frontiers in finance

for decision makers in financial services June 2004

FINANCIAL SERVICES

Regulation: all risk and no reward?

Expanding regulatory horizons
Regulatory risks around the world are escalating and regulators are now interacting on many levels. So how can you protect your organization everywhere from risks that can rise anywhere?

The art of compliance
The role of the compliance function continues to evolve but what does a successful function look like?

Capital adequacy: insurers play catch-up
Prudential regulation within the insurance sector is moving towards a Basel II-type model. Can insurers step up to the challenge?

Beware: consumers
How can organizations successfully respond to an increasing consumer regulatory trend and what are the dangers they face?

A quiet revolution
China's accession to the WTO has profound implications for the country's financial services markets, creating risks, challenges and opportunities in equal measure.

AUDIT ▪ TAX ▪ ADVISORY

In this issue

Regulation: all risk and no reward?

Much has happened in international financial services in the past six months. Business confidence has improved as the economies of the world's richest countries have recovered, most noticeably in Asia, North America and the UK. There are still weaknesses in the economies of continental Europe, but the Organisation for Economic Co-operation and Development (OECD) is predicting real GDP growth in the eurozone of 1.8 percent this year, and 2.5 percent in 2005.

Financial markets around the world got off to a good start in 2004, adding to the impressive gains of last year. "Improvements in global growth prospects and corporate finances, coupled with a robust appetite for risk, underpinned increases in equity and credit prices," says the Bank for International Settlements* (BIS) in its first quarter review. "Not even further revelations of corporate malfeasance seemed to unsettle investors."

It would be hard to get more bullish than this, which is why merger and acquisition activity in the financial services sector has started up in earnest after two years in the doldrums. Much of this is confined to domestic markets, but we are seeing significant cross-border activity too, with banks and insurers pursuing acquisitions in Europe and the US. And there is intense activity in emerging markets, particularly in China which is drawing direct and indirect foreign investment into its banks and insurance companies.

*BIS Quarterly Review March 2004

Unfortunately, with all this renewed activity comes not just the promise of reward, but the risk of failure. Market risk, credit risk, operational risk – you name them, all these risks and many more loom larger on risk managers' radar screens when their companies are in expansion mode. And in an environment of change and heightened risk the regulators are monitoring the situation ever more closely to maintain the stability of the financial system, prevent financial crime and protect the interests of customers.

Regulatory risk is on the increase…

So from a financial institution's point of view, regulatory risk must be high on the risk agenda. Despite globalization, we still live in a very diverse world when it comes to financial services regulation. In some countries, intensive regulation has been around a very long time, and although the issues change and best practice evolves, the art of compliance is generally well developed. But in others, where regulations and regulators are much younger – especially in the area of dealing with customers as opposed to prudential and capital issues – even the concept of a compliance function and what it should do is quite new.

This issue of *frontiers in finance* is designed to help readers in all regulatory environments – from the mature to the recently created – in understanding the issues that affect them. Any firm that falls foul of the regulators faces not only having to pay fines and compensation, it also faces major reputational damage.

In the US, we have seen very large fines and remedial actions imposed on major financial institutions for conflicts of interest between their research and investment banking activities, and on mutual fund companies for late trading and market timing abuses. In the UK, retail banks and insurers continue to be punished for mis-selling financial products to consumers. And in various jurisdictions, institutions have been disciplined for failing to comply with anti-money laundering measures. There are countless other recent examples of regulatory failure and regulator enforcement action across the globe.

…but there are rewards

So regulatory risk has become, perhaps, the biggest risk of all. But it does not have to be a case of 'all risk and no reward'. There are benefits to be had, if it is managed properly.

If a bank achieves higher risk management standards under the new Basel Capital Accord, it will benefit from lower capital requirements. If, as insurance regulation moves to a more risk-based approach, an insurer handles its risk management issues effectively, it will become more capital efficient.

If firms consider their compliance arrangements as strategically critical, there is great scope for benefits in technology leverage, business and functional integration, resource optimization and cost reduction.

If, in dealing with consumers, retail financial services providers take on the spirit and objectives of regulation, not just the letter of the law, there are great opportunities for reward from consumers with their continued custom and loyalty.

And if groups set themselves, and demonstrably maintain, high standards of governance, customer treatment and compliance, they are entitled to expect the 'regulatory dividend' of less onerous and intrusive supervision from the regulators. We believe that regulators should be seen to be providing such an incentive more extensively.

Regulatory risk must be managed

That's why we're focusing on regulatory risk and reward in this issue of *frontiers in finance*. We deal with a number of themes, but four in particular stand out.

The first is the increasing globalization of regulation. There is an increasing degree of coordination between national regulators on policy, supervision and enforcement matters. The ripple effect should not be underestimated. On the other hand, detailed rules still differ widely from country to country. Both phenomena create extra risk for global groups.

The second key theme is the regulators' focus on effective corporate governance, the role of the board and especially the accountability of senior management, with regulators making it clear (in a variety of ways and with a variety of powers) that they will hold senior managers responsible for any significant regulatory failures in their organization.

The third theme is rising consumer protection. As Sir Brian Pitman, Senior Adviser to Morgan Stanley, pointed out at a European retail banking conference recently, "*caveat emptor*, buyer beware, is steadily being eroded in most of the western world." We are moving towards a principle of 'let the seller beware', with the onus falling on personal financial services firms to ensure that customers buy the appropriate products.

The fourth is the convergence of regulation across different financial sectors. There has been a trend, with notable exceptions, for countries to merge their various financial regulatory bodies into a single regulator. And although there are still big differences in the way different sectors are supervised, moves are being made in many countries to put all sectors on similar supervisory footings. One consequence is that an issue or expectation arising in one industry sector is rapidly extended across all other sectors.

But, as with all types of risk, there is an upside as well as a downside. The essence of any type of business – and financial services is no exception – is that if regulatory risks are properly identified and managed, then the regulatory environment can be turned to business advantage.

So regulation is definitely not 'all risk and no reward'. The rewards are there to be taken. Financial services regulation is at different stages of development around the world. Readers in countries where it is a relatively new concept may want to learn more about what good compliance looks like. Readers operating in jurisdictions where regulation has long been a fact of life may want to benchmark themselves against best practices operating in other companies to ensure their regulatory risk management is up to scratch. Either way, we hope you find this issue of *frontiers in finance* useful.

Brendan Nelson, KPMG LLP (UK)
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Regulatory risks around the world are increasing and often difficult to track. Unless your regulatory risk management operations are effective, you may not understand, let alone manage, your growing risks nor maximize your emerging opportunities. *By Hugh Kelly and John Somerville*

Expanding regulatory horizons

For multinational financial services firms, regulations worldwide are ever increasing; regulators are becoming more aggressive and compliance risks are growing. Regulatory standards are getting tougher. But standards are getting tougher in different ways in different jurisdictions. Regulatory environments around the world remain disparate and often contradictory, even as they become more stringent. This poses a serious challenge for global organizations – particularly their central/head office risk and compliance oversight arrangements.

Of the largest international financial sector regulatory and control failures of the last 10 years, a very high proportion derived from operations away from the group's home-country and center of risk control. In many cases, these failures were in jurisdictions where the group's operations were not particularly significant.

As businesses become decentralized in their management structures, in many cases relying on a complex matrix management configuration encompassing a mixture of line of business, geographical and legal entity reporting structures, the challenge of obtaining sufficient assurance at group/head office level that global regulatory risks are well understood and managed has greatly increased.

Successfully meeting this challenge requires unprecedented rigor in corporate governance, group risk management, and regulatory compliance arrangements.

A shrinking world

Regulators are talking on many levels:

- Multilaterally through international supervisory bodies, such as the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), as well as the cross-sector coordination efforts of the Joint Forum.
- On the regional level, e.g. in Europe where the focus of the European Union (EU) and Committee of European Securities Regulators (CESR) is now expected to move rapidly from policy to implementation/enforcement;
- And, most significantly for individual groups, bilaterally: home-country regulators are increasingly talking in very specific terms to the host country regulators across the world of their supervised groups. For example, the Japanese Financial Services Authority (FSA) holds regular bilateral meetings with the UK's FSA, the US Federal Reserve (Fed) and Office of the Comptroller of the Currency (OCC), and Germany's Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). So, for example, a compliance problem in a small Japanese subsidiary of a global organization can come to the attention of a home-country regulator and rapidly become a big issue. Indeed, emerging issues such as the Basel II Capital Accord and increased financial sector reliance on cross-border outsourcing arrangements, will provide even greater impetus to home-country regulators to coordinate more closely with their host country counterparts in the future.

It has become critically important, therefore, for group senior management and compliance and control functions to understand, for every jurisdiction where the group does business, both the character of the current regulatory regime and the trends in regulation that affect that regime; and how their own operation's business, governance and risk profile map against that external assessment.

Global challenges

But how do you protect your organization everywhere from risks that can arise anywhere?

"These are big challenges," Sean Hughes, Group Head of Compliance for Australia's international banking organization ANZ, tells KPMG. As a first step, he emphasizes the importance of fostering an understanding of the fundamental business benefits of compliance. "As compliance professionals, we want our people to own their compliance obligations. If they don't see the sound business reasons for complying with regulations, it's hard for them to be willing to expend the resources necessary to do so."

Sound business reasons for rigorous compliance operations include, of course, the avoidance of regulatory violations and enforcement actions. But the benefits do not stop there. A proactive attention to compliance can, in fact, help you educate regulators about the nature of your business and influence the development of the regulatory environment. Listed below are strategies that can help you achieve both sets of benefits.

Strategies for success

Assume the aggressive trend among regulators will continue

Regulators everywhere must be seen as tough and effective to meet the expectations of their stakeholders – and, fundamentally, to fulfill their *raison d'être*. The publicity of a successful enforcement action can be helpful to them, both in demonstrating their effectiveness and in conveying a deterrent message. Groups which are 'tall poppies' in local markets may be especially at risk. Such awareness should be built into your business risk profiles.

Know your regulators

Leading groups are proactive. Senior head office representatives meet often with local regulators. They actively participate in local industry policy development and debate, inputting to regulators during development of regulations, rather than reacting negatively once new regulations are issued.

A proactive attention to compliance can, in fact, help you educate regulators about the nature of your business and influence the development of the regulatory environment.

Global groups can also benefit from helping to inform local regulators – particularly in emerging regulatory jurisdictions – about industry developments in other financial centers. For example, a multinational insurance firm recently helped Japanese regulators become more open to trends elsewhere by creating a joint effort to study how other insurance markets were deregulated.

Let your regulators get to know you

This will help regulators understand your business. In some large banks in Germany, for example, regulators are invited to sit in on meetings of the supervisory board. In the US, the OCC and the Fed have resident examiners permanently located in large banks in order to facilitate real-time communication with bank management and quicker follow-up on issues and risks. And in Japan, dialogue between regulators and firms' internal audit staff from head office has improved as the Japanese FSA shared its perceptions of the local operations' risks and their regulatory concerns.

Know your business thoroughly, including your weak spots

Companies may know their own local regulatory environments well, but they can sometimes overlook those of overseas countries where they are either new or only small players. Issues may not get onto their 'radar screen' due to the relative size of the local operations. For example, in Australia, some foreign banks with large home-country operations had not considered the possible impact of Australia's new licensing regime. As a consequence, some have been very late in turning their attention to the issue. It is now too late to take action, and they are facing a risk of either operating without a license with attendant threat of fines and reputational damage; or having to withdraw temporarily from the relevant business.

Assess the effectiveness/sufficiency of your global and regional compliance oversight functions

Are you able to track standards of compliance and emerging risks in all the countries where you operate? Regulators are increasingly scrutinizing groups' oversight of overseas operations and examining the adequacy of their central controls. What resources do you devote to this? How well structured is the process? How much is it based on on-site challenge to the overseas operations and how much reliance is placed on self-assessment style reporting? What is the quality of group reporting of global compliance risks (as well as issues that have already arisen) to the group board/audit committee?

Challenge whether you have the right balance between global standards and local compliance procedures

For example, some organizations take the regulation providing the highest standard (from among all of the countries in which they operate) and apply this standard across all jurisdictions. While this results in 'over-complying', some groups consider it to be a more effective and manageable practice than applying and tracking multiple rules in multiple jurisdictions. But, they cannot apply this rule without flexibility. So, if in a particular jurisdiction it makes good commercial sense to adopt a lesser standard or rule in line with local requirements, then this should be considered.

Other groups adopt a limited number of high level group compliance standards/principles with which all their global operations must comply and then overlay the detailed local requirements in each jurisdiction.

➜ CEO discussion points

- ➜ How good is our understanding of the regulatory environments and trends in all the jurisdictions in which we operate?
- ➜ How well do we evaluate our standards of compliance arrangements in all of those countries?
- ➜ How well are our global and regional compliance oversight structures designed and resourced?
- ➜ What is the quality and depth of our dialogue with regulators in each jurisdiction?
- ➜ How quickly are potential compliance concerns, wherever they arise in the world, notified and escalated to group compliance and group management, and is it quickly enough to enable effective pre-emptive action to be taken?

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Whichever approach is adopted, local operations may complain that they cannot compete effectively when they are subject to more onerous requirements than their local competitors. That's when the tough decisions have to be made around the different pulls of risk, reputation and profitability.

Compliance awareness and accountability must be integrated in core business operations

In some countries with less developed local regulatory environments, this is easier said than done. But, unless local business management heads are bought into the need to adhere to high standards of conduct and group compliance principles, and take ownership of compliance themselves, the effectiveness of local compliance functions will be severely constrained. Group/head office management have an important role to play in setting the right expectations in this area of subsidiary/divisional management.

