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FINANCIAL SERVICES

# Evolving Banking Regulation

A marathon or a sprint?  
November 2010

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### About this report

This report was developed by KPMG's network of regulatory experts. The insights are based on discussions with our firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies.

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# Foreword

When we released our first *Evolving Banking Regulation* report in November 2009, there was still significant uncertainty around the eventual shape of banking regulation. What a difference a year makes. Policy makers in every region have sprinted ahead with new rules for banks. The Basel Committee has finalized new principles for capital and liquidity. The United States has passed the Dodd-Frank Act, which touches on virtually every aspect of its financial sector.

Proposals have been put forward by global, regional and national policy setting bodies which will change the structure, supervision and governance of financial services. But we are nowhere near the finish line – regulatory change remains on the G20 agenda and will continue so for years to come, as we enter the much longer marathon towards implementation and transformation of the industry.

Working through the enormous volume of policies and proposals which have been issued this year, I am struck by how much uncertainty remains. High level proposals are still subject to detailed rulemaking and implementation guidelines – and I have no doubt the devil will be in the detail. All stakeholders agree on the need for a safe, effective financial sector. But how we strike the balance between ‘safe’ and ‘effective’ – for there will be trade offs – remains a contentious issue, as evidenced in some of the announcements in the lead up to the G20 summit in Seoul in November. Tensions and competing priorities between nations will, in the end, influence the tone and detail of how changes are finally implemented on a local level. Outcomes look increasingly likely to differ by region, and indeed by country, but by how much?

Despite commitment to a level playing field from the G20, the IMF, the FSB and other major players, the reality is very different. Major jurisdictions are taking different paths over issues including systemically important financial institutions, governance, remuneration and supervision. This is partly driven by very different starting points – countries that emerged relatively unscathed from the financial crisis are reluctant to implement costly measures to improve safety and resilience. Timelines for implementation will also diverge – both by geography, and within that by institution – as larger cross-border banks race ahead to demonstrate their stability and position themselves for opportunities.

Safety and soundness dominate the policy agenda in Europe. We are seeing the end of ‘light touch’ supervision in favor of a multi layered ‘intensive supervision’ – with potential knock on consequences for Europe’s competitiveness in the global financial markets. In the US, compliance with Dodd-Frank will require liaison with new and reconfigured regulatory entities, operational redesign, and vigilant attention to one of the largest rule-making exercises in the history of the country. But the accelerated time line to finalize rules increases the risk of unintended consequences – which will have an effect on all markets globally. Asia Pacific is not a homogenous region, there is significant variation in the approach to financial services regulation; however overall the Asia Pacific banks were relatively unscathed by the crisis. Nevertheless, there is significant work to be done to develop the infrastructure, governance and risk management required to manage businesses which will become more complex and global in outlook.

Given these developments, I believe four themes are likely to have the greatest impact on the final shape of the new rules as we move into the core implementation phase:

- Stakeholder expectations must be re-adjusted to reflect capital and liquidity constraints – banking will be a more costly business both for institutions and for their customers. How these changes play out between nations is likely to vary, in some cases significantly, which will increasingly make some markets more attractive to do business in.
- Systemic risk will be a key focus, but sharp national differences on insolvency law and economic imperatives will continue to complicate a cross-border approach to supervision, crisis management and resolution, as central bankers try to balance the need for market safety with political pressure to create a framework for economic growth.
- Demonstrable change in how banks govern their businesses – with much greater weight given to risk-adjusted returns, and a significant increase in the accountabilities of management, the Board, and on supervisors to assess the effectiveness of these changes. There are significant consequences for attracting and retaining staff, and developing markets.
- Increased focus on the customer and core banking services – added capital, liquidity and operational costs will make trading business less attractive and lead to reduced capital allocation to these businesses. Banks will refocus on retail and commercial banking, and core services such as payment and custody. But this area too has challenges – increasing regulatory focus on consumer protection means banks must

simplify offerings and increase transparency, which risks stifling innovation and choice at a time when state pensions and investment and savings returns, are diminishing.

Development of the regulatory paradigm is clearly having a significant impact on the industry, and around the world. Regulators are under pressure to get the mix right between a safe and effective financial system by establishing a new framework of rules for local supervisors to implement, but the success will only be evident some way down the track. Leading global financial institutions are facing the challenge to implement critical changes in capital and liquidity well ahead of stated timetables, in order to meet or exceed market expectations. But many national financial institutions are not yet in a position to respond to the full implications of these changes and the journey to full compliance will be long and intensive.

So is it a sprint, or a marathon? I believe it will be both – and it is the financial institutions that plan and prepare early, embedding the new requirements in how they govern and direct the business, who will be best positioned for success.



**Jeremy Anderson**  
Global Chairman  
KPMG's Financial Services practice



# Executive Summary

The journey towards a re-shaped financial sector is now well under way. Policy bodies are moving towards the final stages of rule making around the core objectives of the agenda for regulatory change set out by the G20. Significant changes are inevitable for every facet of the banking industry – and indeed the wider financial services industry. But how this change will play out for different business models and in different jurisdictions looks set to be very different.

Capital and liquidity have been a primary focus of the financial press since the crisis. The new bank capital and liquidity requirements agreed by the Basel Committee on Banking Supervision (BCBS), and supported by G20 governments, will strengthen the resilience of financial firms. We argue in our chapters on **Capital** and **Liquidity** that these changes will cause a systemic reduction in banking profits, resulting in a fundamental re-shaping of the sector. Changes may make banking safer – but could also limit the diversity and innovation which has underpinned economic expansion.

The G20 summit in Seoul supported an emerging focus on financial institutions deemed globally systemic (G-SIFIs). As we discuss in our chapter on **Systemic Risk** these institutions are likely to be subject to additional layers of regulatory and supervisory scrutiny. While the G20 has approved a framework for a consistent international approach to G-SIFIs, it leaves scope for additional national supervisory add-ons for G-SIFIs and application of different rules for local SIFIs. This could result in a very unlevel playing field for large cross-border institutions.

Imposing new regulations will require a significant step up in supervisory authority and scrutiny, which has been in evidence for some time in major markets. Our chapter on **Supervision** sets out the significant structural changes to the supervisory framework in Europe and the US, which will add further complexity. As we argue in our chapter on **Governance and Remuneration**,

supervisors are also using expanded Board and senior management accountabilities to shine the light on governance and remuneration. Changes in these areas are proving extremely challenging for banks in all regions, and may prove more so in Europe where new rules rather than principles are under discussion.

Customer treatment receives a renewed focus by policy bodies. The G20 in Seoul re-emphasized the need for customer protection, and as we observe in our chapter on **Customer Treatment** we expect a move towards simplified retail offerings – which may enhance transparency but could limit choice. Traded markets is an area which has received relatively little mainstream press. Yet changes in the capital requirements and market structure around securities and in particular derivatives trading will drive a major shift in the sector. As we argue in our chapter on **Traded Markets**, many product offerings will no longer be economically viable. These changes may weed out some of the purely speculative trading of the past, but could limit useful financial market innovation.

The level of new capital requirements will be inextricably linked to the accounting bases associated with financial assets and liabilities, an area subject to significant revision in the coming years. The effort continues, at the G20's urging, to create an internationally harmonized set of accounting standards but differences add further uncertainty and complexity to banks efforts to plan for the new regulatory framework.

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**Table 1: Regulatory Pressure Index**

Regulatory reform	Europe	North America*	Asia Pacific	Regulatory drivers
<b>Capital</b>	4	4	2	All banks will feel the impact of higher charges, regulators in the US and particularly in key European markets are already indicating they may levy higher charges than global minimums. 'Global SIFIs' will face the highest charges, but mid tier banks face particular challenges to meet new requirements at a cost consistent with adequate returns.
<b>Liquidity</b>	5	4	4	Liquidity requirements will bite hard across the industry, but particularly in developed markets where the added cost of funding will reduce margins and curtail more complex (and higher return) product lines, while at the same time responding to supervisory expectations, particularly in Europe, of local liquidity self sufficiency. In Asia Pacific banks will have to make major changes to how they look at liquidity, and in some markets there may be issues with the quantity of high quality liquid assets available.
<b>Systemic Risk</b>	5	5	1	Large cross border banks, based predominantly in Europe and the US, will suffer the brunt of eventual proposals for systemic institutions, with European markets subject to multiple layers of macro-prudential supervision which could add further to their compliance burden.
<b>Supervision</b>	4	5	2	Supervisory intensity is already increasing substantially in the US and Europe, and this will add significantly to the compliance burden of firms in these regions, whereas the shift in ASPAC is less marked given more conservative approaches already in place in many markets.
<b>Governance</b>	4	4	4	New guidance on governance, and enhanced supervisory scrutiny, will drive a significant step up for financial institutions in every region, and equipping boards, management and staff to fulfil their obligations is a significant challenge. In Asia it is recognized that improving corporate governance is an important issue, likely to be given additional impetus by recent events.
<b>Remuneration</b>	4	3	1	Remuneration is relatively lower profile in Asia Pacific, and not a focus. Despite public outcry in the US, regulators are taking a measured but pragmatic approach. The EU is considering the introduction of additional regulation which could set the most restrictive pay criteria – with knock on effects for its attractiveness to high quality staff.
<b>Customer Treatment</b>	3	4	1	Now prominent on the regulatory agenda, customer treatment will be a particular step change in the US with the introduction of a dedicated agency to write and police consumer issues, but figures only marginally in Asia Pacific where Australia has traditionally set a strong standard for consumer protection and other markets are still focussed on a basic suite of retail products.
<b>Traded Markets</b>	4	4	1	The US and Europe will be most affected by capital charges given the size of trading activity, but the US has proposed additional restrictions which could drive a proportionately bigger reduction there.
<b>Accounting and Disclosure</b>	3	3	3	Uncertainty over the final outcome of new rules and the scale of convergence between IASB and FASB will complicate planning for banks, but the general thrust of change in key areas like valuation, recognition and impairment is expected to increase the base for calculation of regulatory capital requirements even further.

\* The US is currently subject to its rule making phase: approximately 240 rules by 14 federal agencies needs to be created over the next 12 months in order to implement Dodd-Frank.

**Key: 5 = significant pressure 3 = moderate pressure 1 = low pressure**

**Table 1: Regulatory Pressure Index**

sets out our assessment of the scale of the challenge posed by key areas of financial sector reform for three major regions – the United States, Europe and the Asia Pacific region (ASPAC). This is based on discussions with our firms' clients in each of these regions, as well as on our professionals' assessment of key regulations and discussion papers.

The accumulation of additional costs driving out of regulatory change will drive a systemic reduction in returns for all banks. Changes to capital and liquidity are a major factor, but so too are the costs associated with expanded compliance requirements around reporting, monitoring, documenting, data capture and modelling. The challenge around retaining talent could lead to less innovation, with uncertain impacts for national economies and their objectives to increase private savings and investment and underpin economic growth.

However, taking account of the practicalities of addressing the issues on institutions, we expect Europe to feel the most significant pressure overall, with the US close behind. Both the EU and the US are going through significant step ups in supervisory intensity, and the concentration of cross border systemically important financial institutions will pose additional challenges for some of their biggest banks. Large proprietary trading books, which were a major driver of profits for some banks in these regions pre crisis, are already being wound down in favour of a focus on less capital hungry banking services.

Challenges in the ASPAC region will differ by country, but overall much of the transition to more intensive and conservative supervision was embedded after the Asian crisis of the late 1990s.

