



cutting through complexity

# Evolving Banking Regulation

## Part One

From Design to Implementation

March 2015

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KPMG INTERNATIONAL



# Foreword

**W**elcome to our latest edition of *Evolving Banking Regulation*. This series is now in its fifth year, which tells us something about the timescale and the complexity of the journey of post-financial crisis regulatory reform. However, the passage of time brings changes.

Regulatory reform has clearly moved from the design to the implementation stage. This is not to say that all the details are in place. Indeed the flow of new regulatory initiatives at times seems both undiminished and overwhelming. But in most areas there is at least now a clear direction of travel, and in many areas sufficient details, to enable banks to up the pace of their own journeys to a viable and sustainable future.

KPMG member firms are helping many banks across the world on these journeys. For some of these banks this has been a

difficult and troubled time as they struggle with regulatory and economic pressures. The regulatory pressures soon turn into too long a list to repeat here, with capital, leverage, liquidity, recovery and resolution planning, capital markets, retail and wholesale conduct, governance, board and senior management responsibilities, and data quality all high up the list.

Meanwhile, the economic pressures are all too evident, with the weakest economic conditions found in parts of the euro area. The increasing regulatory emphasis on stress testing has combined the regulatory and economic pressures in ways that banks have found particularly challenging – as KPMG member firms found when advising many banks, supervisory authorities and central banks during the European Central Bank's (ECB's) Comprehensive Assessment.

For too many banks, the journey to date has focused almost entirely on meeting

new and tougher capital, leverage and liquidity requirements through some combination of deleveraging, retrenchment, earnings retention, and where and when possible raising new equity. This may have enabled these banks to meet immediate regulatory requirements.

But following this path does not represent a strategy for a viable and sustainable future. Banks must look beyond simply meeting regulatory requirements if they are to achieve satisfactory returns on equity. This requires a strategic focus on their customers, business model and risk appetite, legal and operational structure, funding structure, IT systems and data management. Without this, banks will come under increasing pressures from shareholders and other stakeholders. We are beginning to see early signs of supervisory pressures here, as supervisors combine their growing interest in business model analysis with concerns about the



impact of unviable banks on the profitability of the rest of the sector.

Many banks therefore need to take more wide-ranging and more radical actions than managing down and de-risking their balance sheets. One key action is reducing costs – it is remarkable that the cost to income ratio has risen across banks in Europe in recent years while falling in banks in other developed economies. Another is re-pricing, to restore or boost margins and returns on assets. A third is investment in IT – to enhance front end business capabilities, to improve risk management, to enable more effective data management and to drive medium term cost efficiencies, while seeking ever more sophisticated ways to guard against cyber security risks.

Banks also need to respond positively to the jobs and growth agendas of both the G20 and the European Union (EU). Some politicians and commentators seem over-eager to exclude banks from these

important agendas, confusing the long-term potential of initiatives such as capital markets union across Europe to promote market channels of intermediation with the short-term substitution of bank financing. Instead, the industry needs to continue to ask the questions KPMG raised in our recent thought leadership on the EU and G20 agendas, in particular how regulation can best enable financial services to support jobs and growth in the wider economy.

This year we are publishing *Evolving Banking Regulation* as a series of papers, beginning with an introductory chapter overviewing recent and forthcoming banking regulation, then moving on to chapters focusing on specific issues. The first such chapter will be on structural issues for banks. Other subject-specific chapters will follow during the year, and are likely to focus on conduct, and culture, governance, data, market infrastructure and resolution.

I hope that clients find this a useful series of publications, that enable them to focus more clearly on the key issues and the steps they need to take if they have not already secured a viable and sustainable future.



**Jeremy Anderson**  
Global Chairman, Financial Services

## Contents

- 4** **Executive summary**
- 8** **Regulatory pressure index**
- 10** **Key regulatory developments:  
from design to implementation**
- 28** **Annex 1 – Financial services and the  
jobs and growth agenda**
- 29** **Annex 2 – Summary of regulatory  
developments**
- 33** **Abbreviations**

# Executive Summary



As shown in our regulatory pressure index, **regulatory pressures continue to mount on banks**. Even if the pace of new regulatory initiatives has begun to diminish, the full reality of earlier reforms is only just becoming apparent.

**C**ombined with weak economic activity, most pronounced in the euro area, regulatory pressures have left many banks in the Europe, Middle East and Africa (EMA) region **struggling to generate adequate profits**, and to demonstrate that they have a viable and sustainable business model. Deleveraging and de-risking the balance sheet may have enabled most banks to meet current regulatory demands for capital and liquidity, but it will not rebuild banks' profitability. The headwinds of the costs of past misconduct in both retail and wholesale markets, and the myriad pressures to increase IT expenditure, do not make it any easier for banks to secure a viable and sustainable future. These

issues are covered in more detail in Part 2 of *Evolving Banking Regulation*.

The detail of regulatory reforms is beginning to become clearer, as is the direction of travel of the remaining reforms. The volume of unfinished business is diminishing as more regulations are **moving through the design and calibration stages to implementation** (see diagram on pages 6-7). And fewer regulatory reform initiatives remain at an earlier development stage. However, some uncertainty inevitably remains about the prospective appearance of new initiatives. Meanwhile, banks continue to grapple with the complexity of keeping track of and adjusting to the sheer volume of measures and the multiple interactions between them.

We focus in this chapter on **five emerging areas** where banks will need to respond to the uncertain evolution of regulatory and supervisory developments.

### Macro-prudential policy

**Banks may not be fully prepared** for the range and magnitude of macro-prudential measures that may affect them. While macro-prudential policy remains a work in progress in many countries, some national authorities have eagerly embraced the use of macro-prudential tools, including higher capital, leverage and liquidity requirements to enhance further the resilience of the banking sector, and restrictions on specific types of lending to dampen emerging financial cycles in credit and asset prices.

### Risk-weighted assets

Regulators are seeking to **limit the extent to which banks can use internal models to drive down capital calculations** for credit and market risk. There has been a backlash from regulators and investors against the perceived inadequacies of banks' internal models, unexplained variations across banks of model results, and the aggressive driving down of risk weights based on internal models. Restrictions on model specifications and parameters, and the introduction of more risk-sensitive standardised approaches against which model-based results can be compared and constrained, will increase capital requirements and systems costs for many banks.

### Comprehensive Assessment

Although the ECB's Comprehensive Assessment had the most immediate impact on banks that needed to rectify capital shortfalls, it also provides a **starting point for the ECB's supervisory approach and for the design and focus of future stress tests**. Banks should expect regulator-driven stress tests to be applied to a wider

range of banks, based in part on more detailed reporting from banks; and to focus increasingly on sovereign debt, international exposures, funding risks, and banks' operational capabilities for running stress tests.

### Supervision

ECB supervision will be a game-changer for the banks supervised directly by the ECB. The ECB's focus on the full range of risks set out in the European Banking Authority's (EBA's) guidelines on supervisory review and evaluation will have implications for banks' strategy and business models, data and IT infrastructure, risk modelling, and the setting of Pillar 2 capital and liquidity requirements on individual banks. Meanwhile, many banks will need to adjust as the ECB eliminates inconsistencies in the past practices of national supervisors.

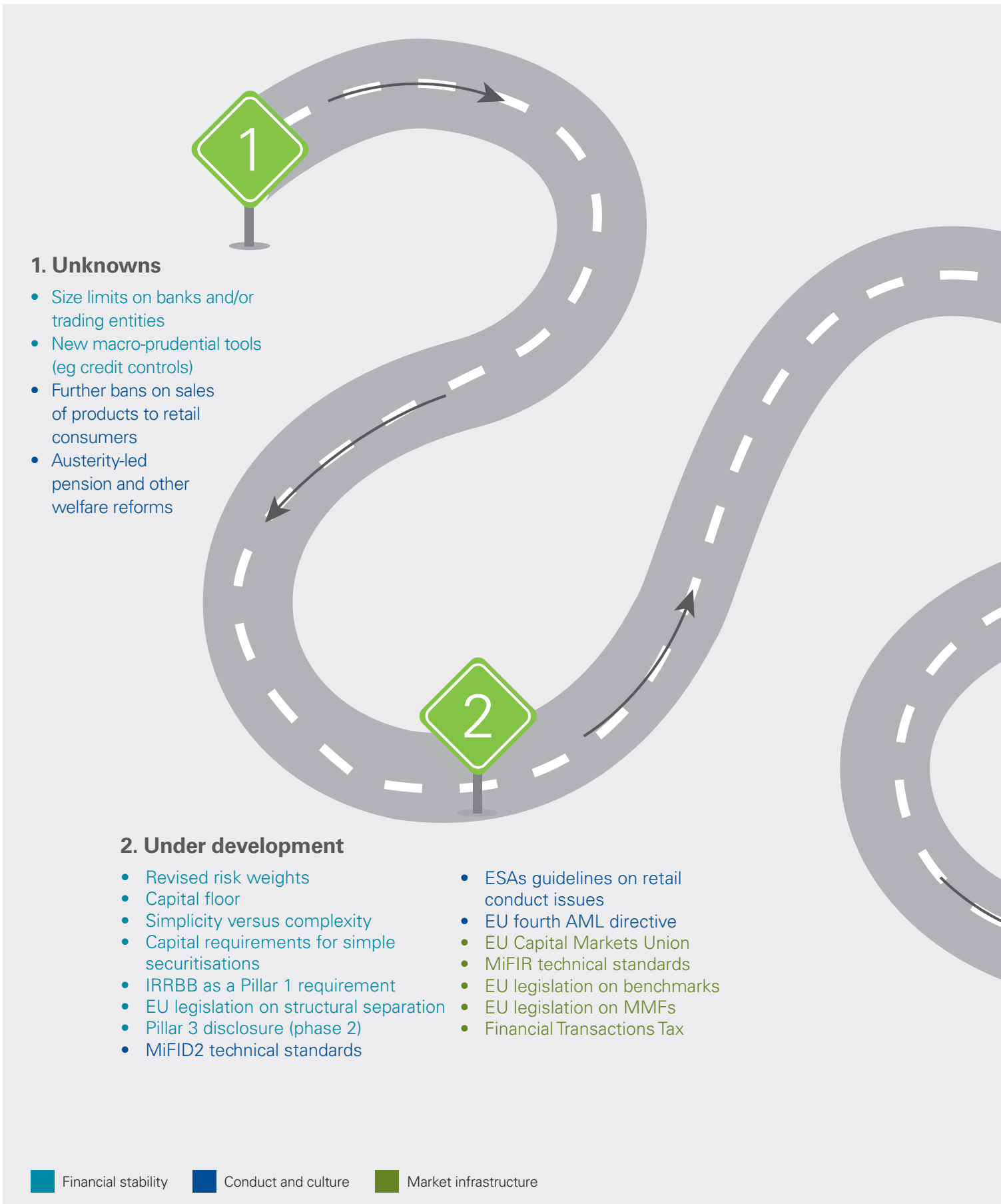
National supervisors beyond the Banking Union area (and indeed beyond Europe) are watching closely the ECB's approach to banking supervision, and are likely to follow at least some of the ECB's supervisory initiatives.

