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cutting through complexity

FINANCIAL SERVICES

New Commission, New Parliament

An agenda for Financial Services in the European Union

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New Commission, New Parliament

The last European Commission and Parliament were formed as the full scale of the financial crisis was still unfolding. As a result, they focused on post-crisis repair, the resilience of individual financial institutions and wholesale markets, and the stability of the financial system. Five years on, the impacts of the crisis – and indeed of the regulatory reform agenda itself – are still working their way through to financial markets and the wider economy.

KPMG believes that the formation of a new Commission and Parliament provides an opportunity to re-evaluate the work programme within the current political and economic context, and to build for the future around four key imperatives:

First, the agenda needs to change to delivering jobs and growth, underpinned by competitiveness, competition and innovation.

Second, positive action is required to promote the contribution that the financial sector can make to jobs and growth. Long-term financing needs to be facilitated and encouraged; European capital markets need to be developed; and banks need to restore their role as providers of loans, trade finance and risk management services.

Third, the regulatory reform agenda needs to be revisited and rebalanced. Although many of the individual measures were necessary, the number of measures and the severity of their calibration has resulted in a negative impact of regulation on economic growth in Europe.

Fourth, greater certainty is required about the end-point of regulatory reform, to enable financial institutions and their customers to plan more effectively for the long term.

This paper proposes specific measures to deliver these objectives.

Proposals on financing jobs and growth are set out on pages 6-11; and proposals on revisiting financial regulation on pages 12-15.

In addition, banks in particular need to restore trust and confidence, through decisive improvements in their culture and behaviour.

KPMG's perspective...

The regulatory reform agenda needs to be re-evaluated for two reasons.

***First,** the current agenda is overly-focused on achieving ever-greater safety and soundness in financial institutions, in the hope that – at some point – this will begin to facilitate financing and growth. This ignores the strong likelihood that ever-greater regulation has already taken Europe to a position in which further safety and soundness is being bought at the expense of growth, both now and over the longer term.*

***Second,** the focus of regulatory reform needs to shift to the positive contributions that the financial sector can make to the EU's jobs and growth agenda.*

Five actions are required to re-position the regulatory reform agenda so that it promotes jobs and growth:

1 Call a halt to some regulatory proposals

Drop the EU legislative proposals on banking structural separation and the long-running and confused proposals for a Financial Transactions Tax.

Cap the cumulative impact of the multiplicity of additional capital requirements.

2 Provide greater certainty

Provide a more certain environment for both financial institutions and their customers.

Ruthless prioritisation of what needs to be done, and pause the implementation of unfinished reforms until at least 2017.

3 Rebalance and recalibrate regulation

Pay more attention to the cumulative impact of existing and proposed regulatory reforms on the wider economy.

Recognise the risk that over-regulation in both prudential regulation and in consumer and investor protection will take us towards the "stability of the graveyard".

4 Develop EU capital markets

Identify and remove restrictions holding back dynamic and innovative capital markets in the EU.