The pressure is on – and for many the journey has already started. Effective compliance, and more importantly, successful positioning for growth in this changing environment, requires careful planning and a steady pace which can adapt to new rules and approaches that continue to emerge. Are you out of the starting blocks yet?

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# 01



## Capital

### Raising the bar...

Basel III undoubtedly sets a higher standard for banks to maintain more robust cushions of capital against their risks. However its impacts on the shape and diversity of the banking market are yet to be properly explored. While the large cross-border banks will be hit the hardest overall, they are also generally in a better position to adapt, because of their size, diversity and access to investors and customers.

It may be the mid tier banks and investment houses that will find it harder to implement the changes: the former finding it difficult to raise capital in a constrained market without government subsidy, and the latter fighting to maintain returns in an environment where many strategies are no longer viable. Impacts on the competitive landscape will be of concern to those who see innovation and diversity as important to a healthy system. All banks will face higher costs and significant changes to the processes which underpin the management, measurement, monitoring and reporting of capital – the cost and complexity of which may drive further fall out among more marginal players.

Since the previous *Evolving Banking Regulation* publication last year, the BCBS has announced and finalized its framework for strengthening capital standards. Although some particularly difficult issues are still subject to consultation and final calibration, the revised capital requirements and the transition path to them were agreed by the G20 at its meeting in Seoul in November. Increased requirements for trading book capital in particular may drive significant re-shaping of many businesses, as we discuss in chapter 7 (**Traded Markets**). The key requirements from the BCBS are summarized in **Table 2: Capital Requirements**. The emphasis on common equity and retained earnings to meet new minimum regulatory capital requirements is a major shift for many financial institutions, particularly for developed markets where there had

been higher penetration of 'innovative' capital instruments to satisfy requirements. In addition, banks will be subject to a minimum leverage ratio of tier 1 capital of at least 3 percent of (unweighted) total assets including off-balance sheet items.

The European Commission's (EC) process is running in parallel with the BCBS roadmap. Changes to trading book capital were passed through amendments to the Capital Requirements Directive (CRD), in September 2010, the so-called CRD 3. In early 2010, the EC launched an initial public consultation on further possible changes to the CRD for banks and investment firms (CRD 4). These proposed changes are closely aligned with the Basel III requirements for capital and liquidity. A further consultation is expected in Q1 2011 reflecting a more final version of Basel III.

The Dodd-Frank Act in the US echoes international regulatory pronouncements on capital by calling for all financial institutions to hold more and better quality capital, initially focusing on larger bank and non-bank financial institutions. The Federal Reserve (Fed) has been given powers to set higher capital and liquidity standards for large, interconnected bank holding companies with total consolidated assets of US\$50 billion or more, and for non-bank financial companies deemed to be sufficiently systemically significant to warrant Fed supervision. Several specific provisions also aim to impose higher capital on risky activities, to limit proprietary trading (the Volcker rule) and to shift some swaps activity into separately capitalized affiliates.

US regulators are expected to incorporate certain features of Basel III (conservation buffer, countercyclical buffer, and liquidity coverage ratio) in advance of the agreed-upon implementation schedule. In the meantime, the US is continuing to implement Basel II for mandatory and opt-in institutions.

### Key Implications

Common equity requirements for banks will jump from a minimum of 2 percent to a minimum of 7 percent under Basel III, including the capital conservation buffer. While many banks already have common equity ratios above 7 percent the proposals will be more of a challenge than might first appear as current calculations are based on Basel II definitions. A tight definition of qualifying capital, higher deductions from capital, and increased capital requirements for the trading book will make a 7 percent capital ratio much more challenging. In addition some national regulators may impose higher requirements than these minimums, either to all institutions or on a case-by-case basis.

### Europe

Although many cross-border UK banks are well positioned to meet these higher core tier 1 capital requirements, having already started the process of bolstering their capital base, government supported banks and continental European banks face tougher challenges. Basel III is stricter than Basel II in its treatment of tax-deferred assets and mortgage-servicing rights, which could reduce capital ratios for some continental European banks by up to one percentage point. German banks may be among those hardest hit as capital components such as silent participations and subordinated loans, which were commonly used for tax reasons in the past, will need to be verified on a case by case basis to assess to what extent

**Table 2: Capital Requirements**

	<b>Core Tier 1</b>	<b>Total Tier 1</b>	<b>Total Capital</b>	<b>Notes</b>
<b>Minimum requirement</b>	4.5%	6%	8%	Core tier 1 represents the highest form of loss absorbing capital (share capital and retained earnings)
<b>Capital Conservation buffer</b>		2.5%		Must comprise common equity, bringing total common equity requirement to 7%
<b>Countercyclical capital buffer</b>		0 – 2.5%		Current proposal: Added by national supervisors depending on local circumstance
<b>Additional Systemically Important Financial Institution (SIFI) capital requirement</b>		To be determined by the BCBS		Still under consideration at a global level. Expected to be set in the region of an additional minimum possibly 5% for G-SIFIs and 2–3% for domestic SIFIs, as a combination of common equity and contingent capital

they can still be treated as capital under the new regime. The leverage ratio will also have significant implications for some banks in the UK and Europe, where these banks carry large amounts of low risk-weighted and off-balance sheet assets. The greater emphasis likely to be placed by host country supervisors on the adequacy of locally held capital will also have an impact on total capital requirements for international banking groups.

### ASPAC

In the [ASPAC Perspective](#) on page 11, Simon Topping explains that Asian banks generally remained well capitalized throughout the crisis. Many commentators have questioned the appropriateness of the Basel III package for a region whose business focus is local and is conducted largely by way of retail and small business and commercial lending. Additionally, an upcoming KPMG/Oracle survey *Evolving Regulatory Reforms: Impact on Asia Pacific Financial Institutions*, highlights concerns over the implications of Basel III for growth in the region. The focus of regulators and banks in Asia is more likely to be on the liquidity requirements forming part of the Basel proposals, risk management and governance, and the challenges of bolstering the expertise and availability of internal resources, data quality and information technology capabilities.

### North America

In general, North American banks are considered to be well capitalized to meet the Basel III standards as many of these banks have been accumulating capital since the financial crisis, and were unwilling to release this capital during the uncertainty of the legislative phase of the Dodd-Frank Act. To the extent that leading banks are in effect over-capitalized, they may release funds towards lending and acquisitions. Further capital changes are expected. Systemically Important Financial Institutions (SIFIs) will be subject to further capital requirements – both under eventual global standards, and in some

cases under super-equivalent national standards, as discussed in chapter 3 ([Systemic Risk](#)).

### Impact on core banking activities

Requiring banks to hold greater capital buffers to absorb potential losses could lead to a further tightening in the price (interest margins and higher collateral requirements) and availability of bank lending. The relatively easier and cheaper access of larger banks to capital and the impact of regulatory costs more generally, may result in smaller banks being acquired by larger banks or choosing to leave the market. This will raise significant issues about the impact of regulatory reform on competition in the banking sector. For this reason, there are long

implementation periods being allowed, to try to ensure that this potential tightening of availability of credit does not occur.

The stated implementation dates of Basel III extend to 2018, but in the regulatory race, supervisory pressure – focusing on capital planning and stress testing by banks – and market discipline are likely to push banks towards much earlier implementation. Many banks are therefore preparing for the new capital regimes well in advance of their proposed implementation dates, and aiming for core tier 1 capital ratios comfortably above 7 percent, rather than risk supervisory sanctions on earnings distribution and remuneration or market censure.

### Issues to consider

Banks should begin by thinking strategically about what impact the new capital requirements will have on the shape of their business:

- Have you carried out appropriate scenario planning and impact assessments to ensure the development of a successful capital strategy?
- Which businesses have the most attractive fundamentals – which businesses in your portfolio should you be considering exiting, growing or divesting?
- Is your organization geared up to effectively and consistently deliver real time measurement, management and reporting of your capital position?
- How will you address the pricing implications arising from changes in the capital requirements for certain products?
- Can the same business models continue under a different structure, minimizing capital requirements? (eg branch versus subsidiary)
- Are you prepared to meet timescales which effectively may be shorter than the announced starting dates? Have you considered the strategic advantages/disadvantages of these timescales?
- Have your capital planning and capital management processes been reviewed in light of the new requirements?
- Will you set your capital target with reference to the regulatory requirements, or will you use other means (economic capital, ICAAP) to determine the appropriate level?
- Have you considered the optimum capital mix in this new environment, including possibly replacing existing capital with higher quality capital?

# Perspectives: ASPAC



## Views on Basel III

When you cut through all the complexity, Basel III is really very simple – it's about making banks more resilient to stress, through stronger capital and liquidity positions and enhanced risk management.

Basel II was a move in the right direction, in that it helped encourage banks to make use of more sophisticated risk management techniques, and made capital requirements more risk-sensitive, but one of the problems with Basel II was that it wasn't sufficiently comprehensive. It was silent on key issues such as liquidity, definition of capital, and leverage. Basel III redresses this. It also gives increased emphasis to some important areas such as stress-testing and capital management, which were present, but underplayed in Basel II.

Banks in Asia Pacific generally fared much better during the financial crisis of the last few years than those in the US and Europe, and so a question some are asking is whether Basel III is really necessary for them. But it would be very short-sighted to take such a view – it's always important to learn from others' experience. Certainly, there are some key messages that all should take on board, and three in particular:

First is the need to make the risk management process more sophisticated, more comprehensive and better integrated; to consider all types of risk, not just credit and market risk, and how they are related and interact. Second, to make greater use of stress-testing – of risk positions, of capital, and of liquidity – and to develop well-articulated contingency plans for responding to adverse scenarios, both of an institution-specific and a system-wide nature. Third is the need to ensure that the bank's strategy, business model and risk appetite are well thought through, and that the capital planning/management process is consistent with this.

Maybe it will be a surprise to some that I haven't identified the requirement for a greater amount and higher quality of capital as a key issue for banks in Asia Pacific. Certainly there will be some for which this will be an issue but, generally speaking, banks in Asia Pacific already operate at considerably higher ratios than is the norm in the US and Europe, and a high proportion of this is typically in the form of common equity, so it is generally of high quality too. So you could say, Basel III endorses what has been the norm for many in Asia Pacific for some time. Similarly, I don't see the new leverage ratio as being a big issue for most in Asia Pacific. Business models here have generally not involved the build-up of excessive leverage. Likewise, the longer-term liquidity ratio, the net stable funding ratio, shouldn't generally be a problem, as regulators have tended to discourage mismatching short-term funding and long-term lending.

What could well prove the most problematic area, however, is the shorter-term 30 day liquidity coverage ratio. This is basically a good idea – that a bank should hold enough liquidity to see it through a stress period – but the problem is that 30 days is probably not the right time horizon in many Asia Pacific jurisdictions. Once a bank gets into difficulty, things tend to happen rather quickly, and so five or seven days may be more appropriate. Local regulators seem likely therefore to stick with this much shorter time horizon, possibly in addition to the 30 day ratio.

Another issue associated with the new liquidity requirements is where all this liquidity is going to come from, as many Asian jurisdictions simply do not issue sufficiently large enough amounts of government debt to satisfy the likely demand. The BCBS acknowledged this issue in its July 2010 press release detailing broad agreement on the Basel Committee capital and liquidity reform package, and some flexibility is likely.

No doubt these details will be ironed out over time. Hopefully the issue of provisioning will also be made clearer. Again, this is an area where many banks in Asia Pacific are relatively well-prepared,

as regulators have in many cases required banks to hold provisions in excess of the amount suggested by the impaired loss model, in effect pre-empting the move to provisioning on an expected cash flow basis.

