KPMG

Luxembourg Banking Insights 2016

Sneak preview

June 2016

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INTRO

In the years since the global financial crisis, we have devoted a great deal of effort to trying to understand the fundamental changes affecting the financial services industry, and gauging how they might develop in the future.

This latest issue of *Banking Insights* focuses on what we see as two of the most powerful influences on financial services:

- the pace and scale of change in the regulatory environment;
- and the continuing revolution being wrought by information technology, data, and the digital economy.

The pace of change and innovation in the industry is irrefutable, and appears to be accelerating. Meanwhile the impacts of regulatory change and technological innovation are becoming linked in unforeseen and significant ways.

Faced with tighter regulatory requirements, banks are being forced to evaluate their business activities to determine which are still attractive from the point of view of profitability, capital, and liquidity costs. Agile market players are making use of this period of transformation to revamp their business models, sales channels, and products.

Banks, furthermore, are fine-tuning their offerings and cultivating new markets while also meeting the requirements of their clients. KPMG is tracking and analysing the latest developments in the banking sector.

Trust has always been central to the relationship between a bank and its customers. And today, data and analytics offers banks an inherent opportunity to create value and build trust.

Yet, as analytics moves from the back office to the front line, banks will need to ensure that they trust their analytics to 'do the right thing' for customers, shareholders, and regulators.

Indeed, just as banks need their employees to act with integrity, they also need their decision engines and algorithms to act with integrity.

In the Trusted Analytics series, KPMG's John Hall and Mitch Siegel explore the symbiotic relationship between customers, trust, and analytics in banking and find that banks may need to reassess the way they ensure trust in analytics.

"Analytics are typically treated as a 'black box' whereas, in reality, organisations need to start thinking about their analytics as independent entities unto themselves; as critical intermediaries between the stakeholders and the organization." – Mitch Siegel, Principal, Financial Services, KPMG in the US.

We, at KPMG, aim to help keep our banking clients safe, by addressing their regulatory agenda, and successful, by using new technology to boost their business models.

"The UK's continued membership of the European Union is desirable for the UK, the European Union and, of course, for Luxembourg."

Pierre **GRAMEGNA**

THE GOVERNMENT
OF THE GRAND DUCHY OF LUXEMBOURG

BIO

Title:
Minister of Finance

Organisation:
The Government of the Grand-Duchy of Luxembourg

Website:
www.mf.public.lu/

Location:
City Centre

A few days from now, British citizens will vote on their country's potential exit from the EU.

"The UK's continued membership of the European Union is desirable for the UK, the European Union and, of course, for Luxembourg".

Although some claim that Britain's withdrawal from the UE would benefit Luxembourg, making it more attractive as a result, Pierre Gramegna emphasises the fact that these two financial centres complement one another, particularly as regards the funds industry: London handles investment strategies while Luxembourg deals with all the other elements. "We very much hope that the world's largest financial centre will remain within the EU".

The UK's decision aside, the majority of the large banks want to be represented within the Eurozone, as the ability to offer banking services throughout Europe from a European head office is strategic. If the UK were to leave, banks based there would find themselves without a European Passport in the absence of a base elsewhere on the continent.

The Chinese authorities chose Luxembourg as the country's gateway into the European market. China's six largest banks have established operations in the Grand Duchy, three of which in the past eighteen months. Our country has taken decisive measures in making our appeal known. Investment funds, deposits and bonds can all be denominated in renminbi in Luxembourg. In addition, Luxembourg was the first non-Asian country to join the AIIB (ed: Asian Infrastructure Investment Bank). "Whenever I see the Chinese Finance Minister, as I did recently at the IMF in Washington, he reminds me that the information is provided by the Chinese themselves".

"Although the banks' results fell by some 6% in 2015, I feel that this is nevertheless a positive result, and I offer my congratulations to the banks, as this shows that they have adjusted".

We had feared that the issues that they were facing – the policy of transparency around taxation, very low interest rates and costs relating to regulatory pressures – would have a more noticeable impact.

The 2008 financial crisis showed us that there were cracks in the system. When these come to light, waves of regulation often follow. The pendulum that had swung too far one way is in the process of swinging heavily in the other direction. The European Union was the central player in establishing new rules, and we were able to achieve something that no-one else ever had: the banking union, with its three central pillars of joint supervision by around 130 systemic banks, joint deposit guarantees and a resolution fund financed by banks rather than the taxpayer. What we have managed to establish is an extraordinary tripartite structure. For Luxembourg, the benefits outweigh the disadvantages, as we enjoy an umbrella, meaning standardised rules and regulatory uniformity.

The majority of Luxembourg's 143 banks are universal banks, which operate in a wide range of the banking world's key areas. We are seeing a number of changes, beginning with an increasingly sophisticated service offering in private banking in order to cater more effectively to current higher-net-wealth clients coming from further away. The trend in investment funds is very positive, with constant growth over the past four years. This is due both to improved markets and, to an equal degree, to the contribution of new assets. We are also continuing to diversify our toolbox (LTIF, FIAR and the fondation patrimoniale, our private foundation regime, are all new products that have been made available to banks and their customers).

Financial technologies are also a key priority for our Finance Minister. This could become the fourth pillar, alongside private banking, funds and insurance. There is an enormous market to be tapped into. There are truly impressive innovations in the areas of payment methods and credit issuance. As with any budding technological revolution that turns an accepted business model on its head, no-one knows what the outcome will be. Major players in the online payment industry, such as Rakuten, have recently been awarded a banking licence, allowing them to grant credit. We will be seeing an increasingly digitalised service and new consumer habits.

Given the explosion in digital data, data protection is on the agenda for both the CCCF (Commission for Financial Sector Monitoring) and the CNPD (National Commission for Data Protection). Luxembourg needs high-quality secure data centres and must understand and anticipate the needs of various sectors, the Cloud, IT systems, etc. We are endeavouring to hold our own in this constantly changing environment. Our legislation is highly advanced, in that it legally recognises electronic signatures. We have extremely detailed rules around the data that are held in data centres to protect them in the event of a system failure. We have tried to anticipate future developments and will continue to do so thanks in large part to the CSSF and the CNPD, both of which examine these very issues.

Managing our financial industry means implementing legislation imposed under Community law, such as MiFID or the money laundering directive, while also innovating and responding to the needs of those within the industry, hence the discussions that are conducted by the high-level committee for Luxembourg's financial centre.