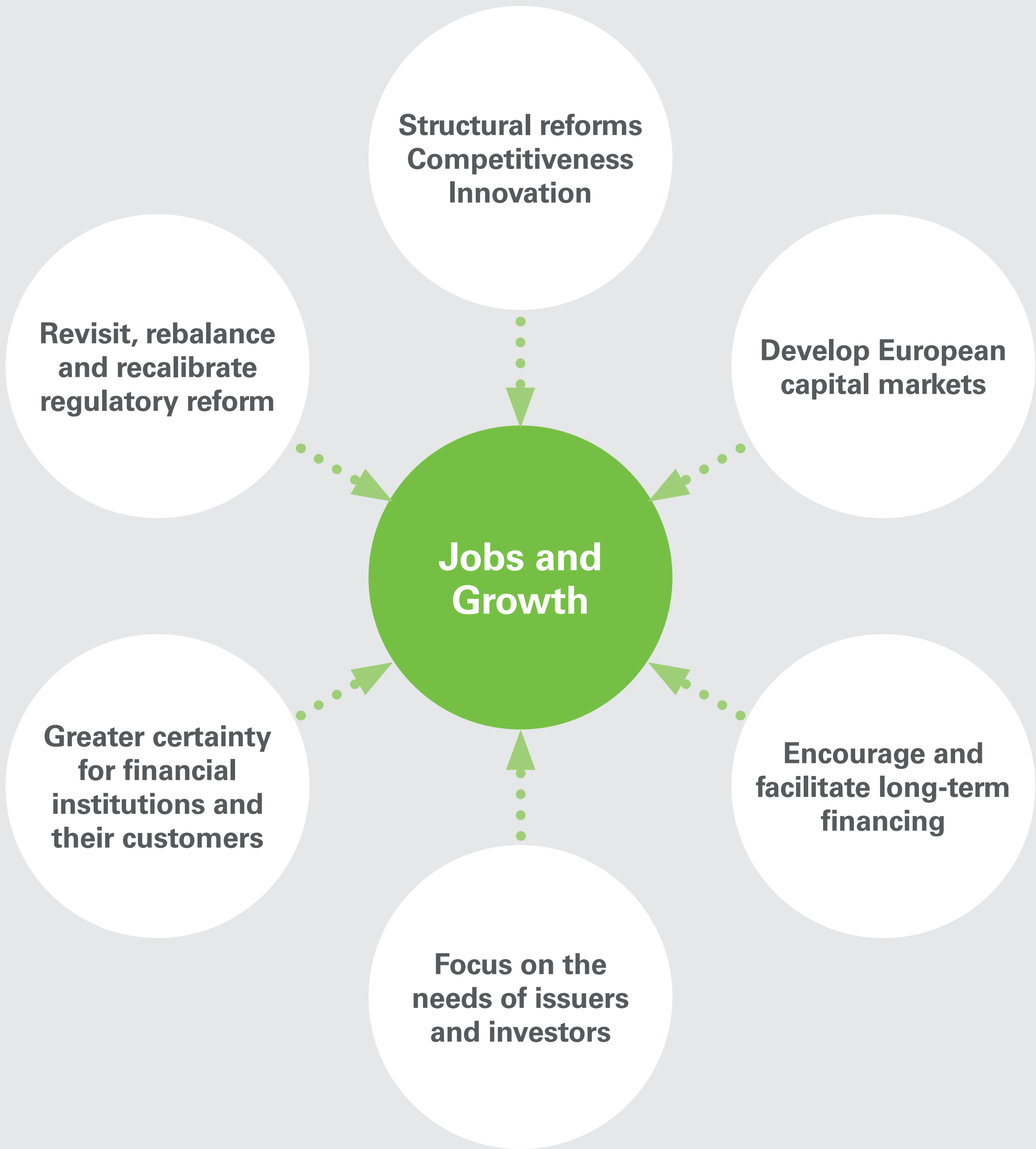
Complete the minimum harmonisation of national legislation and tax systems necessary to support efficient and effective EU capital markets.

5 Encourage and facilitate long-term financing

Reduce the regulatory constraints on the provision of long-term infrastructure finance by insurers, asset managers and banks.

Reduce the regulatory constraints on the issuance and holding of high quality securitisations, including the securitisation of SME financing.

An agenda for Financial Services in the European Union



State of play on financial regulation

Wide-ranging EU measures completed since 2009 are summarised in Table 1. These cover all sectors of financial services, prudential and conduct of business requirements, wholesale and retail markets, resilience and resolution, and the introduction of Banking Union in the euro area.