So, in many important ways, banks in Asia Pacific are perhaps better-placed to meet the new capital and liquidity numbers under Basel III than many banks elsewhere. For them, the challenge may be more on the risk management side, and it is here that, in my view, the emphasis needs to be – on systems and people resources rather than financial resources.

Of course, Asia Pacific is a very diverse region, with both advanced and less advanced economies and financial systems. Some have very well developed supervisory capabilities; others are further down the learning curve. Some have implemented Basel requirements (such as Basel II) on the same timetable as other major jurisdictions, while others are still in the process of doing so. But if there is one thing that is a common factor in most Asia Pacific jurisdictions, and which perhaps differentiates Asia Pacific from the US and Europe, it is that both bank managements and regulators have consistently tended to be relatively conservative in relation to risk-taking, innovation, and capital and liquidity positions. This innate conservativeness – possibly a cultural feature, possibly a response to having gone through the Asian financial crisis in the late 1990s – has served Asia Pacific institutions well in the recent crisis.



### **Simon Topping**

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# 02



## Liquidity

### A steep incline...

Although capital grabs the headlines, the new liquidity requirements in Basel III will be at least as significant, if not more, for many banks and their customers. Maintaining higher liquidity buffers may depress banks' margins and ultimately reduce the range of products they offer customers. Banks will have to make significant investments to monitor and manage liquidity more effectively in an increasingly constrained and heavily supervised landscape, and to respond to the increasing demands of some host supervisors for branches to meet local liquidity requirements.

One key contributor to the failure or near-failure of many banks during the crisis was a lack of liquidity and the consequential impact of a loss of depositor confidence. Given the nature of the banking business model and the key role banks play in maturity transformation, a perceived liquidity shortfall can rapidly escalate into a 'run' with collateral damage across the system. Since the crisis, regulators have been focusing much more attention on ensuring and defending adequate liquidity standards and reducing the moral hazard generated by public support for banks and their depositors.

The BCBS has proposed two new minimum liquidity requirements, designed to enhance both the ability of banks to repay their liabilities as they fall due and the maturity matching of banks' balance sheets. There is a particular emphasis on moving banks away from relying too heavily on short-term wholesale funding:

- Liquidity coverage – banks must hold sufficient high quality liquid assets (cash, government bonds, covered bonds and highly rated corporate bonds) to enable them to withstand for 30 days the loss of a proportion of their retail deposits and an inability to roll over any corporate and wholesale deposits.
- Net stable funding – banks must hold sufficient stable sources of funding to match their lending of over one year maturity.

Both the BCBS and national regulators have also emphasized the importance of the boards of banks understanding liquidity risk, taking a close interest in setting a risk appetite, and satisfying themselves that these risks are properly monitored and controlled; the need for banks to run a range of stress tests, covering both bank-specific and market-wide vulnerabilities; and for banks to have adequate systems, data, reporting and management information to enable continuous management of liquidity.

These quantitative and qualitative requirements are expected to be implemented in the EU through the CRD. In the US detailed liquidity requirements will emerge from the rule making currently being undertaken by various US federal banking regulators.

As with capital, some national regulators may set additional standards to those in Basel III. The UK has already implemented new liquidity arrangements which are, in many respects, more restrictive than those proposed by the BCBS and are likely to remain so.

### Key implications

Under the new liquidity regime proposed by the BCBS, banks will be faced with higher requirements for liquidity buffers.

The costs of liquidity will increase sharply, as a larger amount of liquid assets will need to be held in low risk, low return assets such as government bonds, and as banks shift from short-term wholesale deposits to retail and long-term wholesale deposits. In combination, there will be a significant drag on liquidity reducing profitability. As Clive Briault discusses in the [Europe Perspective](#) on page 15, this could be further reinforced while all banks seek to increase their reliance on a limited pool of retail and longer-term wholesale deposits. It may be hard to re-price other businesses to compensate, especially at a time when aggressive moves to migrate customers to alternative, more profitable, products will be under greater political and competition authorities' scrutiny. This is likely to drive a long-term shift in balance sheet planning from an asset-based approach to a liability management strategy, reducing the probability of significant balance sheet expansion.

Banks will also need to put in place stronger systems and controls for managing liquidity and liquidity risk. Senior management has a clear obligation to monitor performance and to deliver significantly enhanced – and more frequent – reporting of liquidity positions. In the UK, the Financial Services Authority (FSA) is already moving to make daily reporting part of a regular regime. It also intends to drill down more deeply into individual banks' positions; and at the same time quantify aggregate industry risk positions on a regular basis. Meeting these requirements will place enormous strains on banks' data and systems which may in many cases be inadequate to the task. Major investment will be necessary. In Germany, the latest consultation

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papers are moving closer to the UK and US requirements that banks run regular stress tests and take proper account of the results in assessing the adequacy of their liquidity buffers.

For international banks the definition of individual liquidity pools will become a critical – and contested – area. This reflects both the demands of some host national supervisors that the branches of foreign banks should be self-sufficient in terms of their local liquidity; and the dominance of the legal entity driver in the approach of some supervisors, forcing legal entity simplification and the matching of liquidity pools with each legal entity.

With the increasing requirements on liquidity, it is clear that liquidity transfer pricing will be an issue for banks, affecting their pricing and therefore their business model. Many complex structures will struggle to demonstrate adequate return in this environment. In October 2010 the Committee of European Banking Supervisors (CEBS) finalized its Guidelines on Liquidity Cost Benefit Allocation. According to CEBS, liquidity management has to include adequate funds transfer pricing policy that considers all relevant liquidity costs (direct and indirect), benefits and risks. Implementation is expected by mid-2011.

### Issues to consider

- Do you understand your current liquidity position in sufficient detail and know where the stress points are – e.g. how sticky are your retail and wholesale deposits?
- Have you considered the impact of new liquidity rules on profitability – has liquidity risk/cost been factored into key business processes and priced internally?
- Is liquidity planning, governance and modeling in line with leading industry practice?
- Are systems, data and management reporting adequate to meet the new requirements?
- How do you determine what an appropriate series of stress tests is and how these will change over time?
- Are you aware of the likely implementation timetable for different elements of the global and national frameworks being proposed?
- Have you assessed your liquidity strategy in light of the existing legal and regulatory structure of your organization? Have you considered the future liquidity requirements of overseas subsidiaries/branches and how these might be met?
- Have you reviewed your liquidity contingency plan? Have you set up Key Risk Indicators to give early warning of impending liquidity problems?
- Are all areas of your business aware of the implications of the new requirements? What impact will this have on your business model?
- Have you considered the interaction between the new liquidity and leverage requirements?
- Have you discussed with your supervisor their plans/intentions regarding providing liquidity to the market/individual institutions, including in times of stress?

# Perspectives: Europe



## Liquidity: A bigger challenge than capital?

Before the current financial crisis there had been very little discussion of liquidity at international level. The BCBS had published just one short paper on liquidity systems and controls during the previous 15 years, while national banking regulators imposed a very diverse set of requirements, many of them dating back decades rather than years.

In my view, this lack of attention, both nationally and internationally, reflected the competing demands of the development, negotiation and implementation of the Basel II capital adequacy regime; the difficulties in identifying a common approach to quantitative liquidity requirements; and the apparent abundance of liquidity in a world where the assets held by banks were becoming increasingly marketable (through trading, securitization and sale and repurchase).

However, liquidity has shot up the agenda – for both banks and their regulators – following the severe drying-up of liquidity since 2007. The BCBS and many national regulators have been developing new liquidity requirements. I regard this as being a long overdue development.

In response to both the recent financial crisis and the prospective new regulatory requirements, we see banks struggling to cope with a higher cost of funding; the need to re-price products to take better account of liquidity risk; restructuring their balance sheets; running and responding to more severe stress tests; and improving their systems, controls and reporting at all levels from the board downwards. In addition, banks need to consider the impact on them of four key factors that

are emerging slowly from the gloom.

First, the tougher requirements are already beginning to generate some ‘unintended consequences’, including:

- Retail deposits becoming not only more expensive but also less stable, as greater competition for retail deposits drives an increased reliance by banks on rate-sensitive and internet funding, and as switching between banks becomes cheaper.
- Long term wholesale deposits being significantly more expensive and more difficult to obtain for smaller banks, with an adverse impact on competition as these smaller banks are ‘squeezed out’ from these sources of funding.
- Increased demand for the highest quality liquid assets reducing the return on these assets, adding to the downward pressures on banks’ profitability.

Second, although the BCBS proposals allow for ‘observation periods’ until end of 2014 for the liquidity coverage ratio and end of 2017 for the stable funding ratio, some national regulators may not give their banks as long as this to adjust. In the UK, the FSA has already introduced a liquidity coverage ratio. Similarly, market analysts and investors have already begun to assess banks against these new standards. So I would expect banks to come under pressure to disclose their liquidity positions against the proposed BCBS ratios well before the end of these observation periods.

Third, some national regulators may decide to impose tougher requirements than the minimum ratios agreed by the

BCBS. In the UK, the FSA has introduced a new liquidity coverage ratio that requires banks to hold sufficient liquid assets to cover liquidity shortfalls for three months rather than the 30 days in the Basel coverage ratio; it requires most branches of foreign banks to be self-sufficient in terms of liquidity; is making judgements on stress testing that equate to liquidity requirements in excess of the Basel minimum ratios; and has introduced a process similar to the Pillar 2 process for capital adequacy whereby the FSA will review reports from the banks assessing how much liquidity they need to hold.

Finally, it remains to be determined whether – and if so, how – systemically important banks will be required by international and national standards to hold additional liquidity, in addition to additional capital, over and above the minimum requirements applying to all banks.



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# 03

## Systemic risk

Part of the bigger picture...

The financial crisis continues to expose the political and economic impacts of major disruption in financial services. Policy makers are establishing new frameworks to deal with both 'systemic institutions' and 'systemic risks'. Detailed proposals on additional capital requirements and other 'add-ons' for systemically important financial institutions (SIFIs) are in progress, but a lack of clarity between 'global' and 'national' SIFIs gives rise to the risk of an unlevel playing field.

Large cross-border banks are likely to bear the brunt of the additional regulatory burdens and changing prudential supervisory relationships, and face a period of considerable uncertainty. Many argue that it is the approach to risk rather than the size of the institution that should be the determining criteria for additional 'systemic' requirements and supervisory arrangements. In any case, the monitoring of systemic risk does not guarantee the identification and prevention of the next crisis. Some threats to financial stability may not be identified, while even identified threats may not be addressed in the context of other, political imperatives.

The financial crisis highlighted two major shortcomings in how the authorities dealt with systemic risk. First, the threat to the system arose in part from the collective actions of financial institutions (for example the combined rapid growth of asset prices and collateralized credit, a slackness in loan origination), and the use of securitizations and credit derivatives to spread risk. But supervisors had focused mainly on the risks facing individual regulated firms, and not enough on system-wide risks. Second, many governments had to commit public funds to support SIFIs, rather than risk the financial instability, loss of key financial functions and damage to the real economy that would have resulted from their failure.

The policy response has been aimed at achieving four core objectives:

- Reduce the risk of failure of SIFIs.
- Increase the powers of the authorities to resolve a failing SIFI without disruption to the financial system and without taxpayer support.
- Instil greater market discipline through a more credible threat of loss to shareholders and creditors.
- Intensify the monitoring of systemic risk, both across the system and within individual institutions.

Global policy setting bodies have proposed a series of measures in varying stages of implementation to meet these objectives, as outlined below.