### Total loss-absorbing capacity (TLAC)

Requiring systemically important banks to hold a minimum amount of 'junior' long-term liabilities that could be bailed-in ahead of ordinary senior creditors will leave many of these banks needing to raise additional debt that qualifies for inclusion, or at least to convert some existing long term debt into eligible debt instruments. This **will add to the increasing cost and inflexibility imposed by regulation on banks' balance sheets**. Banks funded primarily by customer deposits (from individuals and corporates) may have to replace some of these deposits with long-term debt.

“ The volume of unfinished business is diminishing as more regulations are moving through the design and calibration stages to implementation, and fewer regulatory reform initiatives remain at an earlier development stage. ”

# Regulation: The road to implementation



## 1. Unknowns

- Size limits on banks and/or trading entities
- New macro-prudential tools (eg credit controls)
- Further bans on sales of products to retail consumers
- Austerity-led pension and other welfare reforms

## 2. Under development

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>• Revised risk weights</li> <li>• Capital floor</li> <li>• Simplicity versus complexity</li> <li>• Capital requirements for simple securitisations</li> <li>• IRRBB as a Pillar 1 requirement</li> <li>• EU legislation on structural separation</li> <li>• Pillar 3 disclosure (phase 2)</li> <li>• MiFID2 technical standards</li> </ul> | <ul style="list-style-type: none"> <li>• ESAs guidelines on retail conduct issues</li> <li>• EU fourth AML directive</li> <li>• EU Capital Markets Union</li> <li>• MiFIR technical standards</li> <li>• EU legislation on benchmarks</li> <li>• EU legislation on MMFs</li> <li>• Financial Transactions Tax</li> </ul> |
|---|--|

Financial stability
  Conduct and culture
  Market infrastructure

### 3. Designed

- Leverage ratio
- D-SIB designation and capital surcharges
- TLAC and MREL
- FSB risk governance and risk governance principles
- BCBS corporate governance principles
- BCBS risk data aggregation and reporting principles
- Macro-prudential tools
- Haircuts on securities financing transactions
- Pillar 3 disclosure (phase 1)
- FSB on assessing risk culture
- Some EMIR technical standards
- IOSCO principles for benchmarks
- ELTIFs

### 4. Calibrated

- NSFR
- BRRD bail-in powers
- IFRS 9/ECL accounting
- Disclosure of securities financing transactions
- MiFID2
- MiFIR
- AIFMD
- MAR and MAD2

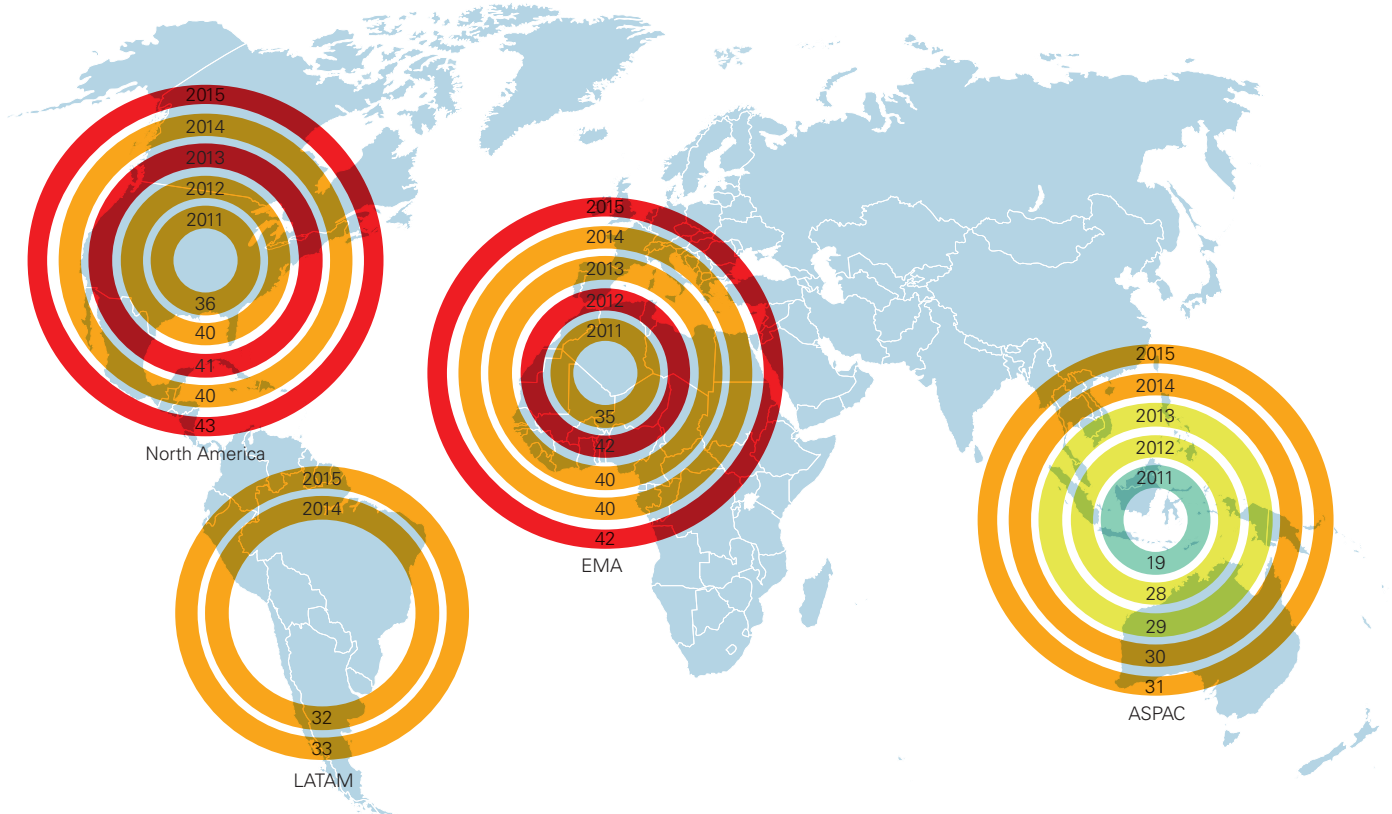
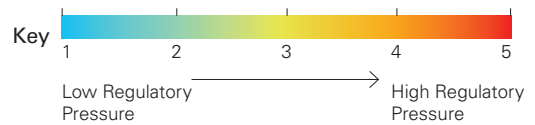
### 5. Implemented (usually on phased-in basis)

- Basel 3
- G-SIB designation and capital surcharges
- Stress tests
- Risk weights on exposures to CCPs
- Capital treatment of securitisations
- Macro-prudential tools (some countries)
- LCR
- Large exposures
- COREP/FINREP
- National structural separation legislation
- BRRD resolution powers
- Deposit Guarantee Schemes
- National and single resolution funds
- EBA SREP guidelines
- ECB supervision in Banking Union
- Remuneration
- Mortgage credit directive
- EMIR

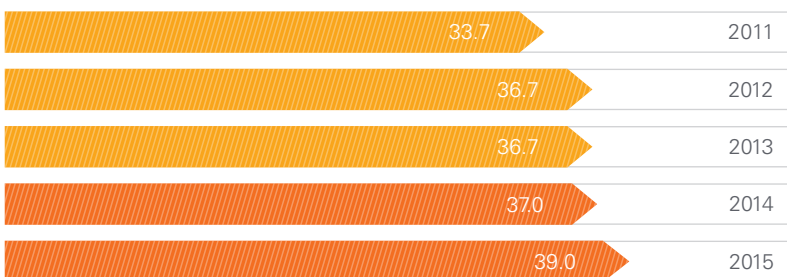
# Regulatory pressure index

Our regulatory pressure index is based on a combination of the views of regulatory experts from across KPMG’s global network and banking clients across the Americas (where we separate out Latin America from North America for the first time); Europe, the Middle East and Africa; and the Asia-Pacific region.

## Regulatory change – regional divergences



## The global pressure continues to grow



**Note:**

- 1) The regional numbers are the sum of the scores in each region across the ten individual areas of regulatory pressure.
- 2) Mexico is included in the Latin America data.
- 3) From 2011 to 2013 the global pressure index is the unweighted average of the indices for North America, EMA and ASPAC. In 2014 and 2015 the global pressure index is a weighted average of North America (one-third), EMA (one-third), ASPAC (one-sixth) and LATAM (one-sixth).
- 4) Data for LATAM is only available for 2014 and 2015

Source: KPMG Internal Survey, 2015.

Overall, regulatory pressures have risen again this year. In some areas this reflects the continuing challenges of implementing regulatory reforms, now that the details of the regulations have become clear. This includes most of the core Basel 3 capital and liquidity standards; risk and performance-adjusted remuneration; and some market infrastructure requirements.

In other areas the regulatory pressures reflect the continuing development of regulatory initiatives that are at various stages of evolution, including the risk weighting of assets, the designation and



regulatory treatment of D-SIBs, macro-prudential policy, retail and wholesale market conduct and culture, risk governance, and recovery and resolution planning.

Across the regions, the steady increase in regulatory pressure on banks in the Asia-Pacific region has continued, particularly in liquidity and retail and wholesale conduct. However, pressures remain highest in North America and Europe, with the most severe pressures in the areas of capital, systemic risk, conduct and culture, and the intensity of supervision. The highest regulatory pressure in LATAM is in the areas of financial crime and tax.