The unrelenting pressure for more regulatory reform shows no sign of abating. There are four main drivers of this in Europe:

First, recently enacted EU legislation requires a massive number of technical standards to be developed by the three European Supervisory Authorities (ESAs) – the EBA,

Table 1: The post-financial crisis EU regulatory reform agenda

Institutional structure	• European Supervisory Authorities (EBA, EIOPA and ESMA) • European Systemic Risk Board • Banking union, Single Supervisory Mechanism and Single Resolution Fund
Banking	• Capital, leverage and liquidity rules (CRR) • Macro-prudential tools (CRR and CRD4) • Corporate governance and remuneration (CRD4) • Deposit guarantee schemes • Recovery and resolution • Responsible lending (mortgages) • Access to basic bank account
Capital markets	• OTC derivatives (EMIR) • Wholesale trading markets (MiFIR and MiFID2) • Central securities depositories • Market abuse
Insurance	• Risk-based solvency rules and supervisory framework (Solvency 2 and Omnibus 2)
Asset management	• Retail investment funds (UCITS V) • Hedge funds and private equity (AIFMD) • European venture capital funds • European social entrepreneurship funds
Consumer protection	• Product design and sales, advice (MiFID2) • Key information documents
Other	• Strengthened supervision of financial conglomerates • Credit rating agencies • Short selling and credit default swaps • Single euro payments area • Accounting, audit and transparency

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EIOPA and ESMA. Some Regulations and Directives in the financial sector require more than 100 such standards to be developed. In addition, the ESAs are developing voluminous supplementary guidelines for national competent authorities.

Second, there is a substantial pipeline of unfinished EU business – already proposed financial reform measures – for the next Commission and Parliament to grapple with.

These include:

- structural separation of banks,
- regulation of money market funds and other elements of 'shadow banking',
- regulation of financial benchmarks,
- strengthened regime on anti-money laundering,
- resolution of clearing houses,
- financial transactions tax,
- investor compensation schemes,
- second insurance intermediation directive on the sale of insurance products,
- long-term investment funds, and
- occupational pension funds.

Third, the EU will be under pressure to respond to the even longer list of unfinished business in the setting of international standards by the Financial Stability Board (FSB) and the three international sector-based standard setters (the Basel Committee, the IAIS and IOSCO):

- For banks, this includes what KPMG has called the 'Basel 4' agenda of finalising the minimum leverage ratio; constraining the internal model-based approach to calculating capital requirements; tougher limits on large exposures; setting minimum requirements for gone concern loss absorbing capacity; and higher standards of risk data aggregation and reporting.
- For insurers, just as the EU has finally reached agreement on the implementation of Solvency 2, there is significant movement at the international level on introducing a basic capital requirement, capital surcharges, recovery and resolution requirements and more intensive supervision for systemically important insurers; and on introducing international standards for a more sophisticated capital framework that will apply to all internationally active insurance groups.
- There has been a surge in outputs from the FSB on risk governance.
- The FSB is developing its five work streams on shadow banking, covering money market funds, repo and securities lending markets, the connections between banks and shadow banks, the identification of other non-banks that potentially pose systemic risk, and securitisation.
- The FSB is also pushing forward on the consumer agenda, some aspects of which could extend beyond the existing and proposed EU legislation and the consumer issues being taken forward by the ESAs.

Fourth, the European Central Bank is taking an understandably risk-averse approach, initially in the context of its Asset Quality Review and its joint stress test with the EBA, but also probably thereafter in both its supervisory activities and its input to regulatory developments.

Financial institutions – and especially banks – are therefore facing both an ever-increasing regulatory and supervisory burden and continuing uncertainty about where all these initiatives will end up.

There is also a serious risk that the post-crisis regulatory reform agenda will not only continue to crowd out the jobs and growth agenda, but will drive Europe even further past the "tipping point" at which the costs of ever more regulation exceed the benefits, with financial institutions becoming even less able and willing to provide SME and long term financing and other financial services to their customers.

Changing mandate, changing priorities

Financing jobs and growth

The current regulatory reform agenda is overly-focused on the single dimension of promoting ever-greater safety and soundness, in the hope that – at some point – this will begin to facilitate financing and growth. This ignores the strong likelihood that ever-greater regulation has taken Europe to a position in which further safety and soundness is being bought at the expense of growth, both now and over the longer term.

