Forging forward: Financial services in 2012

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The turmoil in our industry shows no sign of abating. The worst dangers of the financial crisis have given way to political and regulatory reaction on perhaps an unprecedented scale. But major uncertainties remain. Banks, insurers, investment managers – all face a future which will be as different as it is currently obscure. The articles in this issue of frontiers review regulatory developments from a number of perspectives; we look at growth prospects in the insurance sector and in the massive but still emerging market of Brazil; operational issues addressed include how to guard against rogue trading and how to implement effective customer remediation when things do go wrong.

There is more. But we hope you find it a stimulating and helpful guide through the complexity of today’s, and tomorrow’s, financial services industry.

At frontiers in finance, we have always tried to live up to the promise of the magazine’s title: to present for the benefit of our clients and other readers leading opinions and analysis addressing issues at the cutting edge of the financial services industry. We have also tried to do this in the most succinct and accessible manner.

A change of editorial responsibility is traditionally a time to take stock, to review and to refresh a publication, and this is what we have been doing. We have sought feedback from the tens of thousands of readers we serve, both within KPMG and in the wider financial services community. It is gratifying to find that in the main we have been living up to our promise. Many of you have emphasized the value of the magazine.

At the same time, just as the financial world is changing, there are ways in which frontiers needs to evolve as well. We still aim to provide a commentary on the key financial services topics of the day which is both relevant to your business and your challenges and also offers practical guidance and solutions. In future, we hope to be a little more forward-looking, perhaps clearer and more concise, and to pay greater attention to cutting through the complexity which can bedevil financial services. We shall be including two or three more regular features, and trying to provide a rather stronger thematic underpinning to each issue.

From the Editorial team

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Insurance
Finding growth opportunities in uncertain times.
As we publish this issue of *Frontiers in Finance*, the financial and economic environment remains fragile in many parts of the world. Financial sector firms face an unprecedented combination of threats from the lack of GDP growth, a lack of confidence in the European bank and sovereign debt markets, and calls for additional capital and liquidity as part of the sweeping changes impacting many parts of the financial sector globally. We remain a long way from durable solutions to the crisis.

While policymakers around the world have responded differently to these threats, on balance the global response has been to increase austerity measures. What is not yet clear is whether austerity objectives will be able to deliver the renewal in confidence and growth that are needed to emerge from the current crisis. At the same time the banks are being required to hold more capital with the attendant risk to new credit origination.

The pace of regulatory change this last year has been relentless, driven primarily by the G20 Financial Stability Board, in the form of requirements for G-SIFIs, the implementation of DoddFrank in the United States, multiple European Union regulations, and an emerging focus on consumer protection. Rarely have we seen executive teams spend so much of their time grappling with regulatory issues. Change programs, impacting people, processes and technology, need to be implemented in parallel, across multiple regions and jurisdictions and under different regulatory frameworks. This is a profound challenge for even the most agile financial institutions.

In addition to adapting to new regulation, banks continue to face the perennial challenges of managing operational risk and implementing transparent and robust remuneration policies. Both areas continue to come under significant scrutiny from governments and regulators.

Amidst the despondency in Europe it is easy to forget that many countries are growing apace. There are tremendous opportunities to grow in Asia, South America, India, and also on the African continent, where the convergence of banking and mobile telephony is creating unprecedented opportunity.

As financial institutions rise to the challenge of providing banking and insurance services to more than two billion ‘unbanked’ people globally, a key focus will be how to achieve this sustainably, so that the financial sector is seen as a partner in responsible development. To this end, KPMG is organizing a global conference to articulate a Business Perspective on Sustainable Growth ahead of the Rio+20 summit in June 2012.

Whether your immediate focus is on the Eurozone and regulatory developments or on the tremendous opportunities in high-growth markets, I hope you will find this edition of *Frontiers in Finance* stimulating and useful as you launch into 2012.
Regulation of the global financial services industry is evolving rapidly, on many fronts and in complex, overlapping ways. In this new recurring section, the heads of KPMG’s three Regulatory Centers of Excellence – Giles Williams (EMA), Simon Topping (ASPAC) and Jim Low (Americas) – recently reviewed the major issues companies in each of their regions are facing from a regulatory perspective in 2012.

Global Round Table: Regulation hots up

Giles Williams: We’re going to talk in a moment or two about the KPMG ‘Regulatory Heat Map’ [Page 9/10] which captures the current impacts of regulation. But first I thought it would be helpful if we put it into a broader context. During the global financial crisis, complete catastrophe was averted partly by luck and partly by concerted action by governments and regulators. The G20 rapidly moved to the forefront of action to restore stability and began the process of building a more resilient global financial services structure. Markets and economies began to recover. However, I think all of us would agree that the global recovery has weakened in recent months and new trends are emerging. The regulatory debate is broad; with the systematic risk arguments, the role of capital and need for liquidity. This is in the context of the wider political dimension focusing on the role of financial services in the rest of the economy, the protection of consumers and the contentious issue of executive pay.

GW: So turning to the ‘heat map’, the G20 regulatory agenda is intended to:
- create a new framework for banks, OTC derivatives, compensation practices and credit rating agencies;
- address the too big to fail issue; ‘fill in the gaps’ in regulation and supervision of the financial sector;
- tackle tax havens and non-co-operative jurisdictions.

The ‘heat map’ locates the principal regulatory initiatives currently being implemented on a grid relating five key themes – financial stability, conduct, market infrastructure, tax and finance and governance – to the three primary industry segments of investment management, banking and insurance. The color key reflects the main geographic regional impacts.

Simon Topping: What really comes across to me from our analysis is that we've seen a significant change in the regulatory landscape over recent months. One of the most obvious points to note is that the three industry segments look really quite similar. There are some differences of emphasis, for sure; but it is now clear that the impact of new regulation will be widespread and comparatively intolerant of special interests. In early 2011 it was still possible to argue that hedge funds should be spared the most draconian new requirements because they played no role in creating the crisis; or that insurers operate a fundamentally more stable business model and require different treatment. Now, however, there is little distinction; this is a real change.

JL: I think that’s exactly right. The political agenda has ensured that the financial services sector as a whole is going to share the pain.
But what we have now is a remarkably complex and ambitious agenda.

