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Commissioner Hill
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Financial Services and Capital Markets Union
European Commission, SPA2 03/071,
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11 January 2016

Dear Sir,

European Commission - Call for evidence: EU regulatory framework for financial services

I am writing on behalf of KPMG's European practices in response to the Call for Evidence on the EU regulatory framework for financial services.

We welcome the decision to recalibrate and revise some of the measures implemented since the financial crisis; not because they were wrong but we now have practical experience of how the measures taken are operating together in practice. It would have been surprising if some revisions were not necessary given the complexity and urgency of the situation in the post financial crisis period.

We are mindful of the reasons for financial stability measures put in place. Equally we recognise the jobs and growth agenda. In our response to the Green Paper on 'Building a Capital Markets Union', KPMG strongly supported the work of the European Commission in its ambitious CMU initiative as an important cornerstone of Europe's jobs and growth agenda.

Since the launch of the CMU last year as Chairman of our European network, I have asked our practices from across Europe to work together to provide input to the work plan, this includes our response to the Green Paper on Building a Capital Markets Union and also contributions to industry groups looking at issues such as revising the Prospectus Directive and simplified securitisations.

As a global network with an operating presence in all 28 EU member states, we will play an active role in supporting the European Commission in its objective to strengthen and deepen Europe's capital markets. We are well-positioned to do so given the breadth and depth of our industry expertise.

You will find enclosed a paper summarising our views on the questions raised in the call for evidence. Our intention is to offer constructive and positive observations on financial regulation where we see areas of inconsistency, duplication, unnecessary complexity.

If you have any questions regarding our thinking I would suggest you contact Giles Williams (giles.williams@kpmg.co.uk) in the first instance.

Yours sincerely

KPMG

KPMG response to the European Commission - Call for evidence: EU regulatory framework for financial services

The call for evidence request from the European Commission comes at a key inflection point for Europe with most of the post financial crisis regulatory reforms now reaching the implementation phase. The design of individual pieces of legislation were well intentioned, but practical experience has shown that when taken in aggregate the cumulative effect of multiple interconnections and duplications is limiting the role that the financial industry can play in supporting economic recovery. The European Commission's approach to take a step back and identify necessary adjustments is the right thing to do to make sure we have a balance between measures to achieve financial stability / safety and those that support jobs and growth.

In our response we offer observations from our experience in financial services across Europe and globally. KPMG has a strong track record in analysing financial regulation and have produced several impact assessment studies, including most recently in 2015 on the Dutch banking sector, a follow up to a report in 2012 and also a linked Belgian study in 2013. We draw upon these in our responses to the call for evidence and would always be happy to have more detailed discussions on any of the points we raise. We also highlight some specific practical audit legislation implementation issues that were unanticipated in the design phase of the new rules.

This written response is in addition to our online questionnaire submission where we have answered the questions where we feel we are best placed to contribute our knowledge.

Overall comments

In KPMG's response[i] last year to the European Commission's Green Paper Building a Capital Markets Union we proposed a series of policy tests that should be applied to support more effective European capital markets. One of these tests was "Make regulation clearer and more consistent" so we welcome the strong signal that the European Commission is sending through this call for evidence. Within our observations we reflect on both finalised and in progress legislation given their significance on the capital markets.

Need for consistency, proportionality and coherence in the regulatory framework

Markets are rightly highly regulated to i) protect consumers and investors and ii) give confidence to market participants, but regulation also adds cost and complexity. The global KPMG Audit Committee Survey (2015)[ii] showed 47% of respondents viewed regulation as one of the greatest challenges for their business. Regulation has a cost, and the private sector – shareholders, employees and customers - must bear this. This call for evidence recognises the need for regulators to ensure effective and proportionate rules without overlaps.

We welcome the European Commission's intention to form a clearer overview of the post financial crisis regulatory framework and to then use the review clauses in the individual pieces of legislation to make adjustments. You have created this opportunity to deliver a holistic view of the required changes. Our experience is that, after several years of intensive legislation, the financial industry is struggling to calibrate the multiple new rules across the capital markets. At a time when we want growth and development of Europe's capital markets this degree of management focus on regulation is inhibiting strategic thinking and innovation in our view. Anecdotally we have observed that the management teams of banks in Asia Pacific have been more focused on transformative strategies including the digital agenda than the banks in Europe, perhaps because they were focusing less senior management time on delivering regulatory change.

Creating a clear longer term vision and road-map

Success of the capital markets in Europe depends on a stable and adaptable financial regulatory framework that fosters and encourages investors and allows intermediaries including the banks to have viable businesses. Global monetary policies are beginning to change and the current 'new normal' of near-zero percent interest rates will come to an end. Europe needs to be in a strong position to fund its growth through capital markets.

With significant external economic factors including global fiscal policies it is important for Europe to focus on what can be done to strengthen its capital markets.