#### More capital, and better quality capital and higher liquidity

The risk of the failure of a SIFI can be reduced in part through the capital and liquidity buffers for all banks as set out in Basel III, and in part through the imposition of additional capital and liquidity buffers for SIFIs. Additional capital buffers could include both contingent capital – which would convert to equity at an early stage when a SIFI began to experience difficulties, and thus help the SIFI to continue as a going concern – and ‘bail in’ capital which would convert to equity just before a SIFI failed, thereby spreading losses to creditors and reducing the need for public support.

The BCBS is developing its own proposals to address systemic issues, including higher capital and liquidity requirements, additional loss absorbency through contingent capital and enhanced supervision, but details are not expected until mid-2011.

In the US the Dodd-Frank Act requires SIFIs to be subject to higher capital, leverage and liquidity requirements, and to meet enhanced requirements on

disclosures, rigorous risk management, concentration of exposures, and resolution plans. In Switzerland, the Swiss National Bank has proposed a total capital requirement of 19 percent on its two largest banks, to be made up of core tier 1 capital of 10 percent and a further 9 percent of capital in the form of two different types of contingent capital.

#### Enhancement of resolution and insolvency regimes

Clearly, SIFIs would be less of an issue if effective resolution, in the event of their failure, were possible. However, many question the likelihood of an effective *global* resolution and insolvency regime being developed and agreed.

Requirements are already in place in some jurisdictions for SIFIs to formulate recovery and resolution plans (sometimes known as living wills or funeral plans), which would assist the authorities in resolving failing SIFIs in an orderly manner, thereby reducing the contagion impact of any such failure. Similarly, some countries have implemented, or are planning to implement, enhanced powers for the authorities to intervene to resolve a failing SIFI by replacing the management of the SIFI and transferring or selling parts of its business in order to maintain core financial services. The US, UK and some other countries are pushing hard for improving national resolution regimes.

Under the Dodd-Frank Act, the FDIC has extended powers to manage the resolution of SIFIs. The International Monetary Fund (IMF) is seeking progress on a cross-border resolution regime. The EU is also examining its approach to resolution and crisis management with the intention of creating consistent crisis management tools for financial services. This could include cross-border cooperation, recovery and resolution plans, resolution funds supported by

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national bank levies and eventually greater harmonization of legal resolution frameworks across the EU. However, some countries remain unconvinced that these regimes will be capable of resolving a failing SIFI and so place more emphasis on preventing failure (and ensuring that in the event of a failure the losses do not fall on taxpayers) as the best way forward.

#### Supervision

The Financial Stability Board (FSB) has recently set out proposals for more intensive supervision of SIFIs, an approach already well under way in major developed markets, to allow for early identification and prevention of issues. More intensive and challenging supervision, along with additional disclosures on risk, are expected to be the norm. Many countries, including Australia and the US, have also taken specific steps to extend the remit of supervisors to capture previously 'under regulated' entities such as hedge funds and investment advisers, discussed further in chapter 4 (Supervision).

#### Structural change in the industry

Proposals in some jurisdictions would limit the size of banks and the activities they are allowed to undertake. In the US, the 'Volcker rule' limits proprietary trading and investments in private pools of capital. The UK has set up an Independent Commission on Banking which is exploring multiple options intended to support a stable and competitive banking sector, including limits on activities and mandatory disposals to reduce balance sheets and risk. Proposals in both the EU and the US to move the bulk of over the counter (OTC) derivatives trading to central counterparties are intended to

minimize market instability arising from counterparty failure.

It remains to be seen whether policy makers will ultimately determine that big banks should be broken up. The argument goes both ways. On the one hand, big banks pose a concentration (or systemic) risk, on the other, big banks have generally been regarded as providing strength and stability to financial systems.

#### Taxation

Bank levies have been implemented in some countries, notably the UK, Germany, and France, and proposed by others including the US and across the EU. The form and purpose of these levies vary between jurisdictions – some are intended to cover the costs of resolution, some to establish a fund to meet future resolution costs, and others to lessen government deficits. Opponents of resolution funds argue that they would reinforce moral hazard by creating the expectation that the funds would be used to support failing banks in the future.

#### Systemic overview

Various existing and newly created national and international bodies have been tasked with 'macro-prudential oversight', including the European Systemic Risk Board (ESRB) in the EU, the Financial Stability Oversight Council (FSOC) in the US, and the Financial Policy Committee (FPC) in the UK. Their role is to identify risks to financial stability – including credit and asset price growth and vulnerabilities in payment, clearing and settlement systems – and to take or recommend actions to mitigate these risks.

#### Key Implications

While the high level objectives around the regulation of SIFIs are broadly

accepted, this masks some significant fault lines over the detailed measures being proposed. These fault lines include the definition of SIFIs, and the effectiveness in practice of applying resolution plans and contingent capital – with many skeptics doubting that either would avoid the need for government support of a failing SIFI.

#### 'Global' versus 'Local' SIFIs

Views differ on how 'dangerous' SIFIs are. The US, UK and Switzerland are the most concerned, given the size and concentration of their SIFIs relative to their GDP. In contrast, many in ASPAC and parts of Europe whose banks were less entangled in the crisis, view the size and business model of their largest banks as a source of strength and stability.

The most recent statements from the FSB and the G20, which distinguish between 'global' (G-SIFIs) and national SIFIs, reflect these differing levels of concern, but risk creating an unlevel playing field on a number of fronts. Global minimum standards for additional capital, liquidity and supervisory requirements look increasingly likely to be targeted at G-SIFIs. National SIFIs (i.e. those which are systemic only at a national level) could then be set lower additional requirements by their national supervisors. Implementation may not be consistent, with some jurisdictions choosing to 'gold-plate' the minimum standards.

These developments will put pressure on global banks to reconsider how they operate and whether they can take a group-wide approach to capital and liquidity. Uneven implementation of SIFI standards may cause some to consider restructuring themselves and relocating parts of their operations to take advantage of less onerous regulation.

### Resolution regimes

Contrasting views across countries on the potential effectiveness of resolution regimes, raise questions about the proper balance between preventing failures of SIFIs through additional capital and liquidity requirements and relying on an orderly resolution regime to limit the impact of a failing SIFI. Again, this could lead to an unlevel playing field for SIFIs subject to different national regimes. The effectiveness of supervisory colleges in resolving issues with cross-border institutions has yet to be tested and may ultimately be constrained by national insolvency law.

Significant differences in national resolution powers and the speed of contagion in the financial sector may undermine the effectiveness of resolution powers for cross-border institutions. Large cross-border institutions have grown complex, and in many cases unwieldy, business and legal entity structures. Effective resolution plans will require that these are thoroughly reviewed and rationalized as part of the process of writing recovery and resolution plans (RRPs).

### Practicality of contingent capital

It is by no means certain that contingent capital can be raised in the volume which is implied in recent proposals. Nor is it clear that contingent capital will meet its objective. Depending on where trigger levels are set, the fact of the conversion could add further stress through a loss of confidence in individual banks and in the financial system more generally.

Both contingent capital requirements and government insistence that bail outs will no longer be available, will significantly increase funding costs for large banks as investors seek compensation for added risk. The risk premium required may undermine the

viability of contingent capital as an option, in which case these banks will need to raise even more common equity.

### Systemic overview

Although various new bodies are being established, it remains to be seen how effective they will be in identifying and addressing risks to financial stability. In particular, little progress has been made outside Asia in designing the 'macro-prudential toolkit' of measures that could be taken and in determining the conditions under which the

measures would be deployed. Financial institutions therefore face considerable uncertainty over the national and international measures that might be taken, and in planning for the impact of these measures on their business strategies and on the capital they need to hold. There is also considerable scope here for uneven choice and use of measures across countries and across different types of financial institution – G-SIFIs, national SIFIs and other banks.

### Issues to consider

- Does management understand which aspects of the business are systemically important?
- Does your business and/or management structure need to be reorganized to facilitate resolution planning?
- How far will funding profiles shift given the push to ensure that private creditors bear any losses?
- Have you begun to understand how to develop a resolution plan, including multiple levels within your organization? Can you collect the information you need to satisfy multiple requests?
- Being designated a SIFI may impose greater costs (in terms of increased capital etc) but it may also bring benefits (e.g. in terms of lower funding cost because of the perception of having been identified as systemically important. Have you considered how you might be affected by this (whether or not you are a SIFI)?
- Have you considered the pros and cons of being located in different jurisdictions?

# 04



## Supervision

### Applying the rules of the game...

Banking supervision is changing significantly. Reducing the likelihood and severity of future financial crises through stronger regulation and supervision is an agreed priority for most governments and policy makers. Stronger supervision will mean not only more intensive reviews of activities diving deep into individual business areas, but also more challenge of banks' strategies and business models. Larger cross-border firms will have to rely on effective cooperation between colleges of supervisors to prevent duplicate and inconsistent supervisory requirements.

The precise 'tone' of supervision, and the balance between supervisory discipline and market discipline remain to be determined. This will depend as much on politics as on the organizational structure of supervisory agencies, with both the supervisors of individual banks and the 'macro-prudential' supervisors of the overall financial system facing a fine balancing act between effective supervision and pressures to deliver a broader political and economic agenda.

The substance and execution of banking supervision in key financial markets faces substantial changes (in both structure and policy). There are six broad themes:

- Implementation of the tougher and more extensive regulations being introduced under the G20 regulatory reform agenda.
- More intrusive, intensive and challenging supervision.
- Expansion of the scope of supervision to capture additional actors in the supervisory net.
- Increased cooperation and coordination among supervisors to improve the scrutiny of cross-border activities.
- New and expanded supervisory powers in relation to the capital conservation buffer and countercyclical buffer.
- New supervisory structures and the allocation of responsibilities for macro-prudential oversight.

The implementation of these changes will depend in part on local political and economic developments. The common element will be more intensive and challenging supervision, within a more rigorous, risk-based and forward-looking approach. This change is already being experienced by regulated firms in areas such as the effectiveness of corporate governance, remuneration, the riskiness of business models, stress testing, enterprise-wide risk management, systems and controls, liquidity, and tighter ring-fencing of the local branches and subsidiaries of overseas firms.

#### Europe

The current Level 3 Committees (CEIOPS, CEBS and CESR)<sup>1</sup> will become European Supervisory Agencies (ESAs) from 1 January 2011, with greater regulatory and legal powers. Initially the ESAs will be relatively small and will require support from key national supervisors in developing policy – but their size and influence could be increased significantly after three years when the success of the new structure is set for review.

The ESAs will be able to write policy, with the aim of creating a ‘single European rulebook’, subject to adoption by the European Commission (EC). In some evolving areas, ESAs may gain a primary role. For example, the European Securities and Markets Authority (ESMA) is lined up to play a key role in the registration and supervision of credit rating agencies and central counterparties – though with support from national supervisors playing host to these bodies. They will also have a mandate to ensure the consistent application of Directives by national supervisors. The ESAs will have the power to mediate and

mandate actions where there are disagreements or inconsistencies between national supervisors in how they apply these rules.

In practice, this system of ‘peer review’ should minimize (but not eliminate) the scope for national variation, and highlight weaker supervision practices. In both cases, there could be significant impacts for the local approach to supervision – it limits the scope for national supervisors to take a more ‘competitive’ approach to political issues, as seen recently with the remuneration debate further discussed in chapter 5 (**Governance and Remuneration**) and the Alternative Investment Fund Managers Directive (AIFMD), even if it still leaves scope for local regulators to apply ‘super-equivalent’ rules.