There have been tremendous changes in our practices and laws over the past twenty years. It is for this reason, alongside others, that events should always be viewed from a wider historical perspective, and never solely from our current perspective. The Panama Papers, for example: it should be kept in mind that the holding or setting up of structures of this kind was not illegal in itself; rather, it is the use of said structures that warrants closer examination. "I believe that we need to take care to avoid confusing separate issues or taking shortcuts."

Luxembourg is an international financial centre with a great many players and high financial flows. It is not unreasonable, on that basis, that we would be named in connection with the matter. In the aftermath of the initial publications, the CSSF asked the banks under its supervision to take stock of these kinds of practices. The vast majority also signed the ICMA Charter (International Capital Market Association), which states that a banker may not proactively assist a client in avoiding his or her tax obligations.

Most legislative initiatives to tackle money laundering are taken at European level, and the money laundering directive will make it even easier to identify economic beneficiaries. We are moving towards a transparent system, and Luxembourg has fortunately chosen to embrace this. Although the financial centre initially believed that greater transparency would mean catastrophe in trading terms, nowadays they cannot help but appreciate the fact that the government shouldered its responsibilities.

Mr. Gramegna feels that the right decisions were made, and that the process is moving forward. The coming months will be just as important in establishing the pace of progress. "We are just getting the ball rolling now and we need to see how fast the others move going forwards. Luxembourg believes that all steps must be taken to guarantee a level playing field and ensure that Europe as a whole remains competitive".

This article was translated from French to English by KPMG.

Megatrends adapted for Private Banking

> INNOVATION

Develop blockchain - what does it mean for our clients? Our services?

Revamp data and analytics - how can we create value here?

Look into robo advisors - new competition or ally?

Research suitability engines - can we still offer investment services as we did in the past?

> EFFICIENCY

Go beyond the obvious in cost management

Build scale, build capabilities

Seek opportunity in industry consolidation

Manage return-on-equity when interest margins are low and some fee incomes are at risk (inducement)

> PRODUCTS AND SERVICES

Restore client trust

Demonstrate a clearer separation between manufacturing, distribution, and transaction processing

> CLIENT GROWTH

Seriously commit to emerging markets

Facilitate client growth which is driven by socio-economic factors, entrepreneurship, and the increasing concentration of wealth

Obtain a single view of the customer so as to be able to improve customer experience, leading to growth

> REGULATION

Keep on top of investor protection regulations

Fulfil reporting obligations to the ECB in their new role supervising business conduct and governance

Rework strategy for attracting talent in the wake of stricter remuneration guidelines

Megatrends adapted to Asset Servicing

> INNOVATION

Develop new distribution platforms, as asset servicers are perfectly positioned to develop D2C or B2B2C platforms

Take the opportunity to be able to provide deep market insight to clients with big data and analytics, using new KPIs

Stay current with blockchain, as it is a potential game-changer for the market that may usher in new actors (e.g. crowdfunding markets)

> EFFICIENCY

Digital ops: get fit to face FinTech newcomers by improving EDM with the use of new technologies (e.g. React, Scala, MongoDB)

Automate processing in order to improve operational efficiency, especially in transaction processing

Cost management: get a better grasp of profitability at the customer/product level

> REGULATION

Continue keeping close tabs on investor protection regulations

Take care of new operational complexities arising from new oversight duties

Balance the asset management regulation agenda with the insurance regulation agenda, as both must be attended to

> PRODUCTS AND SERVICES

Provide adapted and flexible products and services to accompany clients' growth and ensure their fidelity

Be at the forefront of new markets, reaping the fruits of new product development (RAIF, LTIF, etc.)

Improve product and service segmentation / specialisation to adapt to niche market demands (real estate, private equity)

> CLIENT GROWTH

Get ready to serve emerging actors (like crowdfunding platforms and D2C platforms)

Strengthen global footprint so as to be able to support client globalisation

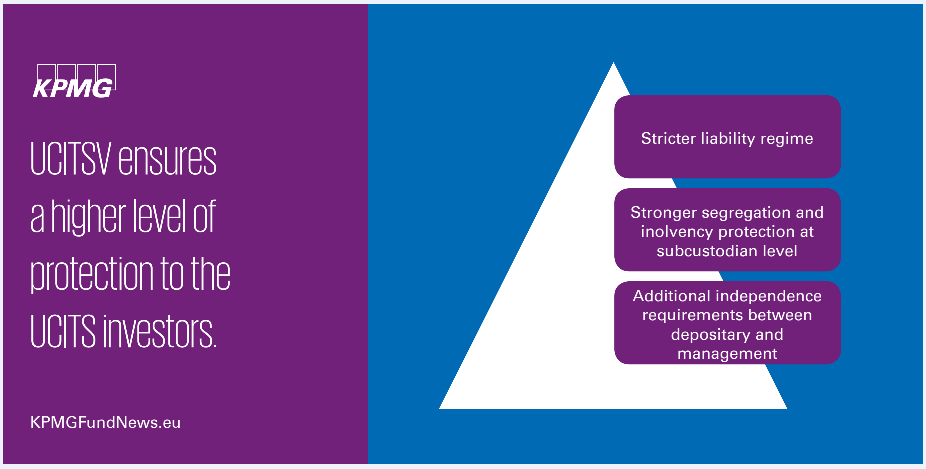
Products and services

There is no question that the revenue of private banks is highly correlated with the performance of equity markets. This cyclicality is no surprise, given that revenue in private banking depends heavily on transaction volumes and asset-based fees (and sometimes even on performance-based fees).

In the context of providing higher transparency to clients, most private bankers risk losing some income in places where their services have never been properly invoiced. In the Netherlands, where a strict ban on inducements was introduced two years ago, we observed new costs coming to clients, such as the "current accounts maintenance fee."

It will be crucial for all client relation managers (CRMs) to properly explain to their clients the significant changes facing business models in early 2018. In all likelihood, few private banking clients will have previously dealt with the contractual relationship between product manufacturers and their distributors.

It is fair to say that many private banking clients have benefited from an enhanced quality of service without being directly charged for it. Now is the time to explain that accessing CRM 24/7 has a cost, that reviewing one's portfolio while reclining on the sofa via e-banking means costs for the bank in terms of infrastructure, development, maintenance costs, and others.