Key issues within the individual areas of regulation include:

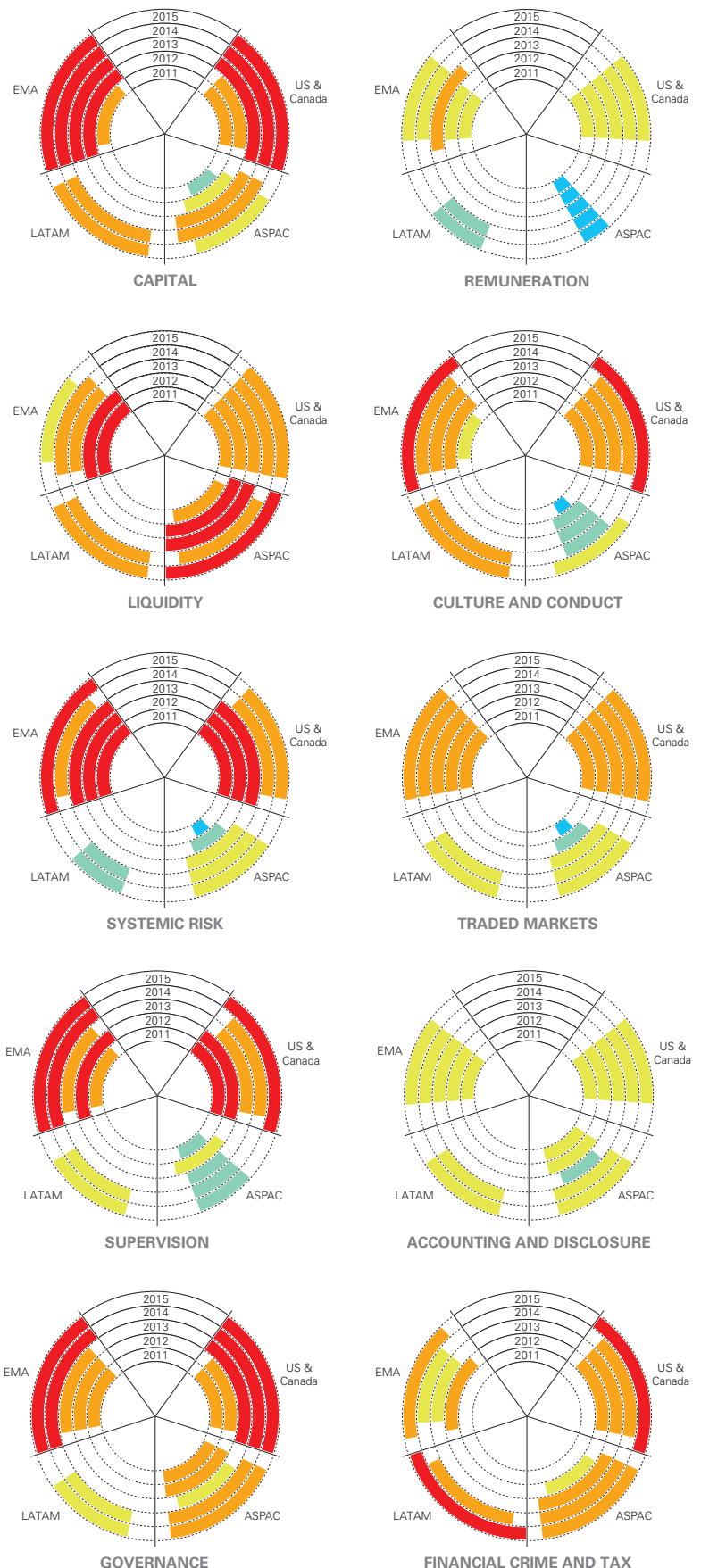
**Capital** – even as the core Basel 3 standards are being implemented, the shift towards ‘Basel 4’ continues, with the calibration of the leverage ratio either set higher than 3 percent (as in Switzerland and the US, and proposed in the UK) or yet to be determined, and new pressures on banks emerging from stress testing and from wide-ranging revisions to risk weighted assets.

**Liquidity** – further revisions to the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) calculations have, on balance, reduced the pressures here, in particular in Europe through the more generous treatment of covered bonds as a source of high quality liquid assets. However, as with capital requirements, the overlay of stress testing (already underway for the largest US banks), Pillar 2 and macro-prudential requirements for liquidity may increase the regulatory pressures on banks significantly.

**Systemic risk** – increasing pressures, in particular in Europe, are building from the designation and regulatory treatment of domestic systemically important banks (D-SIBs), minimum requirements for banks to issue long-term bail-in liabilities, and the increasing use of macro-prudential instruments.

**Culture and conduct** – a series of misconduct episodes in retail and wholesale markets has left banks and regulators seeking to improve conduct and culture. Regulation and supervision are becoming increasingly intensive and intrusive in this area.

**Supervision** – in addition to the generally tougher supervision that has emerged in all regions since the financial crisis, making the ECB the single banking supervisor in the Banking Union area has already led to a more demanding supervisory approach for many banks subject to direct supervision by the ECB.



Source: KPMG International Survey, 2015.



# Key regulatory developments: from design to implementation

**T**o a large extent 2014 was a year of the finalisation and implementation of substantial elements of banking regulation. In the European Union the CRR and CRD4 came into force in January; the BRRD, MiFIR and MiFID2 were agreed in April, for implementation from 2015 onwards; and the ECB became the single banking supervisor in the Banking Union area, taking on direct supervision for the major 123 banks. Some national authorities have already implemented macro-prudential policy measures.

Elsewhere in the EMA region, Basel 3 continues to be implemented in an increasing number of countries, led by Saudi Arabia, South Africa and Switzerland as members of the Basel Committee, followed by Bahrain, Kuwait and Qatar. Some countries are also moving forward on the designation of D-SIBs and the calibration of capital surcharges on D-SIBs.

The Basel Committee agreed the detailed calibration of the LCR and the NSFR, for implementation from January 2015 and January 2018

respectively. The Committee also issued new international standards on large exposures, the standardised approach to measuring counterparty credit risk, the capital treatment of securitisations, bank exposures to central clearing counterparties, corporate governance, and Pillar 3 disclosures. However, the Committee has not yet agreed the calibration of the leverage ratio, which is due to become a binding requirement from January 2018.

Meanwhile, some new regulatory reform initiatives have continued to emerge, even seven years after the start of the financial crisis. The most important of these include:

**Risk weighted assets** – the Basel Committee has issued a series of consultation papers on the standardised approaches to credit, market and operational risk; on the setting of a capital floor based on these revised standardised approaches; and on other constraints on internal model-based approaches to credit and market risk.

**Resolution** – the Financial Stability Board (FSB) (for global systemically important banks (G-SIBs) and the EBA (for all EU credit institutions with significant critical economic functions) have proposed minimum requirements on bank issuance of long-term bail-inable debt.

**Structural separation** – the EU Commission issued a proposed regulation on prohibiting proprietary trading in all credit institutions and forcing the ring-fencing of trading entities from core deposit-takers within major banking groups, even as Belgium, France, Germany and the UK were implementing national legislation with much the same content. This is covered in more depth in Part 2 of this year's

*Evolving Banking Regulation*, on bank structure.

As discussed in previous issues of *Evolving Banking Regulation*, banks need to assess and understand the actual and prospective impacts of all these regulatory reforms – both individually and collectively, and in combination with other pressures on banks' profitability and balance sheets. In the area of capital alone, banks need to meet the multiple constraints of Pillar 1 minimum and buffer requirements; prospective changes to risk weightings; Pillar 2 requirements; macro-prudential requirements; a minimum leverage ratio; stress testing; and minimum requirements for loss absorbing capacity. The key question is whether banks can develop – or in some cases maintain – a viable strategy and business model, given these multiple constraints.

In this chapter we focus on five specific areas that will be important for most banks. Together they span the range of regulatory and supervisory reforms being designed or implemented. And they demonstrate the need for banks to remain alert to pressures from multiple sources, including not just new international and national regulatory requirements but also from national (and EU Banking Union-wide) supervisory, macro-prudential and resolution authorities.

“ Banks need to assess and understand the actual and prospective impacts of all these regulatory reforms – both individually and collectively, and in combination with other pressures on banks' profitability and balance sheets. ”

### 1. Macro-prudential regulation – watch this space

“ These measures can, both individually and collectively, constitute a significant requirement on banks, in some cases as large as the move from Basel 2 to Basel 3. ”

One lesson of the financial crisis was the importance of assessing and responding to risks to financial stability at a financial sector level, in addition to the regulation and supervision of individual financial institutions. This has resulted in the rapid growth of ‘macro-prudential’ policy, focusing on risks to financial stability arising from within the financial sector, or likely to be propagated through the financial sector, and on tools to address these risks.

Within this, useful distinctions have been made between cyclical (for example the build-up of asset price bubbles and rapid credit growth) and structural (interconnectedness and vulnerabilities within the financial system) risks to financial stability; and between policy tools directed at enhancing the resilience of financial institutions (such as temporary or permanent additional capital, leverage and liquidity requirements) and those directed at addressing the risks at source (such as limits on exposures between financial institutions).

#### Implications for banks

- Banks need to understand what macro-prudential policy measures might be applied to them, when, by whom, and on what basis.
- These measures may be difficult to predict and follow, especially where new and multiple agencies are involved.
- Macro-prudential requirements can be large – both absolutely and relative to other regulatory requirements.
- Macro-prudential requirements can also be wide-ranging – they can operate not just through additional capital requirements, but also through leverage, liquidity, lending standards, sectoral risk weightings and property taxes.
- Additional complexity may arise through the patchy application of reciprocity across countries to banks’ cross-border exposures.

#### Institutional structures

Institutional structures for macro-prudential policy are taking shape across the EMA region. These are taking different forms, with a mixture of approaches in terms of the roles and responsibilities of central banks, ministries of finance, supervisory authorities and financial stability committees in each country. And in Europe there are the additional complications of (a) the EU-wide role of the European Systemic Risk Board (ESRB) in macro-prudential analysis and issuing recommendations and warnings to member states and to other relevant authorities; and (b) within the Banking Union the overlapping roles of the ECB and national authorities in using macro-prudential policy tools.

#### Powers

National authorities (and the ECB) are putting powers in place for the use of a wide range of macro-prudential policy tools. In the EU, many of these powers and tools are specified in the CRR and CRD4, including:

- the counter-cyclical capital buffer (along the lines set out in Basel 3);
- a systemic risk buffer (SRB), where the CRD4 provides discretion for member states to impose an SRB in order to address long-term non-cyclical systemic risks not already covered by the minimum capital requirements;
- capital surcharges on G-SIBs and other systemically important financial institutions; and
- additional macro-prudential tools specified in the CRR, such as large exposure limits, liquidity requirements, sector-specific risk weights to target asset bubbles in the residential and commercial property sectors, limits on intra-financial sector exposures, and public disclosure requirements on credit institutions.