**GW:** The G20 would no doubt argue that it is deliberately comprehensive and consistent. I have a quote from the final declaration from the Cannes Summit in November 2011, where they emphasized: “We are determined to fulfill the commitment we made in Washington in November 2008 to ensure that all financial markets, products and participants are regulated or subject to oversight as appropriate to their circumstances in an internationally consistent and non-discriminatory way.”

**ST:** Well yes, but a more pragmatic assessment also raises a number of areas of concern notably:
- the scale and cost of the additional regulatory burden, all of which will be borne, in the end, by financial services companies and their customers
- the scope for inefficiency, duplication, inconsistency and contradiction
- the opportunities for regulatory arbitrage
- the damage to global GDP which may follow the imposition of a more costly, less profitable, less responsive financial services sector.

**JL:** Our three Regulatory Centers of Excellence are uniquely placed to compare and contrast the impact in different geographic regions. Where are the agendas most strongly correlated across the three regions? Clearly, the most obvious area is where firms are truly global in the first place: regulation has to impose a consistent global framework. But there is a deeper area where the end-game itself implies convergence. For example, the pressure for structural reform in the banking sector may be stronger and more

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**IMPLEMENTATION PROGRESS**

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During the global financial crisis, complete catastrophe was averted partly by luck and partly by concerted action by governments and regulators. The G20 rapidly moved to the forefront of action to restore stability and began the process of building a more resilient global financial services structure.

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REGULATORY HEATMAP

Investment management

Financial Stability  Conduct of Business Agenda and Investor Protection  Market Infrastructure and Trading  Tax and Finance

Banking industry

Financial Stability  Conduct of Business Agenda and Investor Protection  Market Infrastructure and Trading  Tax and Finance

Insurance industry

Financial Stability  Conduct of Business Agenda and Investor Protection  Market Infrastructure and Trading  Tax and Finance

European Union  Global – G20  UK National  United States
explicit in the UK and elsewhere in the EU. But the consequences will inevitably be felt here in the US, and in Asia, and will drive change towards comparable ultimate goals.

**ST:** Indeed. For instance, recovery and resolution planning is now a significant regulatory agenda item in Australia, impacting on companies which remained untouched by the crisis. So to a significant extent a common agenda is emerging, and common themes are extending across all geographical regions. But although the G20 emphasizes the international and global nature of the framework it believes is necessary, there are differences in emphasis, and the balance between the five themes is different.

**GW:** Some of the marked contrasts can be seen in the conduct agenda. This is not an especially significant imperative in Asia. It is of some relevance in the USA, but there it remains heavily colored by a strong caveat emptor principle: the customer needs to recognize and assume an appropriate degree of risk, and so the emphasis is on supporting information provision and understanding. In Europe, however, it is a key theme of the regulatory agenda: the cultural and policy mind-set is that the consumer needs protection, and cannot – or should not – be exposed to excessive risk.

**ST:** Nevertheless, despite such differences, I think we are seeing a kind of creeping convergence in individual regional agendas. Issues of governance run across all three regions, although the strength of implementation necessarily varies, from very prescriptive in the EU to – as yet – more consensual in the Far East. There is convergence too in the way the objective of strengthening financial stability is being extended into insurance through Solvency II; and in the way that protection against systemic impacts is leading to resolution and recovery planning for insurance companies.

**JL:** So a key question is how far, and in which directions, will these regional agendas influence each other in future. How far will the US begin to reflect European concerns? Will the US agenda be increasingly reflected in Europe?

Evidence seems to show that policymakers and regulators are acting in a responsible and thoughtful manner, seeking to be proportionate and achieve the broad objectives of restoring stability and increasing resilience without unduly damaging competitiveness or economic value.

**ST:** Nevertheless, financial services will cost more, and deliver lower returns, to the extent that greater regulation imposes higher costs and lower profitability. The main problem arising from this is there is little evidence as yet that consumers accept the implications for the costs and benefits they receive. This is going to make the challenge for CEOs all the greater. But there are clearly some key questions they need to be asking themselves.

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**MORE INFORMATION**

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Brazil –
The new hotspot in investment management

By Marco Andre Almeida and Lino Junior

Brazil is now a major economic power, one of the top-10 global economies by purchasing power parity. It ranks ahead of its ‘BRIC’ counterparts Russia and India (although it is smaller than China). The country enjoys a relatively stable macro-economic environment, with consumer and investor confidence continuing to strengthen. Inflation has been brought down since the early years of the new millennium, although it remains around 6.5 percent in 2011. However, interest rates remain high – the short-term risk-free rate currently stands at 10.5 percent.

Unlike many other large economies, Brazil has a comparatively welcoming attitude to investment funds and hedge funds – recognizing the need to attract foreign investment to underpin continued economic and infrastructure development. The combination of high returns and a favorable regulatory regime is driving a massive wave of interest in investment in Brazil: it is indeed the new hotspot in investment management.

Investment Management industry in Brazil

Brazil’s investment management industry is mature, well-managed and effectively-regulated. All funds – including those which would be described as hedge funds – must be registered with the Comissão de Valores Mobiliários (CVM) – Brazil’s equivalent of the Securities and Exchange Commission. The capital markets association, ANBIMA, operates a system of self-regulation which is generally well-regarded. The market is transparent, with daily updates of asset values and portfolio details being posted on the internet.

Although the investment management sector is large, it faces competition from certificates of deposit and savings accounts. The total investment portfolio is concentrated in Brazilian assets, with 60 percent of total investment in government bonds.

Alternative investment industry in Brazil

There is increasing interest in the alternative investment market in Brazil. A number of different classes of investment vehicle exist. These are all summarized in the panel on the next page.
High returns and a favorable regulatory regime is making Brazil the new hotspot in investment management. Infrastructure investment in Brazil is pressing as Brazil prepares to host the World Cup in 2014 and the Olympics in 2016.

“As a country and an economy, we need private equity and venture capitalists to invest and to help our entrepreneurs,” Maria Helena Santana, Chair of the Comissão de Valores Mobiliários (CVM) – Brazil’s SEC

The most attractive emerging market for private equity
A recent survey by Coller Capital and the Emerging Markets Private Equity Association shows that Brazil has overtaken China as the most attractive market for fund managers’ deal-making in the coming year. Brazil offers a number of fiscal incentives for inward investment in private equity funds (Fundos de Investimento em Participações – FIPs):

- Income and capital gains received by the funds are usually not subject to taxation in Brazil;
- There is no withholding tax on disposal of FIP quotas for non-residents as long as they hold, together with related parties, less than 40 percent of the shares of the FIP and are not located in a low tax jurisdiction (defined as where income is taxed at less than 20 percent and/or where there are restrictions on disclosure of shareholder composition or beneficial ownership).