We want Europe to be seen as an attractive investment opportunity for global investors and so need a longer term plan for the financial system – the Capital Markets Union (CMU) initiative is an essential pre-requisite for this. As with other sectors that underpin Europe's economy a comprehensive long term strategy with clear outcomes that citizens, participants and stakeholders can understand is important – we are also supportive of the Digital Single Market and European Energy Market strategies. The Commission is in a unique position to bring together all the necessary stakeholders to discuss a strategy covering policy objectives, mechanisms to deliver and outcomes. The risk is that otherwise we will continually tweak and change the rules creating uncertainty and lack of predictability, which will inhibit growth of our capital markets.

In our 2014 report New Commission New Parliament[iii] we made a number of recommendations, including calling a halt to some legislation and providing greater certainty over what is still to come. Businesses need to plan ahead to make the changes required to their systems, processes and organisational structures. Our 2015 Evolving Banking Regulation - from design to implementation[iv] report includes a 'road-map' highlighting where areas of uncertainty remain, we have produced similar pieces of analysis for the Investment Management and Insurance sectors.

We recommend that the Commission takes the opportunity from the results of the call for evidence to produce a complete roadmap of regulations including those still being discussed by international bodies such as the FSB, Basel Committee, IOSCO and IAIS. This could then be used to identify where the key interactions are and where future adjustments could be made to make the framework more appropriate within the context of growing and effective capital markets. It would flush out the unanticipated consequences and allow balanced recalibration between financial stability and innovation.

Answers to specific questions in the call for evidence

Rules affecting the ability of the economy to finance itself and grow

Q1) Unnecessary regulatory constraints on financing

Impact of CRDIV/CRR capital and liquidity requirements

KPMG in the Netherlands' report The state of Dutch banks in 2015[v] builds on a study from 2012 on the cumulative impact of regulations, and provides a useful snapshot of banks' balance sheets, some key points include:

I. Liquidity Coverage Ratios (LCR) are well above the minimum required levels. This has been achieved by increasing buffers of High Quality Liquid Assets (HQLA) and lowering short-term wholesale funding.

II. Net Stable Funding Ratios (NSFR) also increased through reduced short-term funding but also an increase in retail deposits.

This could be an area that requires careful monitoring in Europe, where the Basel III requirements are applied to a larger number of banks through CRD IV/CRR, than is the case in other jurisdictions such as the US, and so the overall impacts on liquidity could be more pronounced.

This trend for liquidity requirements being met by an increase in retail deposits is important in the context of CMU where we should aim for more savers becoming investors, and illustrates the careful balance that needs to be achieved between policy goals for stability against those for growth.

The Dutch report concludes that while banks have improved their capital ratios, the current low level of profitability combined with additional regulatory reform has given rise to new challenges. As the leverage ratio limits balance sheet growth, banks may restore profitability by investing in riskier assets and by further increasing the cost of credit. The extent to which the cost of credit may increase will depend largely on banks' ability to lower their cost structures. In our scenario analysis, the cost of credit is expected to increase by between 20bps and 45bps, assuming that banks are able to achieve targeted cost reductions and reduce loan impairments.

By increasing the cost of credit, the return to profitability of Dutch banks will come at a price for the real economy. Moreover, it remains to be seen whether banks will be able to support full economic recovery. If the target leverage ratio is set at 4% and the economy fully recovers, banks will need to raise additional capital to meet demand. In such a scenario, the availability and accessibility of alternative financing sources may become vital for Dutch corporates.

The findings of the Dutch study support the prediction KPMG made in a 2012 report Liquidity a bigger challenge than capital[vi] that for many banks, the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements are 'the iceberg below the water' as liquidity standards would force banks to adjust by:

a. Reduce the overall size of their balance sheets to increase the proportion of customer funding – since, for the banking system as a whole the supply of customer (retail and corporate) deposits is inelastic.
b. Move from short-term wholesale funding to longer-term wholesale funding, with a consequent increase in funding costs.
c. Hold a larger amount of liquid assets, and within this switching into liquid assets that qualify as high quality liquid assets for the purposes of the LCR, with a consequent reduction in interest income, profitability and return on equity.
d. Reducing the proportion of longer-term lending, which is more expensive to fund under the NSFR.

'Basel IV' – the pipeline of bank capital requirements

In our 2013 Basel 4 – Emerging from the mist[vii] report we expressed concerns that capital, liquidity and leverage requirements on banks were extensively developing before the Basel III standards had been fully implemented, with consequences on banks' functioning in the economy.

The 2015 update to the report Basel 4 revisited[viii] reassessed our concerns. We estimated in 2013 that major UK banks might need an additional GBP 50 billion of CET1 capital (an increase of around 25 percent) to meet all the regulatory requirements beyond Basel III, or to make a corresponding reduction in risk weighted assets. In practice, between June 2013 and June 2015 these banks have increased their CET1 capital by GBP 20 billion, and reduced their risk weighted assets by GBP 350 billion, thereby increasing their CET1 capital ratios from 9.4 percent to 12.0 percent.

