Frontiers in Finance
For decision makers in financial services
July 2012

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cutting through complexity

From the Editorial team

The business environment for financial services remains challenging. The global financial system remains fragile and the outlook is still very uncertain. Economic recovery is questionable. Sovereign debt – especially in the eurozone – is a growing source of concern. New regulatory measures are still unclear. Political leaders are clearly struggling to manage a return to stable and sustainable growth.

Financial services firms need to think hard and develop new strategies and business models for the changing environment. But in doing so, it is important that banks, insurers and asset managers stay focused on their clients as they work through and around the changes in the system. This is a theme which underpins most of the articles in this edition of the magazine.

One way of understanding the imperative is to recognize regulatory developments are much more than compliance. All these external changes have direct impacts on relationships with customers. All carry threats, but equally all offer opportunities when properly analyzed. As we demonstrate, compliance reporting can bring significant benefits in understanding and managing the business. The increasing focus on consumer protection is really a stimulus to doing business better and making real improvements to the customer experience.

Apparently, technical issues such as the Foreign Account Tax Compliance Act (FATCA), or measures to migrate derivatives transactions to regulated exchanges will bring new dynamics to the client and customer experience which will open up opportunities for competitive advantage if implemented effectively. In a different way, technological changes – the obvious example in this issue relates to payments systems – have a direct impact on the customer experience despite initially seeming to be confined to the back office.

Although policymakers and regulators may appear to have different priorities from those involved in managing financial services firms, in the end everybody has a common interest in a stable, properly functioning industry. Many apparently burdensome or challenging external changes are, in reality, spurs to satisfying client and customer needs more effectively.

Thank you for your feedback on the relaunched *frontiers* in February of this year. We hope the articles in this issue are equally stimulating.

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KPMG in the US

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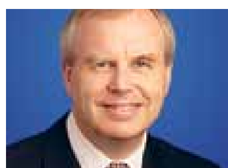
KPMG's Global Financial Services Chairman discusses how rebuilding trust and looking ahead remains an imperative for the sector.

A question of trust



Jeremy Anderson
Global Financial Services Chairman

In October 2011, a report on perceptions of ethics in the City of London made headlines when it revealed that only 14 percent of professionals working in the financial services sector correctly recalled the motto of the London Stock Exchange: My Word is My Bond (*dictum meum pactum*).[1] Notwithstanding this, the core philosophy which this familiar phrase encapsulates, that of mutual trust, remains fundamental to all financial transactions. Within an 'open outcry' stock market, this trust implies specifically that an oral commitment to a contract will be honored. More broadly, when customers and clients entrust funds to financial services providers, trust underpins fiduciary responsibility. When firms such as ours issue audit opinions on financial statements, the value of that opinion is built on trust. In the monetary system, as we are witnessing in the ongoing eurozone crisis, the concept of a fiat currency is contingent upon mutual trust.

Trust is fragile and can be undermined in many ways. At the time of writing, the allegation that some banks manipulated the daily LIBOR interest rate setting has caused another public furore.

More incrementally, the financial crisis over the last 4 years has eroded the public's trust in financial services companies, in the individuals that lead them and in the financial system as a whole. This is damaging in a number of ways. It threatens the reputations and performance of individual companies.

But it also hampers the ability of the sector to contribute to growth and to articulate its usefulness and worth to society at large. Rebuilding that trust remains an imperative for the sector.

Many of the initiatives being pursued by regulators and politicians in the aftermath of the crisis are aimed at promoting transparency and accountability in order to re-establish trust. We see this in areas as different as consumer protection, compliance, improved regulatory reporting, corporate governance and risk management. Industry players can feel almost overwhelmed by what is now frequently described as a tsunami of new regulation. The regulatory agenda must be embraced, however, despite its potential adverse consequences on the balance of risk and reward and profitability, in order to build trust. While responding to the challenge of complying with this wave of regulation, financial sector firms should also seize each available opportunity to ensure that consumers feel they are receiving a good deal, supported by excellent services and objective advice that is transparently aligned with their long-term interests.

Looking further ahead, we expect business models to evolve and increasingly focus on how financial sector firms create sustainable economic value. This will, include the financial services sector driving investment in environmentally sustainable businesses.

As set out on page 16, at KPMG's global conference in preparation for the Rio+20 Summit this month, a body of evidence was presented to suggest that investing in sustainable businesses is not only good for the environment, but also beneficial for return on equity. Driving sustainable investment will be a reinforcing component of the sector's strategy to demonstrate its tangible contribution to society, and to rebuild mutual trust.

[1] Value and Values: Perceptions of Ethics in the City Today, St Pauls Institute, October 2011. ComRes surveyed 515 professionals working in the FS sector in London online between 30th August and 12th September 2011.

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Investment managers face a challenging new landscape. The direction of travel – towards the implementation of tougher regulatory measures – is clear, but the path to implementation is fraught with unanswered questions.

Investment management: The regulatory pressure intensifies

By Giles Williams, Simon Topping, Jim Low, Charles Muller, John Schneider

Global regulators continue to develop policy and strategy to implement G20 commitments. As a new KPMG report shows, the current focus is firmly on financial stability, investor protection and transparency of products and markets.[1]

In the EMA region, new regulation consists both of updated existing legislation and new directives and regulations. A number of countries, such as South Africa, face new regulations based on either existing EU or local rules; for example, Treating Customers Fairly (TCF) – based on the UK regulatory structure already in place – and revisions to the Pension Funds Act (Regulation 28).

The global emphasis on increasing market infrastructure and transparency, as well as registration and reporting requirements, has led to key regulations such as the European Market Infrastructure Regulation (EMIR), Markets in Financial Instruments Directive (MIFID 2) and Alternative Investment Fund Managers Directive (AIFMD), which will affect capital markets and the financial sector as a whole.

In the Americas, measures to tackle consumer protection and systemic risk reporting have been packed into the Dodd-Frank Act. Dodd-Frank does not just affect firms in the US: It will have far-reaching impacts throughout the Americas and beyond, to Europe and the Asian and Pacific Council (ASPAC). The Dodd-Frank Act will impact the proprietary trading activities and banks ability to seed funds, which will likely result in new fund strategies that will feed this void. Dodd-Frank also brings a more rigorous and wide-ranging approach to conduct rules. Other countries in the Americas also have stringent local regulatory standards with which to comply. Territories such as Canada are likely to feel the effects not just of Dodd-Frank, but key European legislation such as AIFMD.

Extra-territorial effects will be felt in response to a number of regulations from multiple regulatory centers. The EU AIFMD reforms mean that non-EU based asset managers will only be allowed to market products in the EU that broadly comply with EU rules. Countries outside the EU (such as Switzerland or the Channel Islands) will therefore have to decide whether to reform their own rules.

In ASPAC, the diversity of the region and its rulemaking processes, alongside demographic change and rapid growth, create challenges for pan-regional market participants. There is a broad focus on investor protection, improved transparency and 'best practice', with reviews of existing regimes already underway. These include the Financial Advisory Industry Review (FAIR) in Singapore; the Future of Financial Advice (FOFA) in Australia; and additional disclosure requirements in Japan.

Financial stability

The global focus on increased capital requirements will affect asset managers' returns. We will have to see if the 'living wills' debate extends into the investment management sector. Many may think this unnecessary, arguing that the investment management industry lacks the potential to cause systemic damage to the global financial system. But experience shows that regulators will want evidence to support the industry's view.

Alternative investments are in the spotlight, with increased scrutiny of hedge funds and other alternative investment vehicles. The focus of regulation in this area – improved due diligence, compliance and clarity – means firms are reviewing and refining business models and operating structures. The global hedge fund industry is becoming increasingly institutionalized through new institutional capital and the continuous evolution of infrastructure and operational processes.

In Europe and beyond, AIFMD will require: additional capital; improved risk and portfolio management; changes to delegation requirements; and increased reporting and transparency requirements – with important third-country implications.

In the Americas, a large body of opinion believes that systemic risk reporting in the US will lead to greater transparency for institutional investors. New developments from the Commodity Futures Trading Commission (CFTC) are imminent, increasing reporting and regulatory responsibilities. Insider trading remains a cloud over the sector, likely to lead to even further reporting and risk controls. The US institutional marketplace is likely to see diversification and consolidation. In Europe and ASPAC, institutional regulatory focus remains on exchange-traded funds (ETFs).

In ASPAC, investor protection initiatives are rolling out in Hong Kong, Singapore, Australia, India and Taiwan. With the growing marketplace and changing demographics in China, they are working to widen asset classes, aiming to attract greater numbers of external funds and reduce market volatility.

Offshore firms have their own specific set of challenges. Key developments include diversification of investment business across geographies and exploration of niche specialisms. Regulation from Europe (AIFMD) and America (Dodd-Frank, FATCA) will have notable implications for offshore centers.

[1] Evolving Investment Management Regulation: A clear path ahead? KPMG June 2012

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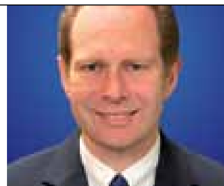
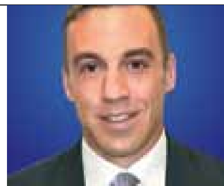

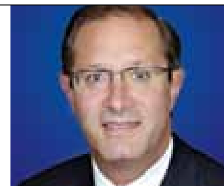

Evolving investment management regulation
For further information on this topic please visit:
www.kpmg.com/regulatorychallenges
and download: **Evolving investment management regulation: A clear path ahead?**

Pensions are also under increased scrutiny, with new requirements being imposed across the world in order to improve transparency and consumer protection.

Governance, remuneration and taxes

The position of politicians and, to an extent, regulators views, can be summarized as the financial sector should pay for the crisis it created. The results are, increasingly, punitive sanctions, constraints on behavior, and additional taxation to help restore government finances. In Europe, rules on asset manager remuneration have been introduced in AIFMD and are expected in the Undertaking for Collective Investments in Transferable Securities (UCITS) Directive, with harsh sanctions foreseen in UCITS 5 and potentially the so-called Packaged Retail Investment Products (PRIPS) Regulation.

Tax has been particularly prominent where authorities are facing unprecedented deficits. The attempt to limit tax fraud has led to the ominous FATCA regulation in the US, which has potential implications for all global firms. It will be interesting to view which jurisdictions impose their own legislation globally.

Europe will see a revision of the Savings Directive and new exchange of information clauses in a wide range of bilateral double-tax treaties. At the same time, additional taxation of the financial sector is being debated, such as the proposed Financial Transaction Tax in Europe and a new Dividends Tax in South Africa.

The volume, variety and complexity of tax regimes throughout Asia-Pacific continues to prove challenging for firms across the region, with a focus on additional taxation of non-resident investors and companies.

