cutting through complexity

# Brisbane G20 summit

A new agenda for financial services

November 2014

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# Foreword

by Jeremy Anderson
Chairman KPMG's Global Financial Services

As the G20 shifts its attention from fixing the problems of the last financial crisis to jobs and growth, the Brisbane summit provides an opportune moment for policy-makers to reflect upon two key questions for regulatory reform: how can we maximise the contribution of the financial sector to jobs and growth, and, given the current stage of global economic recovery, should we press the pause button on additional major reform initiatives?

The answers to these questions will be of critical importance to the strength of the world economy, to financial institutions and to their customers. We need an informed debate here between policy-makers and the financial sector. The world economy may have stabilised, but it remains fragile and, in balancing resilience and growth measures, we must ensure that downside risk from a lack of financing does not increase.

## First, how can we maximise the contribution of the financial sector to jobs and growth?

It is important that the G20 recognises the many contributions that the financial sector can make to jobs and growth. The key growth strategies identified by the G20 – investment in infrastructure, reducing trade barriers, competition and labour market participation – can all be supported by the financial sector, through lending, investment, capital markets, insurance, fund management, payment and settlement systems, and risk management.

The G20 therefore needs to shift its focus on regulatory reform to consider how this contribution of the financial sector can be encouraged and facilitated. We do not have all the answers here, but to promote debate on this subject we offer some proposals in this paper, including:

- Adjusting the capital and liquidity requirements on banks undertaking long term financing and trade finance;
- Treating the issuers and holders of high quality securitisation more like the issuers and holders of covered bonds;
- Refining capital charges, improving market liquidity and providing a more predictable tax regime for insurers and other long-term investors in infrastructure and the corporate sector;
- Developing capital markets, in particular in countries and regions where non-bank intermediation plays a small role; and
- Providing mechanisms for greater long-term investment through managed funds.

## Second, has the current regulatory reform agenda gone too far?

The G20 has placed an understandable emphasis on increasing the safety, soundness and resilience of the financial system. But there comes a point where the costs of moving ever further in this direction – the higher costs and reduced availability of financial products and services, the localisation and fragmentation that arise from the inconsistent implementation of regulatory reforms across jurisdictions, and the continuing uncertainty over the end point – outweigh the benefits of reducing the probability of another financial crisis. A completely safe financial sector would be of little economic and social value.

Many believe this tipping point has already been passed, in particular in Europe. Again, we do not have all the answers here, but we propose in this paper that regulators should be brave and bold in:

- Focusing more on the cumulative impact of regulation on the financial sector and on the wider jobs and growth agenda;
- Re-evaluating the cost benefit analysis of some regulatory reforms;
- Prioritising the remaining initiatives, and providing greater certainty on the substance and timing of these remaining initiatives; and
- Reducing inconsistencies in the implementation of international regulatory standards.

Meanwhile, we call upon banks, in particular, to intensify their efforts to introduce cultural and behavioural change, so that regulators can more comfortably take a step back. We need to break out of the ultimately unproductive environment we find ourselves in; often regulators believe that they need to tackle everything because parts of the financial sector cannot be trusted to play their part in improving standards.

# Introduction

The G20 is hoping that the November Brisbane summit will be the last time a significant political impetus is required to finalise the direction of travel of regulatory reform in financial services.

The G20 wants its primary focus to become its jobs and growth agenda. There is however a tension between financial stability and wanting the financial services sector to contribute to the creation of jobs and economic growth.

Implementation of the regulatory reform agenda will continue for many years to come but - if sufficient agreement can be reached at the Brisbane summit - without the Financial Stability Board (FSB) taking a front row seat at the G20.

The key regulatory reform issues for the Brisbane summit will include proposals for systemically important financial institutions to hold a minimum amount of gone concern loss absorbing capacity; cross-border resolution; shadow banking; and international consistency in the regulation of derivatives markets.

**KPMG view:**

**Rather than simply letting regulatory reform run its course, the G20 needs to adjust the direction and details of these reforms so that financial services can make a more positive contribution to jobs and growth. In particular:**

- Long-term financing by insurers and asset managers and other channels of intermediation need to be facilitated and encouraged;
- Capital markets need to be developed, particularly outside the US;
- Regulatory constraints/ disincentives to banks fulfilling their role as providers of loans, trade finance and risk management services need to be reduced; and
- Financial institutions, their customers and investors need to see more consistency and certainty in financial regulation.

Meanwhile, the key regulatory issues being taken to Brisbane will not be fully resolved at the summit. Considerably more policy development and consultation will be required after the summit. New commitments are likely to emerge. And the key issues are only a small part of an unfinished regulatory agenda.