It is time to switch to a second dimension, in which finance is viewed as a facilitator of jobs and growth, alongside greater competition, competitiveness and innovation. This requires the promotion of long-term financing, of capital markets and an equity culture, and of alternative channels of financial intermediation.

To achieve this, a much clearer and more detailed EU vision is required - high level platitudes are not a sufficient basis for real progress here.

This paper therefore outlines a series of specific proposals for encouraging and facilitating the contribution of the financial sector to jobs and growth in the wider economy.

These proposals are based on three underlying propositions:

First, public sector financing is constrained by currently high levels of government expenditure, high government deficits, and the rising costs of education, health and pensions. Moreover, the public sector is not always best placed to identify and deliver profitable investment opportunities. There needs to be a greater focus on private sector funding, not least for roads, rail and digital technology infrastructure.

Second, long-term infrastructure financing and the provision of longer-term financing for SMEs is usually best undertaken by long-term investors – either directly or through capital markets (equities and bonds) – rather than by bank lending.

Third, European capital markets remain under-developed, for reasons ranging from the lack of an equity culture to differences across national legislation. There is a need for deeper and more liquid capital markets, and for a single capital market that enables and facilitates effective and efficient long-term intermediation for the benefit of issuers and investors.

It is time to switch to a second dimension, in which finance is viewed as a facilitator of jobs and growth.

Developing EU capital markets

The Commission should consider why the EU is so different from the US in terms of the size of its capital market and why so many European companies source finance through the US market. The US has been more successful in developing an equity culture among both investors and corporations.

Consider to what extent capital markets in the EU are being constrained by legislative or regulatory restrictions. It is unlikely that an effective capital market can be created simply through additional legislation and other government interventions.

Ensure that any moves towards a 'capital markets union' focus on creating a genuine single market, with deeper and more liquid European capital markets that meet the needs of companies wanting to raise funds and of investors.

Remove the preferential tax treatment of interest payments relative to dividends. Current systems of tax relief on interest payments favour the issuance of debt over equity as a means of funding businesses (including the funding of banks).

Develop a private placements market, making it easier to fund finance within Europe.

Greater education of consumers and investors about longer term and equity investing.

Take a more global approach to the EU financial sector – many financial institutions and their customers are global, not confined to the EU.

Remove trade barriers, in particular by including the financial sector within the trans-Atlantic and other trade negotiations.

Tackle the fundamental lack of competitiveness of many European economies. This is not specific to the financial sector, but in some cases the lack of competitiveness (and competition) extends to financial services. Moreover, regulatory reform may be having a negative impact on competitiveness in financial services.

Commission road map for long term financing needs to be strengthened

Strengthen the Commission road map[1] to meet the long term financing needs of the European economy. Apart from the ELTIF proposals (see page 10), this road map does little more than to repackage a number of initiatives that are already more or less in progress, with too much emphasis on the 'solution' being more official intervention, not less. The road map needs to be based on more specific and detailed proposals on changes to the regulation of banks and insurers; how European capital markets could be developed; what is really meant by "better use of public funding"; and the extent to which the availability of greater information on infrastructure investment plans would attract more private finance to infrastructure investments.

Undertake better analysis of the underlying problems that are causing the lack of financing of infrastructure and for SMEs; and of whether initiatives that have been successful in some countries (for example in Germany) could be replicated elsewhere. This could form part of an improved Commission road map.

Focus on the provision of enhanced credit information on SMEs, to encourage the development of both bank and alternative financing channels.

Increased government-backed long-term financing (in whole or through guarantees or government agencies – as with the EIB) alongside the private sector financing of productive ventures.

A greater focus on jobs and growth in the impact assessment of new legislation and in post-implementation reviews, and a shift away from relying on the unfounded assertion that ever-safer banks are necessarily better placed to provide additional financing (if banks were funded entirely by capital they could play only a very limited role in financing the wider economy).

1 *Commission roadmap to meet the long-term financing needs of the European economy* European Commission, March 2014.

