



EU Financial Services regulation

**A new agenda demands a
new approach**

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01 Introduction

Against a challenging economic and geo-political backdrop, the incoming Commission President has set a full regulatory agenda that will directly and indirectly impact the financial services industry. Climate change, the digital society and capital markets union feature prominently, along with the perennials of financial stability and consumer protection.

The Commission agenda includes an emphasis on the EU's place on the international policy stage. How will the absence of the UK impact the EU's global positioning in regulatory debates? Will EU financial markets be open and international, or closed and domestic?

Greater use of the European Supervisory Authorities' (ESAs') enhanced supervisor convergence powers is already being signalled and the national regulators also have a key role to play. How will these supervisory actions pan out and what impact will they have on authorised firms?

A challenging context

There is a majority of new faces involved in the regulation and supervision of financial services, across the leadership of the EU institutions and within the European Parliament. New faces bring fresh ideas, but they also indicate a depletion of institutional knowledge about unfinished legislative proposals and the detailed background to post-crisis regulation.

In addition to the new full agenda, legislative proposals outstanding from the previous parliament will need to be completed or binned. The Commission will have to resolve implementation issues with current rules, manage the wave of reviews of post-crisis regulation and complete work on the on-boarding of agreed global standards into EU rules.

Against a backdrop of heightened trade disputes and other geo-political tensions, the importance of open capital markets, to the EU real economy and to all financial market players and beneficiaries, is recognised in comments by senior policy-makers. There can be tensions in achieving this in practice, however, as evidenced by the "equivalence" debate.

Meanwhile, the global regulatory agenda is evolving and there are different approaches to the review of post-crisis rules.

Key messages

The adoption over 18 years ago of the "Lamfalussy" process for EU legislation, with its four distinct levels, is the cornerstone that is meant to underpin the EU's approach to financial services regulation. In practice, however, the application of the process has fallen short of its original clarity. Technical provisions have been included in Level 1 legislation and there has been a tendency to address issues of national divergence via more and more detailed regulations. Consequently, Level 1 legislation often cannot adapt quickly to market developments and new technologies.

Legislation could be developed in a way that suits the nature of European financial services today and incentivises innovation, stimulates competition and improves customer choice, with no sacrifice of regulation and protection. **A process developed almost 20 years ago remains fit for purpose, but only if all institutions are disciplined in how they apply it.**

The impending wave of reviews of post-crisis regulation raises questions about the capacity of the EU institutions and of the industry to inform and undertake these reviews. There is also a concern that, given each piece of legislation has a different review date set in law, **the EU institutions may be hampered from looking at issues in the round, across different pieces of legislation.**

The ESAs' use of their enhanced powers and the increased expectations on collaboration and information-sharing between national competent authorities (NCAs) will likely result in **tightened supervisory procedures and additional information requests for authorised firms.**

Most immediately, **firms should review any dependencies on presumed equivalence decisions in their Brexit risk assessments and contingency plans.** They should continue to factor in a range of outcomes, including no deal, and therefore the sudden loss of passports and other critical measures, such as those relating to group capital requirements.

It is generally presumed that the UK and EU regulatory regimes will continue to be aligned in the short term, but that in the medium term they will tend to move apart, as the EU reduces its dependence on what will become a third-country financial centre and the UK looks to serve other financial markets, while operating under its own rules. This divergence will feed through to the EU and UK positions in global debates.

Together with the evolving global regulatory agenda, and potentially divergent approaches between the EU and the US in particular, this points to **an increasingly fragmented rule book for global players** – counter to repeated industry demands for open markets and a level playing field at global level. It could also mean even greater pressure on supervisors to avoid extra-territorial impacts and to accept the supervision in other jurisdictions.

The EU will need to understand and balance the desire to promote the international role of the Euro with calls for third-country firms to be required to comply with EU rules and to submit to EU supervision, and for the EU to exert extra-territorial reach.

A process developed almost 20 years ago remains fit for purpose, but only if all institutions are disciplined in how they apply it



02 Changing faces

Across the leadership of the EU institutions that have a direct say in the regulation and supervision of financial services, there is a predominance of new faces, with changes in key Commission staff positions also expected. 60 percent of the members of the European Parliament (MEPs) are new to the role and the balance between political groupings has seen a significant shift.

New faces bring fresh ideas, but they also indicate a depletion of institutional knowledge about unfinished legislative proposals and the detailed background to post-crisis reforms.

The European Parliament

Italian socialist MEP, David Maria Sassoli – a former TV journalist and a late candidate in the electoral process – is the new President of the European Parliament. He leads a Parliament that has a different political balance to its predecessor and contains many new faces. 60 percent of the 751 MEPs are new to the role.

The two largest political groupings – EPP¹ and S&D² – lost 16 percent of their seats, with significant gains for Renew Europe³ (up 61 percent), the Greens⁴ (up 48 percent) and Eurosceptics (up 13 percent). In total, Eurosceptic MEPs now hold more seats than the EPP group, but they do not comprise one political grouping.

73 seats are held by UK MEPs, 29 of which are members of the UK's Brexit Party, which is not attached to any of the EU political groupings, but which has a strong political affinity with the two main Eurosceptic groups, ECR⁵ and ID.⁶ After the UK leaves the EU, 27 of the 73 seats will be allocated to other member states. In particular, France and Spain will gain five seats each and the Netherlands will gain three.

More women have been elected to the European parliament than ever before, but men still account for 60 percent of MEPs.

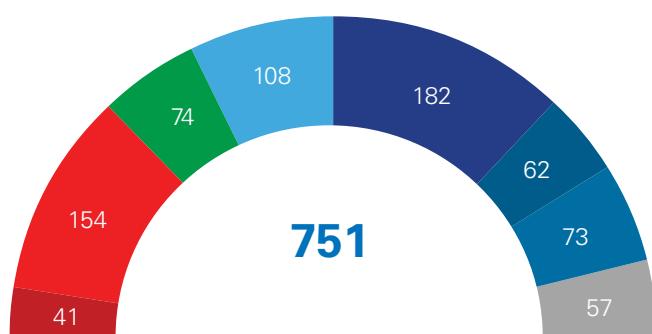
Of the 22 parliamentary committees, **ECON**, the Committee on Economic and Monetary Affairs is of paramount importance for the financial services industry.

It handles most financial services legislation and sustainable finance matters, and conducts the questioning of the European Central Bank (ECB) president and the ESA chairs.