Client growth

Luxembourg's financial marketplace offers a great deal of highly skilled professionals who understand the issues that an international client base may face. The shared vision for Luxembourg as a clear choice for the private banking sector encompasses three dimensions:

Excellence: by addressing clients' complexities with the right range of experts and by always seeking innovation so as to offer clients the best quality;

Niche: by serving the upper segment of international clients with multi-jurisdictional interests; and

Compliancy: by endorsing the new standards that regulate the profession and sharing expertise across the group that the Luxembourg entities belong to.

Innovation

Innovation in 2016 means moving quickly and sourcing niche expertise externally.

"I don't think any organisation can innovate at the pace our current environment demands by relying on internal ideas," says Jeremy Anderson, Global Chair of Financial Services for KPMG. "Innovation that will truly advance an organisation—that is, improve its customer focus, lower costs, and become more agile—requires tapping into external experts and technologies."

We are seeing more financial institutions engage in external partnerships with academic institutions, technology experts, government agencies, industry innovators (e.g. FinTech companies), high value consultants, researchers, and customers, as well as each other. financial institutions are creating an ecosystem that brings certain elements in-house: the expertise, experience, and technology, as well as the facilities they need to leapfrog ahead to more current ideas, products, business models, and, in some cases, even talent.

By pursuing external ideation, financial institutions also benefit from the unique, customer-focused perspectives their collaborators offer. This enables companies to leverage research and data to understand evolving customer demands—both corporate customers and consumers—and the impact of megatrends.

External ideation also affords opportunities to understand how corporate customers and others within the industry are innovating change to their business models to capture market opportunity and increase operational efficiencies.

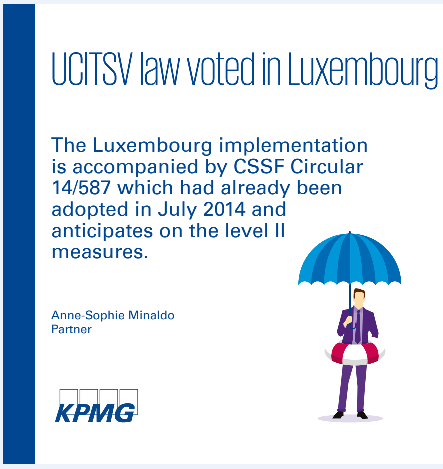
The nature of each relationship is unique to the organisation and partnership involved. Each one begins with having to understand the key objectives of the partnership and to consider the individual factors and desired outcomes. These factors lead to a variety of options, such as formalised collaborations, supply arrangements, joint ventures, and outright acquisitions.

To support this ecosystem, financial institutions will need to put in place internal structures, capabilities, and culture that encourage the fast-paced, ongoing cycle of experimentation and the "safe-failure" needed to hone breakthrough innovations that can truly differentiate an organisation on the market.

How will you architect your innovation ecosystem?

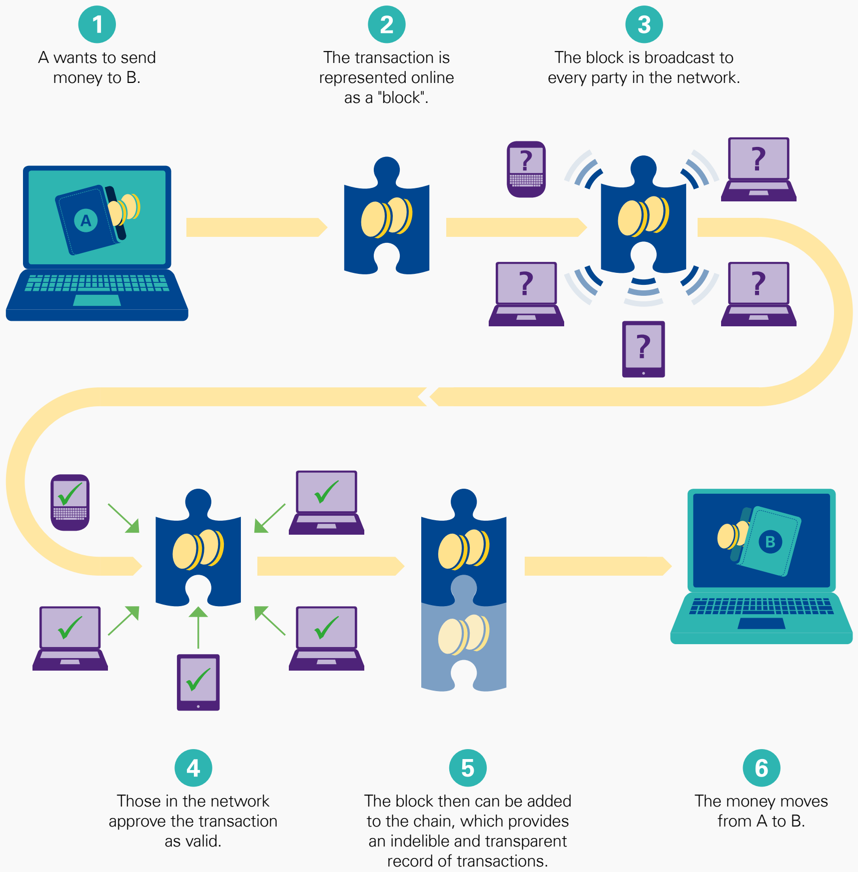
There are plenty of factors to consider in developing an innovation ecosystem that will support long-term growth for your organisation. To help you get started, we have developed the Innovation Ecosystem series. Over the next nine weeks, we will explore some of the third-party partners financial institutions should consider for their innovation network. The series will review the benefits these institutions could offer your organisation and how best to partner with them.

We look forward to engaging in discussions with you about innovation and the opportunities external partners can provide in transforming and growing your company.



Blockchain

How a blockchain works



Source: The Financial Times - Technology: Banks seek the key to blockchain

Rising interest in blockchain but challenges for financial services

During 2015, Citibank, Santander, Wells Fargo, HSBC and other big banks announced partnerships with fintech companies to leverage blockchain to make banking processes more efficient, timely and secure. At the same time, IBM moved forward with an open source blockchain initiative in tandem with numerous partners, from the London Stock Exchange to technology companies like Cisco and Intel. These organizations believe the potential disruption blockchain could create – in terms of decreasing transaction times, self-automating smart contracts, lowering transaction costs, minimizing fraud and opening the door to micro-transactions – is impossible to ignore.

While blockchain's potential impact is interesting, regulatory and market changes could hamper blockchain's use on a global scale. Some analysts also suggest that blockchain has been burdened with excessive investor expectations that cannot realistically be fulfilled. Corporate investors also need to accept that blockchain solutions will need time to be tested and adapted to industry requirements at scale. Corporate investors need to encourage industry-focused engineers to define the problems blockchain can help resolve, find the best and most cost effective technology solutions and work through limitations to scope, scalability, velocity and usability.