The strategic and business implications for banks we set out two years ago have become even more pronounced. Many banks have:

i. Raised more capital and/or reduced their on- and off-balance sheet activities, which will have increased the cost and reduced the availability of bank finance for individuals, corporates and other bank customers; and reduced liquidity in some markets.
ii. Re-evaluated the balance between lower and higher risk businesses as regulation takes a less risk-sensitive approach to capital requirements. Once liquidity needs have been met, there is a strong perverse incentive for banks to reduce their holding of less risky assets, including sovereign debt, other highly rated securities, prime mortgage lending, high quality corporate lending and fully secured exposures. This may lead to a significant shift in some banks' business models, and in the price and availability of these types of bank intermediation.
iii. Banks also need to respond to the data and systems implications of capital, liquidity and leverage requirements, not least in calculating (and disclosing) the revised standardised approaches and the leverage ratio; and in undertaking a range of stress tests. The initial apparent inertia to address the challenges set out in Basel Committee principles on risk data aggregation and reporting (BCBS 239) has now been set aside – in Europe, the data challenges from the ECB's Asset Quality Review were the primary driver for this change.
iv. As covered in our Evolving Banking Regulation - The Search for a Viable Strategy[ix] report in 2015, the multiple regulatory and commercial pressures on banks are making it more difficult for banks to develop and implement viable and sustainable business strategies, and to meet the expectations of their customers, investors and regulators simultaneously.

We highlighted in the 2013 Basel 4 – Emerging from the mist report the many 'parallel tracks' of regulation that would potentially have an impact on banks' capital and liquidity requirements, including capital surcharges for systemically important banks, the use of macro-prudential instruments, resolution and structural separation within banking groups. These have progressed over the last two years, and in some cases have gone significantly further than predicted. The Financial Stability Board proposals for Total Loss Absorbing Capital (TLAC) and the use of multiple macro-prudential instruments in countries such as Norway and Sweden are examples of this.

Understanding the 'trade off' between different regulatory policy approaches is well illustrated by a recent Bank of England paper[1]. The paper re-runs the earlier (2010) Basel Committee estimates of the costs and benefits of higher capital requirements taking account of more recent regulatory reforms such as resolution, ring-fencing and TLAC.

The report concludes that the optimal Tier 1 capital ratio is in the region of 10-14 percent, below the Basel Committee estimates of 16-19 percent, but with additional counter-cyclical buffers imposed in periods when economic risks are elevated. The analysis estimates that implementation of effective resolution plans can reduce the optimal level of bank capital

[1] http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper35.pdf

ratios by 5 percentage points (from 16 percent down to 11 percent). This shows the need to look across different rules and take into account their effects, reducing if necessary one set of requirements to balance out another.

Role of insurers and pension schemes in infrastructure financing

Life insurers and pension schemes need long-term asset classes with predictable cash flows to match the obligations arising under their long-term liabilities, especially in relation to pensions. The European Commission has been actively encouraging pension providers to invest in infrastructure investments, seeing a natural fit between Europe's long-term funding needs and the long-term nature of life insurance liabilities.

This creates a problem as insurance sector regulation is focused on ensuring consumer protection and ensuring that all risks, including those within investment portfolios, are properly understood and managed; with both duration matching and cash flow matching equally important. An issue with some infrastructure projects is the potential unpredictability of cash outflows, especially during the development phase of the project, and the timing of future cash inflows. Changes to governmental fiscal policies and regulatory interventions do not make as stable an investment proposition as should be possible with these types of assets.

So it is not clear whether infrastructure projects are necessarily the right type of investment for pension savings. Projects often come with the risk of construction and development overruns or lower potential operational returns, which could lead to consumer detriment. This may lead to caution, especially from pension schemes, as any loss would be passed to customers.

Solvency II rules mean that insurers must hold capital at the level of a 1 in a 200 year event which is incompatible with significant portfolio realignment into infrastructure investments. We have already seen warnings from regulators including the Bank of England about the dangers involved with infrastructure investments, which influences insurers' investment decisions[2].

Although the Commission's proposed amendments to the Solvency II seek to incentivise insurers to move into this asset class, it is unlikely to achieve the desired results. There are a number of reasons for this:

i. A number of insurers had already made commitments to invest part of their portfolio in infrastructure investments in advance of this initiative. However these are amongst the largest insurers in Europe. For example, the UK government announced in 2013 that six of the major UK life insurers had announced plans to collectively invest at least GBP 25 billion in UK infrastructure by the end of 2018. Of these, five have now received internal model approval from the PRA, so the proposed changes to the calibration of the standard formula would have no direct impact on them[3].
ii. The proposed definition of "qualifying infrastructure investments" is narrowly drawn, which will limit the potential projects that insurers could invest in to qualify for the associated reduced capital requirements.