1. Macro-prudential regulation
2. Risk-weighted assets (RWAs)
3. Comprehensive Assessment
4. Supervision
5. TLAC and MREL – new kids on the block

Moreover, the ESRB has advised the European Commission to amend the CRR and CRD4 to remove the 2 percentage points cap on capital surcharges on domestic systemically important banks, to allow the application of a capital surcharge on a group of banks that are collectively (but not individually) of systemic importance, and to remove the restrictions designed to constrain countries from imposing both a systemic risk buffer and a capital surcharge on systemically important banks.

In addition to the growing use of these tools by a number of countries, some countries have also:

- set maximum loan-to-value (LTV) ratios and imposed limits on affordability (through maximum loan to-income (LTI) and debt-to-income (DTI) ratios, and through stress tests for increases in interest rates);

- included systemic risk as an element in setting Pillar 2 capital requirements;
- proposed that the leverage ratio should increase in line with any additional capital requirements imposed for macro-prudential purposes; and
- proposed the reintroduction of credit controls.

These measures can, both individually and collectively, constitute a significant requirement on banks, in some cases as large as the move from Basel 2 to Basel 3.

The authorities in Norway and Sweden have been particularly active in the use of macro-prudential tools. Norway has already introduced (or announced the introduction of) a series of macro-prudential measures that increase the minimum common equity tier 1 (CET1) capital requirement for systemically important banks to 13 percent.

## Macro-prudential measures in Norway

**SRB:** 3 percentage points on CET1 capital ratio.

**Counter cyclical capital buffer:** 1 percentage point on CET1 capital ratio.

**D-SIBs:** 2 percentage point buffer on CET1 capital ratio.

**Monetary policy:** element of 'leaning against the wind' in setting interest rates to reflect financial stability considerations.

**RWAs:** constraints on internal ratings based (IRB) models for residential mortgage lending to drive the average RWA on this lending to 20-25 percent.

**LTVs:** guideline upper limit of 85 percent LTV on residential mortgage lending.

**Affordability:** requirement on banks to check affordability on residential mortgage lending taking account of a 5 percentage point increase in lending rates.

Source: KPMG International, 2015.

## 2. Risk-weighted assets (RWAs) – the next regulatory frontier

### Basel 4 – Emerging from the mist



Read this publication for more information on Basel 4

The initial focus of Basel 3 was primarily on the numerator of the capital adequacy ratio – the quality (increasing emphasis on CET1 capital and harmonisation of deductions from capital) and quantity (multiple buffers) of a bank’s capital. Changes to the denominator were confined to specific areas such as the risk weights on securitisations and on counterparty credit risk in bilateral trades.

Since then, however – and as predicted in KPMG’s analysis of ‘Basel 4’ in September 2013 – the Basel Committee and other regulatory authorities have been working more comprehensively on the denominator of the capital ratio: a bank’s risk-weighted credit, market and operational risk exposures.

The intention of the regulators is clear: to introduce a revised set of standardised approaches, and to use these to constrain the extent to which banks can reduce their capital requirements through the use of internal models. Completing the ‘Basel 4’ picture, these RWA revisions will then complement the development of international standards on leverage and the use of severe but plausible stress tests as additional determinants of minimum capital requirements.

### Implications for banks

- Reduce significantly the benefits to banks from the use of internal model-based approaches to credit, market and operational risk.
- For some banks, increase the capital required under the standardised approaches.
- Systems and data management enhancements to calculate the new standardised approaches – including by banks using internal model-based approaches.
- Supervisory checks that banks are collecting and applying accurate data on their risk exposures, including the

valuation of residential and commercial real estate, and the calculation of corporate leverage ratios. Deficiencies here could lead to the imposition of additional ‘Pillar 2’ capital requirements.

- Wider economy implications as banks re-price and pull back from some activities. The move to risk drivers and more risk-sensitive risk weightings will accentuate the capital requirement cost to banks of exposures judged under the proposals to be at the riskier end of the spectrum. This could increase the cost – and reduce the availability – of bank finance and other services for these borrowers and other customers. The use of the proposed credit risk drivers will increase the capital cost of lending more than €1 million to small and medium enterprises (SMEs), lending against high LTV residential and commercial real estate, and lending to other banks with low capital ratios and poor asset quality.

### Rationale and overall regulatory approach

Regulators are concerned that:

- the standardised approaches to credit and counterparty risk relied too heavily on external credit ratings;
- some banks have been too aggressive in the use of internal model-based approaches to drive down risk weightings; and
- risk weightings generated by internal models are too complex and opaque, and this lack of transparency constrains the scope for relying on market discipline.

Having published a series of analyses of variances across banks in the results of using internal ratings-based (IRB) models for credit and market risk, the Basel Committee and the European Banking Authority (EBA) have been developing a series of proposals designed to constrain

1. Macro-prudential regulation
2. Risk-weighted assets (RWAs)
3. Comprehensive Assessment
4. Supervision
5. TLAC and MREL – new kids on the block

variability across banks and the aggressive use of models to drive down risk weightings. These include:

- constraining internal models for credit and market risk;
- additional disclosure requirements, including what the capital charges would have been under the corresponding standardised approach;
- the role of the leverage ratio as a back-stop to protect against model errors; and
- a wider-ranging strategic review of the capital framework, focusing on the costs and benefits of basing regulatory capital on banks' internal models, whether internal modelling options have improved banks' risk management frameworks, and developing alternative approaches that maintain adequate risk sensitivity while reducing or removing reliance on banks' internal models.

Within this overall approach, the Basel Committee has proposed a series of specific proposals covering both standardised and internal model-based approaches.

#### Credit risk: standardised approach

In its consultative document on revisions to the standardised approach to credit risk (December 2014), the Basel Committee set out proposals to make the approach more risk sensitive, more closely aligned (in terms of definitions and scope) to the internal ratings-based approach, and less reliant on external credit ratings.

The main proposals are to introduce a 'risk drivers' approach to some asset classes, with these risk drivers determining the standardised risk weights:

- *Corporate exposures* – replace external credit ratings with two risk drivers: the revenue and leverage of the borrower, to determine risk weights ranging from 60–300 percent.
- *Residential mortgages* – determine risk weights by two risk drivers: loan-to-value and debt-service coverage ratios, with risk weights ranging from 25–100 percent.
- *Other retail* – tighten the criteria to qualify for the 75 percent preferential risk weight.
- *Exposures secured on commercial real estate* – two options here: (a) to treat these as unsecured exposures to the counterparty, with a national discretion for a preferential risk weight under certain conditions, or (b) to determine risk weights on the basis of the loan-to-value ratio, with risk weights ranging from 75–120 percent.
- *Banks* – replace external credit ratings with two risk drivers: the capital adequacy ratio and an asset quality ratio of the borrower, to determine risk weights ranging from 30–300 percent.
- *Credit risk mitigation* – amend the framework by reducing the number of approaches, recalibrating supervisory haircuts, and updating corporate guarantor eligibility criteria.
- *Sovereigns, central banks and public sector entities* – no changes at this stage, pending a wider review of sovereign exposures.

“ The Basel Committee has been developing a series of proposals designed to constrain variability across banks and the aggressive use of models to drive down risk weightings. ”

Risk	Revisions to standardised approach?	New constraints on use of models	Impact of proposed new capital floor on banks using model-based approaches
Credit	yes	yes	yes
Market	yes	yes	yes
Counterparty	yes		yes
Operational	yes		yes

Source: KPMG International, 2015.

These proposed new risk weights are generally higher on average than under the current standardised approach – in particular the proposed range of risk weights for corporates of 60–300 percent is considerably higher than the current range of 20–150 percent; while for exposures to other banks the range begins at 30 percent rather than the current 20 percent. The Basel Committee's quantitative impact study should clarify the extent to which the new risk weights would lead to higher capital requirements – but banks should be undertaking their own analysis to assess the potential impact of these proposals on the shape of their credit book, pricing and therefore profitability.

### **Counterparty credit risk: standardised approach**

The Basel Committee published its final rules on the standardised approach for measuring counterparty credit risk exposures in April 2014. These are based on calculations of a replacement cost and potential future exposures for derivatives and long settlement transactions.

### **Market risk: standardised approach**

Within its third consultative document on the fundamental review of the trading book (December 2014), the Basel Committee proposed a more risk-sensitive standardised approach to market risk. Its earlier proposals for a cash flow-based calculation of the standardised approach have been replaced with a 'sensitivity-based approach' (SBA). The SBA would require banks to use price and rate sensitivities as inputs to the different asset class treatments, to capture more granular or complex risk factors across different asset classes in the trading book.

This is closer to the approach currently taken by major banks – many of whom still have large parts of their trading book under the standardised approach – and should therefore reduce the implementation cost of the revised standardised approach (compared with the cash flow method). However, the reliance of this approach on the pricing models of firms still comes at a cost to simplicity and consistency, and it will be more complicated than the current standardised approach for market risk.

### **Operational risk: standardised approach**

The Basel Committee proposed a revised standardised approach to operational risk in its October 2014 consultative document. This would:

- replace the existing basic indicator and standardised approaches with a single revised standardised approach;
- replace gross income with a 'business indicator' (BI) as a proxy for the level of operational risk, and remove the current links to different business lines. The BI would be the sum of net interest income, fee income and expenses, other operating income and expenses, and the absolute values of banking book and trading book P&Ls; and





- apply coefficients to the BI based on the size of a bank, with these coefficients increasing with size. Operational risk charges under the proposed approach would therefore increase non-linearly with the size of a bank, unlike under the current approaches. The capital charge would be 10 percent of the first €100 million of a bank's BI, 13 percent of the next €900 million, 17 percent of the next €2 billion, 22 percent of the next €27 billion, and 30 percent beyond €30 billion.

### Capital floor

The Basel Committee is consulting (December 2014) on a capital floor based on the revised standardised approaches, to replace the 'Basel 1' capital floor. The basic proposal here is to formulate a capital floor based on the proposed new standardised approaches to credit, market and operational risk. The Basel Committee offers no proposed calibration of the capital floor, but has invited comments on:

- the level at which a capital floor would operate – at an overall level across all risk exposures, for each of credit, market and operational risk, or for specific types of exposure (for example, different types of credit risk);
- adjustments for provisions, which enter the calculations of the standardised and internal ratings-based approaches to credit risk in different ways; and
- whether the standardised approach should reflect the use of national discretions in the application of Basel standards.

