



Frontiers in Finance

Issue #60

Risk proofing the future

On the cover

Andrea Pozzi, Grupo Santander, page 6

Featured interviews

Julian Johns, Trunomi, page 51

Karina Whalley, AXA Global Parametrics, page 59

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Letter from the editors

Growing signs of a return to territorialism, new emerging technology risks, ongoing operational risks and a rising focus on environmental risks are all making the financial services agenda increasingly fluid, complex and uncertain. Combined with the changing needs of customers and the appearance of new types of competition along with evidence of slowing economic growth and low interest rates in the US, Europe and China, the pressure on financial services organizations is growing.

This edition of *Frontiers in Finance* is about facing the challenges head on and triumphing over them. Instead of staring numbly at the risks, the articles compiled for this edition aim to help readers better manage their risks; more effectively respond to changing regulation; and uncover opportunities for competitive advantage. It is about capitalizing on the regulatory and risk landscape.

The articles explore a wide range of risks facing banks, insurers and asset managers around the world. Some, such as our articles on managing AI risks and RegTech, take a look into the future to help decision-makers plan their longer-term business and operating strategies. Others, such as our articles on weather-related risks, the adoption of IFRS 17 and the shift to alternative reference rates were written to help readers overcome much more clear and present challenges.

Throughout this edition, our authors and subject matter experts offer forward-looking and practical advice to help financial services firms turn some of today's social priorities into longer term competitive advantage. We look at how Environmental, Social and Governance considerations are influencing investments by Asset Managers. We explore tax in the digital financial services world. And we shine a spotlight on efforts to stamp out human rights risks in the sector.

In today's financial services environment, decision-makers can either fret about the risks and challenges they face or they can take steps to capitalize on them. We hope that this edition of *Frontiers in Finance* catalyzes the pessimists into action and offers the optimists new ideas to help turn risk into opportunity.

On behalf of KPMG's Global Financial Services network, we would like to thank all of those industry leaders, observers and subject matter experts that participated in the development of these articles.

To learn more about any of the issues raised in this edition of *Frontiers in Finance*, or to discuss your company's own unique risks and challenges, we encourage you to contact your local KPMG office or any of the authors listed at the back of this publication.



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Contents

Chairman's message

4

Cover story
How Grupo Santander is staying
ahead of non-financial risks

6



10 The banking board of the future: The changing face of risk and governance

The digital era is redefining global banking and challenging the role of boards with bewildering speed.

14 The future of tax: The impact on new business models

As business models evolve, pressure on the international tax system grows.

18 Bye-bye IBOR: The transition to alternative benchmarks

Banks preparing for transition today will reduce potential downside risks in the future.

22 IFRS 17: Making the most of the extra year

A look at what insurers can do to make the most of the time they have been given to implement IFRS 17.

26 The move to multiparty investing

Understand the drivers, benefits and challenges of multiparty investing.



30 A better view: Getting on top of your non-financial risks

Create an integrated approach to non-financial risk management.

34 Keeping the AI in line: Managing risk in an automated world

How financial institutions can improve their control and governance over AI.

40 Fintech regulation: Balancing risk and innovation

How asset managers can respond to regulatory uncertainty and fintech.

44 Get serious about cyber: Protecting the crown jewels

Embedding cyber awareness into risk and organizational culture.

48 Beyond compliance: Regtech and the transformation agenda

Leveraging regtech to integrate regulatory change into the business.

51 One to watch: Trunomi

A new platform to help financial institutions deal with data rights regulation globally.



52 The rise of responsible investment

ESG moves from the sidelines to the forefront of decision-making.

56 Combating climate risks: The future of insurance

How insurers can take the lead on climate change.

59 In the eye of the storm: Q&A with AXA Global Parametrics

Karina Whalley provides insight into the actions insurers can take to combat climate change.

60 The risk of human rights violations

Managing human rights issues prevents harm and protects the bottom line.

66 Combating financial crime

Move from fundamental to transformational customer due diligence maturity.

70 Closer scrutiny of costs versus performance

Regulators seek simple and meaningful disclosure about costs and performance.

Resilient enough?

Believe it or not, it's been 10 years since the global financial crisis ripped through the industry. And we have seen significant changes in regulation, business models and risk management approaches since then. But is the industry more resilient as a result?

James P. Liddy
Global Chairman, Financial Services
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A decade of heavy lifting

One thing is for sure: the increased regulatory focus on capital and the resiliency of funding sources over the past decade has put the industry on a much stronger footing. Indeed, after a decade of regulatory scrutiny of business models, management oversight, capital resiliency and loss absorption capabilities, many of the risks that precipitated the financial crisis are now being better managed. Compensation models have been revised and many companies now have a much better understanding of the attendant risks.

At the same time, we have also seen a massive shift in the way financial services organizations view and manage their risk inventory. Rather than being relegated to the back seat in strategy sessions, we have seen risk management start to take a much more prominent role in setting the strategic direction and advising on day-to-day management activities. Most management teams are spending significantly more time thinking about their business models, their management practices and the intersection between business activities, risk management and compliance. And financial institutions are stronger as a result.

The risk profile changes

Yet, at the same time, the world has become much more complicated over the past 10 years. And that is creating new risks and accentuating old ones. In my conversations with financial services CEOs, I am frequently struck by a growing sense of concern and unease. CEOs are worried about the changing needs, wants, desires and dynamics of their customers. They are concerned about new technology risks and new competitors. They are worried about geopolitical events and their impact on current business models. And they are concerned about the potential for continued regulatory scrutiny and challenge.

Public trust in institutions — which took a beating during the financial crisis — has rebounded somewhat. But social norms and expectations have also changed and that has brought a number of financial services firms into the spotlight for business practices that (at one time) were considered the norm but may now be seen as predatory. While trust may be on the rise, customer loyalty and 'stickiness' is not, and that has only increased the risk of a misstep.

An evolving regulatory environment

Not surprisingly, regulators are also becoming increasingly concerned about these risks and issues. Over the coming decade, we expect to see regulators continue to focus on some of the broad-based issues of the past — capital resiliency will continue to remain high on the agenda, particularly in Europe and Asia, as will loss absorption capabilities and capital allocation methodologies. Regulators will also be focused on ensuring product suitability; looking at how customers are being treated and mitigating some of the more recent business and investment practice issues.

But, at the same time, we also expect to see regulators shift their focus towards ensuring that financial institutions have the capabilities they need to identify and manage risks as they emerge. Regulators are increasingly looking at whether financial institutions have the right data and analytical capabilities to properly identify, measure and manage potential risks. And they are taking a closer look at whether decision-makers have the infrastructure — including the right systems, processes and talent — to help ensure a high degree of management attention on managing risks.

A new view on resiliency

As this edition of *Frontiers in Finance* makes very clear, the financial services industry continues to face some very challenging risks. Throughout this edition, our subject matter experts have identified some of the bigger and more pernicious issues now emerging on the horizon for many financial services organizations. And they have offered their perspectives on how decision-makers and industry executives can start to address and respond to the evolving risk profile that most financial institutions are now grappling with.

When I talk with financial services decision-makers, I often focus on a series of broad issues — from assessing the resiliency and efficacy of the business model through to managing the disruption that is emerging from new technologies and new customer expectations. The key, in my opinion, is

to understand the core characteristics that will likely drive the most successful financial services firms through the 21st-century (see below for a list of characteristics) and to start building an action plan that encourages these characteristics to manifest.

What is clear is that — while financial institutions and regulators have made great progress over the past decade — the risk profile has continued to change. Financial services organizations will need to be agile and analytical if they hope to successfully navigate the turbulent waters ahead. Those financial institutions that are able to move quickly — either as disruptors or as fast followers — will be better placed to navigate through these periods of change. Those that stick to their knitting and fight to retain the status quo will almost certainly run afoul of the new risk environment and changing business dynamic. ■



Are you managing your risks? A checklist for 21st-century enterprises. *Do you have...*

- ✓ A clear strategy and vision that is well understood throughout the organization?
- ✓ A coherent culture and customer-centric values?
- ✓ An enabling governance and a clear focus on execution capabilities?
- ✓ A motivated and energized workforce?
- ✓ A 'total quality' mind-set and focus?
- ✓ A suite of appropriately balanced compliance and risk management activities?
- ✓ A focus on making innovation and collaboration a core competency?
- ✓ An entrepreneurial culture where independent thought and action is encouraged?
- ✓ Agile technology and enabling technological platforms?
- ✓ An organizational recognition of the value of data?
- ✓ A total focus on customer experience and expectations?
- ✓ A continuous drive for financial and operational excellence?
- ✓ Deep analytical capabilities?
- ✓ A plan to deliver everything as a service?

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Continuously adapting to a changing world:

How Grupo Santander is staying ahead of non-financial risks

Andrea Pozzi, Grupo Santander
Francisco Pérez Bermejo, KPMG in Spain

The universe of non-financial risks is continuously evolving. And financial services organizations will need to move quickly to keep up. Here is how Santander — one of the world's largest banks — is working to stay ahead of their risks.



“The reality is that our competitive advantage lies in the **trust and confidence of our clients**. As we progress through our digital transformation, my team helps ensure that we’re really thinking through all of the different potential unintended consequences of the new technology.”

“In this job, you can’t ever allow yourself to be satisfied,” says Andrea Pozzi as we sit down in her office in Madrid to talk about non-financial risks. “The risk landscape is continuously changing and that means you need to constantly be thinking about what you can be doing to improve your program. There’s never a dull day when you are managing these types of risks.”

As the Global Head of Grupo Santander’s Non-Financial Risk unit, Andrea has a unique view into the growing complexity of managing risk in an increasingly globalized financial services marketplace. Santander is, after all, one of the world’s largest banking groups with a solid presence in 10 markets across Europe and the Americas, serving 144 million customers.

Taking the risk out of digital transformation

While the sheer size and scale of the organization creates some obvious risks, what Andrea is most worried about is how the organization will handle its current shift towards digitization. Not surprisingly, perhaps, cyber risk is high on her agenda.

“We need to help the organization ensure that whatever we do is robust and protects our clients. The reality is that our competitive advantage lies in the trust and confidence of our clients. As we progress through our digital transformation, my team helps ensure that we’re really thinking through all of the different potential unintended consequences of the new technology.”

The list of potential risks that accompany a large-scale digital transformation is long. Among other things, Santander’s Non-Financial Risk unit is looking for possible increased risk of fraud through digital technologies, as well as the range of third-party risks that come with the development of new banking models.

“The big challenge is how to maintain our robust control framework when the organization is trying to transform in an environment that is trying to be disrupted,” she notes. “Frankly, I’m less worried about specific technologies than I am about the sheer pace of innovation. As an organization, we have a deep desire to move quickly to meet the evolving needs of our clients. But we need to do that in a controlled way.”

Putting risk management first

It’s a challenge that regulators also seem to be worried about. “After the financial crisis, the regulators were very focused on credit and market risks. But now they are starting to shift their focus towards non-financial risks — cyber and data security, in particular,” Andrea notes.

However, while regulation may be the driving force behind many banks’ non-financial risk programs, that is not the case for Santander. “I’m not building the program to meet the regulatory requirements; I’m building a program that solely positions the bank correctly and ensures it is managing its risks appropriately. At the end of the day, that’s also what the regulator wants.”

Reinforcing the first line of defense

To create a solid second line of defense, you need a strong first line. And Santander has been very active in developing and strengthening their first line, particularly in fast-moving areas like cyber.

In fact, Andrea spends much of her time focused on ensuring that non-financial risk becomes better integrated into the business. In part, that means creating the right tools and processes to drive a continuous feedback loop for non-financial risks. “We need the business to constantly be identifying risks, evaluating them, measuring them, controlling them and then using that knowledge to start again,” Andrea adds.

It also means making sure that non-financial risk is factored into the organization's long-term strategic planning process. Andrea's focus is on working with leadership to integrate it even further. "I think we're just starting to get really good at thinking about the risk-returns of non-financial risk and using that information to help make decisions and better inform our future investments," she adds.

A robust yet flexible second line

With a strong first line in place, Andrea's team is able to form a robust second line of defense around that. "We really focus on helping to define the Group-wide framework, programs, policies and procedures that help the lines of business in each country mitigate and manage risks," she noted. "But we also need to recognize that there is no 'one-size-fits-all' answer to non-financial risk. So we want to create programs that are also flexible enough to meet the unique needs of the lines of business and countries."

Given the complexity of the organization's risk matrix, one of the key roles for Andrea's team is in helping the Group aggregate, define and measure all of the various non-financial risks in their spheres of operations (and some that lie well beyond their current sphere but still pose potential long-term risks). "It's really the only way to maintain a reliable yet holistic view of the risks facing the organization," she admits.

Through my discussion with Andrea, it is also clear that the organization's leadership is highly involved and invested into the way non-financial risks are being managed. "Our technology and cyber committee is chaired by our Group CEO, José Antonio Alvarez. And he's not just a figurehead on the committee — he is actively engaged, asking great questions,

offering up smart challenges and really helping the organization think through the risk implications of our digital agenda," she notes.

No silver bullet in technology

Andrea does see opportunity for new technologies and tools to improve the way the bank manages non-financial risk. "We're working with our internal analytics teams to see if we can find better ways to proactively identify and monitor potential signals of future risk. I'm hoping to build towards a form of automation that continuously monitors for early warning signs and lets me know when certain risks have increased. It's all possible with today's technology. And we are working towards that."

However, she also notes that technology is just one part of the equation. "We are certainly looking at, and using, digital processes and tools. But there will never be one tool — digital or otherwise — that will manage everything for us. And that means we need to keep thinking about how we integrate different tools as we move through our own evolution," she notes.

Never stop evolving

Ultimately, Andrea's view is that the management of non-financial risk must be a continuously evolving practice to deliver the flexibility financial services firms need in the current environment. "With non-financial risk, you are never really done. You need to be constantly thinking about how to evolve — not just by looking ahead at things on the horizon — but also by looking behind to understand how you can do better the next time."

"In this job, you can't ever allow yourself to be satisfied," she reminds me. ■

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The banking board of the future:

The changing face of risk and governance

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What does the banking board of the future look like? That's a pressing question today among banks, their leaders and supervisors, as headwinds of change rewrite the rules for success in the global banking industry.



The rise of data, robotics and artificial intelligence (AI). Bold challenges from fintechs and beyond. Evolving customer expectations. Unprecedented cyber risk and privacy concerns. The digital era is indeed redefining global banking and challenging the role of boards with bewildering speed and unprecedented scope.

Banks and their boards are also feeling the pressure of increased supervisory scrutiny and new requirements that focus on enhanced risk-management and governance skills, board composition and diversity, and clearly defined board responsibilities in the interconnected digital economy. Supervisors in various jurisdictions are prompting banks and their boards to take a critical look in the mirror — voluntarily or otherwise.

Supervisory initiatives in Europe and Australia, for example, are instructive for what they reveal about emerging concerns for what the banking board of the future should look like.

And we expect banks and supervisors in other global geographies to maintain a close watch on what's happening there and beyond.

High and specific expectations for banking boards

Europe's banks are facing an array of supervisory requirements concerning the skills of board members and their responsibilities. The European Central Bank's (ECB's) 2016 SSM supervisory statement on governance and risk appetite¹ articulates specific requirements concerning the expected skills of banking board members. The ECB is also requiring clearer separation between first and second line of defense, addressing lending activities and risk control.