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[2] http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech819.pdf
[3] https://www.gov.uk/government/news/new-infrastructure-plan-published-by-government
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263148/the_UK_insurance_growth_action_plan.pdf
http://www.bankofengland.co.uk/pra/Documents/solvency2/imapprovals051215.pdf

iii. The risk management and due diligence that will be required will make it difficult for insurers to initiate a gradual build up in infrastructure investments. The costs associated with hiring the in-house skill required to perform both the initial project due diligence and ongoing monitoring may deter some insurers.
iv. The mandatory look-through approach applies to all forms of indirect investment (such as collective investment schemes). Infrastructure funds would therefore need to ensure that all underlying infrastructure projects meet the definition in order for insurers investing in infrastructure via such funds to benefit from the proposed changes. It is unlikely that existing infrastructure funds will be able to meet these requirements and so it will require new start-up funds to step in.
v. The current amendments only relate to infrastructure projects. While the Commission has asked the European Insurance and Occupational Pensions Authority (EIOPA) to review any changes that may be relevant for infrastructure corporates, there is as yet no clarity where this may land.
vi. Although the amendments propose a reduction in the capital charge for infrastructure debt instruments compared to corporate bonds of the same duration, the level of capital required can still be significant at very long durations. Given life insurers are being encouraged to invest in infrastructure to match their long-term liabilities, this could act as a disincentive.
vii. As constructed under the proposals, an “infrastructure project entity” would have to meet stringent conditions in order for insurers to classify the investment as a “qualifying infrastructure investment”. The vast majority (if not all) of these would be unlisted investments, effectively limiting insurers’ appetite for significant investment, not least due to the prudent person principles of Solvency II, which require the total unlisted investments to be kept to prudent levels.

Given these regulatory challenges there would need to be more certainty on how the potential for consumer detriment could be managed before the life insurance sector as a whole could move significantly into infrastructure investments.

The potential of ELTIF investment in SMEs

Take-up of European Long Term Investment Funds (ELTIFs) has been disappointingly low despite the wide range of eligible assets, including unlisted small or medium enterprises (SMEs) and listed SMEs with a market capitalization of no more than EUR 500 million.

A fundamental problem is the restricted investor base and the operational complexity involved in marketing ELTIFs to eligible retail investors. Larger institutions can already invest in such assets directly or via alternative investment funds and so do not necessarily wish to invest in funds with constrained investment and borrowing powers. Access by retail investors to ELTIFs is restricted to those with investible portfolios of at least EUR 100,000 who can invest no more than 10 percent of their portfolio. Therefore, only firms with a complete knowledge of the retail investor’s portfolio can distribute ELTIFs. This further constrains an already narrow subset of investors.

The restrictions on retail investors should be revisited. Concerns on the grounds of liquidity risk and market risk are to some extent misplaced. For example, within pensions and long-term savings wrappers, regular redemption activity is either prevented by law or discouraged by fiscal penalties, so regular redemption vehicles are not necessary. Many “mass affluent” EU citizens could reasonably be allowed to invest smaller sums of money into ELTIFs, especially under the strengthened investor protection rules in MiFID II and the enhanced disclosure regime to be created by the Packaged Retail Investment & Insurance Products

Key Information Document (PRIIP KID). See our comments to Question 4) on the regulation of crowdfunding where currently restrictions on retail investors are considerably lower.

Q2) Market liquidity

The Impact of regulation on market liquidity

Several studies, including from the IMF[4] and ESMA[5] show that banks are holding significantly less inventory of corporate bonds for market-making purposes, both absolutely and in particular as a proportion of the rapidly growing corporate bond market. Although other factors may also be at work here, this reduction in inventories is likely to be a response to the higher capital, liquidity and other regulatory costs of holding market-making inventory.

These studies investigate many different measures of market liquidity, and generally conclude that while some indicators show a decline in market liquidity, others show no significant change. This may be the result of non-banks becoming more active on both sides of the market, and possibly of the limited growth of trading platforms that facilitate direct trading among market participants without the need for market makers.

However, as discussed in the IMF[6] report from October 2015, this situation may reflect benign cyclical conditions, including very low interest rates, which have a) made it cheap to fund bond purchases and b) encouraged demand for corporate bonds as part of a search for yield. The IMF expresses concern that if the benign conditions were to change, demand for corporate bonds could decline significantly, leaving increasingly concentrated holdings among mutual funds, pension funds and insurance companies with homogeneous investment strategies. The IMF points to hedge funds behaving more like investment funds rather than acting as substitutes for market makers. Our own research in the KPMG 2015 Global Hedge Fund survey[x] predicts that by 2020 pension funds could become the primary source of capital for hedge funds. Regulation was also cited as the greatest challenge on growth of these funds over the 5 years.