Numerous cross-border challenges

Investment managers today face multiple challenges and regulatory reforms across jurisdictions – in addition to further demands from both local and international regulators. Firms must adapt to survive and thrive in this re-shaped industry. To stay on top of the full regulatory change agenda, firms must ensure that their business models and compliance functions take into consideration the full suite of regulatory requirements and the associated strategic implications, both for their business and the industry as a whole.

Key industry challenges

1. Cross-border implications of global, regional and national regulatory change
2. Increased reporting and accountability to improve transparency
3. Consumer conduct – to increase investor protection and industry trust
4. Additional risk management requirements

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Following the global financial crisis, regulators have focused on consumer protection as one of the primary themes of reform. Many financial services firms and some of their service providers are struggling to respond to a wave of new requirements. The key is to understand that this is not essentially a regulatory and compliance issue: It is about doing business differently and making real improvements to the customer experience as the foundation for competitive advantage.

Consumer protection: Much more than compliance

By Linda Gallagher and Fiona Fry

In the wake of the global financial crisis, policymakers and regulators across the world have intensified their efforts to strengthen consumer protection policies and supervision. One of the consequences of the crisis has been severe damage to consumer confidence in financial services, with detrimental impacts both for the industry and the wider economy. A continuing series of mis-selling scandals in a number of countries and the mortgage crisis in the US has convinced policymakers of the inadequacy of existing regimes to protect individual consumers. It is now recognized that measures to rebuild customer confidence and ensure effective consumer protection are essential in promoting global financial stability.

The consumer protection agenda is perhaps more advanced in Europe and the US than elsewhere, but the rest of the world is catching up quickly:

– In the US, the core consumer protection functions are being concentrated into one agency, the Consumer Finance Protection Bureau (CFPB); this has the responsibility for consistently implementing and enforcing federal consumer financial laws to ensure that all consumers have access to markets for consumer financial products and services which are fair, transparent, and competitive. Prudential regulators and supervisory agencies are increasingly vigilant, coming down heavily on financial institutions. The period 2011-12 witnessed a number of consumer protection enforcements and settlements in the areas of mortgage foreclosures, overcharging of overdraft fees, payment protection programs, treatment of service members' accounts, force-placed insurance, and credit card claims.
– In Europe, similarly, there have been a number of enforcements and monetary settlements in the financial services industry. Most of these have been related to fines and compensations with respect to mis-selling of financial products, particularly of payment protection insurance (PPI) by UK retail banks. To strengthen the focus on consumer protection, the UK government is restructuring the regulatory regime, creating a Financial Conduct Authority (FCA) as a specialist regulatory agency. This agency will take on responsibility for restructuring the retail financial services market, which was started by the FSA under its Retail Distribution Review. This will see commission for sales of investment products banned from 1 January 2013, in an attempt to remove the inherent conflict of interest between providing suitable advice to consumers and sales force remuneration and incentives.
– In Australia, the credit regulator has forced a major card company to stop charging 'punitive' rates of interest to customers who fail to pay on time. The Australian Securities and Investments Commission said it was concerned that the charges breached the national credit code, with extra interest being charged on the entire card balance rather than the outstanding amount.

The G20 Principles on consumer protection make the point that: "Additional and/or strengthened dedicated and proportionate policy action to enhance financial consumer protection is … considered necessary to address recent and more structural developments."[1] The current Chief Executive of the FSA has said that the new consumer protection regime reflects the judgment that "The degree of consumer detriment seen over the last decade has been at an unacceptable level to society…"[2]

Recovering from this position will be a major challenge for the financial services industry.

Far more than compliance

No segment of the financial services industry will escape the greatly increased regulatory focus on consumer protection, conduct and customer treatment. Retail banks, commercial and wholesale banks, investment banks, insurers and fund managers will all feel the impact. Consumer protection has far-reaching implications for most business activities, from product development through to customer interactions across the whole sales and product life cycle. Consumer protection concerns could also affect the markets in which an organization operates: geographical distribution arrangements, customer base, products offered, etc. The impact of new regulation may drive companies to exit certain markets or fundamentally restructure their activities or their organizations.

It is clear, then, that consumer protection is far more than a regulatory and compliance issue. Of course, compliance is necessary and will need to be monitored, but to delegate (and relegate) consumer protection solely to a compliance or risk function without business involvement and ownership would be a major mistake. Regulation may be the principal driver at present, but consumer protection should now be seen as one of a company's top strategic and cultural issues. It is a business issue that should be considered at the board level and across all operations and functions if businesses are to 'future-proof' themselves from the cycle of mis-sales, complaints and repayment that have characterized so many of the recent scandals. We have seen some recent cases, such as the PPI mis-selling scandal in the UK, wipe out an entire year's worth of profits at one of the biggest banks. The creation of programs to redress that situation that will run for many years and, in effect, become sizeable business units in their own right. So, an institution's future success may well depend on how effectively it meets the challenge of enhancing consumer protection.

The experience of the Treating Customers Fairly (TCF) initiative launched by the UK Financial Services Authority (FSA) in 2004-05 is instructive. This focused on the importance of delivering appropriate outcomes for consumers and sought to prevent substantial failures from occurring. However, it is widely seen to have failed in improving consumer confidence and the customer experience. The reason? Financial services companies treated it largely as a compliance and management information issue. The customer impact was largely limited to experiencing more bureaucracy and

[1] G20 High-level principles on financial consumer protection, October 2011
[2] Speech by Hector Sants, Chief Executive FSA, 2 March 2011.

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From compliance to business transformation: key questions for the C-Suite

- **Is delivering consumer value a clear priority for the C-Suite and the board?**
- **Does your organization have a clear, consistent and widely understood definition of consumer risk and consumer protection, and a process to assess the amount of consumer risk across the business?**
- **Do you have a clear understanding of the costs of remediation activities to your organization and the impact on capital and brand perception?**
- **Have you considered the impact of consumer protection on your business model, core processes or infrastructure?**
- **Is delivering consumer value included in all financial leadership discussions?**
- **Does your organization have a complete view of where consumer risk arises within your business and/or throughout the life cycle of your products and services?**
- **What standards and data do you use to identify, analyze and address consumer risks and potential consumer harm across every line of business?**
- **What intelligence does your analysis of consumer complaints provide and how do you use it to drive better business practices or product improvements?**
- **How quickly and decisively do you identify and address consumer issues?**

paperwork rather than improved service. The new FCA will build on the foundation laid by TCF but now focus on the outcomes achieved for customers and on challenging the operating models of all financial institutions, from product development through the whole product life cycle, with powers to intervene to amend or ban products if it see fit.

The central mission of the Consumer Financial Protection Bureau (CFPB) is to ensure that "Consumers get the information they need to make the financial decisions they believe are best for themselves and their families – that prices are clear up front, that risks are visible, and that nothing is buried in fine print. In a market that works, consumers should be able to make direct comparisons among products and no provider should be able to build, or feel pressure to build, a business model around unfair, deceptive, or abusive practices." From their mission statement to their examination practices, the CFPB is focusing on business issues and strategies in addition to compliance requirements.

Just good business

The key point is that a company which engages actively with its customers, treats them fairly and provides them with products and services which meet their needs is simply pursuing competitive advantage by doing business well. The best companies will do the right thing automatically, not because of consumer protection regulation but because it is good business.

What regulators may regard as consumer protection is, from the perspective of the financial services provider, rather a matter of delivering value to consumers: understanding their needs; designing products which meet those needs appropriately and are consistent with customers' risk profile and risk appetite; and providing those products at a reasonable and transparent price.

So maximizing consumer value is *business* – not just a mandate, but an opportunity. It must move to the boardroom and to the executive management agenda. And it has implications across the enterprise, from product development and pricing, to channels and markets, to compensation structures, and customer interactions all along the way. In future, consumer value will be a leading contributor to a company's success. The need, then, is to reset corporate culture around compliance and conduct, to find new ways to innovate – rethinking business models, packaging new products, marketing them through the right channels, at the right price, to the right person – all while turning a profit.

Embracing consumer value as a cultural and operational foundation is the way to rebuild trust, improve customer experience and satisfaction, and gain market share. The fundamental requirement is to rebuild relationships with customers so that confidence can return. The consumer protection agenda, though currently being driven by regulation, should result in business models and practices which improve consumer service and the customer experience:

- the provision of timely and understandable information
- protection from unfair, deceptive, or abusive practices
- elimination of outdated, unnecessary, or unduly burdensome regulations on consumer financial products and services
- consistent enforcement to promote fair competition
- transparent and efficient markets for consumer financial products and services.

Regulators will continue to supervise financial institutions and some of their service providers to ensure they are treating customers fairly. They may also make specific interventions to eliminate harmful products or practices and ensure appropriate redress in the event of failure. But if companies act rationally, with their own and their customers' long-term interests in mind, the necessary changes will emerge without a heavy additional regulatory burden.