# Key messages

**The direction and details of regulatory reform need to be adjusted to facilitate the contribution of the financial sector to jobs and growth...**

We set out in this paper specific proposals to promote and facilitate the contribution of the financial sector to the wider economy.

The regulatory disincentives (both capital and liquidity requirements) for banks undertaking long term financing and trade finance should be reduced, albeit while still recognising the inherently risky nature of this business.

Insurers and other long-term investors could provide more infrastructure, SME and other long-term financing if capital charges on such financing were reduced, market liquidity was improved, and more predictable tax regimes were in place.

A more accommodating capital treatment for both issuers and holders of high quality securitisation could revitalise the safer parts of the securitisation market, and potentially enable the securitisation of SME loans.

Capital markets and other alternative sources of finance should be encouraged to develop, especially in countries and regions where these types of intermediation currently play a small role in the financing of the wider economy.

European proposals for long-term investment funds open to both retail and professional investors should encourage greater long-term investment through managed funds.

**Continue reading:**

**Recognising the potential contribution of the financial services sector to jobs and growth**

**Pages 8 - 11**

### The regulatory issues being taken to the Brisbane summit will be difficult to resolve...

International agreement on gone concern loss absorbing capacity, cross-border resolution, the regulation of shadow banking, and derivatives clearing and reporting will be difficult to reach. Any broad consensus on the way forward here tends to break down at the level of detail and national implementation.

International inconsistency in application is therefore likely to remain a key concern for financial institutions and their customers, with localisation and fragmentation imposing potentially high costs on users of financial products and services.

Continue reading:

Key issues that the FSB will bring to Brisbane — Pages 13 - 17

### The current regulatory reform agenda may be imposing unnecessarily high costs on the financial sector...

We set out specific proposals in this paper to address the significant cumulative impact of regulation on the financial sector and its customers.

Regulators should focus more on the cumulative impact of regulation; on the scope for prioritising specific regulatory measures while pausing others; on reducing the damaging impact of the continuing uncertainty about the end point of regulation; and on providing greater international consistency in the implementation of international standards.

Meanwhile, banks in particular need to take decisive actions themselves to restore trust and confidence.

Continue reading:

Meanwhile, the rest of the regulatory reform agenda rolls on — Pages 18 - 23

# Recognising the potential contribution of the financial services sector to jobs and growth

## A proposed agenda for the Brisbane summit...

In February 2014, the G20 Finance Ministers and Central Bank Governors committed to developing new measures with the ambitious objective of raising the level of G20 output by at least 2 per cent above the currently projected level in the next five years. A Brisbane Action Plan, to be discussed by the G20 at the November summit, is intended to put in place short and medium-term actions to help achieve this objective.

The main focus of growth strategies will be on macroeconomic and structural reforms at the national level in four areas with the greatest potential to lift global growth:

- Increasing quality investment in **infrastructure**. The G20 is focusing on finding ways to boost private sector involvement in infrastructure development.
- **Reducing barriers** to trade. National measures to enhance countries' ability to participate in global value chains can facilitate increased trade activity, fuelling economic growth.
- **Promoting competition**. Reforms to promote competition help economies become more productive and innovative.
- Lifting **employment and participation**.

**KPMG view:**

The G20 should recognise the importance of the financial services sector in contributing to jobs and growth. The table below illustrates the contributions that the financial sector can make to each of the four growth areas identified by the G20.

| | Infrastructure | Competition | Employment | Trade |
|---|---|---|---|---|
| Credit | ✓ | ✓ | ✓ | ✓ |
| SME financing | | ✓ | ✓ | ✓ |
| Trade finance | | | | ✓ |
| Equity and bond markets | ✓ | ✓ | ✓ | |
| Insurance | ✓ | ✓ | ✓ | ✓ |
| Risk management | ✓ | | | ✓ |
| Payment and settlement systems | | | ✓ | |
| International payment and settlement systems | | | | ✓ |
| Supply chain finance | | | ✓ | ✓ |
| Long term investment | ✓ | | ✓ | |
| Fund management | ✓ | | ✓ | |

Source: KPMG International 2014

The current regulatory reform agenda is overly-focused on the single dimension of promoting ever-greater safety, soundness and stability. Significant 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.

However, this regulatory burden has increased the costs, 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 its contribution to 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.

Financial stability is clearly important. However a balance must be struck between a very stable, albeit lack-lustre market, and a market that creates the right conditions to sustain economic growth and job creation. Excessive regulation risks stifling responsible and sustainable growth.

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

It is therefore time to add a second dimension, in which the financial sector is viewed as a facilitator of jobs and growth. This requires a change in regulatory focus to supporting jobs and growth. The G20 should therefore instruct the FSB – and through the FSB the international standard setters – to focus on a revised agenda, as set out on pages 10-11.