FIP investments are subject to certain restrictions:
- The portfolio company is usually a Sociedade Anônima (S.A.), and is required to have its financial statements audited by an independent auditor registered with the Brazilian CVM. The FIP must have influence in strategic decisions and its management.
- The investment must adhere to the existing foreign exchange regime for investments in Brazil’s capital market.
- The financial tax (IOF) is levied on the inflow of foreign funds into the FIP at a 2 percent rate (reduced to zero on 1 December 2011).
**Private Equity Funds (FIPs)**

- **Size in September 2011:** R$ 78.4 billion.
- **Taxation:** 15 percent. Non-resident investors (other than those located in ‘low tax jurisdictions’) which hold up to 40 percent of the fund are exempted.
- **Comments:** Minimum subscription of R$100,000. Invested companies must comply with certain corporate governance rules.

**Multi-Strategy Funds**

- **Size September 2011:** R$ 395 billion.
- **Taxation:** from 15 percent to 22.5 percent (some exemptions).
- **Comments:** Portfolios can include any financial investment, in accordance with limits established in the by-laws and CVM regulation. Overseas investments are allowed in funds with minimum subscription of R$1 million up to 100 percent and in other funds up to 20 percent.

**FIDCs (Credit Receivables Investment Funds)**

- **Size in September 2011:** R$ 65.7 billion.
- **Taxation:** generally from 15 percent to 22.5 percent.
- **Comments:** At least 50 percent of resources should be invested in credit receivables. Derivatives are optional, provided the objective is to hedge spot positions. Most funds value credit receivables at cost plus accrued income, less allowance for losses as determined by the Brazilian Central Bank. New rules effective from 2011 are consistent with IFRS approach.

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**Investing in the Brazilian financial market:**
Non-resident investors may invest in Brazil’s financial and capital markets on level terms with resident investors. They need simply to hire a legal representative in Brazil (a financial institution), and complete the necessary paperwork. However, getting the structure right and optimizing the balance sheet to take advantage of the favorable tax opportunities as well as to comply with domestic legislation and regulation is complex. Where purchases of local companies are concerned – as they have been with sovereign wealth fund investments – the necessary due diligence can be time-consuming.

Having said this, the requirement in Brazil for infrastructure investment, especially, is pressing, particularly in the transport sector. In addition, Brazil is to host the football World Cup in 2014 and the Olympic Games in 2016, both of which require major investment in the country’s infrastructure. It has been estimated that Rio de Janeiro alone needs $36 billion of investment to prepare for these two events. Brazil’s investment management industry is most definitely open for business.

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**MORE INFORMATION**

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1. CIA World Factbook, February 2011.
2. EMPEA/Coller Capital Emerging Markets Private Equity Survey – 18 April 2011
4. As quoted in The Economist, 17 February 2011
A reactive approach to a rogue trading can have dire consequences for a firm. The right actions and approach can defend against this threat.

Rogue Trading: Controlling the risk

By Bill Michael

Rogue traders have always existed in one form or another. The combination of breach of faith, betrayal of trust and deception is common to most areas of financial crime. What tends to mark out the contemporary rogue trader is a particular set of circumstances and characteristics:

– the individual involved is normally not motivated by personal greed, at least directly
– his deception starts small but spirals out of control
– the sums involved can reach astronomical proportions.

It is unsurprising that the actions of such individuals hit the headlines. Among the most notorious instances in recent years:

– Kweku Adoboli is alleged to have caused UBS to lose $2.3 billion trading on market futures in 2011.
– Jérôme Kerviel lost Société Générale €4.9 billion over three years to 2008, again as a result of trading stock market futures.
– Brian Hunter lost $6.5 billion for Amaranth Advisors in 2006, trading on natural gas futures.
– Perhaps most famously, Nick Leeson brought about a loss of £827 million, and caused the collapse of Barings Bank after 233 years of existence, through his trading on the Nikkei Index.

Such stories receive sensational media coverage, and it is always dramatic to depict a single individual being responsible for such catastrophic consequences. However, the real reasons behind, and causes of, rogue trading are more complex. It is these features which companies need to understand if they are to institute effective controls.

The first key point to note is that no company is immune. Wherever large sums of money flow through large institutions, there will always be the potential for rogue trading to emerge. Constant vigilance and defense in depth are essential. Furthermore, it is usually not the most high-profile, complex or apparently risky areas of activity which are most susceptible. The majority of rogue trading occurs in comparatively humdrum or presumed safe parts of the business, out of the spotlight. Problems can start small but rapidly escalate to threaten the whole firm.

There are also a number of institutional and individual features which contribute to rogue trading. These are the subject of increasing debate in the industry. It is perhaps a cliché to point to the excessive risk-taking mentality and aggressiveness of mainly-young, mainly-male traders. But there is no doubt that there is a tendency for companies to hire as traders people who tend to be more prone to such activity. When traders are speculating with other peoples’ money, the need for external controls is clear.

Secondly, a corporate culture which encourages (acceptable) risk-taking can easily become one where excessive risk-taking mentality and aggressiveness of mainly-young, mainly-male traders. But there is no doubt that there is a tendency for companies to hire as traders people who tend to be more prone to such activity. When traders are speculating with other peoples’ money, the need for external controls is clear.

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Motivating factors: the environment
What are the typical factors that create the environment for rogue trading activity?

- **Aggressive culture** of P&L and revenue performance rather than wider risk and control based metrics
- **Remuneration** linked to short term performance
- **Repeated control breaches** tolerated by senior management
- **Insufficient challenge** to (by control functions) and within (by supervisors) front office
- **High volumes of trades** supported by fragmented IT systems and complex processing environment
- **Poor understanding** of complex products and trading activities by senior management

that successful trading may bring kudos and a bigger bonus. Rather, a trade at the limit of acceptability may go wrong. Instead of closing out the position and triggering a loss, the trader may try to recoup the loss next day. All goes well until a loss cannot be recovered. Then the trader embarks on the disastrous course of repeatedly doubling up in a desperate attempt to recover the situation, all the while engaging in increasingly elaborate deceptions to disguise his true position.