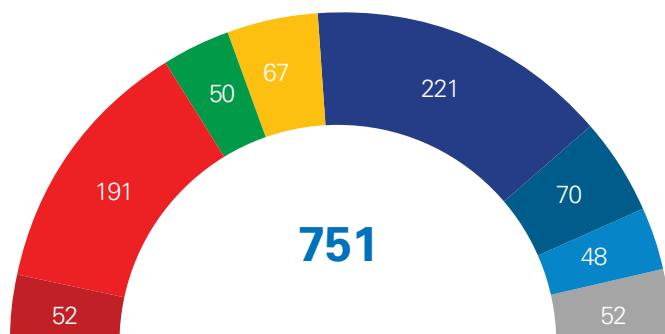
Italian socialist MEP Roberto Gualtieri was set to be committee chair for the second term in a row. Following his appointment as Italy's finance minister, ECON will now be chaired by his national and political colleague, Irene Tinagli.

European Parliament

2019-2024



2014-2019



1. European People's Party (Christian Democrats)

2. Progressive Alliance of Socialists and Democrats

3. Previously known as the Alliance of Liberals and Democrats for Europe, ALDE

4. The Greens/European Free Alliance

5. European Conservatives and Reformists

6. Identity & Democracy

ECON is the fifth biggest parliamentary committee, having 60 members, half of which come from Germany (eight), UK (eight, five of which are Brexit Party members), Italy (six), France (four) and Spain (four). The political groupings with the highest representation are EPP (14), S&D (13) and Renew Europe (eight), and there are 17 MEPs from Eurosceptic parties/groups.

The European Commission

The incoming President of the European Commission, Ursula von der Leyen was also a late candidate in the political contest. She is a member of the centre-right Christian Democratic Union party and previously served for 14 years in the federal government of Germany.

In her candidacy statement to the European Parliament,⁷ the incoming President said she would ensure full gender equality in the new College of Commissioners. Her proposed line-up achieved this balance, together with a spread of political affiliations and geographical representation. She has also called on all Commissioners to ensure a gender and geographical balance in their cabinets.

She has created three Executive Vice President (EVP) posts out of the team of eight Vice Presidents:

- Frans Timmermans (Netherlands) will coordinate the work on the “European Green Deal” and manage climate action policy
- Margrethe Vestager (Denmark) will coordinate the agenda on a “Europe fit for the digital age” and be the commissioner for competition
- Valdis Dombrovskis (Latvia) will coordinate the work on an “Economy that Works for People”, be the **commissioner for financial services** and be responsible for anti-money laundering policy, including global standards

Other positions of note for the financial services industry are Phil Hogan (Ireland) for trade and the replacement for Sylvie Goulard (France), who did not pass the Parliamentary hearing stage.

The UK did not put forward a candidate for Commissioner, but the President has said that if the Brexit deadline of 31 October is extended again, there will have to be a UK Commissioner.

Other key actors

The incoming President of the **Council of the EU** is Charles Michel, who was Belgium's prime minister and is a member of the Party for Freedom and Progress, which is within the Renew Europe group.

Christine Lagarde, previously Minister of Economy, Finance and Industry of France and Managing Director of the International Monetary Fund, is to take over from Mario Draghi as the President of the **ECB** in November 2019. The ECB President also chairs the General Board of the European Systemic Risk Board (**ESRB**).

The head of the ECB's Supervisory Board is Andrea Enria, previously chair of the European Banking Authority (**EBA**). The ECB has direct oversight of the most significant Eurozone banks under the Single Supervisory Mechanism (SSM), a key element of Banking Union. Under the New Commission's plans (see section 03), the ECB could also oversee banks' top executive appointments.

Elke König has been chair of the Single Resolution Board (**SRB**) since its establishment in December 2014. The SRB is another key element of Banking Union. Its mission is to ensure the orderly resolution of failing banks, with as little impact as possible on the real economy and public finances of the participating EU member states and others.

Gabriele Bernardino and Steven Maijor remain chairs of the European Insurance and Occupational Pensions Authority (**EIOPA**) and the European Securities and Markets Authority (**ESMA**), respectively. In March 2019, José Manuel Campa replaced Mr. Enria as chair of the **EBA**. Prior to his appointment, Mr. Campa was Global Head of Regulatory Affairs for the Santander Group and, prior to that, Professor of Finance and Economics at IESE Business School.

The **EU Agency for Cybersecurity**, formerly known as ENISA, received more powers under a regulation published in April 2019, known as the Cybersecurity Act. The Agency's work will include drafting certification schemes to provide better protection of internet-connected devices, enhancing the security of 5G telecom networks and increasing security standards for cloud providers. The term of the current Executive Director, Udo Helmbrecht ends mid-October 2019.

⁷ https://ec.europa.eu/commission/presscorner/detail/it/speech_19_4230

03 Resetting the agenda

During the candidacy stage, the incoming Commission President set out six political guidelines and a very ambitious timetable. She has since set out the priorities for each Commissioner, including for financial services. The Council has done likewise. There are common themes that will have particular resonance for and direct impact on the financial services industry.

The financial services agenda is especially long and includes a large number of wide-ranging initiatives described as building on Capital Markets Union (CMU), which will impact ordinary companies as well as financial services firms and financial institutions.

Recently-adopted ECB measures, and Mr. Draghi's request for European and national authorities to take action on fiscal policy and structural reform, will add to the pressures on regulators.

Commission President's agenda

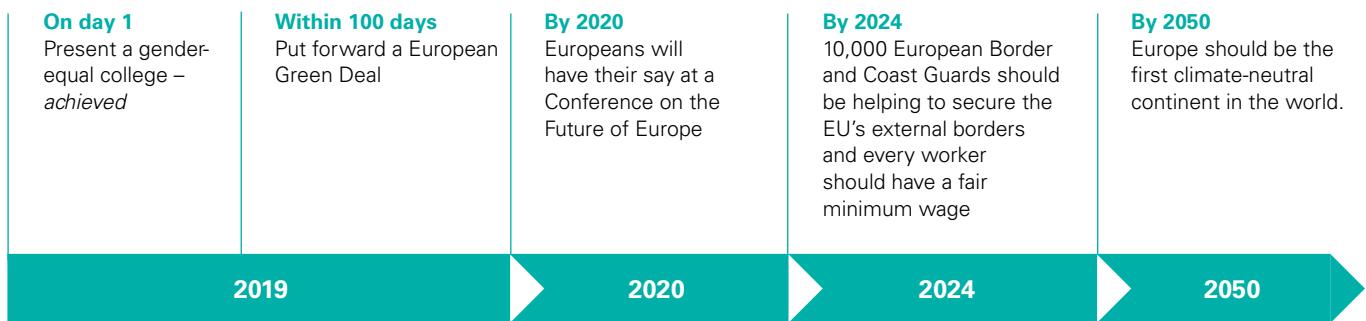
The incoming President's "Political Guidelines", as set out in her candidacy paper,⁸ focus on six headline ambitions for Europe over the next five years and beyond. A number of the guidelines, or elements underpinning them, are of particular relevance for financial services firms and institutional investors.