The key to success is the combination of:

cryptography

distributed ledger technology

deep industry and regulatory experience and knowledge

technologists who can effectively navigate clients through the current IT landscape.

Short-term blockchain opportunities exist

In spite of these challenges, there are many reasons for the banking industry to pursue innovation in distributed ledger technologies, such as the potential short-term benefit of digital identity or digital financial passport. Many banks see positive improvements related to how digital identity is currently being facilitated and enabled at banks, which could allow better choice and portability of customers between financial institutions and ultimately higher customer satisfaction as individuals are able to take control over and gain benefit from their own identity

Efficiency

By extracting more value from all of their available data sources, banks can develop a better understanding of customer needs and thus offer more effective and profitable services, which translates into a competitive advantage and a means of staving off threats posed by new market entrants.

For banks, boosting revenues from customers hinges on several imperatives:

- becoming proficient at quickly gathering and leveraging valuable structured and unstructured data about their customers—and their target new customers
- gathering the data on customers and their behaviour that is often buried deep in banks' data mines and in third-parties' repositories
- determining how best to monetise those sources of value

Although the challenges are clear and the options to move forward are fairly well known, a disconnect remains between many banks and their customers. Driven by advances in technologies already adopted by other industries, consumers are demanding the same from banking, but the banking industry has been slow to adapt.

The real competitive advantage will go to those players who are able to successfully combine data from all available sources to develop a better understanding of customer needs and, as a result, serve customers more effectively and profitably.

European banks are struggling with high costs and low profitability. Balance sheet restructuring has not increased the very low returns on assets and returns on equity of many European banks.

Five areas provide significant scope for many banks to reduce costs:

- On average, more than 50% of banks' costs relate to staffing, a significant portion of which goes specifically to people processing customer transactions. This is mainly due to a lack of complete automation of the service processes. STP (straight-through processing), therefore, is a relevant topic to many banks. STP aims to pare back the human input required to process transactions to an absolute minimum —banks should identify their STP throughput rates and try to dramatically increase them.
- Self-service channel usage also has significant cost implications. By giving customers more power and responsibility to carry out their own banking activities, there will be less need for human input from the bank.
- Simplification: the cost base of banks comprises, among other things, complex products, services, legal and operating structures, operating platforms and systems, and booking models. There is scope to simplify in all these areas, and to drive down costs accordingly.
- First-time resolution means that processes are resolved immediately at the first point of contact with the customer, whether it is at a branch or a contact centre. This contrasts with the currently prevalent centralised model, where the vast majority of transactions end up in central operations.
- Investment in technology: besides simplifying aspects in the cost base, IT investment is capable of reducing costs over the longer term, while also improving (or at least protecting) income through improved customer service, risk management, and cyber security.

Regulation

The European Central Bank (ECB) published its annual report on supervisory activities in March. It provides useful insight into the 2016 priorities and workings of the ECB as a supervisor.

Business model and profitability risk

Return-on-equity (RoE) averaged 4.6% in 2015. The EBA's most recent estimate of EU banks' cost of equity was 9.15%. The ECB has reiterated its message that the large number of non-performing loans (NPLs) is clearly dragging RoE down and impairs banks' abilities to generate capital. One of the keys to addressing this is to proactively address NPLs.

Three special initiatives will carry on

The SSM's three special initiatives of 2015—options and national discretions, the supervisory review and evaluation process (SREP), and NPLs—remain on the agenda for 2016. Of note, the rules for options and national discretions came into force in March 2016.

Interesting details on supervisory activities and organizational design

Notable details on supervisory activities and organisational design

Besides the aforementioned and already well-known strategic stance of the ECB, the report outlines some interesting details on supervisory activities and organisational design.

Specifically, the ECB is now operating at nearly full capacity with around 1,000 permanent staff members. However, KPMG's ECB Office understands that this number is also significantly augmented by national experts seconded to the ECB, giving the institution a large pool of staff-power. This contrasts with institutions such as the EBA who are forced to manage with significantly smaller staff resources.

The supervisory fees levied in 2015 totalled €296 million, which is a relatively high figure but not unexpected since this project by the ECB is still in the start-up phase. For comparison, BAFIN—which has over 2,500 staff members and covers banking, insurance, and securities firms—charged just over €200 million for the 2014 industry levy. The ACPR in France, with a staff of just over 1,000, charged approximately €185 million to the banking and insurance industry in 2014. Of note is that the ECB recently announced a budget of €404 million for 2016. It seems inevitable that, with this escalation in costs, budget and cost control may soon become an issue for the SSM.

In its discussion of cooperation with other regulators, the report mentions that a Memorandum of Understanding that prioritises third countries will be signed in 2016. This area of cooperation between supervisors is something that global banks are keen to get a fix on.

TOMORROW

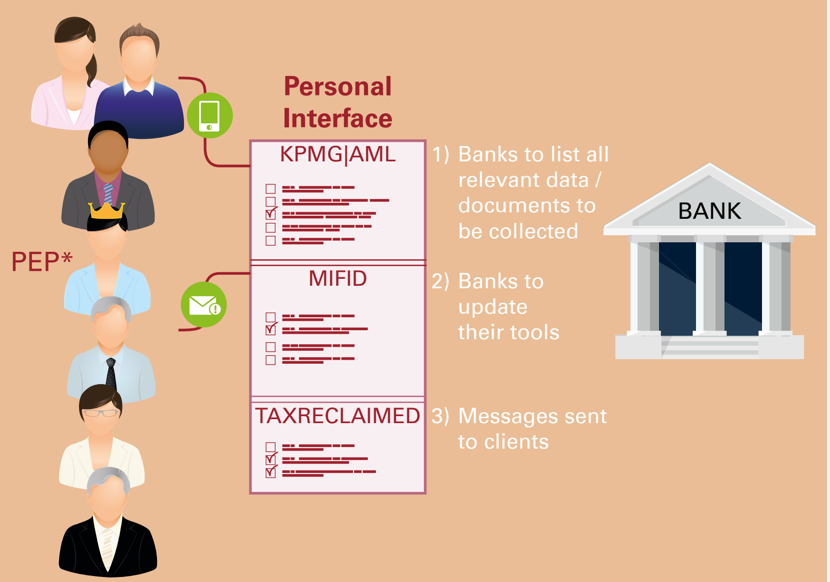
Breathe and take your time to structure your approach towards your clients before interacting with them from many angles at once.

