; long-term assets and ESG factors; engagement with third countries and IAIS; improved reporting, data and analytics of EIOPA and national supervisors; supervisory convergence
- Financial stability: identifying, assessing, monitoring and reporting risks



**ESMA** is implementing its new mandates and enhanced role, including direct supervision of third-country central counterparties, investor protection, relations with third countries, sustainability, technological innovation, cross-border fund distribution and the investment firms’ prudential framework. Also:

- Supervisory convergence: consistent application of MiFIDII/MiFIR for secondary markets; work on the performance and cost of retail investment products; facilitating the development of its data-driven supervision
- Assessing Risks: publishing annual statistical reports based on EMIR, AIFMD and MiFID II data, and promoting cooperation on risk analysis
- Single Rulebook: contributing to implementation of CMU, Fintech and Sustainable Finance Action Plans; developing the necessary rules under EMIR 2.2/EMIR Refit; reviewing MIFID II/MiFIR
- Effective supervision: of credit rating agencies, trade repositories, entities under the Securitisation Regulation and SFTR, and Tier 2 CCPs under EMIR 2.2; and recognition of third-country CSDs



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# New EU digital finance package

## The European Commission has issued a large and wide-ranging package of measures relating to digital finance.

The measures are intended further to enable and support the potential of digital finance in innovation and competition, while mitigating the risks.

The digital finance package<sup>1</sup> comprises a Digital Finance Strategy, draft regulations on digital operational resilience (DORA) and on markets in crypto-assets (MiCA), consequential amendments to existing legislation and a pilot regime on market infrastructure based on distributed ledger technology (DLT). The new Retail Payments Strategy was released at the same time (see page 10).

### Digital Finance Strategy

The Commission notes that the future of finance is digital and that Europe must take full advantage of this in its recovery strategy, to help repair the social and economic damage brought by the pandemic while protecting consumers against risks stemming from increased reliance on digital finance. The renewed strategy is four-fold. Europe should:

- Embrace these trends and all opportunities offered by the digital revolution
- Drive digital finance with strong European market players in the lead
- Make the benefits of digital finance available to European consumers and businesses

- Promote digital finance based on European values and a sound regulation of risks

The Commission is focusing on four priorities, across which it will pay special attention to promoting new opportunities that digital finance offers to consumers and to protecting consumers wherever appropriate, including due compliance with data protection rules. It says it remains committed to working closely with international partners.

### 1. Tackle fragmentation in the Digital Single Market for financial services, thereby enabling

- European consumers to access cross-border services and firms to scale up their digital operations:
- Harmonising rules on customer onboarding in 2021
  - Building on the upcoming review of the e-IDAS<sup>2</sup> Regulation to implement an interoperable cross-border framework for digital identities
  - Considering additional harmonised licensing and passporting regimes
  - Strengthening the European Forum for Innovation Facilitators (EFIF)

- Establishing an EU digital finance platform to foster cooperation between private and public stakeholders

### 2. Ensure that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency. In addition to MiCA (see page 8):

- A draft oversight framework for critical third-party ICT providers, such as cloud service providers
- A European cloud services marketplace, integrating all cloud service offerings, by end-2022
- EU cybersecurity agency (ENISA) to develop a cybersecurity certification scheme for cloud services in conformity with the Cybersecurity Act
- Rules on the prudential treatment of software investments for banks to be adopted shortly
- Removal of potential material regulatory obstacles to innovation
- Interpretative guidance on how existing regulations are to be applied to new technologies

<sup>1</sup> [www.ec.europa.eu/info/publications/200924-digital-finance-proposals\\_en](http://www.ec.europa.eu/info/publications/200924-digital-finance-proposals_en)  
<sup>2</sup> Electronic identification and trust services



- By 2024, clarity on supervisory expectations about how financial services rules should apply to artificial intelligence (AI) applications

**3. Create a European financial data space** to promote data-driven innovation, building on the European data strategy, including enhanced access to data and data sharing within the financial sector:

- Ensuring that publicly disclosed information is available in standardised and machine-readable formats
- Setting up an EU-funded infrastructure for public disclosure
- In 2021, a strategy on supervisory data on the necessary conditions to enable the use of innovative technologies, including RegTech and SupTech tools, for reporting to supervisors by regulated entities
- By mid-2022, a legislative proposal for a new open finance framework, building on and aligned with broader data access initiatives, and co-ordinated with the review of the Payment Services Directive (PSD2)

**4. Address new challenges and risks associated with digital transformation.** In addition to DORA (see below):

- ESAs to advise on “same business, same risk, same rules” issues
- By mid-2022, adaptations to existing consumer protection and prudential rules, in order to protect end-users of digital finance, safeguard financial stability, protect the integrity of the EU financial sector and ensure a level playing field (including large-scale lending outside the banking perimeter)
- Funding of financial literacy programmes focusing on digitalisation

