KPMG

Banking Briefing

Q1 2015

Banking Union | CRS/OCDE | MiFID/MiFIR | Hot topics

Welcome

Welcome to the first edition of the KPMG Banking Briefing !
Your insight to the forthcoming challenges that banks will face in the near future.

This Banking Briefing contains information of professional interest to the Luxembourg Banking community organised under three or four megatrends illustrated by one interview of a banking and the hot topics of the period to come.

Each megatrend will provide information on :

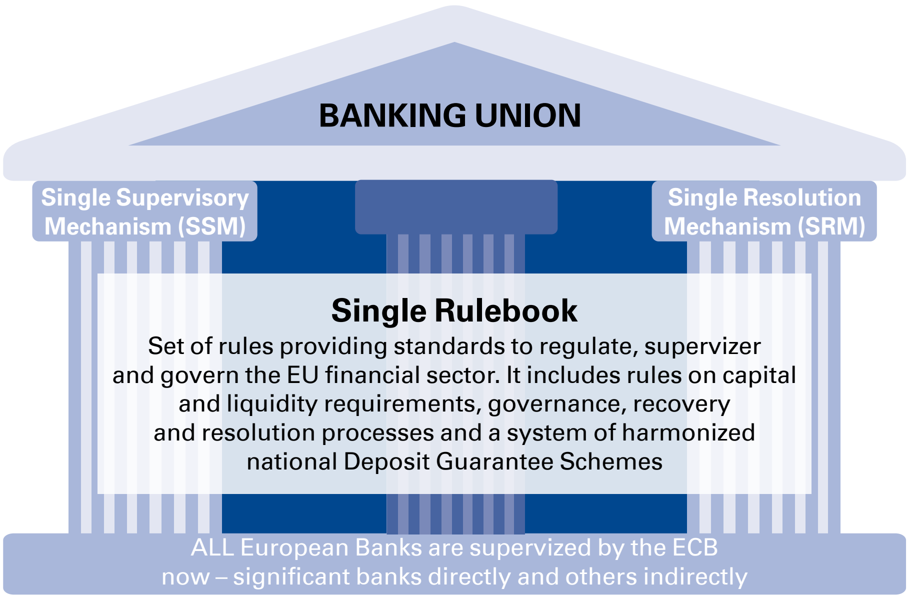
- **Who are the stakeholders of the future challenge ?**
- **What is the context ?**
- **What are the challenges ?**
- **What is the impact for your organisation ?**

For this first edition, we have chosen 3 megatrends which will heavily impact the banking industry now and in the near future:

- **ECB supervision and the Single Supervision Mechanism (SSM) :**
  A complete shift in the banking supervision in Luxembourg and within the EU.
- **The Common Reporting Standard (CRS) :**
  It describes the due diligence procedures that must be followed by financial institutions to identify reportable accounts. CRS and exchange of information is a new paradigm for private bankers. It will significantly impact the client, the relationship manager and the bank's operational organisation.
- **MiFID2/MiFIR:**
  The legislation, in the form of a Directive that recasts MiFID (MiFID II) and a new Regulation (MiFIR) is one of the most important pieces of the post crisis regulatory reform puzzle. Not only are there new markets requirements including those relating to position limits, algorithmic trading and transparency but there are also new conduct of business requirements that add up to significant change for banks and other firms.

  Our Banking Briefing will be issued on a quarterly basis and we are convinced that it is a good summary of the challenges ahead for the banking industry.

Stanislas Chambourdon
Head of Banking



Aims of Banking Union:

- transparent and consistent supervisory process;
- equal treatment of EU banks;
- safer banking system by early intervention.

Are You ready for the SSM?

Objectives of SSM	Questions you should be able to answer satisfactorily in response to SSM objectives
Strengthen bank capital and liquidity	Are you confident that your ratios are reliable, robust, accurate and consider all relevant regulations? Have you established strong and robust ICAAP/ ILAAP?
Ensure soundness of bank assets and credit processes	Are you confident that you meet the high standards of the ECB as shown in the Asset Quality Review?
Monitor financial figures and identify early warning signals of failures	Have you set clear and reliable measures and forward looking indicators to comply with regulatory expectations as regards early warning systems?
Discourage wrong and/ or adverse risk taking behavior	Have you set clear and adequate remuneration policies in compliance with CRD IV / CRR? Are you confident that you have implemented a risk transfer pricing mechanism which is accurate, reliable and reflects the economic reality as regards cost of capital and liquidity for different business lines, products, etc.?
Better manage potential banking failures	Have you thought through and developed different scenarios which may put your bank under severe capital and liquidity shortage? Have you established remedial action plans responding to these severe negative scenarios?
Establish consistent supervisory framework	Are you ready for the new way the ECB and local competent authorities such as the CSSF will execute their supervisory mandate, for example through the supervisory review and evaluation process (SREP)? Are you able to react in short notice with reliable and accurate information?