You should only contact them once you have a clear view of what you need and when.

1. List all the identified needs (additional information, new documents for evidencing some of the qualitative data you already have, etc) **COORDINATION**
2. Link those required documents to implementation plans **PLANNING**
3. Put a **tool** to easily exchange data at clients' disposal, information **SYSTEMS**

It is key to your success that you explain what you need from them and why. You should give them an active role to play in enhancing the protection they will get from you.

Help them to understand the background of your request: explain, raise awareness, educate your people and your clients.



* Politically Exposed Persons

"This is the first time that a CSSF Director General has come from the private sector. As such, it symbolises a commitment to bringing those two worlds closer together."


Claude **MARX**

BIO

Title:
Director General

Organisation:
CSSF

Website:
www.cssf.lu/

Location:
Strassen

On taking over as head of the CSSF at the beginning of the year, Claude Marx, a member of the high-level committee for Luxembourg's financial centre, discovered a wealth of talent. His three directors, for example, have over one hundred years' experience between them in their respective fields! They have seen financial legislation emerge and develop over the years, as well as the European financial union framework in which they play an active role.

While Mr. Marx is an ESMA (ed: European Securities and Markets Authority) member and a member of its board of supervisors in Paris, many CSSF employees take part in meetings held by European and international bodies. Claude Simon, for example, participates in the oversight mechanism, and is among those valuable few to whom the European authorities turn for guidance.

"Our job is to observe the law. That has not changed."

In a constantly changing industry that is witnessing the arrival of new technologies, and particularly financial technologies, Mr. Marx nevertheless welcomes the fact that the industry has anticipated and kept pace with regulatory developments. This has been achieved through a focus on dialogue between the various industry players, the Finance Ministry, Luxembourg for Finance and the professional associations, such as ABBL, ALFI and LPEA.

This is the first time that a CSSF Director General has come from the private sector. As such, it symbolises a commitment to bringing those two worlds closer together, as well as the similarities between the man himself and each player involved in making these discussions more effective, in a reflection of what is happening in a broader sense within the country itself.

With 630 officials and a twofold increase in personnel in six years, the CSSF workforce may seem to be quite large for a small country. Given the volume of work to be done and the size of the financial sector, however, it is still insufficient.

This rapid growth brings with it new challenges in terms of internal organisation, information technology and human resources. These challenges will be addressed by a new director, brought in specifically to that end.

Such challenges include the completion of the new building that was designed five years ago by local agencies as a short-term base for new personnel, and endeavouring to find a longer-term solution to cater for the 150 additional officials that the organisation might require in the future.

There is one particular development that confirms that the financial centre is in rude health. While banking operators will continue to consolidate, in an effort to absorb the costs of regulations or in response to low interest incomes, new banking structures are showing an interest in Luxembourg, whether for new locations or acquisitions within a group, e.g. in order to share an IT platform.

As to investment funds, there is an upwards trend towards growth, with 3900 funds, 370 management companies established in Luxembourg and a dynamic alternative sector.

Lastly, Luxembourg's appeal for finance sector professionals is confirmed, particularly for financial technologies and those wishing to take advantage of the benefits of regulation, with a focus on the European Passport for the free provision of services, which opens the door to the European Union.

Mr. Marx draws on his experience of the private sector in his efforts to optimise resources and internal organisational structures. There can be similarities between public and private organisations on certain issues, such as recruitment.

Unlike the private sector, however, which is reliant on its shareholders, the CSSF is independent from the government. It is responsible for ensuring compliance with legislation put forward by the CSSF and approved by Parliament, and also acts as an advisor to Parliament, particularly on matters regarding financial technologies.

Ever true to its principle of discretion, the CSSF also sanctions legislative and regulatory violations. It does not, however, systematically make these decisions known, as it deems that the fines imposed or measures applied to leadership are generally sufficient.

Striking a balance between efficiency and complexity

With a very sizeable financial sector, in addition to the provision of public oversight for company audit professionals, the new Director General has ambitious goals, given the expectation for greater efficacy, speed and quality in an increasingly complex world. His remit continues to extend to the monitoring of supervised institution administrators, and of their engagement in particular.

Moreover, field visits require further development, hence the importance of hiring new talent and establishing a sound internal organisational structure.

A typical day for the Director General of the CSSF is similar that of many other officials: long!

Twelve-hour days are standard, particularly in order to meet with companies that want to establish a presence in Luxembourg and have questions concerning the regulatory framework, those delivering updates on the events of the previous year, and companies with specific absorption or business model amendment projects.

Mr. Marx attends these meetings as often as possible.

Tax risk, however, such as the Panama Papers, is not among his central concerns, as this is essentially a past risk. This has been particularly true since early 2015, with the introduction of the automatic exchange of information on the interest income of European Union residents.

As to other financial income, a significantly expanded automatic exchange system has been in place since 2016. The banks are gathering information on financial income, and will share that information from 2017.

Put simply, for all EU residents and all residents of those countries with which Luxembourg has signed a double taxation agreement (and among the 100 signatories to the OECD Common Reporting Standard), there is nothing left to hide, irrespective of whether accounts are held directly or through complex structures.

Mr. Marx, HSBC's Director General for 17 years, also observes that it is important to avoid judging past actions against the laws of the here and now, or of the future. For the past forty years, neither Luxembourg nor its neighbours required its banks to ensure that their clients were honouring their tax obligations. Those days are over.

Since 2009, and following the G20 summit in London, we have been moving irreversibly towards ever greater transparency. The banks must be prepared for this.

They are encouraged to endorse the ICMA Charter (International Capital Market Association), which includes, among other requirements, an obligation not to assist clients in avoiding their tax obligations. Those banks that refused to endorse the Charter were required to provide justification for that decision, following reiteration of the criteria for exchange, anti-money laundering and the prevention of terrorist financing under which clients suspected of serious tax offences by the bank must be proactively reported.

We are in the process of moving towards total transparency around tax risk.

Yet continued vigilance is needed against the threat of money laundering. The banks are facing a challenge in terms of profitability, and some are turning towards new clients and new markets.

This geographical expansion is, in itself, a positive development. However, in terms of client categorisation, banks that in the past typically had clients worth less than one million euros are now focusing on high-wealth clients, with 10 or 100 million euros, or even more. New challenges are emerging around tracking clients and client transactions. A sharp regulatory eye is needed, then, to ensure that banks operating in regions or countries with which the regulator is less familiar, in comparison with neighbouring countries, and where objective information is often harder to gather, avoid the risks of money laundering or corruption.