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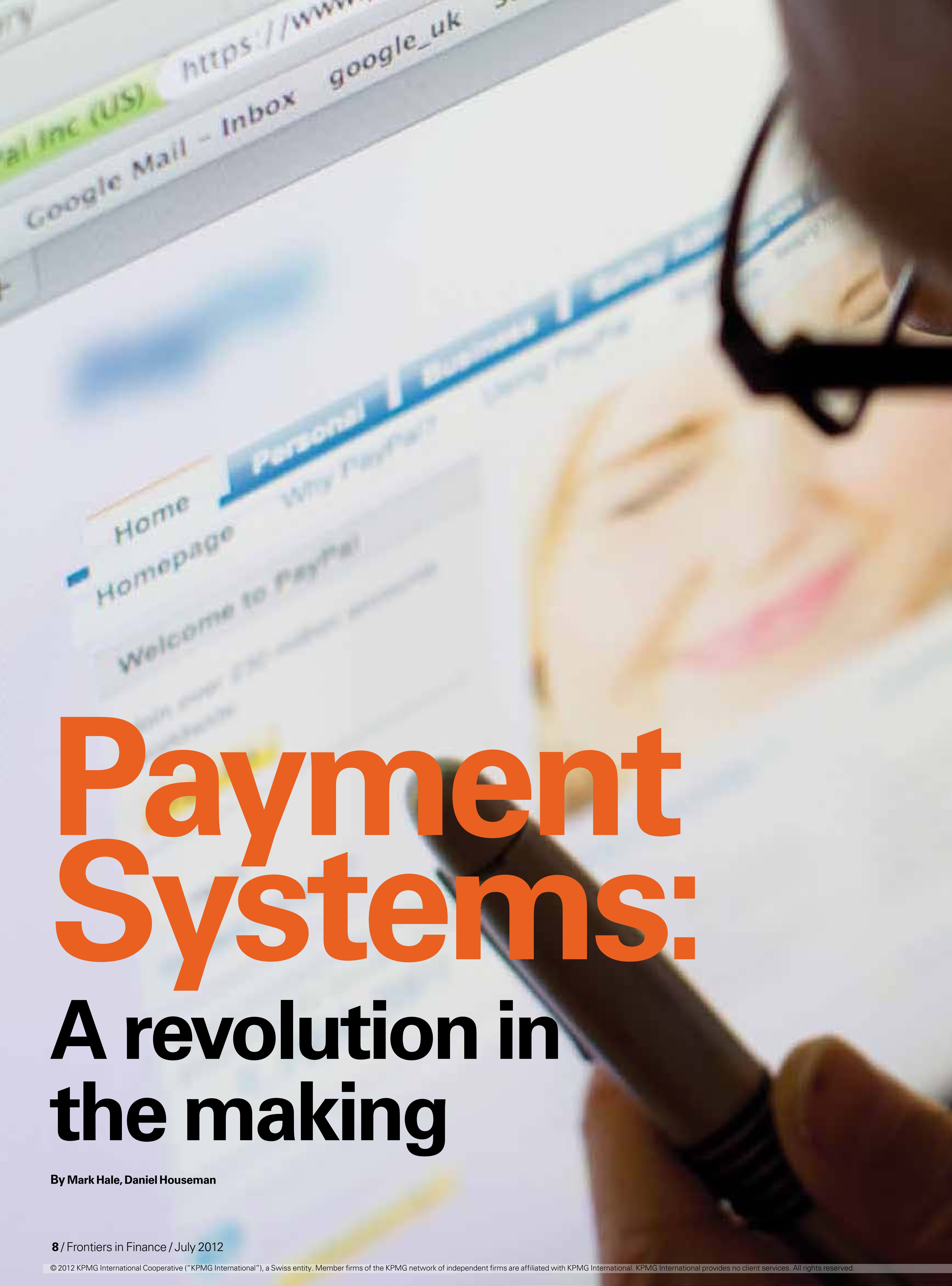

Payment Systems:

A revolution in the making

By Mark Hale, Daniel Houseman

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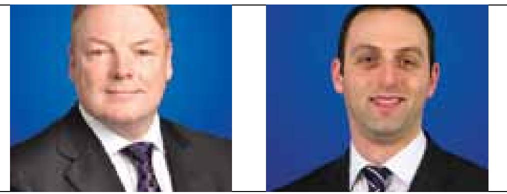

Payment systems are often taken for granted and undervalued. They should not be, since they underpin main street, the wheels of industry, the operation of markets and the existence of government. No other banking activity is as important to either society or business as payments.

Payments are now moving back to center stage as banks rediscover their essential purpose. No longer dismissed as a back office function to be managed as cheaply as possible, payments are being used to reconnect with customers, to re-engage with their economic activities and to become a key part of their digital lives.

Technology and regulation are driving innovation in payment systems and creating new sources of value. So significant are the changes that the future payments market will have a profound effect on the structure of today's banking sector.

Economic transactions have historically been characterized by asymmetry of power and information. Although free market competition has created pressure to innovate and improve productivity, producers have historically held a near – monopoly of information and, therefore, power over consumers. The information technology revolution, and above all the internet, have now turned this on its head, so much so that we are currently witnessing the democratization of commerce: For the first time, the customer is genuinely king. This is transforming the relationship between banks and their customers.

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A double challenge for banking

Bankers are already facing major constraints on their business as policy makers and their regulators try to prevent a recurrence of the recent financial crisis. Responding to all this while coming to terms with truly transformational change in their customer relationships will be an enormous undertaking. It is evident that banks are yet to fully appreciate the rate and implications of it.

For better or worse, the payments business holds the key to the transformation facing banking. At the moment, payments is seen as a matter of back-end, back-room transaction processing. The priority is often to manage it as cheaply and efficiently as possible, preferably by centralizing it in some low-cost operational center, often off-shoring it to a low-cost economy. But the business of payments is a core banking function and it underpins all others. Nothing happens without payments, which are at the heart of all economic transactions. What is immensely significant is that technology is going to revolutionize the use or function of payments in the consumerist age: Reducing costs, lowering barriers to entry, increasing functionality and yielding higher quality information.

Power will shift to customers, transaction processing will be commoditized and traditional franchises and revenue pools will either be disrupted or evaporate. Welcome to the new world of payments.

New entrants and innovation

We are already seeing that traditional banks no longer have a monopoly of the payments business. Many new payment service providers are entering the field – think of PayPal, Google Wallet and Square to name a few – some of which have become massively successful in a very short time. In 2011, for example, PayPal counted 106 million active accounts in 190 markets, and processed a net total payment volume of US$118 billion.[1] One key characteristic underlies the success of these new entrants: innovation.

Traditional banks are slow to innovate. This is a consequence of historical conservatism and is a function of complex corporate bureaucracy; historically, there has also been a lack of competition and no real imperative to innovate. As a consequence, it is often necessary for regulators to press banks to respond more effectively to consumer demands and needs. The example of Faster Payments in the UK is a case in point, being introduced only as a result of regulatory pressure. Until then, the concepts of automated clearing owed more to the technology of the horse and carriage than the computerized process.

Real innovation in payments is being stimulated by new entrants creating dynamic business models to respond to changing customer requirements. Traditional banks are now having to respond. The loss of trust in banks following the crisis has significantly increased regulatory scrutiny and pressure at the same time as customers have become more demanding. And it is not just retail customers. A number of large corporations are acquiring banking licenses themselves – Siemens for example, which is now able to go directly to the European Central Bank for liquidity and deposit surplus cash there.[2]

Banks' historic franchise is therefore under attack from many directions at once. In the payments field, this raises three questions: To what extent is the threat significant? How and to what extent can the banks respond? And what will the industry look like in 10 years' time?

How significant?

To answer the first question, it is instructive to consider why so many new entrants are converging on payments. To some extent, of course, it is because setting up an in-house payments capability is complementary to the core business. PayPal, for example, was acquired by eBay in 2002, with obvious benefits both for the online auction business and for its customers. But there are other benefits.

First, there is the purely financial value of attracting mass customer payments and deposits: Processing transactions, even if the great majority of them are cleared rapidly, can generate massive liquidity, and very cheaply.

However, far more significant in the longer term is what the intelligent application of information technology can deliver when allied to a payments system. This is especially true of systems with mobile capability, for example, when allied with mobile phones. Traditional payments instruments – think checks – provide little information about a customer. By contrast, information technologies can in principle deliver massive amounts of detail about individual consumer habits, preferences, interests, purchases and physical locations: Where they shop, where they live, where they visit on the Internet and what they buy. The potential for tailored marketing, cross-selling and upselling is enormous.

To give evidence of change, in April 2012, Google acquired the payment technology company TxVia to broaden its digital payments offering. As a result, Google Wallet will be potentially accessible to all Google users, including users of the 100 or so significant businesses Google now owns such as YouTube, Picasa and the Android Smartphone operating system.[3,4]

Many new payment service providers are entering the field – think of PayPal, Google Wallet and Square to name a few – some of which have become massively successful in a very short time.

Can traditional banks respond?

In the early days of this challenge, there is substantial mileage to be gained in improving existing systems and business models. As we have seen, conventional payments are indeed becoming more efficient and responsive. But at some point, radical change will be necessary, and banks are going to find this hard.

Even as retail banks work hard to establish a single customer view and to get a customer's name right more consistently and more reliably in their communications than ever before, the new kids on the block are delivering 70-100 points of consumer-driven data personalization in their current customer interactions. They

[1] https://www.paypal-media.com/about, retrieved 7 April 2012.
[2] Financial Times 7 December 2010
[3] Financial Times 15 February 2012
[4] http://en.wikipedia.org/wiki/List_of_acquisitions_by_Google

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are currently investing in next generation algorithms and data strategies.

The imperative to invest in payments will, of course, present challenges to organizational structures and to traditional investment processes: It will have to compete with other demands and avoid being crowded out by the mandatory 'dead hand of regulation'; it will also need a new culture and a new approach.

One irony is that banks may soon be caught out for a second time in how they respond to these technology challenges. As we have seen, in the last decade or so, the typical pattern for the payments function was to centralize it in areas where economies of scale and skill could be maximized, far remote from the customer. Now, in response to the need to reconnect with customers, the trend is moving into reverse. Functions are being restored to the front line; direct contact with the customer is becoming paramount. But this is happening just at the point when technology is becoming capable of really significant individual personalization and connection.

Advanced payments and communication technology, when effectively implemented, can provide the customer with a rich and tailored experience which is simply unavailable otherwise. And it can do so at the point when they most need credit or access to payments.

The future payments landscape

We have seen where innovation is leading and where payments innovators are heading. By contrast, we are concerned that conventional banks, for a variety of reasons, will find it hard to respond. And so that leads to the final issue: What are the implications for the structure of the payments industry in a decade? Two conclusions can be drawn: First, it is likely to be very different; new entrants to payments will also be offering other core banking services. We have already seen this in credit cards; deposit services and lending are next. Second, if traditional banks do not respond rapidly and effectively, the major payments players in the future will include companies such as Google and Apple or perhaps Wal-Mart. With their closer connection to the customer, their entrepreneurial culture and superior customer service, they could truly threaten banks' existence. The looming threat from such massive global players should make any bank think long and hard about its business model for payments.

The future of payment systems

Payment technologies and companies currently operating outside the regulatory framework of financial institutions are beginning to behave more like banks as they diversify into new technologies and services. This will gain the attention of the regulators and as they come under focus of the regulators and face regulation it may lead to a change in their business models.

Read more about shadow banking on page 28.

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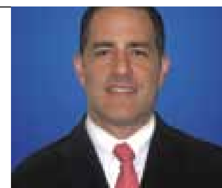
David Neuenhaus



FATCA: Impacts and implications

By David Neuenhaus and Richard Hinton

Few issues in the international tax field have excited as much attention recently as FATCA, the US government's Foreign Account Tax Compliance Act. Since its passage in March 2010, criticism and concern about the implications have been mounting steadily. Equally important, how companies transition to FATCA compliance will have a significant impact on their relationships with their customers, investors, counterparties and services providers.

The cost of compliance and the impact on customers, investors and counterparties
Initial criticism of the FATCA regime included references to the burden of compliance on companies, in both financial and operational terms.

There was also significant concern over the need to acquire detailed personal information from clients, investors and counterparties and pass this information to US authorities. In addition to the general data and privacy implications, legal constraints faced by institutions in many jurisdictions would prevent them from revealing the relevant customer information.

In response to these concerns, the Internal Revenue Service (IRS) has been working constructively with the industry and non-US governments in recent months to allay concerns and to develop an implementation regime which will be both practical and require more proportionate (i.e. lower) implementation costs. Nevertheless, FATCA will still entail a profound reorientation of the relationships between national tax authorities, financial services providers and their customers. And those customers will increasingly be feeling the consequences.