Good communication is essential

Ensure efficient compliance and issues reporting, particularly within communication channels between headquarters and all subsidiaries. Most organizations have found the need to combine regular written status reports with mechanisms to encourage less formal and more immediate dialogue, e.g. regular and ad hoc telephone contact. Information once thought incidental, such as a risk management issue within a small subsidiary, must be able to reach the attention of senior management quickly.

Again, Sean Hughes at ANZ emphasizes the importance of communication about compliance. "We operate on a 'no surprises' basis," he says, "which means bad news within the organization reaches senior management, who, along with me, present discoveries of compliance failures to regulators. We don't wait for them to discover our mistakes". Most organizations aspire to the same, but achievement of this requires exceptionally strong and effective lines of communication and measures to mitigate a 'blame culture'.

Know your competitors

Monitor other firms' issues with regulators and assess the extent to which you share their exposed weaknesses. Don't assume their troubles cannot become yours.

Benefits of a global compliance approach

Among the benefits of fostering an effective global compliance approach in these ways are:

Reputation protection: Top of the list – a 'must have' – for financial sector CEOs. The cost of poor regulatory risk management can be very significant in terms of reputational loss in local markets as well as globally.

Promotion of your global brand: The effective implementation of global compliance standards will make it easier for you to create and meet common customer expectations worldwide, particularly around the core values of integrity and fair dealing.

More efficient operations: As well as synergies in compliance processes, businesses that communicate well across national boundaries on risk and compliance issues tend to learn more quickly and effectively about what works well and can be shared (e.g. use of technology in compliance management and surveillance).

The exponential growth of financial services regulation, its disparate detail and the increasing aggressiveness of many country regulators all highlight an area of increasing reputational risk to global financial services groups. Management of this risk requires effective compliance structures, excellent communication, clear common standards and active regulator relationship management. Head office regulators are increasingly challenging groups' governance in this area and efforts to ensure such challenges can be effectively answered are likely to be handsomely repaid.

Amid the constant ramping up of expectations by the public, by government, by consumers and by regulators, and the spate of corporate scandals over the last few years, those who run financial services organizations are asking "Are we doing everything we should be doing to prevent a problem blowing up in our face?". *By Pamela Hauser and Marcus Sephton*

The art of compliance

Some of the most celebrated recent scandals are cases of fraud or outright mis-management. It is notable that the worst cases are not in the financial services world, however, there are enough examples of regulatory and compliance failures to make this a special area of focus. Just think of mutual fund practices in the US, and pension and mortgage endowment mis-selling in the UK. And think also of the reputational impact on the firms involved in these scandals.

How are businesses responding?

In all these cases the authorities are holding business leaders to account – in the most serious cases through the criminal courts – for regulatory failures. How are successful business leaders responding to this challenge? Through a focus on corporate governance with a combination of:

- Setting out a clear vision for the organization, with clarity around values and desired culture.
- Recognition that primary responsibility for regulatory risk management rests with the board and senior management.
- Clear accountabilities, delegated authorities, objectives and performance management and reward.
- Unequivocal business standards and expectations of behavior.
- Risk management and oversight.
- Independent internal audit.
- A function that advises on and monitors regulatory risks and standards of compliance.

An increasingly vital element of the response of businesses is this last development: a function whose purpose is to help businesses manage regulatory risks and compliance. This article explores how the function is developing and evolving in different parts of the world, and some of the essential ingredients for success.

As a reader, your response to the challenges set out in this article will vary depending on the jurisdictions in which you operate. Those sitting in Australia, the US and the UK, for example, which are more mature markets in terms of regulation, may welcome the opportunity to go back to basics, to stand back from the day-to-day challenges of heavily regulated markets and ask: what is our compliance function trying to achieve, and what progress have we made towards that objective? Those in other countries may be asking themselves different questions – where do we begin in developing a compliance function and why do we need one anyway? Surely our legal/internal audit/risk functions cover our regulatory responsibilities?

This very fact illustrates one of the greatest challenges for multinational groups – how to establish compliance functions and a compliance framework which are capable of providing an executive and board with appropriate information to assess the level of regulatory risk within a group, when 'compliance' means different things in different jurisdictions and the skill base for conducting the work varies so widely around the world.

The changing face of compliance and regulatory risk management

'Compliance' is a term that has been around for some time in many countries, but it is often used without consistency or consensus as to its meaning and often without too much thought. 'Compliance' – and the associated scope of the compliance function – can therefore mean many different things to different organizations. For some, that scope embraces all or many of the laws and rules that the business faces, including financial services regulations, data protection, disclosure requirements, etc. For others, the scope can be limited to elements of the rules of the financial services regulator(s), including:

- How the business conducts its affairs with customers and other external parties.
- How the business manages its own capital.
- The effectiveness of internal systems and controls.
- Corporate governance and senior management responsibilities.

These variations in the scope of the compliance function are largely due to the fact that the need for such a function has emerged as regulatory regimes have developed, and the scope and role of the function is often shaped by the regulatory focus in that regime.

In the US, for example, the in-house function has had a long history, initially in the areas of anti-trust laws, highly regulated industries such as financial services, and activities involving risk to personal safety or the environment. Often this function has been staffed by lawyers and has tended to focus on technical aspects of interpretation of the rules.

Outside of the US, in the UK and Australia, the breadth of regulation has changed to cover not just prudential requirements but also the manner in which products are sold, the responsibilities of senior management and the effectiveness of controls. Compliance functions have therefore become business consultants, who advise the business across a whole range of activities which may be impacted by regulation. This requires a completely different mind – and skill – set.

This more active role is also illustrated by the way in which compliance functions in more highly regulated jurisdictions monitor the extent to which their companies are complying with the rules – a responsibility which is recognized in the October 2003 Basel consultative document, "The compliance function in banks."

When establishing compliance functions there is no 'one size fits all' solution. The response will vary according to the relevant jurisdictions.

In summary , taking a broad view of compliance functions around the world, what we can say is that:

- Whatever the jurisdiction, there is increasing acceptance among financial organizations of the need for a specialist function that assists those organizations in understanding how to comply with a defined set of rules and regulations. For each organization that set of rules might be different; the crucial thing is to be clear about the scope of the function.
- But this does not mean that the compliance function is responsible for 'ensuring' compliance with the rules – there is widespread recognition among regulators that the burden of maintaining adequate controls to meet regulatory requirements rests squarely with management. At the same time, regulators themselves recognize the value of a separate and independent compliance function that supports senior management in relation to their regulatory responsibilities, monitors standards of compliance within the business and alerts senior management to key regulatory risks. In the absence of such a function, regulators understand that there is a very real risk that those at the top of organizations will be unaware of the standards of compliance within their organizations.

So, the need for a compliance function is accepted. But in regulatory circles the talk now is not just of compliance – a simple 'meeting the letter of the regulations' approach – but also of 'regulatory risk management', since regulators and financial services groups in many countries are increasingly seeing compliance with regulations as another area of risk to be managed – indeed as a subset of operational risk.

Unlike other forms of risk management, there is less scope to live with or take steps to mitigate regulatory risk; as compliance with the law and regulations is not optional. Where responsibility for regulatory risk management lies within organizations varies significantly. In some countries the move is towards developing compliance functions that can take on this new and more demanding role.

A clear sign of this change in thinking is evident in both the UK and Australia, where the function now commonly reports through to the Head of Risk and is positioned internally to work closely with the operational risk team. This is opposed to the strong trend in the US where the function typically reports through to the Head of Legal.

So what is the role of a compliance function and what can and should it achieve?

Different places, different challenges

When establishing compliance functions there is no 'one size fits all' solution. The response will vary according to the relevant jurisdictions. Some things, however, are clear:

- The role of the function must be clearly defined with measurable objectives against which its progress can be monitored and assessed. In simple terms this means considering the extent to which the compliance function will take responsibility for:
  – educating and briefing the business on the regulatory requirements which impact upon it;

➜ CEO discussion points

New compliance functions

➜ Have you established a compliance function for all of your operations?

➜ If not, what objectives do you have for your compliance function?

➜ Where can you find the necessary skills for this function?

➜ How will you maintain the independence of the function?

For those where the function is already set up

➜ How does your compliance function match up to its original objectives?

➜ To what extent is that function actively helping you to manage regulatory risks?

➜ How do you measure the cost of compliance and how is this being managed for cost effectiveness over time?

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– assisting the business to develop its own controls and associated procedures;
– monitoring the effectiveness of those controls, reporting on the results and defining remedial action to address weaknesses identified;
– tracking regulatory developments and maintaining good relationships with regulators.

- The compliance function must be independent. Successful compliance functions within groups often have two reporting lines – one to the CEO of the relevant business unit and one to the Head of Group Compliance who reports in to the parent company.
- The compliance team must have the right skill set. In countries where the concept of a compliance function is new, these skills are often drawn from legal and internal audit departments. What is vital is that the compliance function understands not just the regulations but also the business – indeed the markets – in which an organization operates and can provide practical solutions to regulatory challenges that do not involve excessive or disproportionate costs, where this is avoidable.

The forces that are shaping the function

Despite all we have said about the differences in compliance functions around the world, there are a number of forces at work that are pushing in the same direction:

- **The convergence of regulators' thinking:** Regulators increasingly agree on the need for a compliance function. However, in many countries this concept is a new one, not just for organizations but also for regulators, so expectations for the function will vary.

- **The impact of Basel:** The Basel consultative document was issued as part of the ongoing efforts of the Basel Committee to address bank supervisory issues and enhance sound practices in banking organizations around the world. The document provides basic guidance for banks and sets out banking supervisors' views on compliance in banking organizations, although it acknowledges the differing regulatory environments and approaches to compliance functions that exist from jurisdiction to jurisdiction.

- **Cost effectiveness and business benefit:** All businesses, wherever they are located, operate under cost constraints and these apply as much to compliance functions as to any other part of an organization's operations. In fact, some might argue that the cost pressures are greater on a function which is often seen as an expensive overhead, rather than a vital part of the risk management framework.

  The concern among senior executives is that the compliance function that they establish will grow exponentially, as it addresses the need to monitor the business. This is not necessarily so: in countries where compliance functions have matured over time, experience has shown that the key to success is not to employ armies of compliance monitors but rather to ensure that there is a partnership approach between the business and compliance oversight, that key risk areas within the business are identified and that resources are targeted appropriately. Also, with the efficient use of technology, for example to assist in the collation of management information, some financial services organizations are finding that their compliance function has grown smaller over time as they learn the art of compliance.

As regulators' thinking on compliance functions converges, and as businesses become more complex in terms of the nature of their activities and the countries in which they operate, the need for an effective compliance function becomes ever greater. That function will evolve over time – as it does, it can develop its role and take on more active oversight of the business. The end game must be that the compliance function becomes an essential part of the risk management universe.

Capital adequacy: insurers play catch-up

The insurance sector has generally followed the lead of others with regard to risk management and capital adequacy practices. Change is coming, however, driven by regulators, the capital markets, and, increasingly, leading insurers that recognize the business benefits of a new regulatory model.
By Tim Childs and Peter de Groot

Preparing for Basel II, and complying with Basel I's market risk requirements, has compelled many banks to invest substantially in highly sophisticated risk measurement models and management practices to satisfy their regulators and help maintain their competitive position in the marketplace.

Even those banks regarded as sophisticated, however, have been daunted by Basel II's data and systems' requirements and their implementation costs. At the same time, they have yet to see the effects of the enhanced transparency expected to result from increased disclosures. As Basel II continues to evolve, however, its influence is extending beyond banking to challenge the insurance sector with the prospect of a new approach to capital adequacy that is risk-based and market focused.

Risky business

The European Commission's (EC) development of Solvency II is one significant indication that prudential regulation within the insurance sector is moving inexorably towards a Basel II-type model – one in which internal models are used to establish capital requirements, and the risk management framework adopted by the board and senior management is scrutinized by both regulatory authorities and the market (see sidebar). However, the outcome for Solvency II is by no means certain and there is still a lot of negotiating to be done.

Many international bodies are seeking to influence Solvency II: the International Association of Insurance Supervisors (IAIS), for example, which represents 150 jurisdictions and has a set of core principles for insurance supervision, is expected to be extensively involved in the evolution of Solvency II. Moreover, countries including the Netherlands and the UK are anticipating its policies by developing their own risk-based approaches to insurance regulation. In the wake of these developments, insurance leaders worldwide have numerous questions, including:

- Why is a new approach appropriate for insurance regulation?
- How are new risk-based approaches developing, and what are their potential implications for insurers?
- What business benefits could offset the potential cost of compliance?

A Solvency II snapshot

Like Basel II, Solvency II in the European Union (EU) is expected to take a three-pillar approach to capital requirements, regulatory supervision, and market discipline. Its aims include:

- Enhanced policyholder protection.
- Greater transparency, comparability and coherence.
- A methodology positioned to reflect risks in individual companies and avoid unnecessary complexity.
- Avoidance of unnecessary capital costs.

Changing approaches to capital adequacy

When the EC and its member states initiated the Solvency II project in 2000, a primary goal was to better align capital adequacy requirements with the true risks of insurance companies. The capital markets will increasingly demand improved transparency in the insurance companies in which they invest. To that end, closer alignment between Solvency II and the proposed International Financial Reporting Standards (IFRS) is expected, which could pose significant threats to Europe's current fixed-ratio capital adequacy model.

Moreover, in the wake of Basel II, the EU and other regulatory bodies also saw an increasing need for a level playing field across the financial sector globally as well as an emerging trend toward convergence of prudential rules for different sectors.

Talking to KPMG, Paul Sharma, Head of Prudential and Accounting Standards at the UK's Financial Services Authority (FSA), says "Basel is exerting indirect pressure on insurance regulators in Europe to move to a risk-based approach. Within single regulators, like the FSA, there's a lot of institutional pressure that says, 'we've got one reputation, one quality way of doing things; it's not acceptable to offer a second-rate product when it comes to regulation in the insurance sector.' In countries with separate regulators, the insurance regulators are recognizing the need to 'show that they're able to modernize without being merged'."