It is much easier to hide transgressions when a large volume of transactions is taking place against a background of fragmented IT systems and complex processes. Where middle- and back-office responsibility is compartmentalized, no-one may be in a position to see the whole picture. Complex trades can be very difficult to value accurately by anyone other than the front-office expert who is carrying them out. If senior management or supervisors don’t fully understand the nature of products being traded or their inherent risk profile, it is much easier for the rogue trader to disguise the true nature of his position.

It follows from these features that an effective defense needs two mutually-reinforcing strands: adequate and appropriate controls and the right tone being set from the top. It has been well-said that there are bold traders and old traders, but there are very few old, bold traders. Senior management need to instill a strong culture of respect for controls – which still promote acceptable risk-taking – while explicitly prohibiting the occasional tolerance of breaches. Turning a blind eye from time to time to an unauthorized gamble which pays off risks undermining the whole control framework.

In such a culture, it is then much easier to institute effective systems and controls and to make sure they are respected. Most cover-up strategies are comparatively simple. The most obvious course, if closing out a trade is going to crystallize a loss, is to avoid booking it in the first place. So systems need to look for long settlement dates, late bookings, use of suspense accounts, fictitious trades which lack counter-party recognition, cancelled trades, excessive gross versus net exposure and so on. Acceptable profiles for all of these characteristics can be developed, with events outside the established parameters triggering an alarm.

There are also a range of non-technical factors which need to form part of an effective control framework. These range from mandatory training to appropriately-disciplined controls on access to systems and records. It has been well-publicized in a number of cases that rogue traders have tended to work odd hours, and have been reluctant to take vacations in case their positions were exposed. Profiles for these characteristics should also be established, and divergence flagged up. Correlation between suspicious activities in a number of areas can be especially valuable.

Systems and controls are typically introduced and/or strengthened in the wake of a rogue trading disaster – if the firm has managed to survive it. But the risk of adopting a reactive strategy is clear. By contrast, firms should be adopting a strategy of continual review, stress testing, monitoring and development, to ensure that their defense is as strong as possible.

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Warren Buffett famously likes to say that, ‘Only when the tide goes out do you discover who’s been swimming naked’. The straitened economic environment following the financial crisis has contributed to the exposure of frauds such as the ‘Ponzi’ scheme run by Bernard Madoff in the US, or various buy-to-let property frauds in the UK. Similarly, when asset values suffer serious reverses and liquidity dries up, investors and customers begin scrutinizing much more closely the soundness of investments they have made or been sold. Some of the malpractice which has emerged in the last few years on the part of the financial services industry has been profound and far-reaching.

In the US, the foreclosure crisis which emerged in 2010 remains unresolved, despite tremendous regulatory scrutiny and notable industry reform. It has revealed a widespread epidemic of foreclosures that were inappropriately initiated and inappropriately handled. Many have involved a lack of understanding of the legal/regulatory requirements and often been coupled with poor or in some cases fraudulent processes:

- Mortgagees have foreclosed on homes with no outstanding debt, employed ‘robo-signing’ methods to expedite thousands of false affidavits and foreclosed on the homes of servicemen and women on active duty in express violation of federal law.
- There have been significant failures of the controls intended to safeguard the positions of both the borrower and the lender.
- Insufficient attention has been paid to borrowers and to the overall borrower experience.
- Institutions placed excessive reliance on third parties – especially attorneys – to do the right thing.

Customer Remediation
JPMorgan Chase was one of the first major banks to halt foreclosures completely, affecting proceedings against 56,000 borrowers in 23 states; in a sworn deposition, a JPM employee admitted that she and her team signed off on about 18,000 foreclosures a month without checking whether they were justified. Bank of America, Wells Fargo and Citigroup were among other major banks to follow suit. The fifth largest lender in the US, Ally Financial, halted evictions and resale of repossessed homes once a document processor for the company admitted that he had signed off on 10,000 pieces of foreclosure paperwork a month without reading them.

In the UK, the continuing issue over the widespread mis-selling of payment protection insurance (PPI) by banks and other providers was dramatically thrust back into the spotlight in 2010. In a volte-face from its earlier stance, the BBA (British Banking Association) decided not to appeal the judicial review decision. This resulted in a need for the UK banking industry to calculate provisioning requirements to cover the anticipated costs of millions of customer claims. Lloyds Banking Group was the first to announce a provision of £3.2 billion. As a consequence, the bank reported a £3.4 billion loss for the financial quarter concerned, and shareholders saw 8 percent wiped off the market value of their investment. Other banks quickly followed suit, with Barclays setting aside £1 billion and RBS £950 million. The estimated total cost to the industry could be £9 billion.

The PPI issue followed in the wake of the systematic mis-selling of endowment mortgages to more than five million UK customers. Millions more were advised to opt out of employee pension schemes for worse-performing private schemes.

As demonstrated through the examples above, these crises can cost the industry billions of dollars in redress and operational costs, requiring onerous, resource-intensive remediation infrastructures to be built and subsequently decommissioned. Many providers have faced quality and consistency concerns that have in turn invited regulatory scrutiny and increased reputational risk as a result. An increasingly intensive and intrusive regulatory landscape, together with growing media and political pressure, make it almost inevitable that the remediation burden will continue to rise over the medium to longer term. Firms should consider it a business imperative to be better prepared.

Many of the principles are consistent with the crisis management discipline. Prevention is better than cure:

- Avoid capping innovative product development by designing flexible risk-based frameworks to deliver robust management, analysis and reporting aligned to different products/services.
- Create a business culture that focuses on customer outcome as well as commercial gain, with early identification and rectification of failings being a key requirement.
- Ensure compliance: interpretation of regulation and statute needs to be thorough, systematic and up-to-date. Avoid technical and tenuous legal interpretations of regulatory rules by maintaining a pragmatic, principle-led ‘treating customers fairly’ approach – get it right.