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"Early preparation and pragmatic action will be key in our ability to meet the forthcoming challenges of the SSM."


Thierry López

Thierry López, Banque Internationale à Luxembourg (BIL), Managing Director and Advisor to the Management Board as Head of BIL Group Risk Management.
With more than 20 years experience, Thierry has been/is a member of various consultative committees for the CSSF and the ABBL (currently and amongst others he is Chairman of the ABBL Banking Supervision Committee). He is the founder (1997) and board member of ALRiM, the Luxembourg association for Risk Management Professionals. He is involved in the academic circle and research as ALM/GRC/Risk Management Professor/speaker at amongst others the HEC-Business School of the University of Liège, the ATTF and the IFBL. He wrote articles and well-known books in English with John Wiley & Sons and in French with De Boeck Université.

> We are now one year after the start of the comprehensive assessment including the asset quality review ("AQR"): What was your first feeling when it was announced that you would be part of the AQR/Stress Test exercises?

By the end of 2013 the European Central Bank (ECB) had started to communicate about its planned review of the largest European banks' balance-sheets and their corresponding resilience to the subsequent stress tests. At first I had mixed feelings.

As the head of risks of a locally systemic bank, I naturally welcomed the ECB's initiative to set up such an important exercise. It was indeed important that the soundness of the banks to be supervised would have to be assessed before the Single Supervisory Mechanism (SSM) formally took over its supervisory role in November 2014. It was also essential, with this exercise, to help restore trust in the European banking sector.

At the same time, the comprehensive assessment raised many questions. As the precise scope of the asset quality review (AQR) as well as the methodologies underlying it were not entirely defined, there was a lot of uncertainty regarding the most appropriate preparation banks would need in this process.

Other questions were related to the detailed planning of the exercise, the way banks would interact with their auditors, the effective workload that would need to be borne by the banks' staff and the impact on their lending capabilities.

All these questions were of particular relevance considering the sensitive environment in which the AQR was going to be implemented and the potential backlash negative results would have had on a bank's profitability and reputation.

> The comprehensive assessment consisted of the AQR and the subsequent stress testing. You certainly faced many challenges, as perhaps did all the other European banks that were subject to the full comprehensive assessment. Can you explain what the main challenges were?

AQR and stress testing are complementary exercises.

The AQR is a "point-in-time" exercise, mainly focusing on the banks' internal accounting/risk practices, including their impact on the reliability of European banks' balance-sheets items. By contrast, the stress test is a "forward looking" exercise assessing the banks' solvency situation in a baseline (i.e. normal state of the economy) and adverse (i.e. stressed state of the world) scenario.

The particular challenge in 2014 was to conduct both exercises in parallel as it put a considerable strain on available resources in the banks.

An additional challenge resulted from the absence of clear guidelines and indications prior to the start of the exercises. Although this is to some extent understandable as both the ECB and the banking sector needed to define the new processes and interactions by a common learning experience, a lot of the pressure that was felt resulted from the absence of clarity in the communication emanating from the ECB.

On the other hand a lot of banks also faced important difficulties in fulfilling the ECB's requirements in terms of reporting. This was mainly due the granularity of the data requested, often not available as such within the banks' systems, the lack of maturity of certain newly defined concepts and, finally, the very strict and tight deadlines.

Whereas the application of the level playing-field principle and the ECB's one-size fits all approach were certainly meant to ensure a balanced interaction, some banks considered that specific issues, such as their size, were not sufficiently taken into account. In this dialogue, the role of our National Competent Authority (NCA), the CSSF, was particularly important and greatly helped to better communicate the situation of our bank.

Regarding the stress testing, important difficulties were linked to the interpretation of the European Banking Authority (EBA)'s methodological guidance within the very limited timeframe available. This difficulty was highlighted by the large number of Q&As published during that time. All in all, challenges were many and the burden on banks was considerable. A lot of lessons were however learned on both sides and I am confident that the following processes will be increasingly smoother.