### Fundamental review of the trading book

The longest running saga in the RWA space is the Basel Committee's fundamental review of the trading book. A second consultation paper back in October 2013 outlined a set of proposals that formed the basis for quantitative impact studies. These proposals included:

- a simpler and tougher boundary between the trading book and the banking book;
- calculating risk weights using an expected shortfall measure, and extending the assumed time horizons for liquidating market exposures, to capture better the impact of stressed market conditions;

- a tougher approach to allowing hedging benefits;
- restricting calculations of the credit risk on securitisations in the trading book to a revised standardised approach; and
- requiring banks using internal models to disclose the capital charges that would have been required under the standardised approach.

In September 2014 the Basel Committee published the first of two quantitative impact studies, applying the proposed standards to a set of hypothetical portfolios (rather than banks' actual portfolios, which will be the focus of the second study). The results showed that the proposed new standards are not likely to increase variability across banks in comparison to the measures in the current market risk framework; the proposed varying liquidity horizons give consistent capital outcomes; constraining diversification and hedging benefits increases the overall capital charges; and overall the proposals would increase capital charges significantly for all asset classes except equities.

In its latest (third) consultation paper (December 2014) the Basel Committee proposed further revisions to the trading book regime, covering not only the standardised approach but also:

- the treatment of internal risk transfers of equity risk and interest rate risk between the banking book and the trading book, to supplement the existing treatment of internal transfers of credit risk;
- two options for the treatment of general interest rate internal risk transfers; and
- a more approximate and more flexible approach to liquidity horizons, including an expected shortfall base horizon for all risk factors and a collection of incremental expected shortfalls for subsets of risk factors with longer liquidity horizons, and the aggregation of these expected shortfall measures with an assumption that factor shocks are not correlated across liquidity horizons.

A second quantitative impact study, based on these proposed revisions and using a sample of banks' actual trading book portfolios, will be undertaken by the Basel Committee in the first half of 2015.

“ The Basel Committee's quantitative impact study should clarify the extent to which the new risk weights would lead to higher capital requirements – but banks should be undertaking their own analysis to assess the potential impact of these proposals. ”

### 3. Comprehensive Assessment – immediate and longer-term impacts

“ The AQR increased significantly the €1.2 trillion of non-performing exposures across the euro area, which already tied up around €100 billion of banks’ capital and dragged down the average return on equity, with a disproportionate concentration of these negative factors in the troubled euro area countries. ”

During 2014, the ECB conducted a Comprehensive Assessment of 130 major banks from 18 member states in the euro area, constituting around 85 percent of euro area bank assets. The two main elements of this assessment were an asset quality review (AQR) and a stress test (conducted jointly with the EBA on an EU-wide basis).

Although the results of the Comprehensive Assessment were of most immediate importance to the banks identified as needing to rectify a capital shortfall, the exercise will also be of wider relevance in providing a starting point for the ECB’s supervisory responsibilities and for the design and focus of future stress tests.

#### Implications for banks

- Post-AQR follow-up agenda set out by the ECB.
- Incentive to sell off non-performing exposures.
- Wider range of banks subject to stress tests specified by the EBA and ECB, requiring these banks to provide more detailed reported data.
- Greater emphasis in future stress tests on specific areas of banks’ activities (sovereign debt, household sector, trading

book, international and emerging market exposures), the leverage ratio, funding and liability structure, and operational risk and the costs of misconduct.

- Greater emphasis in future stress tests on banks’ processes and systems for converting macro and financial variable stress tests into an impact on their capital ratios.

#### Asset quality review

As expected, the AQR identified a series of issues, reflecting in part the application of a common approach to impairment criteria and provisioning levels across the euro area, and in part the failure of some banks to meet adequate standards in the identification of non-performing loans and other exposures, and in making adequate provisions against impaired assets.

18 percent of loans reviewed under the AQR were reclassified from performing to non-performing, with the highest proportions in loans to large corporates, shipping exposures, project finance and other non-retail. This in turn increased significantly the €1.2 trillion of non-performing exposures across the euro area, which already tied up around €100 billion of banks’ capital and dragged down the average return on equity, with a disproportionate concentration of these negative factors in the troubled euro area countries.

1. Macro-prudential regulation
2. Risk-weighted assets (RWAs)
3. Comprehensive Assessment
4. Supervision
5. TLAC and MREL – new kids on the block

## Non-performing exposures and returns on equity (number of banks)

Number of banks by NPE and RoE buckets			
		RoE	
		Less than 10%	More than 10%
NPE	Less than 5%	55	21
	Between 5 and 10%	17	2
	Above 10%	30	5

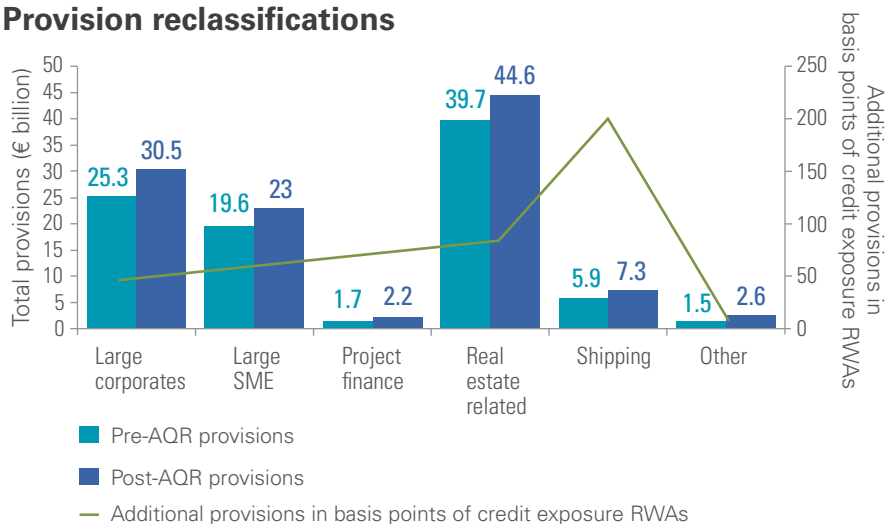
Source: ECB/EBA; KPMG Analysis

As non-performing exposure ratios increase, bank profitability is dragged down, as evident in the table above. Immediate attention is required to manage or sell non-performing exposure portfolios. But this alone will not restore profitability.

Higher non-performing exposures were also one driver of higher levels

of provisioning, although in many cases higher provisions were also required against exposures that had already been classified as non-performing, in order to take account of the extent of impairment and the impact of weak or deteriorating economic conditions (see chart below).

## Provision reclassifications



Source: European Central Bank, 2014.

“ The ECB intends to follow up the key shortcomings revealed by the AQR. ”

Another area of deficiency uncovered by the AQR was in the use of fair value models in banks' trading books. Nineteen of the 26 banks sampled here were found to be deficient in at least one of model validation, CVA calculations, independent

price verification, fair value adjustments, and profit and loss attribution.

The ECB intends to follow up the key shortcomings revealed by the AQR, as shown in the table below.

### AQR shortcomings

#### Fair value hierarchy

Banks will need to revisit their internal definitions and ensure they are aligned to accounting policies adopted by the EU.

#### Forbearance

Banks will need to meet revised expectations on how they identify exposures to which forbearance should apply.

#### Provisioning

Large AQR adjustment to carrying values highlights the poor coverage ratios across the industry and a need for banks to improve their provisioning processes.

#### Collective provisioning

The AQR revealed that a number of banks were out of line with accounting standards in (i) not drawing a clear distinction between individual and collectively provisioned exposures; (ii) not justifying and quantifying emergence periods applied to incurred but not reported calculations; and (iii) using nominal or market rates rather than the effective interest rate.

#### Data systems and quality

Some banks lacked easily accessible financial information for debtors such as earnings before interest, taxes, depreciation and amortisation (EBITDA) and cash flows, making it difficult for them to assess the true financial health of borrowers.

#### Trading book processes

Banks were found to have weaknesses in model validation; credit valuation adjustment (CVA) calculation methodologies; fair value adjustments; independent price verification; and management information on P&L attribution.

## Stress tests

The EBA stress test was applied to 124 banks across the EU, covering at least 50 percent of the national banking sector in each member state. The results of the AQR informed the starting point of the stress test for banks in the euro area.

The EBA stress test used an adverse scenario designed by the European Systemic Risk Board to reflect a set of systemic risks, including a further deterioration of credit quality; a sharp increase in global bond yields; renewed doubts over fiscal sustainability; an abrupt reversal in risk sentiment towards emerging market economies; and a contraction in the availability of market funding for banks.

Over a three-year period this adverse scenario included:

- real gross domestic product (GDP) 7 percent lower in the EU than in the baseline scenario by end-2016;
- unemployment in the EU 2.9 percentage points higher than in the baseline scenario by end-2016;
- EU government long-term bond yields spiked at the end of 2014, at 150 basis points higher than baseline on average across the EU, and over 300 basis points higher in Greece;

- equity and house prices 20 percent lower than in the baseline scenario, and commercial property prices 15 percent lower;
- banks' longer-term funding costs reflect the increases in bond yields, while their short-term funding costs rise by 80 basis points; and
- currencies of central European economies depreciate by 15–25 percent.

Banks were then expected to assess the impact of this adverse scenario on their capital ratios, with the impact passing through a number of transmission mechanisms, including net interest margins, loan and trading book losses, higher provisions, and higher risk-weighted assets.

The impact of the stress test was assessed in terms of the CET1 capital ratio, using the CRR transitional arrangements that apply in 2014–2016. Banks were expected to meet an 8 percent CET1 ratio under the baseline scenario, and a 5.5 percent ratio under the adverse scenario.

Overall, the AQR and stress test results showed that, under the adverse scenario, EU banks' CET1 ratios would fall from 11.8 percent at end-2013 to 8.4 percent at end-2016 (see chart below). More than half of this overall decline was attributable to

the impact of impairments, provisions and higher risk weights in the corporate sector, including SMEs.