Several market factors intrinsic to the insurance sector also play an important role in the drive for Solvency II:

The presence of financial conglomerates (of banks and insurance companies), and regulators' consolidated supervision of such entities, creates additional pressure on regulators to impose similar capital and accounting standards across sectors. "If I were the leader of a conglomerate," notes Sharma, "why would I want strong risk management in the banking (less risky) part of my business and less strong risk management in the insurance (more risky) part of my business?"

Cross-sectoral arbitrage – where risk is transferred from the banking sector to the insurance sector because less capital is required to support the risk, such as in the use of credit derivatives – is becoming increasingly prevalent and has the potential to create increasingly large flows of capital from one sector to another.

High-profile failures of insurance companies in countries worldwide underscore the need for regulators to catch up with the market – and for insurance companies to better understand their risks.

Foreign investor expectations are also important factors in some Asian countries. Growth has been the model in this region for many years, but countries including Singapore, Korea, and Hong Kong are beginning to focus more on managing their capital, data, and shareholders' expectations. They are looking to Australia, Europe, and the US for useful lessons.

A risk-based model offers innumerable benefits…

A fundamental business question for insurers is: Are you charging enough premium to cover your risks and your capital costs? The argument is that if you can't prove to shareholders that a business is profitable, you should not be underwriting it. Being focused on risk, Solvency II can be expected to address those issues:

- A more transparent system will help insurers make decisions based on capital needs; thus, business strategy can be aligned with the capital used in the business.
- Risk modeling can help you assess capital needs more closely, identify and evaluate major risks, and determine capital implications by risk category.
- Scenario analysis can enable a future focus, rather than past-period snapshot analysis.

…but, the transition poses considerable practical difficulties

The problem, of course, is that many insurance companies lack sufficient loss data, and highly developed risk management models, to make risk decisions effectively. Taking risk is insurers' bread-and-butter, but, paradoxically, their own risk management systems have long been considered less robust than that of banks:

- Many insurers lack a sophisticated means of evaluating exposures to losses – the foundation of a capital requirements calculation. Or, they do not trust the data: if their models recommend a GBP£600 premium, but the market will bear only GBP£400, some may choose to maintain market share by charging the lower price – a tactic that has resulted in some large business losses.

➜ CEO discussion points

- ➜ Do I genuinely know my risk-adjusted return for various businesses and products, or just my return?
- ➜ Do we have the data and systems to achieve internal models' reliance and, if not, will we be at a competitive disadvantage? What will it take to get the data and develop the needed risk management systems?
- ➜ Will our risk management framework withstand scrutiny?
- ➜ Can we achieve capital savings and more efficient capital allocations through the adoption of more robust risk measurement models?

The problem, of course, is that many insurance companies lack sufficient loss data, and highly developed risk management models, to make risk decisions effectively.

- Like banks, insurers struggle with defining risk appetite (that is, what are my major risks, how much risk am I prepared to accept, am I taking enough risk?) and then building the answers into a policy framework that drives the risk management of the business. Solvency II can be expected to focus minds on establishing a clearer link between how much capital is used in underwriting and how much is used to value that potential business.
- Banks have long relied on formalized key performance indicators and scorecards. Many insurers, on the other hand, have yet to differentiate their risks – insurance, market, credit, liquidity, operational – and to work out the interactions between them.
- Many insurers are unable to quantify their exposures to individual re-insurers without significant manual intervention in systems that do not capture that fundamental information.

These data inadequacies are formidable. Yet building the systems, and capturing the necessary data, will demand sizable investments of time, energy, and financial resources. Many companies have yet to be persuaded of the value of those investments.

Why are some insurers embracing a new model?

Even among those US, Australian and Asian insurers that use risk-based capital adequacy models, the goal of increasing market share has historically taken precedence over improving profitability. But some senior leaders around the globe are reconsidering their business priorities. What factors are driving this shift?

Capital is expensive. Effective use of capital becomes increasingly important in an environment in which insurers have lost money on their investments, and, as in Japan, face a negative spread. To secure lower-cost capital, and to meet shareholder expectations, insurers will face increasing pressure to demonstrate how they calculate both premiums and their risks.

Profitability is increasingly preferable to volume. Increased capital market scrutiny means that competitors that under-price will find their ability to stay in the market severely limited.

Regulators worldwide are holding senior management to a higher standard. A comprehensive understanding of different risks and their impact is not common among insurers' senior management and boards. Information may be available internally but may not be shared appropriately with the most senior level of management – a situation that regulators will find untenable in a post-Enron world.

What are the implications for insurers?

As Solvency II evolves, national regulators worldwide are moving toward risk-based capital adequacy models in a variety of ways and at varying speeds. Insurers now need to consider their strategies for meeting the increased regulatory burden to preserve, or enhance, their competitive position in the market. They also need to consider how to align systems and data management strategies with parallel standards such as IFRS. New resources will inevitably be needed.

Solvency II is more than a regulatory issue. In fact, it is a business opportunity CEOs should use – not just respond to – as a means of improving their own management information systems and increasing organizational awareness of the high costs of unknown risk.

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Beware: consumers

As Adam Smith[1] articulated over 200 years ago, a key justification for free enterprise capitalism is that organizations survive and prosper through meeting the needs of customers. *By Douglas Henderson and Sarah Willison*

In many countries, especially where the spirit of free enterprise is most enthusiastically embraced and competition is fiercest, financial sector regulators are asserting that prospering organizations are failing to meet customers' needs. Indeed, regulators are intervening more deeply in how businesses go about marketing and selling to their customers. They may not have the same approach, or even focus on the same issues, but they are promoting an increasing level of consumer protection regulation.

How can global organizations take account of this consumerist regulatory trend in shaping their commercial strategies and managing their regulatory and reputational risks? And how should this align with global branding and the desire to achieve a consistent approach to the treatment of customers, wherever they are located? To answer these questions, we need to reflect on the dynamics of the trend itself.

The trend

Regulators' growing assertiveness is driven by:

- **Information asymmetry:** An increasing gap between the sophistication of financial products and the financial literacy of consumers, leading to a lack of confidence among regulators that consumers understand the products or services that they are buying; and
- **Recent regulatory failures:** A spate of high profile cases around the world that have led regulators to strengthen consumer protection regulation.

While regulators around the world may agree on the problem, their response to it is globally disparate. In some countries the focus is on product regulation, in others on disclosure of financial information, and in still others on selling practices. In some countries, regulators are seeking to close the gap between products and consumers' financial literacy. In others, the view (and the law) is that it is not the regulator's job to educate consumers. And while regulators have introduced consumer protection measures and pursued enforcement actions, many have also recognized a paradoxical effect. Well-publicized regulatory action can create an unhelpful level of risk aversion in investors.

Indeed, critics of aggressive consumerist regulation argue that there is a large and developing risk: heavily regulated jurisdictions will increasingly foster a compensation culture which will, in the long run, hamper innovation and entrepreneurial behavior and increase cost. This risk is recognized by the UK's Financial Services Authority (FSA) where

Anna Bradley, Head of Retail Themes, acknowledges to KPMG, "Competition is fantastically important. In truly competitive markets, consumers do very well. So, in addressing market failures, we have to be careful not to put shackles on firms and prevent them from developing innovations. It's the first-step firms that will drive change in this arena."

An overview of consumer protection regulation in key jurisdictions

While the trend in prudential regulation has clearly been one of international harmonization, there has been no comparable unifying force in consumer regulation. This may well be because variations in product development and selling practices reflect the cultures of individual countries and the strength of the consumer lobby. The challenge for multinational firms is to comply with the accompanying regulatory variations while achieving consistency in customer expectations.

Below are examples of key markets and their consumerist regulatory approach.

Europe

The European Commission's Financial Services Action Plan (FSAP) includes consumer protection among the cornerstones of its design for a single market in financial services by 2005, and many directives address aspects of the subject (e.g. the Investment Services, the Distance Marketing, and Insurance Mediation Directives). Nevertheless, the approach and scope are very fragmented, and the philosophy of implementation between member states is very diverse. Some countries (e.g. the UK) unapologetically go far beyond the minimum directive requirements in their consumer regulation; others appear to take a very light-touch approach to implementing or enforcing even the minimum requirements.

In the UK, the FSA's current campaign of "Treating Customers Fairly" emphasizes the responsibility of financial services firms to incorporate a consumer-focused approach in the development of business strategy.

In discussing the concept of "Treating Customers Fairly", the FSA's Anna Bradley says, "Financial institutions need to ask themselves whether or not they have properly integrated thinking about 'treating customers fairly' into their corporate strategy – not delegated it to a compliance department but taken responsibility for it at a senior management level."

Bradley goes on to articulate the kind of measures which the FSA believes organizations should have in place in order to ensure that they treat their customers fairly, including:

- Processes to identify the long-term needs (not just short-term appetite) of consumers for whom they are designing and distributing products.
- Approaches to advertising and sales which take account of the financial literacy of customers.
- Stress-testing of product risks against changing economic scenarios.
- Stress-testing of risks to the firm itself from its retail strategy, including customer types/segments, product types, sales and distribution methods etc.

United States

In the US, the focus is shifting from mandatory disclosure of financial information to measures to protect the consumer against what regulators deem abusive practices. Historically in the US, *caveat emptor* has been the guiding principle, with regulations focusing on full disclosure. Sales practice regulation in the securities, investments and insurance sectors and fair lending regulation in the banking sector have long been in evidence. But the much-publicized prosecutions by New York Attorney General Elliot Spitzer have brought a fresh regulatory prominence to the fair treatment of customers and measures to combat abuses. This changing focus may encourage the adoption of more principles-based strategies among firms.

Australia

Financial services reform has seen the introduction of a new 'single' licensing regime, new rules at point of sale including enhanced disclosure requirements and an attempt to raise the standard of advice given to retail customers generally with extensive new training requirements for those providing 'advice'.

Asia

Historically, very little consumerist regulation has existed in the region. So-called 'know your client' issues have begun to emerge, and this has been encouraged through the presence of the global players operating in the region. At the same time, Asian regulators are becoming more protective of the consumer and take the view that voluminous disclosures to the consumer around, for example, illustrations of investment return are not in practice protecting most consumers due to complexity.

Meeting the challenges

Regulators and firms may agree with the principle of fair treatment of customers, but there is widespread debate about how best to put it into practice. The basic task for firms is to explore whether, and to what extent, their business operations agree with regulators' expectations of customer treatment. We suggest the challenge is at two levels.

The first is strategic, whereby firms must ensure that there is alignment of commercial and regulatory objectives. When deciding what products to offer through which distribution channels, i.e. in developing their commercial strategy, organizations must take into account the long-term needs of their customers. In other words, firms must consider whether their strategy is designed to contribute to meeting their customers' needs, rather than just their own short-term profitability. As Bradley says, "The first thing I would ask CEOs is whether or not they can put their hands on their hearts and say that they, as a firm, are treating their customers fairly." A preliminary step in this process is to engage with regulators, to convince

→ CEO discussion points

- → Are we having a meaningful dialogue with our regulators on the match between our business strategies and their expectations?
- → How do we gain assurance that we have understood the panoply of relevant consumer regulations in all the countries where we do business and have adequate awareness and compliance processes to satisfy them?
- → Are we stress-testing our products and business models for those products to see if they are meeting our standards of consumer service?
- → Do we have adequate systems and controls in place to understand the long-term impact of our products on our customers?

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them that consumer needs are being considered at the strategic level.

The second challenge is at the level of business control and execution. This is tougher. Here the management challenge is to embed in the organization a customer-led culture by incentivising the right behaviors in staff; and to develop customer- and quality-orientated management information which can give early warning of customer neglect and non-compliant behavior.

Here an essential step is to develop substantive compliance controls, to enable compliance not just with the letter but also with the spirit of regulation. In meeting disclosure regulations, for example, firms have been able to develop processes that provide customers with essential information without antagonizing them with an unnecessary cascade of paper.

Another step is the development of systems to monitor all the disparate consumer regulations governing a firm's operations in every location and all the compliance processes embedded in the business to meet them. Because regulators almost everywhere are getting more aggressive, the reputational risk is huge.

Among the dangers for multinationals attempting to meet these challenges, two are key:

- **Failure to comprehend the scope of regulatory requirements in every jurisdiction where you operate.** Overseas companies entering new markets frequently make the error of transporting successful products or selling practices from another market without properly assessing the impact of the new regulatory regime on those products or practices.

- **Failure to understand who your customers are, including their level of financial literacy and their range of needs.** At present, regulators assert that an in-depth understanding of the dynamics of consumer needs and behaviors is lacking in the industry. There is developing agreement among regulators and firms that consumers must learn to be responsible for their own financial decisions, but that the industry must help them get there.

The really enlightened – and successful – business will be one that can integrate compliance in its operations and by doing so meet the rising challenges without committing the above mistakes.

Consistency of approach

A complementary aim for multinationals is to have their global brands associated with consistent customer expectations around the world. Customers flying from San Francisco to Singapore expect to receive the same level of service in both places, and when they do, their trust and loyalty are strengthened. Sharing experience of good practice in different jurisdictions can help multinationals define global compliance standards, meet regulatory requirements in each jurisdiction and achieve consistency in customer expectation and satisfaction.

In summary, then, regulators are becoming more assertive in their protection of consumers, although they are approaching their objective in widely different ways. Multinational firms must meet this challenge at two levels – the strategic and the operational. Failure to do either can expose them to significant regulatory and reputational risk. In addition to the risks, however, there are significant business opportunities. By adopting a consumer-driven approach multinational firms can begin to establish global compliance standards and achieve consistency of service for their customers around the world.