> The AQR was structured around 9 workblocks. The ECB, the CSSF and the auditors have reviewed many processes, files… What, if any, have been the main benefits from the AQR for the BIL organization?

The benefits of having participated in these exercises are twofold.

On the one hand, both the AQR and the stress tests have made it possible to demonstrate the soundness of the Luxembourg banking system and its strong resilience under adverse and stressed circumstances.

On the other hand, the review of the banks' internal policies and procedures, on both their accounting and risk practices, has made it possible to confirm the overall quality of the banks' processes and practices while at the same time areas for improvement were identified.

Those improvements will increase the quality of internal decision-making processes, enhance transparency as well as trust in the banks' risk profile and, finally, restore confidence in the overall European banking system.

As such, I do consider that the ECB's main objective has been reached.

> SSM is now up and running. You have been elected chairman of the ABBL banking supervision committee (BSC): Based on your AQR/Stress Test experience, you have certainly points that you would like to share with the banks which have not been part of this exercise?

In the course of 2015, the ABBL BSC will focus on the implementation of the SSM. In this new supervisory landscape, it is crucial to find the right channel for conveying the messages of the Luxembourg banking community: This is being done via the participation of the ABBL in the SSM Strategy Group of the European Banking Federation (EBF). This high-level Group gathers the representatives of the largest banks of the SSM and those of several national associations, including the ABBL. It has now been operational for one year, and has proven to be an efficient forum in which to address the key messages of the banking industry to ECB officials through physical meetings in Frankfurt. The ABBL BSC will play an active role in providing input to the EBF SSM Strategy Group via the ABBL delegate. Among the priorities the SSM Strategy Group has identified for 2015, the treatment of national discretions by the ECB and the functioning of Joint Supervisory Teams (JST) are two topics to be discussed by the ABBL BSC.

Finally, let me highlight that the ABBL BSC also represents the Less Significant Banks, which are subject to the indirect supervision of the ECB. The supervision of these banks raises different issues (e.g. the organization of the consolidated supervision for small groups), which the ABBL BSC will also take on board.

Regarding those Less Significant Banks, the main challenges will be to succeed in converging towards ECB's standards and avoid the subsequent regulatory burden and related consequences on their internal profitability.

Early preparation and pragmatic action plan will be key in their ability to meet the forthcoming challenges of the SSM.

Single Rulebook is the foundation for the Banking Union – Have you already thought about and implemented a strategic response to the upcoming new regulatory requirements?

Illustration of some key actions to be taken in Q1 2015	What to do?
Develop/ Refine your recovery plan based on current guidelines (incl. EBA draft technical standards). It is a key component of the SSM and regulators will expect high degree of accuracy, soundness and relevance for a particular business model. Update your plan when needed due to new requirements.	• Develop/ Review your current recovery plan in light of the latest regulations and guidelines. Ensure that all details required by the regulator are accurately and adequately reflected. • Consider review of it independent of the person(s) involved in the development of the plan.
Ensure accurate application and **full compliance with CRD IV package**.	• Perform comprehensive review independent of the person(s) implemented the CRD IV package.
Develop a sound capital and liquidity plan considering the various enhanced and new regulatory measures (e.g. capital ratio, liquidity ratios, leverage, large exposures/ concentration risk, Total Loss-Absorbing Capacity) and aligned to business strategy	• Considering and integrating all new regulatory measures into a capital and liquidity plan. The plan should be specific to and accurately reflect the banking business model. • Ensure independent assessment of them (e.g. internal audit).
Draw conclusion from **comprehensive assessment** (Asset Quality Review and Stress Testing) taken place during 2014 whether or not you were part of the comprehensive assessment	• Review all technical areas which were subject to the comprehensive assessment and relevant to your business. • if you were not engaged in AQR: perform assessment on all relevant areas to ensure readiness for a review by the regulator.
Implement **risk transfer pricing according to CCSF 12/552**	• Ensure compliance of the risk transfer pricing in accordance with the CCSF circular 12/552 as amended • Consider independent review of technical methodology.
Kick-off project as regards the new requirement from **BCBS 239 «Principles for effective risk data aggregation and risk reporting»**	• Plan and perform impact/ gap assessment; Assess implications on the various business activities.
Review your **EMIR compliance** considering current regulations and new short-term requirements as they may severely impact your business and risk processes	• Perform an in-depth independent review (e.g. by internal audit). • Reflect on EMIR in light of your specific business model.