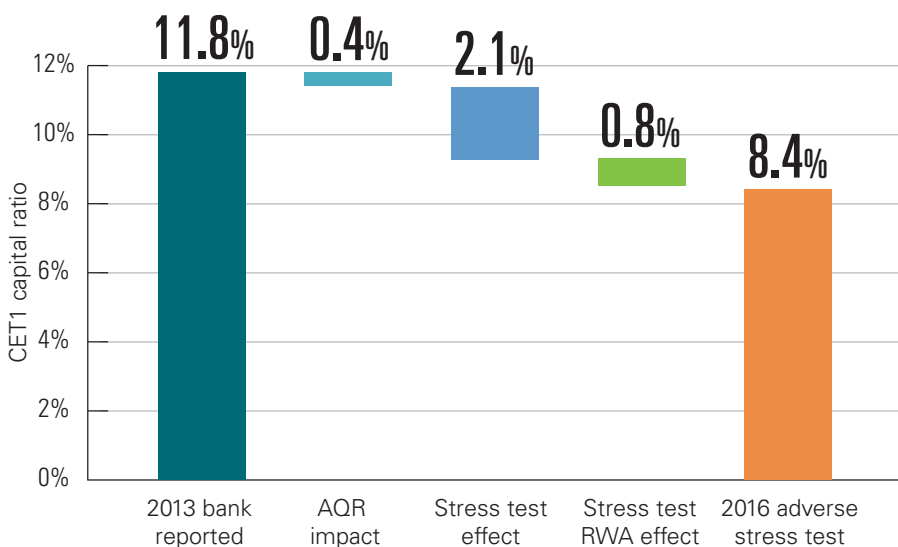
Within this overall result, 25 banks would have a capital shortfall, in the sense of being unable to withstand the stress test without their CET1 ratio dropping below 5.5 percent. However, 12 of those banks had already raised or retained sufficient capital during 2014 to meet the stress test, while four other banks had plans to do so as part of longer-term restructuring plans. The remaining nine banks submitted plans to improve their capital positions by the middle of 2015 – these plans were all approved by the ECB in December 2014.

In addition, 20 further banks were identified as facing capital constraints as a result of showing a post-stress CET1 ratio of between 5.5 and 7 percent, or below 5.5 percent on a 'fully loaded' CRR basis (assuming all the transitional arrangements had been completed).

Meanwhile, some national authorities, including in the UK, extended the stress test, by applying it to a wider range of banks and/or by applying a tougher adverse scenario in addition to the standard EBA adverse scenario.

The stress test exercise also revealed inadequacies in the availability and quality of data at some banks, and the difficulty faced by some banks in modelling the impact of an adverse scenario on their net income and capital ratios. There are strong echoes here of the results of the 2014 Comprehensive Capital Analysis and Review (CCAR) in the US, where the Fed announced that five (out of 30) bank holding companies had failed the CCAR because of inadequacies in their ability to run a stress test, while only one of these banks showed a capital shortfall. Supervisors in Europe are likely to follow the lead of the US Fed in focusing increasingly on whether banks have adequate processes and systems to convert macro and financial variable stress tests into an impact on capital ratios.

## Comprehensive Assessment adverse scenario impact on capital ratios



Source: European Banking Authority 2014.

### 4. Supervision – a new world for major banks in the Banking Union

“ The ECB has the resources, expertise and inclination to undertake large-scale data analysis, so banks should expect a demand for data at a very granular level. The data requests during the AQR may therefore be only the beginning of the ECB’s demands.”

In November 2014 the ECB assumed responsibility for the supervision of all credit institutions in the Banking Union. This will be a game-changer for these banks, in particular the 123 banks supervised directly by the ECB itself, with a significant impact on banks’ strategy and business models, data and IT infrastructure, and risk modelling.

#### Implications for banks

- An increasingly pan-European approach to supervision and the phasing out of national discretions.
- Rigorous supervisory assessment of key supervisory review and evaluation process (SREP) areas.
- Higher Pillar 2 capital requirements.
- Increasing number of inspections – both bank-specific and as part of horizontal reviews.
- Increasing data demands by the ECB – so banks need a technical infrastructure which is both flexible enough to allow for changing requests and well-enough embedded in a bank’s risk management infrastructure to facilitate periodic exercises such as stress tests.
- New ECB supervisory culture.

#### ECB supervision

Banks supervised directly by the ECB will be supervised by joint supervisory teams, drawn together from the ECB’s own staff and staff from the relevant national supervisor(s). This will take some time to settle down, as the detailed logistics are determined, but it is clear that the ECB does not intend to allow the details to delay the full implementation of this approach.

ECB supervision will also mean that directly supervised banks are subject not only to a single rule book, but also to a single supervisory authority interpreting and applying the rules.

#### Key features of ECB supervision will include:

- A common SREP, following the ECB’s Guide to Banking Supervision and the EBA’s SREP guidelines (December 2014). This covers some elements which will be new for banks in some countries, such as the supervisory review of the viability of a bank’s business model, and supervisory and challenger models of a bank’s capital and liquidity. It will also include detailed bank by bank assessment of more traditional risk areas, such as credit, counterparty and concentration risks; market and operational risks; securitisation; and internal governance and risk management.
- A series of horizontal reviews, including a review of variations in risk weighted assets across jurisdictions arising from differences in national requirements and supervisory approaches to banks’ use of internal models. This would complement the AQR and fit with the extensive work of the Basel Committee and the EBA in this area. The Comprehensive Assessment was an early example of how this will operate, with the ECB seeking to apply centrally-determined interpretations and judgements in order to drive consistent supervisory approaches across the Banking Union.
- Rigorous risk analysis at a sector and systemic risk level, based on very detailed data from the banks. The ECB has the resources, expertise and inclination to undertake large-scale data analysis, so banks should expect a demand for data at a very granular level. The data requests during the AQR may therefore be only the beginning of the ECB’s demands.

1. Macro-prudential regulation
2. Risk-weighted assets (RWAs)
3. Comprehensive Assessment
4. Supervision
5. TLAC and MREL – new kids on the block

- Follow-up to the deficiencies uncovered in the AQR and the stress test.
- Pressure from the ECB on national supervisory authorities to apply more consistent approaches to the banks they continue to supervise, in line with the ECB's approach to directly supervised banks.

The regulation establishing the ECB as the banking supervisor in the Banking Union area also gives the ECB a wide range of supervisory powers and sanctions. Banks which fail to adapt quickly to the ECB's challenges run the risk of earning low supervisory 'scores' which in turn may lead to supervisory actions, such as higher capital or liquidity Pillar 2 requirements or structural measures to improve a bank's recovery and resolution planning. The ECB has already been active in setting Pillar 2 capital requirements for the banks it supervises directly; has issued

recommendations that banks should take a conservative approach to dividend distributions; and has announced a review of variable remuneration.

#### **Similar supervisory approaches elsewhere ...**

Although the setting of Pillar 2 capital requirements has been part of the armoury of banking supervisors for many years, it is being used more actively across the EMA region. Sweden and the UK have revised their approaches to setting Pillar 2 capital requirements, in the light of the CRR and the EBA's SREP guidelines; while outside the European Union many national authorities in the rest of Europe, and across Africa and the Middle East, are adopting tougher and more intensive supervisory stances. Kuwait, the UAE, Qatar and Saudi Arabia are placing more emphasis on ICAAP and SREP as key elements of their supervisory approaches.



### 5. TLAC and MREL – new kids on the block

The FSB issued a consultative paper on TLAC (Total Loss Absorbing Capacity) just ahead of the G20 Brisbane summit in November. The FSB proposals are limited to G-SIBs (excluding those from emerging economies) and will not apply until 2019. However, the closely related EBA proposals for EU credit institutions to hold Minimum Required Eligible Liabilities (MREL) will apply a similar approach – and apply it much sooner – to a wider range of banks in Europe.

#### Implications for banks

- Banks subject to a TLAC and/or MREL requirement may need to raise additional debt that qualifies for inclusion, or to convert some existing long term debt into eligible debt instruments. This may be expensive and have a significant impact on a large bank's cost of funding. Investors in eligible debt will know that they will be among the first to be bailed-in in the event that a bank is put into resolution, and will demand a coupon to reflect this. There may also be constraints on which investors are allowed to hold eligible debt. Some banks may struggle to raise additional long-term debt.
- Banks funded primarily by customer deposits – from consumers and corporates – may have to replace some of these deposits with long-term debt. Re-engineering the liability stack to meet TLAC and MREL requirements could be very challenging and take time.
- G-SIBs in the EU will have to meet whichever requirement is higher for them – the RWA-based TLAC or the total liability-based MREL.

- In addition banks will need to take account of:
  - **Strategic considerations:** additional funding costs may accelerate the closure of sub-scale and unprofitable businesses.
  - **Balance sheet management:** the TLAC and MREL requirements add to the increasing cost and inflexibility imposed by regulation on banks' balance sheets, including higher capital and long-term debt on the funding side, and high quality liquid assets on the asset side.
  - **Risk management:** funding risk appetite will need to be constrained to ensure that a bank meets continuously its capital, MREL and any TLAC requirements, further limiting strategic flexibility.
  - **Local requirements:** international banking groups may also be subject to local jurisdiction requirements on their overseas subsidiaries. MREL will be set for each regulated credit institution, so the relevant national authorities would have to agree to any pre-positioning of MREL at parent or holding company level, which may constrain the ability of banking groups to implement a 'single point of entry' approach to the issuance of TLAC or MREL. This adds yet another layer of complexity to making cross-border resolution operate effectively. Banks should also not place too much weight on the smooth functioning of cross-border resolution arrangements – the US Fed announced in August 2014 that one of the shortcomings in major US banks' resolution planning was placing too much reliance on these arrangements.



1. Macro-prudential regulation
2. Risk-weighted assets (RWAs)
3. Comprehensive Assessment
4. Supervision
5. TLAC and MREL – new kids on the block

### What do TLAC and MREL provide?

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 banks. The writing down or conversion into equity of creditors' claims provides a means of meeting losses and of recapitalising a failing bank without using taxpayer funds and without the constraints imposed by a liquidation under ordinary insolvency procedures.

TLAC and MREL take this one step further, by requiring systemically important banks to hold a minimum amount of 'junior' liabilities that could be bailed in ahead of ordinary 'senior' creditors, and without disrupting the provision of critical functions or giving rise to material risk of successful legal challenge or compensation claims.

If a bank 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 TLAC or MREL. Other creditors would only be bailed-in if this proved insufficient to meet losses and to provide any required recapitalisation of the bank.

### What is included in TLAC and MREL?

The TLAC and MREL proposals differ slightly in their eligibility criteria, with the MREL proposals based on the provisions of the BRRD, which do not require eligible liabilities to be subordinated to all other non-TLAC liabilities.

	TLAC	MREL
<b>Tier 1 and tier 2 regulatory capital</b>	✓	✓
<b>Debt that is:</b>		
More than one year remaining maturity	✓	✓
Unsecured and uninsured	✓	✓
Not subject to any depositor preference		✓
Contractually (or under governing law) subject to bail-in in a resolution	✓	
Subordinated to all other non-TLAC liabilities	✓	

Source: KPMG International, 2015.