The ECB's SSM supervisory statement notes that today's banks "face economic, financial, competitive and regulatory headwinds" demanding heightened focus on "sound governance and risk-management practices within a clearly articulated risk-appetite framework."

The report also stresses the SSM's "high and specific expectations" regarding banking boards, including their need to challenge, approve and oversee management's strategic objectives, governance and corporate culture.

The ECB has also reviewed its approach to its 'fit and proper' assessments — used to appraise board members' experience and overall suitability — and has moved authorizations into a newly created Directorate General.

Our view is that while economic forces and disruptive technologies, as noted earlier, are exerting their own pressures for boards to evolve, the greater impact in Europe may come from the supervisory side.

This seems clear given banks' lacking underinvestment to date in IT and risk data systems, low profitability plus the fact that banking boards have an important role for the establishment of the EU Banking Union and Capital Market Union, two key initiatives to support Europe's single market. But it remains to be seen if banks will make progress in line with the requirements to establish the EU Banking Union and Capital Market Union.

Supervisors want greater focus on non-financial risk

Australia's banks, meanwhile, are encountering close scrutiny from that nation's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.² The ongoing inquiry has a spotlight firmly trained on boards and governance practices. The commission is raising questions concerning the need for boards to:

- set a highly visible 'tone from the top' on culture
- address board skills, expertise and diversity
- remain sufficiently engaged on dealings with regulators

“Banks and their boards are feeling the pressure of increased supervisory scrutiny and new requirements that **focus on enhanced risk-management and governance skills, board composition and diversity, and board responsibilities in the digital economy.**”

¹ European Central Bank: SSM supervisory statement on governance and risk appetite, June 2016. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm_supervisory_statement_on_governance_and_risk_appetite_201606.en.pdf

² Interim Report — Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 28 Sept. 2018. <https://financialservices.royalcommission.gov.au/Pages/default.aspx>



“The digital era is indeed redefining **global banking and challenging the role of boards** with bewildering speed and unprecedented scope.”

- determine accountability and expectations on corporate misconduct
- provide greater oversight of operational detail and non-financial risk
- gain insights into ‘knowing what they don’t know’ on non-financial risk for enhanced governance oversight.

The Royal Commission is generating much public dialogue concerning unethical practices, complacency, poor accountability and disregard for regulators within the sector. The inquiry has not concluded but its impact on the industry is expected to be significant.

The Royal Commission comes in the wake of the Australian Prudential Regulation Authority (APRA) inquiry into the Commonwealth Bank of Australia (CBA).³ The inquiry highlighted challenges with governance, accountability and culture that had likely contributed to a series of issues and incidents at the bank. Many of the themes identified in the report are not exclusive to CBA, and the rest of the Australian financial services industry has been through a period of introspection to understand where they too may need to raise risk management standards. The increased expectations on the board, recalibration and improvement in the lines of defense, enhancing non-financial risk reporting and the impact of remuneration on risk management are some of the areas that most organizations will need to address in the near future.

Preparing bank boards for 21st-century challenges

As supervisory, technological and economic forces combine to exert new pressures on banking boards to evolve, more supervisory directives and initiatives can be expected. It remains to be seen how far — or quickly — banks around the world will move to modernize their boards for the digital economy — or if they will wait until supervisors lead the way on driving change.

³ *Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (CBA)*, 28 August 2017. <https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu>

Our view is that banks should waste little time implementing real change in their boardrooms to meet emerging challenges in the fast-evolving and increasingly complex global environment in which they operate — as supervisors in the EU and Australia are making abundantly clear. Ultimately, boards judged to be falling short of supervisory requirements could face compulsory

changes to their composition. We have already seen examples of this in Spain, Germany, Italy and Finland.

It is increasingly vital for banks to do all they can to build boards that will deliver future success. Doing so will require boards to possess the following key capabilities. They will:



Include informed and highly proactive board members who have a clear understanding of emerging risks and issues that transcend *financial* factors to include the *non-financial* spectrum.



Be equipped to consistently address *all* of today's — and tomorrow's — risks, including: cybersecurity, automation, data privacy, compliance, legal issues, customer service, integrity and reputation, and the quality of new products and services.



Be prepared to address strategy and related risks that come with the interconnected ecosystem of new partnerships and alliances today's banks are forming to deliver innovative services to customers. Board members will need the acumen to understand these challenges — and to deliver the insights and skills needed to effectively manage them.



Enhance board diversity as it relates to gender but also to age, skill set and digital acumen. Increased diversity can help to challenge traditional assumptions/attitudes, 'group think' and any reluctance to deal with difficult or less-understandable issues in the digital economy.



Include board members with non-industry experience who can bring valuable new insights to issues and risks amid the changing operating environment, including the impact of digitization in areas such as data analysis, customer experience, product development and external communications. Non-industry members can contribute to boards' collective knowledge, competencies and experience while also challenging traditional approaches.



Create and sustain modern cultures and values for their organizations. Tomorrow's boards will ideally promote a healthy 'decision culture' within the organization, one that provides opportunities to challenge risk decisions from diverse management perspectives.

Amid the headwinds of change, some innovative new initiatives are already emerging. We are seeing more multiday training sessions and 'boot camps' aimed at heightening the acumen board members possess on technology, governance and regulation, risk

management, ethics, culture and beyond. More change initiatives are sure to follow. While the watchword for boards has traditionally been oversight, the future of boards will inevitably require an informed new focus on oversight and insight. ■

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The future of tax:

The impact on new business models

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Competitive pressure, digital progress, and the ever-growing regulatory demands on organizations have driven an evolution of traditional financial services models in ways that are changing the landscape of the industry. We now see an industry where the lines are constantly blurred: the physical and digital overlaps, organizations are connected in new ways, and activity constantly transcends borders.

As business models evolve, pressure on the international tax system grows. Legislative action to deal with the inadequacies of the tax system takes time, yet the complexity of the business models expand with increasing speed.

New business models

Let's look at some of the emerging new models.



Banking:
Markets as a
Service platforms

Markets as a Service (or MaaS) is a new operating model for the banking industry whereby one bank, with sufficient access to infrastructure expenditure, back-office capability and existing large volume of transactions, provides a platform-based service across the trade lifecycle to other banks and financial institutions. The service would provide other banks, that do not possess the necessary expenditure, back-office capability or scale, the opportunity to operate efficiently with their client base, paying the MaaS service provider a fee to use the platform. The platform provider has a responsibility to ensure the MaaS platform is operational on an ongoing basis, including from a technical and regulatory standpoint.



Insurance: Open-source language coding of actuarial models

Evolving regulatory demands are putting pressure on actuarial activities — whether reduced reporting timelines, more efficient coding of models or the quantity of actuarial processes required. This pressure is driving new activities, such as cloud-based actuarial models, and the emergence of actuarial model coding using open-source languages such as 'Python' and 'R', enabling better data analysis and visualization. 'Open-source' means the code is freely available, can be modified, enhanced and reviewed, inevitably driving more collaboration, but also standardization, across organizations.



Asset Management:
Distributed
Ledger technology

Distributed Ledger Technology (DLT) enables the fund management industry to meet the growing demands of investor needs, digital operational processes and new regulations. The service provides scalable solutions for back and middle offices, enabling automation of manual and repetitive tasks through the use of smart contracts. This includes the processing of fund orders, corporate actions, account management (fund registers), and a drastic decrease in the need for reconciliations, as trades are shared among interested parties instantly. DLT also gives asset managers greater visibility on their value chain, enabling them to develop new products that respond more accurately to the needs of their final customers.

How to tax these new models?

Tax departments in financial services organizations will need to spend time understanding the detail of new business models; the tax issues requiring consideration are complex and the related regulation and practice is emerging. Some key areas for consideration are set out below.

What drives value?

Tax professionals will need to think differently about what drives value compared to the traditional business models; transfer pricing and profit allocation principles will need to evolve to deal with the new business models. For example, in a MaaS model, is the value in the operation (e.g. speed, security) of the platform being offered, the technical/regulatory sanctity of the platform, or the infrastructure backbone (and its associated capital expenditure) that supports the platform?

The development (and protection) of intellectual property in these new models is critical to preserving the relevance of organizations. Tax professionals will need to assess whether new intellectual property is being developed, or whether the new activity is simply a digitalization or re-packaging of an existing activity.



Tax professionals will need to **think differently about what drives value** compared to the traditional business models.”

The challenge of the existing tax system in taxing new business models

The international tax system does not cope with these new models particularly well. In most established jurisdictions, the tax system is characterized by a number of common issues.

1

Taxation generally operates by reference to **single legal entities**, leading to quite **rudimentary aggregation of taxation** across international groups.

2

There are often **specific tax rules** that tax overseas profits, but these usually look at **passive income**, or income derived from **avoidance activity**.

3

There is no universally accepted definition of **what drives value**, leading to disputes across borders and, sometimes, domestic **legislative protectionism**.

4

Tax on **activity flow** is in its infancy, particularly in financial services, and is usually limited to **value added tax** on specific items.

5

Taxation of activities underpinned by **digitalization** is something that tax authorities, and other bodies such as the OECD, are keen to deal with, but limited progress has been made, leading to the introduction of unilateral measures (e.g. the recent UK **Digital Services Tax** proposal released on 29 October 2018).

Due to open-source coding in actuarial models, tax professionals will need to re-evaluate whether, and to what extent, value exists in the model, particularly where there is a convergence to standardization. Given that there is potentially a shift in the way actuaries operate, is there value in the actuarial model itself, or does value shift to the analysis and insights actuaries now focus their time on?

Where is the income generated?

DLT provides a new set of challenges in relation to the taxation of income. Where a ledger is distributed, ownership of the ledger necessarily sits with multiple parties in potentially multiple locations; identifying where value in relation to the ledger is generated can be a considerable task, in particular, given how rapidly the DLT platform expands as new parties and transactions join the ledger.

Similar challenges exist in the cloud-based model where multiple actuaries access the model from potentially different locations. Identifying who has created value in relation to a sequential exercise is clear; identifying value in a shared model where activities interact and overlap is likely to be more challenging.

Whose income is it?

Allocation of income across legal entities will become far more complicated. For example, in the MaaS model, the trade lifecycle is adapted to introduce a service provision from one bank to another. The recipient of the platform service utilizes the platform in order to continue serving its own clients, creating a certain

dependency on the platform, particularly where the integration of the platform creates a relationship with the service provider that is difficult to switch without operational disruption. The platform is backed by infrastructure and operations that may potentially sit across multiple legal entities in multiple locations.

Taxation of 'flow'

The discussions regarding a financial transactions tax in the EU, and the evolving OECD/EU proposals in relation to digital taxation, have not yet impacted financial services, but there is growing concern that new rules could hit financial services organizations, many of whom operate on very thin margins; similarly, there is concern that digital taxation could have collateral impact on financial services business models, in particular where those rules are not tightly defined — to date, the financial services industry has relied upon exemptions relating to regulated activity (e.g. under MiFID II), but these come under pressure with new business models, whether this be service provision between banks, or the use of DLT to facilitate transaction flows.

Reflections

This article provides the briefest of snapshots into an industry that is evolving at an unprecedented pace. The challenge of tax professionals is to ensure they can balance the requirement to fully understand the models that are emerging, while dealing practically with the challenges of an international tax system that must adapt to the evolution that is taking place. ■

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Bye-bye IBOR:

The transition to alternative benchmarks

James Lewis, KPMG in the UK
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Benchmark rates are changing and this is having a massive impact on financial markets and market participants around the world. Yet, with little clarity on the plan for transitioning away from the established Interbank Offered Rates (IBORs), many financial services organizations are struggling to manage the risks and develop their transition strategy.



The end of an era

Concerns about benchmark rates have been swirling for years. Indeed, even before the LIBOR scandal hit in 2012,¹ unsecured wholesale borrowing activity had been in decline. And that meant that the rates were becoming increasingly subject to ‘expert judgment’. As the LIBOR scandal made immensely clear, the potential for manipulation was high.

When, in July 2017, the UK’s Financial Conduct Authority (FCA) announced it would no longer compel panel banks to make LIBOR submissions after 2021,² the writing was on the wall: the IBORs’ days were numbered.

Over the past year, it has become increasingly clear that global regulatory preference was a benchmark replacement favoring risk-free rate (RFR) based on transactional data. Central banks have encouraged industry working groups to form to help solve issues arising from establishing and then transitioning to a new more trustworthy benchmark rate. In the run-up to 2021, working groups and several industry advocates have been working diligently to ensure that the new rates have established robust underlying cash markets, sufficient liquidity in hedging instruments, broad acceptance from market participants and are devoid of past issues.

No small feat

While on the surface this may seem like a ‘find and replace’ exercise, the reality is that the shift from IBORs to RFRs will be significant. IBORs currently underpin a huge range of financial products and valuations, from loans and mortgages through to securitizations and derivatives across multiple jurisdictions. They are used in determining all sorts of tax, pension, insurance and leasing

agreements. And they are embedded in a range of finance processes such as remuneration plans and budgeting tools.

Not surprisingly, the volumes that will be impacted by this change are enormous. According to the Financial Stability Board, there were more than US\$370 trillion worth of notional contracts that — in some way or other — were tied to LIBOR, EURIBOR or TIBOR in 2014.³ And that number has grown since then.

The impact will also be felt far and wide. The challenge will be particularly acute for central counterparties, exchanges, investment banks, retail banks, insurers, broker-dealers, hedge funds, pension funds and asset managers. But the ripple effects will also be felt by corporations and consumers as the shift changes valuations on everything from derivatives and corporate bonds through to business and consumer loans.

New challenges emerge

There is still significant uncertainty about how the transition to RFRs will pan out. There are currently Working Groups for each of the five LIBOR currencies⁴ (representing the US dollar, the UK pound sterling, the Japanese yen, the Swiss franc and the Euro) with responsibility for developing alternative RFRs to LIBOR within their home jurisdictions.

The market challenges that this is creating seem daunting. Working Group members, key end users and other market participants are working hard to create markets for new instruments that are underpinned by the RFRs. Liquidity in these rates need to build to ensure a successful transition. This ultimately requires impetus from end users to transition away from IBORs, which have been embedded in systems and processes for over 3 decades.

“Central banks have encouraged industry working groups to form to help solve issues arising from establishing and then transitioning to a new more trustworthy benchmark rate ... In the run-up to 2021.”

¹ The Financial Times, *My thwarted attempt to tell of Libor shenanigans*, 27 July 2012

² The Financial Stability Board, *The future of Libor*, 27 July 2017

³ The Financial Stability Board, *Market Participants Group on Reforming Interest Rate Benchmarks Final Report*, July 2014

⁴ https://www.boj.or.jp/en/paym/market/jpy_cmte/cmt180801c.pdf

“Liquidity in these rates need to **build to ensure a successful transition.** This ultimately requires impetus from end users to transition away from IBORs, which have been embedded in systems and processes for over 3 decades.”

For multinational and global financial institutions, the task will be exponentially more complex. In part, this is because there will likely be significant regional differences, timelines and approaches to the transition. In the US, for example, the Alternative Reference Rates Committee (ARRC) is tracking against a ‘paced transition plan’ for moving USD LIBOR exposures to SOFR (the alternative RFR proposed for the US)⁵; in the UK, urgency has been heightened by a Dear CEO letter circulated by the PRA and the FCA⁶; for the Euro area, the ECB Working Group is currently looking to mitigate the potential of a ‘cliff edge event’ for EONIA and EURIBOR when the EU Benchmark Regulation transition period finishes on 1 January 2020.⁷

Most financial institutions will also need to grapple with some of the ‘knock-on’ impacts of the shift away from IBORs. Consider, for example, how the new rates may influence hedge accounting practices at many financial institutions. In the US, the FASB has already proposed adding SOFR to the list of interest rates that may be eligible for hedging. How the other new RFRs will influence hedge accounting remains to be seen.