New implementation proposals
In February 2012, the US Department of the Treasury and the IRS issued proposed implementation regulations for FATCA. These lay out a step-by-step process for US account identification, information reporting and withholding requirements for (FFIs), other foreign entities and US withholding agents. They aim to minimize the burden and cost of compliance consistent with achieving the core objectives of the Act. The rules and implementation schedule have been extended to allow additional time for resolving local law limitations – especially on data protection and confidentiality – to which some FFIs may be subject.

The proposed regulations:

- calibrate due diligence requirements according to the value and risk profile of the account and by permitting FFIs in many cases to rely on information they already collect, for example under anti-money laundering or 'know your customer' rules;
- enlarge the scope of 'deemed compliance', in order to focus the application of FATCA on higher-risk financial institutions that provide services to the global investment community.
- extend the transition period to provide sufficient lead time for financial institutions to develop the necessary systems and maximize the number of financial institutions that will be able to comply with FATCA.

The governments of France, Italy, Germany, Spain and the UK have announced an intent to pursue bilateral agreements with the US to implement FATCA for their local FFIs.

The governments of France, Italy, Germany, Spain and the UK have announced an intent to pursue bilateral agreements with the US to implement FATCA for their local FFIs.

These will allow FFIs to report the necessary information to their respective governments, and thus dispense of the requirement to amend conflicting national legislation, such as national privacy laws. In return, the US will provide similar information on the European government's nationals with accounts in the US and refrain from imposing withholding tax obligations on local FFIs on payments made to entities in those and other FATCA agreement countries.

The core impacts on customers and investors, however, remain the same: in certain instances they may have to provide additional personal information to their financial services provider where they do not currently do so.

Compliance strategies
As the FATCA rules are clarified, financial services firms will need to determine their compliance model strategies. For many, the deemed compliant route appears to offer the benefits of a light-touch regime, with lesser impact on customers. However, multinational companies with operations in a number of jurisdictions, both those currently pursuing bilateral agreements and others,

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Richard Hinton

face the prospect of dealing with complex and inconsistent local FATCA regimes in different countries – not a recipe for simplicity or low-cost implementation.

For many institutions deemed compliant status is not an option. Their customers may face greater information related reporting requirements and could face account closure in the event of non-compliance.

In general, though, there seems to be the beginnings of recognition in the industry that FATCA compliance, in the form which is now emerging, may not be as burdensome as previously thought. Now, attention is starting to turn once again to how to best exploit the competitive advantage of continuous access to the enormous US market for financial services.

Customer and investor relationships

It is clear that in many instances customers and investors will be asked questions about their US tax status during first contact and account-opening processes. Firms may also have to ask for new information from existing customers. This may be easier for banks, which tend to have relatively frequent interactions with their customers. But insurance companies, which may have no direct contact with customers for years or even decades, could find it especially challenging. How will they respond to clients' queries?

As we have seen, one consequence of the bilateral agreement model is that FATCA requirements will vary from one jurisdiction to another. Add to that the variation in compliance strategies to be adopted, and customers and investors will face a bit of a lottery over the extent and depth of the impact they experience. Firms will need to consider the impact FATCA's implementation will have on their customers and investors. If firms are clumsy in how they implement FATCA, this could damage customer and investor relationships.

A new world of tax data transparency

FATCA will potentially open the financial affairs of an untold number of consumers and investors to the US fiscal authorities. Furthermore, because the stated policy objective of FATCA is to improve transparency and reporting, not to collect withholding tax, the US government recognizes that FATCA partner countries have the right to reciprocal action. So the US is open to adopting an intergovernmental approach to improve international tax compliance. Initially, this will involve the US and its five European partners in collecting and exchanging on an automatic basis information on accounts held by residents of the six countries. The US also intends to "work with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards."[1]

Financial services providers and their customers and investors alike are going to have to get used to a very different world of international tax data transparency.

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[1] Joint statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA, US Treasury Department, February 2012

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The time is now for investment managers to invest in their own future

By Rabih Ramadi

The investment management industry is facing major challenges in various aspects of its business, from pressure on margins to ongoing market volatility, tighter scrutiny and regulation and more demanding client requirements. Like any industry, the natural tendency for investment managers may be to retrench, address each of these issues on a silo basis and wait for the market to return. However, the scale and diversity of the changes underway means that a piecemeal approach will be inadequate. A holistic change management program is essential to ensure future profitability – and the time to act is now.

These are testing times for the investment management industry. The stuttering global economy and market volatility are making it difficult to deliver profitable growth, even as the ever-tightening regulatory environment – especially in North America and Europe – is driving up the costs of risk management and compliance.[1] As a result, margins are being squeezed.

At the same time, both retail and institutional clients who have suffered a worrying few years are increasingly looking for a tailored service that more accurately reflects their individual situations and approaches to risk, reduces their exposure to fluctuations, minimizes the management fees and transaction charges that eat into returns and increases the transparency of the investment strategies being pursued on their behalf. How to protect consumers from unnecessary risk by enhancing transparency and establishing greater product controls has also been at the heart of recent regulatory change.

With the balance of market power in this traditionally product-driven industry gradually shifting toward clients and regulators, survival and success are no longer just about profitable products. These are just the table stakes. Winning will come from understanding clients and regulators' needs as well as optimizing the business cost structure.

These fundamental shifts mean that the old inefficient business models that evolved in the past can no longer be sustainable. The days when it was possible for each product team to have its own business priorities, compliance and reporting arrangements and approaches to client communication are gone. To profit and grow in the new environment, investment management firms will have to adopt scalable operating models that enhance organizational flexibility, speed of response and operational efficiencies. Standard functions operating across all asset classes will need to be further established across support functions.

Seizing the benefits of an integrated change program

Larger firms are responding to their particular challenges regarding cost structures by focusing on core competencies, optimizing their processes, migrating jobs from the front office to back office and optimizing their location strategies. At the same time, agility and flexibility in client service are increasingly recognized as critical success factors for investment managers moving forward and driving investments in client experience initiatives. Regulation and compliance are no longer secondary issues, but are high on the chief executive's agenda. As a result, the most forward – looking companies have already started to invest in their risk and compliance functions in response to increasing regulatory complexity and more demanding client requirements.

Key to the new business models will be a clear understanding of future revenue growth priorities, cost structures, evolving regulatory requirements and client aspirations.

The challenge now is to bring all these activities together at a time of limited investment budgets in an integrated program that exploits available synergies to minimize the costs of change and ensure it delivers a competitive edge.

Addressing all these issues together will require sophisticated change management. There is no single silver bullet solution that firms can take off the shelf. Each firm is different and will have to develop its own future business

[1] See *Evolving Investment Management Regulation: Meeting the Challenge*, KPMG, June 2011.

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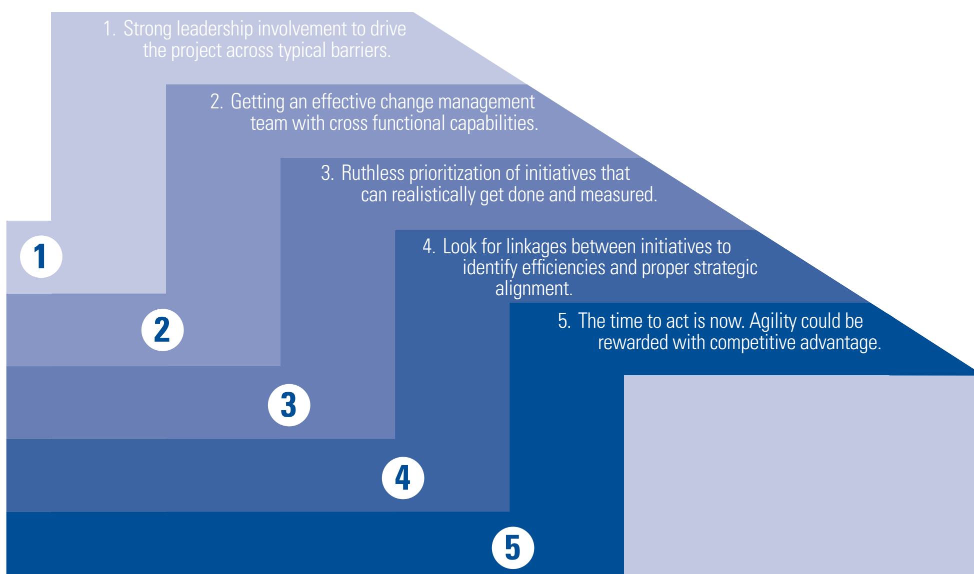
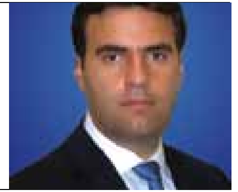
model and associated change program. Key to this model will be a clear understanding of future revenue growth priorities, cost structures, evolving regulatory requirements and client aspirations.

Understanding these parameters will require a clarity by senior management for where the individual firm ultimately wants to end up. What size? What levels of profitability? What products? What clients? What geographies? What parts of the investment management value chain? Only with this clear vision can a firm define the changes it needs to make and ensure that the change program addresses all the drivers – client, regulatory, competitive – in a holistic way and is harnessed to increase operational excellence, eliminate duplication and deliver simpler, standard processes enterprise-wide.

Such a change program can only be created and driven by a small group of senior managers with the necessary business and industry overview, leadership skills and authority to secure internal stakeholder buy-in to the program and drive through change. Sales & Distribution, Portfolio Management, Risk Management, Operations, Finance,

Key components of an effective change management program:




Rabih Ramadi

Compliance and others, despite all their potentially conflicting priorities, have to support and implement the changes. This will not happen overnight. It will take time and a multi-year program to execute the best ways to simultaneously meet customer needs, deliver regulatory compliance, lower costs, improve margins and grow revenue.

Patience and a systematic approach will be required. In the past, a firm might have 10 bright ideas for strategic projects and try to implement all of them simultaneously. Halfway through, market and priority changes would push the organization to drop five of them. The remaining five would run into problems because their budget constraints and interdependencies had not been sufficiently appreciated. They would then be put on hold while the issues were sorted out. In the end, nothing would happen.

This may be an exaggeration, but not much of one. Firms cannot afford this approach any more. Within the overall change plan, they need to focus on a small number of key changes a year and make them happen, with concrete deliverables, timelines and comprehensive quarterly reporting. Adopting an integrated approach will enable firms to achieve efficiencies by building on common themes across client, cost optimization and regulatory requirements. The metrics need to be built from the bottom up, initiative by initiative, to create the top level key performance indicators (KPIs) for the firm, not the other way around. This will lock the whole program together and ensure that detailed frontline changes are aligned behind the desired strategic outcomes.