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- **2011** – Adoption of EUDAC Automatic exchange of information ("AEoI") on salaries, directors' fees and pensions
- **Apr 2013** – Pilot Project on AEoI
- **Jun 2013** – First draft of the modified EUDAC
- **Sep 2013** – G-20 calls on OECD to develop Multilateral Standards for AEoI
- **Jan 2014** – AEoI under current EUDAC applicable (first exchange of information in 2015)
- **Feb 2014** – First issue of the CRS/CAA
- **Jul 2014** – Second issue of the CRS/ CAA and related comments
- **Oct 2014** – Convergence between the OECD and EU process (Alignment of the modified EUDAC towards the CRS, signature of the Multilateral CAA)
- **Dec 2014** – Adoption of the modified EUDAC by the council
- **2015**
- **Jan 2016** – Expected entry into force Deadline for new accounts
- **Sep 2017** – First exchange of information

OECD

CRS/ EUDAC vs. FATCA

Due diligence

Increase of the number of clients to review under CRS

CRS based on the identification of Tax Residency

No thresholds for individuals, other than that of 1 million of USD for account with high value

Procedure of self-certification to be clarified

Governance and Scope

Definition of Financial Institutions is similar but less deemed-compliant statuses

Definition of Passive Non financial entity is extended to Investment entities established in non-participating jurisdictions

No concept of "Responsible officer"

Reporting

Reporting to the local authorities

Reporting will be based on FATCA data Increase of the number of clients to review under CRS

Withholding Tax

In the context of CRS/modified EUDAC:

No withholding tax

No notion of nonparticipating Financial Institutions

CRS/modified EUDAC will have several **operational impacts** and is a client-centric project.

On the client side, you will need to organize the pre-existing client review, elaborate client communication plan, and review your General Terms & conditions.

On the internal side, you will need to adapt your IT systems, adapt the on-boarding process, classifiy related entities, adapt your control framework, train your relevant staff, and select and implement reporting solution.

Key challenges

- Huge volume of data to be exchange
- New IT infrastructure for the exchange of information
- Tight dur diligence and reporting deadlines
- Managing divergences between FATCE and CRS/EUDAC

To do in Q1 2015?	How?
Tax information related to fiscal years as from 2016 and exchanged as from 2017. In order to get ready in 2015 to be fully compliant on 01/01/2016, you need to start to ensure that you have internally the proper **knowledge** (and a good understanding of the challenges ahead).	Advisory from Tax specialist **(workshop)**
Scope of CRS and modified EUDAC is similar to FATCA across three key dimensions (Financial information, financial institutions and reportable accounts). However similar does not mean identical.	Start a **gap analysis** between FATCA and modified EUDAC. Project Management Help from Tax specialist

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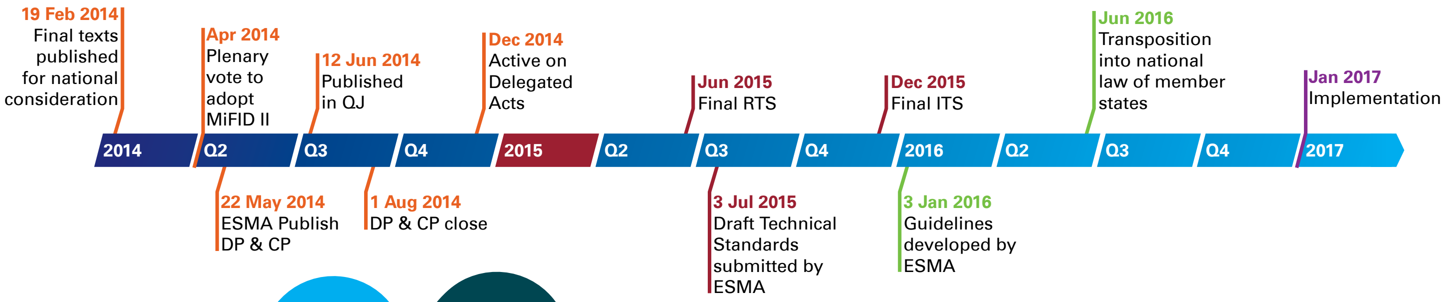