An increasingly intensive and intrusive regulatory landscape, together with growing media and political pressure, make it almost inevitable that the remediation burden will continue to rise over the medium to longer term.
can demonstrate that it did its best to consider
will be more forgiving if a financial institution
consumers are affected. Ultimately, the world
– Always be transparent.
– Identify the root cause and make sure your
– Document all critical decisions and how
– Develop a clear, explicit project and action
– If a problem does emerge, address
imperative:
However, in the event an issue and/or control
– Introduce standards, policies and controls to
– Controls need to be designed in an
– Controls need to be tested and re-designed
– The provider must always assume
– Information sharing (industry forums)
However, in the event an issue and/or control
– If a problem does emerge, address
– Develop a clear, explicit project and action
– Document all critical decisions and how
– Identify the root cause and make sure your
– Always be transparent.
It is important to avoid the checklist mentality,
and ensure the focus is on understanding how
consumers are affected. Ultimately, the world
will be more forgiving if a financial institution
can demonstrate that it did its best to consider
the impact and outcome for its customers
throughout the process.
If a product or service fails to deliver the
right customer outcome, the firm should:
– Identify the population of customers affected.
– Determine the level of detriment based on
the customers’ situations and experiences.
– Taking the above step may allow the
population to be segmented based on likely
detriment and appropriate actions for specific
customer groups (previously paid/declined
claims, arrears customers, open/closed
policies, ineligible, etc).
– If a customer raises concerns directly, the
firm takes into account the identified failings
when investigating and assessing the
customer’s allegations.
– Redressing the customer should always
reflect a desire to put them back in the
position they would otherwise have been
had the failing not occurred.
– Any customer impact should be rectified in a
timely and consistent manner to reduce
further adverse customer impact.
For most firms, their existing operations and
resources cannot absorb the requirements
of the remediation activity. As a result, there
is a need for large numbers of temporary
resources, with limited time for robust training
and competency frameworks. This in turn
results in subjectivity when assessing and
redressing complaints leading to inconsistent
outcomes, high levels of rework and regulatory
scrutiny.
Most large financial institutions can
 demonstrate at least one such experience in the
past. The key to avoiding this is to develop a
consistent approach to the upfront work in
understanding and identifying the impact of the
failing. The findings should be used to inform
the scope of the remediation activity and drive
population segmentation. Once this has been
established, an automated approach to triaging
the customer population for mailing and
responses can be developed. The rules used
to drive the system will reflect the customer
segmentation defined by the upfront work
undertaken by the firm, driving objective and
consistent outcomes that are right first time.
The extent of an automated solution is
dictated by the complexity of the customer
remedy. For example, a customer with an open
policy may want to maintain the policy and the
benefits therein, making it more appropriate
to relax the terms. However, a customer with
a closed policy may simply wish to receive
financial compensation. There are many
potential outcomes; it’s never a case of one
size fits all.
While the main focus of remediation
activity is to rectify any customer detriment in a
compliant and timely manner, a key
benefit is often missed. Understanding the
core reasons for the failings provides the firm
with a window of opportunity. Not only can
the failings be used to design a more robust
risk framework, they can also help to inform
and mould business culture, product and
sales development. If, for example, the issues
arose as a result of the incentives and drivers
in place, the business should review whether
these existing incentives encourage the right
behaviors and outcomes. They may choose
to weight future incentives towards suitability,
persistency and quality, not just volumes.
The final piece in the jigsaw is the
governance and reporting structure. The
firm should be able to access and provide
transparent material that informs all areas of the
business – such as compliance, complaints,
product design and marketing.
Engaging all relevant business areas and
driving accountability for necessary change is
key to reaping the benefits of remediation and
reducing future liability and failings.
In summary, a firm’s ability to deliver
successful remediation projects and use
the learnings from them to shape its future
business model is completely within its grasp.
However, time will tell whether the industry
continues to view remediation as an expensive
and inevitable result of identified failings, or
grasps the opportunity to use the learnings for
long-term financial and reputational gain.

1. New York Times, 29 September 2010;
2. Washington Post, 22 September 2010

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Create a business culture that focuses on customer outcome as well as commercial gain, with early identification and rectification of failings being a key requirement
In September of 2010, the Basel Committee on Banking Supervision specified additional details for capital requirements. These focused on target ratios and the transition periods during which financial institutions need to comply with the new regulations. The resulting framework, known as Basel III, was endorsed by the G20 at its November 2010 meeting in Seoul. While some areas continue to be fleshed out – most notably in relation to the regulation of systemic institutions – the core principles are in place to encourage banks to strengthen their underlying risk management capabilities.

Basel III was developed as a response to the deficiencies in banking and financial regulation revealed by the global financial crisis. Specifically, the third of the Basel accords aims to correct the following:

- Build up of excessive on and off-balance sheet leverage by the banking sector along with a decrease in the level and quality of the capital base
- Significant contraction of liquidity and credit availability resulting from the spread of the banking crisis through the rest of the financial sector
- Interconnectedness of systemic financial institutions through various complex transactions
- The use of short-term and wholesale funding, used by the financial sector as a cause of de-leveraging and flight to quality.

The reforms under Basel III are designed to increase the resilience of banks during periods of stress and address system-wide risks that can severely impact the financial sector.
Banks are already cleaning up their balance sheets, but raising new capital and retaining more earnings will be a continuing process. This will impose a double strain on shareholders who will see dividends constrained alongside calls for additional capital.

These reforms are broken down into four key proposals:

– Increasing the quality, consistency and transparency of the capital base to ensure a more resilient banking sector
– Improving risk coverage of the capital framework to strengthen the resilience of banks and minimizing the risk of shocks being transmitted between financial institutions through complex transactions
– Supplementing capital requirements with a leverage ratio to help contain concentration of too much leverage in the banking sector
– Lowering procyclicality and promoting countercyclical buffers that can be applied in stressed environments, contributing to a more stable banking system.

Development of these new proposals has been continuing with extreme urgency and on a very tight timescale. Individual national agencies in Europe along with the EU are currently in the process of translating the proposals into domestic legislation, even as core details on systemic risk are still evolving. Implementation is designed to begin in 2013 and despite the fact that some fundamental issues are yet to be resolved, banks cannot afford to be idle. Recommended areas for action include:

Increased quality, consistency and transparency of the capital base

Banks are expected to improve the consistency of their common equity component of Tier 1 capital as regulatory adjustments will generally be applied to this component. Additionally, Tier 2 capital is to be simplified and Tier 3 eliminated. The goal is to improve the transparency of capital, with all elements of a bank’s capital required to be disclosed.

Some banks are already adjusting their balance sheets; however, raising new capital and retaining more earnings will continue to be challenging and impose a double strain on shareholders who will see dividends constrained alongside calls for additional capital.