No regrets

Yet, while the timing and transition to RFRs may seem uncertain, our experience suggests that there is much that firms can be doing to prepare. The key is to position the organization through dynamic and early-stage planning while still maintaining the agility required to pivot against a range of potential transition options. This is about taking the ‘no regret’ actions that will support the transition regardless of the final timing and approach.

Planning for the transition will require firms to take on a series of key activities such as:

- **Identifying exposures and developing a transition strategy:** Firms will need to identify all of the products that will likely be in scope and start analyzing the legal language in order to both assess the scale of the challenge and to determine the most appropriate strategy for achieving contractual changes and mitigating franchise and client risks through the transition.
- **Assessing the initial impact:** All business units will need to assess their models and systems to analyze the areas currently impacted by IBORs. Firms will need to consider how best to alleviate potential operational, legal and conduct risks involved in changing a complex infrastructure that is currently heavily reliant on LIBOR.
- **Setting up the RFR program:** This will require the development and management of an organizational, cross-functional RFR program that handles all business lines and jurisdictional differences while also ensuring alignment and coordination across critical issues.
- **Creating the right governance and awareness:** Organizations will need to develop internal governance processes that allow them to properly oversee changes to policies, systems, processes and controls while also ensuring employees are educated on the implications of the transition.

⁵ <https://www.newyorkfed.org/arrc/index.html>

⁶ <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-transition-from-libor-banks.pdf>

⁷ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html

— **Communicating with clients:** Firms will need to conduct clear and early communication with their clients in order to educate, inform and — eventually — renegotiate contracts. Managing the conduct risk with clients through the transition will be key, particularly given the potential for value transfer as existing positions are re-referenced to RFRs.

Getting ready

While the task at hand may seem overwhelming, it is clear that those who can use their data effectively and develop a flexible strategy will ensure a more efficient transition plan. The uncertainty of timing and the complexity of the change will require continual re-evaluation of the sequencing and prioritization of activities over the next 2 to 3 years.

Many firms may also want to consider how they might leverage newer technologies to help drive their transition program. For example, some firms are already incorporating smart technologies to help them identify where changes might need to be made across their various systems, models and databases. Where firms have large volumes of unstructured contracts, AI tools are being piloted. In particular, the digitalization of contracts will have benefits to firms beyond the IBOR transition.

For smaller firms, however, the greatest challenge will likely come down to resources and skills. The planning and transition process will require a significant investment of time and manpower. Running it in parallel to ‘business as usual’ will be a challenge for resource-light firms. Some global financial institutions are estimating transition costs at between US\$400 million to US\$500 million; smaller institutions should not underestimate the magnitude of this transition.

Make the most of the time

Clearly, there is still much uncertainty surrounding the discontinuation of the IBORs. But, even so, we believe it is possible for firms to move forward by creating a plan that includes flexibilities to accommodate the transition to RFRs as the approach and timelines become better established.

Those that move quickly, smartly and flexibly today will have the opportunity to make the transition efficiently and minimize potential downside risks. Those that wait for full clarity before taking steps will almost certainly struggle to meet the deadline before the IBORs potentially disappear at the end of 2021. ■

KPMG member firms are producing regular content — the **Evolving LIBOR series** — to help firms easily digest the complex changes transitioning from LIBOR to Risk Free Rates may generate. Please visit kpmg.com/evolvinglibor.

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IFRS 17:

Making the most of the extra year

Mary Trussell, KPMG in Germany
Frank Dubois, KPMG in Singapore
Bryce Ehrhardt, KPMG in the US

Insurers now have an extra year to implement IFRS 17. Naturally they want to use the time wisely. But what exactly does that entail? And is the answer the same for all?

When the IASB tentatively agreed to a 1-year deferral of the IFRS 17 effective date in November 2018, we saw as many insurers shedding tears of frustration as those that let out a sigh of relief.



Of course, an additional year is a bonus. But many insurers — both large and small — had been hoping for a longer extension. Some face the challenge of applying a complex standard to a myriad of different products. Many have found the new standard's data requirements a tall order. Most recognize they need more time with their software vendors to test, validate and configure their solutions to fit their particular business needs. Taken together, almost all are finding the practical steps needed to implement the standard time-consuming and complex.

The 1-year deferral does more than simply push the reset button on the implementation countdown clock. The goalposts are also being realigned to reflect proposed amendments to the standard — albeit in ways that most insurers will welcome — and insurers will need to analyze and assess the changes, update their implementation plans and then execute on them. When the standard was initially issued, insurers had approximately 3.5 years before the effective date. With the 1-year deferral, the clock now shows less than 3 years to go. We all have to raise our game to hit the new target.

Time well spent by all

What can insurers do to ensure they are making the most of the time they have been given? In our discussions with insurers around the world, we often focus on five key areas.

1 Strengthen your road map: If you have not already developed an implementation road map, do so immediately. If you already have an existing road map, now is the time to take a step back and ask whether it is practical and achievable given your resources, the additional year and proposed amendments. Cross-check progress against plans. Don't forget to consider any areas that have been on hold in the hope of further amendments. Ensure you have the right tools and capabilities to achieve all objectives by 2022.

2 Scenario plan: Identify uncertainties and then conduct robust scenario planning exercises and test your assumptions to ensure you are prepared for a variety of outcomes and situations. Focus on 'no regrets' activities that deliver immediate value while recognizing any potential uncertainties in the environment or in the standard (for example, until the proposed amendments are finalized).

3 Practice, practice, practice: The additional time means more time for test runs and parallel runs. Recognize that delivering IFRS 17 results will require multiple iterations, challenge and oversight before sharing with the outside world. Particularly for the more advanced organizations, this additional year offers valuable time to ensure tools, processes and people are ready for implementation. Also, don't forget to allow ample time to design, test, and implement new controls around the revised and new processes.

4 Talk to stakeholders: Use the extra year to strengthen communication with the business, subsidiaries and stakeholders. It will be critical to build into your implementation program time to help stakeholders understand what your IFRS 17 financial results will look like and how to interpret those results. Review current performance metrics and identify the drivers of IFRS 17 results. Work with the business to consider what metrics can be continued, which need refreshing and what needs to be replaced. Consider briefing investors and analysts early and throughout your journey on the approach and progress.

5 Look for opportunities: Don't overlook the potential for related opportunities on the road to implementation. Consider using IFRS 17 as the catalyst to upgrade your finance and actuarial capabilities. Spending the time to understand your data architecture, i.e. the data flows and interfaces throughout your end-to-end

What is IFRS 17?

IFRS 17 is a new financial reporting standard for insurance contracts. It was issued by the International Accounting Standards Board (IASB) in May 2017 and marks the biggest single change to insurance accounting bigger than the introduction of IFRS itself. The IASB has recently voted to defer the mandatory effective date of IFRS 17 and the fixed expiry date for the temporary exemption in IFRS 4 from applying IFRS 9 to 1 January 2022.

“Most recognize they **need more time with their software** vendors to test, validate and configure their solutions to fit their particular business needs.”

“
We find that breaking the program down into more **manageable sprints and rotating people** onto and off the program throughout its life are techniques that can help the program stay on track.”

processes, can help you understand what can be done to simplify, standardize and automate financial and actuarial processes. Find opportunities to streamline. And look for commercial opportunities to optimize reinsurance arrangements, product design and pricing and asset liability management. Consider strengthening the links between the two by enhancing planning and performance management.

New year, new challenges?

But the extra year also brings challenges. Besides the obvious concern about whether the IASB's proposed changes will make the standard more meaningful and less complex to implement, many will likely face challenges ensuring that employees and top management continue to prioritize the project. For those that already started their IFRS 17 journey, what was already a long-haul just got longer — and typically more costly.

Keeping everyone motivated and aligned to overcome project fatigue (particularly given all of the other disruptions that may occur over the next 3 years) is priceless. We find that breaking the program down into more manageable sprints and rotating people onto and off the program throughout its life are techniques that can help the program stay on track. Staff rotations to the program help people to acquire new skills and experience to meet their personal goals, inject new life and energy into the team and spread knowledge as they graduate from the program into new roles.

But is the answer the same for all?

One size doesn't fit all and entities need to find the right pace of change to fit their culture and ambition — after all, some entities are tackling this solely to achieve compliance for local reporting. For others, it represents a whole new language to explain their business.

So how might some of these different groups of entities react to the changes?



Welcome relief for 'front-runners'

For the fortunate few who started work ahead of the standard being issued, and have the discipline to regularly update their work plan to accommodate change, one option might be to press ahead, using the additional time for further dry runs and to learn to steer their business on the new basis. Others will use the time to upgrade their finance and actuarial capabilities, automating where possible and rethinking processes to improve agility.



A wake-up call for 'late adopters'

But what about any late adopters?¹ The problem facing the unprepared is not just one of increased risk of non-compliance. It's also that they will likely face much higher operating costs in the future as they work to catch up with those that took the time to investigate the challenges thoroughly and invest in automation, and have put themselves at the back of the line to access a fast-draining talent pool. We urge these insurers not to hit the snooze button and to use the new timeline and proposed amendments as a wake-up call to get started.



A reality check for perfectionists

In an attempt to reach the perfect answer, some insurers find it difficult to land accounting and actuarial judgments or identify their target architecture and select a software solution provider. If that sounds like you, we would strongly recommend using the deferral as a shot in the arm to re-invigorate your program, with a focus

¹ At KPMG we regularly survey insurers on their readiness for IFRS 17 and IFRS 9 and our most recent temperature check tells us that fully forty eight per cent of smaller insurers have yet to meaningfully start on their implementation program. KPMG International, In It To Win It.

on right to left thinking that compares where you need to get to with where you are now. Perhaps you've held off from a detailed evaluation of the impact of IFRS 17 on reinsurance ceded, in the hope that the standard would be updated. That hope has been addressed (at least in part) and so the time to start the analysis is now.

Making the most of the extra year

Ever since the new standard was announced, we've been advising IFRS filers to prepare for the single biggest

evolution in insurance reporting — certainly bigger than the implementation of IFRS and even bigger than Solvency II. While the extra year will provide some welcome wiggle-room for many insurers, the reality is that it will take hard work and tight timelines to ensure you are fully prepared.

Insurers need to make the most of the extra year. With the proposed amendments, it's a bigger window of opportunity than many dared hope for. ■



One size doesn't fit all and entities need to find the **right pace of change to fit their culture and ambition** — after all, some entities are tackling this solely to achieve compliance for local reporting. ”

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The move to multiparty investing

Marco Müth, KPMG in Germany
David Neuenhaus, KPMG in the US

Last summer, a consortium led by Deutsche Finance Group and including Turkish private equity real estate firm BLG, Germany's biggest pension fund (BVK) and a large public insurer, and New York developer Shvo joined forces to acquire the 'Gucci Building' in Manhattan. Over in the UK, a consortium of UK and Canadian pension plans, led by the West Midlands Pension Fund, purchased Red Funnel, the original Isle of Wight ferry company.

These are among several high-profile consortium transactions that have taken place within the last 2 years and are indicative of a growing trend: institutional investors turning to multiparty investing to gain access to the competitive global real estate and infrastructure markets.

Multiparty investing

Multiparty investing takes many forms including consortiums involving several parties, simple joint ventures and fund investing where the investor typically takes a more passive role leaving the active management to the fund manager, who takes a fee for their services. In some scenarios, an investor may be investing in a fund established specifically for them or in a pooled fund with other investors. Each form of multiparty investing gives rise to its own set of challenges. Risks are as unique as each partnership and can include managing different investor profiles, issues in relation to substance and deemed agency liquidity risks, general partner and limited partner expectations, and specific regional challenges.

Benefits run deep

Scale, knowledge and a sharing of risk. These are among the obvious benefits of multiparty investing. For example, over the past several years, pension funds and institutional investors have developed significant interest in investing in infrastructure assets, which offer attractive long-term characteristics, such as protection against inflation. The challenge is the size of the required capital. Pooling resources is the only way to build the capacity to invest in these larger investments.

Building a knowledge base and gaining access to experience is another key benefit of multiparty investing. For example, an investor from Europe looking to make their first direct investment in the US may seek out a joint venture with someone in the US who has built a

strong track record locally and has access to deals and transactions the European investor does not.

In the case of indirect investments via funds, the investor gains the experience of the fund manager in the form of access to the market, the ability to get deals done and working within the regulatory requirements. One of the key benefits of investing indirectly in a fund is risk diversification. Instead of only buying one asset, the investor is buying into a number of assets where the risk is economically diversified across a larger number of assets, different regions and currencies.

What's driving multiparty investing

Three interconnected key factors are behind the rise in multiparty investing:

- the low interest rate environment around the world, which has led to an increase in pricing
- the boom of alternative investments, such as investments into real estate and infrastructure, which has created a sellers' market
- with the sellers in the driver's seat, they can easily choose to whom they want to sell because of the excess capital in the market that needs to be deployed.

In this environment, joint ventures, consortiums and investments with fund managers facilitate access to deals.

Another factor increasingly leading institutional and sovereign wealth fund investors to seek out partners is the growing complexity of the regulatory environment, specifically with respect to finance and tax. By investing with others who have experience navigating the regulatory environment of a given jurisdiction, it becomes easier to find the right structure and the right transaction.



Around the globe, from country to country, **there are limitations** as to what the investor can do both at the investor or investee location.”

Risk proofing the future

For example, institutional investors looking to make direct investment, origination, execution and asset management capabilities are critical. But not all institutional investors have the same level of sophistication.