Investing for the future

So this is no time to pursue 'business as usual' in the hope that everything will return to pre-2008 conditions. It may not.

The transformation that is happening to the investment management sector is creating opportunities as well as challenges. The keys to success include understanding the complete nature of the transformation and articulating a firm-wide vision for the new world, developing and executing a new business model that delivers operational efficiencies and an enhanced competitive position and becoming ever closer to clients by listening more and using a combination of personal contact and emerging technologies to enrich communication and transparency. Even though investment managers may be struggling to achieve revenue targets and cope with rising regulatory costs, this is no time to retrench.

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Financial Services Companies: The business case for sustainability

By Jeremy Anderson, Global Chairman, Financial Services, KPMG

As increasing attention the world over is given to sustainability issues, there is mounting evidence that sustainability is not just a *way* of doing business but is, in fact, *good* business. This is true not only for industry sectors with a tangible connection to the environment (such as energy, transport or mining), but also in financial services, which intersects with other industry sectors as the provider of finance, enabling sustainable enterprises to be built and grow.

This was one of the themes explored at KPMG's global business summit in New York City, "Business Perspectives on Sustainable Growth: Preparing for RIO + 20."

The panel for the Financial Services sector break-out session comprised:

- **Michael Baldinger**, CEO, SAM Group Holding
- **Michel Lies**, Group CEO, Swiss Re
- **Kenneth B. Mehlman**, Head of Global Public Affairs, KKR
- **Stephanie Miller**, Director, Climate Business Group, IFC
- **Curtis Ravenel**, Global Head, Sustainability Group, Bloomberg

That such a senior group of leaders from a broad cross-section of the financial services sector chose to lend both their presence and voices to this topic underscores just how critical an issue sustainability has become.

Sustainability impacts our industry sectors (banking, capital markets, insurance and investment management) in numerous ways. In this article we focus primarily on how sustainability impacts the 'buy side' within banking and investment management. Future articles will consider the role of the insurance sector in putting a price on climate-related risk and how the financial sector can support sustainable development in emerging markets.

There is ample evidence to support the idea that sustainable practices are good for business. Kenneth B. Mehlman noted during the summit that, at its essence, sustainability is about the use of resources and ultimately it is a cost-effective, bottom-line-oriented activity. "Pollution is expensive … if you can reduce the amount of energy you use, the amount of water that your company uses, if you can reduce the amount of waste that is generated, if you can reduce the amount of forest products you use, you're going to save money."

Sustainability as a business strategy extends beyond being energy-efficient and reducing one's own carbon footprint – as do the benefits. A recent study published by Robert G. Eccles and George Serafeim of Harvard Business School and Ioannis Ioannou of London Business School showed that corporations that have placed sustainability at the heart of their strategies have consistently better performance than their peers with regard to valuation, profit and loss and return on equity. The authors studied a matched set of companies from 1992-2010 termed high sustainability and low sustainability. In the year that the companies were matched, the two groups operated in the same sectors and were almost identical in terms of size, capital structure, operating performance and growth opportunities, according to the authors.

The study, published in late 2011, provides some of the most compelling non-anecdotal evidence to date about the value of sustainable business practices. According to the authors, US$1 invested in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of high sustainability companies would have grown to US$22.6 ($14.3) by the end of 2010 based on market prices. In contrast, US$1 invested in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of low sustainability companies would have only grown to US$15.4 ($11.7) in the same timeframe.

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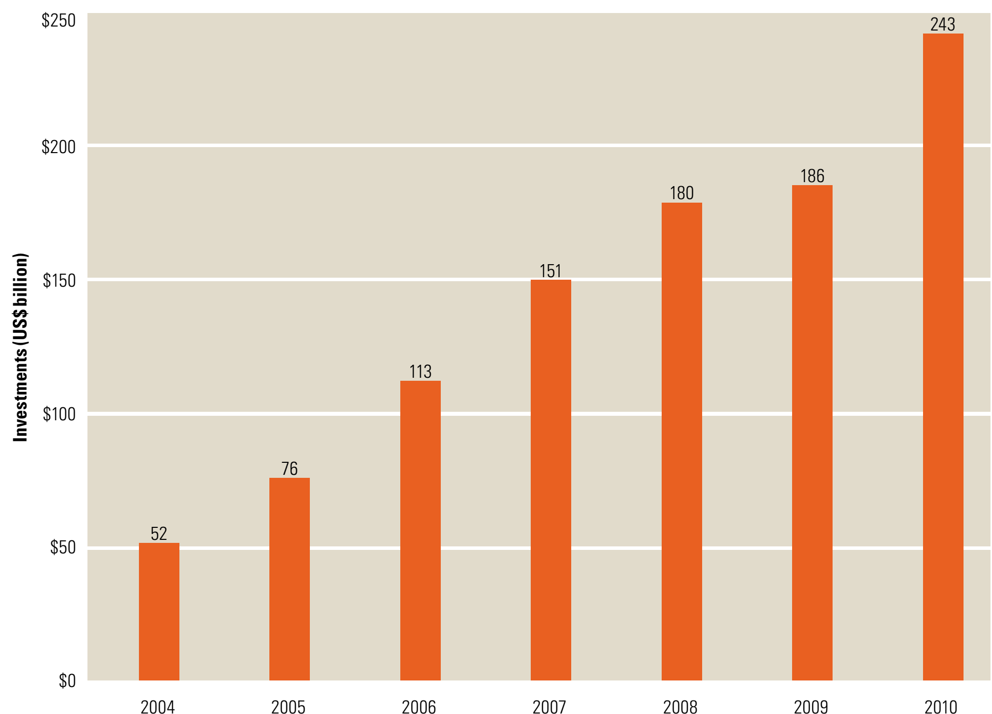
Jeremy Anderson

Among the characteristics of the high sustainability companies were "a coherent set of corporate policies related to the environment, employees, community, products, and customers." The authors posit that the high sustainability companies outperform the others because their cultures and practices allow them to "attract better human capital, establish more reliable supply chains, avoid conflicts and costly controversies with nearby communities (i.e. maintain their license to operate) and engage in more product and process innovations in order to be competitive."

What does this mean specifically for financial services companies? As the leading providers of capital, banks are uniquely placed to promote sustainability by encouraging businesses and individuals to use capital and resources in ways that benefit themselves, society and the environment, as well as those that supply the capital. Financial service companies are increasing their investments in green funds, clean energy technologies and sustainable projects and offering "green" products/incentives to consumers. Between 2004 and 2010, such investment has increased almost 500 percent, from US$52 billion to US$243 billion.



Source: Bnef.com, accessed on 29 December 2011
(Note: Figures include investment in renewable energy, bio fuels, smart grid and similar energy technologies)

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Among the consumer-oriented products being offered are mortgages that reward customers who reduce their energy consumption (in Canada) and banks that offer cash credits to customers who adopt sustainable living practices (in the US). Bank of America offers a US$1,000 credit to borrowers whose homes meet certain energy-efficiency guidelines. Similarly, Citizens Bank gives US$0.10 cash back to its Green Sense accountholders every time they perform a paperless transaction.

Finally, banks are working to reduce their own carbon footprints through such measures as encouraging both employees and customers to adopt "paperless" initiatives, increase use of ATMs and move to online transactions. Such practices, combined with an internal focus on using resources more efficiently and incorporating cleaner energy practices will also have a positive impact on the bottom line for banks.

Such green-themed products and practices not only have the potential to be additional sources of revenue or cost-savings for banks, but they also serve as points of distinction to consumers who often see little differentiation between financial products and the institutions offering them.

Not to be overlooked is the opportunity sustainability offers to help banks regain the credibility and trust that were eroded or lost in the wake of the financial crisis. Between 2007–10, the Edelman Trust Barometer reported that trust in the US and UK banking sectors fell 39 points and 20 points respectively. And this phenomenon was certainly not limited to banks in North America or the UK.

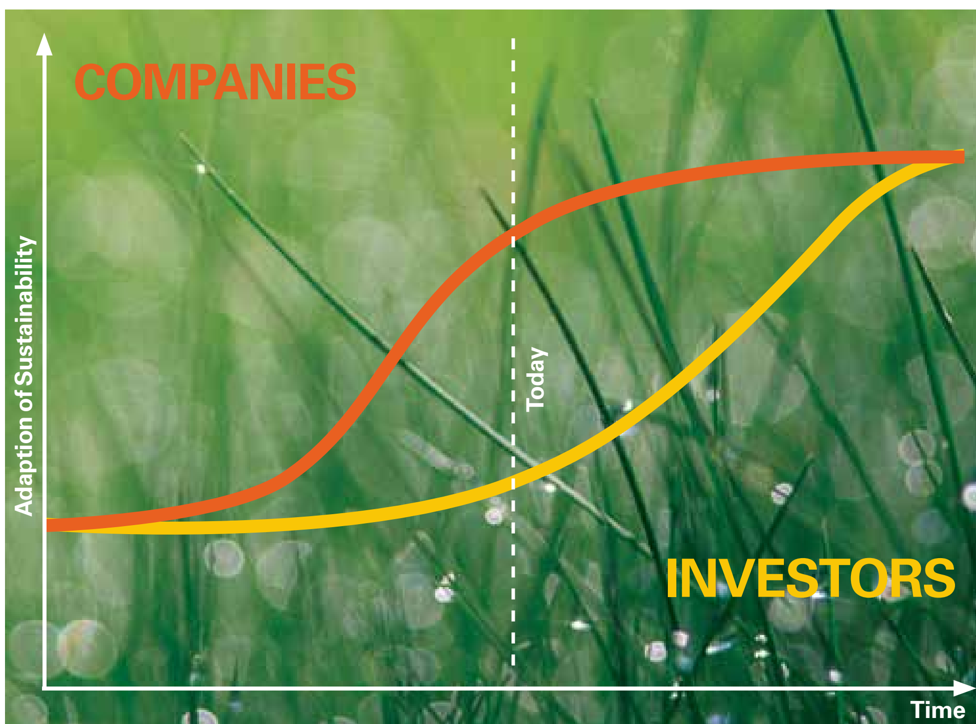
"The public perception is largely that anyone involved in the financial services industry is presumed guilty," commented KKR's Mr. Mehlman. "Rather than point fingers at someone else, companies can demonstrate that what you do isn't just good for you, it's also good for other people." Doing this can create genuine value for a company as well as show leadership about a subject that is important to a wide variety of stakeholders.

Mr. Mehlman also pointed out that companies need to put the Environmental, Social and Governance (ESG) data they have about themselves to good use. "If you don't understand all aspects of your business then fundamentally … you are an investor that is simply waiting for a problem and you're not really doing your job as an investor or as an owner of the company." KKR collects and analyzes ESG data across a substantial number of its portfolio companies, which also allows for sharing of best practices and finding opportunities for reducing waste and operating costs.