**Digital operational resilience**

DORA aims to establish a comprehensive EU framework with rules for all regulated financial institutions. It will streamline and upgrade existing financial legislation and introduce new requirements where gaps exist:

- to better align firms’ business strategies and the conduct of ICT risk management, thereby improving overall management

of ICT risks, ensuring that firms can assess the effectiveness of their preventive and resilience measures and identify ICT vulnerabilities

- to harmonise and streamline the reporting of ICT-related incidents and increase supervisors’ knowledge of threats and incidents by enabling them to access relevant information
- to apply testing requirements proportionately, depending on a firm’s size, business and risk profile
- to strengthen firms’ oversight and ensure sound monitoring of third-party ICT providers to better manage risks stemming from dependency on them
- to raise awareness of ICT risk and minimise its spread through information-sharing, including allowing firms to exchange cyber threat information and intelligence

The regulation will also create more coherent and consistent incident reporting mechanisms, thus reducing administrative burdens for firms and strengthening supervisory efficiency.

### Markets in crypto-assets

MiCA aims to clarify the application of existing EU rules to crypto-assets and introduce a new, harmonised legal framework for crypto-assets covered by existing rules. It defines three different types of crypto-assets not covered by the existing rule:

- crypto-assets – digital representation of value or rights which may be transferred and stored electronically, using DLT or similar technology
- asset-referenced tokens – a type of crypto-asset that purports to maintain a stable value by reference to fiat currencies or commodities and can be used as means of payment (i.e. stablecoins)
- e-money tokens, which are also used as a means of payment, but with their value established by reference to only one fiat currency

MiCA will impose different levels of authorisation on the issuers of the different types of assets. For general crypto-assets, an issuer will have to be a legal entity, issue a “white paper” (a prospectus) and notify the national regulator (NCA) of the paper. An asset-referenced token issuer will have to be an EU legal entity and authorised by the NCA, with a white paper approved by the NCA. An e-money token issuer will have to be authorised as a credit institution or as an “electronic money institution” under the Electronic Money Directive (EMD2).

There will be obligations such as capital requirements, conflicts of interest, governance, custody of reserve assets, complaints handling etc. The requirements (e.g. in terms of capital and investor rights) will be more stringent for significant asset-referenced tokens, which will be supervised by the EBA.

Similar obligations will be required for significant e-money tokens. To ensure market integrity, crypto-assets falling under MiCA will be subject to bespoke measures to prevent market abuse and will not be subject to the Market Abuse Regulation (MAR).

MiCA will grant to NCAs the power to authorise and supervise crypto-asset service providers (such as crypto-asset wallet providers), with ESMA establishing a register of such firms. The Commission is also considering updating the prudential rules for crypto-assets held by financial firms, will explore how to leverage DLT to improve capital-raising operations of SMEs and, by 2021, will integrate these sectors into the sustainable finance taxonomy.

### Amendments to existing legislation

To achieve DORA's, MiCA's and the DLT market infrastructure pilot's objectives:

- Solvency II, UCITS, AIFMD, Institutions for Occupational Retirement Provision Directive (IORPD II) and the Statutory Audits Directive will include cross-references to DORA as regards those entities' management of ICT systems and tools
- CRD will require ICT business continuity and disaster recovery plans to be in accordance with DORA
- MiFID II will include cross-references to DORA and amended provisions relating to continuity and regularity in the performance of investment services and activities, resilience and sufficient capacity of trading systems, effective business continuity arrangements and risk management
- PSD2 authorisation rules will refer to DORA and the incident notification rules will exclude ICT-related incident notifications that DORA will harmonise
- The definition of financial instrument under MiFID II will be amended to clarify beyond legal doubt that such instruments can be issued via DLT
- A new provision in MiFID II will temporarily exempt DLT market infrastructures from certain provisions to enable them to develop solutions for the trading and settlement of crypto-assets that would qualify as financial instruments





## DLT market infrastructure pilot

There is currently limited use of this potentially transformational technology in market infrastructure. Existing financial services regulations were not designed with DLT and crypto-assets in mind and sometimes cause regulatory obstacles. DLT can allow for near real-time settlement, thereby reducing counterparty risk during the settlement process. It could also mitigate some cyber risks that centralised market infrastructures raise, such as the single point of failure. It could decrease costs by freeing up capital through reduced need for collateral posting, and automated processes (with the use of smart contracts) could simplify back office processes.

The pilot will provide a safe environment (a “sandbox” approach) and evidence for a possible permanent EU regulatory regime. However, unlike some existing sandboxes, the pilot will not be open to unauthorised firms, so may

limit access by smaller innovative fintech firms.