# Recognising the potential contribution of the financial services sector to jobs and growth

## Encourage bank lending to SMEs, infrastructure and trade finance

- Reduce the regulatory disincentives (both capital and liquidity requirements) for banks undertaking long term financing and trade finance, albeit while still recognising the inherently risky nature of this business.
- Promote "high quality" securitisation 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[1] set out the arguments here, but did not follow this up with specific proposals to reverse the many post-financial crisis regulatory constraints on securitisation (high capital requirements, retention requirements, and limited scope to use securitisation as high quality liquid assets under the liquidity coverage ratio). One simple improvement here would be to treat high quality securitisation in the same way as covered bonds in capital and liquidity requirements (for both issuers and holders of these securitisation).

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

## Encourage insurers and other long term investors to provide more funding for infrastructure, SME and other long-term investments

The role that insurers could play in the provision of longer-term financing needs to be recognised and encouraged, in particular where insurers have long-term liabilities.

- Take a more accommodating approach to long-term infrastructure and SME investment within risk-based solvency requirements for insurers, such as Solvency 2 in the EU. This could include:
  - reducing the high capital charges applied to longer duration and lower rated investments and unlisted equity;
  - ensuring that insurers are not penalised by the application of a look-through approach to investment in collective investment schemes;
  - 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 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 recent Bank of England paper[2] identified 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.
- Address the design and contractual arrangements that may be holding back investment in infrastructure projects[3], and 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.

[3] *Understanding the challenges for infrastructure finance*, BIS Working Paper 454, August 2014.

## Encourage asset managers to invest more in infrastructure

- Proposals in Europe for Long-term Investment Funds (ELTIFs) provide a constructive example of an 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.

## Develop capital markets

Outside the US, the under-development of capital markets and the reliance on bank financing has accentuated the negative impacts of the financial crisis.

- Other countries should consider how the US developed an equity culture and capital markets more generally. Greater education of consumers and investors about longer term and equity investing may have a role to play here.
- The FSB should encourage jurisdictions to assess the extent to which capital market development is being held back by legislative or regulatory restrictions. The focus needs to be on creating deeper and more liquid capital markets, attuned to the needs of investors and of companies wanting to raise funds. Effective, efficient and dynamic capital markets cannot be created simply through additional legislation and other official interventions.
- The preferential tax treatment of interest payments relative to dividends should be reconsidered. Current systems of tax relief on interest payments create an unhelpful incentive for the issuance of debt over equity as a means of funding businesses (including the funding of banks).
- Private placement markets need to be developed.
- In under-developed markets, the authorities should consider making benchmark issuers, or encouraging major borrowers to do the same.


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# Key issues that the FSB will bring to Brisbane

The post-financial crisis work programmes of the FSB and the three main international regulatory standard-setters in banking (Basel Committee on Banking Supervision, BCBS), insurance (International Association of Insurance Supervisors, IAIS) and securities (International Organisation of Securities Commissions, IOSCO) have been dominated by the four core areas on which the G20 has focused:

- **Building resilient financial institutions**, through higher levels and quality of capital and liquidity, limitations on leverage, more liquidity, and improved risk governance;
- **Ending "too-big-to-fail"** through both resilience and recovery and resolution – allowing large financial institutions to be resolved in an orderly manner and without taxpayer bail-outs;
- **Addressing shadow banking risks**, by understanding these risks, regulating non-bank credit intermediation, and limiting the interconnectedness between banks and the shadow banking sector; and
- **Making derivatives markets safer**, through the central clearing of derivatives.

The FSB will bring a set of proposals on these four core areas to the Brisbane summit with the intention that the G20 will provide sufficient political support to enable the FSB and the international standard setters to finalise the details over the next few years, without the need for further G20 level input and guidance.

The FSB has also entered the **trust and culture agenda**, through its initiatives on benchmarks and indices, and on how supervisors can measure risk culture. The FSB will bring to the summit a progress report on its work on strengthening the existing LIBOR, Euribor and TIBOR financial benchmarks, along with possible alternatives.

# Key issues that the FSB will bring to Brisbane

## Ending "too-big-to-fail"

### Gone concern loss absorbency capacity ("LAC")

The bail-in tool is a key component of the set of resolution powers that national authorities should have in place to deal with failing financial institutions. Clearly a lack of confidence at the point of resolution requires attention to liquidity – however maintenance of capital buffer is equally important. The bailing-in of creditors when a financial institution is placed into resolution provides an alternative to a bail-out using taxpayer funds and to a liquidation under ordinary insolvency procedures. The writing down or conversion into equity of creditors' claims provides a means of meeting losses and of recapitalising a failing financial institution. This is clearly understood and supported in most jurisdictions.