1 "An Inquiry into the Nature and Causes of the Wealth of Nations", 1776.

Fighting financial crime

The profile of financial crime continues to rise, but with the help of law enforcement, new regulation, and strong internal controls, financial institutions can fight back. *By Bernard Factor and Giles Williams*

Financial institutions face increasing threats from a wide range of financial criminals. Globalization, increasing political pressure, economic conditions, and the sophistication of information technology are among the factors that are helping to create an environment in which fraudsters and money launderers can prosper.

The problem

Fraud increasingly poses a threat to society as a whole – and the scale of the problem is growing exponentially:

- The UK's Home Office estimates fraud in 2003 to have cost approximately GBP£14 billion[1].
- The Hong Kong Police measured a 59 percent increase in fraud in the first nine months of 2003. With a significant migration to e-based transactions (estimated to rise in Hong Kong by 3,500 percent from US$2 billion in 2000 to US$70 billion by 2004), the Hong Kong Police anticipate increased potential for fraudulent activity[2].
- The US-based Association of Certified Fraud Examiners estimated that six percent of revenues would be lost in 2002 as a result of occupational fraud and abuse, equalling US$600 billion of US GDP[3].

In addition to the wider implications for society, these findings inevitably impact on financial institutions, as the criminals need to bank and invest their ill-gotten gains. More specifically financial crime will impact financial institutions in a variety of ways:

Money laundering

- The United Nations Office of Drug Control and Prevention estimates that US$500 billion to US$1 trillion in funds is laundered worldwide annually by drug dealers, arms traffickers, terrorists and other criminals[4].
- US federal law enforcement agencies seized more than US$300 million in criminal assets that were attributable to money laundering in fiscal year 2001[5].

The terrorist threat

- ATM and credit-card fraud by organized criminals and terrorist cells is on the rise, as well as soaring levels of identity fraud, which compound the global problem.

Credit risk

Levels of corporate fraud have continued to rise in recent years:

- KPMG's LLP (US) 2003 Fraud Survey indicated that 75 percent of the 459 listed companies surveyed reported that they have experienced an instance of fraud[6].

Similar trends have emerged in both Europe and Asia with highly publicized cases in which senior management or employees have been able to borrow large sums with no realistic prospect of repaying the funds.

The UBS money-laundering case study that follows this article, bears out that there are 'many faces' of financial crime. Examples of the guises in which financial criminals come include:

- **Fraudulent borrowers**, who take advantage of non-existent or inadequate internal credit controls and poor due diligence practices.

- **Money launderers**, who subvert account monitoring policies and procedures.

- **Terrorists**, who use depository accounts to fund day-to-day activities.

These financial criminals create significant risks for institutions' reputations. Moreover, their activities have a variety of regulatory compliance implications. Financial institutions and regulators have discovered that fighting such crime requires a multi-faceted approach based on the specific risks these widely divergent crimes present. More importantly, regulators are asking financial institutions to explain how, specifically, they are analyzing their risks and, at a practical level, fighting the various forms of financial crime.

Questions to be answered

As a result financial institutions need a coordinated approach to identify their risks and create a risk-based control framework to address them. Key questions to ask at the outset are:

- **Credit policy**: Who is the potential borrower, and why is that individual/corporation seeking a loan? What is the money being advanced for? Does the transaction make economic sense? An understanding of such risks and their controls must be built into the credit process.

- **Anti-money laundering (AML)**: Who is the customer, and what is the source of the funds? Policies and procedures designed to help institutions know their customers and monitor transactions must be in place and in use.

- **Terrorist activity**: Institutions need to be closely involved with appropriate government bodies and law enforcement agencies to help prevent terrorists from gaining a foothold within the institution. Is the institution up to date with the latest thinking on how terrorists fund their activities?

The regulators' response

Disruption of criminal activities calls for coordinated activity and intelligence sharing among individual financial institutions, regulators, and law enforcement agencies. Many countries have taken a number of important legal steps to combat financial crime and have regulatory structures requiring financial institutions to establish and maintain specific systems and controls. For example:

- In the UK, the Financial Services Authority (FSA) has increased its focus on reducing fraud. New legislation requires regulated individuals to report when they have reasonable grounds to suspect that financial crime has occurred. The Proceeds of Crime Act (2002) requires that suspicious transaction reports be made not just when a person 'knows or suspects' that a person is engaged in money laundering, but when a person has 'reasonable grounds for knowing or suspecting' such activity is occurring.
- The European Union (EU) has issued a new directive to combat the laundering of the proceeds of serious crimes. Member states must enact this new directive into local legislation.
- In the US, the Patriot Act's information-sharing statute (section 314) requires that virtually all financial institutions review their records every two weeks and report concerns about money laundering and terrorist financing to the Financial Crime Enforcement Network. The Patriot Act also requires US banks to document the identities of those who control foreign customers' accounts as well as the sources of funding for those accounts.
- The US's Sarbanes-Oxley Act (2002) provides international direction on fraud control and management issues including the responsibilities of senior management to ensure that sound internal controls exist and are implemented appropriately.
- Australia, among others, announced in 2003 its intention to align its AML regime with international standards, based on the 40 recommendations of the Financial Action Task Force (FATF).
- New auditing standards (ISA 240/SAS 99), require auditors to take a proactive approach to assessing whether management has in place appropriate systems and controls to manage the risk of fraud.

→ CEO discussion points

→ How well has the business identified and analyzed the risks of financial crime across the institution?
→ Has the system of internal controls kept pace with changing risks and the growth of the institution? How do I know that these controls address the real financial crime risks faced by the firm?
→ Are the appropriate controls fully integrated into the business lines?
→ Is there an effective whistleblower program in place so that employees are aware of it and are encouraged to use it?

How can firms address the issue

Financial institutions need to take different approaches to managing financial crime, depending on the extent to which they are exposed to each type. Such approaches tend to encompass five broad elements, which can be described as follows:

- **Governance**: the role of senior management is to provide direction on how the institution should manage the issue; establish key responsibilities and establish internal and external reporting protocols. Senior management need to assume ownership of financial crime governance. In addition to setting a practical strategy and organizational framework, management needs to ensure there are appropriate performance measures and monitoring programs to test the robustness of the control systems.

- **Strategy and policy** involves establishing a comprehensive approach to managing financial crime and misconduct in order to ensure that the organization has appropriate anti-financial crime policies and procedures in place. Policy and procedures must provide clear guidance to staff on how and what to report in relation to each type of financial crime.

- **Risk** involves a financial crime risk assessment undertaken by the business and operational risk functions. Enhancements can then be made to manage the risk of fraud through improved controls. A proper assessment needs to be made of the threats posed by financial criminals throughout the business, including assessment of the risks specific to the products and markets in which the institution is involved.

- **Culture** aims to ensure that training is provided as appropriate, taking into account the different needs of management and staff and what impact they can have in preventing and detecting financial crime. Employees need to be trained to understand the warning signs of fraud, their reporting obligations, and the internal processes available for confidential reporting. The environment should be one in which staff feel encouraged to escalate their concerns, knowing that relevant safeguards are in place for their protection.

- **Investigation**: firms need to adopt a robust and well coordinated investigative approach to assess exposure risk, identify how fraud or misconduct arose and implement recovery plans. The use of appropriate investigation techniques is also critical for enhanced checking of potentially higher risk customers and employees.

Conclusion

Financial institutions have an obligation to the community to take these important steps as well as regulatory and shareholder responsibilities to do so. However, they cannot operate in a vacuum: to be successful in fighting financial crime, financial institutions need the support of regulators and law enforcement. They also need a comprehensive, risk-based program for fighting financial crime which is based on a sound understanding of the types of financial crime to which they are exposed.

1 Home Office Research Study 217 – The Economic and Social Costs of Crime.
2 http://www.info.gov.hk/police/pprb/peb/english/102502_e.html
3 Association of Certified Fraud Examiners. "2002 Report to the Nation: Occupational Fraud and Abuse," p. ii.
4 US General Accounting Office, Report to Congressional Requesters, "Combating Money Laundering – Opportunities Exist to Improve the National Strategy," September 2003, p.6.
5 National White Collar Crime Center, August 2003, citing the US Department of the Treasury, The Office of Enforcement (2002, July). The 2002 national money laundering strategy. Retrieved July 23, 2003, from http://www.treas.gov/offices/eotffc/publications/ml2002.pdf
6 KPMG LLP (US) Fraud Survey 2003, p. 2.

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No entry for money launderers

Swiss legislation governing financial institutions is among the most rigorous in the world. 'Know Your Customer' and transaction monitoring processes and tools developed by the Swiss financial services community are highly sophisticated in the areas of fraud prevention and detection, anti-money laundering (AML) and identification of terrorist funds. The following text illustrates the thorough approach which one of the largest Swiss global banks, UBS, applies. It is based on discussions with UBS's internal money laundering prevention specialists headed by John Cusack, Managing Director and Deputy Group Compliance Head. *By Stuart Robertson*

'Pecunia non olet' – money is odorless

S. Mute is an experienced client adviser at UBS. One day, B. Clean, Senior Partner at the law firm Clean & Partners, calls to introduce a new client to UBS, as he has regularly done in the past. At the agreed meeting, Mr. Clean introduces a German national, Mr. Schmidt. Mr. Schmidt informs Mr. Mute that he earns his living as a consultant and has been living in a Latin American country for more than 20 years. Given the volatile political situation in this Latin American country, he would now like to open an account in the name of his Panamian-based company, 'Perfect Co.'. Within the course of the next two years Mr. Schmidt introduces two more business people from his adopted country in Latin America to Mr. Mute, again via the law firm Clean & Partners. Both Mr. Gonzales and Mr. Garcia open a numbered account with UBS.

According to somewhat imprecise (given the nature of the issue) estimates by experts of the International Monetary Fund (IMF), worldwide criminal transactions amount to approximately US$1,000 billion to US$1,500 billion per annum[1], even though the amount of criminal funds laundered is much lower. This is about one eighth of the gross domestic product of the US. Roughly 10 – 30 percent of the overall monetary turnover remains in the various cycles of the financial system. Money launderers aim to wash their loot by transferring it into a squeaky clean account balance.

The various laundering programs include fictitious transactions in goods, securities trading, insurance policies, real estate and commodities. In order to suppress all doubts about the legality of these funds, different amounts are moved around via transactions in varying degrees of complexity. Nowadays, only Hollywood gangsters turn up in the lobby of a Swiss bank with a suitcase full of money and try to open a numbered account. In reality, any physical monetary deposits exceeding CHF100,000 from a new client must be carefully investigated in line with regulatory decrees.

Gatekeepers of the financial system

One fine day, Mr. Mute learns of a business scandal in that specific Latin

The Swiss Money Laundering Reporting Office, MROS, received a total of 863 notifications of justified suspicious facts in 2003, amounting to a total value of CHF 616 million.

American country. According to the newscast, the CEO of Oil Co., a Mr. Garcia, has negotiated an oil deal with a US company at a price well below the market price. In return, he is said to have received a kickback. The personal adviser of the president, Mr. Gonzales, informs the press of an impending investigation. Client adviser Mr. Mute immediately contacts the compliance department.

Since banks and finance intermediaries act as gatekeepers of the financial system, they have an important role in the prevention, detection and reporting of relevant criminal activity and the fight against money laundering. The Swiss Money Laundering Reporting Office, MROS, received a total of 863 notifications of justified suspicious facts in 2003, amounting to a total value of CHF 616 million[2]. The number of notifications in Switzerland has thus trebled within the last four years. This is mainly due to the tightening of the compulsory reporting requirements and their application to financial intermediaries in the non-banking sector. Today, approximately 500 banks, securities brokers and fund managers, more than 7,000 financial intermediaries in the non-banking sector (asset managers, fiduciaries, law offices and notary offices), as well as life insurers and gambling establishments, are subject to compulsory reporting.

John Cusack, Head of Money Laundering Prevention at UBS, points out that every account application is subject to a clearly defined vetting process. UBS develops a risk profile based on the applicant's domicile, nationality, and economic background, but also on the amount deposited and a number of other criteria.The higher the risk, the more thoroughly the prospective client is scrutinized. This evidently poses a certain dilemma to the bank. On the one hand, the checks need to be watertight to avoid any future allegations of abetting money laundering. On the other hand, the bank does not want to alienate new clients by excessively questioning their integrity. If too many ambiguities exist, the bank will opt not to enter into a particular client relationship.

Awareness of potentate funds

Most deposits into the account of Perfect Co. were made by US banks. The deposits were evenly transferred to the accounts of Garcia and Gonzales. Given the context, the bank's compliance unit suspects that the deposits constitute in fact the reported bribes from the US oil company.

Funds from potentates such as Marcos, Mobutu and Abacha have made the financial services community sit up and take notice. UBS now has access to a database containing the names of more than 500,000 politically exposed persons (PEPs). However, solely being considered a PEP does not in itself represent a sufficient reason for suspicion. Nevertheless, if the first triage identifies a prospective new client as a PEP, the PEP Special Unit will investigate further.

The same procedure applies to so-called sensitive countries; i.e. states in which corruption is a fairly common phenomenon given the prevailing political risks, stability of the legal system, corruption index and other clearly defined criteria. Governmental and non-governmental organizations provide the relevant indicators. The delineation of the world into sensitive and non-sensitive countries does not mean, however, that money laundering is a problem exclusive to developing countries. According to MROS, the vast majority of suspicious notifications received in the course of the last year also related to Swiss contractual parties and economic stakeholders. Nevertheless, as Cusack points out, by deploying and aggregating relevant risk factors tailored to each client segment, only a small fraction of clients are classified in the higher-risk sector. Corporate audit helps ensure that all client advisers and compliance specialists are applying the same yardstick and that all client relationships are periodically reviewed. This methodology further serves the purpose of enhancing the aptitude of the system throughout the audit process. However, no matter how sophisticated these processes may be, the decisive factor in this matter is the experience and power of judgment of the client advisers and compliance specialists.