Concerns about **climate change** take first place. The Commission will "invest record amounts in cutting-edge research and innovation, using the full flexibility of the next EU budget to focus on the areas with the greatest potential." Parts of the European Investment Bank will be turned into Europe's climate bank, with a doubling of its financing dedicated to climate investment by 2025. The incoming President recognises, though, that public finances alone will not be enough – "We need to tap into private investment by putting green and sustainable financing at the heart of our investment chain and financial system."

She committed to complete both **CMU** and Banking Union (**BU**). A private-public fund specialising in initial public offerings of SMEs⁹ will be created. Agreement on a common backstop to the Single Resolution Fund (a last-resort insurance measure in the event of a bank resolution) and the European Deposit Insurance Scheme (EDIS) will be sought as swiftly as possible, and measures will be proposed for a robust bank resolution and insolvency framework. The task will not be easy. Opponents of EDIS, for example, are worried about the implications of mutualising EU-wide risks.

The incoming President is a strong proponent of the view that diverse teams produce better results and that innovation happens when people from different backgrounds and perspectives work together. By the end of her mandate, she promises to ensure full equality at all levels of Commission management and the Commission will propose the setting of quotas for **gender balance** on company boards.

The incoming Commission President has set an ambitious timeline:



8. https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf

9. Small and medium-size enterprises

In her subsequent letter to each Commissioner elect, the incoming President underlined her commitment to collegiate working, a strengthened partnership with the parliament, an open and co-operative approach to legislation, respect for the principles of proportionality and subsidiarity, and a focus on the application and enforcement of EU law.

The Commission President's Political Guidelines:

- **A European Green Deal: to be the first climate-neutral continent**, including a just transition, a Sustainable Europe Investment Plan, more ambitious targets for 2030 and preserving Europe's natural environment
- **An economy that works for people: more social fairness and prosperity**, by supporting small business, deepening Economic and Monetary Union, an action plan for the EU's Pillar of Social Rights, a Union of equality and fair taxation
- **A Europe fit for the digital age: grasping the opportunities from the digital age within safe and ethical boundaries**, by empowering people through education and skills
- **Protecting our European way of life: our citizens and our values**, by upholding the rule of law, having strong borders and a fresh start on migration, and internal security
- **A stronger Europe in the world: strengthening the EU's brand of responsible global leadership**, including free and fair trade, playing a more active role and defending Europe
- **A new push for European democracy: nurturing, protecting and strengthening our democracy**, including a greater say for Europeans, strengthening the partnership between the Commission and the European Parliament, more transparency and scrutiny, and protecting democracy



Of particular note are that **each Commissioner should ensure delivery of the United Nations Sustainable Development Goals and adoption of a “one in, one out” principle: each legislative proposal that creates new burdens for individuals or businesses should relieve them of an equivalent existing burden at EU level**, in the same policy area.

The financial services agenda

The Commissioner for financial services, EVP Valdis Dombrovskis has been set a challenging agenda by the incoming President:¹⁰

- complete BU, notably by finalising the common backstop to the Single Resolution Fund and the EDIS
- speed up progress on CMU to diversify sources of finance for companies and to tackle the barriers to the flow of capital, including making cross-border investments easier, improving the supervisory system and harmonising insolvency and tax proceedings
- develop a green financing strategy to ensure that the EU can direct investment and financing to the transition to a climate-neutral economy
- put forward a fintech strategy to support new digital technologies in the EU financial system
- develop a new private-public fund specialising in initial public offerings for SMEs, as part of the EU's SME strategy
- put forward a new, comprehensive approach to fighting money laundering and the financing of terrorist activities, including through better enforcement of legislation, better supervision, adapting to risks linked to new technologies and taking a stronger role in setting international standards
- ensure a common approach with member states on cryptocurrencies, to benefit from the opportunities they create and to address the new risks they may pose
- develop proposals to ensure Europe is more resilient to extraterritorial sanctions by third countries

The focus on CMU is not surprising. A report¹¹ by a task force of the European Capital Markets Institute questioned the credibility of CMU, because “risk capital has barely grown”.

A number of the report’s recommendations will likely feature in the more detailed agenda being considered by the Directorate General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA). Its agenda will be long and include ongoing matters, such as:

Safeguarding financial stability:

Banking – prudential regulation, insolvency, non-performing loans, macro-prudential framework

Non-banking – leverage loan market, the supervisory toolbox, non-bank financial intermediation, ESRB recommendations (liquidity and leverage in investment funds, use of margins or haircuts for derivatives and securities financing transactions, central counterparty inter-operability arrangements)

Retail financial services and consumers: financial inclusion, over-indebtedness, financial literacy, credit scoring and data privacy requirements, use of artificial intelligence-based scoring technology

Managing a challenging international environment: in particular, Brexit-related risks to financial stability, market integrity and investor protection arising from cross-border activity, while continuing to support a stable and integrated financial system and promoting the international role of the Euro (including the balance between EU and non-EU financial services, equivalence monitoring, and increased outreach and co-operation with international counterparts)

The Council of the EU

The Council of the EU represents member state governments. Its strategic agenda for 2019-2024 notes that in recent years the world has become increasingly unsettled, complex and subject to rapid change. This creates both opportunities and challenges for the EU, which needs to strengthen its role in this changing environment, says the Council.