In order to ensure that an income-linked transaction, in an Arab country, for example, is legally clean, it is worth returning to the banker's fundamental professional obligation: familiarity with the client, with their professional activities and the origins of the client's wealth more generally. The greater the wealth, the more information is expected in order to document client declarations.

It is important to be aware of the origins of funds transferred to Luxembourg, and to understand and document transactions passing through Luxembourg banks. This is a risk-based approach, and the vigilance of the banker needs to be proportionate to those risks: if, for example, the client is from a region where it is difficult to gather objective information, such as Sub-Saharan Africa, Russia or China, is engaged in a high-risk occupation (politically exposed individual, or someone liable to be corrupted), or on the basis of the size of the transaction amounts.

The banks ensure this vigilance through the use of systems that conduct systematic and periodic transaction scans, which are supervised by the auditor, who is also required to perform checks at set intervals and prepare reports to be made available to the external auditor and to the CSSF when it orders an on-site inspection. The primary check source, however, continues to be the annual review, conducted by the company auditor, and the periodic reports that are sent to the auditor regularly by the compliance department. These documents are assessed and verified in detail to ensure the correct application of these provisions.

The same vigilance is needed for the Panama Papers affair. In concrete terms, it is not a question of verifying whether or not the bank ensured that its client paid the necessary taxes ten years ago. The CSSF does, though, ensure that the banks have fulfilled their duty of familiarity with their clients and their transactions in cases where structures have been used extensively. This anti-money laundering component has become a key priority while tax risk is disappearing, especially as scandals such as Petrobras or Fifa highlight the international dimensions of these arrangements.

Update on major regulatory projects.

The G20 issued new standards on capitalisation, known as Basel III; as a result, capital ratios and capital quality have improved. Luxembourg's presence on the Basel Committee and within the Central Bank in Frankfurt provided the opportunity to insist on rule-based enforcement, particularly as regards risk management, rather than increased capital requirements.

The other element concerns consumer protection and transparency around financial data. For MiFID 2, the Commission proposed that implementation be postponed until January 2018, but the banks are in the process of making their preparations.

Moreover, technical standards, EMIR and the new Market Abuse Directive will come into force in July of this year, and will be followed by other regulations on investor protection.

What remains an unknown quantity are the technical standards, whether Level II or III, which come either from the European Commission or from European authorities such ESMA, EBA (the European Banking Authority) or EIPOA (the Insurance Authority). Around a hundred of these standards, which are technical and lengthy, have already been issued but remain difficult to absorb. For example, there are standards regarding remuneration for banking directors and investment fund management company directors that were prepared by EBA for banks and by ESMA for funds.

This trend will continue, but for the time being the regulator is familiar with the basics of these new regulations. Furthermore, the Commission is interested in how all these rules will coexist, and in any potential changes that may be needed. Supervised entities have now reached saturation point, and are unable to take on board any major new legislation.

These difficulties are of course shared by the regulator. Mr. Marx observes that this legislative arsenal was born out of the 2007-2008 financial crisis, which showed that the banks were undercapitalised relative to the risks involved, and that they were not behaving as they should as regards the market, hence the need for new standards.

This new prudential supervisory structure was established throughout the Eurozone in record time, and is just two years old. Pillar 1 is in place, and Pillars 2 and 3 are underway, with resolution on the one hand (what to do should the bank experience financial difficulties?) and the guarantee fund on the other.

Despite some diverging views between certain Member States, all States contribute to the national guarantee funds, in the same proportions. The aim is to move over to a re-insurance scheme within the next three years, before a move to a direct insurance scheme from a European fund by 2024.

Lastly, as regards the securitisation funds for which the capital markets union voted in favour, regulator vigilance will be required for these off-balance-sheet funds. While the details of the regulation are not yet available, the idea is for there to be sufficient capital in circulation for project funding, particularly for SMEs, before a battery of measures provide further clarity to the practice. ESMA will be responsible for Level II technical standards.

Better capitalised and better supervised banking.

“We have gone from a world of patchwork supervision to a standardised system in which oversight duties are divided up under the same standards – the single rule book”, observes Mr. Marx. The major banks are monitored directly by Frankfurt and by joint supervisory teams; the others are overseen by their national authorities.

An established and functional system; a revolution to which the CSSF has successfully adjusted, yet not without the application of significant resources.

This article was translated from French to English by KPMG.

> **We are experiencing a period of limitless regulatory creativity. For small- and medium-sized banks, it is becoming almost impossible to manage.**

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In today's economic and regulatory environment, Luxembourg's banks are reinventing themselves, and pivoting primarily towards emerging countries, markets with high economic growth, and wealth creators.
This diversification is a good thing for Luxembourg's financial centre, where clients have traditionally come primarily from neighbouring countries.

With offshore accounts no longer offering their previous advantages, we are now facing competition on the domestic markets.

Although Switzerland is a serious competitor for the private banking sector, clients take into account not just the risk rating of the bank that they choose to work with, but also the country in which that bank operates. It is worth remembering that Luxembourg has a AAA credit rating, which represents guaranteed stability for investors.

Our banking sector results for 2014-2015 proved relatively stable, and we also expect an increase in assets under private bank management for 2016. Furthermore, we are seeing a change in our clientele, with some high-net-worth families relocating to Luxembourg in order to benefit from our expertise in cross-border banking and wealth structuring services.

Heightened vigilance is needed in the provision of these services, particularly following the adoption of the fourth money laundering directive. The inclusion of serious tax infringements among the directive's primary offences means the application of the same repressive measures. Bankers are obliged to report tax fraud and aggravated tax fraud to the financial intelligence unit.

Our model is changing. It is no longer the case that the service range comes solely from private banking; other banks are moving in, such as the Chinese, who come here to use their European Passport from Luxembourg. The nature of their operations will change over time, from services to companies, fund management, custodian banking, etc.

The digital agenda is also central to discussions around the transformation of the banking industry, with a view to offering our clients a modern and dynamic interface. Our operations will be supported by a range of financial technologies, which will become part of our value chains. It is a time to share ideas, to develop partnerships. Work is required to ensure that these technological developments are utilised in accordance with the rules of the profession and to the benefit of our clients, with data and payment security needing tailored supervision.