Money laundering has many faces

With media reports being too imprecise and names such as Gonzales and Garcia being very common, the bank initiates a special investigation. The results corroborate the suspicion that Messrs Garcia, Gonzales and Schmidt are actually involved in this scandal. The notification of MROS is thus based on substantiated suspicions.

Politically Exposed Person (PEP)

Throughout the world, there are about 500,000 persons identified as PEPs. This means approximately 2,000 persons in each country, no matter what its political situation may be.

Head of states and other dignitaries, as well as Cabinet Members and Members of Parliament belong to the circle of PEPs.

Simple affiliation to a certain group of people does not in itself constitute suspicion. Together with other elements, however, it may provide the basis for further investigations.

Even members of the diplomatic corps are – despite their diplomatic immunity – registered in the PEP database of financial institutions.

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Recommended Reading:
Annual Report of the MROS; www.fedpol.ch

If a crafty money launderer was actually able to convince the bank of the legality of his assets and open an account, or if an account holder becomes delinquent, the transaction pattern quite often gives the game away. Substantial cash transactions or frequent transfers of significant amounts attract attention. Of course, such transactions may well be legal and justifiable. For this reason, the UBS specialists investigate conspicuous transactions based on the individual client profile. They compare the client's transaction pattern with that of a peer group. If any doubts persist, the client adviser seeks a consultation with the client. If such a discussion does not lead to clarification or if the client refuses to disclose the required information, a substantiated suspicion is filed with MROS and the relevant account is usually blocked.

Given the total number of four million retail and private clients, highly sophisticated systems are imperative for transaction surveillance purposes. UBS invests substantial funds in IT-based AML support systems. Its current objective is the availability of a data-warehouse with historical data serving as a basis for the identification of transaction behavior patterns and for building meaningful peer groups. According to Cusack, such expenditures have become necessary and in the long-term interests of the Bank. The challenge is in the selection, implementation and management of these IT-based tools in order to properly protect the Bank against accepting or dealing with criminal funds and in so doing, get value for money: the legal requirements in Switzerland and the Federal Banking Commission rules are particularly exacting. This, Cusack believes often leads to the perception in Switzerland that Swiss banks are saddled with a competitive disadvantage. In fact, the success Switzerland has had in dealing with money laundering is being emulated by others and recognized as international best practice, and so consequently a level playing field is once more being laid.

Fighting terrorism

The preliminaries of money laundering usually aim at obtaining an economic advantage. Hence, there is a fundamental difference in comparison to the financing of terrorism. The monetary transactions in support of terrorism are precursors to the act, and the transferred amounts are comparatively modest – a fact which presents particular difficulties for banks. Financial institutions are thus dependent upon a close cooperation with investigative and surveillance authorities, specifically on lists of names that can be run against their own client database. The 'Lists' provided by governmental authorities based on intelligence can be one of the most important tools in this context. It remains imperative, however, that the lists contain accurate and sufficient details about the persons identified and that the process leading up to the naming of persons on such lists has the confidence of the international community.

Cusack believes that with these safeguards in place there is no question as to whether or not such lists would contribute to eroding Swiss banking secrecy because, put plainly, Swiss banking secrecy does not protect criminals and terrorists. Only accounts for which a suspicion can be clearly substantiated are reported to MROS. In 2003, all institutions subject to MROS reporting filed a total of five notifications on account of suspected terrorism. During the year, in the aftermath of the twin tower disaster in New York, 95 notifications were filed. These 95 reports accounted for 99 percent of all the assets frozen on the basis of the 115 reports recieved since 11 September. In their fight against terrorism, the UBS specialists need to develop a particularly sensitive nose, since money is odorless – or is it?

The names in the above illustrations are purely fictitious.

1 Jean-François Thony (2004), "Money Laundering and Terrorism Financing: An Overview, in: Current Developments in Monetary and Financial Law", Volume 3, International Monetary Fund 2004.
2 Federal Department of Justice and Police, Money Laundering Reporting Office Switzerland (MROS): 6th Annual Report 2003: first published in March 2004.

Avoiding the regulators' red flag on outsourcing

Outsourcing may be good for your bottom line – but regulators want to know whether it's good for your customers. As regulators sharpen their teeth, be careful your plans don't get the wrong sort of attention.

Article by Michael Conover, Scott Harrison and John Machin

Outsourcing key business functions to offshore locations, and offshoring your own operations, are increasingly popular among financial institutions. When implemented properly, outsourcing has proven its potential for lower costs and increased flexibility.

Warning notes

However, regulators are sounding warning notes to financial institutions on the need to consider outsourcing carefully before taking the decision, following three recent developments.

The first is the type of activities being outsourced – which have moved 'up the value chain' from the back-office (data entry and order processing) to front-office activities much closer to the heart of regulated financial activities. For example, outsourcing partners in India are now providing mutual fund accounting activities, and dealing directly with firms' customers.

Secondly, many organizations are moving these outsourced activities offshore, whether through an agreement with an outsourcing supplier, an offshore 'captive' office where activities are conducted by the firm's own employees, or a mix of both. Popular destinations include India, South Africa and China.

And outsourcing doesn't work for everyone, which leads us to the regulators' third concern – the failure rate of outsourcing. Indeed, in a number of high profile cases recently, financial organizations have brought outsourced activities back in-house.

Together, these developments have led to significantly higher risks for firms – and regulatory concern that they will increase the risk of poor service to customers. The regulatory consequences for companies can be significant – from prevention of the outsourcing, to onerous control requirements to a damaged reputation with the regulator. All of these underline the importance of convincing your regulator that you have identified and mitigated the risks of any outsourcing.

What common principles of regulation apply?

Though approaches vary (see table overleaf for some examples), in general regulation shares three common principles:

- **Responsibility:** Outsourcing an activity does not mean outsourcing responsibility or accountability – in other words, you can delegate but not abdicate. Regulated firms must demonstrate proper due diligence on the choice of supplier, setting and enforcing service standards, implementing the right management structure to oversee the operation and introducing adequate monitoring. If outsourcing arrangements fail, it is the regulated firm (and its senior management) that will be subject to regulatory action.

- **Risk management:** Regulators expect firms to conduct a thorough analysis of the strategic issues and risks of the outsourcing (as opposed to keeping it in-house), to show that the benefits outweigh the risks and to have implemented strategies to mitigate risk. If regulators are not confident that the risks of outsourcing have been properly assessed and mitigated, in some jurisdictions they can prevent the outsourcing from going ahead or at least delay it.

- **Access:** Moving activities offshore does not place them outside the jurisdiction or reach of regulator(s). They have the same rights of access to operations conducted offshore and will exercise them. What's more, regulators now speak to their counterparts in other countries (see 'Expanding regulatory horizons' article on page 6) – so don't assume out of sight will be out of mind. This is particularly true for global outsourcing agreements with one service provider – we have often seen a problem in one country lead to discussions with regulators in other countries.

Although the principles are similar, each jurisdiction has different regulatory requirements. In emerging markets, such

Country	Regulator(s)	Approach	Developments
UK	Financial Services Authority (FSA)	Principle-based	The FSA is tightening up on outsourcers and is introducing further guidance in 2004 to strengthen the existing requirements. Key concerns are: • Risk rating of outsourcing proposals, including the specific risks of overseas jurisdictions (e.g. data privacy). • The supplier's capacity to take on the contract. • Appropriate oversight of the outsourcing. • Contingency plans and exit strategies. • In the case of offshoring, the extent to which the specific risks of the locality have been fully considered (e.g. infrastructural issues).
US	Office of the Comptroller of the Currency (OCC) and other banking regulators	Principle-based	The OCC issued official guidance in 2002, and the Federal Financial Institutions Examination Council is likely to issue additional guidance in 2004. Key concerns are: • Risks associated with the bank's outsourcing relationships. • Due diligence (including careful consideration of contract matters and choice of law and forum provisions). • Ensuring effective risk management practices are in place (including compliance risk). • Oversight of processes and how relationships with foreign service providers will be managed.
Germany	BaFin*	Rule-based (guidance has been issued under the Banking Act). Current rules do not apply to the insurance sector.	Key concerns are: • The extent to which the central management function is weakened by the outsourcing. The central management function cannot be outsourced under German rules. • The outsourcer's ongoing ability to control the risk of the outsourced activity. • Whether outsourcing contracts fulfill the regulatory requirements. • The control and monitoring of the performance of the supplier on an ongoing basis. • Whether the firm's controls and the audit rights of the BaFin and external and internal auditors are sufficiently guaranteed in the contract and in practice. • Whether the outsourcing leads to a 'virtual bank' which is not permitted under German law.
Hong Kong	Hong Kong Monetary Authority (HKMA)	Principle-based	The regulator has issued a great deal of guidance, with key concerns around: • Due diligence on suppliers. • What to include in the Service Level Agreement – including rights of access of the outsourcer, its auditors and regulator. • The adequacy of contingency plans. • Complying with legal obligations under the Banking Ordinance; an independent security assessment. • The firm's understanding of the issues specific to the offshore location (legal system – including data protection, regulatory regime, and infrastructure).

*Bundesanstalt für Finanzdienstleistungsaufsicht

as South Africa and China, outsourcing is moving up the risk register but specific guidance is still forthcoming. This adds to the complexity of a multi-site or global outsourcing, i.e. moving a number of operations in different countries to one location, or outsourcing to a service provider – who will deliver those services in multiple locations. In Europe there is recognition among banking supervisors of the risks associated with differing regulatory standards; for this reason, the Committee of European Banking Supervisors has published proposals for a set of principles to be adopted by regulators in order to provide a common regulatory approach on outsourcing.

Though regulatory powers vary from country to country, they may include:

- Requiring pre-approval for (and so power to prevent) 'material outsourcing'.
- Conducting supervisory visits of outsourced operations (wherever located).
- Ordering detailed investigations of outsourced arrangements by skilled persons.
- Requiring organizations to make alternative arrangements for the outsourcing.
- Ordering remedial action to address failings (including insourcing or choosing alternative suppliers).
- Disciplining and fining firms and senior managers for regulatory failings.

What brings outsourcing overseas up the risk register?

Offshoring raises particular risks that are high on regulators' agendas:

- **Market stability:** There is a concern that suppliers will over-commit, and too many businesses will be contracted with too few suppliers – which could constitute a risk to the industry as a whole. Market stability can also be disrupted by geopolitical and terrorist risks, so expect business continuity and disaster recovery plans to be scrutinized. Viable exit strategies are a must. Firms need to plan ahead and have back-up arrangements in case the supplier cannot meet the required standards either through a lack of finance, resources, or poor controls.

- **Protecting rights of customers:** Organizations must provide assurance that suppliers are adhering to standards for privacy, data protection and regulation (especially regarding customer contact). They must also demonstrate effective 'remote' oversight regarding the training and competence of staff performing the outsourced functions.

- **Reducing financial crime:** Locating offshore does not excuse financial institutions from establishing and maintaining effective 'Know Your Customer' and anti-money laundering (AML) procedures, which will need to be customized and appropriate to the delegating business.

Gaining the confidence of the regulator

Whether or not outsourcing/offshoring has to be formally approved, obtaining and maintaining the confidence of your regulator is vital. To achieve this, you must get your risk/reward ratio right.

The risks of outsourcing must be balanced against the benefits – before outsourcing begins and on an ongoing basis. Before it happens, you need to ensure the balance favors outsourcing – and not just in the short-term. And throughout the lifecycle of the outsourcing you need to be able to demonstrate proper oversight of the outsourcing, including appropriate monitoring of performance against service standards. If performance levels drop over a sustained period, there should be a formal process for determining whether to transfer to another supplier or take the activity back in-house.

To get the balance right, you need to:

- Identify the relevant risks, especially those relating to the location you have chosen.
- Measure the risks – this often means talking to people on the ground who can advise you how much of a risk infrastructure, availability of skills, etc, really pose.

An assessment based on a thorough consideration of all risks will be a valuable tool in establishing an open dialogue with your regulator(s). You should involve them at an early and appropriate stage, be willing to talk through your risk assessment and explain any areas (such as geographical, political and terrorists risks) that may need clarification.

With this foundation in place, you stand a much better chance of managing the long-term relationship with your regulator on a sound footing and getting the green light.

Conclusion

Outsourcing can be an extremely effective means of reducing costs while at the same time maintaining – or even improving – standards of service. However, regulators are increasingly recognizing the risks of outsourcing and acting to protect customers.

The primary requirement from a regulatory perspective is a strong risk control framework throughout the lifecycle of the outsourcing.

Those that fail to identify and mitigate the risks of outsourcing, or fail to manage their relationship with the regulator(s) in an appropriate way, face significant regulatory hurdles, from prevention of the outsourcing, detailed and costly investigations, and onerous reporting requirements through to taking the outsourced activity back in-house.

→ CEO discussion points

- → How material is this outsourcing to your business?
- → Why did you decide to outsource – what was the decision process and how was it documented?
- → What due diligence has been undertaken on the preferred supplier – capacity, governance, views of referees – and location?
- → Do the outsourced activities meet your organization's data protection, customer privacy, 'Know Your Customer' and AML standards and requirements?
- → What contractual arrangements have been put in place?
- → What contingency, including exit, arrangements have been established in the event of supplier failure?
- → What reporting arrangements are in place with the supplier?