The Council’s strategic agenda for the next five years is therefore focused on four main priorities:

- protecting citizens and freedoms
- developing a strong and vibrant economic base
- building a climate-neutral, green, fair and social Europe
- promoting European interests and values on the global stage

10. https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-valdis-dombrovskis-2019_en.pdf?utm_source=POLITICO.EU&utm_campaign=bed50cc9d4-EMAIL_CAMPAIGN_2019_09_10_11_06&utm_medium=email&utm_term=0_10959edeb5-bed50cc9d4-189827757

11. https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-valdis-dombrovskis-2019_en.pdf?utm_source=POLITICO.EU&utm_campaign=bed50cc9d4-EMAIL_CAMPAIGN_2019_09_10_11_06&utm_medium=email&utm_term=0_10959edeb5-bed50cc9d4-189827757

To deliver these priorities, the Council says that the EU will defend the fundamental rights and freedoms of its citizens, support the common values underpinning the EU's democratic and societal models, uphold the rule of law and ensure the territory's integrity.

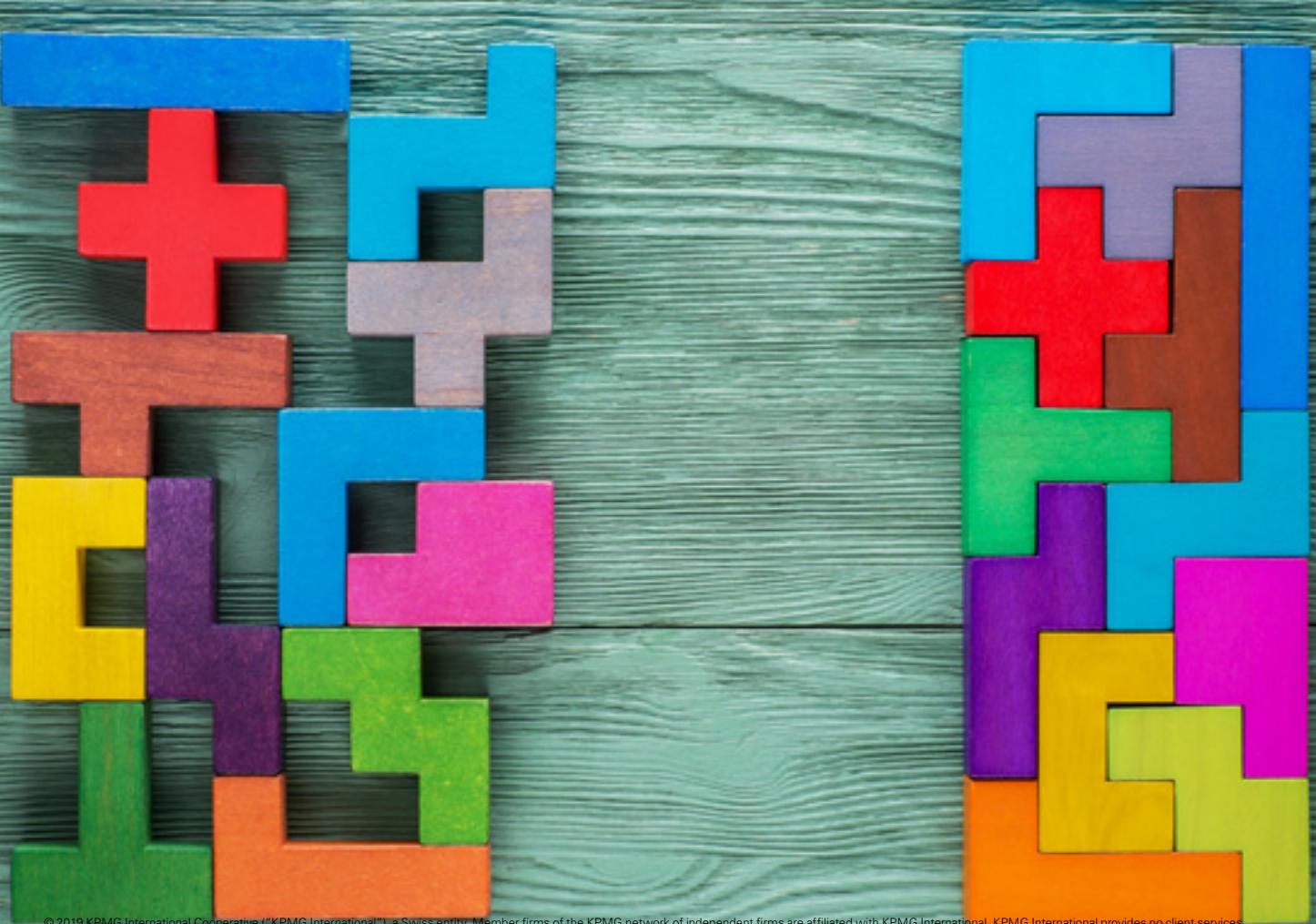
It notes that a strong economic base is of key importance for Europe's competitiveness, prosperity and role on the global stage, and for the creation of jobs. As technological, security and sustainability challenges reshape the global landscape, the EU needs to renew the basis for long-term sustainable and inclusive growth and strengthen cohesion in the EU. The Council also wishes economic and monetary union to be deepened, BU and CMU completed, and the international role of the euro strengthened.

The strategy recognises that the EU must work on all aspects of the digital revolution and artificial intelligence: infrastructure, connectivity, services, data, regulation and investment. It needs also to increase investment in people's skills and education, do more to foster entrepreneurship and innovation, and increase research efforts.

The Council seeks a level playing field, including in the area of trade. This requires fair competition within the EU and on the global stage, promotion of market access, and fighting unfair practices, extraterritorial measures and security risks.

It describes climate change as an existential threat, but which affords an opportunity to modernise and for the EU to become a global leader in the green economy. This will require, among other things, significant mobilisation of private and public investments.

As regards the EU's place on the world stage, the Council states that the EU needs to be more united in admitting that it can engage with other global powers on an equal footing only if it avoids a piecemeal approach and presents a united front, backed up by EU and member state resources. This point has a particular resonance for financial services, as we discuss in section 07.



04 Legislating for the future

The adoption over 18 years ago of the “Lamfalussy” process for EU legislation, with its four distinct levels, is the cornerstone that is meant to underpin the EU’s approach to legislating a rapidly-evolving financial services marketplace. In practice, however, the application of the process has fallen short of its original clarity.

Technical provisions have been included in Level 1 legislation and there has been a tendency to address issues of national divergence via more and more detailed regulations rather than via Level 4 powers (supervisory convergence). Consequently, Level 1 legislation often cannot adapt quickly to market developments and new technologies.

Named after Alexandre Lamfalussy, who chaired the EU advisory committee that created it, the Lamfalussy process sets out a clear distinction between Level 1 legislation and Level 2 delegated acts and implementing measures, which remains the ideal model for financial services regulation.