Encouraging insurers to provide more long-term funding for infrastructure investments

Recognise the role that insurers could play in the provision of longer-term financing, in particular where insurers have long-term liabilities.

Take a more accommodating approach to long-term infrastructure investment within Solvency 2. Although Solvency 2 has been helpful in lifting some restrictions on long-term infrastructure investment by insurance companies, this could be taken further by reducing the high capital charges applied to longer duration and lower rated investments, and to unlisted equity; ensuring that insurers are not penalised by the application of a look-through approach to investment in collective investment schemes (which will include the new European long-term investment funds – see below); recognising the difficulties in obtaining sufficient data for the use of internal models in these types of investments; relaxing the requirements on asset and liability matching (because infrastructure investments tend to generate no income stream in the early years, with an uncertain level and timing of returns thereafter); and reducing the requirement for a "prudent" limit (currently usually 10%) on investments that are not traded on a regulated financial market.

Take steps to avoid the potentially negative impact of Solvency 2 and stress testing on insurers' holdings of equity – a Bank of England paper[2] identifies risk-sensitive regulatory requirements as a contributory factor in the structural switch from equities to safer assets by UK insurance companies and pension funds over the last 20 years, with adverse consequences for the appropriate allocation of capital in the real economy.

Allow infrastructure investments to be tranched. Insurance companies and other investors would find it easier to invest in infrastructure if there was scope for these investment opportunities to be structured in tranches, with junior claims being more equity-like and thus potentially more attractive to hedge funds, while senior tranches could be structured to be more bond-like (with lower but more regular returns and with more scope for external ratings).

Encourage investment in capital issues by improving secondary market liquidity in corporate bond issues. Secondary market liquidity has declined significantly as a result of penal capital requirements and moves to impose structural restrictions on banks.

Provide certainty over the tax regime for long-term investments.

2 *Procyclicality and structural trends in investment allocation by insurance companies and pension funds,* Bank of England Discussion Paper, July 2014.

Supporting asset managers to invest more in infrastructure

Implement the proposals for European Long-term Investment Funds (ELTIFs). This would be a constructive attempt to increase the funding of long-term investments, through ELTIFs managed by authorised alternative investment fund managers. These funds will be able to invest in long-term illiquid assets such as unlisted companies, infrastructure projects and real estate, as well as in other ELTIFs, European venture capital funds and European social entrepreneurship funds.

Increase the supply of funds by improving access to EU asset management products in non-EU markets.

Developing EU capital markets
Commission road map for long term financing needs to be strengthened
Encouraging insurers to provide more long-term funding for infrastructure investments
Supporting asset managers to invest more in infrastructure
Promoting bank lending to SMEs and infrastructure

Promoting bank lending to SMEs and infrastructure

Promote "high quality" securitisations of bank lending, in the context of SME lending and more generally. A recent paper by the European Central Bank and the Bank of England[3] set out the arguments here. But it did not follow this up with specific proposals to reverse the many post-financial crisis regulatory constraints on securitisations (high capital requirements, retention requirements, and limited scope to use securitisations as high quality liquid assets under the liquidity coverage ratio). These constraints have discouraged "high quality" and "simpler" securitisations. **One simple improvement here would be to treat high quality securitisations in the same way as covered bonds in capital and liquidity requirements for banks,** with the capital implications of holding such assets also reassessed on the buyers' side (other banks and insurance companies).

Reduce the regulatory disincentives for banks undertaking long term financing, albeit while still recognising the inherently risky nature of this business. For example, when finalising the net stable funding ratio, greater recognition should be given to "desirable" long term lending (trade finance, SMEs and infrastructure). More radically, this ratio could be replaced with a much simpler limit on the use of short-term wholesale funding by banks.

3 *The case for a better functioning securitisation market in the European Union* Bank of England and European Central Bank Discussion Paper, May 2014.