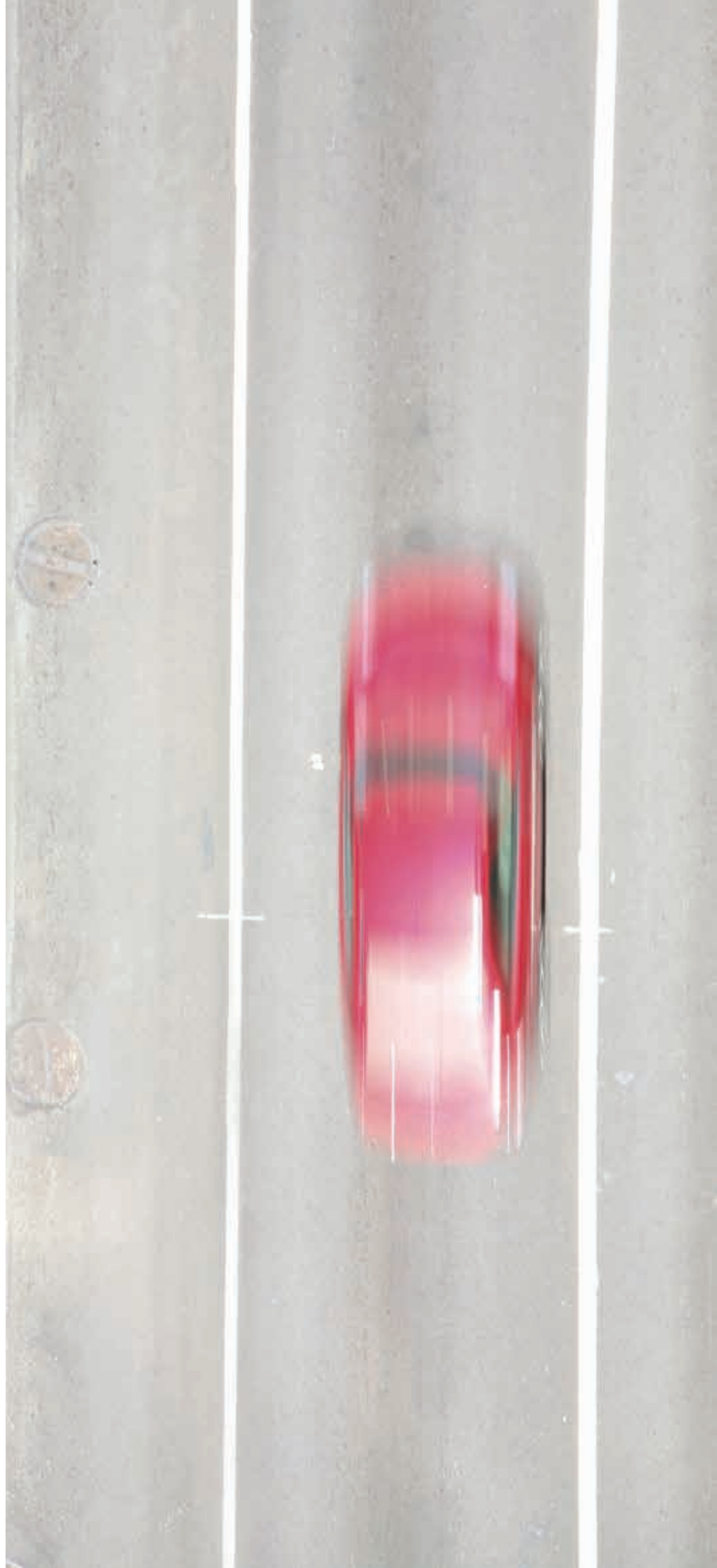
The complex regulatory environment

Around the globe, from country to country, there are limitations as to what the investor can do both at the investor or investee location. For its own public pension funds, Canada has what's called the 30 percent rule, which limits these institutional funds from owning more than 30 percent in any deal. This ensures the funds remain passive and do not own or manage companies outright.

Addressing the challenges of multiparty investing

Often the reason for partnering in an investment also presents challenges to making the deal happen. For example, a joint venture partner may have the experience and access to get a deal done, but they may not align in other respects. The task is to find a partner or partners that fit the requirements, and align with the values and interests, of the investor. ■

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For institutional investors looking to enter a multiparty investing relationship, we recommend:

1

Choosing the right people. Controlling and managing an investment is important over the lifetime of the investment. It becomes even more important when investing indirectly via a third party asset manager or partner if the fund already exists. Conduct due diligence at the fund level and at the portfolio level. In a consortium, it is critical that investors are like minded, able to collaborate and have a clear understanding of each other's investment philosophy.

2

Understanding the differences in the jurisdictions of each partner as well as those of the jurisdiction where the investment resides. From a tax perspective, the relative position of the investors will vary as different countries may have more favored status, or better treaties. Some countries are more scrutinized than others because they have not provided the same level of disclosure. When the investors come together, some may be better off in one structure over another. From the outset, be clear on the relative sensitivities and what's important in a preferred structure from one group of investors versus another.

3

Having a risk management plan. While the potential for better governance is a key benefit of partnering in large scale investments, it is important to put in place processes to address future regulatory changes or changes in the funds involved.

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A better view:

Getting on top of your non-financial risks

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Non-financial risks are creating big challenges for financial services organizations. There are two reasons that executives and decision-makers may not be seeing the full picture.



Your non-financial risks may be the biggest threats to the future success of your organization. And the list of potential hazards is long and varied: cyberattacks, emerging technologies, reputational issues, climate change, mis-selling, misconduct, a return to territorialism, geopolitics, human rights (see article on page 60)... the scope for issues seems to be growing every day.

Yet, while most financial institutions have done a fairly good job shoring up their financial risk capabilities (particularly since the global financial crisis), our experience working with leading banks, asset managers and insurers suggests that few organizations enjoy the same level of sophistication when it comes to their non-financial risks.

The problem isn't that managers aren't aware of the risks. Nor is it a lack of effort or desire to address these risks. More often, the problem comes down to poor visibility.

Seeing all the dimensions

There are two reasons that executives and decision-makers may not be seeing the full picture. The first is that most executives are only looking at one dimension of the risk. KPMG member firms' work with financial services firms around the world suggests that most continue to rely primarily on quantitative measures when identifying, measuring and ranking non-financial risks. Far too few also incorporate qualitative measures to get a better view of the risks they face.

Rather than just measuring the quantity of infractions that occur or the number of training sessions conducted, for example, financial services firms could also be tracking situations where infractions *almost* occurred. They could be conducting root cause analysis. And they could be overlaying media information and other sources to understand where other institutions may be experiencing increased risks.

The value of integration

The other big challenge facing financial services firms comes down to a lack of integration across their various risk activities. The reality is that most — if not all — financial services firms currently assess and manage their non-financial risks in silos. Business continuity management is managed in one silo; third-party risk in another; IT security in yet another. But the three can often be very interlinked: a third-party system could lead to an IT security issue that could impact business continuity.

Yet, more often than not, risk management requirements are covered by separate functions; communication between functions is limited; oversight is fractured; and the number of reports being generated becomes overwhelming. Decision-makers and managers are only able to see pieces of the puzzle rather than the whole picture.

Getting to the full picture

KPMG firms have worked with a number of large banks, insurers and asset managers around the world. And our experience suggests there are seven key areas where all financial services firms should be focusing on in order to create a more holistic and integrated non-financial risk management approach.

1 Taxonomy: Making sure that everyone in the organization is speaking the same language is key to creating better integration across risk functions. Indeed, a common understanding of the taxonomy, definitions and delimitations of terms are a key prerequisite for an integrated approach. While complete standardization may not always be possible, key terms (such as risks, impacts, causes and occurrence probabilities) should be clearly defined.

2 Governance: Where possible, risk functions should be integrated into fewer units. This will encourage improved interaction



The problem isn't that **managers aren't aware of the risks**. Nor is it a lack of effort or desire to address these risks. More often, the problem comes down to **poor visibility.**

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Financial institutions may want to consider starting with the **harmonization of their reporting layout and assessment grids**, taking great care to subsequently integrate the results.”

between responsibilities (by optimizing tools, IT and reporting, for example) and enhance efficiency within the units responsible (in both the first and second lines of defense). A clear definition of the role of the Second Line of Defense, including independent reporting to the management board, is critical.

3 Methodologies: Financial institutions should be working to improve the efficiency, productivity and integration of their risk functions by reducing the number of risk identification and assessment tools being used across the organization's second line of defense. This will involve increasing the number of synergies within the different functions and interlinking the tools and methodologies across the functions, thereby creating the basis for an integrated level of control.

4 IT systems: Similarly, financial institutions will want to reduce the number of IT tools currently being utilized across the second line of defense. This is an opportunity to implement robust integrated technical solutions (versus continuing to use generic tools such as Microsoft Office apps). Creating a common technical platform can help to simplify the sharing of information and can enable all data to be pooled together to improve overall reporting.

5 Data: Rather than relying solely on quantitative risk data, risk managers and senior management should be working to enhance their view by identifying, collecting and then integrating qualitative data sources and measures. Understanding which data sources should be used (based on value, reliability, ease of access and security, for example) will be a

critical first step. Finding ways to integrate quantitative and qualitative data into clear and actionable reports to management will also be key.

6 People and culture: While IT systems are important, it's the people behind the systems and the culture of the organization that enable successful integration. Creating a culture of risk awareness, compliance and management across the entire enterprise is key to ensuring that your people not only understand the importance of non-financial risks but also how to properly report and manage them. This must start within the risk function but, very quickly, it must also be embedded across the lines of business.

7 Reporting: Integrating existing reports into a single overarching non-financial risk report will be key to helping senior management focus on the right risks at the right time to support strategic decision-making. Financial institutions may want to consider starting with the harmonization of their reporting layout and assessment grids, taking great care to subsequently integrate the results. Ensuring that the right risks are being raised and reported in the right way will be key to managing the growing scope of potential non-financial risks.

Given the pace of change both inside and outside of the financial services sector, we believe it is particularly worrying that executives and boards are not seeing the full non-financial risk picture. The risk inventory for financial services firms is changing constantly. And that makes it more critical than ever for managers and boards to be able to see and understand the risks they face. ■

10

Key questions for senior management

- 1 Does your non-financial risk framework adequately cover all the potential risks your firm faces?

- 2 Do you understand the impact of strategic decisions on your risk profile?

- 3 Does your appetite for non-financial risk align with decision-making?

- 4 Does your firm’s risk culture influence the way your firm manages non-financial risks?

- 5 Are you overly focused on the financial impacts of non-financial risk events?

- 6 Are you encouraging the business and its support units to own their non-financial risks?

- 7 Is your reporting across the sub-categories of non-financial risk consistent?

- 8 Are your risk management silos integrated and coordinated?

- 9 Does your entire organization speak the same language with regards to non-financial risk?

- 10 Are you confident that you are tracking and measuring the right non-financial risks?

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Keeping the AI in line:

Managing risk in an automated world

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Financial services firms are embracing artificial intelligence and emerging technologies like never before. But are they ready to manage the risks?



Ask any financial services CEO if their organization is using or piloting artificial intelligence (AI) and you're sure to get a positive response. In fact, in a recent global survey of financial services CEOs, just 1 percent admitted they had not yet implemented any AI in their organization at all.

Not surprisingly, financial services firms are becoming increasingly aware of the significant benefits that AI can deliver — from improving the customer experience and organizational productivity through to enhancing data governance and analytics. And they are beginning to realize how AI, machine learning and cognitive capabilities could enable the development of new products and new demand that would not have been possible using traditional technologies. Our survey shows that the majority are now implementing AI into a wide range of business processes.

While this is great news for financial services firms and their customers, the widespread adoption of AI across the organization also creates massive headaches and challenges for those charged with managing risk.

New risk challenges emerge

Part of the problem is the technology itself. By replicating a single mistake at a massive scale, a 'rogue' AI or algorithm has the potential to magnify small issues very quickly. AI is also capable of learning on its own, which means that the permutations of individual risks can be hard to predict. Whereas a human rogue employee is limited by capacity and access, an AI can feed bad data or decisions into multiple processes at lightning speed. And that can be hard to catch and control.

The 'democratization' of AI is also creating challenges for risk managers. The reality is that, with today's technologies, almost anyone can design and deploy a bot. As business units start to see the value of AI within their processes, the number of bots operating in the organization is proliferating quickly. Few financial services firms truly know how many bots are operating across the enterprise and that means they can't fully understand and assess the risks.

All of this would be fine if risk managers were positioned to help organizations identify, control and manage the risks. But our experience suggests this is rarely the case. In part, this is because few risk managers have the right capabilities or understanding of the underlying algorithms to properly assess where the risks lie and how they can be managed. But the bigger problem is that risk management is — all too often — only brought into the equation once the bot has been developed. And that is far too late for them to 'get up to speed' on the technologies and provide valuable input that can help implement effective controls from the outset.

It's not just financial services decision-makers and risk managers that are struggling with these challenges. So, too, are regulators, boards and investors. They are starting to ask difficult questions of the business. And they are not confident about the answers they are receiving.

Getting on the right path

There are five things that financial services organizations could be doing to improve their control and governance over AI.

1 Put your arms around your bots. The first step to understanding and managing AI is knowing where it currently resides, what value it currently delivers and how it fits into the corporate strategy. It's also worth taking the time to understand who developed the algorithm (was it an external vendor?) and who currently owns the AI. Look at the entire organizational ecosystem — including suppliers, data providers and cloud service providers.

2 Build AI thinking into your risk function. We have helped a number of banks and insurers identify and assess the capabilities and skills needed to create an effective risk function for an AI-enabled organization. It's not just about risk managers having the right skills. It's also about becoming more agile, technologically savvy and commercially focused. Particular attention should be placed on the development of sustainable learning programs that include the theory, practical and contextual capabilities required to encourage continuous learning.

“By replicating a single mistake at a massive scale, a 'rogue' AI or algorithm has the **potential to magnify small issues** very quickly.”

“More than just new technology skills, organizations will need to consider how they **transform the organizational mind-set** to apply a risk lens to AI development and management.”

3 Invest in data: Data is a fundamental building block for getting value from new and emerging technologies like AI. And our experience suggests that most financial institutions will need to continue to invest heavily into ensuring their data is reliable, accessible and secure. This is not just about feeding the right data into the machine; it is also about helping to mitigate operational risks and potential biases by verifying the quality and integrity of the data the organization is using.

4 Develop an AI-ready risk and control framework: While some internal audit functions and risk managers are using existing frameworks such as SR 11-7 and the OCCs Risk Management Principles as a starting point, we believe that AI professionals, risk managers and boards will need to develop a purpose-built risk and control framework (figure 1) that can help mitigate data privacy, security and regulatory risks across the entire life cycle of the model. For more details on KPMG’s Risk and Controls framework [click here](#).¹

5 Go beyond the technology: The reality is that AI — once fully realized — will likely extend across the entire culture of a financial services firm. And that will require decision-makers to think critically about how they ensure they have the right skills, capabilities and

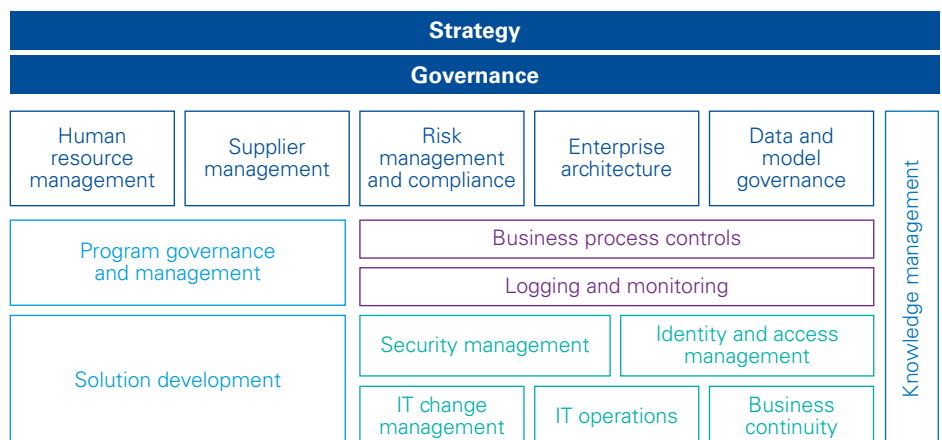
culture to encourage employees to properly operate, manage and control the AI they work with. More than just new technology skills, organizations will need to consider how they transform the organizational mind-set to apply a risk lens to AI development and management.

Looking ahead

While there are still significant unknowns about the future evolution of AI and its associated risks, there are a few things that we know for sure: financial services firms will continue to develop and deploy AI across the organization; new risks and compliance issues will continue to emerge; and risk management and business functions will face continued pressure to ensure that the AI and associated risks are being properly managed.