At Level 1, the co-legislators should set out the core principles, allowing the ESAs to develop at Level 2 the detailed rules, based on the realities of the market and empirical data. Importantly, by keeping such detail at Level 2, it allows the regulatory bodies to respond more quickly to emerging market trends and risks, and to innovation and technological advance.

Unfortunately, this clear separation has rarely been maintained. Instead, the detail of Level 1 legislation has been fought over in the early hours of the morning, with a series of compromises that include increasingly granular requirements that bear poor relation to hard evidence. Legislation has become increasingly prescriptive, and the process progressively less suited to a fast-moving marketplace, just as the pace of change has accelerated.

It is time for a more disciplined and fact-based legislative approach – a return to Lamfalussy. It would be a good start, for example, to agree that no Level 1 legislation should include data, formulae or thresholds, or anything that requires calibration on an ongoing basis. Such matters need to be promptly reviewed and adjusted as markets evolve, and should not be hard-wired into Level 1. The departure of the UK from the EU will have a material impact on the calculation of certain thresholds, such as those in MiFID II/MiFIR,¹² for example.

Any concerns about delegating too much to the ESAs ought now to have been put to bed, given the conclusion of the thorough discussions under the review of the European Financial Services Framework (EFSF – see section 06). The ESAs’ role in developing Level 2 delegated acts is to advise the Commission on what is required, not to act independently. Scrutiny by the co-legislators is built into the process. Also, the ESAs’ increased powers and their renewed determination to tackle areas of divergence between national regulators, should be given time to have an effect.

Re-establishing the clear distinction between Level 1 and Level 2 will also allow innovation to flourish. With so much detail now enshrined in Level 1, adapting rules as new technology emerges has become a slow and painful exercise, disadvantaging consumers and businesses. Ensuring all requirements are technology-neutral will enable regulation more readily to adapt to technological developments. The Commission’s consultation on the potential review of the EU Distance Marketing of Financial Services Directive 2002 provides one such opportunity.¹³

There is a real opportunity to develop legislation in a way that suits the nature of European financial services today and incentivises innovation, stimulates competition and improves customer choice, with no sacrifice of regulation and protection. A process developed almost 20 years ago remains fit for purpose, but only if all institutions are disciplined in how they apply it.

12. Markets in Financial Instruments Directive, revised/Markets in Financial Instruments Regulation

13. https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-6079786_en

“ It is time for a more disciplined and fact-based legislative approach – a return to Lamfalussy ”



05 Managing the inheritance

Work on some financial services legislative proposals was not completed before the end of the last Parliament. Some of these proposals have received explicit mention in the Commission's new agenda. Others did not make that cut but are still on the work schedule, and some may fall by the wayside.

In addition, the new Commission will have to resolve implementation issues and manage the wave of reviews of post-crisis regulation, the differing dates of which are set in each piece of Level 1 legislation. It will also need to complete work on the on-boarding of agreed global standards into EU rules.

Outstanding legislative proposals

All votes taken by the European Parliament before the May elections remain legally valid for the new Parliament, which will pick up work on Commission proposals where the previous Parliament left them. For legislative proposals that had not reached the Parliament's plenary session before the elections, there is no legally-binding Parliament position and the work already undertaken on those proposals during the previous parliamentary term lapses. It is for the new Parliament to consider its position afresh.

Outstanding legislative proposals, in addition to those mentioned in section 03, include the Level 1 Taxonomy Regulation, which will define what environmental, social and governance (ESG) mean, with a particular focus on the E factor. Its absence is a growing concern for asset managers and institutional investors, which by 2020 will need to disclose the ESG features for every product and investment strategy.

Resolving issues with existing legislation

Implementation of legislation adopted over the last couple of years has thrown up a number of issues. Their resolution is likely to require amendments at least to Level 2 measures and, in some cases, to Level 1 legislation. Also, implementation of more recently-adopted legislation awaits the related Level 2 measures.

In the retail market, for instance, duplicative and conflicting product disclosure requirements are cited by the industry and consumer representative bodies as a major issue for consumers. For example, the PRIIP KID¹⁴ has been described as a good initiative but a technical failure.

The report of the Joint Committee of the ESAs on the cross-border supervision of retail financial services identifies the main issues that NCAs face when supervising financial institutions that provide cross-border retail financial services within the EU. A number of these issues can be resolved by the ESAs and the NCAs (see section 06), but the report also highlights issues that need to be addressed at Levels 1 or 2:

- greater clarity on when activities carried out through digital means fall under passporting rules
- consideration of the ESAs' high-level principles on cooperation as the basis of any new or amended legislation

Level 2 measures are awaited for the pan-European personal pension product (PEPP), which is hailed as a step forward for the CMU project. In contrast, CMU has been hampered by the absence of Level 2 measures on disclosures under the Securitisation Regulation. The banking industry has noted that requirements for simple, transparent and standardised notifications remain too onerous.

The level of cross-border bank claims in the EU has shrunk to the level of 2005, about half that of 2011. Banks have attributed the decline to fragmentation resulting from national implementation of EU capital and liquidity requirements. The Bank Recovery and Resolution Directive bail-in regime and the high minimum levels required for banks' eligible liabilities are also cited as factors.

The calibration and setting of thresholds is a wider theme. Brexit poses particular challenges to existing and proposed EU financial services regulation in this regard, within MiFID II/MiFIR for example. Adjustment to the calibration of thresholds is made more difficult by their inclusion in Level 1 legislation, as we discuss in section 05.

14. Packaged retail investment and insurance-based products, key information document



There are also issues relating to how the BU mechanisms work in practice. The treatment of significant risk transfers is often not granted by the SSM, for instance, with the effect that capital is lost. Officials have underlined the importance of dual-recourse for covered bonds (against both the asset pool and the bank itself), but the banking industry has questioned their value, given the unpredictability of the resolution/insolvency process.

Wider reviews of post-crisis legislation

Each piece of post-crisis legislation contains a review clause, specifying the scope of the review and the date by which it must be completed (or commenced) by the Commission. Many such reviews are due to be completed over the next two to three years. Some are outstanding (Alternative Investment Fund Managers Directive, for example) and some cover major pieces of legislation, not least MiFID II/MiFIR.

This raises questions not only about capacity (of the EU institutions and of the industry) to inform and undertake these reviews, but also whether the set dates will hamper the EU institutions from looking at issues in the round, across different pieces of legislation.