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Tracking the European single market

The European single market is slowly evolving, but the long-term market impact remains uncertain. Financial services institutions need to understand how evolving single market legislation could affect them – as well as consider how they may still be able to influence its development. *By Dirk Auerbach, Richard Cysarz and Jonathan Jesty*

When the European Council met in Lisbon in March 2000, it set out an ambitious ten-year strategy to make the European Union (EU) "the world's most dynamic and competitive economy."[1]

The Financial Services Action Plan (FSAP) was conceived to achieve the framework for the completion of the single market in financial services. The FSAP is a program of 42 measures targeted for completion by 2005 that is designed to enhance competition and choice, deliver efficiency gains, fuel investment, and facilitate job-creation (see sidebar)[2].

Most of the FSAP measures (39 of 42) have now been agreed at the EU level (mostly in the form of new and amended EU directives), although several key directives have yet to be proposed or completed, including the Risk Based Capital Directive (the Basel parallel).

Financial institutions with operations in (or wishing to be active in) Europe need to understand, and establish how best to participate in, this evolving process (see sidebar on following page).

Wholesale vs. Retail Market Impact

The status of the single market and the impact of the FSAP are very different for the wholesale and retail markets.

Different countries still have varying aspirations about how harmonized the European market should be and how quickly. "We are probably all working towards the same goals, but such a market could arrive at different times in different sectors", Michael McKee, Executive Director of Wholesale Banking and Regulation within the UK's British Bankers' Association (BBA), tells KPMG.

Wholesale

- A cross-border market in inter-bank, bond, and over-the-counter (OTC) instruments has thrived for many years, though less so in the equity markets.
- Anticipation of the single market, along with the introduction of the euro, has been broadly encouraging of the cross-border market.
- Clearing, settlement and payments infrastructures are commonly agreed as a future priority area for further integration.
- The revised Investment Services Directive (ISD) is expected to drive more competition between exchanges and market participants for market share and the trading of European securities.

Retail

The retail markets have so far remained essentially local. National champions remain the dominant model. Structural obstacles to consumers embracing the concept of buying retail financial products 'cross border' are considerable. They include:

- Language differences.
- Culturally disparate approaches to personal financial planning and savings.
- Desire for face-to-face advice on investment products (despite the growth of internet business).
- Ingrained retail distribution structures, particularly retail banks, against the background of, in some countries like Germany, a highly fragmented banking industry.
- Still divergent consumer protection rules.
- Disparate tax regimes.

Getting to know the Financial Services Action Plan (FSAP)

The FSAP is intended to:

- **Complete a single EU wholesale market** – in which market participants can buy and sell financial instruments freely across borders and raise capital in other member states on the basis of domestic financial disclosure documents.
- **Create open and secure retail markets** – in which financial institutions can provide services to EU consumers on the same terms and conditions as they do domestically.
- **Establish high and consistent prudential requirements** to help ensure the safety of the financial markets and support the full utilization of the single 'passport' based on home-country authorization and supervision.

Progress in achieving anything like an effective single cross-border retail market varies greatly across sectors. One of the greatest areas of achievement is in the marketing of retail mutual funds. Here, significant progress has been achieved through 'BtoB' marketing of fund products, rather than 'BtoC' relationships, as Sheila Nicoll, Deputy Chief Executive of the UK's Investment Management Association (IMA), points out to KPMG. As competition increases, and investors and distributors become more educated

Lamfalussy and CESR

The FSAP enables financial services institutions to influence how the regulatory requirements develop at four levels of the process: the Council, the Parliament, the Commission, and the Regulators.

"The biggest benefit of the FSAP," says McKee, from the BBA, "is that it's driving discussion between the member states, the market participants, the regulators and the law-makers, about what sort of European capital market they want. And even though some of those participants may be more reluctant than others to be driven forward, on balance that is what's happening – Europe is being driven forward to a more integrated, developed pan-European market, in a range of products".

To that end, the 'Lamfalussy approach' was designed within the FSAP process to speed up and increase the effectiveness of the single market regulatory initiatives. It created the Committee of European Securities Regulators (CESR), a group of 25 regulators (one from each member state), who work together on regulations and measures to implement the directives. Similar committees in the banking and insurance sector have also been created.

Says McKee, "We think that Lamfalussy is the right approach because it allows the regulators to work on more common approaches in discussion with industry and the EU institutions."

Financial institutions have the opportunity to influence policy developments at the various levels, in particular during consultation on the directives themselves, CESR's recommendations and proposed regulations and proposals for national implementation.

Involvement sooner rather than later is important, as any involvement left until national implementation may be severely limited.

"A legislative framework in and of itself does not deliver a single market," notes McKee. "A single market is delivered by economic actors, fund managers, corporations, all seeing economic opportunities in cross-border business. On the other hand, the FSAP will produce a range of changes that will lead to better integration – but not necessarily complete integration."

There is widespread skepticism about how much overall economic difference the single market will make in the short-term.

and selective, this trend should continue. However, there's much still to do and the IMA is seeking change in three areas in particular:

Deregulation of local registration requirements: The IMA believes that the European passport under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive (which established mutual recognition of mutual funds meeting prescribed criteria) should mean what it says: if a fund is accepted as a UCITS in one state, it should be marketable in the others. There should be no need for restrictive and time consuming local registration requirements.

Facilitation of fund mergers: It is very difficult in some member states to merge funds domestically and even harder to do cross border; simplified, harmonized rules are needed to make this much easier and enable firms to reap the benefits of consolidation and efficiency. The European market is half the size of the US but has three times as many funds. The IMA believes that consolidation is overdue.

The ability to pool: firms should be able to centralize as many of their back-office functions as possible so that they can operate one product infrastructure and adapt their offerings to different markets, rather than replicate their operations across all the states in which they have products.

"These are needed steps we hope will be part of the ongoing UCITS debate", says Nicoll.

Time to focus on enforcement

The greatest threat to the hoped-for economic benefits from the FSAP will likely be market distortion arising from situations in which individual member states choose to go beyond the requirements of the directives (so-called 'super-equivalence') or a failure on the part of regulators to enforce the new standards.

So far, implementation of the various measures (and predecessor directives) has been mixed:

- Ambiguity in directive texts allows inconsistent and sometimes illogical implementation.
- Additional local regulatory rules, registrations, and approvals often conflict with the spirit of the free market, sometimes veering toward protectionism.
- Differing interpretations by member states of directive requirements, or different domestic regulatory 'overlays', result in vastly different impacts in member states.

➜ CEO discussion points

➜ How well do I understand the FSAP and how it could affect my business model?
➜ What key potential European scenarios should I be planning for?
➜ Has my organization sought to influence the European debate? What are the priority issues for us to influence?
➜ How well do we use our trade associations?
➜ To what extent have we considered what opportunities there are in accession countries?

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At the same time, a consensus is emerging that the focus should now be on effective implementation and enforcement of existing directives; little appetite remains for additional legislative initiatives. Both the Commission's and CESR's recent reviews have promised such a focus – a move that will be welcomed by institutions that want to penetrate a single, free market. But enforcement of single market legislation alone will not be enough to address the remaining gaps. More robust controls around competition and proactive enforcement of competition law will likely also be needed.

Issues for accession countries

The challenges of a multi-faceted European regulatory regime that has evolved over decades are exacerbated for the ten accession countries, which joined the EU in May. By 2007 there will be 27 member States in the EU.

However, many accession countries' banks have already been purchased by large EU banks, which are already familiar with the European agenda/ regulation and direct compliance arrangements from their established EU head offices. But for others, and for the regulators, the 'catch up' challenge will be significant.

What institutions can do

What can – and should – institutions do in this environment?

- **Consider the potential impact of the directives on your business.** Effective consideration needs to be at several levels: strategic, operational and compliance. Many focus (if at all) only on the latter, to their potential long-term cost.

- **Plan for different scenarios within Europe.** Various very different economic outcomes (and timings) are still possible as a result of regulatory and other changes, and they will vary across sector. Is your business strategy 'stress-tested' against potential scenarios?

- **Don't wait for national implementation proposals.** It may be easier to understand them and their practical effect, but by the time they emerge it is probably too late to change them. Keep an eye, especially, on the CESR proposals, as this is the level at which substantive policy is now made.

- **Use and participate actively in trade associations.** Find out what issues they are championing, whether you agree, how you can use them to help you keep track and leverage your voice.

Conclusion

When considered alongside the compliance issues financial institutions face in implementing Basel II, International Financial Reporting Standards (IFRS), and other evolving regulation, just keeping track of the various FSAP and other European initiatives represents a tough challenge. And there is widespread skepticism about how much overall economic difference the single market will make in the short-term.

Over the longer term, however, consistent regulation and also deregulation, if achieved, should gradually be recognized as a cornerstone of a free, open, single market in financial services, with the attendant benefits of competition, efficiency, and choice. But there is a long way to go, and factors other than regulation are more likely to set the pace – factors such as the speed of wider acceptance of the euro, appetite for major cross-border bank mergers, progress with tax harmonization, and the extent of enforcement against national anti-competitive practices.

1 http://europa.eu.int/comm/lisbon_strategy/index_en.html
2 Frits Bolkestein, Member of the European Commission in charge of the Internal Market, Taxation an Customs, "Learning the lessons of the Financial Services Action Plan," Address at Edinburgh Finance and Investment Seminar Edinburgh, 29 January 2004. http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt =gt&doc=SPEECH/04/50|0|RAPID&lg=EN

A quiet revolution

China's financial regulators are broadly sticking to the market opening promises of their World Trade Organization (WTO) commitments, but will they relax their iron grip on foreign business operations? *By Jack Chow, Paul Kennedy, Bonn Liu and Stephen Yiu*

China's accession to the WTO has profound implications for the country's financial services markets, with an ongoing program of deregulation which will open China fully to foreign competition by the end of 2006. Exactly what the transformed industries will look like is anyone's guess, but with the Chinese economy in transition and regulation in a state of flux there are clearly risks, challenges and opportunities in equal measure.

Since the markets originally opened in the 1980s, foreign financial enterprises in the country have operated under a regulatory straitjacket, with many experiencing painful losses. Their fate is now in the hands of China's three new independent financial regulators, the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC) and the China Securities Regulatory Commission (CSRC). The regulators' priority is healthy development of the home market. Restructuring and new regulation are therefore geared towards increasing the competitive ability of domestic businesses in preparation for when things really open up.

Rates of change and progress across the banking, insurance and securities markets differ, but a common theme is that regulators welcome foreign investment and want local businesses to be able to learn and improve through joint ventures. However, there are still stiff entry qualifications and tight limits on investment and business scope – all of which may have the effect of maintaining barriers to entry. A key challenge for foreign businesses is to understand and negotiate the complex regulatory framework and ensure appropriate regulatory risk management structures are in place to ensure continued compliance.

Let us consider the current position in the quite different sectors of banking, insurance and securities/fund management.

Is the tide turning for foreign banks?

Despite the tight regulatory restrictions, high capital requirements and low returns which have kept foreign banks out of many sectors of the market, bottom line results have been slowly and steadily improving and asset bases increasing. The number of foreign banks obtaining licenses for new branches or Renminbi business has also been growing steadily. Now in 2004, it's clear that the frosty attitude of China's regulators to foreign banks is finally thawing.

The last year has seen renewed focus by China's policy makers on restructuring the beleaguered state banks, culminating in the December 2003 injection of US$45 billion[1] of China's foreign exchange reserves into two of the big four state banks (which together account for two thirds of the country's banking assets).

The formation of the CBRC in April 2003 saw a marked change of attitude to the role foreign banks can play in developing the local banking sector. Encouraging moves from the CBRC have included a proposal to reduce capital requirements and increase the upper limit for foreign investment in local banks. BNP Paribas formed China's only wholly foreign owned bank[2] when it bought out its joint venture partner in October 2003. In February 2004 a handful of major foreign banks were granted licenses to carry on local currency business with People's Republic of China (PRC) corporates, continuing the market-opening trend that will culminate in granting access to the lucrative local currency retail business some time after December 2006.

However, the regulator is unlikely to loosen its grip on existing and new foreign bank branches. New licenses for existing branches will continue to require two years' profitable operation at branch level. Foreign banks will be limited to a maximum of one new branch a year. Regulators are also likely to continue their requirements for high levels of capital at individual branch level – regardless of the bank's overall capital

→ CEO discussion points

Entering the Chinese market for the first time

- → Do we have a clear understanding of the regulatory requirements in our proposed market sector?
- → What are our requirements for speed of entry into the market versus control?
- → Do we know enough about potential joint venture partners, their culture, aspirations and strategies?
- → What regulatory risk factors are likely to have an impact on our financial model (for example pricing deregulation, relaxing of sales and investment channel limitations)?

Existing interests in China

- → Do we fully understand the regulatory risk profile of our existing Chinese interests?
- → What influence do we have on the direction of thinking of regulators?
- → Do we have a clear strategy to handle change as the Chinese markets open up?

A key challenge for foreign businesses is to understand and negotiate the complex regulatory framework and ensure appropriate regulatory risk management structures are in place to ensure continued compliance.

position. In addition it is expected that foreign banks will soon be required to recapitalize those branches that have significant accumulated losses brought forward from prior years, regardless of current levels of profitability.

The market will become more competitive. Local banks are adapting quickly to improve their service and can be expected to leverage their access to cheap funds from local savings and their branch networks. This, together with regulated interest rates and the lack of a convertible currency will continue to frustrate foreign banks and limit their ability to exploit their competitive advantage.

As a final twist, China has recently given fast track access to Hong Kong incorporated banks through the Closer Economic Partnership Agreement (CEPA) signed with Hong Kong last year. This will bring a batch of hungry Hong Kong banks to join the party – in particular in Southern China where they will enjoy a cultural advantage. Sixty-two foreign banks with 191 branches and sub-branches[3] are already operating in China's larger cities, in what might fast become an over-banked market.