A European Systemic Risk Board (ESRB) will look at emerging macro-prudential risks. Its role will include carrying out market-wide stress tests to help determine the system’s sensitivity to shocks as discussed in chapter 3 (**Systemic Risk**). Its main interaction with firms will be in issuing risk warnings (public and private) and in recommending (but not mandating) mitigating action on such risk warnings.

#### UK

The UK arrangements are diverging from the wider European model. Unlike the ESA structure, planned supervisory changes will separate prudential from market and conduct of business regulation and supervision, with significant implications for UK regulated firms in dealing with multiple supervisory agencies. The Bank of England will discharge its responsibilities for the prudential regulation and supervision of banks and insurance companies through a subsidiary agency, the Prudential Regulatory Authority (PRA). One major

*The substance and execution of banking supervision in key financial markets faces substantial changes (in both structure and policy).*

1. CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors  
CEBS: Committee of European Banking Supervisors  
CESR: Committee of European Securities

driver for these changes is to ensure the effective coordination of macro-prudential oversight with the prudential regulation and supervision of individual firms. Thus the Bank of England will also have a Financial Policy Committee (FPC) to assess threats to financial stability, including the growth of credit and of asset prices.

Meanwhile, the Consumer Protection and Markets Authority (CPMA) will focus on consumer and market protection and act as a single conduct of business regulator and supervisor for both retail and wholesale firms. The implications of this is outlined in chapter 6 (**Customer Treatment**). This division of regulatory responsibilities reflects a historically greater focus on consumer protection in the UK than in much of the rest of Europe.

However, ways of working and the boundaries between micro and macro issues, between prudential and conduct of business issues, and between market supervision and market stability issues, remain to be determined. Teething problems may cause difficulties for supervised firms.

## US

The Dodd-Frank Act effectively expands the framework of financial services regulation to a variety of new firms, products and regulators. The core regulatory framework for insured depository institutions (banks and thrifts) is not substantially different, but there are four key exceptions:

- The creation of the Financial Stability Oversight Council (FSOC).
- The creation of the Consumer Financial Protection Bureau (CFPB).
- Increased powers for the Fed where institutions (both financial and non-financial) are deemed to be systemically important.

- The long anticipated elimination of the Office of Thrift Supervision (OTS), with the reallocation of its powers and duties to the other federal bank regulatory agencies (OCC, the Fed and FDIC).

The FSOC will undertake macro-prudential supervision within the US. Working through the Fed, it has significant powers to review and modify the strategy and activities of institutions deemed to be systemically important. The impact of more supervision on these firms, their strategies and their business models is likely to be substantial.

The consumer protection functions of the OTS, OCC, FDIC and the Fed will be largely transferred to the CFPB on or around July 2011. The CFPB will have all consumer protection rule-making authority in addition to supervisory responsibility for insured depository institutions with assets in excess of US\$10billion, as well as their affiliates and service providers. The CFPB will also have supervisory responsibility for non-bank financial companies that provide consumer financial services and products. Smaller institutions stay under the purview of their primary federal regulator while also being subject to the rule-making authority of the CFPB.

Finally, the OCC will now supervise federally-chartered thrifts in addition to national banks and has rule-making responsibility for all thrifts. The Fed has authority over thrift holding companies. Thrifts are likely to find themselves subject to much more rigorous supervisory standards under the OCC, eliminating a 'regulatory arbitrage' opportunity to take advantage of the more flexible approach of the OTS. Industrial banks, credit card banks and trust banks are likely to be subject

to enhanced regulatory scrutiny in areas such as governance and risk management.

There are a number of other changes in the authority of individual regulators:

- The FDIC gains authority to act as receiver for certain systemically important institutions that fail (including bank holding companies and non-bank financial companies).
- The Securities Exchange Commission (SEC) and CFTC will share supervisory responsibility for OTC derivatives, subjecting this market for the first time to coordinated oversight of its activities and risks.
- Investment advisers to private pools of capital (including private equity, hedge funds and certain real estate funds) are also pulled in to the regulatory net by requiring registration by July 2011 and will then be regulated by the SEC.

As Hugh Kelly discusses in the **US Perspective** on page 24, the scale of supervisory change brings significant risks of an outcome which is rushed and uncoordinated.

*Managing multiple relationships and the changing supervisory spheres of influence, may cause some firms to consider changing their structures and business models to achieve the most effective balance of supervisory oversight.*

## ASPAC

As noted earlier in this report, regulators in ASPAC have generally adopted quite a conservative approach, reflecting the less developed nature of some jurisdictions, plus the lessons learned from the Asian Financial Crisis. Regulators in ASPAC never went in for 'light touch' or 'principles-based' regulation, and therefore have less backtracking to do. Generally they have been more rules-based, more prescriptive, and have required banks to hold conservative buffers and maintain conservative limits. As a consequence, there may be a less dramatic change in the style of regulation and supervision in many ASPAC jurisdictions compared with elsewhere. Similarly, there is likely to be far less organizational change in the supervisory set-up.

## Key Implications

### More supervision

Financial institutions are already facing more intensive and intrusive supervision, more coordinated supervision among supervisory agencies and a widening of the regulatory net. Larger and more complex firms face a balancing act to manage relationships with multiple supervisors who may find themselves pulled in different directions, not only by regulatory initiatives but also broader political and economic imperatives. This will drive increased cost and changes to compliance. Managing multiple relationships and the changing supervisory spheres of influence, may cause some firms to consider changing their structures and business models to achieve the most effective balance of supervisory oversight.

## Unknown quantities

The tone, style and demands of new agencies have yet to be established. Firms are gearing up for another wave of rule making and supervisory scrutiny, as new bodies come on line and look to establish their authority. This will have implications for data, systems and reporting requirements, and provide scope for disruption for firms as the lines of demarcation between the new bodies take shape. The rise of the ESA structure in Europe is likely to mean less scope for local variation in the implementation of EU-wide requirements – this may even the race, but could reduce the competitiveness of larger and more international firms and markets.

## The macro-prudential overlay

Financial institutions will be subject to both micro and macro supervisory action – firm-wide level supervisory requirements will be supplemented with actions driven by broader macro-prudential assessments of risks to financial stability. For larger firms in particular, this will add an additional layer of supervisory scrutiny and requirements.

## Issues to consider

- Does the Board understand the implications of change in supervisory tone and approach?
- Are the existing and developing supervisory requirements understood and are they, and the supervisory relationship, being managed appropriately? Have you considered appointing a regulatory relations manager?
- Is the firm's management information strong enough to deal with new national and international supervisory agendas – especially in Europe?
- Are you keeping abreast of all the new regulatory/supervisory requirements? Have you upscaled your compliance function?
- Do you have a process for maintaining an up to date understanding of all relevant requirements (e.g. a compliance manual) and for meeting these requirements?

# Perspectives: US

## Restoring the balance – Regulation and Responsibility

The issue of banking regulation reform may be more a question of how far this should go and what unintended consequences might be than whether reform is needed. In the last few months, my discussions with senior banking executives in the US have revealed a very real anxiety that the impact of Dodd-Frank, and a very conservative approach to implementation by the regulators, may result in an overly restrictive regime, with an impact on consumers, bankers and the wider economy alike. In addition, there is widespread uncertainty over the implementation of new regulation. The November 2010 election results will yield a new Congress with a new House to feature more than 20 percent new Members along with House and Senate chambers controlled by different sides of the aisle. How the new Congress will impact the new regulations is today very unclear, which in the short-term adds to the uncertainty.

We have a complex regulatory framework in the US, with multiple agencies with specific remits operating to different, sometimes overlapping agendas. Dodd-Frank adds new agencies to the present structure, including a Financial Stability Oversight Council (FSOC), Office of Financial Reporting (OFR) and a Bureau of Consumer Financial Protection (CFPB), and reallocating some of the current responsibilities of existing agencies. There is concern, about how effectively all these bodies will work together to achieve a cohesive outcome.

This risk is magnified by the short timescales on which these reforms are

to be instituted and new regulations promulgated. The timetable for consultation, comment and Congressional review is really quite tight. There is a risk that in a rush to implementation the interaction between different measures may receive too little consideration and yield unintended consequences.

One of the major features of the new US regulatory regime is the resurgence of a consumer protection agenda. There is no doubt that in the period leading up to the crisis some consumers were sold over-complex mortgage products which they didn't understand and at the end of the day were not appropriate for them. But while stronger consumer protection and oversight is appropriate, if the pendulum swings too far it may distract attention from the real issue: the effectiveness of banks' own underwriting standards.

Clearly strengthened supervision is desirable to introduce a more effective oversight of safety and soundness. The principle of requiring higher capital requirements for more risky activities and, in general, a more robust internal capital adequacy assessment process (i.e., an ICAAP), is entirely correct. Many US banks are already at or above the core Basel III ratios proposed for introduction between 2013 and 2019, and they are likely to move swiftly to demonstrate compliance well capitalized position. But the impact of additional requirements – capital buffers for SIFIs, counter-cyclical buffers, additional liquidity provisions and high risk weightings for certain asset classes – is less predictable.

*There is no doubt that in the period leading up to the crisis some consumers were sold over-complex products which they didn't understand and which they couldn't afford.*



Nor is it obvious that rules-based measures should be made to take all of the strain. There would be value in exploring smarter regulation, and supervisory innovation. Bank boards need to be encouraged to do a better job, challenging senior executives not just over core business decisions themselves but over the risk management judgments underlying them. US financial service regulators have historically shown that they can recognize the benefits of effective corporate governance and internal checks and balances. We need to restore the balance between regulation and responsibility.

The net result of competitive regulatory attitudes, hasty implementation and over reliance on a rules-based supervisory process could be a regulatory framework which is over-burdensome, and which leads banks to become over-conservative in their business practices – with undesirable economic implications. While individually many of the measures being proposed are sensible, even essential, a very real worry is whether all the pieces will work effectively together. A vibrant, efficient banking sector is an essential driver of the US – and of the global – economy. If we end up stifling innovation and banks' ability and willingness to lend, the price could be high indeed. Good, credit-worthy borrowers could be starved of finance; banks' returns could be depressed; the economic recovery, already patchy, could be more severely constrained.

Many senior regulators appear conscious of the risks of over-reaction.

On executive compensation, for example, they are being careful to work with the banks to encourage greater linkage between risk management performance and pay, but recognize the need for appropriate compensation for the best performers in the interest of a banking sector which brings benefits to all.

So there are some encouraging signs even in the face of significant unknowns, such as what the next Congress chooses to weigh in on, why, and how – especially since the new House and Senate majorities are likely to have different views about Dodd-Frank as enacted. Overall, the underlying concern will persist: whether we can prudently calibrate the integrated impact of new regulation, so that it strikes the right balance between safety and soundness and the ability of US banks to serve the national economy to greatest benefit.

*While individually many of the measures being proposed are sensible, even essential, a very real worry is whether all the pieces will work effectively together.*



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# 05



## Governance and remuneration

### Following orders...

While many of the core principles of corporate governance are well established, the crisis has shone a spotlight on the effectiveness of these arrangements. Firms' approaches to remuneration, risk appetite, risk management, the expertise and experience of non-executive directors, and the overall effectiveness of banks' corporate governance are under intense scrutiny. Demonstrating the required changes in culture and behavior will be challenging for many banks. So the priority for banks is not only to improve their governance arrangements but to be able to demonstrate this to their supervisors, investors and counterparties.

Clearly, governance is a key issue for banks of all types, in both developed and less developed markets; and will therefore be high on the agenda of banks and supervisors in each of the regions considered in this report.