Demand for ESG data is also increasing among mainstream financial analysts, driving growth at Bloomberg's Sustainability Group, which provides ESG data through the standard Bloomberg terminal. Curtis Ravenel (Global Head, Global Sustainability Group) presented data at the above summit showing a more than 100 percent increase in hits on ESG data fields since the start of 2010. Building up historical data sets and comparability between companies are some of the key challenges that Bloomberg is focused on. We can expect, then, that banks will further integrate sustainability with their strategies, not only to restore the financial sector's reputation but also because it makes good business sense.

This being said, the picture across the industry is not universally positive, particularly in these challenging economic times. AVIVA announced earlier in 2012 that it was laying off some 160 people from the teams that look after corporate governance issues for

Closing the gap



Sustainable Asset Management's (SAM's) findings are consistent with those of the Harvard study, and suggest that companies can adopt environmentally and socially responsible policies without sacrificing shareholder wealth creation.

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organizations in which AVIVA invests, the team that researches ESG issues and from the fund management team that leads on socially responsible investing. This decision was not driven by AVIVA management having a change of heart about the importance of sustainable investment, but by commercial reality. While clients expressed support for responsible investment, in practice, this was not matched by sufficient fund inflows.

AVIVA's actions indicate a curious situation. Many of the world's leading companies see the value of sustainability, yet investors sometimes do not. This is a dichotomy that Michael Baldinger, CEO of Sustainable Asset Management (SAM) spoke about in depth at KPMG's global summit.

SAM was founded in 1995 as the world's first investment company focused solely on sustainability investing. The premise for SAM's approach to investing, Baldinger explained, is that analysis which relies only on companies' financial criteria is insufficient. And that sustainable businesses will perform better than others over the long term. Over the past 17 years, SAM has developed a research platform focused on under-researched, non-financial factors that it believes have a significant impact on investment performance.

Systematically integrating these factors into traditional financial analysis gives a more comprehensive view of companies' potential for value creation which, in turn, allows for better-informed investment decisions. "Our experience has taught us that companies that can anticipate and manage current and future economic, environmental and social opportunities and risks are best equipped to prosper in a hyper-competitive and changing global business environment," Mr. Baldinger told the attendees.

In 1999, SAM and Dow Jones Indexes created the Dow Jones Sustainability Index which, based on SAM's research, identifies and includes the world's most sustainable companies by sector and has become a global benchmark for corporate sustainability. Since then, some major global companies have decided to link top management remuneration to the Dow Jones Sustainability World Index – just one indication of the premium that strategic decision makers place on sustainability.

The chart on page 18 shows that adoption of sustainable practices has accelerated, yet, "the investor is lagging behind significantly," Mr. Baldinger said. He likened the images the lines form to that of a whale and said that SAM's goal is to "slim the whale" by closing the gap between how companies and investors view sustainability.

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?

SAM's findings are consistent with those of the Harvard study and suggest that companies can adopt environmentally and socially responsible policies without sacrificing shareholder wealth creation.

Mr. Baldinger concluded, "I used to say, 'Sustainability investing is the future of investing.' I actually believe now that statement is wrong. Sustainability investing has become an imperative of the present."

While data show that a focus on sustainability creates value for companies and can enhance their brands, it is also clear that not all stakeholders are aware of the value that is generated. That is a challenge for companies. Clear, consistent sustainability measurement is important. Integrated reporting – coupling how efficiently (sustainably) companies are managing their organization and its resources with the discussion of financial results – ultimately provides stakeholders with a more holistic view of an organization's health.

Yet, in challenge also lies opportunity. Those companies at the forefront must continue to supply vision, leadership and support with regard to sustainable practices. Financial institutions, among the world's largest and most influential companies, are in a unique position to advance sustainability on many fronts, whether by reducing their own carbon footprint or educating their investors. Responsible use of resources, increased transparency and quality of data, a willingness to create innovative solutions and a commitment to partnering with other industry sectors will demonstrate the viability and worth of sustainable business practices and lead to greater adoption within the financial sector and across each of the sectors with which it intersects.

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One of the key strands in policymakers' initiatives in the wake of the financial crisis is to reduce risk in derivatives markets by encouraging the migration of transactions to recognized exchanges or central counterparties (CCPs). The financial services industry has already made good progress in this direction. However, it is a move which will change the dynamics of the market for companies and organizations seeking effective risk management through financial derivatives.

Derivatives: Clearing the way

By John D'Agostino, Rajesh Gosain, Karl Ruhry

The derivatives market was the venue in which the financial crisis played out. Regardless of whether this relationship was causal, world political leaders, notably in the context of the G20, decided early on to institute wide-reaching market reform to increase transparency, reduce risk and help improve financial stability. In particular, the over-the-counter (OTC) market was felt to be especially opaque. A clear policy was adopted of encouraging the migration of standardized OTC derivative contracts to regulated exchanges or central counterparties (CCPs):

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the Financial Stability Board and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.[1]

Central clearing has a number of benefits:

- Since the clearer mediates between two principal parties and underwrites the deal in the event of a default, it contributes to security. In effect, counterparty risk is transferred to the clearing house which can manage risk through pooling, mutualization and margin.
- Since prices for listed derivatives are generally available to all market participants, it increases transparency and promotes the effectiveness of the price discovery mechanism.
- It introduces the market benefits of centralized and potentially enhanced liquidity, increased efficiency and market access to a larger base of participants.
- The clearing house can use margin to manage the risk of excessive leverage.

In the US, Title VII of the Dodd-Frank Act, also known as the Wall Street Reform and Consumer Protection Act of 2010 introduces new regulation of OTC derivatives and imposes the requirement that a range of swaps should be cleared through exchanges using CCPs. In Europe, the Commission is proposing to amend the European Market Infrastructure Regulation (EMIR) and introduce a Markets in Financial Instruments Regulation (MiFIR) to regulate OTC derivatives, CCPs and trade repositories. This would also create a new framework for supervising clearing houses across the EU.

Industry reaction

The derivatives sector itself sees the long-term benefits in moving to CCPs and is supporting the transition. In certain cases, parties to derivative trades will necessarily have specialized requirements which cannot be met by widely-traded products. Some bespoke products will continue to be traded OTC. However, in many more cases, participants' legitimate hedging requirements can be met by standardized products. Standardization and the move to CCPs are thus complementary.

However, an efficient market cannot be created overnight. It takes time and investment in systems and processes to build the necessary network of connections between CCPs to enable them to communicate. One of the principles of the move to clearing is that counterparties can choose between competing CCPs, a principle known as interoperability. CCPs create links to each other so that a user of a first CCP can execute and clear trades with a counterparty that has chosen a second CCP. But this complicates the systems challenges.

" Non-centrally cleared contracts should be subject to higher capital requirements. We ask the Financial Stability Board and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk and protect against market abuse. "

Progress

Despite these challenges, over the last 2 or 3 years, good progress has been made – in the credit-default swap (CDS) market in particular. The International Swaps and Derivatives Association (ISDA) notes:

> The size of the CDS market has been reduced by more than 75 percent through a combination of clearing and compression; more than US$15 trillion has been centrally cleared while portfolio compression has eliminated more than US$70 trillion. Over 40 percent of the interest rate swaps market is now centrally cleared. Another US$106 trillion of interest rate swaps has been eliminated due to portfolio compression.[2]

Progress with commodity swaps, though, has been somewhat slower.

[1] G20 statement, Pittsburgh, September 2009
[2] http://www2.isda.org/clearing-and-portfolio-compression/

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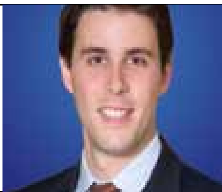
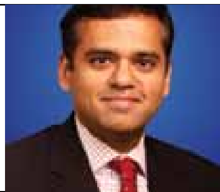
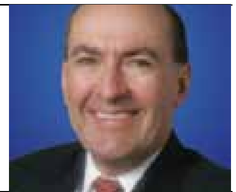
John D’Agostino  Rajesh Gosain  Karl Ruhry 

Impacts
A key issue is that none of these changes comes without costs, both to dealers and to their clients. These fall into two broad areas: direct costs which feed through into individual prices (e.g. commissions, capital cost, technology cost) and indirect costs which may follow from a restructuring of the market (e.g. spreads and impact on liquidity). In many cases, dealers are still wrestling with the implications of both.

Given the nature of derivatives, margins for standardized products tend to be low. As a result, any deviation in the cost structure can have significant impacts on economic benefits. Not only will prices to clients rise. But volumes will fall and dealers may decide to withdraw from offering certain contracts, reducing choice, reducing liquidity and further increasing costs for clients. The wider economic impacts could be subtle but widespread. The derivatives market exists so that participants from multinational companies to public authorities to pension funds can manage and control their risks. To the extent that this market is disrupted, both costs and risks can increase as a result of measures originally designed to promote the opposite.

Risk and liability will be redistributed in complex ways. Large exposures will be transferred to CCPs. However, the capacity of a CCP to absorb risk is determined by the equity capital injected by its members, the margin it collects and the practice of marking positions to market. Existing derivatives CCPs generally collect an initial margin from their members to cover potential future exposure in the event that a clearing member defaults. This initial margin, which is a form of collateral, is typically delivered either in cash or in the form of securities that have high credit quality and can easily be sold. CCPs will need the former OTC derivatives to be actively marked to market along with the collateral. Since OTC derivatives are currently mostly marked to model, the assumptions and the input market data will have to be very accurate and consistent as well as audited at regular intervals. In addition, credit and market risk will become merged at the CCP. This will be a new concept to most participants.

As always, change provides the chance to rationalize and to invest to increase efficiency. Faced with the need to build new communications systems, companies are exploiting the chance to create new technical infrastructures. Large multinational banks are positioning themselves to pick up derivatives business as other providers exit the market and/or seek to become CCPs themselves. Clients should see a more rational and orderly market in due course.

Outstanding issues
Central clearing is not a panacea. As we have seen it increase transparency and can reduce risk. But it will increase costs and may have unwelcome side effects at least in the foreseeable future. One major regulatory concern is that CCPs themselves could become systemically important institutions. In March 2012, Bill Dudley, President of the Federal Reserve Bank of New York, said, “In essence, global CCPs will be systemically important. Thus for the system to be safer,

The size of the CDS market has been reduced by more than 75 percent through a combination of clearing and compression; more than US$15 trillion has been centrally cleared while portfolio compression has eliminated more than US$70 trillion.

it is not sufficient to ensure that trades are standardized and that they are mandated to be cleared through CCPs, but also it is necessary that CCPs be bulletproof.”[3]

Dudley also highlighted the potential risks arising from the proliferation of national CCPs, reflecting concerns also expressed by the International Swaps and Derivatives Association (ISDA). While interoperability will reduce the dangers of fragmentation, the technical challenges of implementing new systems which were noted above mean that effective interoperability remains some way off. In addition, a number of national regulators are arguing for a structure of multiple locally-incorporated CCPs to serve local clients, which would further compromise the benefits of moving to central clearing.