The reality is that — given the rapid pace of change in the markets — financial institutions will need to be able to make faster decisions that enable the organizations to move from ideation to revenue with speed. And that means they will need to greatly improve the processes they use to evaluate, select, invest and deploy emerging technologies. Those that get it right can look forward to competitive differentiation, market growth and increased brand value. Those that delay or take the wrong path may find themselves left behind. ■

Figure 1: Risk and Controls Framework



Source: AI Risk and Controls Matrix, KPMG 2018

¹ <https://assets.kpmg/content/dam/kpmg/uk/pdf/2018/09/artificial-intelligence-risk-and-controls-matrix.pdf>

5 Questions financial services Boards and lines of business should be asking about AI

1

How does the organization's use of AI align to the organizational strategy and how does it maximize value impact of strategic outcomes?

2

What new risk and compliance issues is AI introducing into the organization and how does that impact our organizational risk profile?

3

How are we leveraging external experts and encouraging our existing workforce to learn the AI and technology skills that the organization requires to properly manage new technologies?

4

Do the organization's risk professionals understand the emerging technologies and their associated operational, compliance and regulatory risks?

5

Is risk management properly embedded into the AI design and development process to ensure risks are identified and managed early?

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Uncover the full potential of artificial intelligence

KPMG Artificial Intelligence in Control helps you bring AI to production — without sacrificing innovation

Today's organizations rely heavily on algorithm-based applications to make critical business decisions. While this unlocks opportunities, it also raises questions about trustworthiness. That's where **KPMG Artificial Intelligence in Control** comes into play.

KPMG member firms believe that the governance of AI is just as important as the governance of people. Whether you're introducing advanced robotics to your business or want to address the integrity of

your algorithms, our AI solutions — Artificial Intelligence Governance and Artificial Intelligence Assessment — can help you establish greater confidence in your technology performance. They help you transparently and effectively govern algorithms, as well as assessing and enabling higher quality output.

Our member firms work to provide a holistic, broad-ranging approach to help you along your AI journey and to achieve your business objectives, now and in the future.

KPMG Lighthouse
Data Driven Technologies

kpmg.com/datadriven





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As we enter an age of governance by algorithms, organizations must think about the governance of algorithms to build trust in outcomes and achieve the full potential of artificial intelligence (AI).”

Fintech regulation:

Balancing risk and innovation

Julie Patterson, KPMG in the UK
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Jim Suglia, KPMG in the US

Fintech is a priority for today's asset management firms, many of which see such technologies as the key to maintaining a competitive edge. It is easy to see why. Fintech innovations promise a myriad of opportunities, from greater efficiency in financial transactions through to the transformation of the business.



In recent months and years, we have seen regulatory bodies worldwide attempt a careful balancing act. On the one hand, regulators recognize the need for innovation, and are working to support and encourage fintech activity through actions such as framework changes and the creation of regulatory sandboxes. On the other hand, there are significant concerns that existing risks, especially surrounding cybersecurity and fraud, are becoming heightened by fintech's growth.

Are financial regulations still fit for purpose?

The digital age has brought significant shifts in every jurisdiction around the world, and financial regulations have not kept pace. The rules as originally written assumed a world in which people conducted business face-to-face, with physical signatures on paper. While regulators have updated rules over past decades, the accelerated pace of change means that regulators are now constantly playing catch-up with the implications of the newest innovations.

Current wisdom holds that fintech technologies do not pose significant financial stability risks in their own right. However, innovations already on the horizon could carry with them increased systemic risks through growing complexity and interconnectedness, greater operational risk, increased liquidity risk, and more. There is also uncertainty around where and how future operational and security risks might arise, meaning that regulators have the unenviable task of fighting fires before they are lit.

In watching recent regulatory changes and related discussions, it is clear that regulators are beginning to fundamentally rethink what 'good conduct' looks like in an age when contact is entirely digital — and may not involve human actors at any point. While

in 2019 and beyond we see increasing divergence in worldwide regulatory standards in asset management, when it comes to facilitating fintech development, regulators appear to be of similar mind. Technologies such as robo-advice, blockchain and cryptocurrencies, and 'big data' are all on the regulatory radar, but addressing the heightened cybersecurity risks is clearly a top priority.

Cybersecurity an area of significant concern

Incidents drive greater scrutiny, so it is no wonder that the cyberattacks in 2018 have led to increased regulatory attention to digital safety and security. The European Securities and Markets Authority (ESMA), Germany's Federal Financial Supervisory Authority (BaFin) and more have all created forums, cybersecurity panels and other methods to help develop appropriate approaches to the increasingly common problem of cybersecurity vulnerabilities. In addition to these steps, the Monetary Authority of Singapore (MAS) has also recently launched a US\$30 million Cybersecurity Capabilities Grant to co-fund financial institutions' establishment of global or regional cybersecurity centers of excellence in Singapore,¹ as well as issuing a recent consultation paper on cyber hygiene that includes essential cybersecurity practices for financial institutions.²

Given that high-level rules regarding operational effectiveness and protecting clients' assets are already in force, in most global jurisdictions, regulators have yet to start changing rules — though change may be on the horizon. In many jurisdictions, the regulatory focus is currently on supervisory activity rather than rule changes. Many regulators are now also looking at fine-tuning the regulations surrounding security tests, checks and controls to keep pace with the accelerating pace of change.



There are significant concerns that existing risks, especially surrounding **cybersecurity and fraud**, are becoming heightened by fintech's growth.”

¹ <https://www.businesstimes.com.sg/banking-finance/mas-unveils-s30m-grant-to-boost-singapore-financial-sectors-cybersecurity>

² <http://www.mas.gov.sg/News-and-Publications/Consultation-Paper/2018/Consultation-Paper-on-Notice-on-Cyber-Hygiene.aspx>



Regulators are also increasingly interested in operational resilience. Trends show that regulators want to see that individual asset management firms have not only the necessary financial capability, but also the technological capability to operate in the current and evolving digital climate. Many fintech innovations connect asset managers to outside organizations, such as through the use of Application Programming Interfaces (APIs), creating the risk that the corporation does not possess the capability or capacity to effectively respond to a cyberattack, or that a response could come too slowly to be effective.

Other evolving risk areas

While cybersecurity may be regulators' top concern, other fintech areas are also making waves. Distributed ledger technology (DLT), such as blockchain, is one area under particular scrutiny. ESMA, for example, indicated that "its legal certainty and broader legal issues — such as corporate, contract, solvency and competition laws — need to be considered and clarified" before DLT can be used for larger-scale financial purposes, while the FCA raised concerns that DLT could lead to a "lack of individual accountability at firms".³ Bitcoin and other cryptocurrencies have also received a skeptical reception from regulators around the globe, with incidents such as the Coincheck hack from early 2018 receiving particular regulatory scrutiny.

Other areas of growing regulatory concern include: robo-advice; crowdfunding, with some regulators proposing simplified rules for securities-based crowdfunding platforms; and continued interest in the implications of AI and big data.

Fintech innovations continue to shape the financial sector around the globe. Asset managers, like regulators, need to strike the right balance between the competitive advantages that fintech can provide and the risks inherent in the integration of these technologies with current business models. ■

³ <https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2018/05/innovative-competitive-environments.pdf>

Responding to the regulatory climate

In talking with our firms' clients, many are asking: how should asset managers respond to the current regulatory uncertainty and changes surrounding fintech innovation? We generally provide two core recommendations.

1

Understand that no action is not an option.

Fintech innovations can provide important competitive advantages, including benefits to the top line, bottom line and overall client experience. Yet even for asset managers that do not wish to engage heavily with fintech or are not looking to be a leader in innovation, the increasing regulatory pressure around organizational resilience demands a response. Understand, too, that it is not only regulators who will be looking to see that asset managers keep valuable data safe from cyber attacks. Malicious actors are actively pursuing vulnerabilities, and attacks will only increase.

2

Know what is happening at every touch point.

Asset managers need to be fully informed about fintech innovations and regulators' current thinking in order to make fundamental decisions about systems and processes throughout the business model, including across geographies. This includes investigating the technological capabilities, security policies and governance of not only outsourced service providers but also the suppliers' suppliers, as any cyber risks that affect these downstream providers can ultimately impact the fund manager.

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Get serious about cyber:

Protecting the crown jewels

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James Arnold, KPMG in the US

The cyber risk facing insurers is constantly changing. Are you ready for the next attack?

Like it or not, insurance organizations are moving into the cross-hairs of hackers. They know what insurance decision-makers and regulators have understood for years: that insurance organizations hold some of the world's most valuable data.

Depending on the line of business, insurers tend to possess not just personally identifiable information, they also have access to deeply personal customer information such as health records, financial histories, driving records, family histories and credit information. Cyber thieves want it all.

A risk not worth taking

At the same time, the risks associated with a cyber breach are also rising for insurers. It's not just the costs — everything from conducting the cyber investigation through to preparing the legal defense — it's also the disruption that a cyberattack can cause as systems are shut down, investigations are conducted and processes are updated.

The reputational impacts of a cyberattack can also be significant. Customers expect their insurers to not only protect their insured assets but also their data. Any erosion of this trust can quickly lead customers to change insurance providers. And the chances of them coming back are slim.

Regulators around the world recognize the heightened risks and implications. And that has led many regulators to promulgate strict cybersecurity and privacy laws that require insurers to demonstrate a much higher level of cyber preparedness than they had in the past. Whether it's Europe's General Data Protection Regulation (GDPR), California's State Privacy Act, New York's Cyber Security Laws or new legislation in the UK, regulators increasingly expect their insurers to demonstrate a strong understanding and level of preparedness for cyber breaches.

The moving target

If the cyber risk would remain static, most insurers would have no problem shutting the door on the hackers and ensuring compliance. But the reality is that the cyber risk is continuously changing and evolving. Try as we might to eliminate new vulnerabilities, the hackers are always one step ahead. Some may simply be bored teenagers looking for some excitement. But, more often than not, the hackers are very sophisticated, dedicated and (often) well-funded criminals. There is no 'getting ahead' of the threat.

The types of risks being faced are also rapidly changing. In the past, the majority of attacks tended to focus on exploiting vulnerabilities to either access and steal confidential information, or to cause some type of business disruption. In the future, we expect to see attackers start to also attack the integrity of insurers' business — changing data and editing rules in a way that erodes business confidence and creates unexpected customer challenges.

It's not just the risks that keep changing. It's also the expectations. Indeed, with every large-scale and public cyber breach, customer expectations for cybersecurity evolve. What was considered a 'good enough' response last year is likely to be lambasted for being 'not enough' today. Companies are expected to learn from the last attack, regardless of whether their organization or industry was involved.

Taking off the blinders

Our experience and our data suggest that some insurance decision-makers may not be fully aware of the risks that their organizations face. According to a recent survey of insurance CEOs conducted by KPMG International last year, just 49 percent of respondents believe that their organization may be vulnerable to a cyberattack. This is dangerous thinking;



With every **large-scale and public cyber breach**, customer expectations for cybersecurity evolve. What was considered a 'good enough' response last year is likely to be lambasted for being 'not enough' today.”

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every organization — no matter the size or the scope — is vulnerable to cyberattack.

What is perhaps more worrying is that just 54 percent of insurance CEOs believe their organization is ‘fully prepared’ for a future cyberattack. Even assuming that CEOs are fully aware of the risks they face (and our conversations suggest that they are not), this data insinuates that many insurers recognize they are woefully behind in their cyber planning and preparation.

Filling the biggest holes

The good news is that there are a number of actions that insurers can take to dramatically reduce their cyber risk and enhance their overall preparedness.

One obvious action is to improve access controls across the enterprise. Indeed, a significant number of the cyberattacks we have witnessed over the past decade have largely focused on stealing (or phishing) employees’ access credentials and using them to gain entry into various systems (with the ultimate goal of achieving a level of administrative or ‘super user’ status that would enable them to loot data and change permissions at will). Strengthening access controls both inside the enterprise and across relevant third parties would help eliminate a significant percentage of potential attack vectors.

The other obvious action tends to center around poor systems and software management. In fact, many of the more virulent attacks take advantage of ‘known vulnerabilities’ — identified gaps in software security that (for the most part) could be eradicated by simply downloading the latest security and software patches. The WannaCry ransomware attacks of 2017 were successful against those organizations that had failed to ensure their security was up-to-date.

Insurers could also be working to improve their cyber risk reporting. The reality is that most risk managers and decision-makers only achieve a very limited view of the actual risks that their organization faces on any given day or month. Far too often, reports are fragmented across

lines of business, offer too limited a view of the risks or ignore the potential interdependent risks that cyberattacks could create. Ensuring that the first and second lines of defense have a realistic view of the cyber risks and controls is critical to managing the risks.

Embedding cyber risk

While these actions may help eliminate the vast majority of the cyber risks now facing insurers, our view suggests that more must be done to ensure that organizations are fully prepared for the next attack.

For example, insurers should be focusing on embedding a level of cyber awareness into their risk and organizational culture. Every employee must understand the risks and buy into the need for greater vigilance. In part, this is about moving from a ‘penalize’ approach to employee awareness towards a ‘promote’ approach where employees are rewarded for demonstrating compliance and initiative.

Risk managers, executives and boards could also be working to ensure that the organization enjoys a much more robust awareness of the overall cyber risks, the available controls and current ‘leading practices’. Participating in industry and cross-industry forums and task forces is a good first step. Improving internal governance processes and enhancing cyber education will also be key.

Get serious about cyber

That insurance CEOs and decision-makers may be becoming fatigued by the continuously evolving cyber risk is understandable. But it is no excuse. Given the regulatory direction of travel over the past few years, it is becoming increasingly clear that it will be the organization’s executives that will be held to account if customer data is stolen or if systems are rendered inoperable by a cyberattacker. The onus is on the board and the executive team to ensure that preparedness is high.

So if you’re not fully prepared for a cyberattack — and 46 percent of those reading this article know that they are not — it’s time to get serious about cybersecurity. ■



Risk managers, executives and boards could also be working to ensure that the organization enjoys a much more **robust awareness of the overall cyber risks, the available controls** and current 'leading practices'.



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Beyond compliance:

Regtech and the transformation agenda

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Chris Steele, KPMG in the UK

While many sound regulations have been implemented since the global financial crisis, the pace of regulatory change continues to increase. For today's financial institutions, regulatory technology (regtech) has never been more critical. Even with a stabilized regulatory landscape, changes implemented since the financial crisis continue to have costly impacts on banks, asset managers, and insurers worldwide. Up to 15 percent of financial institutions' staff now work on governance, risk management, and compliance¹ — yet even with this investment, regulatory compliance is by no means assured. Financial institutions have paid well over US\$340 billion in fines in the 10 years since the financial crisis, and one report estimates that the total is likely to top US\$400 billion by 2020.²

¹ <https://www.ft.com/content/3da058a0-e268-11e6-8405-9e5580d6e5fb>

² [https://www.reuters.com/article/us-banks-regulator-fines/u-s-eu-fines-on-banks-misconduct-to-top-400-billion-by-2020-report-idUSKCN1C210B](https://www.reuters.com/article/us-banks-regulator-fines/us-banks-regulator-fines-u-s-eu-fines-on-banks-misconduct-to-top-400-billion-by-2020-report-idUSKCN1C210B)



In the coming months and years, regulators around the world are expected to turn their focus to investigating how well financial institutions have integrated regulatory change into their businesses. Identification of breaches of anti-money laundering (AML) regulations and know-your-customer (KYC) non-compliance are also expected to grow. Nor is there any expectation that this level of regulatory rigor will be relaxed within the foreseeable future. This means that, in order for financial institutions to adapt to and excel in this new normal, regtech must be a critical part of the transformation agenda.