The long term resilience of financial services, as in any industry, relies on sound governance. The governance of banks, including the approach to remuneration as a subset of that issue, has attracted renewed scrutiny from both politicians and supervisory bodies in the wake of the financial crisis. National and international codes of conduct for corporate governance have existed for many years, and recent publications from international regulatory bodies have not changed the overall shape of the principles of effective governance. But there has been a shift in emphasis to reflect the particular issues raised by the current financial crisis and a move in some countries towards regulators writing detailed requirements for regulated firms into their own rule books, rather than relying on national codes of conduct that apply to all firms whose shares are publicly traded. A good example of this is the way in which regulators in a large number of jurisdictions around the world have implemented the new remuneration requirements for banks.

### Principles

Governance principles and new supervisory guidance which explicitly guide supervisors to review and challenge business models, Board performance and remuneration now sit alongside clear provisions allowing supervisors to levy capital or other penalties where compliance with these principles is sub-standard.

The Basel Committee's latest set of *Principles for Enhancing Corporate Governance* (October 2010) highlights six particular areas on which banks and their supervisors should focus as a result of the financial crisis:

- Boards should be actively responsible for the business and risk strategy of the bank, its organization, financial soundness and governance, and should provide effective oversight of senior management.
- Senior management must ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the Board.
- A firm-wide approach to risk should include effective risk control (including a chief risk officer), compliance and internal audit functions, each with sufficient authority, stature, independence, resources and access to the Board, and with the capability to adapt to changes in the internal and external risk landscape. Risks should then be identified, assessed and monitored on a firm-wide and individual entity basis.
- Internal controls should be effective in design and operation.
- Risk management should communicate on a timely basis to the Board, senior management and across the organization.
- The Board should understand the risks arising from complex or opaque corporate structures.

On remuneration, many jurisdictions are adopting the FSB *Principles for Sound Compensation Practices* (September 2009). The key principle emphasized by the FSB is that remuneration should be aligned to risk and to long term performance outcomes. To achieve this, the FSB has recommended that financial institutions should ensure that:

- Total variable compensation does not limit the ability of financial institutions to strengthen their capital base.

*The governance of banks, including the approach to remuneration as a subset of that issue, has attracted renewed scrutiny from both politicians and supervisory bodies in the wake of the financial crisis.*

- Variable compensation pools take account of total costs to support risks taken, and certainty of future revenues – significant declines in performance should be mirrored by significant declines in variable compensation, including claw backs of amounts previously awarded where relevant.
- 40–60 percent of variable remuneration is deferred for at least three years, and at least half of this should be in the form of non-cash payments.
- Key elements of remuneration for senior management and for staff whose actions influence significantly the firm's risk position are disclosed.

Supervisors should review remuneration policies for compliance with these principles and take action through the setting of Pillar 2 capital requirements where policies are found to be inadequate.

#### Implementation

The EU has introduced amendments on remuneration to the CRD, applicable from January 2011, that include detailed rules rather than the previous 'principles' based approach. The CRD amendments set stricter criteria on deferred and variable pay arrangements, and include supervisory requirements to ensure that overall remuneration is not detrimental to the capital base and is capable of being clawed back where in contravention of the FSB principles. This will reinforce the more intensive supervisory scrutiny of corporate governance and remuneration policies. Alongside these measures, the comment period has recently closed on the EU's green paper on corporate governance. It takes a significant step beyond the Basel principles in its potential impact on remuneration and extension of the accountabilities of

the Board. In particular, it proposes a potential formal sign off on the effectiveness of internal controls by management (which echoes Section 404 of the US Sarbanes Oxley Act but covering risk and other controls), and raises the issue of whether there is a need for even more restrictive, mandatory measures around remuneration. Eventually, rules could apply to the global operations of EU banks and to the EU operations of global banks.

In the US, the Dodd-Frank Act sets out a number of high level principles on remuneration and governance. These include a 'non binding' say for shareholders in remuneration, claw back provisions and Board appointments, and reinforce the need for independent compensation committees and remuneration disclosures for larger companies. Separately, the FSB principles have been incorporated jointly by the Fed, OCC, OTS and FDIC in the final *Guidance on Sound Incentive Compensation Policies* released in June 2010. It is applicable to senior executives and other employees, including groups of employees (for example loan officers) who may expose the organization to material amounts of risk.

In ASPAC, the major jurisdictions have implemented the new remuneration requirements, as required by the G20. There is also an increasing focus on governance by many supervisors.

#### Key Implications

Across the globe, financial institutions are already experiencing greater supervisory scrutiny of governance and remuneration arrangements in response to the lessons learned from the current financial crisis. New regulatory rules and guidelines reinforce existing powers to examine governance and remuneration issues.

*The competitiveness of EU headquartered banks in attracting talent could be seriously challenged as a result of the tough rules around deferral and the requirement to attach a retention period, in addition to any deferral period, to equity instruments awarded to employees.*

Many banks are already looking at the necessary changes to governance and to remuneration policies. But these issues are difficult – many banks have yet to consider fully the information and education implications behind equipping boards and core risk functions to carry out their expanded roles effectively. Although supervisors have issued further guidance to help firms understand how to apply ‘risk based remuneration principles’ in practice, this is also an area which will evolve over the coming years.

While global bodies have pushed to ensure a consistent approach on governance and remuneration, the differing approaches between the EU ‘rules based’ approach and the US more ‘principles based’ approach could result in significantly different outcomes in each jurisdiction, depending upon the will and capability of supervisors to push towards an equivalent standard.

The competitiveness of EU headquartered banks in attracting talent could be seriously challenged as a result of the tough rules around deferral and the requirement to attach a retention period, in addition to any deferral period, to equity instruments awarded to employees. Financial institutions will also find it difficult to relocate employees to the EU region if there are divergences in the remuneration structures implemented across their global operations. In ASPAC, while banks in many financial centers have adopted remuneration policies similar to those in the West, there are equally centers where this is less of an issue. Clearly there is a concern that banks (or at least trading/investment banking staff) might relocate to Asia, if Asia were not adopting the same new remuneration policies being adopted in the West.

### Issues to consider

- Has the Board really debated the risk appetite of their bank?
- Has the governance structure of the bank been reviewed, including the roles and responsibilities of the Board of Directors, the senior management, non-executive directors, etc?
- Does the bank meet best international practice on independence of the Audit Committee, Risk Committee etc?
- Has the bank reviewed whether the Board has an appropriate mix of skills and experience, including risk management?
- Do you have adequate education, governance and reporting arrangements to enable new accountabilities to be fulfilled? Is regular training provided to Board members?
- Does the Board receive sufficient detailed information to enable it to exercise its oversight role effectively?
- How well prepared are banks to provide a formal attestation to the existence and effectiveness of a broad spectrum of internal controls?
- Has the Board identified current and future risks that it would consider for risk adjusting performance, and considered how the processes would work?
- Will non-EU firms apply the EU rules on remuneration structures across their global operations? Will divergence in deferral and retention requirements enable the firm to attract and relocate talent to their EU operations if a less strenuous deferral and retention requirement is applied to regions outside the EU?

# 06



## Customer treatment

### Getting protection right...

Consumer treatment and protection is a key feature of the emerging framework for banking regulation, alongside measures to control and constrain the structures and operations of banks themselves. In the United States there has been a raft of legislation that will affect the retail banking model, notably in relation to mortgages and credit cards, while in Europe the sale of banking, insurance and investment products will come under increased scrutiny with the roll out of new EU conduct of business legislation and wider consumer protection proposals.

At a time of fragile economic recovery, policy makers should be mindful of getting the right balance between protection on the one hand and overly restricting consumer choice and innovation on the other. While Asia is probably less likely to follow this route in the short term – with the exception of new rules on selling of retail investment products, which has been an issue – if there is evidence of significant customer detriment this could prompt a rethink in the ASPAC region on consumer protection more generally.

### Retail distribution in Europe

One of the core strands of the revised consumer protection strategy in the EU is around retail distribution. Persistent shortcomings in the structure and operation of the retail investment market have led to customer detriment – either because consumers end up with products that are unsuitable for them or because the charging structure is burdensome and regarded by regulatory bodies as too high.

For banks in the EU that are major distributors of investment products, this enhanced consumer protection is likely to require:

- describing with greater clarity the services and products they provide to consumers, and the charges that consumers pay for advice;
- greater emphasis on the fiduciary duties of banks to their customers;
- mitigating the potential for adviser and sales force remuneration to drive mis-selling; and
- increasing consumer confidence in the quality of advisers and sales forces.

A number of consequences may follow from this:

- the number of financial advisers and sales forces might diminish;
- parallel amendments to the capital resources and insurance requirements for banks will be tough and lead to some consolidation and rationalisation in the industry; and
- research suggests that consumers will resist paying high fees for advice, so profitability will suffer.

As a result of these changes, some banks may either stop selling investment products or move more towards the provision of simpler, more standardized products which can be ‘explained’ and sold quickly and cheaply. Complex

products will be much harder to sell into the mass market, and so will give way to standardized, ‘plain vanilla’ ones. Other banks may target high net worth individuals who are willing to pay appropriate fees for specialist advice. Product providers will need to develop new channels to market, appealing to consumers through the quality of service, product, brand and ease of administration, and to do this, change the behavior of consumers.

In addition, a number of countries are increasing their supervisory oversight of basic banking products, including deposit accounts, credit cards and mortgages, with an emphasis on product design and – particularly for mortgage lending – on the responsibility of providers to check the suitability of the product (including the affordability of borrowing).

Although the avowed aim of regulators is to improve consumer protection and restore confidence, there is some debate on whether all consumers will actually benefit, and on the appropriate balances between tougher regulation, consumer education and consumer responsibility. While deposit protection is one route with limits that will cover many consumers, this is recognized as a back stop.

### ASPAC

A number of jurisdictions in ASPAC, including Hong Kong and Singapore, have introduced similar requirements to the European ones described above on the selling of retail investment products. This followed a mis-selling scandal involving Lehman’s ‘mini-bonds’ and similar instruments. Also on the consumer front, a number of jurisdictions are introducing enhancements to their deposit protection schemes, including higher coverage levels. This is seen as an important contributor to maintaining confidence in the banking sector in

*Although the avowed aim of regulators is to improve consumer protection and restore confidence, there is some debate on whether all consumers will actually benefit.*

problem situations, and as an important plank in the resolution regime. Aside from these two areas, there does not appear to be a big push for enhanced consumer protection in ASPAC at present – although this could change.

#### Consumer and investor protection in the US

The Dodd-Frank Act establishes a Consumer Financial Protection Bureau (CFPB) to consolidate and extend the regulation of the offering and provision of consumer financial products and services. The CFPB will have the power to make rules on the offering and provision of consumer financial products and services under the relevant laws and regulations, and to apply these rules – through comprehensive consumer protection examination and enforcement – to all providers of consumer financial products and services covered by the laws, regardless of size or whether the provider is a depository institution. The CFPB may take action to prevent these providers from committing or engaging in unfair and deceptive or abusive acts or practices. Some exceptions are provided for entities regulated by the SEC and the CFTC, certain retailers and merchants of nonfinancial goods and services, and certain automobile dealers.

The Dodd-Frank Act also modifies some of the existing laws with respect to consumer residential mortgages extended by bank and nonbank mortgage originators to introduce new protections, including a duty of care for mortgage originators; a minimum standard for extensions of mortgage credit; enhanced consumer protection for high cost mortgage borrowers; and a newly defined low risk 'qualified mortgage'.