Revisiting financial regulation

Waves of regulatory reforms have been introduced since the financial crisis, to make financial institutions safer, to make the financial system more stable, and to shift the costs of failures from taxpayers to the creditors of, and shareholders in, failing institutions. Seven years after the financial crisis began, the flurry of EU legislative activity on financial services in April this year was not the end of the road for regulatory reform but merely an artificial break point necessitated by European Parliament elections and the appointment of a new Commission.

The Commission's comprehensive review of the financial reform agenda, published in May this year, claimed that the benefits of the regulatory reform measures introduced since the financial crisis will far exceed their costs.

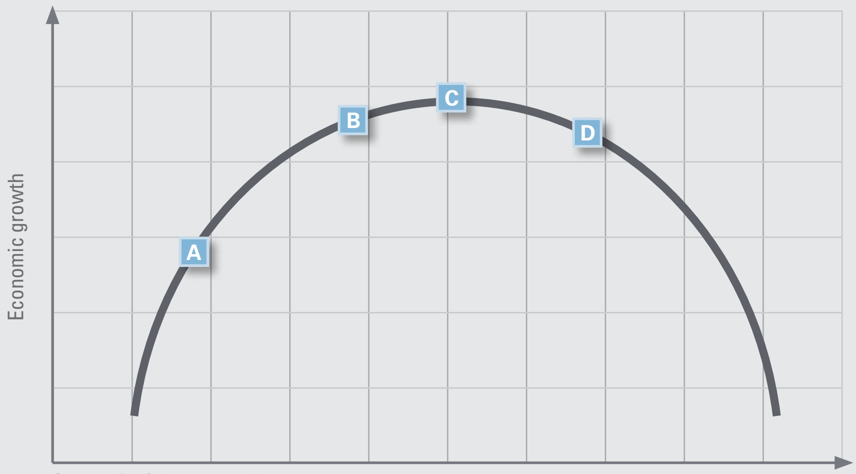
However, KPMG's financial sector regulation experts have argued that the relentless introduction of more and more regulation may already have taken many economies, especially in Europe, beyond the 'tipping point' to a position where the costs of regulation exceed the benefits.

The introduction of more and more regulation has increased the cost, reduced the availability of financial services and reduced innovation in financial services. Its negative impact on economic growth has been seen most powerfully and immediately in the downward spiral of bank deleveraging and weak or negative economic growth in Europe over the last few years. Banks have exited many markets, shrunk their balance sheets, sold capital- and liquidity-intensive assets, and pulled back from the provision of risk management services to their customers.

KPMG believes that three actions are required to deliver regulatory reforms that are compatible with the jobs and growth agenda: **halting some proposals; rebalancing some existing regulations; and providing greater certainty.**

The relationship between regulation and economic growth may be illustrated by a simple chart, plotting these two variables. There is general agreement that before the financial crisis we were at point A, where too little regulation contributed to the costs of financial crises on economic growth. Official estimates of the Basel 3 capital and liquidity reforms moved regulation up to point B, leaving scope for additional regulatory reforms before reaching the 'optimal' point C. However, the evidence in Europe – in particular the extent of deleveraging by banks – suggests that we have moved beyond point C to point D, where excessive regulation is so damaging to the wider economy that the net impact of regulation on economic growth has become negative[4].

Regulation versus economic growth



Source: KPMG International, May 2013.

4 This is discussed further in chapter 2 of *Evolving Banking Regulation*, KPMG International, February 2014.

Calling a halt and providing greater certainty

The EU legislative proposals on banking structural separation should be dropped. They will not add significant value in addition to other regulatory reforms already under way on capital and liquidity, market resilience, recovery and resolution, and the more intensive supervision of systemically important banks. And national requirements on structural separation have already been introduced in the key jurisdictions of France, Germany and the UK.

The long-running and confused proposals for a Financial Transactions Tax should be dropped. They are too focused on taxing banks for their past misdemeanours, and will have only negative impacts on jobs and growth in the wider economy.