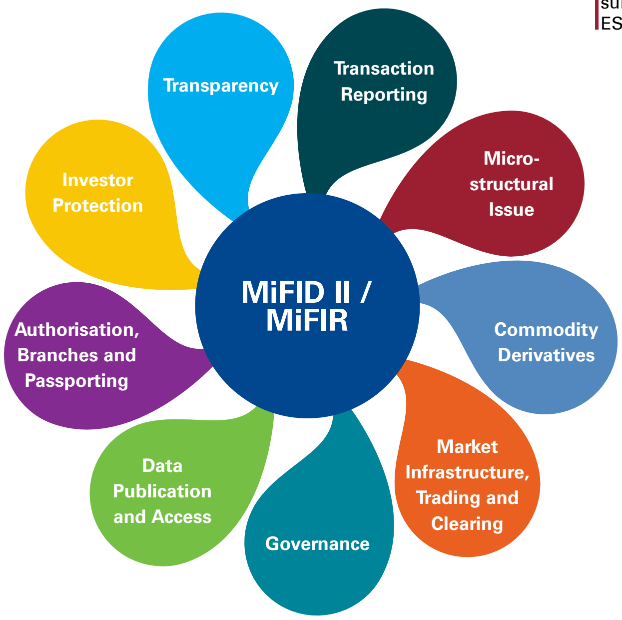

MiFID II is a significant piece of legislation – as big a project as MiFID I. Impacts will be from board to desk levels, affecting most functions and business lines.
104 Technical Standards add detail to the MiFID II framework, with very short time to review Discussion Paper and Consultation Paper.
MiFID is connecting and linking with a number of other Directives (EMIR, MAD, CSDR, AIFMD, CRD IV) and is also creating harmonisation across Directives.

Firms must take stock of business activities that will be affected and design project.

Investor Protection

- Restrictions on advice and new requirements for inducements and unbundled services.
- New definitions of complex and non-complex products.
- New emphasis on suitability and appropriateness tests.
- Strengthening of client asset protection and appointment of officer
- Best execution extended to new products, increased disclosure

Transparency

- Pre-trade transparency extended to all liquid MiFID products. Waivers tightened.
- Post-trade transparency extended to all liquid MiFID products. Deferred publication tightened.

Transaction Reporting

- Transaction reporting requirements extended to new products and new data fields.

Micro structural Issues

- Direct electronic access needs increased governance and control
- High frequency trading firms to be authorised and regulated
- Algorithmic trading subject to testing, review and disclosure, increased fees

Commodity derivatives

- Commodity derivatives position limits for both ETD and OTC. Daily position reporting.

Trading and Clearing

- Trading venues reclassified as MTF, OTF, SI
- OTC derivatives trading on centralised venues where subject to clearing
- Indirect clearing arrangements extended to ETD products
- Formalised criteria required for portfolio compression and data to be published
- Increased real time processing for trading, clearing and transfer of collateral

Data Publication and Access

- Non-discriminatory access between CCPs and trading venues
- Non-discriminatory access to and license requirement for benchmarks

To do in Q1 2015?	How?
Raise awareness accross the institution	Organize presentation of the MiFID II content and key changes
Define the key stakeholders and a project sponsor	Initiate the project roadmap and key mission
Identify the main challenges for each theme and quantify the impact	Refer to the KPMG minimum list of questions to be addressed
Produce a high level impact analysis	Output of the above listed activities

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Regulatory

UCITS V – depositary

Level of independence between the management company and its depositary is still in the air...

Will we end with an outright legal or "structural" separation of these two entities, barring any form of joint ownership or belonging to the same consolidated or will the Commission allow for "independence" to be interpreted along "functional" lines?

The latter will permit the Relevant Entities to maintain common management structures, as well as cross-shareholdings, subject to the proper identification, management and disclosure of potential conflicts of interests.

Accounting

IAS 39 is history, IFRS 9 a mystery?

From 2018, IAS 39 will be history and IFRS 9 can no longer be a mystery as a variety of financial statement preparers may find themselves affected by the changes.

Read our blog on IAS 39:

39JFK

blog.kpmg.lu

Tax

Modernization of the advance tax agreement procedure

The advance tax agreement procedure has been modernized and explicitly formalized into Luxembourg domestic law, following thereby the current global trend towards increased transparency.

The most important change is the creation of a new ruling commission ("*commission des décisions anticipées*").

For further information, please visit www.kpmg.lu

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Upcoming conferences

25 February	KPMG Luxembourg Gender Diversity Summit
4 March	Inaugural KPMG Luxembourg Fund Debate
17 March	Big Data conference

Register at events@kpmg.lu

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