It will create the concepts of DLT multilateral trading facility (MTF) and DLT securities settlement systems. Existing MTFs authorised under MiFID II or securities settlement systems operated by a central securities depository (CSD) authorised under CSDR will be allowed to be authorised as a DLT equivalent and apply for temporary exemptions to existing regulation that curtails the use of DLT. For example, existing regulation envisages trading and settlement functions performed by different infrastructures. If granted the necessary exemptions by an NCA under the pilot, a DLT MTF could perform functions usually performed by CSDs, such as settlements and safekeeping.

To preserve financial stability, the regulation limits the size of the issuance or trading of transferable securities on DLT market infrastructure and does not allow

sovereign bonds to be included. Trading on DLT infrastructures will be subject to MAR. ESMA will be mandated to review MiFID II data reporting and pre- and post-trade transparency rules and to propose amendments for financial instruments issued via DLT.



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# Retail payments: four pillars

## The Commission reveals its vision for retail payments.<sup>1</sup>

Despite the wave of innovation around crypto-assets and DLT-based offerings, most new digital payment solutions are largely based on traditional cards or bank transfers, irrespective of whether the provider is a bank or fintech firm.

However, new means of initiating payments are developing fast (watches, glasses, belts etc), which build on advanced authentication technologies, and central banks are considering issuing central bank digital currencies (CBDCs).

The volume of cashless payments has increased, but cash currently remains the predominant method of retail payments in the EU. The EU payments market is still fragmented, despite improvements brought about by the development of the single euro payment area (SEPA) and the Payments Services Directive (PSD2).

The Commission welcomes private sector initiatives but notes the risk of inconsistencies and further market fragmentation, and the need for a clear governance framework. Its vision is:

- A broad and diverse range of high-quality payment solutions, supported by a competitive and innovative payments market, and based on safe, efficient and accessible infrastructures
- Competitive home-grown and pan-European payment solutions, supporting Europe's economic and financial sovereignty

- The EU makes a significant contribution to improving cross-border payments with non-EU jurisdictions, thereby supporting the international role of the euro and the EU's "open strategic autonomy"

The strategy is based on four interlinked pillars:

- 1. Increasingly digital and instant payment solutions with pan-European reach:** increasing consumer trust in instant payments; cross-border payment solutions; reaping the full potential of SEPA; exploiting the potential

<sup>1</sup> [www.ec.europa.eu/finance/docs/law/200924-retail-payments-strategy\\_en.pdf](http://www.ec.europa.eu/finance/docs/law/200924-retail-payments-strategy_en.pdf)

of electronic identity (eID) for customer authentication; improved acceptance of digital payments; and maintaining availability of central bank money.

The Commission will assess:

- whether to require all providers to adhere to the SEPA instant credit transfer scheme
- whether consumer protection measures are sufficient for instant payments (PSD2 review)
- whether to enhance the effectiveness of the crisis management of payment systems
- whether mitigating measures for financial firms' liquidity risk are sound
- whether additional AML/CTF measures are required
- a label and logo for eligible pan-European payment solutions
- deployment of EU specifications for contactless card-based payments
- promotion of the use of eID and solutions based on trust services
- acceptance of digital payments and acceptance and availability of cash within the euro area

## **2. Innovative and competitive retail payments markets:**

- reaping the full potential of PSD2; ensuring a high level of security for retail payments; fostering consumer protection; and future-proof supervision and oversight of the payments ecosystem.
- A comprehensive review of PSD2 launched by end-2021
  - Draft open finance legislation by mid-2022
  - Lessons learned from implementation of the June 2020 EBA Guidelines on ICT and security risk management

## **3. Efficient and interoperable retail payment systems and other support infrastructures:**

- open and accessible payments ecosystem, and access to necessary technical infrastructures.
- Settlement Finality Directive extended to include e-money and payment institutions
  - A right of access to technical infrastructures considered necessary to support the provision of payment services

## **4. Efficient international payments:**

- Payment system operators to facilitate linkages between European and third-country instant payment systems

- Implementation of global standards (such as ISO 2022) by end-2022
- Payment system providers to use SWIFT's Global Payment Initiative to improve transparency of cross-border transactions



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# CMU version 2

## The European Commission has adopted a new Capital Markets Union action plan.

The Commission notes<sup>1</sup> progress since 2015, with 12 out of 13 legislative proposals implemented, but that EU capital markets remain fragmented.

Individuals and businesses, especially in the smaller member states, are still not able to benefit fully from the deep, competitive, efficient and reliable sources of funding and investment that capital markets can offer. **“A strong and complete CMU is needed now more than ever, in order to support the economic recovery following the COVID-19 crisis and finance the green and digital transitions.”**

The action plan sets out measures to deliver three main objectives.

Some of the actions are mandatory for the Commission to undertake (such as reviews of specific pieces of legislation), others have been well-heralded (such as a consolidated tape – see page 14) and some may prove difficult to achieve within the timeline or may prove intractable (such as withholding tax relief at source or harmonisation of aspects of insolvency laws).