But ever since the bail-in tool was first proposed there has been a debate about whether financial institutions – and in particular systemically important banks – should be required to hold a minimum amount of "junior" liabilities (LAC) that could be bailed in ahead of ordinary "senior" creditors. So, if a financial institution was placed into resolution, its equity and other tier 1 capital would be written off first; followed by the writing down or conversion into equity of its tier 2 capital; and then the writing down or conversion into equity of any other debt that is designated to be part of its available LAC. Other creditors would only be bailed-in if this proved insufficient to meet losses and to provide any required recapitalisation.

The FSB is due to bring high-level proposals to the Brisbane summit on:

- The types of liability that could be included within LAC;
- The minimum amount of LAC that banks should issue (with this minimum amount likely to depend on the systemic importance of each bank, globally and domestically); and
- Where in a banking group structure this LAC should be held – at parent/holding company level (the so-called single point of entry approach) or in each operating company (the so-called multiple point of entry approach).

The intention is that these proposals would be published for consultation (and a quantitative impact study would be undertaken) after the Brisbane summit, then finalised during 2015, and implemented over a lengthy transition period.

However, it remains unclear how much progress the FSB will be able to make on LAC ahead of the Brisbane summit, leaving open the possibility that any consultation will have to begin with some high level principles, leaving some difficult decisions to be taken later.

**KPMG view:**

Even if some high level principles can be agreed in Brisbane some difficult issues will remain:

- Jurisdictions where banks are funded predominantly by retail and corporate customer deposits are reluctant to force these banks to replace some of this funding by LAC debt instruments;
- Jurisdictions where some major banks are state-owned may not use the bail-in tool to deal with failing institutions, and so are reluctant to require banks to issue LAC debt instruments;
- It will be difficult to reach agreement on a minimum amount of LAC, on how this might vary across different types of bank, and on restrictions on which investors (in particular other financial institutions and retail investors) are allowed to hold LAC debt instruments (to avoid knock-on systemic impacts if these instruments had to be bailed in). In the EU, these issues were left to national discretion in the Bank Recovery and Resolution Directive;
- It may also be difficult to agree whether a minimum LAC requirement should be expressed as a percentage of risk-weighted assets or a non-weighted measure of a bank's balance sheet (or indeed both, as with the capital and leverage requirements for banks);
- It seems likely that both the single and multiple points of entry approaches will be allowed – the question here is whether the FSB will offer guidance on which approach would be preferred for different types of banking group;
- Even if international standards can be agreed for LAC, this will not prevent the localisation of LAC and bail-in requirements for bank subsidiaries in individual jurisdictions, just as, in some cases, local regulators have set local requirements for capital, liquidity, funding and corporate governance; and
- However much can be agreed for banks, difficult questions remain about the amount of LAC that should be held by other types of financial entities, such as insurance companies and financial market infrastructure.

# Key issues that the FSB will bring to Brisbane

## Cross-border resolution actions

Whatever powers are put in place by national authorities, the success of the cross-border resolution of a major financial institution will depend on a mixture of formal powers and more importantly the willingness of jurisdictions to cooperate with each other, and manage the risk of regulatory arbitrage. Otherwise major financial groups will continue, in the words of former Bank of England Governor Mervyn King, to be "global in life, but national in death".

The FSB will bring two proposals to the Brisbane summit on cross-border resolution.

First, arrangements for the bail-in of debt issued under foreign law, so that LAC can be bailed-in across a group as and when required.

Second, a mixture of statutory and contractual elements to facilitate temporary stays on close-out and cross-default rights in financial contracts when an institution enters resolution, so that counterparties do not use resolution as a trigger point for closing out derivatives and other contracts. As part of this, the industry has been asked to develop a proposal for a contractual approach and ISDA is working on a new protocol to introduce suspension of early termination or cross-default rights.

**KPMG view:**

Effective cross-border resolution remains by far the most important test of post-financial crisis international cooperation and coordination. The specific proposals being brought to the Brisbane summit are key elements of this, but they will not be sufficient in themselves to deliver effective cross-border resolution.

This will require either a fuller set of formal powers and binding commitments that apply cross-border (as the Bank Recovery and Resolution Directive provides within the EU), or a much stronger and wider-ranging set of international agreements that could be relied upon in the event of the need to resolve an international financial institution. Earlier moves towards international agreement – for example the discussions between the US and UK authorities – were a useful starting point, but some jurisdictions that have been excluded from these initial discussions reacted by intensifying their contingency planning for national solutions.