Reduced on and off-balance sheet leverage

Banks need to constrain build up of excessive on and off-balance sheet leverage to avoid destabilizing their deleveraging processes. Accordingly, banks will be expected to reinforce their risk-base capital requirements with a backstop measure based on gross exposure to be incorporated into Pillar 1.

This backstop measure is designed to prevent the build-up of excessive leverage in the banking system. The implications are as yet unclear, in particular as to how individual institutions will be impacted. It could lead to reduced lending or it could incentivize banks to focus on high-risk/higher-return lending. Ironically, this raises the wider issue of shadow banking. There have been a number of public comments notable from the FSB on this issue. As banks deleverage it is likely that a public policy response will follow that brings these assets back within the scope of regulation.

Short-term liquidity

As a result of the crisis, global regulators and policymakers have realized that liquidity is potentially as significant as solvency for the stability of the financial system. The Basel Committee has strengthened its liquidity framework by developing new minimum standards for funding liquidity:

– A 30-day Liquidity Coverage Ratio (LCR) will help ensure that banks have sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors.
– Assets get a liquidity-based weighting varying from 100 percent for government bonds and cash, to weightings in the range of 0 to 50 percent for corporate bonds.

Because the introduction of the LCR will require banks to hold significantly more liquid, low-yielding assets, there will be a correspondingly negative impact on profitability.

There is a debate about whether the liquid, low-yielding assets i.e. sovereign debt should attract a risk weight under the Basel III formula. The irony is that this would reduce the amount of capital available to support credit origination and the knock on impact on national and the global economy. The political reality of this is that the ongoing debate between growth and financial stability will continue. A further market development is the increasing use of covered bonds to generate longer dated liquidity. Up to a point this will be successful but at some time these instruments will absorb so many good quality assets as collateral that the ability of banks to rebalance their asset portfolio will be limited and this cannot be a good policy outcome.

Longer-term funding

Partly as a result of liquidity requirements, banks may tend to change their funding profile, with a demand for additional longer-term funding. The Net Stable Funding Ratio (NSFR) is designed to encourage banks to use stable funding sources and reduce their dependence on short-term funding. The NSFR compares available funding with required funding, using weighting factors to reflect the stability of the funding available and the duration of the asset.

Banks will need to increase the proportion of wholesale deposits with maturities greater than one year; this is likely to lead to higher funding costs. Stronger banks with a higher NSFR will be able to influence the market price of assets, while weaker banks will see their competitiveness reduced. While this could be read as a description of one of the core objectives of Basel III, it also implies that competition may in fact decrease as a result.

Counterparty risk management

Significant strengthening of the framework for trading book and securitization risk has already been introduced as part of Basel 2.5 (July 2009). Basel III will introduce further changes to the treatment of exposure to financial institutions and counter-party risk on derivative exposures. In addition, the committee will be imposing greater pressure to drive standardized derivative trading onto regulated exchanges.

Conclusion

Basel III represents more than just another set of regulatory requirements for financial institutions across the globe. The policy makers are trying to find a balance between financial stability and economic growth. For management, the proposals will have fundamental impacts on capital allocation, pricing of products for customers and the wider business model and the returns to shareholders. Banks with a vision to excel in a post crisis world are taking action now to address Basel III requirements, strengthen their profit-making capacity and manage the new reality that Basel III will place on them.

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A new recurring section which seeks to bring clarity around complex and often misunderstood financial services concepts or issues.

Extraterritoriality

By Giles Williams and Kara Cauter

“When I use a word,” Humpty Dumpty said, in rather a scornful tone, “it means just what I choose it to mean — neither more nor less.”

The ability of words to change their meaning in response to social and environmental change is one of the main sources of the power and flexibility of language. At the same time, it can also lead to ambiguity and confusion. In specialized contexts such as the world of financial services, words and concepts can acquire particular significance; they can also be used in incorrect or contradictory ways.

In this, the first of a series of regular columns, we take a look at a concept which is attracting increasing attention: extraterritoriality.

Traditionally, the concept of extraterritoriality focused on an individual, an institution or a location being exempt from the legal jurisdiction which would generally apply to a particular location. A classic case is diplomatic immunity, where a diplomat serving his nation overseas is not liable to the legal framework of his host country but remains accountable to his native law. To give a comparatively trivial example, diplomatic missions and international organizations in the UK typically refuse to pay up to £500,000 in parking fines each year. Extraterritoriality can also apply to physical locations: the headquarters of the United Nations in New York, and the International Court of Justice in the Hague enjoy extraterritorial status; the extraterritorial status of the US base at Guantánamo Bay is disputed by Cuba.

However, although the core emphasis of the concept in this view is on removal from particular jurisdiction, this also implies the extension of some other jurisdiction outside its normal scope. This is the sense in which it is applied increasingly commonly in areas of international law. More correctly termed extraterritorial jurisdiction, it describes the efforts of national legislatures to impose their
Recent serious concerns which have been more stable international financial structure. have the potential to disrupt progress towards a controversial. Disputes over extraterritoriality the Dodd-Frank Act or FATCA are increasingly USA. The implications of legislation such as of contemporary extraterritorial ambition is the necessary. Hence the most powerful source it applies, and the ability of the legislature in question to impose its authority, by force if necessary.

Any state can, in principle, claim legal powers over persons or places external to it. However, the force of law depends in the end on two factors: the consent of those to whom it applies, and the ability of the legislature in question to impose its will beyond the national boundary. Such attempts can be seen in the European Commission’s increasing use of Regulations rather than Directives to legislate for member states’ behavior. These developments give rise to tricky issues of jurisdiction, legal competence and national sovereignty.

Any state can, in principle, claim legal powers over persons or places external to it. However, the force of law depends in the end on two factors: the consent of those to whom it applies, and the ability of the legislature in question to impose its authority, by force if necessary. Hence the most powerful source of contemporary extraterritorial ambition is the USA. The implications of legislation such as the Dodd-Frank Act or FATCA are increasingly controversial. Disputes over extraterritoriality have the potential to disrupt progress towards a more stable international financial structure.