ESMA has already begun work on its advice to the Commission, having issued a number of calls for evidence and consultation papers. It is also updating various related guidelines.

ESMA called for evidence by early September on the impact of the MiFID II inducements and costs and charges requirements¹⁵ and on the cost of market data and the development of a post-trade equity consolidated tape.¹⁶ ESMA believes that a consolidated tape has not yet emerged because the regulatory framework provides no real incentive for investment firms and trading venues and because there is competition in data provision by non-regulated entities.

15. https://www.esma.europa.eu/sites/default/files/library/call_for_evidence_impact_of_the_inducements_and_costs_and_charges_disclosure_requirements_under_mifid_ii_0.pdf
 16. <https://www.esma.europa.eu/press-news/consultations/mifid-ii-mifir-review-report-development-in-prices-pre-and-post-trade-data>

On-boarding global standards

The EU will need to on-board completed or expected global standards, including Financial Stability Board priorities, the last parts of Basel 3, an international capital standard for insurers (still under discussion) and IOSCO¹⁷ recommendations (e.g. liquidity management, calculation of leverage and performance fees in investment funds).

The Commission has already received EBA's advice on the final elements of Basel 3 reforms in the areas of credit risk, operational risk, output floor and securities financing transactions, together with a cumulative impact assessment.

Further advice from the EBA – on market risk and credit valuation adjustment risk – is expected later in 2019 due to the later completion of these parts of the Basel 3 framework.

Implementation of legislation adopted over the last couple of years has thrown up a number of issues

06 Converging supervisory practices

The greater use by the ESAs of their enhanced Level 4 powers is already being signalled, but as evidenced in a recent report, the NCAs also play a key role. A lack of co-ordination or information-sharing between NCAs can undermine supervisory convergence and create regulatory lacunae.

Outcome of the EFSF review

The EFSF review resulted in hundreds of pages of amendments to the four Regulations that established the ESRB and the three ESAs, and to ESMA's supervisory role under MiFIR for data providers and benchmarks.

The ESRB's role and governance were reinforced and the consultation process strengthened. Third country representatives can be invited to participate in relevant work streams and the composition of the "Advisory Scientific Committee" has been extended. For the ESAs, the overall themes of the revisions were greater transparency and consultation, enhanced governance structures and wider scope.

There is additional text on board independence and member state neutrality, and a reference to gender balance. The role of Stakeholder Groups is enhanced, wider use will be made of Co-ordination Groups, and new Consumer Protection and Financial Innovation Committees are to be established. Each ESA must publish an annual work programme and agree one or two "Union Strategic Supervisory Priorities" each year that will feed into NCAs' work programmes.

Consultation requirements on guidelines and recommendations are increased. Questions from industry must be published when received and before the answers are issued, to allow time for stakeholders to submit views. Time-limited no-action letters have been introduced.

New or enhanced areas of focus or scope for the ESAs include:

- EU-wide resilience assessments and stress tests
- Development of systemic risk measures and indicators of consumer harm
- Cybersecurity and taking account of financial innovation
- Consideration of ESG-related factors
- The supervisory approach to the fitness and propriety of key function holders
- Extended product intervention powers

The ESAs are expected to collect, analyse and report data on consumer trends (including costs and charges), undertake in-depth thematic reviews of market conduct and co-ordinate NCAs' "mystery shopping" exercises. More generally, there are increased expectations on communications between the ESAs and NCAs, and on mechanisms to achieve supervisory convergence.

The EBA has a significantly enhanced anti-money laundering role (AML). It must seek prior consent from EIOPA and/or ESMA for actions against non-banks. There is now a debate on the creation of a new European authority for AML.

Pursuit of supervisory convergence

The ESAs have identified supervisory convergence as a strategic priority. They state that supervisory convergence is not a one-size-fits-all approach but a process for achieving comparable supervisory practices in member states. Increased use of their "peer review" powers (whereby NCAs are requested to examine each other's work) is likely to increase.



Varying implementation of EU rules between member states and patchy enforcement of existing rules can give rise to particular issues as regards the supervision of cross-border activity. Poor collaboration between NCAs can compound these issues, as highlighted in the Joint ESAs' report of July 2019 on cross-border supervision of retail financial services.¹⁸

There can be particular issues where activities are carried out through digital means, or where the NCAs do not have complete and up-to-date information on which passport(s) a firm is actively using and for what. The report identifies the need for enhanced co-operation between NCAs to tackle these issues and for high-level principles on cooperation to be considered as the basis of any new or amended legislation.

The ESAs classified the issues NCAs can face into three categories:

- **institutional and organisational:** e.g. unclear allocation of supervisory responsibilities; inconsistent passport procedures; and insufficient information exchange provided for by the legislation
- **supervision and enforcement:** e.g. home NCAs prioritising supervisory activity based only on what the authorised firm does in the home member state; use by authorised firms of third parties in host member states; and aggressive and misleading marketing of complex products to retail investors
- **regulatory gaps and arbitrage:** differences in implementation due to insufficient harmonisation or clarity of some EU laws

The ESAs' use of their enhanced powers and the increased expectations on collaboration and information-sharing between NCAs will likely result in tightened supervisory procedures and additional information requests for authorised firms.

18. <https://eba.europa.eu/documents/10180/2551996/Final+Report+on+cross-border+supervision+of+retail+financial+services.pdf>

07 Acting on the global stage

The importance of open capital markets, to the EU real economy and to all financial market players and beneficiaries, is recognised in comments by senior policy-makers. There can be tensions in achieving this in practice, though, as evidenced by the “equivalence” debate. And the EU’s approach to the supervision of Euro-denominated overseas trades could run counter to the desire to promote the international role of the Euro.

It is not yet certain how the absence of the UK will impact the EU’s global positioning, or to what extent the UK’s own position will change. Meanwhile, the global regulatory agenda is evolving.

A challenging backdrop

As described in section 03, the new Commission’s agenda includes the need for the EU to play an active role in global debates. There is recognition, however, that the international environment is challenging, with a heightening of trade disputes and other geopolitical tensions.

There are Brexit-related risks to financial stability, market integrity and investor protection arising from cross-border activity. The right balance needs to be achieved between EU and non-EU financial services, and the EU’s “equivalence” framework (see below) will come under increased strain.

Meanwhile, global regulatory bodies are engaged in: reviews of the post-crisis regulatory reforms that have already been implemented; unfinished business as other parts of the regulatory reform agenda near completion or implementation; and moves into new or more intensive areas of regulation such as fintech, retail market conduct, and interest and exchange rate benchmarks.