## Structural separation and other issues

The FSB is working on an assessment of the cross-border impacts and global financial stability implications of the structural banking reforms being implemented or proposed in some major jurisdictions.

The FSB will also bring to the Brisbane summit a report on identifying systemically important financial entities other than banks, insurers and financial market infrastructure.

**KPMG view:**

The FSB review of structural requirements on banks is to be welcomed if it recognises that these requirements 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.

As yet, the basis for identifying systemically important asset managers, finance companies and other such financial institutions remains vague. And considerably more thought needs to be given to the regulatory measures that would follow from the designation of any such financial institutions as being of systemic importance.

The FSB should 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 within the financial sector.

## Shadow banking

The G20 and the FSB are seeking to transform shadow banking into transparent and resilient market-based financing. As part of this the FSB will update the Brisbane summit on:

### Information sharing

Information-sharing among FSB members commenced in May 2014 to support the oversight and regulation of shadow banking entities. A peer review on national implementation of the high-level policy framework is due to commence in 2015.

### Securities financing transactions

The BCBS is due to publish a framework for haircuts on non-centrally cleared securities financing transactions.

### Banks' exposures to the shadow banking sector

The BCBS has finalised its framework for large exposure and risk-sensitive capital requirements for banks' investments in the equity of investment funds, to mitigate spill-over effects between banks and shadow banking entities.

The key issue for the G20 will be whether a combination of these initiatives and the work under way on money market funds and securitisation will be sufficient to achieve the desired transformation, transparency, safety and reduction of systemic risk in the shadow banking sector.

**KPMG view:**

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'.

It is important to recognise the value of some alternative channels of finance, both for consumers and for facilitating economic growth, particularly in emerging markets. For example, capital markets need to become more developed in many countries. This may also explain why many Asian countries are taking a more accommodating approach to shadow banking than are the authorities in the US.

## Making derivatives markets safer

The FSB has published a series of reports on how international standard setters and national jurisdictions are implementing OTC derivatives market reforms. While progress continues to be made in national implementation, considerable unevenness remains across jurisdictions. The OTC Derivatives Regulators Group will report again before the Brisbane summit on how the identified outstanding issues have been or will be resolved.

**KPMG view:**

This is a key area where international consistency is required, not least to reduce the costs to both financial institutions and their customers that will arise from fragmentation and having to meet multiple inconsistent national or regional requirements.

This is also one reason why it is so important that financial services are included in international trade negotiations.

# Meanwhile, the rest of the regulatory reform agenda rolls on

Despite all the progress made over the five years since the FSB was established – and the seven years since the financial crisis began – many difficult issues remain unresolved. The key political issues being brought to the Brisbane summit by the FSB are only the tip of the continuing regulatory reform iceberg. Many other issues remain to be resolved under the direction of travel established by the G20 and the FSB.

**KPMG view:**

The financial sector is suffering from the continued uncertainty about the regulatory reform agenda, even seven years after the financial crisis began. In the context of the wider jobs and growth agenda, the G20 and the FSB should provide a more certain environment in which financial institutions – and their customers – can operate, by:

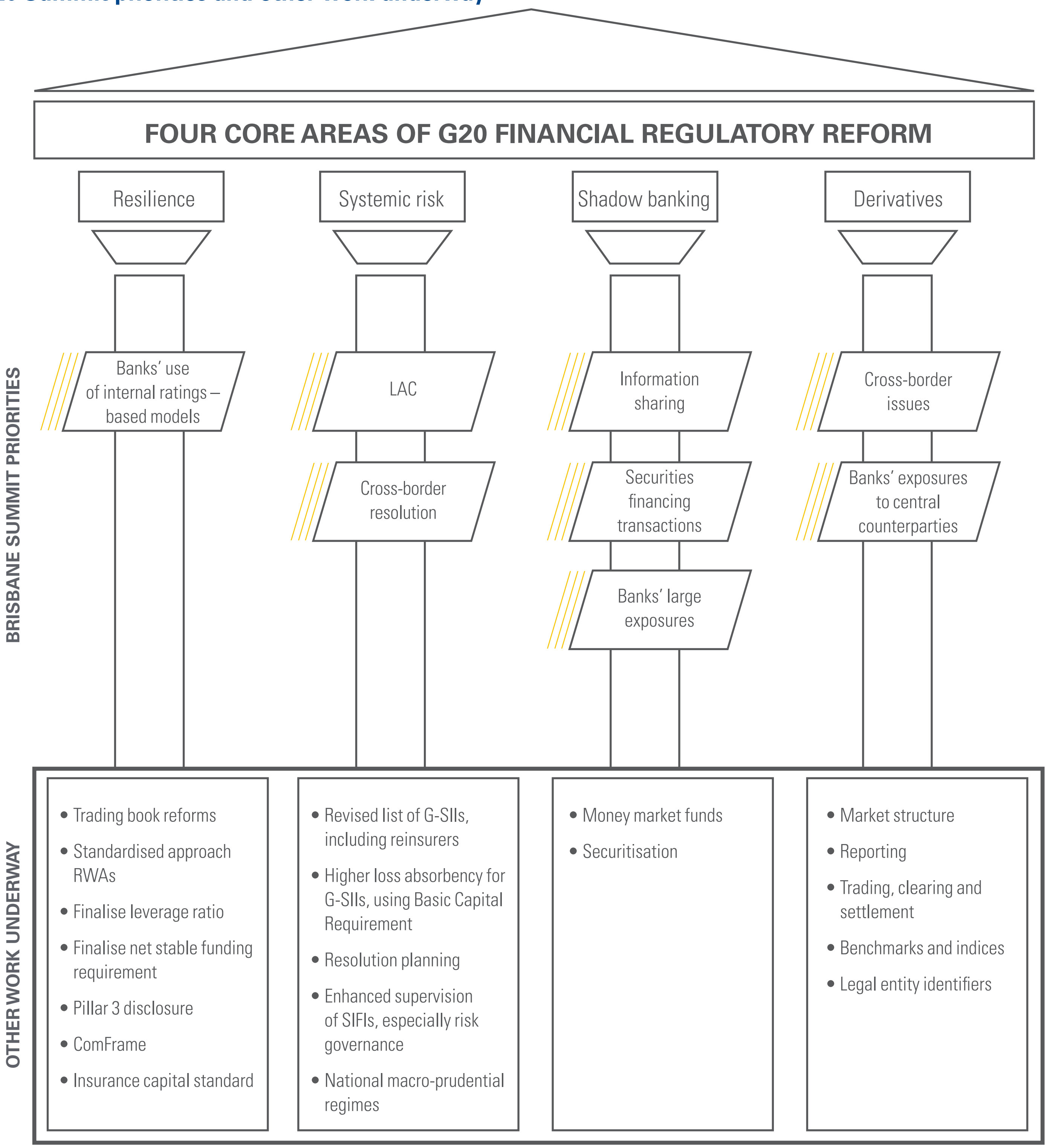
- pressing harder for greater global consistency to avoid the complexity, cost and distortions of inconsistent regulations globally and across sectors; and
- more ruthless prioritisation of regulatory reforms, or pausing before implementing further reforms.

### Banks

For banks, there remains a long list of regulatory reforms to be finalised. This includes:

- The finalisation of the BCBS proposals on
  - the final calibration of the leverage ratio (where some countries, including Switzerland, the US and the UK, have already announced or signalled a tougher approach),
  - limiting arbitrage opportunities between banks' trading and banking books,
  - the use of internal models by banks to calculate capital requirements against both credit and market risks – high level proposals on this are likely to be presented to the Brisbane summit,
  - the standardised approach to calculating risk weighted assets,
  - the net stable funding ratio, and
  - revised disclosure proposals that build on the work of the FSB Enhanced Disclosure Task Force;
- The national implementation of capital surcharges on domestic systemically important banks and other systemic risk buffers;
- Higher capital requirements in response to the results of stress tests;
- Enhanced supervision, including the national implementation of the FSB principles on risk governance, and further emphasis on the viability, sustainability and resolvability of banks;
- Structural reforms in the US and Europe; and
- The growing use of macro-prudential tools.

## G20 Summit priorities and other work underway



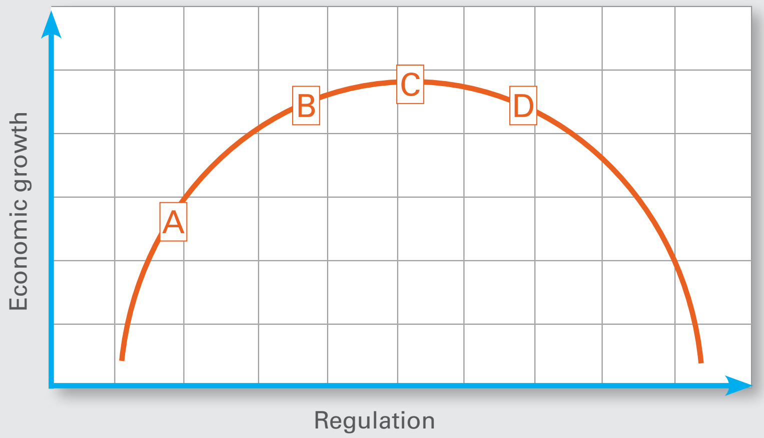

Source: KPMG International 2014

# Meanwhile, the rest of the regulatory reform agenda rolls on

**KPMG view:**

We have argued in other KPMG publications[4] that these additional requirements on banks could take regulation beyond – or even further beyond in Europe - the 'tipping point' at which the costs of additional regulation exceed the benefits.