Recent serious concerns which have been raised include:

- A spokesperson for Michel Barnier, Internal Market and Services Commission at the European Commission, said, “We are aware of the extraterritorial application of the Dodd-Frank Act; we are not happy with it and this is something we are discussing closely with our US counterparts, hoping to find mutually convenient solutions.”
- The chairman of the International Swaps and Derivatives Association said, “With regard to extraterritoriality, there are today large and growing concerns regarding the applicability of the Dodd-Frank Act outside the US. These concerns have been raised both by US and non-US entities. There is a great deal of uncertainty among market participants about whether and how to implement a new regulatory framework that might duplicate or conflict with that of their parent country.”
- Eight trade associations wrote to the European Commission and the US Treasury expressing concern that regulatory change may create conditions that will lead to fragmentation of markets, protectionism and regulatory arbitrage.
- The European Commission has complained to US Treasury Secretary Timothy Geithner and to Commissioner of the IRS Doug Shulman about the “severe impact” that FATCA will have in terms of costs of compliance and penalties in cases of non-compliance. The Commission also points out that FATCA may conflict with EU member states’ internal data protection laws.
- Jim Flaherty, Federal Minister of Finance in Canada has expressed concern both about FATCA and about the “nerve-wracking” effect that the Foreign Bank Account Report (FBAR) reporting rules have on Canadians, complaining that the US legislation would essentially cause Canadian banks to become extensions of the IRS.

It may seem a rather technical concept. But extraterritoriality is actually at the heart of the current debate about constructing a sounder, more consistent global framework for financial services regulation. It gives rise to inevitable tensions between those who seek to make and impose the rules and those who are subject to them. It is important that policymakers and legislators can find agreed routes through these difficulties. If not, the world could retreat into self-interest, protectionism and regulatory arbitrage.

For individual financial services firms, extraterritoriality brings a different set of complexities. It means that in some jurisdictions they will find themselves complying with two sets of rules – home and host. And it probably adds duplication. Much of the push for extraterritoriality reflects a lack of confidence by home supervisors in the effectiveness of the rules proposed in the host jurisdiction, so recognition of similar reporting and practices is limited.

1. Hansard, HC Deb, 19 July 2011
2. Paulina Deymek, speaking at the Association for Financial Markets in Europe’s annual post-trade conference in London 11 May 2011
3. Thomson Reuters Dodd-Frank Watch, 26 October 2011
4. FX Week 11 Jul 2011
5. STEP Journal www.stepjournal.org
6. KPMG Canada 20 September 2011

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Insurance: Finding growth opportunities in uncertain times

By Frank Ellenbürger, Gary Reader, Laura Hay, Simon Donowho, and Mary Trussell
Insurers worldwide face a range of challenges that may seem to threaten prospects for growth. But, as our global insurance leaders point out, change is often accompanied by opportunity. Companies who can adopt a strategic approach, with clear goals and a well-articulated vision of what success will look like, can secure a competitive advantage from the current uncertainty.

Doing business in fraught and uncertain national, regional and global economies is not easy for anyone. Insurers in mature North American and European markets in particular face challenging economic conditions, disruptive regulatory changes, and cuts in public spending. These are significant challenges to growth. Historically, for example, there has been a high correlation between Gross Domestic Product and non-life insurance volumes. So a sustained period of zero or low economic growth will act as a major brake. Equally, the attractiveness of some products depends on the performance of the capital markets, which are under severe pressure. Depressed share prices and low price/earnings ratios also mean that some market capitalizations of European and North American insurers are below book value. In these conditions attracting investment to fund growth plans is another challenge.

If many European and North American economies are in well-publicized deficit, many Asian economies are in surplus. But this superficially benign condition throws up its own challenges for local insurers. In particular, these surpluses mean there is no large or well developed debt market and the lack of such long-term investment opportunities increases interest rate risk, complicates duration-matching — especially for products with a mortality risk — and constrains the insurance industry’s ability to create the innovative and attractive longer-term products that are increasingly in demand.

However, some Asian and Latin American markets have the enormous advantage that economic growth, rising living standards, and the »
So, while closeness to the customer and speed of innovation will be important, more than ever quality of management and consistency of execution will be vital to deliver profitable growth. The leading insurers of the future are likely to be those that integrate risk and performance management in an effective and timely fashion. We are in a period of sustained transformational change; and doing nothing is not a winning strategy.

There are important lessons for Western insurers, especially those seeking to take advantage of growth opportunities in the East. In particular, strategies have to recognize that to win in Asia or other developing markets, insurers – wherever they originate – need detailed, hands-on local knowledge so they can identify which markets to target, how to approach them and, crucially, how to access distribution networks.
emergence of a financially more sophisticated, asset-rich middle class mean that insurers are not competing for a share of a finite market. In principle, everyone can grow in those dynamic, emergent economies – if they have access to efficient and effective distribution channels.

With agency distribution dominant in Asia, the ability of insurers to attract existing agencies with a strong network is key. And, although distribution deals with banks may appear to be a fast-track route to the customer, in practice most Asian markets have many more insurers than banks. Consequently, the banks can command high rates of commission and tie-up fees. Overall, the successful growth strategies and business models in Asia are the ones that are able to manage relationships with distributors effectively.

In Latin America, meanwhile, the trend towards banking distribution has driven consolidation of the insurance industry over the past few years. Future success is likely to be more dependent on innovation in products and distribution channels.

Regulatory developments such as Solvency II in Europe or the Solvency Modernisation Initiative in the US are also transforming the way insurers operate – from capital requirements, to risk management, to transparency of reporting and provision of information, to distribution arrangements and sales processes. Not only are these changes absorbing large amounts of management time and energy, they are also threatening to introduce additional structural costs. This places an intense focus on the need for insurers – especially in Europe and North America – to take active steps to review their business models, reduce their cost base and become more efficient, for example by investing in back office systems and moving even further and more quickly towards shared services.

But this focus on efficiency is also an opportunity. There is no one-to-one correlation between growth in revenues and growth in profitability. Anyone with experience trying to do business in India and China, for example, will testify to that. In the current climate, business strategies and models have more than ever to focus in an integrated way on profit growth, rather than simply pursuing volumes for their own sake.

For European and North American insurers – and indeed those insurers in relatively mature markets like Australia, Japan and Korea – the Asian and Latin American markets may seem rich in opportunities for growth. But challenges remain. There is, for example, no ‘Asian’ market as such. There are instead a number of different markets in different stages of economic and social development, each with their own evolving regulatory challenges in such areas as capital requirements, data privacy and customer protection. This complexity creates a massive potential burden for anyone attempting to create a pan-Asian business. Regulatory change in these new markets can happen quickly and local insurers have already recognized that success lies in being nimble and efficient: they decide on a target operating model and then grow into it. For example, having identified IT as an important enabler of growth, they are actively avoiding creating large infrastructures in each country in favor of shared services.