Importantly, the Commission states that it will act in full compliance with better regulation rules and the simplification objective (the “one-in-one out” rule), and will **“keep discussions inclusive, giving sufficient room for all voices to be heard”**.

### A green, digital, inclusive and resilient economic recovery

The Commission’s aim is to support recovery by make financing more accessible to companies.

Measures will be directed at both companies seeking capital and finance providers. Listing rules will be simplified, in order to promote and diversify small and innovative companies’ access to funding, and the Commission will assess the possibility of promoting market-making activities by financial firms. An EU-wide platform (or European single access point) will provide investors with seamless access to financial and sustainability-related company information (like the US “EDGAR” system).

There will be appropriate prudential treatment of long-term SME equity investment by banks. The review of the Securitisation Regulation will aim to enhance banks’ credit provision to EU companies, especially SMEs, and to scale up the EU securitisation market. Banks might be required to direct SMEs, whose credit application they have turned down, to providers of alternative funding. Regulatory obstacles will be removed for insurance companies to invest long-term and the review of the European long-term investment funds (ELTIFs) Regulation will seek to channel more long-term financing to companies and infrastructure projects, especially those contributing to the objective of smart, sustainable and inclusive growth.

### Individuals save and invest long-term

With a view to making the EU “an even safer place” for individuals to save and invest long-term, the Commission will assess the feasibility of developing a European

financial competence framework and the possibility of introducing a requirement for Member States to promote learning measures supporting financial education, especially in relation to responsible and long-term investing.

Rules on inducements and disclosure (in MiFID II, IDD and the PRIIP KID) will be reviewed and amended to ensure retail investors receive suitable advice and clear and comparable product information. The Commission will also seek to reduce the MiFID II information overload for experienced retail investors (see page 14) and, for financial advisers, to improve their level of professional qualifications and introduce a pan-EU label.

In the retirement savings arena, the Commission will facilitate the monitoring of pension adequacy in member states through the development of pension dashboards, develop best practices for the set-up of national tracking systems for individual Europeans and launch a study to analyse auto-enrolment and other practices to stimulate participation in occupational pension schemes, with a view to developing best practices for such systems across member states.

### A genuine single market

Nearly half the measures relate to the integration of capital markets, including improving the cross-border provision of settlement services in the EU and creating an effective and comprehensive post-trade consolidated tape for equity and equity-like financial instruments.

<sup>1</sup> [www.ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union\\_en](http://www.ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union_en)

The Commission will introduce an EU definition of “shareholder” and further clarify and harmonise rules governing the interaction between investors, intermediaries and issuers, in order to facilitate cross-border investor engagement. It will examine possible national barriers to the use of new digital technologies in this area and strengthen the EU’s investment protection and facilitation framework.

It will seek to introduce a common, standardised, EU-wide system for withholding tax relief at source, in order to lower costs for cross-border investors and prevent tax fraud. It will undertake a legislative or non-legislative initiative for minimum harmonisation or increased convergence in targeted areas of non-bank insolvency law, in order to make the outcomes of insolvency proceedings more predictable. With the EBA, it will explore possibilities to enhance data reporting to allow for a regular assessment of the effectiveness of national loan enforcement regimes.

More generally, it will work towards an enhanced single rulebook for capital markets by assessing the need for further harmonisation of EU rules and monitoring progress towards supervisory convergence, including taking stock of what has been achieved in Q4 2021 and considering measures for stronger supervisory coordination or direct supervision by the ESAs. Specifically, it will assess the implications of the Wirecard case for the regulation and supervision of EU capital markets and act to address any shortcomings that are identified in the EU legal framework.



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## CMU2 timeline

Q3 2020	— Auto-enrolment study
Q1 2021	— Prudential treatment of long-term SME equity investment by banks — Promotion of market-making activities by firms — Assessment of effectiveness of national loan enforcement regimes
Q2 2021	— Feasibility of a European financial competence framework — Strengthened investment protection and facilitation
Q3 2021	— EU-wide platform of company information — European Long-term Investment Fund (ELTIF) Regulation review — Removal of regulatory obstacles for insurance companies to invest long-term
Q4 2021	— Simplified listing rules for public markets — Possible requirement for banks to direct SMEs to alternative funding — Securitisation Regulation review — Development of pension dashboards — Examination of national barriers to use of new digital technologies — Improved cross-border provision of settlement services — Post-trade consolidated tape for equities — Enhanced single rulebook — Stronger supervisory coordination/supervision by the ESAs — Improved qualifications for MiFID financial advisors — Best practices for national tracking systems
Q1 2022	— Reduced information for experienced retail investors — Feasibility of a pan-EU label for financial advisors — Possible requirement for member states to support financial education — Assessment of inducements and disclosure rules
Q2 2022	— Minimum harmonisation/convergence in non-bank insolvency law
Q4 2022	— EU-wide system for withholding tax relief at source — Possible enhancements to data reporting
Q1 2023	— Improved qualifications for IDD advisors
Q3 2023	— “Shareholder” definition and amended rules on interactions between investors, intermediaries and issuers



# MIFID II: a two-stage review

## MiFID II review takes shape.

In the May edition,<sup>1</sup> we reported that the MiFID II/MiFIR review had been started but there was a way to go. There have since been considerable developments, particularly that updates to the directive and regulation are to be made in two stages.