Despite the many challenges, the outlook is more positive. While regulation remains restrictive, it is gradually moving closer to less oppressive international norms. The economy remains vibrant and consumers are showing a distinct appetite for credit products. Access to the retail market is within sight. Those canny enough to negotiate the pitfalls and stay the distance may get one of those fabled money-printing licenses after all.

Changing the shape of insurance

Since the mid 1980s, when Chinese insurance was dominated by the People's Insurance Company of China (PICC), the industry has moved slowly toward a more competitive model. But there is still a long way to go:

- The life market is in its infancy. Three insurers hold 92 percent of the market[4] and penetration is low:

China's potential

Domestically, the State banking and insurance sector faces serious restructuring to make it efficient and competitive. Financial enterprises are dogged by historical problems including overstaffing, weak internal controls, poor or mandated lending and investment decisions, and a market which historically has not required the breadth of products offered internationally. There is cultural resistance to borrowing and debt, and the choice of quality products for investment is limited.

On the upside, China's potential as a growth market for financial products is vast, both in traditional banking and the developing insurance, investment banking and securities sectors. Fast economic growth, boosted by exports and substantial foreign direct investment, has led GDP to increase by 9.1 percent in 2003[6], higher than most other countries, and this rapid expansion demands capital. Wealth levels are on the increase: the richest 10 percent enjoy an average disposable income of US$2,300 per month.

Those at the high end of the income spectrum will clearly demand more sophisticated and competitive financial services and products, as will business enterprises in busy sectors like import/export. One indicator of the market's potential is the country's substantial savings rates, currently running at 42 percent of GDP in 2002[6]. Local banks are sitting on almost US$1.25 trillion in household deposits[7]. On the credit side, the potential for consumer banking services is indicated by the current very low penetration in credit cards: only one million[8] real credit cards circulate in China compared with approximately 450 million debit cards[9]. Growth in total consumer credit has also been around 50 percent per annum for the last two years.

premiums were just 3.33 percent of GDP in 2003[5], compared with a world average of 4.7 percent

- Non-life is dominated by one player with 70 percent[10] of the market (the top three hold 94 percent[4]). But there is fast growth, boosted by growing disposable income, increasing investment in fixed assets and rising ownership of motor vehicles and private homes.

Until recently, the regulators have been sticking to their guns about strict segregation between life and non-life business. However, since its formation at the end of 1998 the CIRC seems now to be having a change of heart. The CIRC has issued a revised rule allowing both life and non-life players to provide short-term health business and accident business.

In common with the banking industry, China's insurance businesses are in need of large cash injections to resolve capitalization problems. Over the last two years, the regulator has revised the solvency margin regulations. Domestic insurers are keen to resolve this issue by IPO listing or by inviting foreign investors to inject capital.

In China, although insurance companies and banks cannot participate in each others' businesses, bancassurance is becoming an important distribution channel for insurance. Bancassurance is allowed on very restricted terms, in that banks can carry products on behalf of insurance companies – but strictly on a branch by branch basis rather than through a centralized relationship. The regulators are determined to keep sectors separate and this is unlikely to change in the near future.

We are, however, seeing a more relaxed attitude to the insurance companies' investments. In the past, they were not allowed to invest in equities or any other high risk vehicles. Now the investment market is opening up and returns are improving, the regulator is slowly starting to permit insurance companies to participate. We can expect to see

Finding your way around the regulatory maze

Foreign entities often find the regulatory environment onerous because they have less knowledge of the system, what is required and what is standard practice. Clarification of regulations can be difficult to pin down, can change without notice, and can be applied with different emphasis by different officers. As a result, the cost of ensuring compliance – as well as the risk of non-compliance – can be very high. As a foreign entrant, you need to be aware of the subtleties of application and practice.

Why might the rules be unclear?

The local Bureau may interpret regulations differently to the State and adopt different practice. To make things more difficult, it is not common for regulators to issue written conclusions – they prefer to give you an oral answer. The risk here is that if the officer in charge moves on to a new post, the new incumbent may change the decision about your case.

It can be difficult to find your way around which authority stands behind the various rules, circulars and notices issued by different supervisory bodies. For example, regulatory bodies may issue rules or circulars on accounting and disclosure for certain items which are not consistent with those issued by the Ministry of Finance (MOF), and it may not be obvious whether clarification should be sought from the regulators or the Ministry.

It can also take a long time to cascade a new rule from the State to the provinces. Usually, the local Bureau will need a specific, detailed rule in place before they will implement any new State regulation.

Complex communication channels

Foreign investors may have difficulty even arranging meetings with the regulators. Additionally, the scope of work of each sub-division of the regulators is very specific and may be rather narrow. Foreign investors may need to arrange a number of separate meetings with the regulator's license approvals, business and accounting departments to work out the possible solution to a complex issue. And even if you do all of that, it can be difficult to obtain a firm final answer.

Building a good relationship with the regulators and policymakers is clearly the key to speeding up the business establishment process. Some businesses have approached this by hiring ex-regulators as consultants, to advise them on how to negotiate the regulatory system, make the right connections and establish channels of communication.

Heavy administrative burden

The regulators have a lengthy catalog of matters on which market entrants have to seek approval before they can proceed. Regulatory reporting for established entities is also very paper intensive and bureaucratic. Even opening a bank account in a foreign currency can be a tedious process requiring approval from both the respective business regulators and the State of Administration of Foreign Exchange. Even though this situation is likely to improve, it is also likely filing requirements will remain burdensome for the foreseeable future – and that means lots of paperwork.

major growth in asset management as a consequence.

Securities: majoring on fund management

In the PRC securities arena, fund management seems to be the sector of most interest to foreign players. Securities brokerage is out of bounds and although there are some Sino-foreign joint ventures in securities, they are limited to areas like advisory work and IPO underwriting.

At 31 December 2003 there were 35 licensed fund management companies in China, managing 95 funds[11] worth around US$22 billion – small potatoes in relation to the total assets of banking and insurance. But fund management has only existed as a regulated industry in China since 1997, and up until 2001 it was completely closed to foreigners. The regulator – the CSRC – is tenaciously pursuing reforms to strengthen the financial markets and enhance corporate governance. Their goal is to establish a mature industry, harnessing the technical capability and experience of the large international players in mutually beneficial joint ventures.

The CSRC deals with investment funds that manage listed assets. It grants approval to the business plans of fund management companies, and sets eligibility conditions for their senior managers. Unlike the banking regulator, they grant licenses for nationwide operation.

Foreign institutions can either set up a joint venture arrangement with a local partner or acquire an interest in an existing Chinese firm. The foreign partner can hold a maximum stake of 33.3 percent, increasing to 49 percent by the end of 2004[12]. In practice, foreign investors are putting policies and shareholder agreements in place to protect their interest as far as possible despite having a minority interest in the joint venture. Only securities houses or trust investment companies are permitted to set up fund management firms. Almost all successful foreign interests in fund management businesses to date are joint ventures with Chinese securities firms, rather than fund management firms. From June 2004 new legislation comes into force to cope with the new products these companies are issuing[13].

Entrants need a large capital base (approximately US$39 million paid-up share capital) and the founding partners must have recorded profits and have a clean record with no regulatory violations in the three years prior to setting up. No foreign firm can invest in more than two fund management firms in China, and can be in a controlling position in only one of them. There are also tight regulations on joint venture funds specifying everything from the minimum number of subscribers at launch (100) to the maximum eventual size of the fund (US$25 million[14]).

The macroeconomics of China indicate good prospects for foreign investors in this sector: there is a large savings pool and an absence of products to invest in. Most intriguing of all is the predicted pensions shortfall. The government is looking to offload the 125 billion yuan[14] state pensions burden: professional management of these funds will probably be called for, and the State pensions operator has already made the first moves toward this by inviting six domestic fund managers to manage part of the portfolio. We believe the plan is gradually to permit a proportion of pension assets to be diversified in equities directly or via domestic mutual funds.

Patience is a virtue…

As the WTO terms kick in there should be a leveling between foreign and domestic businesses. Over time, the regulators want to create an environment where local financial services operators are more modern and competitive. Foreign investors will find their niches, develop by joint venture or acquisition and settle down to servicing their chosen markets. However, growth may be slow and steady rather than dramatic.

Ultimately, success for foreign investors will depend on setting the right price and building trusting relationships with regulators, government and local partners. The rewards should be worth waiting for.

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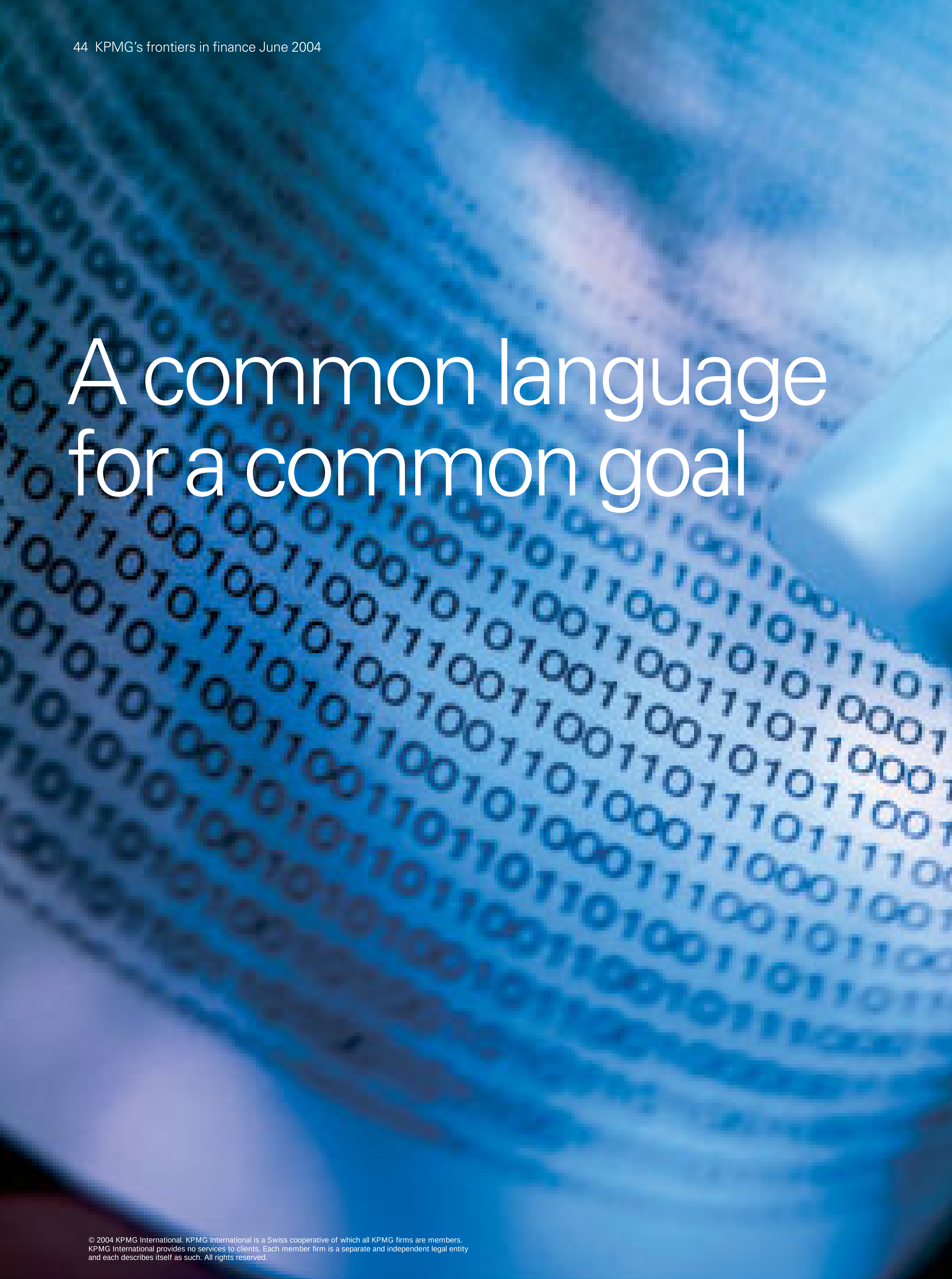

A common language for a common goal

Regulators worldwide are working to improve reporting processes with the help of the computer language XBRL. A coordinated approach to regulatory reporting will be one of the first ways that financial services entities can benefit from its use.

By Michael Elysée, Geoff Shuetrim and John Turner

The drive to enhance business reporting is fast accelerating among regulators and industry groups around the world. What's more, in response to higher levels of market scrutiny and an intensified regulatory environment, leading financial services organizations are working toward closing their books faster, more accurately, and with greater confidence. They are also stepping up their efforts to improve the education of investors and analysts.

The success of such efforts ultimately will depend on two key factors:

- The quality, integrity, and timeliness of information; and
- The evolution of web-based technology tools that increase the flexibility and comparability of reported information, thus enhancing its value.

XBRL (eXtensible Business Reporting Language) 'fits the bill' as an important innovation that is gaining momentum worldwide in meeting these two goals.

Financial sector regulators and XBRL

XBRL is also receiving substantial attention from regulators worldwide as a way to reduce provider burden and to improve the quality of information used by government. Among the more prominent to announce its use are the US Federal bank supervisory agencies, the UK Financial Services Authority (FSA), and the US National Association of Insurance Supervisors, while many others are examining its utility.

We believe that ultimately XBRL will underpin improvements across the spectrum of business reporting.

Moreover, credit and investment decisions will gradually evolve to depend on ready access to financial information in XBRL form. Initially, companies providing data to capital markets in this format will stand out. Over time, we believe use of XBRL will become a business necessity.

Thus, XBRL warrants the attention not just of financial institutions' IT departments but of their senior leaders.

The ABCs of XBRL

XBRL is a freely available standard developed by a 200 plus member international not-for-profit consortium. Members include accounting organizations, regulators, financial institutions, corporations, software vendors, and government entities.