On investor protection, the Dodd-Frank Act contains several provisions aimed at enhancing existing investor protection rules, including a 'skin in the game' requirement on originators of securitizations to retain 5 percent of the credit risk, with the exception of securities backed by low-risk mortgage loans; authorization for the SEC to impose a standard of care on broker-dealers that provide investment advice, once the SEC has completed a six-month study on harmonizing broker-dealer and investment advisory fiduciary standards; new whistleblower protections and incentives; and a requirement for municipal securities advisors to register with the SEC and be subject to a fiduciary duty and other rules.

#### Taxation

Information gathering and transparency are key elements of the global tax agenda, and have a significant impact on the way banks interact with their customers. There is considerable pressure for banks to become holders of tax for the authorities, and while many do not want to take this position, it is becoming clear that it is no longer tenable for banks to claim it is not their role. The recent agreement reached between the UK tax authority and the Swiss authority is significant. While preserving the cherished privacy of Swiss banks, it has opened the path for multibillion dollar revenues across Europe. Although details are still being confirmed, it is based on the broad principle of raising revenue while protecting the identity of account holders. This agreement is to be replicated in Germany and there are similar agreements in place between

*The CFPB will have the power to make rules on the offering and provision of consumer financial products and services under the relevant laws and regulations, and to apply these rules – through comprehensive consumer protection examination and enforcement – to all providers of consumer financial products and services covered by the laws.*

Hong Kong, Singapore and various other jurisdictions. The US and Switzerland updated their tax treaty in 2009, but there are still further issues to resolve. In the US, the Foreign Account Tax Compliance Act is intended to ensure that all US account holders are identified and a 30 percent tax will be applied to institutions for withholding this information.

#### Key implications

In Europe and many parts of ASPAC, banks are having to take major decisions on how they sell, advise on and provide both investment and retail banking products. Business models will need to adjust to the changing regulatory and market landscape, and a cultural change will be required.

Significant regulatory oversight in the US means the CFPB will have a substantial impact on banks and non-banks of all sizes. Non-banks which have been largely unregulated will experience the most significant changes, including reporting requirements and enforcement actions. It is clear that the primary focus will be on compliance, fair lending and unfair and deceptive and abusive acts or practices; breaches will attract enforcement, reinforcing the need for significant change. This will require firms to introduce systems changes, operational changes, enhanced testing requirements, and new minimum standards for 'qualified mortgages' and other products.

#### Issues to consider

- Have you taken full account of existing and prospective regulatory requirements on the design, marketing, selling, and giving advice on investment and basic banking products?
- Have you considered the impact of these regulatory requirements on your business model, including the type and range of products you sell or advise on?
- Do you have the systems, data and reporting in place to meet these regulatory requirements?
- Are you paying closer attention to customer issues generally? For example have you reviewed your complaints handling procedures? Do you monitor customer satisfaction?
- Have you considered how changes in the coverage level of deposit protection schemes may affect your funding cost/availability?

# 07



## Traded markets

### Complex exchange...

The US and EU have progressed reforms affecting the traded markets which will significantly increase costs in the system as well as safety and security. New capital charges for market risk, and in particular counterparty risk, are game changing and will require fundamental changes to bank business models. Many structured and complex products will be phased out, and universal banks are likely to scale back these business lines in favor of less capital intensive flow business and core client services such as cash management.

Proposals for structural change to derivatives markets aim to enhance the resilience and regulatory oversight of trading activity by increasing transparency, discouraging complexity, and reducing systemic risk. A further squeeze on margins and increased operating costs is likely, but with many details as yet to be defined, the final impact on pricing, risk and liquidity remains uncertain, and differences between EU and US legislation could lead to increased costs and onerous compliance requirements. The business-users of derivatives are largely unaware of the increase in cost that these reforms will bring.

Low capital requirements for trading activities, and the opacity and complexity of derivatives markets, have both come under the spotlight as a result of the financial crisis. An early focus of the BCBS amendments to capital requirements following the events of 2007 and 2008 was a significant extension to traded risk requirements. New rules capture additional market, credit and counterparty risks not originally covered in the Basel II framework and will significantly increase the regulatory capital that banks need to hold against their trading activities. The BCBS has estimated that the new rules will increase regulatory capital requirements against trading book risks by three to four times from current levels and against counterparty credit risk by six to eight times. There is also increased emphasis on stress testing, which will require many banks to enhance significantly their IT and reporting infrastructure.

Basel III also introduces significantly higher minimum capital requirements for securitized products. This includes higher risk weights for re-securitization exposures (for example, the securitization of asset backed securities) and for off-balance vehicles. Securitized products will no longer be eligible for the capital-reducing internal models approach for market risk, implying that they are not regarded as true trading book assets. Synthetic CDOs and correlation credit derivatives also have increased capital charges under Basel III, although they are still eligible for the internal modeling approach. In the US, the focus has been the Dodd-Frank Act, which will be implemented through more than 100 regulations, which are still being drafted. In addition the emerging financial regulation in both the EU and US pushes

migration of derivatives trading onto open and more closely regulated markets, while prohibitive levies on capital are designed to penalize continuing OTC derivatives activities.

In practice, the result is likely to be a significant reduction in complex, structured trading and a shift towards 'vanilla' products. The change will be most dramatic in universal banks as the scale of potential profits may no longer justify the associated volatility and capital usage. In extreme cases, as in the US and potentially in the UK, the decision may be taken out of the hands of banks and mandated through legislation. The key initiatives in market risk changes and in derivatives markets are outlined in [Table 3: Traded markets](#) on page 36–37.

#### Key implications

Most transaction activity in illiquid or complex products will be subject to higher regulatory capital requirements. The combination of additional market risk charges will, in aggregate, increase significantly the regulatory capital costs of market trading activities. The US is the only jurisdiction to date which has implemented an outright ban of proprietary trading activity by deposit taking institutions, though the UK is considering it. Its practical effect remains to be seen, and many universal banks are already significantly limiting trading activity given increased costs and are focusing on client driven services.

#### Capital costs undermine attractiveness

Some of the new risk requirements introduce the potential for both subjectivity and volatility in regulatory capital calculations. Charges such as Credit Valuation Adjustment (CVA) rely on the assessment by each institution of the relative creditworthiness of

*The BCBS has estimated that the new rules will increase regulatory capital requirements against trading book risks by three to four times from current levels and against counterparty credit risk by six to eight times.*

**Table 3: Traded Markets – Issues and implications of proposed changes**

Key initiatives	Objective	Issues
<b>BCBS Market risk capital requirements</b>		
Counterparty credit risk	Increase capital charges and encourage better management of counterparty risk: <ul style="list-style-type: none"> <li>– Higher correlation and risk weightings for SIFIs.</li> <li>– Higher risk weightings of counterparty credit risk for banks using internal models.</li> <li>– New capital charge to capture potential increases in CVAs due to widening of credit spreads.</li> </ul>	<p>Major impact on trading book capital – drives majority of increase in many books. Significant implications for data capture to feed enhanced requirements for back testing, stress testing, and monitoring. Complexity and subjectivity in variables, including correlation factors for interconnected counterparties (for example financial institutions).</p> <p>Firms could respond through the increased use of central clearing counterparties and exchanges in the trading of derivatives; enhanced collateral management processes to mitigate exposures; and the development of sophisticated funds transfer pricing to take into account derivative counterparty risk at point of trade.</p>
Stressed VAR requirements	Increase capital charges by calculating VaR using data from a stressed market, reducing procyclical effects.	New models, data selection and model development will require regulatory approval.
Extended Incremental Risk Capital charge (IRC)	Address migration risk as well as default risk for credit positions.	Significant increase in capital charge, particularly for banks with large-scale credit operations. IRC will dominate the market risk capital requirement in most large banks.
Securitizations must move to standardized approach, and subject to 5% risk retention	Increase substantially the capital charge for securitizations, and improve risk management incentives through a new requirement on the originator to retain at least 5% of the risk.  Firms will no longer be able to recognize netting and correlations reflected in internal models.	<p>Some securitization activity will no longer be economically viable.</p> <p>Firms will need to review their risk management and governance procedures, and ensure that they have adequate documentation.</p>
Comprehensive Risk Measure (CRM) charge	Increase the capital charge on credit correlation products (e.g. synthetic CDOs, First to Default).	Introduces complex and significant ambiguity over calculation.
Improvements to governance and risk management of trading activity	Part of a wider emphasis on improving governance and risk management, with a focus on greater Board understanding and challenge, effective policies and procedures, and rigorous IT build and test.	<p>This will be a focus for supervisory review, with shortcomings resulting in higher ‘Pillar 2’ regulatory capital requirements.</p> <p>The Boards of many firms are already reassessing risk appetite and applying greater scrutiny to complex business lines.</p> <p>Embedding fundamental improvements to risk management and governance remains a priority but significant work remains.</p>

Key initiatives	Objective	Issues
<b>US Dodd-Frank Act</b>		
US Volcker Rule	Prohibit banking institutions from proprietary trading activities, and limit the extent to which they can sponsor and invest in hedge funds and other private pools of capital.	Difficult to define proprietary trading, and could push riskier activities to the shadow banking sector. Limiting the activities that banks can undertake is also an option under consideration in the UK.
US Swaps push out provision	Move certain swaps activity into separately capitalized affiliates.	
<b>Derivatives</b>		
Trade through Central Counterparties	Reduce the breadth of counterparty risk and improve the transparency of market activity.	This will concentrate systemic risk in central counterparties, which might not be able to withstand future shocks.  Firms will need to review data and technology infrastructure 'readiness' to deliver new stress testing and reporting requirements efficiently.
Additional capital, liquidity, margin and collateral for OTC trades	Disincentivize OTC activity by increasing costs of business, as regulators set additional capital and other requirements for uncleared trades, plus specific margining requirements in the US.	The detail of the additional requirements remain to be set, and it is not yet clear whether they will be consistent across jurisdictions. There will be exemptions for non-financial counterparties, but major participants will be caught by the rules.
All trades reported to trade repositories	Increase transparency of market activity.	Firms face significant data and process implications to ensure the consistent and effective delivery of real time trade information.  It is not yet clear whether EU and US supervisors will recognise third party repositories and will work to harmonized reporting definitions.  Differences in implementation timetables may give rise to regulatory arbitrage, with new and existing trades migrated to 'slow track' jurisdictions.

counterparties, and therefore may be calculated differently by different institutions. As OTC derivative trades are migrated onto central counterparties (CCPs) we would expect the significance and volatility of CVA to reduce. However, one unintended consequence of standardization and central clearing is that the CCPs themselves may pose a systemic risk.

Capital calculations also rely on the application of accounting fair value rules which can be applied differently by different institutions. They are themselves currently the subject of significant, and differing, new proposals by the IASB and FASB.

#### Structural changes to markets

Derivatives trading will be further affected as significant proportions of existing books are subject to standardization – reducing margins, increasing reporting, and giving rise to significant operational disruption as firms work through which businesses remain attractive for them and what process, data and IT changes will be required under the new trading paradigms. A transitional problem is that many existing contracts are difficult to dismantle and replace with 'plain vanilla' alternatives. To the extent that banks

are locked into many such contracts for a number of years, they will suffer additional capital requirements.

#### Increased supervisory focus

In both the EU and US markets, regulators are being given additional powers to develop and implement policy, and to oversee derivatives activity. In the US, the SEC and CFTC share joint responsibility, while in the EU the newly forming European Securities and Markets Authority will oversee exchanges and central counterparties, with support from the national host regulators of these bodies.