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. Excessive regulation can damage the the wider economy such that the net impact of regulation on economic growth becomes negative.




Source: KPMG International, May 2013.

We therefore recommend that:

- Regulators should consider again the cumulative impact of existing and proposed regulatory reforms, and focus more than hitherto on jobs and growth in the impact assessment of new regulation.

  Cost benefit analyses and impact assessments have:

  – underestimated the impacts of regulatory reforms on the wider economy;

  – relied heavily on the untested assertion that ever-safer banks and other financial institutions are necessarily better placed to provide additional financing and other services – without recognising that there must be a point at which funding through capital has a negative impact on the availability and cost of financial services; and

  – hidden behind the assertion that high costs are worth paying to reduce the probability of another financial crisis, without demonstrating how each additional regulation delivers further benefits.

- Regulators should also consider the appropriate balance between greater resilience and greater resolvability – there must be a point at which these should become substitutes rather than complements. Similar trade-offs also apply elsewhere. For example, 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.

[4] *Moving on: The scope for better regulation,* KPMG International, May 2013; and *Evolving Banking Regulations,* KPMG International, February 2014.

- The cumulative impact of the multiplicity of additional capital requirements – current and prospective – should be capped, to reflect the "tipping point" risk. Earlier estimates by the BCBS suggested that, looking at capital ratios alone, this tipping point occurs at capital ratios of around 15%.
- 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) should not be allowed to result in disproportionate increases in capital requirements and a regulatory framework that is insufficiently risk sensitive, or to disincentivise banks (for example, in developing markets) from investing in more advanced risk management approaches.
- Macro-prudential policy makers should:
  – take more account of the progress already made in improving the resilience of the financial sector when considering the use of macro-prudential tools;
  – take greater account of the potential impact of these tools on the wider economy; and
  – provide greater certainty about which tools might be used, and under which circumstances.

## Insurers

For insurers, the IAIS – in response to considerable pressure from the FSB – has set out an extensive and ambitious reform programme for the next five years. This includes:

- Revising the list of global systemically important insurers (G-SIIs) by the end of this year, including an assessment of whether any reinsurers should be added to the list of the nine insurance firms already identified;
- Developing a Basic Capital Requirement (BCR) for G-SIIs – with proposals to the Brisbane summit and confidential reporting by G-SIIs from January 2015;
- Using the BCR as a basis for applying higher loss absorbency requirements to G-SIIs, with effect from 2019;
- Developing an Insurance Capital Standard (ICS), primarily for internationally active insurance groups (IAIGs) – to be developed mostly by the end of 2016; with refinement and final calibration in 2017 and 2018, and application to IAIGs from 2019;
- Developing a group-wide supervision model (ComFrame) for IAIGs which includes holding company oversight and transparency around both home and host country operations – with field testing in 2015 and 2016; further refinement in 2017 and 2018; and implementation from 2019.

**KPMG view:**

It is important to establish greater international consistency in capital standards for insurers and reinsurers and to establish a sufficiently robust basic level of capital. However, the proposed timetable for this may prove to be over-optimistic, given the resistance of some insurance regulators, in particular in the US, to these moves.