The ultimate concern with this position is that the holders of corporate bonds may find them difficult to sell into a falling and illiquid market. The growing importance of electronic trading platforms and algorithmic trading may then serve to accentuate rather than mitigate the impact of the shortage of market-making capacity in the market. Although small, there were some market liquidity issues in the US associated with the recent interest rate rise which highlights the potential for market fragility.

This feeds into a debate beginning at the FSB on financial stability concerns arising from the asset management sector with a perceived growing mismatch between increasingly long term and illiquid assets, and liabilities which promise immediate or early redemption to investors. The unanticipated consequences of regulation therefore extends beyond the economic inefficiency of illiquid markets to a significant threat to financial stability more widely.

[4] http://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/c2_v3.pdf

[5] https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-efs_trv_1-15_526.pdf

[6] http://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/c2_v3.pdf

Q3) Investor and consumer protection

Consistency of investor protection rules

The right levels of investor protections give retail investors greater confidence to move from cash-deposit savings into investments. Equally some of the filters in place to protect investors need careful calibration to balance protection with creating the right incentives to enter into investment.

Once implemented MiFID II, PRIIP KID and the Insurance Distribution Directive (IDD) will introduce enhanced and more consistent levels of investor protection across products but these increased levels could lead to higher costs, reduced choice and less availability of products across investor types. Some actions include:

i. Getting investor protection levels right is crucial for restoring confidence and boosting levels of investment.
ii. As we have already referenced levels of protection in ELTIFs, which could be used to increase investment in SMEs, are set at too high compared to similar asset classes for most retail investors to access.
iii. Getting consistency right is important as currently small savers have varying levels of protection compared to wealthy 'semi-professional' investors.

Q4) Proportionality / preserving diversity in the EU financial sector

The impact of regulation on bank lending

As we highlighted in our response to Question 2) on market liquidity, the impacts of Basel III capital and liquidity rules have a particular impact in the EU compared to other jurisdictions as through CRDIV/CRR the rules apply to banks of all sizes, with only some discrete concessions for particular business models. KPMG's 2015 Dutch banking study[xi] again provides some useful data points here.

i. Of the six banks examined in the original 2012 study KPMG predicted a EUR 200 billion balance sheet reduction was needed by the end of 2015 to meet capital requirements.
ii. The 2015 study found that the banks had actually shrunk their balance sheets by EUR 220 billion by the end of 2014, so by a greater amount and earlier than predicted. Assets relating to non-core activities decreased by 20 percent during that period and lending growth fell to -4.00 percent by March 2015.
iii. Given the relative overall strength of the Dutch banking sector compared to other EU countries the trend indicated by the Dutch example illustrates the potential scale of change taking place in banks across Europe.

Many policymakers assert that the more capital that banks hold the more able they are to maintain levels of lending into the economy, but some differing views exist:

i. A recent Bank of England Staff Working Paper[7] isolates the supply side impact of credit shocks since the financial crisis – so separating out the supply of credit from any changes in the demand for credit by corporates.
ii. The paper finds that the contraction in credit effects are robust, statistically significant and economically large. The results suggest that a 10 percent contraction in borrowing caused by credit supply led on average, to a 5-6 percent fall in capital per head, a 5-8 percent fall in labour productivity, and a 7-9 percent fall in average pay

[7] http://www.bankofengland.co.uk/research/Documents/workingpapers/2015/swp557.pdf

for the affected firms, and that firms experiencing adverse credit shocks were also more likely to fail.

iii. The paper does not identify the precise causes of this credit supply shock – some will have been due to regulation, but banks may also have cut back the supply of credit in response to other factors, such as the availability and cost of funding.

It seems likely that capital and liquidity requirements have in some way contributed to reduced lending capacity into the economy. CMU presents a way of rebalancing Europe's dependence on bank lending, but replacing the reduced capacity will take time to develop, meanwhile banks of all sizes will adapt their balance sheets by withdrawing from some lending and introducing tougher lending criteria.

Potential role of crowdfunding

A constructive policy approach is being taken towards alternative forms of financing, crowd-funding as an example is in some countries a growing part of the funding mix for corporates seeking debt or equity financing. The Commission's approach to monitor and assess rather than rushing in to regulate seems sensible. Ensuring appropriate levels of investor protection is important, but cutting off this alternative channel at a time of reduced bank lending would be the wrong thing to do. Research in the UK by Nesta and University of Cambridge[8] shows the alternative finance industry in the UK has grown from GBP 267 million in 2012, to GBP 666 million in 2013, and GBP 1.74 billion in 2014, and is on track to double again in 2015. Around 95 percent of those figures relate to debt finance and invoice factoring, but the fastest growing segment currently is raising equity.