There are important lessons here for Western insurers, especially those seeking to take advantage of growth opportunities in the East. In particular, strategies have to recognize that to win in Asia, insurers – wherever they originate – need detailed, hands-on local knowledge so they can identify which markets to target, how to approach them and, crucially, how to access distribution networks.

The extent of economic and social change also requires insurers in all markets to pay more attention than ever to the needs of customers. In major Asian markets, populations are becoming wealthier, more urbanized and more sophisticated in their approach to financial services. Similarly, the growing wealth of Latin America is increasing consumption – so people have more goods and properties to insure – and driving more conscious savings behavior.

In Europe and North America, meanwhile, austerity measures are cutting into public provision of pensions, healthcare and welfare benefits, which will inevitably lead to increased interest in self-provision.

The winners will be the ones who understand these changes and offer the right savings and protection products at the right time, crafting products that match people’s requirements with their ability to pay. The winners will also maintain close contact with customers, supporting people with appropriate products at every stage of their life – from savings, to life products to non-life products – and pursuing conservation activity to track funds as policies mature and go off-book.

In this new world recruiting and retaining creative, energetic talent will be crucial. China will need to attract back the skilled people, like actuaries, who are currently working on European insurers’ Solvency II programs. European and North American insurers, for their part, will have to address their inability to compete successfully for top talent with superficially more glamorous industries like investment banking.

Insurers in Europe and North America whose business strategies are currently defensive and heavily focused on compliance will need to look beyond regulatory change to identify the markets, customers, products and business models that will deliver profitable growth in the face of increased global competition. The recent investment by a state-owned Chinese reinsurer in Lloyds of London is just a hint of the potential for Asian insurers to leverage the strength of their domestic business by expanding into global markets. M&A may appear to be an attractive route to growth in Western markets – especially as banks sell off their insurance assets to boost capital reserves and enable a tighter focus on ‘core’ business. Given the regulatory barriers to entry, M&A may also be essential for both Eastern and Western insurers to gain sustainable access to high-growth Asian markets. In North America, companies currently tend to be well-capitalized in relation to today’s requirements, but the uncertainty around future requirements means they are perhaps concentrating more on strategic, focused acquisitions than on some of the larger scale deals of the past. However, leveraging financial strength alone will not be enough to guarantee success. Effective post-M&A integration will be needed to ensure the fundamental goals of efficiency, flexibility and low cost are not compromised.

So, while closeness to the customer and speed of innovation will be important, more than ever quality of management and consistency of execution will be vital to deliver profitable growth. The leading insurers of the future are likely to be those that integrate risk and performance management in an effective and timely fashion. We are in a period of sustained transformational change; and doing nothing is not a winning strategy.
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New world for insurance – Progress Report on Phase II
September 2011
Following up on the New World for Insurance publication that was launched in March 2011, this update examines how far the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have come in addressing technical concerns with the insurance accounting proposals as well as providing a view on what might lie ahead.

Frontiers in Finance Supplement: November 2011 Defined contributions pensions: A global solution to pension funding challenges
Increasing life expectancy coupled with a proportionately smaller working age population around the world is creating challenges for maintaining unfunded social security and defined benefit (DB) pensions in many countries.

The architecture of integration: A guide to M&A in Financial Services
September 2011
A guide which focuses on strategic priorities that have been driving FS companies to dispose and acquire while pinning down the key factors that can distinguish between successful transactions from potential and actual failures. It will help you understand what’s driving the new market, who the buyers are now – and show you how to avoid making the mistakes that have slowed and derailed so many FS mergers and integrations during the past few years.

Monetizing Mobile
July 2011
The era of mobile banking and payments is dawning. Around the world and across the banking value chain, everyone is waking up to the huge potential of a market that is rapidly changing the way that customers interact with their financial institutions. This report looks at how banks are responding to this evolution and who we think will be winners.
Wholesale markets – under the spotlight
October 2011
Following the financial crisis the US$600 trillion global ‘Over The Counter’ (OTC) derivatives market received widespread criticism for its complexity and opacity - and as a result is facing a fundamental industry shake up. Current proposals on OTC derivatives will fundamentally change the marketplace. This report explores the key challenges and critical areas of focus for financial institutions. It also looks at how the industry should start to position itself ahead of final rules.

The Agile Asset Manager: Organizational strategies and competencies to outmanoeuvre the competition
August 2011
Why agility is becoming an increasingly critical competence and how agility can be created and deployed in developing and operationalising strategy.

FATCA and the funds industry: Defining the path
June 2011
KPMG surveyed leading fund promoters in 12 countries to look at the key challenges the industry needs to address as a matter of urgency to prepare for FATCA implementations.

RRPs – insurers
August 2011
The financial services industry has faced much criticism and fallout from the global financial crisis. Subsequent debate and developments have focused on the causes of the crisis and how to avoid a recurrence in the future. This discussion paper highlights the need for the industry to be more engaged in the question of whether insurers are systemically important - and focuses on the application of recovery and resolution planning for insurers.

Evolving banking regulation – the outlook for 2012
December 2011
The journey to re-shape the banking sector continues, in a time fraught with uncertainty. The ever-expanding set of regulatory and related reform initiatives at global, regional and national levels, pose substantial challenges for banks. Particularly when combined with the European sovereign debt crisis which is in danger of creating instability and dragging down economic growth. In the second edition of Evolving Banking Regulation, KPMG’s Global Financial Services Regulatory Centres of Excellence, along with KPMG firms’ professionals, explore some of the key challenges and areas of focus for banks facing the implementation of the “first wave” of regulatory reforms and a new, “second wave” of reforms.

Frontiers in tax
November 2011
In the latest edition of frontiers in tax KPMG’s Global Financial Services Tax practice focuses on some of the many regulatory issues facing financial institutions today. Following the financial crisis the US$600 trillion global ‘Over The Counter’ (OTC) derivatives market received widespread criticism for its complexity and opacity - and as a result is facing a fundamental industry shake up. Current proposals on OTC derivatives will fundamentally change the marketplace. This report explores the key challenges and critical areas of focus for financial institutions. It also looks at how the industry should start to position itself ahead of final rules.
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