One challenge is the provision of financing for these development activities at a time when banks are facing falling interest margins. In order to maintain a satisfactory commission level, it is vital that we offer "haute couture" services – asset management, structuring, investment funds – to our international clients.

Results for the first quarter of 2016 will be significantly lower than the 2015 results. The current environment, in which charging interest on our clients' deposits is viewed as a viable option, is unprecedented.

The ECB's (European Central Bank) measure applies primarily to inter-bank deposits. However, the credit institutions then applied it to institutional clients, and some are considering using it for high-net-worth clients under private banking.

An increase in administrative costs (14% against 2014) can be explained in part by compliance costs relating to new regulatory requirements. In 2013, these costs were estimated at over EUR 380 million, or 1% of GDP (gross domestic product) and close to 4% of the financial centre's net banking income. We are talking about substantial costs. A new study will be conducted this year to assess changes in this expenditure.

We are experiencing a period of limitless regulatory creativity. For small- and medium-sized banks, it is becoming almost impossible to manage.

Although the number of banks in Luxembourg remain stable, we have seen two key shifts, each of which cancels out the other:

- The arrival of a dozen new banks in the past two years
- A consolidation effect within smaller banking groups, where compliance costs and low interest margins are too great a burden for profitability.

The majority of the organisations present in Luxembourg are subsidiaries or branches of international groups, and some strategic decisions will depend on the interests that the Luxembourg operation represents. A gateway to the Eurozone? Operational optimisation?

The supervision of systemic banks by the European Central Bank continues to constitute a barrier to the deployment of some groups, and the handling of "small systemic banks for small markets" remains a concern.

Despite the establishment of a mechanism with proportionality principles, regulatory requirements remain much the same for all banks. Only supervision is slightly different, with the difference for banks of systemic importance being the additional equity requirement. In Luxembourg, the CSSF has identified 6 banks for which the additional equity requirement will be 0.5-1% on 1 January 2019.

This article was translated from French to English by KPMG.

> “Europe would be well advised, I think, to maintain the diversity of its banking environment.”

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> What has been your experience with regulators from the ECB over the last two years?

Being a relatively small institution without international subsidiaries or branches, albeit classified as a systemic local bank, we have seen several mismatches in terms of the single supervisory mechanism (SSM) regulators’ expectations on one hand, and our capabilities on the other. Previously, we dealt only with decision-making bodies that were local, so we were used to taking a more pragmatic approach—we knew whom to call if we needed information, and more than likely the office we were calling was a few minutes’ drive away. Our documentation and our procedures were, and still would be, good enough for our needs, our size, and what we are doing, but it isn’t up to scratch for what the new regulator wants. This is because the SSM regulator wants documentation to be part of a global supervisory framework, even for activities our bank is hardly or only marginally involved in.

Working with the CSSF means working with a regulator who knows us quite well, and who also knows the national environment, the local economy, the financial sector here, and so on. They know that the BCEE is a small actor on a European level. They understand that we are a self-governing public institution, which, from a corporate governance standpoint, is much different than being a stock-quoted banking group, and they adjust their regulatory activity accordingly.

The global supervisor, on the other hand, applies more or less a “one-size-fits-all” policy and wants you to fit into it—and this is not easy. While it certainly makes sense to have a common base of information, this causes a small bank like the BCEE some undue challenges. For example, during the comprehensive assessment exercise in 2014, they wanted details about our procedures for provisioning for liabilities, operational risks, etc.—but we had practically nil on our balance sheet, so we had no written procedures in place and instead analysed occurrences on a case-by-case basis at the management level. Nevertheless, we had to set up a written documentation on the subject to fulfil the regulators’ expectations.

I must say as well, however, that it’s not completely doom and gloom—our local representatives of the joint supervisory team (JST) are very accessible and responsive and certainly do their best to convey and explain messages from and to the global supervisor. But they are now a part of the SSM and have to stick to the global rules, so it’s nothing like the level of connection we had before.

> How specific is the information the global regulators are looking for?

Let’s take the 2016 supervisory priorities as an example. The topics are vast, from an analysis of our business model and its sustainability to governance, credit risk, capital adequacy, liquidity, and data quality issues. Imagine that you’re asked to prove that your business model is sustainable. You must provide figures and forecasts, yes, but you must also do it in an integrated way. It's not enough to say that your income statement will have such-and-such a look in a few years' time. Rather, you have to say, if I want to make a bigger profit on my credit business and given my margin, then how many more credits will I have on my balance sheet? And what does that mean for my risk-weighted assets? And for my solvency, leverage, or liquidity ratios?

And when I say risk is a topic, it's not just as simple as that: credit risk, market risk, operational risk, cyber risk, reputational risk...you name it—they are interested in the whole range of risks that can possibly be identified for a bank. How will we be affected by these risks? What's our diagnosis for the different risks? What's the possible impact? It's a holistic approach to figures, a much more forward-looking approach than in the past.

In terms of figures to provide, there is the basic reporting, the FinRep and CoRep, but also ad hoc reports to do as well. And then you have not only the SSM but also the single resolution mechanism (SRM) now at work, which has their own templates—we have been working for several weeks now on the granularity of these templates so that they can assess our resolvability and eventually draw up our resolution plan.

Often it's not just about the depth of information but the breadth of topics that need to be commented on in the first place. For example, the supervisor noticed that our non-performing loan ratios were very low and we were therefore an outlier compared to our peer group which they defined and whom we are unaware of. So we had to cross-check our figures and explain. This is not easily or quickly done, and the root of the difficulty for us lies actually in the fact that activities like these are labour intensive and risk taking away our focus from our business, which it's obviously important that we don't lose sight of.

> Have you reacted to all of this by hiring?

Yes. We have staffed up significantly in finance, regulation and risk management. We're still in the process of doing so and it's not quickly done. It's hard to find the right people, so you often end up recruiting them out of university—but then, of course, you have to get them up to speed and invest in them and that takes time. And all of that is fine, but at the same time the regulatory machine is ramping up further and further and you have to keep up with it—today, not tomorrow.

> What do you see on the horizon?

We don't see the end. Part of the reason it's hard to get ahead of this regulation landslide is that the regulators are still sorting themselves out too—they are not always fully organised and experienced either. For example, new regulations are added quite often, but nobody on their side seems to have the job of telling you which older regulations have become obsolete. In addition to that, the regulators are working partly in silos, and there ends up being a lot of overlap in the data you're sending to one place and to another. The same data might be asked for in different formats and with varying parameters.