### Stage one

The European Commission has proposed the first set of changes as part of a wider set of measures contained within the Capital Market Recovery Package.<sup>2</sup> The package aims to help financial markets support Europe's recovery from the COVID-19 pandemic. It also includes amendments to the Prospectus Regulation and securitisation rules.

Proposed changes to MiFID II are in three parts:

- Proposals to reduce the amount of information that needs to be provided to non-retail clients (including exemption of best

execution reports and costs and charges reporting) and, contrary to supervisory moves (see page 18), to dis-apply the product governance requirements to simple products, even for retail clients. These measures will go some way to meeting market participants complaints that the reporting and product governance requirements are overly burdensome and not valued by non-retail clients.

- Options to create exceptions from the investment research rules in relation to SMEs and fixed income. The Commission asserts that there has been a

decline in research coverage for small and mid-cap companies in recent years, a point which is refuted by some regulators, including recent ESMA risk analysis research.<sup>3</sup>

- Proposed amendments to the commodity derivatives regime to promote the nascent euro-denominated energy derivative markets by, amongst other measures, removing position limits for non-agricultural commodity derivatives.

The Parliament and Council are expected to adopt these amendments by end-2020. The UK government will need to decide

1 [www.home.kpmg/content/dam/kpmg/pl/pdf/2020/05/pl-horizons-may-2020.pdf](http://www.home.kpmg/content/dam/kpmg/pl/pdf/2020/05/pl-horizons-may-2020.pdf)

2 [www.ec.europa.eu/commission/presscorner/detail/en/ip\\_20\\_1382](http://www.ec.europa.eu/commission/presscorner/detail/en/ip_20_1382)

3 [www.esma.europa.eu/sites/default/files/library/esma\\_50-165-1287\\_report\\_on\\_trends\\_risks\\_and\\_vulnerabilities\\_no.2\\_2020.pdf](http://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf)

whether to amend the on-shored UK version of these regulations for the UK regime to remain equivalent.

## Stage two

The Commission is expected to produce a more comprehensive review proposal, at the earliest in Q3 2021. Meanwhile, ESMA continues to issue consultations and review reports. In the last quarter, the reports have focused on simplifying the current complex transparency regime while trying to improve transparency.

ESMA makes 18 recommendations in its report<sup>4</sup> on the **transparency regime for equity instruments**, in particular:

- restricting the use of reference price waiver to large orders
- increasing the minimum quoting obligations and a revised methodology for determining the standard market sizes relevant for the quoting by SIs
- simplifying the double volume cap regime by transforming the mechanism into a single volume cap with the deletion of the trading venue threshold of 4%
- clarifying the scope of the share trading obligation, specifically in relation to third-country shares

Market participants have agreed with ESMA's view, published earlier this year in its consultation, that the **transparency regime for non-equity instruments** is too complicated and not always effective at providing transparency. Therefore, ESMA's final recommendations include: deleting the specific waiver and deferral for, respectively, orders and transactions above the "size-specific to the instrument" (SSTI) threshold; and streamlining the deferral regime with both a simplified system based on

volume masking and full publication after two weeks.

The obligations in MiFIR for **pre-trade transparency from systematic internalisers (SIs) for non-equity instruments** have tried to strike a delicate balance between ensuring meaningful pre-trade transparency in non-equity instruments while limiting the risks SIs may face when trading against their proprietary capital for the execution of client orders. ESMA's final report<sup>5</sup> recommends:

- maintaining the publication of the quotes in liquid instruments while deleting the requirements to provide quotes to other clients and to enter into transactions with multiple clients
- removing the obligation in relation to illiquid instruments
- harmonising the way in which SIs publish their quotes in equity and non-equity instruments

ESMA issued in parallel a call for evidence<sup>6</sup> on **practical issues related to the application of RTS 1 and RTS 2**, which contain the main implementing measures in respect of the MiFID II/MiFIR transparency regime for equity and non-equity instruments.

The **organised trading facilities (OTF) framework** of MiFID II was intended to extend the definition of trading venue to those organised facilities offering trading in bonds and derivatives and thereby bring the same principles of organisation and transparency to these markets that apply to equities. ESMA's consultation<sup>7</sup> on OTFs seeks views around market participants' concern that the trading venue perimeter is not clear and that systems such as aggregators provided by technology firms, bulletin boards and fund managers' internal crossing systems

are in effect operating as trading venues, but without authorisation or having to comply with MiFID II/MiFIR provisions imposed on OTFs.