The rising need for regtech

To date, many institutions have been focused on using technology to help achieve compliance, while minimizing risk from misconduct and regulatory investigations. Now that focus is shifting towards a greater focus on cost, especially as institutions look for ways to reduce the cost base and achieve meaningful profit growth in the face of increased demands from regulators and customers alike. However, regulators will want to see financial institutions continue to strengthen their core risk management governance, controls, practices, and reporting. In addition to cost savings and efficiency, the coming increase in both supervisory activity and associated expectations should push financial institutions to consider more robust regtech solutions.

In previous years, a primary consideration when pursuing innovation was whether to build, partner, or buy a regtech solution. As the quality and diversity of regtech offerings continue to rise, the conversation has changed, with a growing number of entities actively looking for alternative solution providers. A fourth option is also becoming far more viable, especially for smaller players challenged by lack of capability and capacity: that of a third-party managed regtech solution.

These models are excellent for managing current uncertainties and addressing immediate regulatory issues. However, over the long term, financial institutions will need to take a broader approach, using

regtech as part of a wider technology transformation initiative designed to help the organization weather increasing complexity. Financial institutions are facing pressures on multiple fronts, from political shifts and global financial changes, to the impacts of new market entrants, new products, and compressed margins. In order to seek solutions to these complex issues, some global investment banks are already pursuing a 'reinvention' strategy using technology to enable the transition into a data company. This type of transformation is the future, and financial institutions should look to take the early steps today.

Supervisory technology to exceed regtech?

While financial institutions grapple with where, when, and how to best use technology in their risk and compliance processes, many regulators are already pushing full steam ahead. Supervisory technology, or SupTech, is being used by more regulators to allow them to deliver faster and more effectively on their core mandate. For example, one growing area of SupTech is in the use of machine learning and AI to examine vast data sets to predict and identify breaches or cases of misconduct. Here, the potential risk to financial institutions is that if the regulator has access to technological capacity far in advance of the organization itself, the regulator could predict risk areas that the institution does not see coming.

Regulators are also starting to push for the ability to gain direct access to financial institutions' data, rather than relying only on data provided to them from reporting. For example, the UK's Financial Conduct Authority has been working with the Bank of England and various other organizations to pilot a program to make regulatory reporting "machine readable and executable ... creating the potential for automated, straight-through-processing of regulatory returns".³ With the right technologies, regulators would not only be able to oversee a broad set of regulated entities and market activity as a whole, but also use analytics capabilities to identify systemic weaknesses and pinpoint areas for future focus.

“Financial institutions will need to take a broader approach, using **regtech as part of a wider technology transformation** initiative designed to help the organization weather increasing complexity.”

³ <https://www.fca.org.uk/firms/our-work-programme/digital-regulatory-reporting>

Addressing complex needs

For banks, asset managers and insurers trying to determine the right regtech options for their needs, we recommend a few critical early steps.

1 Assess the organization's needs. Too often organizations pursue specific technologies rather than addressing defined pain points or process gaps. In order to achieve the desired returns, you should approach regtech investment with both a clear understanding of the organization's needs and a strategic view of the issues that you are trying to solve. As a first step in this process, we recommend completing a full assessment of the organization's regulatory and risk management requirements. Next, create a heat map of the organization's ability to deliver against those requirements. Consider not only whether the organization has the necessary capability and capacity, but also how effective, efficient and timely that delivery will be.

2 Understand your solution options. Once you are clear on the organization's needs and have discerned the pain points in your regulatory compliance or reporting process, the next step is to fully explore potential solutions. The regtech landscape has evolved considerably over the past few years, and there might be more options — and newer solutions — than you first realize. Some regtech solution options also create valuable customer benefits, such as removing friction in the customer onboarding process. For organizations that have not kept up with the latest regtech trends, technologies, and third-party companies, seeking help with this process or getting advice on the best fit can be a good option. For example, KPMG Australia, through the KPMG Matchi Regtech portal, currently supports a regulator client with a research subscription and reporting service for fintech and regtech innovation, providing an online portal that delivers

market-leading access to the latest analysis and data about local and global trends, developments and providers.

3 Accelerate remediation efforts. When issues arise — especially when it comes to a breach, vulnerability, or problem with non-compliance — the impulse can be to buckle down rather than seek help or new solutions. Yet speed and accuracy are critical when dealing with regulators, and third-party support can be the most effective route forward. For example, new remediation-related regtech solutions use optical scanning, OCR capabilities, and AI to extract data points to identify customer files for remediation. Such solutions can transform a difficult, time-consuming, and labor-intensive remediation process, and enable the organization to move forward swiftly.

4 Design and implement an effective operating model for regtech. Ensure your organization has clear and well-defined governance structures and operating models for engaging with, implementing, and managing regtech initiatives. This should include assigned ownership for each area. Also look to create a group that includes both domain (e.g. Financial Crime) and functional specialists (e.g. Data Analytics) to help identify and assess potential regtech solutions, as well as support the implementation process.

Many financial institutions are still reeling from the costs and other implications stemming from the massive regulatory changes implemented over the past 10 years. Regtech is the key to addressing these challenges. With the right automation and technology solutions, financial institutions can achieve sustainable change and meaningful cost savings while responding effectively to regulators' demands and the imperative to prudently manage the evolving risk landscape for the benefit of all stakeholders. ■

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One to watch

Trunomi

By David Milligan, KPMG Matchi

In each edition of *Frontiers in Finance*, we spotlight a new idea, solution or technology that — we believe — has the potential to transform the financial services industry. For this 'risk and regulation' edition, we selected Trunomi, a UK-based data rights platform that is helping financial services firms deal with the growing body of data rights regulation around the world.

David Milligan (DM): What does Trunomi's platform do?

Julian Johns (JJ): Simply put, we turn data regulation into a competitive advantage by enabling financial services firms to use data rights to empower their customer relationships and drive trust. We do this by enabling data rights capture across a wide range of customer touchpoints and then distributing that, very simply, within the business.

DM: How does the solution help build trust?

JJ: Our solution lets financial services firms provide their customers with a personal data rights portal where they can control what information is stored, why it is stored, how long it is stored and all of the various rights that come with that. And that demonstrates to customers that you are serious about protecting their rights which, in turn, builds trust.

DM: What specific 'pain point' does Trunomi solve for financial services firms?

JJ: With the introduction of various data privacy rights regulations — like GDPR — financial services firms really need to know exactly what consumer data they have, where they are storing it and why.

For larger banks and insurers, for example, it's a massive struggle to manage this type of data rights capture at scale, particularly using legacy infrastructure. At the same time, challenger banks and fintechs are looking to quickly stand up new data rights infrastructure and want a fast and easy customer facing solution.

Our platform solves these challenges and many others such as reporting and integration — securely, at speed and at scale.

DM: How do you ensure security of the data you receive?

JJ: That's the beauty. We don't have access to any customer data at all. What we focus on are the data rights capture processes. And that means that banks can avoid some of the more worrying third party risks that come from sharing data. Our solution is also based on a distributed ledger technology, which means that our records are always secure and are quickly accessible if companies need to respond to a specific event or reporting requirement.

DM: How has your solution been received by financial services firms?

JJ: Extraordinarily well. We're working with leading banks and insurers in a number of markets. And we've seen significant interest from fintechs. In part, I think that is because we are helping solve a very immediate and difficult challenge that most financial services firms now recognize has become rather urgent. But it's also because we focus on both the front end and the back end of data rights capture. And that makes us very different from other solutions or work arounds that these firms had been trying in the past.

DM: How do you see data rights changing over the next few years?

JJ: We're already seeing a shift towards 'one to many' type relationships where customers provide their banks and insurers with permission to share data with third parties in order to secure better rates or deals. I think the next big shift will be around data rights portability — allowing consumers to move or alter their permissions at the end of the customer relationship. Both of these trends will require financial services firms to become much better at managing their customer data rights. ■

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The rise of responsible investment

David Dietz, KPMG in the UAE
Minh Dao, KPMG Australia

Environmental, Social and Governance (ESG) investing began with a letter and call to action. In January 2004, then UN Secretary-General Kofi Annan wrote to the CEOs of significant financial institutions to take part in an initiative to integrate ESG into capital markets. Where are we today?

Since then, ESG has evolved and moved from the sidelines to the forefront of decision-making for asset managers and institutional investors. Increasingly, ESG considerations are being integrated into the charters of a growing number of entities, included in their practice and applied to the due diligence process when assessing assets to be acquired.

Consider the numbers: In 2017, ESG investments grew 25 percent from 2015 to US\$23 trillion, accounting for about one-quarter of all professionally managed investments globally.¹

This growth was fueled in part by the rise in the Socially Responsible Investment Movement more broadly, which is also impacting company behavior with respect to ESG. In a recent study by KPMG International, more than one-third (36 percent) of C-suite and board members surveyed indicated that investor pressure had increased their company's focus on ESG.²

Understanding the rise in ESG and the Social Investing Movements

World economies are facing growing indebtedness and unsustainable asset prices as we enter an unsettling geopolitical reality, where nationalism and populism are creating go-it-alone state mentalities leading to rising military, economic and commercial tensions. At the same time, failure to mitigate climate change and growing cybersecurity breaches continue to grow as threats to global stability.

In this environment, it's clear ESG criteria are best suited to effectively assess an organization's resilience, adaptability, long-term sustainability and capacity for growth. This requires a forward-looking, qualitative and expansive approach to investing, one that examines

what-if scenarios and relies less on past performance and historical data as a predictor of future performance.

ESG in practice

Creating ESG guidelines is a growing priority for asset managers around the world and across the financial services sector. This is particularly true of institutional investors, such as sovereign investment funds and pension funds. This group is acutely aware of the negative impact to reputation investments that are not viewed as socially responsible can have. As a result, they are rigorous in ensuring the assets they acquire are compliant with human rights, labor rights, corruption and environmental laws, and more than this, that they are compliant with their own internal benchmarks for what is responsible investing.

While the ESG movement is global, some regions are further along the ESG continuum than others. For example, Europe, Australia, New Zealand and Canada are leaders in terms of prioritizing ESG considerations, which can vary from jurisdiction to jurisdiction and from entity to entity.

In December 2017, six sovereign wealth funds came together to create the One Planet Sovereign Wealth Fund Working Group. Its objective: to develop an ESG framework to address climate change and encourage sustainable growth and market outcomes. The framework is based on three principles: to align climate change awareness and influence investment decision-making; to promote value creation by encouraging businesses to address the impact of climate change; and to integrate the risks and opportunities of climate change in the management of investments.³

“

In a recent study by KPMG International, more than **one-third of C-suite and board members** surveyed indicated that investor pressure had increased their company's focus on ESG.”

80%

of the world's **largest corporations** use global reporting initiative standards.

¹ <https://www.bloomberg.com/professional/blog/global-sustainable-investments-grow-25-23-trillion/>

² <https://assets.kpmg/content/dam/kpmg/be/pdf/2018/05/esg-risk-and-return.pdf>

³ <https://oneplanetwfs.org/>

“
In a recent study of 1,000 individual investors ... 71 percent believe companies that **focus on the environment and social goals** will earn better returns.”

More and more, investment managers are creating ESG charters and frameworks that require looking at a company's environment and contamination policies, at the governance structures it has put in place to avoid corruption, at the diversity of its board and whether or not it is taking aggressive tax positions.

Doing the right thing pays dividends

Increasingly, institutional and individual equity investors have made the link between ESG information, a company's purpose, values and strategy and its performance. Studies confirm that having appropriate ESG policies in place is not just about doing the right thing and being compliant with laws and regulations, it's financially beneficial. Companies with sustainable practices outperform companies that have not integrated ESG considerations into operations.

In a recent survey of 1,000 individual investors, 75 percent said they are interested in sustainable investing and adopting its principles as part of their strategy and 71 percent believe companies that focus on the environment and social goals will earn better returns.⁴

A poll of 900 board members and business leaders from 41 countries by the Audit Committee Institute reveals that 47 percent of respondents believe ESG-focused companies outperform competitors.⁵

Moving beyond the regulatory requirements

The rise in ESG considerations on the part of businesses and investors is happening in tandem with a heightened regulatory environment that has also increased ESG requirements and accounting standards demanding transparency around disclosures in financial statements.

Leading organizations understand that regulatory requirements are just a starting point. In order to deliver strong returns over the long term, it is necessary to be proactive and to go beyond being compliant in creating a robust ESG framework. That's why they are joining forces and forming organizations such as the One Planet Sovereign Wealth Fund and creating their own, more far-reaching ESG requirements.

In today's environment where change and uncertainty seem to be the only constants, more and more investors are taking a long-term view and choosing to put their money into companies that act responsibly. ESG investing is already reshaping global markets. This trend is poised to continue making ESG analysis a critical part of the investment process. ■

⁴ <https://www.morganstanley.com/ideas/sustainable-socially-responsible-investing-millennials-drive-growth>

⁵ <https://assets.kpmg.com/content/dam/kpmg/be/pdf/2018/05/esg-risk-and-return.pdf>

Driving ESG success

For institutional investors and companies looking to implement and improve ESG considerations, we recommend:

1

Developing a formal ESG charter that reflects the values of your organization and its stakeholders. ESG can encompass broad concepts but they must be of value to your stakeholders.

2

Making ESG a business priority. This starts at the top but it goes beyond creating a policy and principles. Your leadership team has to make the societal and economic case for ESG and gain buy in from across the organization and the people who will be implementing it. Understand that ESG criteria are evolving and broadening in meaning. For example, for some organizations, ESG includes board diversity and equal employment of women. Stay on top of new developments and adapt. Track ESG issues and communicate them to the board and shareholders.

3

Actively taking ESG criteria into consideration when assessing new investment and review and align legacy investments with ESG principles. Be prepared to navigate a challenging transition period. Throughout this time, communicate why the changes are being made.

4

Involving your board of directors. Given the increasing importance stakeholders assign to the management of ESG, boards can play a key role in identifying and managing ESG risks and opportunities, determining which ESG issues are of strategic significance, and embedding ESG into your strategy and culture to drive long term performance.⁶

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⁶ https://assets.kpmg.com/content/dam/kpmg/be/pdf/2018/05/esg_risk_and_return.pdf

Combating climate risks:

The future of insurance

Serena Brown, KPMG International
Chris Nyce, KPMG in the US

Natural disasters killed more than 10,000 people in 2018. They left millions more homeless. In the same year, natural catastrophe-related economic losses reached US\$160 billion. The vast majority — 95 percent — of the registered events were weather related.¹

¹ <https://www.munichre.com/topics-online/en/climate-change-and-natural-disasters/natural-disasters/the-natural-disasters-of-2018-in-figures.html>



Adding further urgency to the issue, a recent report² by the International Panel on Climate Changes spoke of the dire consequences for people, economies and ecosystems which would result from global warming exceeding 1.5 °C above pre-industrial levels. The World Economic Forum's Global Risks Perceptions Survey 2018–19³ revealed extreme weather events, failure on climate change mitigation and adaptation, and natural disasters as the three most likely risks of significant concern. No wonder climate change is rapidly rising up the public agenda.

It is also rocketing up the insurance agenda. Not just because natural-disaster insurance claims are rising, but also because insurers are increasingly recognizing that the mid- to long-term outlook on climate change carries some massive risks.

Understanding the risks

Back in 2015, Mark Carney, Governor of the Bank of England, delivered a speech⁴ in which he warned insurers that 'the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors (including business, political, and technocratic authorities) — imposing a cost on future generations that the current generation has no direct incentive to fix'.