Often referred to as 'bar codes for financial statements,' XBRL provides organizations with a way to prepare,

Figure 1 So why consider XBRL?

	Paper	Proprietary non-XML	Proprietary XML	XBRL
Facilitates system-to-system data integrity	○	●	●	●
Supported by development tools in use by companies	●	○	●	●
Supported by accounting packages in use by companies	●	○	◓	●
Facilitates data definition	○	○	◓	●
Facilitates validation definition	○	○	○	●
Can leverage public accounting framework	○	○	○	●
Implementation time	●	●	●	◓
Availability of technical knowledge	●	●	●	▾

Proprietary Non-XML – an in-house definition and messaging technology.

Proprietary XML – an in-house designed data representation for moving information from one system to another. Like XBRL but without the benefit of being a standard that many systems conform to.

● Fully meets this criteria
◓ Partly meets this criteria
▾ Somewhat meets this criteria
○ Does not meet this criteria

XBRL offers sophisticated users of information a new way to define and automate data exchange, without the need to replace existing systems.

publish in a variety of formats, reliably extract, and automatically exchange a wide variety of business reporting information – financial and otherwise. Use of XBRL allows organizations to:

- 'tag' or label information so that it has structure and context;
- enter it into a system once, and then;
- make it available for multiple purposes and in a variety of accounting environments.

Pros and cons

Of course, XBRL is a very new technology, and it has been slow to accelerate. Without the right technical support, which to date comes from a small number of vendors and service organizations, users face relatively slow implementation times while technical knowledge improves. Scarce resources certainly drive up the cost of adopting a new technology, and that is something users will likely face in the short-term. However, we believe that financial institutions should begin to examine XBRL. Reasons include:

- The standard has stabilized.
- Vendors are adopting XBRL quickly.
- Regulators are increasingly treating the standard as something they have to move towards.
- Taxonomies (the XBRL representation of reporting standards) are being finalized.
- Tools, techniques, and familiarity with the technology are starting to become an action point for IT professionals in the financial sphere.

XBRL in action

XBRL is already a prominent issue for accounting organizations around the world, and substantial effort has gone into the development of accounting concept classifications (called 'taxonomies') that express accounting standards in XBRL:

- The American Institute of Certified Public Accountants (AICPA) has led the effort to capture US GAAP.
- The International Accounting Standards Committee Foundation (the IASB governing body) has sponsored the development of International Financial Reporting Standards (IFRS) taxonomies.

In addition:

- The **Danish Commerce and Companies Agency (DCCA)** now allows electronic filing of company financial statements in XBRL, creating greater visibility and improved transparency for Danish businesses and the framework for improved compliance reviews.[1]
- The **US Federal Deposit Insurance Corporation (FDIC)** is replacing its most important quarterly data collections from banks with mandatory XBRL-based filings, reducing by half the time needed for US bank regulators to process these returns and release information to bank examiners. The development directly affects the approximately 9,000 US banks that must submit the quarterly financial filing forms known as 'Call Reports.'[2]
- The **UK's Inland Revenue** department has developed a set of XBRL taxonomies that will allow the agency to shift from paper-based to XBRL-based electronic filing of corporate tax returns.[3]
- Responsible for analyzing the financial regulatory filings provided by Australia's 12,000 banks, insurers, and pension funds, the **Australian Prudential Regulation Authority (APRA)** has offered these financial institutions the option of filing in XBRL format since 2001.[4]

Already supported by the large ERP vendors, the standard is increasingly being supported by a wide range of accounting vendors as well as specialist consolidation and reporting tools.

More information is available at www.kpmg.com/xbrl

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➜ CEO discussion points

- ➜ Are our IT professionals familiar with XBRL?
- ➜ Do our staff manually re-enter general ledger transactions and business unit financial statements to get them from format to format?
- ➜ Should we be examining the impact of XBRL on the cost of carrying out credit assessments?
- ➜ Are our regulators moving to use this standard? If so, can we encourage them to coordinate their efforts with those of other jurisdictions in which we operate?
- ➜ Are management decisions supported by business performance measures? Is the enterprise run from reliable numbers? How often does 'gut feeling' substitute for quality data?

Why XBRL is important to financial institutions

Harmonized regulatory reporting

Financial services organizations that operate across country borders generally need to provide regulatory data in every country in which they are licensed. Similar but slightly different reporting obligations create re-work and substantial effort, not just for accounting, capital management, and risk management specialists, but also in terms of IT capital spend.

For the first time, XBRL allows regulators to cooperate across borders and agree not just to the broad principles associated with regulation but also to the specific definitions of regulatory reporting concepts. We believe financial institutions are well placed to encourage this type of cooperation.

Enhanced credit risk analysis

Reducing manual effort is the top priority when examining the efficiency and effectiveness of credit scoring. We have found that banks that can shave even a small proportion of the cost of this business process will do so. By reducing processing costs with XBRL, financial intermediaries can also realize improved levels of analysis. Better information, benchmarking, and more frequent review of a client's financial performance should benefit banker and customer alike.

Improved business processes

For banks and other large-scale users of complex internal management information, the ability to acquire financial statements and management reports in a platform-independent format via XBRL should help simplify complex reporting processes and help leaders to make quicker and more reliable decisions. Manual processing (i.e. re-keying and data handling) accounts for too much of the real-life time, effort and risk associated with report production. Each time information is re-keyed or manually transformed, the process is slowed and, inevitably, errors occur. XBRL offers sophisticated users of information a new way to define and automate data exchange, without the need to replace existing systems.

Conclusion

Over the next several years we expect to see increasing pressure from market participants on the reporting function of those companies seeking debt and equity. Much of that pressure relates purely to regulatory and market reform concerning disclosure rules and practices. But some will relate to the seemingly mundane issue of information supply.

Eventually, a new equilibrium will be reached. Providing performance information in XBRL form will be the norm, and we believe those that fail to do so will be penalized by the market via reduced visibility and other barriers, including handling and administration charges. And until that time we expect to see increasing incentives for companies seeking capital to embrace XBRL in their reporting strategy.

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The Basel II and Organisation for Economic Co-operation and Development (OECD) consultations continue to move forward in parallel, with similar timeframes – emphasizing the impact tax and regulation have on each other and the regulators' sharpening focus on tax as an operational risk.
By Jörg Hashagen and Jane McCormick

Basel II, OECD and tax: a complex relationship?

Basel II is nearly upon us. The tax implications of the new Basel Capital Accord may not be at the top of everyone's agenda, but they will bring major change and they coincide with the OECD's ongoing discussions about international taxation.

However, many organizations are considering how to restructure operations to meet the new Basel Accord. If you intend to do this, you need to consider the tax implications carefully – both now and in the future as your capital funding structures change over time. If you do not, you run the risk of your regulatory capital being eroded by taxation.

Depending on the final shape of the new Capital Accord, your capital requirements may be greater or less. With Basel II less than a year off, many banks are already putting funding in place to cover extra capital requirements – although it is difficult to quantify how much you need and in some cases you may ultimately need no extra funds. One certainty is that once you start to move money around your organization, there are going to be tax consequences – possibly even tax costs.

Also, regulators are increasingly aware that tax is itself a significant operational risk. So how are you responding to the tax implications of Basel and the regulatory requirement to manage tax risk? Do you understand how tax and regulation impact on each other and what you should be doing now to prepare?

Basel II and the OECD 'working hypothesis': a complex interrelation

The original Basel Accord adopted a 'one size fits all' approach, under which it was relatively easy to identify where market and credit risk belonged and allocate it appropriately around the world.

Basel II, effective in 2007, is going to mix things up a little. Firstly, it will introduce a more sophisticated way of categorizing loan assets, allowing banks to differentiate between relatively low- and high-risk lending. But it also adds a tricky new element into the mix: operational risk.

For those planning to adopt more advanced approaches to operational risk, allocating risks and associated capital geographically could present a complex problem. If your risk lies in your IT systems or your management structure, how can you say where in the world that risk belongs? One thing is certain: tax, as a major element of operational risk, will now have more effect than ever before on capital requirements.

Since the release of its initial discussion document concerning the taxation of Permanent Establishments (i.e. branches) in 2002, the OECD has continued to grapple with the issue of double taxation. The current drafts of the working hypothesis cover banks and global trading organizations and came up for another round of discussion in March 2004. Their basic proposition (referred to

as the 'working hypothesis') is that branches should be taxed broadly as though they were separate legal entities and that regulatory capital should be allocated to individual international branches according to the risk-weighted assets of each branch. If this practice is adopted, the tax treatment of branch banks will be inextricably linked to the bank's regulatory capital.

Key questions still unanswered

Some countries may be 'early adopters' of the working hypothesis: the UK, for example, has decided not to wait for final conclusions, and has already put legislation in place in line with current OECD thinking with effect from this year. On the whole, though, it is likely to be some time before the OECD publishes full conclusions and their approach is adopted internationally. In this light, it is surprising that the OECD's debate is still being conducted with reference to the existing Basel Accord, without taking into account the changes expected under Basel II.

The action which financial institutions take to manage their regulatory capital position will have a big tax impact.

There are big problems with the working hypothesis even under the existing Capital Accord, largely because it requires banks to divide risk assets between geographic locations whilst Basel looks at the bank as a whole. The working hypothesis might be more valid if risk measurements only referred to credit risk. The inclusion of market risk makes the proposition much more difficult to sustain: a global banking operation may well hedge market risk across different locations. It gets even more difficult with Basel II's inclusion of operational risk. The fact that operational risk cannot necessarily be tied to physical operations in a particular jurisdiction is given no consideration in the OECD discussion document.

Another problem which the working hypothesis raises is that a proportion of regulatory capital may be in the form of debt instruments or 'innovative' structures, which may carry tax deductible interest under the tax rules of a bank's home state or under those of the particular branch which issued the instrument. The question remains how these instruments should be dealt with, especially where payments are deductible in one jurisdiction which would not be deductible in another. This problem will remain under Basel II.

What action can you take now?

Making strategic decisions – plan ahead

Assuming that both Basel II and the OECD working hypothesis are adopted, the action which financial institutions take to manage their regulatory capital position will have a big tax impact, both in terms of overall taxable profits and the jurisdiction in which they are taxed. Long-term strategic decisions about the location and funding of operations should be taking this impact into account. A healthy exercise you can carry out now is to look carefully at where you are locating risk, where there might be degrees of flexibility in relocating it, and quantify the relative impact on tax costs.

In considering long-term structures it is also worth bearing in mind that the capital funding requirements of different businesses are likely to change as a result of the new Capital Accord. Some businesses, such as mortgage lending where there is a high level of collateral, may require less capital in the future. Others — especially those where there is a high degree of operational risk – will need more. Moving capital, especially across international borders, often has a tax cost. This means that ideally any capital funding structures put in place should be capable of being unwound or restructured in the relatively near future without adverse tax consequences. Capital funding structures may be available which should help banks to achieve this flexibility.

The question you need to ask is where and how tax issues might arise which could directly or indirectly have a significant adverse impact.

Smart use of compliance data

If your organization is aiming to adopt the internal ratings based approaches to credit risk, you are probably putting models in place to measure and monitor risk assets in preparation for Basel II. Your tax professionals need to take a look at what is proposed, to assess whether the models will help in collating the data you need for tax purposes, if the working hypothesis is adopted. Significant additional compliance costs could be in prospect if you need to put together a completely separate set of data for tax purposes. A good question to ask is whether the data you are collating on risk-weighted assets can be split on a geographic basis and whether – if you are making changes to your systems/implementing new systems in order to meet the Basel requirements – the needs of your tax department can be taken into account in relation to data collection and analysis.

You may also need to consider where assets are booked and whether the booking location can be defended as valid for tax purposes. The OECD may consider representations on this point, but one can foresee circumstances in which the initial booking location of assets (or their transfer between branches) may not be accepted. This issue can be particularly difficult where booking is centralized for purposes of operational efficiency or in the case of global banking facilities.

What we really need is further guidance from the OECD: the existing discussion of this issue is somewhat outdated and very limited on the question of capital. Greater cooperation between the OECD, Basel and the EU would be most helpful. As an organization, it may be helpful for you to engage personally with regulators on the tax implications of the New Accord.

Looking at tax as an operational risk

Tax is an operational risk. Any financial institution intending to adopt the advanced approach to operational risk will be interested in tax risk management, and it's certainly an area regulators are becoming more aware of since it can erode capital if not managed effectively. The question you need to ask is where and how tax issues might arise which could directly or indirectly (e.g. by affecting the viability of a particular product) have a significant adverse impact.

To be classed as good managers of tax risk, banks will need to take a comprehensive approach to identifying where tax risk may arise and develop approaches to monitoring and managing these risks – many and varied as they will no doubt be.

Experience suggests that financial institutions tend to be good at managing risk in areas where the tax position of the organization itself is a core component of the business in question – leasing, for example. They are less good at identifying and managing the more obscure or non-core areas of risk: for example, where the risk is that the tax impact on a customer or counterparty is not as represented to them.

Giving thought now to developing a solid strategic approach to management of these risks is sure to pay off.

→ CEO discussion points

- How well have we evaluated the tax costs associated with restructuring in order to meet regulatory capital requirements?
- How confident are we that our tax risk is well controlled?
- Where might we be at risk of double taxation as a consequence of Basel II? Have we taken account of the OECD working hypothesis?
- Would systems we are building for Basel compliance also be useful for tax compliance?
- Are we collecting the right kind of geographic data?

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Regulation: all risk and no reward?

Regulation: all risk and no reward? Introduction

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Capital adequacy: insurers play catch-up

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No entry for money launderers

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Avoiding the regulators' red flag on outsourcing

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A quiet revolution

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A common language for a common goal

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Basel II, OECD and tax: a complex relationship?

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