Clearly, there are still major challenges to be overcome if the underlying objectives are to be met.

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[3] Quoted Financial Times 22 March 2012

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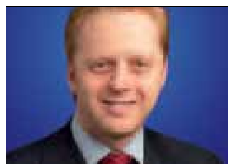
Recovery and resolution planning for insurers: Sensible risk management

By Rob Curtis and David Sherwood

Rob Curtis



David Sherwood

Since the global financial crisis, there has been continual debate about its root causes and over the appropriate regulatory and policy response to avert a recurrence. So-called Systemically Important Financial Institutions (SIFIs) have received particular attention in this regard. In the case of major banks, the broad direction of the necessary measures was readily apparent (closer supervision, enhanced capital requirements and so on) and regulators are well on their way to creating new and stronger frameworks of protection. But for non-bank financial institutions, the way ahead has remained less obvious.

In some cases – for example hedge funds – the policy response has been that they should be brought within the framework of regulation despite strong arguments that they played little role in creating the crisis. In the case of insurers, the debate has taken a different course, questioning whether insurers could in principle ever be classified as SIFIs, presenting systemic risks comparable to those of major global banks.

The bases of the argument that insurance is different are familiar: fundamentally different business models, capital structure, maturity profiles, liquidity characteristics and so on.[1] Nevertheless, there are routes by which insurers could in principle generate systemic risks and the G20 and Financial Stability Board (FSB) have made it clear that, in some circumstances, insurers may be classified as SIFIs and subjected to similar requirements as systemically-important banks. These could include constraints on non-core insurance activities such as credit protection and asset leverage, but in particular the requirement to develop recovery and resolution plans (RRPs) or so-called 'living wills'.[2]

However, leaving aside the possible regulatory drivers, there are strong reasons why insurers should be looking seriously at the principles behind RRPs and developing appropriate plans. The financial crisis did expose deficiencies in risk management in the insurance sector and it is no more than prudent and responsible risk management for insurance companies – SIFIs or not – to look seriously at recovery and resolution planning as part of an integrated risk management structure.

Recovery and resolution plans

As the name suggests, RRPs are designed to address two distinct phases of crisis which may affect an institution:

- ***Recovery:*** In the event of capital or liquidity stress, the plan provides for a strategy to prevent organizational failure. This may involve restructuring, sale of assets and certain non-core business lines, raising new capital from the market and other activities that may mitigate the risk of failure.
- ***Resolution:*** If failure cannot be avoided, the RRP offers the regulatory authorities a mechanism to take control of the situation and resolve the organization by implementing a pre-determined strategy, minimizing the harm and cost to creditors and public funds.

[1] See for example Recovery and Resolution Plans for Insurers: The need for a broader debate, KPMG, August 2011
[2] cf. Evolving Insurance Regulation: Time to get ahead... KPMG, February 2012

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The necessary planning needs to be integrated into an institution's risk management framework, not bolted on separately or treated as a formal compliance exercise. One of the best routes forward may be to expand the requirements of the Own Risk and Solvency Assessment (ORSA), which requires insurers to undertake an assessment of their own risks, complemented by an assessment of the capital required to meet such risks:

> "Every insurer should undertake its own risk and solvency assessment (ORSA) and document the rationale, calculations and action plans arising from this assessment. The ability of an insurer to reflect risks in a robust manner in its own assessment of risk and solvency is supported by an effective overall ERM framework, and by embedding its risk management policy in its operations."[3]

By expanding the ORSA requirements, the conceptual framework of RRPs could be practically applied as part of the ORSA analysis that insurers would be expected to review and include, applicable to all firms.

Extending the ORSA

Extending the role of the ORSA to satisfy the needs of effective recovery and resolution planning would involve a number of complementary strands:

Potential economic impact considerations

The ORSA assessment in future would need to consider explicitly risks posed to the

To be in a position to effect appropriate mechanisms, insurers will need insight into the potential triggers. These are likely to require scenario analysis to understand the pressure points and the likely sequence of events.

[3] International Association of Insurance Supervisors, ICP 16 Enterprise Risk Management for Solvency Purposes

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wider economic environment. Such macro considerations do not currently feature heavily in most insurers' ORSA assessments. Insurers would be required to have mechanisms in place to restore the group in the case of solvency and/or going concern issues – or at least to consider such scenarios within their ORSA or internal model analysis – and in a worse case situation, to deconstruct the group in an orderly manner. To be in a position to effect appropriate mechanisms, insurers will need insight into the potential triggers. These are likely to require scenario analysis to understand the pressure points and the likely sequence of events.

Risk appetite and strategy
One of the lessons of the crisis was that supervisors and a number of insurance groups, did not fully understand those inherent underlying risks with potential systemic relevance. How risk appetite is effectively used and monitored is less well understood by supervisors – in particular, how the risk appetite of an insurer fits with the strategic direction of the company. Formalizing such analysis and extending it to, for example, instances of mergers and acquisitions may also assist regulators to better assess the systemic relevance of firms, as well as enabling insurers to articulate potential impacts on the business model.

Greater focus on non-core insurance activities and off-balance sheet items
Part of the ORSA analysis needs to examine the impact that non-core insurance activities and off-balance sheet items may have on the business. Failure to recognize the risks such activities can pose to a group creates a material weakness in the overall risk management capabilities and functions of a group. Special purpose vehicles, hedge funds, derivatives, private equity, structured credit products, insurance linked instruments and hybrid instruments that embed derivatives and dynamic hedging programs all require additional scrutiny. A first step would be to require firms to undertake specific analysis of such instruments within their ORSA assessments, with particular regard to whether such assets lead to an increased systemic risk scenario.

Mandatory use of reverse stress testing
The use of reverse stress testing or test-to-destruction analyses (which identify scenarios that are most likely to cause an insurer to fail) should also form part of a firm's overall risk management analysis and assessment and could therefore form part of the ORSA. This can assess the adequacy of management actions proposed in order to avoid business failure. In relation to resolution, insurance failures are typically resolvable through an orderly runoff, but exceptions to this have occurred and remain plausible. There may therefore be a case for putting in place arrangements to ensure an orderly conclusion to various scenarios.

Improving risk management
In reviewing the ORSA requirements and the draft Pillar 3 requirements of Solvency II, the European Insurance and Occupational Pensions Authority (EIOPA) laid stress on "what is to be achieved by the ORSA rather than on how it is to be performed."[4] Whether or not the ORSA itself forms the context for recovery and resolution planning, such analysis can contribute a valuable and distinct perspective to insurers' overall risk management frameworks. And in the end, improved risk management is the core aim of both insurance companies and supervisors alike. Insurers are not banks. Rather than facing a banking model for recovery and resolution planning, insurers should engage with regulators to shape the discussion to include recovery and resolution planning as part of an integrated risk management structure.

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[4] Consultation Paper On the Proposal for Guidelines on Own Risk and Solvency Assessment, EIOPA-CP-11/008, 7 November 2011

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Financial services companies are not just facing massive new regulatory burdens. They also face the challenge of demonstrating compliance through the associated reporting requirements. In the face of multiple and overlapping reporting challenges, it is not surprising that many companies struggle. The key to success is to turn the reporting challenge into an opportunity for significant improvement in understanding and managing the business.

Making the best of compliance reporting

By Chris Collins, Stefan Cooper, Peter Luscombe

Financial services companies are facing dramatic increases in the reporting burden. Regulatory requirements are becoming much more demanding and the reach of regulation is extending into previously unregulated sectors of the industry. As a result, reporting requirements are increasing rapidly:

- In banking: Basel III; recovery and resolution planning; increases emphasis on stress testing; Dodd-Frank and the Foreign Account Tax Compliance Act (FATCA) in the USA; MiFID 2 and the European Markets Infrastructure Regulation (EMIR).
- In insurance: implementation of the IAIS Insurance Core Principles; Solvency II; local Risk Based Capital (RBC) reform; FATCA again; recovery and resolution planning; agent and sales-force management; the longer-term implications of accounting change.
- In capital markets: Dodd-Frank will force participants to comply with more comprehensive and real-time regulatory reporting requirements for interest rate, currency, equity, credit and other commodity swaps. This includes all cleared and uncleared trades regardless of the method of execution.
- Proposed new regulations for hedge funds, investment management firms and products such as financial derivatives will all be accompanied by requirements to report to relevant regulators.

Meeting the challenge

In the first instance, the reporting challenge is a matter of data acquisition, systems and analysis. As in all such cases, the implications for investment, operational cost and management effort can be profound. There is scope for efficiencies in all these respects. But the biggest source of efficiency lies in identifying the data required, acquiring it in the best way and ensuring its integrity.

In turn, this involves a detailed understanding of the business model and how it operates in practice. Developing this can be an immense undertaking. It is surprising how few companies have a complete, coherent and detailed inventory of the processes and operations underlying their own business through the life cycle of their transactions. Creating a data dictionary to

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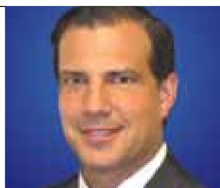

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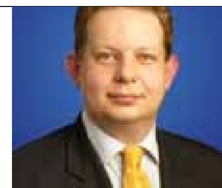

reflect that inventory and gather the information necessary for reporting is made more challenging by the existence of competing reporting regimes: statutory, regulatory, compliance and tax.

From business unit to business unit, product to product, the need is to create a baseline documenting the transaction life cycle and – critically – the management accountabilities for each step and process. Data integrity is crucial. Quality assurance processes are necessary to ensure that any reporting built on the baseline inventory and data is accurate and relevant. Legal entity structures can introduce serious complications when they cut across regulatory and/or reporting lines. A significant cross-referencing component needs to be included in the overall data structure and processes. The regulatory reporting function and the control framework need to work together to ensure that errors are identified and followed up and that the appropriate amendments to procedures are made for the future.

Bespoke reporting tools can provide valuable structure and control for the process and can reduce the headcount needed to support ongoing reporting. However, there are also common pitfalls that need to be considered:

- The cost of implementation can be significant, particularly where multi-language reporting requirements exist, technology platforms are diverse and substantial numbers of reports are requested.
- Business requirements need to be clearly defined to ensure that the system will pull the right data in the right format as stipulated by the regulation.
- Although tool vendors may provide support in identifying changes to reporting requirements, organizations should be wary of anyone who promises too much, as the ultimate responsibility will always lie with the regulated entity.