There are three channels through which climate risks could crystallize.

The first is the physical risks from extreme climate events, which include storms, heavy rain, flooding, drought and associated wildfires, and heat waves. It is hard to predict the changing intensity, frequency and concentration of these events such as clusters of typhoons. Insurers also struggle to foresee the indirect risks such as disruption to economic value chains.

The second class of risk is the transition risk; basically, the 'unknowns' about how

the world will evolve towards a low-carbon economy in terms of public policy, regulation, actual temperature change, social expectations and technological developments. That's even more difficult to measure or price. And, given the slow progress on transition, the potential for a panicked, forceful policy response in a few years' time — sparking a disorderly transition — is increasing.

The third class of risk is the liability risk. Recent estimates suggest that there have been close to 1,000 climate change-related class action lawsuits filed in 25 countries. Rhode Island, for example, filed a suit that alleges 21 companies knowingly contributed to climate change and failed to adequately warn citizens about the risks posed by their products.⁵ Law suits are creating concerns for companies' insurers.

It is not inconceivable that some insurers could suffer a triple loss: a large increase in director and officer liability insurance policy claims arising from failure to mitigate, adapt or disclose climate risks; a drop in asset value if they also invest in these companies; and litigation from policyholders who believe their insurers failed to fulfil their fiduciary duty to construct climate-resilient asset portfolios.

The industry takes the lead

The good news is that there are a number of initiatives to improve awareness and catalyze a response to climate-related risks. For example:

- The Insurance Development Forum⁶ — an industry-led public/private partnership — is making great strides towards the more effective use of insurance and its related risk management capabilities to build greater climate resilience and protection for people, communities, businesses, and public institutions that are vulnerable to climate-related disasters and their associated economic shocks.

“

Yet, while **industry and government efforts** seem to be moving ahead, our view of the market suggests that most individual insurers still have a long way to go before they can confidently claim to be **understanding, mitigating and managing their climate risks.**”

² <https://www.ipcc.ch/sr15/chapter/summary-for-policy-makers/>

³ http://www3.weforum.org/docs/VEF_Global_Risks_Report_2019.pdf

⁴ <https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability.pdf?la=en&hash=7C67E785651862457D99511147C7424FF5EA0C1A>

⁵ <https://www.climate-liabilitynews.org/2018/07/02/rhode-island-climate-liability-suit/>

⁶ <https://www.insdevforum.org/about>

Environmental, social and governance

- The UN Environment Programme's Principles for Sustainable Insurance Initiative has been steadily increasing its focus on climate resilience, with leading insurers currently developing a new generation of forward-looking risk assessment tools to better understand the impacts of climate change on their business.
- The multi-stakeholder InsuResilience Global Partnership for Climate and Disaster Risk Finance and Insurance Solutions aims to strengthen the resilience of developing countries and protect the lives and livelihoods of poor and vulnerable people against the impacts of disasters.

Yet, while industry and government efforts seem to be moving ahead, our view of the market suggests that most individual insurers still have a long way to go before they can confidently claim to be understanding, mitigating and managing their climate risks.

Start from within

There are a number of actions that insurers could take to improve the way they assess and manage the near and longer-term impacts of climate change.

One of the most important things insurers can do is to fully embed climate-related risks into their overall governance and risk management frameworks. This includes sharpening quantitative risk modeling (including scenario analysis) around perils impacted by climate change and measuring the potential for liability claims against high carbon emitter. The recommendations of the Financial Stability Board (FSB) Taskforce on Climate-related Financial Disclosures provide a helpful road map in this regard — spanning governance, strategy, risk management, as well as metrics and targets.

Insurers will want to consider whether their liabilities and investments are

properly diversified to avoid excessive risk concentration. That may include tilting portfolios towards companies and industries which are relatively climate resilient and best positioned for the low carbon transition, and spreading regional exposure.

Insurers could also be taking action to drive greater awareness and response to climate change within their customer base and their markets. Just like some insurers offer lower home insurance premiums for home owners that install strong locks and robust alarm systems so, too, could businesses be offered lower premiums if they have taken the steps necessary to reduce their vulnerability and increase their preparedness for extreme climatic events.

There is also the opportunity for insurers to be more proactive in helping governments and municipalities improve resilience by using their experience, data and models to help enhance building codes and land zoning regulation. And they could be more forceful in encouraging their corporate and government policy holders to voluntarily adopt standardized climate-related financial disclosures.

Your future success depends on it

To be clear, the response to climate change is not only about moral and ethical responsibility for an existential threat to life. Insurers also have a business imperative to preserve their existing markets, policies and investments, and also to create new markets and green investments. Further, as insurers look to developing markets for the next round of growth, those countries' greater exposure to climate-related risks will require insurers to better understand, quantify, and rigorously combat the impacts of climate change.

The reality is that there will likely be more climate-related regulation and legislation in the very near future. Insurers will have no choice but to act. ■

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In the eye of the storm

A Q&A with Karina Whalley, Public Sector Business Development Manager at AXA Global Parametrics

How worried should insurers be about climate change?

Very. Back in 2015, our CEO shook up the sector by suggesting that a 2 degree Celsius increase in temperature might be insurable but a 4 degree Celsius increase globally certainly would not be. A 4 degree temperature rise would likely increase volatility in weather risks that, in turn, would raise uncertainty for insurers in their risk pricing which could lead to increased pricing buffers. This could make insurance prohibitively expensive for certain risks. From that angle alone, it's critical that insurers take climate change seriously.

How is AXA Global Parametrics assessing and measuring the impacts of climate change?

We recognize that climate change is modifying the patterns of risk. You can't simply rely on backward looking historic data and statistics anymore. We are incorporating physical models to assess shifts in climate and we also use detrending methods as well as emphasising more recent historic data. These techniques help give us a better understanding of the risk and how it is evolving and therefore allow for more accurate pricing of the risk. It requires looking at a range of perspectives, models and data to understand how a portfolio will be impacted.

How is regulation influencing the debate?

I think some of the more recent regulatory changes have been incredible. On the one hand, they force the industry to think seriously about the volatility of the risks inherent in climate change. At the same

time, they also force corporates to assess their own risks and that, in turn, should drive significant demand for solutions like weather risk transfer structures.

Besides writing policies, are there other ways insurers could help?

Certainly. I think we are in a great position to help our clients – individuals, corporates and governments alike – understand and reduce their climate related risks. In some cases, that might be through working directly with governments to improve risk analysis. In others, it might be rewarding clients who demonstrate risk reduction behavior. I think insurers could also be better at using the asset side of their balance sheet to influence how development is achieved especially through climate resilient infrastructure investment in emerging countries.

What advice would you offer other insurers today?

I think the most important action insurers can do is to start engaging in existing development and climate focused initiatives. I am very supportive of the projects currently underway within organizations such as the Insurance Development Forum which is actively plugging climate risk model gaps, launching sovereign climate insurance programmes and driving climate focused investment. I also think insurers should be putting a lot more time towards educating themselves, their clients and their potential clients about the risks associated with climate change. It's not about scaring people, but it is about providing a reality check.

Contributor



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The risk of human rights violations

Richard Boele, KPMG Australia
Dr. Meg Brodie, KPMG Australia
Jerwin Tholen, KPMG in the Netherlands

Financial services organizations are being challenged as never before to recognize and respond to the serious risk of human rights violations within their operations and across their global networks of suppliers and partners.



Today's trend of emerging legislation — as witnessed in the US, the UK, the Netherlands, France, Australia and beyond — is intensifying finance-sector scrutiny concerning human rights issues that include:

- forced labor, child labor and other slavery-like practices
- unsafe or unhealthy working conditions
- displacement of local communities
- discrimination by race, age, gender, sexuality and other protected attributes
- underpayment for labor or services provided.

Respect for human rights is considered a fundamental business responsibility today under the UN 2011 Guiding Principles on Business and Human Rights (UNGPs). In addition to the UNGPs — under which global financial firms must possess a clear policy on human rights management — the OECD's Guidelines for Multinational Enterprises provides financial institutions with best practices for responsible global conduct. This includes a focus on due diligence and the requirement to assess real and potential human rights issues, act on findings, track responses, and communicate how issues are being managed.

The trend towards enhanced human rights awareness and performance among financial firms also includes the need for grievance mechanisms. As specified under both the OECD Guidelines for Multinational Enterprises and the UNGPs, banking clients receiving project financing must have a grievance mechanism to address and resolve issues or violations.

While the UNGPs are considered the internationally accepted framework for business practices regarding human rights today, financial-sector compliance remains limited. Today's typical executive response on the issue? "What does human rights have to do with us?"

Preventing harm and protecting the bottom line

Failure to identify and respond to issues can lead to costly and disruptive legal action, investor divestment, negative publicity, reputation damage and significant financial loss. Managing human rights is not only about doing the right thing to prevent harm — it's also about protecting the bottom line.

Several widely reported human rights cases involving banks have served as instructive examples of what type of risks emerge in the financial sector. For example, several Dutch banks provided more than US\$5 billion in financing or investments to palm oil producers who were found to be involved in human rights cases that included environmental issues and disruption of local communities in several countries.¹

Some global financial institutions are making progress in the wake of such revelations. Major initiatives include the Dutch Banking Sector Agreement on International Responsible Business Conduct, created to ensure that, in the case of corporate lending and project financing, human rights are respected as set out under both the OECD Guidelines and UNGPs. The agreement requires banks to be transparent about investment portfolios, client screening and their response to clients involved in human rights cases. Dutch banks will also maintain a grievance mechanism for human rights cases.

“The trend towards enhanced human rights awareness and performance among financial firms also includes the need for grievance mechanisms.”

¹ <https://nltimes.nl/2018/07/02/dutch-banks-structurally-involved-abuses-palm-oil-sector-report>

“Expansion into new global markets — both by financial firms and their **business customers, partners and suppliers** — is an activity where business should look for red flags.”

In addition, 73 Dutch pension funds with EUR1,179 billion in invested assets in December 2018 signed a covenant with the Dutch Government, NGOs and unions to map, predict and prevent or address human rights violations within their global portfolios.²

In Australia, banks and other financial institutions are beginning to respond to new modern-slavery legislation requiring large businesses to publicly report on how they manage the risk of modern slavery within operations and across supply chains. One leading firm we worked with is deepening supplier relationships in high-risk geographies as part of a suite of measures to better manage the risk of negative human rights impacts.

In addition to responding to media coverage, voluntary agreements and covenants, the financial sector is also pushed to act upon human rights as an outcome of the National Action Plans (NAPs) for Human Rights. NAPs are policy documents in which a government articulates priorities and actions that it will adopt to support the implementation of international, regional, or national obligations and commitments with regard to a given policy area or topic.³

More than 20 countries explicitly mention finance and the banking sector in their NAPs. The French NAP, for instance, states: “Given the financial sector’s importance in providing loans, managing assets and financing projects, it has a duty to promote the adoption of responsible management practices by the companies it finances or invests in, especially in the human rights field”. Moreover, France has implemented a regulatory framework that is relatively unique in that some of its provisions specifically target the finance and banking sector (the Grenelle II Act of 12 July 2010). France is also examining whether to extend environmental, social and governance reporting requirements for institutional investors in Europe to cover human rights.

Every customer, supplier or partnership can pose an unseen risk

As expectations and requirements to improve human rights risk management grow, all financial institutions should explore new ways to identify, manage and report on potential issues that can emerge that involve:

- working conditions among employees or operations
- partners in the global value chain, including suppliers and beyond
- customers acquiring project financing, loans, asset-management services and more
- acquired businesses or activities in new global markets and regions.

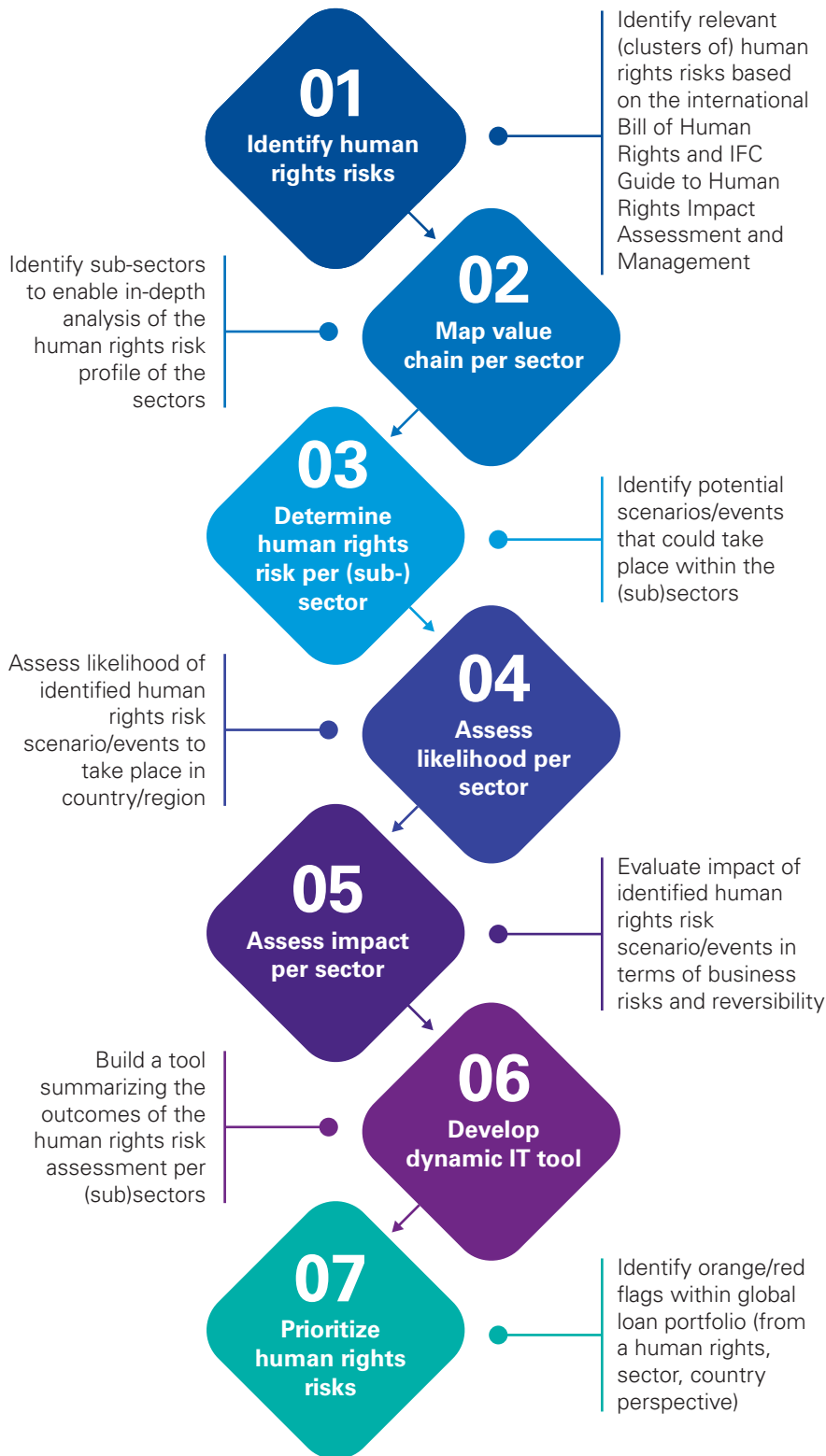
Financial institutions must acknowledge that every business, partnership or sourcing decision entails significant questions about potential human rights issues. This reality demands a shift in thinking — away from traditional *risk-to-business* concerns and towards non-financial *risk-to-people* concerns. Legislation requiring transparent reporting over human rights risk — such as modern slavery laws in the UK and Australia — is compelling boards to take on accountability for such non-financial issues and risks.