ESMA is also consulting<sup>8</sup> on the **MiFIR reference data and transaction reporting obligations**. As with the transparency regime, ESMA's objective is to simplify the current reporting regimes and enhance the quality of the data reported, by ensuring consistency among various reporting and transparency requirements. Issues raised in the consultation include a possible revision of the "traded on trading venue" concept and alignment between the EMIR and MiFIR reporting regimes to reflect the EMIR Refit review.

An ESMA consultation on **algorithmic trading** is expected to be published imminently.

Finally, ESMA's draft rules<sup>9</sup> on the provision of investment services by **third-country firms** under MiFID II/MiFIR, to reflect changes introduced by the Investment Firms Directive and Regulation, include annual reporting to ESMA.



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4. [www.esma.europa.eu/sites/default/files/library/esma70-156-2682\\_mifidii\\_mifir\\_report\\_on\\_transparency\\_equity\\_dvc\\_tos.pdf](http://www.esma.europa.eu/sites/default/files/library/esma70-156-2682_mifidii_mifir_report_on_transparency_equity_dvc_tos.pdf)

5. [www.esma.europa.eu/file/56345/download?token=ljesJ7EW](http://www.esma.europa.eu/file/56345/download?token=ljesJ7EW)

6. [www.esma.europa.eu/sites/default/files/call\\_for\\_evidence\\_rts\\_1\\_and\\_rts\\_2\\_review.xlsx](http://www.esma.europa.eu/sites/default/files/call_for_evidence_rts_1_and_rts_2_review.xlsx)

7. [www.esma.europa.eu/sites/default/files/library/esma-70-156-2013\\_consultation\\_paper\\_on\\_the\\_functioning\\_of\\_organised\\_trading\\_facilities.pdf](http://www.esma.europa.eu/sites/default/files/library/esma-70-156-2013_consultation_paper_on_the_functioning_of_organised_trading_facilities.pdf)

8. [www.esma.europa.eu/document/cp-mifid-ii-mifir-review-report](http://www.esma.europa.eu/document/cp-mifid-ii-mifir-review-report)

9. [www.esma.europa.eu/file/57258/download?token=ClrwF7\\_d](http://www.esma.europa.eu/file/57258/download?token=ClrwF7_d)

# Financial and operational resilience for banks

## Swift central bank and regulatory responses have been instrumental in supporting banks and their customers through the pandemic.

Some initial emergency measures have been unwound, some are nearing their end-dates and others continue or have been extended. Regulators face difficult decisions about the extent to which their actions can now support or impede the recovery. Meanwhile, the prudential agenda continues to expand into areas such as climate risk and digital resilience.

### Financial resilience

The fallout from COVID-19 will be with banks for a long time and the extent of the damage has not yet been fully realised. Non-performing loans will increase, with credit provisioning widely expected to peak in Q4 2020 and Q1 2021. Dividend restrictions are still in force but, if extended for too long, risk becoming a drag on profitability. At some point, capital buffers will need to be restored to pre-pandemic levels.

The challenging conditions were highlighted in the ESAs' first joint risk assessment in September, which flagged concerns around asset quality and a prolonged lower-for-longer interest rate environment. This is expected to weigh on the profitability and solvency of financial institutions and contribute to the build-up of valuation risks. The ESAs also noted a risk of decoupling of financial market performance from underlying economic activity and recommend five key policy actions:

1. Monitor risks and perform stress testing
2. Foster flexibility where and when needed: leverage the existing regulatory framework, including capital and liquidity buffers to absorb losses
3. Support the real economy: use capital relief to support continued lending
4. Stay prepared for disruptions to EU financial institutions and their clients at the end of the UK's transition period
5. Supervise digital transformation by carefully managing ICT and security risks, including outsourced ICT activities

### The outlook for Basel 4

Perhaps unsurprisingly, banks and regulators are at odds on moving to the next phase of Basel implementation, with regulators coming under increasing pressure to review. Industry has called out the burden already on banks and

recommended more detailed impact assessments to consider European specificities and avoid premature delivery of the CRR3 proposal. Longer term concerns are being raised around bank profitability and the need to avoid piling more pressure onto an already stretched banking system. The final reforms were agreed under very different economic conditions and regulators should consider whether they remain fit-for-purpose, say some banks.

For now, the Committee members and other regulators are holding firm, highlighting the benefits that Basel reforms have offered in recent months and the need to complete the programme to the agreed schedule. However, the debate continues: in the current climate, do the remaining Basel 4 revisions still stand up to scrutiny? And will banks be able to step up to the January 2023 deadline or do the new requirements risk destabilising recovery efforts?