There are different approaches to the review of post-crisis rules. The over-arching reviews in the US, for example, have led to a reining back of some of the earlier adherence or “super-equivalence” to international standards.

The EU, on the other hand, has continued to propose new rules – for example on sustainable finance and under CMU – and its reviews of post crisis regulation are piecemeal given the different dates stipulated in legislation. We wait to see the impact of the “one in, one out” principle (see section 03) in practice.

Meanwhile, although Asian regulators are adopting the recommendations of the global bodies they are also increasingly questioning the relevance of some of these standards for their local circumstances.

This points to an increasingly fragmented rule book for global players – counter to repeated industry demands for open markets and a level playing field at global level. It could also mean even greater pressure on supervisors to avoid extra-territorial impacts and to accept the supervision in other jurisdictions.

Equivalence – a new approach?

An “equivalence” decision requires a positive assessment of the third country’s regulatory framework, which enables the EU to rely on the third country’s rules and the work of its supervisor. There are around 40 equivalence provisions in EU financial services legislation and the European Commission has to date taken over 280 equivalence decisions for more than 30 countries.

Equivalence decisions are critical for third-country firms. They can reduce or eliminate overlaps in compliance requirements, allow certain services, products and activities of third-country firms to be available in the EU, and enable the application of a coherent prudential regime to EU firms operating outside the EU.

ESMA Chair, Steven Maijor said in February 2017 that the EU’s third-country framework needed to be overhauled.¹⁹ There is no generic framework – it is a series of different provisions in different pieces of legislation, each of which is time-and resource-intensive. The industry is concerned that the equivalence process is not transparent or time-certain, and that an equivalence decision might be suspended or withdrawn with insufficient notice for firms to make alternative arrangements or for markets to adjust. The prospect of Brexit has heightened these concerns.

19. <https://www.esma.europa.eu/search/site/maijor%20speeches?page=6>



In July 2019, the European Commission issued a Communication²⁰ on its approach to equivalence, which did not alleviate industry concerns. The Commission notes that recent legislation (such as the new prudential rules for investment firms – IFD/IFR²¹) include “improved” equivalence provisions, which emphasise that decisions need to be risk-sensitive, reflect closely the third country’s regulatory and supervisory framework, and take into consideration the impact of third-country activities in the EU. They also underline that ongoing compliance with any criteria and conditions must be ensured.

The Commission says there must be ongoing monitoring of a third-country’s framework after an equivalence decision has been made, to ensure that “potentially serious divergences” are identified early and addressed. It also says that the assessment of a third country whose firms are likely to make intensive use of an equivalence decision will require a more significant set of risks to the EU to be assessed. No countries are named, but the UK and the US, for example, spring to mind.

The Communication refers both to assessments being outcomes-based and that they involve “a rigorous case-by-case assessment of third-country rules.” It also refers to other factors being part of the assessment, including tax transparency and anti-money laundering rules, for instance. Moreover, equivalence – both initiating an assessment and the decision itself – is in the Commission’s gift. Third countries and firms have no right to require that an assessment be undertaken, and the Commission has the right to suspend or withdraw an equivalence decision at any time.

Most immediately, firms should review any dependencies on presumed equivalence decisions in their Brexit risk assessments and contingency plans. They should continue to factor in a range of outcomes, including no deal, and therefore the sudden loss of passports and other critical measures, such as those relating to group capital requirements.

As seen during the legislative debate on IFD/IFR, some in the EU argue that the equivalence framework should be replaced by a requirement for third country firms to register in the EU and to abide by EU rules. While such an approach would seem at first sight to be more aligned to the US approach, it would be counter to the long-standing acceptance of the “substituted compliance” concept.

Supervisory approach is key

There are calls, by ESMA for example,²² for more detailed global standards for wholesale markets and a removal of jurisdictional rule differences, to avoid the need for lengthy comparative analyses of each other’s rules and disputes over supervisory reach.

Various speeches by senior EU and US officials have indicated a common desire for open markets and that cross-border activity should not be constrained, recognising that financial services are inherently international and therefore demand a common approach. The jurisdictions have much in common – rule of law, open markets and freedom of ownership. They can and should be able to work together. However, removing all differences in the rules is likely to be some way off, if ever fully achievable, as it could be seen as cutting across national sovereignty. Therefore, supervisory practice is key.

The debates on the clearing of derivatives and the supervision of central counterparties is a pertinent example. The post-crisis reforms to derivative clearing requirements led to a coming together of supervisory minds. More recently, the push by the EU to regulate overseas clearing of Euro-denominated derivatives appeared to diverge from the post-crisis approach and caused concern in the industry.

Partly in response to the EU’s announcements, and partly because it had been re-considering its approach anyway, the then chair of the US Commodity Futures Trading Commission (CFTC), Christopher Giancarlo said²³ that the CFTC will defer to regulators abroad for the supervision for overseas clearing of US dollar trades.

20. <http://kpmgmai.co.uk/collect/click.aspx?u=jRYOrR8N39Qia3NDPz/yeFrRs6KxuEs26k8dagBgwE8E/EZjFYcB48lJjpGS3emfNjlQvJcUDEooh4LVYxwecoqzOK01gih&rh=ff004f5488fabab2017867070d4f940544370ccc>
 21. Investment Firms Directive/Investment Firms Regulation
 22. https://www.esma.europa.eu/sites/default/files/library/esma71-319-120_fese_dinner_address_dublin_june_2019_steven_maijor.pdf
 23. <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo75>

It will, though, adopt a differentiated approach, seeking stricter comparability for substituted compliance with requirements intended to address systemic risk and affording more flexible comparability for substituted compliance with requirements intended to address market and trading practices.

He also commented that if the EU intervenes in the clearing of Euro trades, it will cast doubt on the EU's objective of making the Euro a global reserve currency. The CFTC does not see it as its business to decide where in the world the US dollar trades as this would amount to "on-shoring," which would question the currency's global nature, he said.

The message for the EU is clear: it will need to understand and balance the desire to promote the international role of the Euro with calls for third-country firms being required to comply with EU rules and to submit to EU supervision, and for the EU to exert extra-territorial reach.