#### Significant shift in business model – and more to come

The combined impact of new rules and proposed market change is that the number of players in trading markets will doubtless diminish, and the volume of such activity decline. To the extent that systemic risk is reduced, these are valuable steps. However, given the inevitable subjectivity of approach in assessing value and counterparty creditworthiness, the changes run the danger of substituting regulators' judgment for that of management acting on behalf of shareholders; and in addition of discouraging innovation and

*A transitional problem is that many existing contracts are difficult to dismantle and replace with 'plain vanilla' alternatives. To the extent that banks are locked into many such contracts for a number of years, they will suffer additional capital requirements.*

the satisfaction of genuine commercial needs. And there may be more to come, as both the FSA in the UK, and the BCBS proceed with 'fundamental reviews of the trading book' to enhance further the supervisory focus on trading activities and management's own risk management standards, and adding further restrictions on opportunities for 'structural arbitrage' between trading and banking books – potentially supporting the introduction of a 'regulatory valuation' to sit alongside accounting valuations.

In ASPAC, where banks are generally not large players in this area, there is currently less focus on these issues. However, bankers and regulators are watching events in the US and Europe closely. An open question remains on whether there will be greater separation of banks' banking and trading businesses.

### Issues to consider

- Do you have a clear picture of your key trading strategies and the potential regulatory capital impact on them under Basel III? In particular, what will be the impact on your securitized product and exotic derivatives businesses?
- Do you have sufficient data to begin segmenting your activities, and analyzing the impact of capital changes to drive strategic business model decisions?
- What structuring options are open to you to minimize regulatory impacts and what would be the regulatory, legal, tax and operational changes of acting on these?
- Are pricing and new business models capable of reflecting the changing cost structures associated with trading activities?
- Does your risk management function follow 'industry best practice'? Is it sufficiently robust and independent to withstand regulatory scrutiny and avoid additional capital requirements?
- Are your regulatory risk models well designed and updated to comply with Basel III standards? Will the controls around them stand up to regulatory scrutiny? Have the models and data been adequately validated and is it clear which risks are captured and which are not?
- How will your IT infrastructure cope with the new model and data standards? Should MI and reporting be enhanced?
- Are your data and surrounding IT architecture capable of delivering new stress testing and reporting requirements on a systematic basis?
- Can collateral management and netting be improved to offset the rising cost of regulatory capital?
- What will be the impact on your core trading operations of changes in product portfolios and migration to exchange trading?



# Accounting and disclosure

## Planned convergence...

Despite G20 pressure for greater harmonization, the progress on convergence of accounting standards has been slow, and the risk of divergence between the FASB and IASB continues. Regulators and investors alike are at risk of reduced transparency with the relative speed of change in IFRS and US GAAP during the convergence process. Assessing the performance and risk position of financial institutions on a comparable basis around the world is a continuing challenge.

### The roadmap for change

In September 2009, the G20 Pittsburgh summit called on the international accounting bodies to “redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011.” The deadline was put back to end of 2011 by the G20 Seoul summit in November 2010.

The IASB and FASB are jointly tasked with addressing this objective. This has led to both Boards accelerating the development of a number of projects, including on financial instruments. Numerous changes to existing accounting standards are in the pipeline, in various stages of completion with varying degrees of harmonization.

The IASB is issuing a new International Financial Reporting Standard on Financial Instruments (IFRS 9) which will change the way in which financial assets and liabilities are classified and measured,

how amortized cost assets (i.e., receivable, loans etc.) are impaired and how related hedges are accounted for. Similarly, the FASB has issued FASB Proposed Accounting Standards Update, Accounting for Financial Instruments (Topic 825) and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topic 815) as an exposure draft addressing the same three topics.

#### Classification and measurement

The first phase of IFRS 9, on the classification and measurement of financial instruments was completed by the IASB in October 2010. However, it still faces some challenges in terms of national adoption/endorsement, especially in the EU. In broad terms, the current structure of four asset categories of financial instruments will be consolidated into just two:

- Amortized cost – which will be applied to assets when the business model dictates they are held to maturity, and give rise ‘solely to payments of interest and principal’.
- Fair value – for all other financial assets, when the amortized cost criteria are not satisfied.

This change aligns accounting principles closely with the regulatory model of ‘banking book versus trading book’. However, this ‘simplified’ approach will in practice require banks to perform complex analysis to determine the appropriate treatment of their assets. Many product sets contain features which straddle the traditional concepts of trading and amortized cost which could make applying seemingly simple principles like ‘solely interest and principal’ an area of debate for some business lines. Wide portfolios of instruments, including certain asset-backed securities, constant maturity

loans and others could fall into this category. The IFRS approach diverges significantly from the current proposals in the US. The FASB has set criteria for recognition that in practice are likely to require that most assets are subject to fair value treatment. However, the opinion of key stakeholders in the financial reporting arena, including regulators, is broadly supportive of the IASB approach.

#### Impairment

The incurred loss model for recognizing asset impairment currently in force under IFRS and US GAAP has been criticized as a result of the financial crisis, with a perception that it led to losses or impairment being recognized too little, too late.

Both the IASB and FASB propose replacing this with a model based on expected cash flows. The IASB model would require banks to take an upfront view of the likely loss on the loan over its life, and spread this charge over the life of that instrument. Subsequently, banks must continually re-assess that initial view in light of all available information, both firm specific and market-wide. Any adjustments would be immediately recognized in the financial statements.

The proposed change would involve significant subjectivity, with scope for differences of judgment and interpretation. It relies on a macro-economic viewpoint regarding the outlook for the firm, its sector, and the wider economy. In addition the proposed model is highly complex in the way that it combines recognition of interest income and impairment, although the IASB appears to be looking for a solution to this to simplify implementation. The present Exposure Draft (ED) would be costly to implement, but the IASB

*Many product sets contain features which straddle the traditional concepts of trading and amortized cost which could make applying seemingly simple principles like ‘solely interest and principal’ an area of debate for some business lines.*

is discussing the feedback received with a view to potentially amending its proposals.

While the stated objective is to simplify and streamline hedge accounting the IASB has not yet provided detailed proposals. On the basis of Board discussions so far, many commentators fear that future rules will be as complex as existing rules. The FASB's exposure draft essentially replaces highly complex, quantitative-based hedging requirements with more qualitative-based assessments. This makes it easier to qualify for hedge accounting with the economic effects of hedging reported consistently over multiple reporting periods. A particular risk could continue to be designated in financial items as the risks being hedged in a relationship, with only the effects of the hedged risks reflected in net income each reporting period. In addition, eliminating the shortcut method and the critical terms match method would result in a more consistent model for assessing hedge effectiveness. Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires, is sold, terminated, or exercised. This would end the ability to discontinue hedge accounting simply by removing a hedging designation, which should in turn contribute to increased comparability and transparency.

#### Other areas of concern

In addition to these differences in approach between the IASB and FASB, other areas of concern include:

- The Dodd-Frank Act in the US requires all references to credit rating agency ratings to be removed from rules and regulation. This could give rise to a significant divergence in the sources of data for mark to market approaches between the US and other jurisdictions. The FSB has recently

launched its own proposals which may bring the two approaches closer together, but this will potentially add further complexity and subjectivity to the valuation of complex instruments traded outside highly liquid markets.

- Some stakeholders in the EU are opposed to the IASB's new approach to financial instrument measurement. They argue that the IASB's approach will preclude the use of amortized cost for some common banking products. If the EU decides not to endorse IFRS and instead creates an 'EU version' of that standard then this could weaken the case for US recognition of IFRS as equivalent to US GAAP and undermine the drive for US adoption of IFRS's for domestic companies.

Much will depend on the political will to resolve current disagreements.

#### Other accounting developments

Both the FASB and the IASB have a number of other issued exposure drafts and proposed changes. Some will have direct or indirect impacts on regulatory capital:

- **Netting:** the FASB and the IASB have looked jointly at netting. The FASB proposed a framework which allows for a flexible application of netting arrangements. The IASB have yet to issue detailed proposals, but the expectation is that its proposals will tighten the already more restrictive rules for netting – the resulting 'grossing up' will increase exposure balances and therefore put further pressure on leverage ratios. Divergence between IFRS and US GAAP should be watched for in this area.
- **Consolidation:** current proposals from the IASB put forward a single consolidation model focused on

'control'. This may bring a number of Special Purpose Vehicles back into the consolidation group with consequential increases in the consolidated balance sheet. This, in turn, may give rise to increased capital requirements against assets that are not currently consolidated.

- **Leasing:** the IASB is proposing to remove the concept of operating lease, with all leases effectively treated as finance leases with so called 'right to use' assets. This may mean that the capital advantages of 'sale and leaseback' transactions on major fixed assets (such as head office buildings) are reversed as assets are brought back on to the balance sheet, leading to deductions from core Tier 1 capital.

Proposals from the FASB building on the recent changes to US GAAP for consolidation of variable interest entities and leasing would have a similar effect of potentially bringing more assets back on balance sheet.

*While the stated objective is to simplify and streamline hedge accounting the IASB has not yet provided detailed proposals. On the basis of Board discussions so far, many commentators fear that future rules will be as complex as existing rules.*

## Key Implications

While there remain a significant number of unresolved issues, banks cannot afford to wait to see how all these dynamics play out. The changes necessary to policies, business models, data architecture, and education on new rules will be time consuming and complex – preparation and gap analysis is already under way in the most advanced firms. Banks which put sufficient thought and effort into planning for these changes will find the transition complex and difficult; those who do not will quickly find they are unable to comply – with the risk of regulatory sanction and loss of market position. There are no quick fixes.

The most critical step for banks is a root and branch analysis of all financial assets. Detailed data on assets should be gathered, and a virtual library of financial assets constructed, segmented by key attributes relevant to the new standards. Data issues and gaps can be identified and remedial measures planned. Once the data are clean and consistent, assets can be assessed for the likely impact of accounting changes, mapping these through to related impacts on regulatory capital calculations.

Investment banks may already mark most of their assets to fair value, but the shape of their balance sheets is likely to change significantly, for example due to increased SPV consolidations. Universal banks traditionally aim to minimize volatility and prefer assets in their retail banking operations to be capable of being measured at amortized cost.

However, ensuring that this is acceptable, and correct, could be a significant challenge, and its scale will only become apparent once the planning exercise has begun. Community banks would be most affected by an expected loss model and could see large losses recognized in their financial statements leading to questions regarding how they might replenish their capital.

In addition, reporting changes may have a significant impact on the products banks can or wish to offer. Options may be available to restructure some products or exit certain businesses in order to minimize capital requirements in advance of the go live date for the new rules. Those who are most proactive in performing such analysis may gain a significant first mover advantage.

## Issues to consider

- Have you classified positions to identify which proposals will impact books?
- Have you considered the capital implications of books/positions most likely to be impacted by new rules?
- Have you looked at the availability and quality of data required to deliver new approaches to valuation and impairment?
- Have you reviewed and stratified your legal entity relationships to identify sheet assets which may come back on balance sheet?
- Have you analyzed your product portfolios to identify assets whose valuation basis may change?
- Do you understand the population of transactions that would be impacted from these proposed rule changes and how are you planning on embedding changes, manually or within existing systems?
- Have you begun to perform high-level modeling to understand the impact to your profit and loss and equity/capital, specifically moving from an incurred loss model to an expected loss model?
- Do you have sufficient resources in place to perform the analysis required in understanding the impact on your infrastructure/ back office?
- Are your risk management and accounting groups prepared to respond to the changes in hedge accounting from a quantitative to a qualitative approach?
- Do you have an appreciation of how the market might react to these changes and eventually how you will tell your story to various analysts as expected loss will create greater provisions to your income statement?

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