An approach to investor protection seen in the UK by the Financial Conduct Authority is to set a limit on the portion of liquid assets that retail investors, excluding sophisticated and high net worth, can invest via equity crowdfunding; at 10 percent of investable assets, excluding property, pension and life insurance this limit is far more generous than would be allowed for ELTIFs or European Social Entrepreneurship Funds (EUSEFs).

Unnecessary regulatory burdens

<u>Q5) Excessive compliance costs and complexity</u>

Professional mobility challenges

The mobility of EU citizens cross borders is one of the founding principles of the EU and as such the challenges of moving professional audit staff from one Member State to another within the European Union are relatively small, assuming they are EU citizens. However, it is much more difficult to move a statutory auditor registered in one Member State to another Member State for the purpose of becoming the signing partner or Engagement Quality Control Reviewer (EQCR) on the statutory audit of a company in the second Member State.

With the adoption of Audit Regulation (537/2014) there is the anticipated increase in tendering activity for the statutory audits of PIEs and in turn, a greater number of changes of audit firm. The need to move audit professionals with the right industry skills, experience and capacity, across countries in the EU at the right time will become a main focus for auditors of PIEs in a new auditor rotation environment. This will be particularly critical in highly complex industry sectors such as banking, telecommunications, energy, and insurance.

Given that the statutory auditor and the EQCR must be registered in the country where the audit is performed we are likely to face scenarios where there are a limited number of audit

[8] https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf

partners with relevant industry expertise and matching country registration, in particular in smaller member states.

The introduction of an EU passport for auditors, which would facilitate greater mobility of both key audit partners and EQCRs across the EU would be hugely beneficial in addressing some of the cross border logistical challenges and also, in our view, fully aligns with the need to consistently deliver high quality audits across the EU. We understand that in response to the globalisation of business activity, the single market and regulatory harmonisation, nine of Europe's leading accountancy Institutes are working together to bring their professional qualifications closer together via The Common Content Project[9] which looks at the education and training of auditors.

The potential impact of the new audit legislation

High quality financial information that investors and wider society can trust is a fundamental cornerstone of a dynamic capital market. This financial information requires the support of a robust, independent and high quality audit. Ensuring the consistent interpretation and application of the new audit legislation[10] is critical to help support the audit profession in pursuit of audit quality, and to enable the profession to fully contribute to both the European Commission's jobs and growth agenda as well as their aim of achieving regulatory convergence ('*better regulation'*) across Europe.

However, given the numerous options that are available to Member States within the legislation a patchwork of different rules across the EU is emerging. Allowing different rules to apply to different categories of Public Interest Entities (PIEs) further complicates the picture – for example, requiring a different audit firm rotation cycle for different types of PIEs (financial institutions versus corporate PIEs) will be difficult to manage for groups with operations in a number of Member States. A non-Financial Institution PIE with a financing subsidiary could, for example, be subject to different rotation periods even in the same Member State. In addition, there is a risk that variations in the interpretation of the new audit legislation in different countries will add to the complexity. For groups containing an EU PIE operating across the EU, such complexity will undoubtedly increase the cost of doing business in the EU.

These complexities and costs are further amplified when we consider the international environment in which most groups operate and which are thereby affected by many other regulatory regimes. The combination of different independence rules in several jurisdictions, including those outside the EU, and the varying audit firm rotation requirements could for example, result in a PIE requiring two audits to be performed by different firms (a local statutory audit and an audit for group purposes) thereby increasing the cost for the EU PIE. A longer term issue is likely to be one of reduced choice given the limited availability of auditors that can meet the multiple independence requirements whilst having the requisite expertise and geographic coverage.

[9] http://www.commoncontent.com

[10] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&qid=1453582188884&from=EN
http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&qid=1453582419043&from=EN

As Member States move closer towards the new audit legislation's application date of 17 June 2016 increased communication and coordination is essential between the competent authorities in each of the EU Member States, with the support of the European Commission, including the newly formed CEAOB. Without such coordination the aim of achieving the greatest level of consistency of interpretation of the rules, thereby reducing complexity, will become increasingly challenging.

Illustrative example in Private Equity funds

An example of the complexity faced by groups in applying this legislation in practice is within the Private Equity sector. This is an area which CMU is targeting for its potential to increase the level of business funding in the real economy. The challenge arising, which we include as a practical example is as follows:

i. A Private Equity fund can contain multiple investments with one or more businesses that will be defined as PIEs because they are listed or partially listed in the EU. The number of PIEs in a typical PE fund portfolio might increase in the future as the listing of a portion of the fund's equity becomes an increasingly common form of exit. Furthermore many funds look to issue bonds on a public market to refinance the capital of their portfolio investments. As a result there may be many EU PIEs within the PE structure across several Member States – each with potentially different rules and interpretations. Where there is a holding entity in the structure which is incorporated in the EU that business will be affected by many of the additional requirements applicable to EU PIEs, including independence restrictions, audit firm rotation and caps on non-audit services.
ii. Private Equity funds generally leave the day to day running of their portfolio companies (including choice of auditor) to the portfolio companies' management and so a wide range of audit firms in many EU jurisdictions are likely to be auditing different portfolio companies, including the EU PIE(s). A possible unintended consequence of the new legislation is that the Private Equity fund is likely to find that many of the multiple audit firms they currently use may be unable to provide (directly or indirectly) to the holding entity the range of services (such as tax and advisory services) that are needed, due to the combination of the PIE auditor rotation rules and new independence requirements. The unintended consequence will be to significantly reduce the number of potential service providers and thereby choice in the EU.
iii. The Member State options and potential inconsistencies in interpretation of the independence rules by different Member States on the list of prohibited services and the calculation of the non-audit fee cap is likely to create added complexity for EU funds given the potential involvement of multiple audit firms.
iv. For non-EU Funds, many of whom are individuals and pension funds, this may also create a potential disincentive to investment in European businesses given the additional compliance costs to investors in the EU.

Given the complexities outlined above, particularly with regard to groups containing an EU PIE, we would welcome:

a) Practical guidance to assist in areas where different Member State options affect Groups with multiple PIEs in the EU; and
b) Consideration being given to enhancements to the audit legislation to address the challenges faced by groups with EU PIEs located in multiple jurisdictions.

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Q6) Reporting and disclosure obligations

Regulatory reporting

Data-related regulatory reporting for banks in particular is increasing significantly with multiple requirements coming from different sets of rules. Firms now need to report to existing national supervisors and also new supervisors and authorities including the ECB, the European Supervisory Authorities, national and European resolution and macro-prudential authorities – all of whom are formulating their own requirements. Some of key developments have been:

i. More information through Pillar 3 disclosures, and the need to report wholesale market trades and securities financing transactions.
ii. Proposed revisions to the standardised approach to credit risk that will require all banks to collate and utilise data on the 'risk drivers' that will determine risk weights.
iii. Pressure to improve risk data aggregation and reporting is increasing, and is becoming a key element in supervisory assessments of banks' internal risk governance.
iv. The need to collate and publish data relating to simpler securitisations and SME credit decisions, as part of the development of the CMU.
v. Improvements on use of data and record-keeping in support of the fight against money laundering, terrorist financing and tax evasion by bank customers.
vi. Various authorities are developing approaches that may eventually constrain banks in terms of data privacy, data storage, cyber security, and even the use of data to cross-sell products and services - especially to retail customers.

KPMG's GSIFI Benchmarking survey 2015[xii] found that despite significant investment in regulatory reporting processes and governance structures, banks are still challenged to meet the increasing requirements of regulators and reduce the costs of compliance. Some key issues include:

i. Only 40 percent had an automation level above 75 percent for regulatory reporting; and a quarter had less than 50 percent automation coverage.
ii. Nearly 80 percent of the sample had been subject to regulatory review or investigation of their Risk Weighted Assets (RWA) calculations in the last three years, with this figure rising to 94 percent for capital calculations.
iii. In response, 64 percent of the sample had put in place internal assurance processes on their RWA and capital calculations.
iv. Only 56 percent of the sample were comfortable that their first line of defence reporting controls are fully documented and assessed.

Trade and transaction reporting requirements

Multiple trade and transaction reporting requirements are causing considerable challenge for capital markets firms. Although most firms have had some form of transaction reporting, for many firms brought under scope of the new rules reporting systems need to be built from scratch. Although not directly responsible for reporting, investors must still provide personal data to their broker or fund administrators for reporting purposes, adding cost and complexity.

The anticipated delay to MiFID II / MiFIR implementation is in part due to the technical complexity of designing reporting requirements. There is also a significant requirement on supervisors to build and develop their own technical systems. Industry and regulators need to handle the duplications and inconsistencies within MiFIR, and between MiFIR and other sets of requirements – including reporting requirements under EMIR, securities financing transactions and wholesale energy transactions under REMIT. The European Securities and Markets Authority (ESMA) intends to develop templates and protocols for transaction reporting that could reduce the number of errors. But this in itself will be a hugely complex task.

There are major challenges before MiFID II transaction reporting can happen. Even though ESMA has begun work on building a financial instrument reference data system, known as FIRDS, there are vital technology builds to complete, as well as changes to the Transaction Reporting Exchange Mechanism (TREM), and the ironing out of other practical issues. It could be some time until all the variables of requirements are known and systems built.

A concern is that for some firms and market participants the burden of requirements will lead to them reducing the services offered or being more selective in the customers serviced, this is already becoming evident in the commodities sector, with some firms going so far as to wind down their commodities businesses. At a time when we are looking at how to grow European markets to fund growth any reduction in market capacity or choice is not a positive development.