Our wish, therefore, is this: to send every piece of information just once. We are of course willing and glad to produce the information wanted by the regulators, but if they can organise themselves so that the information has one point of entry on their side, and then they just share it amongst themselves within the appropriate limits, we would have a massively clearer process on our side.

FinRep is an attempt at this, which is certainly heading in the right direction—but it's not sufficient at the moment. In addition to FinRep you have the short-term exercise (STE), which means thousands of additional data points, and numerous other ad hoc reports, questionnaires, and impact studies, not to mention the lengthy bi-annual stress test exercises. They have also had the idea of a European reporting framework, which the ECB is hoping to develop. This is also a good step, but it will take years to develop. In the meantime the reporting machine is still ramping up, so I envision at least a number of years in the reporting maze still.

> Would you say that, from the BCEE's standpoint, Europe is managing these regulations well?

Several times it has crossed my mind that the BCEE is a little bit caught in the crossfire here. We were basically untouched by the financial crisis; we were not an instigator. With our size, geographical area of activity, low leverage level, high capitalisation, and well mastered activities, we could not really be called a risky bank. This is not to suggest that we should be excluded from reporting requirements or anything as extreme as that, but by virtue of being a small player we are getting a very raw side of these new regulations, when we were far from being a contributor to the crisis that the regulations are in reaction to.

More generally, Europe would be well advised, I think, to maintain the diversity of its banking environment. At the pace they're on right now they will suffocate some of the small players, which means market disruption in the wrong direction—more space will be taken up by those banks that are too big to fail, the same ones that can clear these supervisory hurdles. I wonder too if the principle of proportionality couldn't be slightly more forefront in the regulators' minds.

The supervisory institution has unprecedented means—a running budget of €404 million for 2016 is hardly unsubstantial. Fair enough—but the banks that the supervisor is regulating have no such budget. They have to adjust their business models to remain sustainable in an environment of low and negative interest rates, shaped by the monetary policy of the ECB. They have to manage their risks, adopt a cost-benefit analysis approach in order to survive, generate sustainable return-on-equity and return-on-investment for their shareholders... so it's sometimes hard to dialogue from these two extreme positions.

This article was translated from French to English by KPMG.

> "In two years' time job responsibilities will be different. Instead of inputting trades, our employees will focus on value-added controls. The bigger picture is that our bank is evolving."

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Nomura makes a long term investment for its business in Luxembourg

> Nomura is currently in the middle of a large back-end system upgrade, correct? Could you tell us a little bit about it? What drove the decision to change?

Currently we have two projects running in parallel: the first is to change our core banking system so that it can handle fund accounting, custody, and all of our banking activities including regulatory reporting. The second project is to centralise all of the bank's master data as well as pricing data—basically, to have a platform where the data is kept.

The change began about two years ago when we decided to change our systems—we previously used a lot of workarounds and EUCs, and implemented processes manually, especially for derivative-related instruments. We saw the potential to improve some of these shortcomings and to increase our overall efficiency. Another driver was to be able to absorb more funds from our Tokyo-based headquarters from which we receive assets directly. We also want to acquire third-party funds and diversify our business. Apart from fund accounting and custody, we also issue medium-term notes and have a small treasury function which is growing, and we aim to further develop our FX transactions. A combination of these goals means that we require significant improvements to the old system.

We have also learned from our previous experience. In the past, we were approaching change from the wrong direction. We wanted to change the fund accounting system first, then custody, and finally the data. We learned that you have to start with the data, and this is where the new central master data system comes in.

> Have you set an objective in terms of efficiency?

We would like to decrease our costs first, but, in a few years' time, we hope to also increase our revenues.

> Was the decision to implement this new system pushed by the group?

No, in fact. It was a local decision that we made at the executive committee level, with the backing of the board and support at the group level. Despite making the decision locally, we naturally wanted the support of the group because other entities in the group receive many reports from us. The new system means our reports could change and it was important that they could anticipate those changes.

> Is this project an exception within the group? After all, it's a major investment for them.

No. The amount invested in Luxembourg is generally quite small. However, it is quite significant for us because we are a small entity.

It's also important to mention that Nomura Group is not a bank, but a brokerage house. Only two entities within it are custodian banks, us and an entity in Japan which only handles Japanese funds. It's a strategic investment for Nomura. The group has important objectives for growth so we need to be in a place where we're competitive and where our Luxembourg subsidiary can help attract new clients—which we have done.

We also work in partnership with the group. We receive help from personnel coming from Tokyo and India who help reduce our costs by providing their project expertise. Some of the IT developers work remotely but most of them work locally and this helps the process too.

> You've gone with SimCorp as your provider for the core banking system and the fund accounting platform. Is that a risk, since they are less experienced on the banking side?

Together with SimCorp, we have extensively analysed their product to ensure that it meets our requirements for a combined fund accounting and core banking solution. The outcome demonstrated the strength of their product. We understand that we are the first client in Luxembourg to benefit from this integrated solution, covering both fund accounting and core banking. There is a clear demand in the Luxembourg market for an integrated solution. We met with the top management of SimCorp and it is clear to us that this product is fully supported by SimCorp's strategy.

> What difficulties are you experiencing? And which challenges do you see coming down the road?

On the technical side, it's certainly not a simple task aligning our two projects. The goal is to ensure the two systems can communicate. However, neither system is live yet because we are still in the integration phase. The SimCorp project is supposed to go live in two phases: the first in October 2017 and the second a year later. However, the SimCorp platform needs data from our platform NeoXam for testing purposes. We are on track to get the NeoXam platform up and running first—and that is unfolding in five phases. The last phase should be live in 2017. A layer of complexity is added by the fact that it is not always clear what dates or information will be needed by both the SimCorp and NeoXam projects. Both projects need to be adapted on an ongoing basis.

On the non-technical side, the major challenge is change management. It hasn't been easy to change people's mind-sets, to convince them that this project is a chance, an opportunity, for them to work differently. The resistance to change is quite natural. In two years' time job responsibilities will be different. Instead of inputting trades, our employees will focus on value-added controls. The bigger picture is that our bank is evolving. We need to acquire more business and stay competitive in this environment. Staying stagnant is certainly not the solution.

> Speaking of people and of business-as-usual, have you been able to maintain a workforce for the transformation without leaving the daily business behind?

It's difficult. At the start of the project, we selected some business staff to focus solely on the project, to work with our dedicated IT and project management personnel. To replace these business staff, we hired temporary staff.

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