Expansion into new global markets — both by financial firms and their business customers, partners and suppliers — is an activity where business should look for red flags. A bank or client business acquiring a company or operation in a new region, for example, is also acquiring any potential human rights issues and legislative requirements related to that company or new geography. Gaining a comprehensive view of risk across their global supply chains should also be a top priority for financial firms.

² https://www.imvoconvenanten.nl/pensioenfondsen/news/2018/12/covenant-pensioenfondsen?sc_lang=en

³ <https://globalnaps.org/issue/finance-and-banking>

A step-by-step approach for granular analysis



Source: KPMG International 2018

“
Financial institutions must acknowledge that every **business, partnership or sourcing decision** entails significant questions about potential human rights issues.”

“ Develop a dynamic IT tool designed specifically to comprehensively summarize, sector-by-sector, the **outcomes of the risk assessment**. In the final step, a firm can prioritize the human rights risks within the financial firm’s global loan portfolio.”

Taking a strategic approach to risk analysis

KPMG is taking a strategic and proven seven-step approach to analyzing human rights risks for global finance-sector businesses that are dedicating the time and resources needed for a proactive stance on today’s reality. This is crucial to these businesses as the number of human rights risks is almost endless and can materialize in nearly all sectors of, for instance, a loan portfolio. Awareness of human rights across the organization and prioritization of them is therefore only the beginning in a process to address these risks to people. As the chart on the previous page shows, we begin by identifying relevant human rights risks based on global standards and map the value chain per sector. The more detailed assessment process follows, in which we:

- map the value chain by sector to identify each sector’s risk profile
- identify potential scenarios or events in each sector
- assess the potential for each human rights risk scenario to emerge
- evaluate the business impact — and the reversibility — of identified risk scenarios.

With the assessment process complete, the business is positioned to develop a dynamic IT tool designed specifically to comprehensively summarize, sector-by-sector, the outcomes of the risk assessment. In the final step, a firm can prioritize the human rights risks within the financial firm’s global loan portfolio.

Key considerations to enhance human rights risk management

Financial services leaders and boards should consider the following steps to enhance and prioritize management of human rights risk:

- set the tone at the top by appointing a board member or board committee with responsibility for human rights
- ensure boards and leaders are committed to respecting human rights and to challenging traditional assumptions about corporate responsibility
- set up a cross-functional working group that includes the sales, procurement, operations, legal, ethics, safety and HR functions to implement a human rights policy
- build human rights actions into annual business-unit plans and ensure that accountability sits with business-unit leaders
- integrate human rights risks into risk management across different business functions
- monitor the effectiveness of systems to manage and respond to human rights risk and establish appropriate grievance and remediation processes
- ensure a clear line of reporting to the board and leaders on human rights risks and impacts so serious cases are escalated rapidly. ■

Where to begin on the human rights journey?

Today's financial services organizations should be asking themselves these important questions.



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Combating financial crime

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Michael Robinson, KPMG in the UK

Banks around the world are spending billions to improve their financial crime management. Yet the number of fines and sanctions being imposed on banks is still increasing. What will it take to achieve efficient and effective customer due diligence?



One would be hard-pressed to suggest that banks are ignoring the need for better customer due diligence. Indeed, according to a Forbes article, some banks spend up to US\$500 million each year in an effort to improve and manage their Know-Your-Customer (KYC) and Anti-Money Laundering (AML) processes. The average bank spends around US\$48 million per year.¹ In the US alone, banks are spending more than US\$25 billion a year on AML compliance.²

With this much investment going into customer due diligence processes, one would think that the number of fines and sanctions imposed on banks would drop. But quite the opposite; our research suggests that the number of fines and sanctions has actually increased over the past 3 years. In the US, where regulators are among the world's most aggressive in imposing fines and sanctions, banks have been hit with nearly US\$24 billion in non-compliance fines since 2008.³

It's not just big fines and the possibility of sanctions that worry bank CEOs and boards; most also now recognize that inefficient AML and KYC processes also lead to lower productivity (due to significant re-work requirements), greater government scrutiny (in cases where problems persist) and the potential for decreased customer satisfaction.

Building maturity

Our recent surveys and experience working with leading banks around the world suggests that many banks currently display a 'fundamental' level of maturity when it comes to customer due diligence: they have a defined policy that is aligned to regulation and is well communicated within the business. But the policy is often poorly executed operationally. Banks with a fundamental level of maturity often find themselves doing significant re-work and manual data entry.

Some of the more advanced banks have achieved an 'evolving' level of maturity. They also have a defined and aligned policy. But their policy is supported by effectively managed processes and procedures. Organizational structure is well established. Roles and responsibilities are clear and technology is being applied to improve KYC operational management.

However, our experience suggests that most banks are looking for ways to be 'transformational' in their approach to customer due diligence. They want to make their policies actionable and embed them in the culture by creating a set of business rules with traceability that allows them to easily identify the impact that any changes to the policy may have on operations. They want processes and procedures that are well defined across customer onboarding, client refresh and screening. They want self-service capabilities that allow customers to easily update their KYC and AML data through multiple channels.

Getting better

When we work with financial institutions to help achieve this type of transformational maturity, we often start by helping decision-makers think about the four key components of customer due diligence.

- 1 Policy and risk management:** Every good AML or KYC process is underpinned by relevant laws, regulations and company policies. The more mature organizations, however, are able to identify the linkage between AML and KYC policies, data requirements, underlying processes and technology. And that allows them to quickly identify how any changes in their policies will influence the wider AML and KYC ecosystem.

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Some banks spend up to US\$500 million each year in an effort to improve and manage their **Know-Your-Customer** and **Anti-Money Laundering** processes.”

¹ Know Your Customer Will Be A Great Thing When It Works." Forbes, July 10, 2018

² "Anti-money laundering compliance costs US financial services firms \$25.3 billion per year," LexisNexis Risk Solutions, October 11, 2018

³ "Europe Goes Harder on Money Laundering With Record ING Fine," The Wall Street Journal, September 4, 2018

2 Processes and services: Most banks now continuously monitor their customers throughout the life cycle with event-driven reviews and specific actions triggered at specific times. The more mature organizations are also working to reduce unnecessary customer outreach by creating bespoke customer due diligence portals that allow customers to perform their own profile maintenance. Some are also now using 'search before' contact models that harvest publicly available data from third-party sources.

3 People and organization: Relationship managers are too valuable to have their time soaked up collecting customer data and conducting manual reviews. That's why the more mature organizations are now starting to create specialized delivery centers that allow 24/7 access to deep pools of talent at an optimized cost. This allows them to bridge existing gaps in the end-to-end process, centralize resources and focus employee skill sets.

4 Data, technology and analytics: Many banks are struggling with siloed, duplicative and inconsistent data, which means their ability to search and access sources is limited. The more mature organizations are creating data models and dictionaries that can serve as the master source of requirements and business rules. Some of the more advanced organizations are now exploring how they can leverage their AML and KYC data to unlock new customer insights that can help influence both product offerings and risk decisions.

The path to efficient and robust customer due diligence is never-ending. Banks will need to continue to invest into newer technologies and processes if they hope to remain ahead of regulator and customer expectations. ■

Three focus areas for transformational customer due diligence

1. Optimize KYC business operations to reduce the total cost of KYC compliance

Implement a data model/data dictionary to capture all required data elements, requirements and business rules based on entity type.

Define data lineage between policy, business rules and technology to ensure alignment with policy and to easily understand the impacts of policy changes.

Leverage technology solutions (e.g. workflow/case management) and client channels to automate the processing of KYC cases, thereby reducing time and improving operations efficiencies.

Ensure the right skilled people are undertaking the right activities in the right way (e.g. sourcing options).

Know your customer better through relevant data collection.

2. Enhance the customer experience for onboarding and refresh

Improve the customer experience and enhance the KYC data collection processes by leveraging clearly defined data requirements and business rules.

Minimize customer outreach by aggregating publicly available customer data.

Provide a true omni channel experience by enabling self service capabilities (e.g. portal, mobile).

3. Improve risk management/financial crimes compliance by assessing and monitoring KYC client information for critical insights

Use evidence based, robust and auditable processes.

Conduct early risk based assessment through customer segmentation.

Achieve quality financial crime judgment rather than simply conducting a data collection exercise.



Case study

Improving compliance and efficiency

When a large global financial institution wanted to develop a solution to enable them to review tens of thousands of customer records against their financial crime policy standards and within a tight deadline, they knew they needed to move away from their existing approach and develop a holistic process that would not only have a minimal impact on customers but also provide a clear audit trail and deliver at the scale required.

Working with the institution and the local regulator, KPMG's financial services and regulatory advisory teams designed and implemented an end-to-end solution comprising new technology tools, hosted in a secure cloud environment and an off-shore delivery center for customer outreach and case reviews. The solution improved the efficiency of customer data collection through a new customer portal; codified regulatory and policy rules into an operational workflow minimizing manual effort and provided detailed management information on progress as well as insights into customer behavior enabling continuous improvement throughout the project.

Not only can the institution now make more holistic decisions supported by a fully auditable process, they have also cut the compliance process time in half, unlocking significant operational efficiencies and savings.

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Closer scrutiny of costs versus performance



Julie Patterson, KPMG in the UK
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Regulators around the world are still trying to deliver on a long-standing target — simple and meaningful disclosure about costs and performance. Some have now trained their sights on the level of costs and charges in funds, and determining whether those costs are justified. It's not surprising given the longest bull market in recent history appears to be coming to an end, growth is slowing and budget-constrained governments are concerned about providing retirement pensions for their growing aging populations.

Taking their cue from investor protection agencies, media and bloggers — who write consistently about the too-high price of investing and the rise in lower-cost exchange traded funds — regulators are turning their attention to the amount of fees that investors are paying for investment advice, and specifically the fees being charged by investment funds.

The message is clear: there's no place to hide on costs and charges. The spotlight on the industry is simply too intense to ignore. All fund management companies have to disclose fully all costs and charges in a way that is clear to investors. This will require firms to review their fee structure processes and demonstrate that they're putting the investor front and center.

From disclosure to cost

According to KPMG International's *Evolving Asset Management Regulation* 2018 report: "Product governance and disclosures remain firmly in regulators' sights, as do fund distributors in general and financial advisers in particular."¹

For example, on 1 January 2018 the European Commission's Packaged Retail Investment and Insurance-based Products (PRIIPs) regulations came into effect. The regulations set out new calculation methodologies and transparency requirements for these investments. Among the key requirements: fund managers must provide Key Information Documents (KIDs) for their non-UCITS (Undertakings for Collective Investments in Transferable Securities) products that include an explanation of the main factors that impact the investment's return, the level of risk, and a table explaining the impact of costs on an investor's investment over time. The regulation is expected to be extended to UCITS at some point.

The focus on the actual amount of fees is new territory for European regulators because it falls under competition law, which is not part of their mandate. That said, they continue to push forward. For example, the European Securities and Markets Authority (ESMA) has received a mandate from the European Commission to issue reports on the cost and past performance of the main categories of retail investment, insurance and pension products. In effect, regulators are beginning to link performance to cost and asking whether the level of costs and charges is reasonable based on performance.²

UK regulators have gone a step further, requiring non-executive board directors of fund management companies to be held directly responsible for the value assessment of each of the funds.

In Canada, the Mutual Fund Dealers Association of Canada (MFDA), the national regulatory body, is pushing to expand further the way investment fees are reported to investors to include ongoing costs, such as management expense ratios. Nearly 10 years on from the introduction of the first phase of the Client Relationship Model (CRM), and over 3 years since the introduction of CRM2, such disclosures are not yet required under these rules.³

In April 2018, the MFDA issued a discussion paper asking for industry feedback on four areas not covered by CRM2: continuing costs of owning investment funds; transactional costs of owning investment funds, such as redemption fees and short-term trading fees; third-party custodial and intermediary fees to administer the fund but not charged by or paid to the registered firm; and costs of other investment products not currently included in the annual charges and compensation report.

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The message is clear: there's **no place to hide on costs and charges.** The spotlight on the industry is simply too intense to ignore.”

¹ <https://home.kpmg.com/content/dam/kpmg/xx/pdf/2018/05/a-parting-of-the-ways-executive-summary.pdf>

² <https://www.esma.europa.eu/press-news/esma-news/esma-receives-mandate-fund-performance-european-commission>

³ <https://www.theglobeandmail.com/investing/education/article-mutual-fund-regulators-push-for-more-fee-transparency/>

Canadian regulators have also been active. In September 2018, the Canadian Securities Administrators (CSA), the umbrella group made up of provincial and territorial regulators, issued a proposal prohibiting investment fund managers from paying so-called ‘up-front’ commissions to the dealers, which can be covered by the management fees charged to a fund.

“The up-front sales commission payable by fund organizations to dealers for mutual fund sales made under the (deferred sales charge) option is a key feature of that sales charge option that gives rise to a conflict of interest that can incentivize dealers and their representatives to make self-interested investment recommendations to the detriment of investor interests,” said the notice published by the CSA.⁴

Canadian regulators are also looking to eliminate a commission paid to dealers who don’t do a ‘suitability determination’, on behalf of clients.

Closet tracking

Increasingly under the microscope of EU regulators are closet tracking funds — funds that mirror their underlying indices, despite being marketed as actively managed and charging an active management fee.

In Sweden, a public inquiry published in 2017 urged greater transparency with regard to how active a fund is and its tracking error. A study that same year by ESMA compared active and passive funds. The goal was twofold: to determine the extent to which actively managed funds beat their benchmarks and to compare the performance of active funds against

passive products. A UK FCA report found that active funds provide poor value for money — a view shared by the European Commission. Based on the FCA report, in March 2018, the UK regulator demanded that asset managers compensate investors who were overcharged for closet tracking funds and that 64 closet tracker funds of 84 suspect funds investigated must change how they market the funds.⁵

What fund managers need to do

- 1** Understand the regulations are not just about disclosure. Increasingly, jurisdictions are asking for clarity around exactly what the fund does and how that translates into costs. This will require a mind shift and new approach on the part of investment managers and fund companies, and to apply this approach to existing funds as well as new product launches.
- 2** Regularly review existing funds. This goes beyond assessing performance and includes ensuring the description of the product and the fees and costs are understood by investors, distributors and brokers.
- 3** Establish processes to ensure you are listening to investors and understanding their needs. Collect feedback on fees, advice, value and act on it.
- 4** Boards must demonstrate they have made disclosure and transparency a priority. While it remains the responsibility of fund managers to accurately and clearly describe the fund and the costs associated with it, the scrutiny on fund management companies has never been greater. ■

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⁴ <https://business.financialpost.com/investing/ontario-comes-out-against-csa-proposal-to-ban-certain-embedded-mutfund-commissions>

⁵ <https://home.kpmg.com/content/dam/kpmg/xx/pdf/2018/05/no-let-up-on-costs-and-charges.pdf>

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The second global report on IFRS 17 and 9 implementation efforts. Includes highlights on where insurers are on their journey, some of the key challenges they continue to experience and what they need to do now to ensure successful implementation for 2021.



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