## Markets

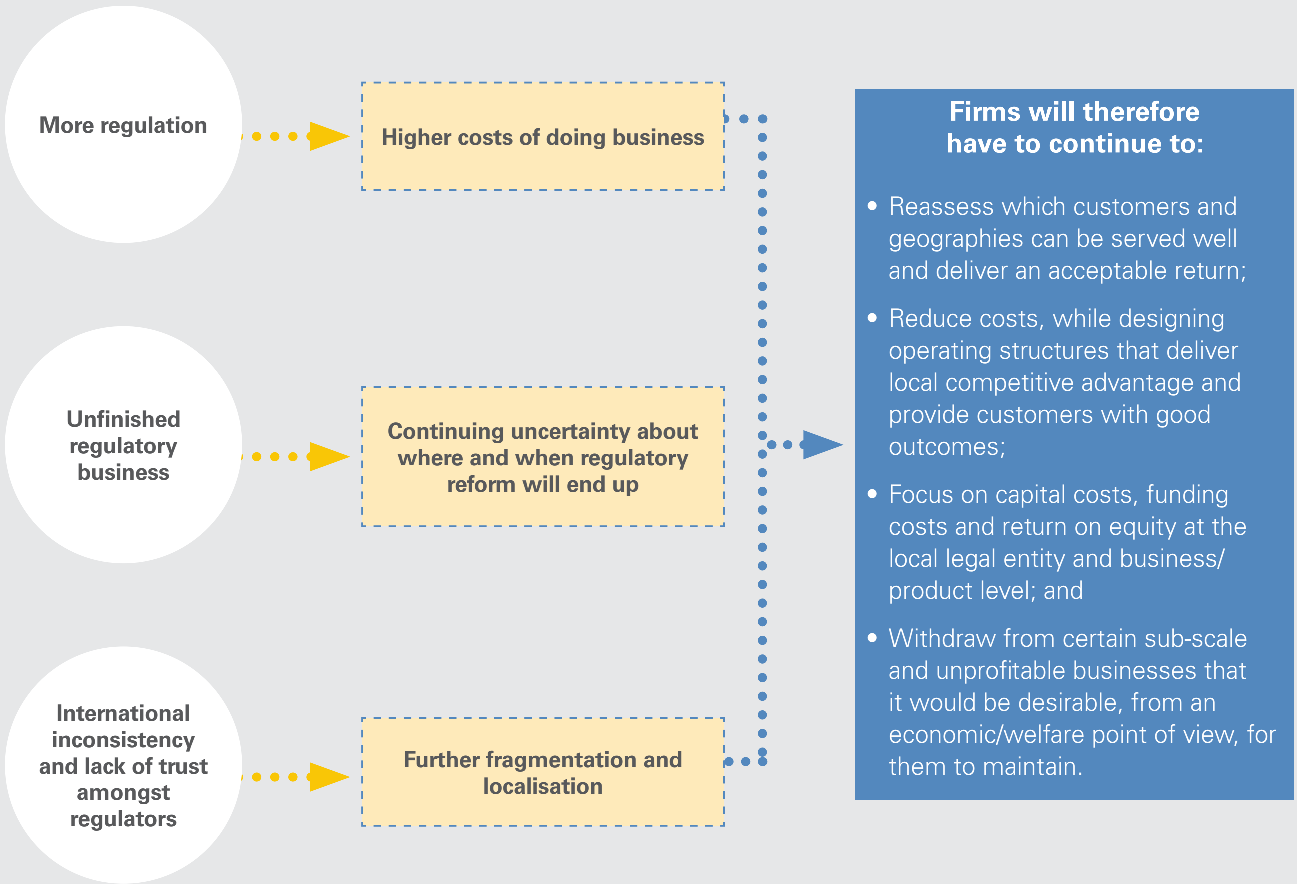
In addition to OTC derivatives and securities financing transactions, the unfinished regulatory business includes:

- Applying recovery and resolution planning to financial market infrastructure, which has increased in systemic importance;
- Decisions on the appropriate regulation of high frequency and algorithmic trading;
- Responding to market fragmentation, not least in terms of data reporting, aggregation and disclosure; and
- The evolving investor protection agenda, where high level principles need to be translated into more detailed requirements in many jurisdictions.

**KPMG view:**

Again, the key issues here are international consistency and mutual recognition, to avoid the costs of fragmentation and localisation.

### Implications for firms of the current regulatory reform agenda




Source: KPMG International 2014

# Contact us


**Jeremy Anderson**
Chairman
KPMG's Global Financial Services
**T:** +44 20 73115800
**E:** jeremy.anderson@kpmg.co.uk

**Simon Topping**
Partner
**T:** +85228267283
**E:** simon.topping@kpmg.com

**Giles Williams**
Partner
**T:** +44 20 73115354
**E:** giles.williams@kpmg.co.uk

**Ricardo S.Anhesini**
Partner
**T:** +551121833141
**E:** rsouza@kpmg.com.br

**Pamela Martin**
Advisory Managing Director
**T:** +1 (202) 533 3070
**E:** pamelamartin@kpmg.com

**Clive Briault**
Senior Advisor
**T:** +44 20 76948399
**E:** clive.briault@kpmg.co.uk

**David Sayer**
Global Head of Banking
**T:** +44 20 73115404
**E:** david.sayer@kpmg.co.uk

**Michael Conover**
Global Head of Capital Markets
**T:** +1 (212) 872 6402
**E:** mconover@kpmg.com

**Tom Brown**
Global Head of Investment Management
**T:** +44 20 76942011
**E:** tom.brown@kpmg.co.uk

**Gary Reader**
Global Head of Insurance
**T:** +44 20 76944040
**E:** gary.reader@kpmg.co.uk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Oliver for KPMG | OM023851A | October 2014