### Recovery and resolution

The longer the crisis continues, the greater the risk to vulnerable banks. In July, the EBA reiterated the importance of resolution planning in times of uncertainty to ensure that resolution stands as a **"credible option in times of stress"**.





Resolution authorities should consider the impact of COVID-19 on banks and their business models when taking decisions on resolution plans and on the minimum requirement for own funds and eligible liabilities (MREL). They should also use and test resolution colleges as the main fora to exchange information and share decisions in times of stress.

The focus on operational resilience grows with the Basel Committee consulting on seven principles<sup>1</sup> (see box). Whilst many of the overarching messages, such as the emphasis on strong governance and use of severe but plausible scenarios to test resilience planning, are consistent with other regulators, the BCBS principles are high level and less prescriptive than the EBA guidelines on outsourcing arrangements<sup>2</sup> or the UK's operational resilience proposals<sup>3</sup>. The Committee proposes to implement the principles by **leveraging existing operational risk frameworks**, meaning that banks are likely to be able to comply without developing specific frameworks for operational resilience. Meanwhile, the European Commission has published a draft<sup>4</sup> Digital Operational Resilience Regulation – DORA (see page 7).

**For more on both financial and operational resilience and the impact of increased digitisation, please look out for our forthcoming papers in the “New Reality” series.**



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## Operational resilience

1. **Governance** – banks should utilise their existing governance structure to establish, oversee and implement an effective operational resilience approach that enables them to respond and adapt to, as well as recover and learn from, disruptive events
2. **Operational risk management** – banks should leverage their operational risk management functions to identify external and internal threats and potential failures in people, processes and systems on an ongoing basis; assess promptly the vulnerabilities of critical operations; and manage the resulting risks in accordance with their operational resilience expectations
3. **Business continuity planning and testing** – banks should have business continuity plans in place and conduct business continuity exercises under a range of severe but plausible scenarios in order to test their ability to deliver critical operations through disruption
4. **Mapping interconnections and interdependencies** – having identified critical operations, banks should map relevant internal and external interconnections and interdependencies to set operational resilience expectations that are necessary for their delivery
5. **Third-party dependency management** – banks should manage their dependencies on relationships, including, but not limited to, those of third parties or intra-group entities, for the delivery of critical operations
6. **Incident management** – banks should develop and implement response and recovery plans to manage incidents that could disrupt the delivery of critical operations in line with their risk tolerance for disruption considering risk appetite, risk capacity and risk profile
7. **ICT including cyber security** – banks should ensure resilient ICT that is subject to protection, detection, response and recovery programmes that are regularly tested, incorporate appropriate situational awareness and convey relevant information to users on a timely basis, in order fully to support and facilitate the delivery of critical operations

1 [www.bis.org/bcbs/publ/d509.pdf](http://www.bis.org/bcbs/publ/d509.pdf)

2 [www.eba.europa.eu/sites/default/documents/files/documents/10180/2551996/38c80601-f5d7-4855-8ba3-702423665479/EBA%20revised%20Guidelines%20on%20outsourcing%20arrangements.pdf](http://www.eba.europa.eu/sites/default/documents/files/documents/10180/2551996/38c80601-f5d7-4855-8ba3-702423665479/EBA%20revised%20Guidelines%20on%20outsourcing%20arrangements.pdf)

3 [www.bankofengland.co.uk/-/media/boe/files/news/2019/december/building-operational-resilience-impact-tolerances-for-important-business-services.pdf?la=en&hash=9075D03636371587C067CB336FAE82FF8F1C0D56](http://www.bankofengland.co.uk/-/media/boe/files/news/2019/december/building-operational-resilience-impact-tolerances-for-important-business-services.pdf?la=en&hash=9075D03636371587C067CB336FAE82FF8F1C0D56)

4 [www.ec.europa.eu/finance/docs/law/200924-digital-operational-resilience-proposal\\_en.pdf](http://www.ec.europa.eu/finance/docs/law/200924-digital-operational-resilience-proposal_en.pdf)



# Growing focus on product governance

## Regulatory expectations of firms' product governance processes are increasing.

ESMA and EIOPA are re-asserting the importance of robust product governance arrangements. The focus is shifting to upstream control, the impact of the pandemic and sustainable finance.

MiFID II and the Insurance Distribution Directive (IDD) introduced expanded rules on product governance. Impacted firms will have developed an assessment framework to meet the requirements, which should now be fully operational and embedded in business decisions. Further, firms' products or services, and the framework itself, are likely to have been through a review cycle by second line, to assure that both are meeting regulatory expectations.

These recent supervisory updates illustrate that attention has returned to product governance and indicate

an emerging renewed focus on the positive impact that robust and objective product governance can have on consumer protection, market integrity and effective competition. The updates also illustrate that supervisors are not fully convinced that firms have implemented (or are operating) the rules on product governance as intended.