“ TLAC and MREL require systemically important banks to hold a minimum amount of ‘junior’ liabilities that could be bailed in ahead of ordinary ‘senior’ creditors. ”

### How much TLAC and MREL is required?

The calculation of the minimum standards is complicated for both TLAC and MREL. Under the FSB proposals a G-SIB would need to maintain TLAC of 16–20 percent of its risk weighted assets, plus its capital surcharge and any capital buffers (the conservation buffer of 2.5 percent, and any counter-cyclical capital buffer or additional systemic risk buffer).

For a G-SIB with a 2 percent capital surcharge this gives a TLAC requirement of 20.5–24.5 percent of its RWAs.

G-SIBs will also be required to meet a TLAC leverage ratio of at least twice the minimum Tier 1 leverage ratio – so at least 6 percent of total exposures (rather than RWA) must be held as TLAC. The FSB also proposes that at least one-third of TLAC should comprise eligible TLAC debt that does not count as regulatory capital.

A minimum TLAC requirement will apply to each resolution entity within each G-SIB and will be set in relation to the consolidated balance sheet of each resolution group. Under a single point of entry (SPE) resolution strategy the only resolution entity will be the parent or holding company. However, to provide host resolution authorities with additional confidence, the FSB is proposing that material subsidiaries located in host jurisdictions are subject to an internal TLAC requirement equivalent to 75–90 percent of the TLAC requirement that would apply to a material subsidiary on a stand-alone basis.

Under the EU proposals, all credit institutions are potentially subject to the MREL requirement. The MREL requirement was set out in high level terms in the Bank Recovery and Resolution Directive (BRRD), which specified that the MREL requirement should be expressed as a percentage



of total liabilities (including own funds), and that the requirement for each credit institution should be set on a case-by-case basis, taking into account the resolvability, risk profile, systemic importance and other characteristics of each institution.

The EBA has further proposed that:

- G-SIBs and domestic systemically important banks (D-SIBs) would be required to hold around 10 percent of their total liabilities as MREL. Half of this could be held as long-term debt instruments;
- medium-sized banks undertaking some critical economic functions would be required to hold MREL proportionate to the share of their RWAs accounted for by the critical functions. In effect,

the additional debt would be bailed-in if necessary to support the critical functions in a resolution; and

- small banks would not be required to hold any MREL in addition to their basic capital requirements, because they would be liquidated rather than put into resolution if they were no longer viable.

The EBA's standards are due for implementation from 1 January 2016, but resolution authorities can allow for a transition period up to January 2019 – and some delay may arise because not all resolution authorities (possibly including the ECB for the Banking Union) will have completed their assessment of resolution strategies by the end of 2015.

## Comparing TLAC and MREL requirements for a G-SIB

Assume G-SIB with balance sheet of €100 RWAs of €35	
TLAC	MREL
<p><b>Total requirement is 20–25% of RWAs = €7–9</b></p>	<p>a) Expected loss = capital requirement = 14–15% of RWAs = €5</p> <p>b) Recapitalisation = higher of</p> <p style="margin-left: 20px;">i) Capital requirement excluding systemic risk buffers (7% of RWAs = €2.5); or</p> <p style="margin-left: 20px;">ii) Capital requirement to restore confidence in line with peer group (15% of RWAs = €5)</p> <p>c) Adjustments for other considerations (unknown at this stage, but could be positive or negative)</p> <p><b>So total MREL = €10 +/- adjustment</b></p>

Source: KPMG International, 2015.

# Financial services and the jobs and growth agenda

KPMG argued last year that the focus of regulatory reform needs to shift from measures designed to address the last financial crisis to the promotion of jobs and growth. Policymakers need to reflect on two key questions here:



- How can we maximise the contribution of the financial sector to jobs and growth; and
- Has the regulatory reform agenda gone too far?

Financial stability is important. KPMG believes that a balance has to be struck between a very stable financial sector, and a financial market that creates the right conditions to facilitate and sustain economic growth and job creation. The G20 and the EU need to adjust the direction and details of their regulatory reforms so that financial services can make a more positive contribution to jobs and growth.

The table below highlights our main proposals to amend the regulatory reform agenda.

Objective	KPMG recommendations
EU capital markets need to be developed further, to create deeper and more liquid capital markets that enable and facilitate effective and efficient long-term intermediation for the benefit of issuers and investors	<ul style="list-style-type: none"> <li>• Focus on creating a genuine single market</li> <li>• Promote a stronger equity culture</li> <li>• Remove legislative and regulatory constraints, at both EU and national levels</li> </ul>
Insurers and other long-term investors need to be encouraged to provide more funding for infrastructure, SME and other long-term investments	<ul style="list-style-type: none"> <li>• Take a less penal approach to long-term investment in Solvency 2</li> <li>• Greater tranching of infrastructure investments, to reflect the preferences of different types of investor</li> <li>• Improve secondary market liquidity in corporate bond issues, by reversing the penal capital treatments and structural constraints on trading banks</li> <li>• Greater certainty in tax regime for long-term investors</li> </ul>
Asset managers need to be encouraged to invest more in infrastructure	<ul style="list-style-type: none"> <li>• Providing mechanisms (including European long term investment funds (ELTIFs)) for greater long-term investment through managed funds</li> </ul>
Bank lending to SMEs, infrastructure and trade finance, and bank risk management services to customers, should be promoted	<ul style="list-style-type: none"> <li>• Make the capital and liquidity requirements less penal for banks undertaking long-term financing and trade finance</li> <li>• Promote high quality securitisations of bank lending, by treating the issuers and holders of these securitisations similarly to the issuers and holders of covered bonds</li> </ul>

# Summary of regulatory developments

## Summary of regulatory developments in 2014, and anticipated developments in 2015 and beyond

### Capital

	2014	2015	Beyond
Capital	<ul style="list-style-type: none"> <li>• CRR/CRD4 implemented in EU (January)</li> <li>• Other countries implementing Basel 3 from 2014 or 2015</li> <li>• Large exposures (BCBS April)</li> </ul>	IFRS9 and expected credit loss accounting (BCBS consultation paper February)	<ul style="list-style-type: none"> <li>• Full phasing in of higher capital requirements (including deductions from capital, phasing-out of no longer eligible capital issues, SIB capital surcharges)</li> </ul>
RWAs	<ul style="list-style-type: none"> <li>• Standardised approach to measuring counterparty credit risk (BCBS August)</li> <li>• Capital treatment of securitisations, using hierarchy of IRB, external credit rating and standardised approaches (BCBS December)</li> <li>• BCBS consultations on revised standardised approaches to credit (December), market (December) and operational risk (October), and on capital floors (December) based on these revised approaches</li> <li>• Third consultation on fundamental review of the trading book (BCBS December)</li> </ul>	<ul style="list-style-type: none"> <li>• Post-consultation and post-QIS development of: <ul style="list-style-type: none"> <li>– Revised standardised approaches for credit, market and operational risk;</li> <li>– Capital floor based on these revised approaches;</li> <li>– Constraints on model-based calculations of credit and market risk exposures; and</li> <li>– Enhanced disclosure</li> </ul> </li> <li>• EBA discussion paper on the future of the IRB approach (March)</li> <li>• Revised risk weightings for simple securitisations (using criteria proposed by EBA and by BCBS/IOSCO in 2014 for identifying simple high quality securitisations)</li> <li>• Review of sovereign risk exposures (BCBS)</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation of revised approaches</li> </ul>
Comprehensive Assessment	<ul style="list-style-type: none"> <li>• Banking Union asset quality review and EU-wide stress tests</li> </ul>		<ul style="list-style-type: none"> <li>• Regular stress tests, with increasing focus on sovereign exposures, funding and liquidity risk</li> <li>• Wider range of banks</li> <li>• Increasing emphasis on qualitative elements</li> </ul>
Pillar 2	<ul style="list-style-type: none"> <li>• EBA Guidelines on SREP (December)</li> </ul>	<ul style="list-style-type: none"> <li>• UK PRA consultation on revised Pillar 2 regime (January)</li> <li>• ECB introducing more consistent Pillar 2 requirements on major Banking Union banks</li> <li>• Pillar 1 minimum capital requirement on interest rate risk in the banking book</li> </ul>	
Leverage ratio	<ul style="list-style-type: none"> <li>• Agreement on definition of total exposure (BCBS June)</li> <li>• UK FPC proposals on higher leverage ratios for larger UK banks (October)</li> </ul>	<ul style="list-style-type: none"> <li>• Calibration of leverage ratio (BCBS): minimum ratio and capital numerator</li> <li>• Disclosure of leverage ratio by banks</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation as a Pillar 1 minimum requirement from January 2018</li> </ul>

## Summary of regulatory developments in 2014, and anticipated developments in 2015 and beyond

### Systemic risk

	2014	2015	Beyond
SIBs	<ul style="list-style-type: none"> <li>Annual update of G-SIB designation list (BCBS November)</li> <li>National designation of D-SIBs and applicable capital surcharges emerging</li> <li>FSB thematic reviews of prudential and supervisory frameworks for G-SIBs and D-SIBs, and of how G-SIBs have responded to these frameworks</li> </ul>	<ul style="list-style-type: none"> <li>Next G-SIB designation list (BCBS November)</li> <li>Further moves by national authorities to designate D-SIBs</li> <li>Results of FSB thematic reviews</li> </ul>	<ul style="list-style-type: none"> <li>Capital surcharges on G-SIBs phased in from 2016</li> </ul>
Macro-prudential regulation	<ul style="list-style-type: none"> <li>National and Banking Union institutional structures being developed and implemented</li> <li>Use of macro-prudential tools emerging, including counter-cyclical capital buffer, systemic risk buffer, sector-specific capital requirements, and maximum LTVs on residential mortgages</li> </ul>	<ul style="list-style-type: none"> <li>Wider use of macro-prudential tools – a broader range of countries activating these tools, and more tools being used within countries</li> </ul>	
Resolution and bail-in	<ul style="list-style-type: none"> <li>BRRD finalised (April)</li> <li>FSB consultation on cross-border recognition of resolution actions (September)</li> <li>EBA consultation on MREL (November)</li> <li>FSB consultation on TLAC (November)</li> <li>ISDA industry protocol on recognition of stays of contract on bilateral derivatives contracts in event of resolution (October)</li> <li>Series of EBA technical standards relating to BRRD</li> <li>Single Resolution Board and Single Resolution Fund established for the Banking Union area</li> <li>National and Banking Union resolution fund financing arrangements (1 percent of covered deposits over 8 years from 2016 for the SRF, over 10 years from 2015 for national funds)</li> <li>National DGS financing arrangements (0.8 percent of covered deposits over 10 years from 2015)</li> </ul>	<ul style="list-style-type: none"> <li>BRRD implemented (except bail-in)</li> <li>FSB quantitative impact study and survey of market investors (for TLAC)</li> <li>Calibration of MREL and TLAC</li> </ul>	<ul style="list-style-type: none"> <li>BRRD bail-in implemented, including MREL (2016)</li> <li>European Commission review of national implementation of MREL in the EU</li> <li>TLAC implemented (2019)</li> <li>Financing of resolution and DGS funds (through to 2025)</li> </ul>