Adaptability and change are key factors. The business model inventory and data dictionary need to be able to cope with different regulators in different geographies. And to be robust against change both in external regulation (which will necessarily continue to evolve) and in the firm's strategy, business model, product line and so on. For example, the proposed over-the-counter (OTC) derivative trade and position reporting requirements under Dodd-Frank will generate profound change to a firm's business practices, operational infrastructure, supervisory system and governance model. These changes will make the demands on the firm's operational infrastructure even more critical to success and to regulatory compliance.

A compliance reporting strategy therefore has to be flexible and anticipatory, using foresight to try to stay ahead of future requirements. The governance process for change management (see panel) is critical to effective change management.

In an ideal world, the different reporting requirements which companies face would be consistent and compatible, drawing on the same single set of data. Moves toward harmonization can be seen. But for the present, it is clear that compliance reporting will remain a complex and costly burden.

Securing the benefit

Is it all bad news? Far from it. The data collection, analysis and quality assurance systems necessary for gathering relevant compliance reporting information are precisely those aspects which management information systems should be embracing. Senior management and the board need exactly this information to monitor performance and ensure the successful implementation of corporate strategies and business models. The adaptive and future-proof character of an excellent reporting regime should provide a valuable foundation for future business development. Identifying accountabilities clearly at each stage of transaction life cycles can be a valuable tool for streamlining management structures and processes.

Investment in an effective compliance reporting regime should therefore also be an investment in developing major competitive advantage.

Regulatory philosophy is moving in a compatible direction, away from a box-ticking model to embrace a more holistic assessment of the business model:

> "There needs to be an effective board that 'sets the right tone' from the top. An effective board is one which crucially, understands the circumstances under which their firm would fail and constantly asks the 'what if' questions. To do this well, a board needs to understand its business model, understand and focus on the material risks, and challenge the executive on the execution of a strategic plan."[1]

The UK Financial Services Authority is similarly requiring companies to identify senior executives with a 'significant influence function' who are responsible for dealing with particular regulatory or enforcement concerns. The regulators' concern for clarity over who is responsible for delivering significant actions is fully congruent with the company's own interest in effective senior management.

In the end, then, there is a complementarity between the regulatory perspective and that which is most effective for financial services companies themselves. Regulators are increasingly adopting a risk-based focus on the business model and tailoring reporting requirements to information which illuminates the relevant issues. This is exactly the approach that forward-looking companies should be taking to meet the challenge of compliance reporting – managing the business through a deep understanding of the risk profile and business model performance.

There needs to be an effective board that 'sets the right tone' from the top. An effective board is one which crucially, understands the circumstances under which their firm would fail and constantly asks the 'what if' questions.

Managing change

As always, one of the biggest challenges to implementing regulatory updates is managing the change. For regulatory reporting, change can come from a variety of sources, all of which need to be managed. Organizations need to ensure that impact assessments, testing, implementation and post implementation review are embedded for all changes and, at a minimum, need to:

- Make sure that responsibility is clearly allocated so regulatory changes can be actively monitored, and ensure these changes are promptly assessed for their applicability to the organization.
- Ensure that a decision-making forum is established with representation from all affected departments (e.g. compliance, legal, finance, operations, technology and front office teams) to interpret and analyze the requirements.
- Make certain that internal changes such as new products, clients, legal restructuring or technology do not adversely impact on the existing reporting framework, introduce new reporting requirements or add too much complexity.

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[1] Hector Sants, FSA, 'Delivering effective corporate governance: the financial regulator's role', 24 Apr 2012, Speech at Merchant Taylors' Hall

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Cutting through concepts In from the shadows: A rational approach to parallel banking

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

By Giles Williams

The term 'shadow banking' was born from the financial crisis. It seems to have been coined by Paul McCulley, former Managing Director of Pacific Investment Management Company (PIMCO), and applied to what he termed "the whole alphabet soup of levered-up non-bank investment conduits, vehicles and structures."[1] From its inception, the media image of shadow banking has been tarred with connotations of complexity, deception, even impropriety. There is a risk that politicians are taking the view that something must be done. Experience shows that this is not the basis for effective policy-making. Fortunately, the quality of the discussion on this topic has improved in recent weeks and we are beginning to see some more informed debate.

What is it?

Let's start with some definitions. According to the Financial Stability Board, the shadow banking system is "the system of credit intermediation involving entities and activities outside the regular banking system."[2] The European Commission, announcing new proposals to regulate this sector,[3] recently characterized its scope as including:

- Money Market Funds (MMFs) and other types of investment funds or products with deposit-like characteristics.
- Investment funds that provide credit or are leveraged, including Exchange Traded Funds (ETFs) and hedge funds.

[1] Teton Reflections, Paul McCulley, PIMCO, September 2007
[2] FSB, Shadow Banking: Scoping the Issues, 12 April 2011
[3] EC, Reference: IP/12/253, 9 March 2012

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Giles Williams

- Finance companies and securities entities providing credit or credit guarantees or performing liquidity and/or maturity transformation without being regulated like a bank.
- Insurance and reinsurance undertakings which issue or guarantee credit products.
- Securitization and securities lending and repurchase agreement (repo) transactions.

Assessments of the size of this sector vary widely and are heavily dependent on definition. The FSB estimated it at around US$60 trillion in 2010.[4]

Why is it a problem?

These companies and institutions carry out certain bank-like activities, such as maturity transformation and liquidity transformation, but they fall outside the full scope of banking regulation. So the potential risks they present may not be fully visible to the authorities. The details vary between jurisdictions, but in most cases, individual investors and counter-parties will be adequately protected by existing conduct regulation. However, matters are not so clear-cut in respect to systemic risk.

The financial crisis revealed clearly that these shadow banking entities may have the potential to severely destabilize effects on the financial system, not primarily through their own activities per se, but as a result of their interconnectedness with the mainstream banking system. It is rarely the case that a hedge fund or investment fund, for example, acts as the sole intermediary between an end-supplier and an end-purchaser of credit. More likely, there are complex chains of institutions involved, some within the conventional banking sector and some without. It is the exposure of the banking system to credit and liquidity risks originating outside it which drives the need to consider how this sector of the financial industry should best be regulated.

As always, it's a question of balance. These non-bank institutions bring very clear benefits to the market. The FSB itself recognizes that intermediating credit through non-bank channels has advantages. For example, the shadow banking system may provide market participants and corporates with alternative sources of funding and liquidity.[5] What's more, as Adair Turner, Chairman of the UK Financial Services Authority, pointed out in a recent lecture at the Cass Business School, much of the financial crisis in Europe did not involve shadow banking activities such as securitized lending, but "plain old-fashioned on-balance sheet lending."[6]

Equally, though, where prudential regulatory standards and supervisory oversight are different from those imposed on mainstream banks, there is the potential for excess leverage and risk to build up in the system, as well as the danger of regulatory arbitrage. Indeed, one factor behind increased concern about the shadow banking sector is the fear that tougher regulation of banks will drive them to try and circumvent and undermine banking regulations. As the European Commission (EC) put it:

> By evading regulation applied to regular banks, shadow banking may also lead to a regulatory 'race to the bottom' within the rest of the financial system – other financial bodies may also try to push certain activities outside the scope of regulation.[7]

Is it still a problem?

On some measures, it may seem that the scale of the shadow banking sector has declined in the aftermath of the financial crisis: The volumes of derivatives, special purpose vehicles and money market funds have all shrunk; Goldman Sachs and Morgan Stanley have voluntarily adopted conventional holding bank status. But this doesn't mean that the underlying issues have gone away.

It is an argument which was explicitly addressed by Adair Turner.[8] In essence, his case is that:

- The modern financial system, with its reliance on fractional reserve banking, is inherently unstable.
- Financial systems which combine traditional banking and credit securities markets are potentially very unstable.
- Even if on some measures the scale of shadow banking has reduced, these factors mean there is always the danger of a repetition of pre-crisis instability, but in changed specific forms.
- Macro-prudential tools – such as counter-cyclical capital buffers – are essential to counter this instability across the whole financial system, banks or non-banks.

The recognition that danger may return, but in a different specific form, is shared by the Institute of International Finance (IIF) "New types of financial intermediary potentially undertaking new forms of intermediation may arise at any time, particularly during periods of rapid regulatory change. This means that frameworks need to be sufficiently generic and flexible to allow new and emerging sources of risk to be taken into account."[9]

Let's start with some definitions. According to the Financial Stability Board, the shadow banking system is "the system of credit intermediation involving entities and activities outside the regular banking system."

Getting the balance right

The challenge is to provide the necessary protection against excessive risk without prohibiting an appropriate level of dynamism and creativity in financial institutions. This is a subtle and complex undertaking which is not helped when specific parts of the financial services sector are singled out for exemplary treatment. We recognize and accept the systemic risk argument, and few would argue against better macro-prudential oversight. The controversy is about micro-prudential regulation, such as regulation of individual firms for two main reasons: First, many of the activities are regulated in one way or another already and, second, if you accept these are decent businesses (and generally this should seem to be the case), then additional regulation could kill them. We need to work out now, rather than when it is too late, what the economic implications of the potential changes would be given the fragility of national economics.

When Michel Barnier, European Commissioner for Internal Market and Services, launched the EC's green paper on the topic in March 2012, he spoke in French, saying the French equivalent of 'shadow banking' is *le système bancaire parallèle.* Perhaps we Anglo-Saxons might start by recognizing that we're dealing with a parallel banking system. The key question, then, is to determine whether the policy response is to address the macro-prudential risks or both micro and macro issues. The results, the costs and wider economic implications will be very different depending on what the regulators choose.

[4] FSB, Shadow Banking: Strengthening Oversight and Regulation, 27 October 2011

[5] FSB, Ibid

[6] Adair Turner, Shadow Banking and Financial Instability, Cass Business School, 14 March 2012

[7] EC, Reference: IP/12/253, 9 March 2012

[8] Ibid

[9] Institute of International Finance, Macroprudential Oversight: an Industry Perspective, July 2011

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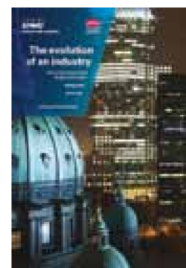

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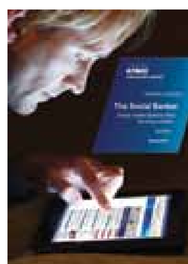

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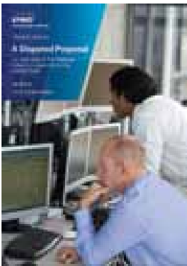

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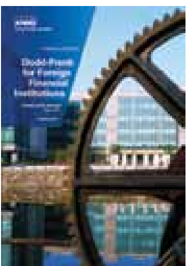

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