In June, ESMA published guidance<sup>1</sup> designed to provide clarification for the compliance function. This guidance included confirmation that compliance should be formally involved in the development and

maintenance of a firm's product governance framework, policies and processes. Further, ESMA expects the compliance function to play a part in each product or service approval, whether relating to manufacturing or distribution.

EIOPA published a statement<sup>2</sup> in July calling on insurance companies to review their product oversight and governance measures because of the potential impact of COVID-19 on products and their utility/value for customers. EIOPA reiterated that it is vitally important that insurance companies place the

1. [www.esma.europa.eu/sites/default/files/library/esma35-36-1946\\_final\\_report\\_guidelines\\_on\\_certain\\_aspects\\_of\\_the\\_mifid\\_ii\\_compliance\\_function.pdf](http://www.esma.europa.eu/sites/default/files/library/esma35-36-1946_final_report_guidelines_on_certain_aspects_of_the_mifid_ii_compliance_function.pdf)  
2. [www.eiopa.europa.eu/content/eiopa-clarifies-supervisory-expectations-product-oversight-and-governance-requirements\\_en](http://www.eiopa.europa.eu/content/eiopa-clarifies-supervisory-expectations-product-oversight-and-governance-requirements_en)  
3. [www.eiopa.europa.eu/sites/default/files/publications/reports/eiopa-approach-to-the-supervisions-of-product-oversight-governance\\_0.pdf](http://www.eiopa.europa.eu/sites/default/files/publications/reports/eiopa-approach-to-the-supervisions-of-product-oversight-governance_0.pdf)  
4. [www.fca.org.uk/publication/consultation/cp20-19.pdf](http://www.fca.org.uk/publication/consultation/cp20-19.pdf)

fair treatment of customers at the heart of their response to the pandemic via their product governance arrangements. The statement went further to state categorically **“where there is a possibility of unfair treatment, EIOPA expects remedial measures to be taken.”** More recently, EIOPA outlined its approach<sup>3</sup> to supervision of product oversight and governance requirements. It reiterates that the key objective is to ensure consumer-centric approaches are implemented in practice.

National regulators are picking up the baton. For example, the UK FCA is consulting<sup>4</sup> until January 2021 on enhanced product governance rules for general insurance (GI) contracts. The FCA will require GI firms’ product governance arrangements more explicitly to address identified consumer harm in the home and motor insurance sector in relation to pricing, to ensure good outcomes for all customers. This will apply to all GI products and will require firms formally to consider fair value in their product governance processes (across core products, add-ons and premium finance).

The ESMA and EIOPA clarifications may have limited impact on some firms. These firms’ overall product approach, conduct culture and partnership approach between the business and compliance has meant that compliance is already fully engaged and playing an instrumental role in ensuring the framework, and its applications, are appropriately aligned to regulatory expectations and are delivering good outcomes for customers. For other firms, the clarifications potentially illustrate the following deficiencies:

- Compliance is kept at arm’s length, so does not have an effective and objective impact on the firm’s process – inadvertently or otherwise. For example, compliance is not a member of the firm’s product governance oversight committee or is involved only at the very end of the process in a limited sign-off capacity (or not at all), rather than having an integral influence on how products and services are designed and reviewed.
- The framework is only superficial and is not used robustly by firms genuinely to shape and challenge their product or service design and/or the appropriateness of the distribution proposition. For example, the product governance framework has been distilled to a simple “tick-box” exercise, which can be completed by the product or service owner.
- Value or product utility is not considered from the perspective of the end-customer, i.e. the firm does not balance its own commercial interests with those of its customers. For example, MI and meeting packs focus on costs purely from the perspective of the profitability of the product or service and not whether it represents value and delivers the intended benefits for the end-customer.

If firms design a balanced and well-considered product or service at outset, priced fairly, with a clearly articulated target market and where customer outcomes are routinely assessed, it significantly reduces mis-selling risks. This, consequently, mitigates future material customer detriment and an adverse impact on the reputation of the broader industry.

By placing attention further upstream, supervisors are seeking to address these risks at source. Consequently, we expect that there will be continued focus on firms’ design and operation of their product process.

**Firms should ensure that their product governance arrangements are fit-for-purpose, aligned to regulatory expectations, robustly and objectively challenged, and delivering good customer outcomes, and that, crucially, firms can evidence this.**

Furthermore, towards the end of 2021, insurers, investment firms, fund managers and distributors will be required to incorporate sustainability factors into their product governance processes, including target market. For more details, see KPMG’s “Delivering sustainable finance”.



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## Coming soon

### **COVID-19: regulatory perspectives on recovery and the new reality**

Policy makers have turned their attention to the **recovery** phase. Look out for our forthcoming publications on that issue and on what the **new reality** may look like, along with the ongoing regulatory agenda.

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## Further insights:

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