How better corporate reporting supports investor decisions

KPMG's 2014 Better Business reporting[xiii] global survey of corporate reporting looked at whether the historical focus of annual reports has contributed to driving short term decision making by both investors and company management. It found a strong disconnect between the key drivers of future business value such as operational efficiency, customer focus and reputation with the content of reports. There is growing recognition by audit committees that reports need to take a longer term view and provide a broader perspective to help investors take their assessments beyond current year earnings. Financial information should only be the start of the story, and better alignment of performance measures with the drivers of shareholder value to support this.

Findings from a KPMG UK survey in 2014 Audit committees' and auditor reports[xiv] shows a positive market reaction to broader reporting of risks by audit committees and appetite from investors for more transparency from companies including more non-financial information in annual reports.

Interactions of individual rules, inconsistencies and gaps

Q10) Links between individual rules and overall cumulative impact

The impact of complexity in market regulations

KPMG held a private roundtable event in autumn 2015 with senior representatives from capital markets firms operating in London, a major concern was that dealing with complex rules, such as the implementation of MiFID II, was the major strategic focus of their Boards.

The requirements across a series of markets rules such as MiFID, EMIR, REMIT, MAD, CSDR and SFTR will require significant changes to systems, processes and organisational structures. A fundamental problems is that rules were developed in relative isolation without a holistic overview of what the end point will be, so there are duplications and inconsistencies.

For effective capital markets the rules investors and securities originators operate under must work together, and where possible Europe's rules need to closely match global markets to maintain the EU's competitiveness. Until the technical details are complete it is difficult to give concrete examples but some key issues include:

i. Reporting is central to many regulatory initiatives, with fast paced evolution of regulations coming from different global regions. Under multiple supervisory regimes, there is a rapid emergence of new, complex and competing reporting requirements faced by firms.
ii. Significant transaction reporting requirements, with firms now at a point of inflection – to continue responding piecemeal with multiple un-coordinated solutions with compressed lead times and inefficiencies, creating significant costs and potential mistakes.
iii. The immediate challenge of sourcing of relevant data from trading systems, and ensuring accuracy and completeness of data submitted to Approved Reporting Mechanisms (ARMS), trade repositories, and relevant Competent Authorities. Mapping the data to the source formats required by the different regulatory reporting requirements is costly and complicated.

To minimise costs and streamline the process a global consolidated reporting approach is required that brings together the reporting requirements across a whole range of regulations for all market participants. This would have the benefit of reducing costs to market participants and give supervisors the accurate data in the format and timescales required.

Q12) Overlaps, duplications and inconsistencies

The problem with 'parallel tracks' of regulation

In our response to Q1) on the unnecessary regulatory constraints on financing we highlighted the impact on banks of so called 'Basel IV' ongoing capital and liquidity requirements, and also what we call the parallel track regulations of recovery and resolution planning and bank ring-fencing or structural reform proposals. The key concern is that various regulatory approaches are being taken to the same policy objective of making banks safer and protecting taxpayers with likely negative effects on how those banks can then provide useful services to the economy.

As we have already referenced banks now hold considerably higher capital levels than pre-crisis, and further requirements are still to come. Global standards on recovery and resolution planning have been implemented so banks and their supervisors now have a clearer set of actions that would be taken in the case of a bank failing. Bail-in requirements on bank creditors mean that in future a failing bank will be less likely to need taxpayer support. In some countries including France, Germany and the UK policymakers have gone further and introduced ring-fencing requirements.

A set of EU-wide proposals for Bank Structural Reform are currently still being considered by the European Parliament after member states reached an agreement on a toned-down approach giving discretionary powers to bank supervisors. Europe's competitiveness and economic success are at risk if regulators continue to target the same concerns before globally agreed rules such as TLAC loss absorbing capital have been allowed to fully take effect.

Summary of KPMG references sourced within paper

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[ii] https://assets.kpmg.com/content/dam/kpmg/pdf/2015/03/2015-global-audit-committee-survey.pdf

[iii] https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Press-releases/Documents/new-parliament-fs.pdf

[iv] http://www.kpmg.com/KY/en/IssuesAndInsights/ArticlesPublications/Documents/evolving-banking-regulation-part-1.pdf

[v] https://www.kpmg.com/NL/nl/IssuesAndInsights/ArticlesPublications/Documents/PDF/Banking-en-Leasing/The-state-of-Dutch-banks-in-2015-1.pdf

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[vii] https://www.kpmg.com/ID/en/IssuesAndInsights/ArticlesPublications/Documents/Basel4-Emerging-from-the-Mist.pdf

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[x] https://assets.kpmg.com/content/dam/kpmg/pdf/2015/03/growing-up-hf-fs.pdf

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[xii] https://www.kpmg.com/ID/en/IssuesAndInsights/ArticlesPublications/Documents/G-SIFIBenchmarkingSurvey 2015 - Regulatory Reporting.pdf

[xiii] http://www.kpmg.com/betterbusinessreporting

[xiv] http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Issues and Insights/audit-comm-audit-reports.pdf