## Summary of regulatory developments in 2014, and anticipated developments in 2015 and beyond

### Liquidity

	2014	2015	Beyond
LCR	<ul style="list-style-type: none"> <li>Calibration and implementation schedules finalised</li> <li>EU Commission decision on use of covered bonds as HQLAs (October)</li> </ul>	<ul style="list-style-type: none"> <li>60 percent minimum LCR from January</li> </ul>	<ul style="list-style-type: none"> <li>Rest of implementation schedule, up to 100 percent minimum from January 2018 (in the EU) or January 2019 (elsewhere)</li> </ul>
NSFR	<ul style="list-style-type: none"> <li>Revised version agreed (BCBS October)</li> </ul>		<ul style="list-style-type: none"> <li>Implementation as a minimum requirement from January 2018</li> </ul>

### Structure, wholesale markets, governance, and data

Structural separation	<ul style="list-style-type: none"> <li>EU Commission proposals (January)</li> <li>National legislation in Belgium, France, Germany and UK</li> <li>UK secondary legislation and PRA guidance</li> </ul>	<ul style="list-style-type: none"> <li>Proposals revisited by European Parliament and Council</li> </ul>	<ul style="list-style-type: none"> <li>Draft EU legislation proposed implementation of proprietary trading and separation proposals in 2017 and 2018 respectively</li> <li>Implementation of UK legislation from 2016, with back-stop date of 2019</li> </ul>
Wholesale Markets	<ul style="list-style-type: none"> <li>FSB progress reports on the implementation of measures for central clearing, trading and reporting of OTC derivatives (April and November)</li> <li>Capital requirements for bank exposures to CCPs (BCBS April)</li> <li>Series of EMIR technical standards</li> <li>MiFIR/MiFID2 finalised (June)</li> <li>ESMA consultation on technical standards under MiFIR and MiFID2</li> <li>ESMA recommendations to European Commission on Delegated Acts under MiFIR and MiFID2</li> <li>MAR and MAD2 finalised (June)</li> <li>FSB standards on haircuts for non-centrally cleared SFTs (October)</li> </ul>	<ul style="list-style-type: none"> <li>MiFIR and MiFID2 implementing technical standards from ESMA</li> <li>EU legislation on reporting and transparency of SFTs</li> <li>Financial Transactions Tax proposals for some EU member states</li> <li>Risk mitigation standards for non-centrally cleared OTC derivatives (IOSCO January)</li> </ul>	<ul style="list-style-type: none"> <li>Implementation of MiFIR and MiFID2 (January 2017)</li> </ul>
Governance	<ul style="list-style-type: none"> <li>FSB guidance on supervisory assessment of risk culture (April)</li> <li>Basel corporate governance principles for banks (BCBS October)</li> <li>National implementation in some countries of earlier FSB papers</li> </ul>		
Data and reporting	<ul style="list-style-type: none"> <li>National implementation of the BCBS risk data aggregation and reporting principles</li> <li>New regulatory reporting and disclosure obligations, including COREP and FINREP in the EU</li> <li>FSB common data template for G-SIBs</li> <li>IMF/FSB progress report on G20 data gaps initiative (FSB September)</li> <li>Enhanced Disclosure Task Force survey of banks' Pillar 3 disclosures (FSB September)</li> </ul>	<ul style="list-style-type: none"> <li>Second G-SIB self-assessment of risk data principles (BCBS January)</li> <li>Revised Pillar 3 disclosure, phase one (BCBS January), for implementation from end-2016</li> </ul>	<ul style="list-style-type: none"> <li>Revised Pillar 3 disclosure, phase two (BCBS)</li> </ul>

Summary of regulatory developments in 2014, and anticipated developments in 2015 and beyond			
Conduct, supervision, shadow banking and CMU			
	2014	2015	Beyond
Conduct and culture	<ul style="list-style-type: none"> <li>• Mortgage Credit Directive (February)</li> <li>• MiFID2 finalised (June)</li> <li>• ESAs guidelines on retail conduct issues</li> <li>• National implementation of tougher conduct requirements</li> <li>• Further details emerge of some banks' involvement in mis-conduct issues relating to interest rate and foreign exchange benchmarks, financial crime and retail market mis-selling</li> <li>• FSB report on interest rate benchmarks (July)</li> <li>• FSB recommendations on foreign exchange benchmarks (September)</li> <li>• Cost of litigation</li> </ul>	<ul style="list-style-type: none"> <li>• ESMA development of technical standards under MiFID2</li> <li>• EU Regulation on accuracy and integrity of benchmarks</li> <li>• Further litigation costs</li> <li>• Fourth AML Directive likely to be finalised, for implementation by 2017</li> </ul>	
Supervision	<ul style="list-style-type: none"> <li>• FSB progress report on increasing the intensity and effectiveness of supervision (April)</li> <li>• ECB becomes banking supervisor for the Banking Union area (November), under the Single Supervision Mechanism</li> <li>• Growing focus on banks' business models and viability</li> <li>• National jurisdiction requirements trapping capital and liquidity at local level</li> <li>• Structural changes in South Africa – move to 'twin peaks' institutional structure</li> </ul>		
Shadow banking	<ul style="list-style-type: none"> <li>• European Commission proposed Regulation on transparency of securities financing transactions (January)</li> <li>• FSB progress report and roadmap for 2015 (November)</li> </ul>	<ul style="list-style-type: none"> <li>• Money market funds (proposed EU legislation under discussion)</li> <li>• IOSCO shadow banking review</li> </ul>	
Capital markets union	<ul style="list-style-type: none"> <li>• European Commission road map on long term financing (March)</li> <li>• FSB update on regulatory factors affecting the supply of long-term investment finance (September)</li> <li>• IOSCO report on market-based financing for SMEs and infrastructure (September)</li> <li>• Continuing EU discussions of Commission proposals on ELTIFs</li> </ul>	<ul style="list-style-type: none"> <li>• European Commission Green Paper on CMU (February) and action plan (Q3)</li> <li>• Finalisation of EU ELTIF legislation</li> </ul>	

Source: KPMG International 2015.

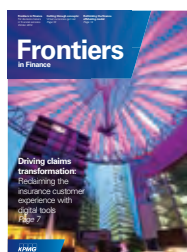


# EBR Abbreviations

AIFMD	Alternative Investment Fund Managers Directive	IFRS	International Financial Reporting Standard
AML	Anti Money Laundering	IMF	International Monetary Fund
AQR	Asset Quality Review	IOSCO	International Organization of Securities Commissions
ASPAC	Asia Pacific Region	IRB	Internal Ratings Based
BCBS	Basel Committee on Banking Supervision	IRRBB	Interest Rate Risk in the Banking Book
BI	Business Indicator	ISDA	International Swaps and Derivatives Association
BRRD	Bank Recovery and Resolution Directive	IT	Information Technology
CCAR	Comprehensive Capital Analysis and Review	LATAM	Latin America
CCP	Central Counterparty	LCR	Liquidity Coverage Ratio
CET1	Common Equity Tier 1	LTI	Loan to Income
COREP	Common Reporting	LTV	Loan to Value
CRD4	Fourth Capital Requirement Directive	MAD2	Second Market Abuse Directive
CRR	Capital Requirements Regulation	MAR	Market Abuse Regulation
CVA	Credit Valuation Adjustment	MiFID2	Second Markets in Financial Instruments Directive
DGS	Deposit Guarantee Scheme	MiFIR	Markets in Financial Instruments Regulation
D-SIB	Domestic Systemically Important Bank	MMF	Money Market Fund
DTI	Debt to Income	MREL	Minimum Requirement for Own Funds and Eligible Liabilities
EBA	European Banking Authority	NPE	Non-Performing Exposure
ECB	European Central Bank	NSFR	Net Stable Funding Ratio
ECL	Expected Credit Loss	P&L	Profit and Loss
ELTIF	European Long Term Investment Fund	PRA	Prudential Regulation Authority
EMA	Europe, Middle East and Africa	QIS	Quantitative Impact Study
EMIR	European Market Infrastructure Regulation	RoE	Return on Equity
ESA	European Supervisory Authority	RWA	Risk Weighted Asset
ESMA	European Securities and Markets Authority	SBA	Sensitivity Based Approach
ESRB	European Systemic Risk Board	SFT	Securities Financing Transaction
EU	European Union	SME	Small and Medium-Sized Enterprise
FINREP	Financial Reporting	SPE	Single Point of Entry
FPC	Financial Policy Committee	SRB	Systemic Risk Buffer
FSB	Financial Stability Board	SREP	Supervisory Review and Evaluation Process
G20	Group of 20	TLAC	Total Loss Absorbing Capacity
GDP	Gross Domestic Product		
G-SIB	Global Systemically Important Bank		
HQLA	High Quality Liquid Asset		
ICAAP	Internal Capital Adequacy Assessment Process		

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Winter 2014

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## Client onboarding

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## Towards the Final Frontier

January 2014

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# Evolving Banking Regulation – Part Two

## Bank Structure: The search for a viable strategy



The second part of the Evolving Banking Regulation series for 2015 will be published in April. It focuses on bank structure, and the search by many banks for a viable and sustainable future in a world where regulatory and commercial pressures are driving business model change.

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- Product and customer proposition and pricing;
- Balance sheet size and composition, on both sides of the balance sheet, and capital planning;
- Legal structure, across types of business and across jurisdictions; and
- Operational structure, including governance, management, organisational structure, risk management and compliance, distribution channels, payment and settlement arrangements, trade and other transaction booking, and the provision of services to support critical economic functions.

Look out for this report at [www.kpmg.com/regulatorychallenges](http://www.kpmg.com/regulatorychallenges)

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