A cap should be placed on the cumulative impact of the multiplicity of additional capital requirements – current and prospective – especially on banks. Although EU legislation recognises that capital requirements should not be additive where they address the same risks, many regulators have seized the opportunity to regard these requirements as being purely additive. For example, Sweden and Norway have introduced both a large systemic risk buffer on their banks and capital surcharges on systemically important banks. Recent advice to the Commission from the European Systemic Risk Board also argues in favour of an additive approach.

The Enhanced Disclosure Task Force proposals for greater disclosure and market discipline should be adopted as an alternative to ever-tougher and less risk-sensitive capital requirements, not simply as an addition to them.

Provide a more certain environment in which financial institutions – and their customers – can operate.

Ruthless prioritisation of what needs to be done to complete the regulatory reform agenda, and then taking these priorities forward as rapidly as possible.

Alternatively, call a pause to the regulatory reform agenda, with a stock-taking and re-assessment in 2017/18.

Make macro-prudential policy more certain and more predictable, to avoid banks having to hold precautionary buffers against the prospect of macro-prudential instruments being utilised.

Clarify the division of responsibilities between the ECB and national macro-prudential authorities in operating macro-prudential policy within the banking union.

Achieve greater global consistency to avoid the complexity, cost and distortions of inconsistent regulations globally and across sectors.

Rebalancing and recalibration

Take a proportionate view and focus on the cumulative impact of regulation

Financial services are not zero-risk businesses – failures will occur from time to time and regulation should focus on recovery where possible, and if not possible, then on orderly exit with minimal disruption to the wider economy.

Regulators should pay careful consideration to the cumulative impact of existing and proposed regulatory reforms, and should take a more proportional view, especially when considering the long list of 'unfinished business'.

Assess carefully the proposals for constraining the use of banks' internal models in calculating capital requirements (through higher risk weightings on exposures and through a minimum leverage ratio) to avoid disproportionate increases in capital requirements and a regulatory framework that is insufficiently risk sensitive.

Avoid automatic capital add-ons in response to the proposed creation of early warning indicators in relation to insurers' Solvency 2 internal models.

Take a proportional view when setting requirements on banks to hold additional gone concern loss absorbing capacity, and when imposing corporate structures to facilitate preferred approaches (single or multiple points of entry) to bail in. The evolution of resolution regimes for non-banks will also need to be proportionate, taking account of their different risk profiles.

Reduce the extent to which regulatory requirements and the increased supervisory focus on business models act as barriers to entry in banking, insurance and asset management.

Recognise the risk that over-regulation in consumer and investor protection will take us towards the "stability of the graveyard" rather than to a position in which consumers and investors make adequate provision for saving, investment and protection. A better approach would be to introduce a more consistent framework across sectors, to reduce overlaps and inefficiencies.

Macro-prudential policy makers should take more account of the progress already made in improving the resilience of banks when considering the use of macro-prudential tools.
They also need to take greater account of the potential impact of these tools on the wider economy.

Take a broader view of where regulation needs to adjust to market realities

The post-crisis approach to 'shadow banking' should focus primarily on risks to financial stability, not – as in the EU – on imposing bank-like regulation on anything that looks vaguely bank-like, in the name of addressing 'regulatory arbitrage'. This fails to recognise the importance and value of some alternative channels of finance, both for consumers and for facilitating economic growth.

The quest for ever-greater harmonisation may already have gone too far, imposing costs that exceed the benefits. The focus here should shift more towards what is necessary for competition to thrive. A smaller set of minimum standards would in many areas provide sufficient equivalence and sufficient protections for consumers. Similarly, the single market should not necessarily be "one size fits all". Smaller financial institutions face disproportionately high costs of regulation.

European authorities need to play an active role in achieving workable global cross-border resolution. The EU legislation on bank recovery and resolution planning makes cross-border resolution possible within the EU, and provides one possible basis for a global solution.

Focus more on the potential causes of the next crisis, be this from different threats to banks such as fraud, systems failures and cyber security, or from non-bank activities (for example, insurance or securities firms, or financial market infrastructure) within the financial sector, rather than imposing ever-increasing measures to prevent a recurrence of the current financial crisis.

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