Close working-level regulatory dialogue

Despite their apparent public policy differences, there is a close dialogue at working level between the EU and the US regulators. The EU-US Financial Regulatory Forum takes place twice a year. It allows the European Commission and European regulatory bodies and their US counterparts to discuss pressing matters. The June 2019 agenda was wide-ranging, illustrating the breadth and depth of the regulatory dialogue, and that the forum does not shy away from difficult issues²⁴:

- Potential spill-overs from Brexit
- Oversight of derivatives clearing houses – differences in approach
- Initial margin rules for non-centrally cleared derivatives
- The US approach to foreign banks' capital requirements

- The EU's newly-articulated approach to equivalence, especially ongoing monitoring (see below)
- The leveraged loans markets
- Implementation of Basel III, on which the US awaits sight of the EU's proposals
- The impact of the "Volcker Rule" on EU investment fund managers
- The EU's sustainable finance package, on which the US is concerned about market distortions
- The search for a solution to data transfer issues arising from the EU General Data Protection Regulation
- A more permanent solution to the tension between MiFID II research payment rules and US brokerage fee rules
- Industry progress on the transition to risk-free rates and the likelihood of major issues

Wider ramifications of Brexit

In addition to concerns about market disruption and data transfer issues in a "no-deal" scenario, Brexit raises questions about how the EU's position in global debates will change absent the UK's input, and to what extent the UK's own position and influence will change. Certainly, the loss of the UK as a major actor in the shaping of EU legislation will change the dynamic in EU legislative debates, as has already happened in the EU approaches to Euro clearing outside the EU, booking models and centralised risk management, for example.

The UK has been active in the development of legislative proposals by the European Commission, and in the consideration of these proposals by the European Council. UK MEPs have been major actors in amending European Commission legislative proposals, sometimes chairing important committees or holding the pen as rapporteur.

24. <https://home.treasury.gov/news/press-releases/sm723>

The UK regulators have played a significant role within the ESA working groups. For example, some parts of MiFID II, such as payments for investment research or investment advice, and the responsibilities of manufacturers and distributors of retail investment products, were heavily influenced by UK thinking. And the UK's work on "value for money" in investment funds has prompted a review by ESMA.

Specifically, the various calibrations underpinning wholesale market thresholds (in MiFID II, in particular) will need to be reviewed when the UK's capital markets are no longer under the EU banner, and the direct input of the UK regulators' knowledge of regulating capital markets will be lost.

It is generally presumed that the UK and EU regulatory regimes will continue to be aligned in the short term, but that in the medium term they will tend to move apart, as the EU reduces its dependence on what will become a third-country financial centre and the UK looks to serve other financial markets, while operating under its own rules. It is reasonable to assume that this divergence will feed through to the EU and UK positions in global debates.

“ questions about how the EU's position in global debates will change absent the UK's input ”



08 Abbreviations

ALDE	Alliance of Liberals and Democrats for Europe	ESRB	European Systemic Risk Board
BU	Banking Union	EVP	Executive Vice President
CFTC	US Commodity Futures Trading Commission	Greens/EFA	The Greens/European Free Alliance
CMU	Capital Markets Union	ID	Identity & Democracy party
DG FISMA	Directorate General for Financial Stability, Financial Services and Capital Markets Union	IFD/IFR	Investment Firm Directive/Regulation
EBA	European Banking Authority	IOSCO	International Organization of Securities Commissioners
ECB	European Central Bank	MEP	Member of the European Parliament
ECON	Economic and Monetary Committee, European Parliament	MiFID II/ MiFIR	Markets in Financial Instruments Directive/Regulation
ECR	European Conservatives & Reformists	NCA	National competent authority
EDIS	European Deposit Insurance Scheme	PEPP	Pan-European personal pension
EFSF	European Financial Services Framework	PRIIP KID	Packaged retail investment and insurance-based product, key information document
EIOPA	European Insurance and Occupational Pensions Authority	S&D	Progressive Alliance of Socialists & Democrats
EPP	European People's Party	SME	Small- or medium-sized enterprise
ESA	European Supervisory Authority	SRB	Single Resolution Board
ESG	Environmental, social, governance	SSM	Single Supervisory Mechanism
ESMA	European Securities and Markets Authority		

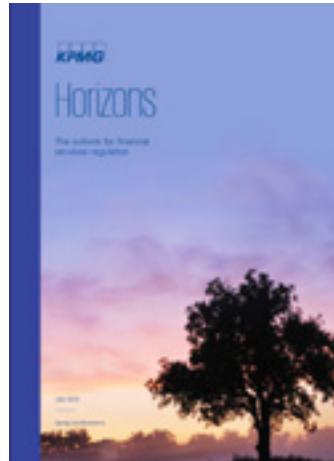
09 Further insights



Impact of ESG disclosures – Embracing the future

September 2019

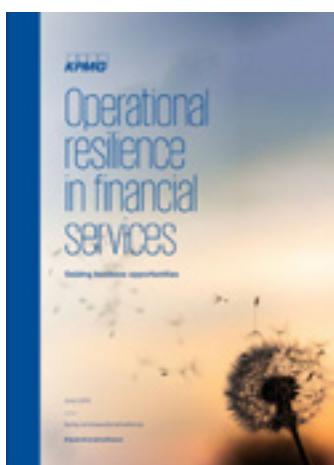
This thought leadership paper looks at the increasing set of requirements relating to environmental, social and governance (ESG) factors, from both accountancy bodies and financial regulators, and their impact on companies and enterprises of all kinds.



Horizons

July 2019

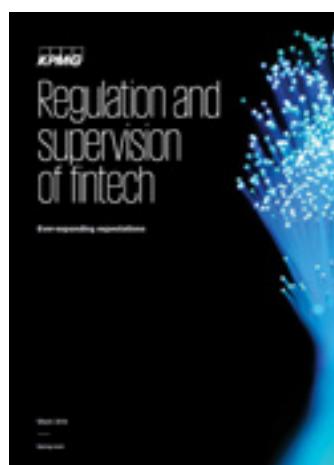
The outlook for financial services regulation. This latest edition of Horizons is your 'go to' read for insights on financial services regulation from the perspective of the EMA region.



Operation resilience in financial services: Seizing business opportunities

June 2019

This discussion paper looks at how countries across the globe are approaching operational resilience; the implications for firms in terms of costs and opportunities; the UK approach and expectations on financial institutions.



Regulation and Supervision of fintech

March 2019

The list of regulatory and supervisory responses to fintech-related risks continues to lengthen. Firms entering the fintech space need to factor the ever-changing nature of regulation and supervision into their strategies, business planning, governance and risk management.

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