



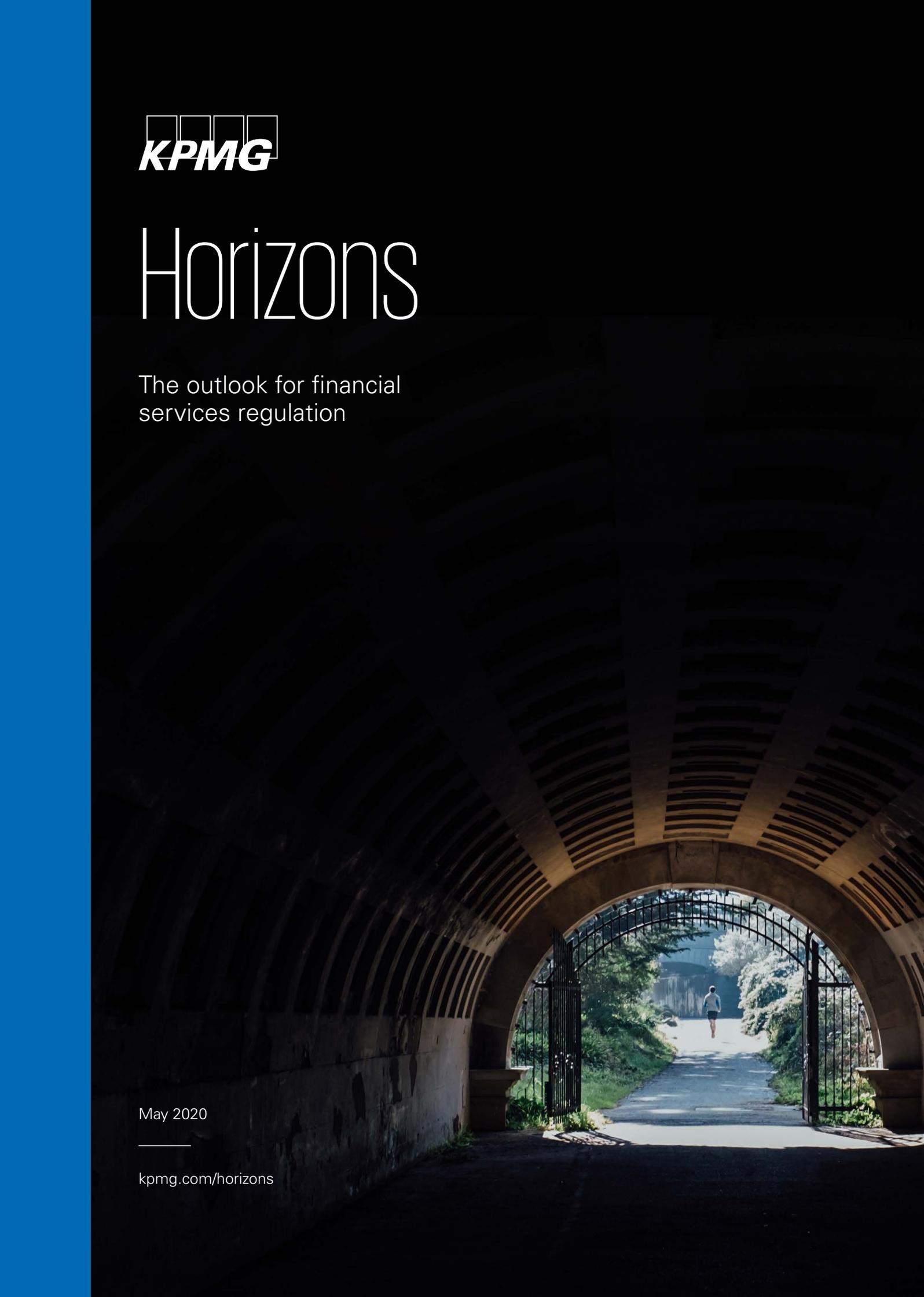
# Horizons

The outlook for financial  
services regulation

May 2020

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# Regulatory agendas bend, but do not break

**In response to the COVID-19 pandemic, regulators have been introducing new concessions or restrictions and delaying the implementation of new rules or consultation deadlines. The wider regulatory agenda currently continues, though. There are changes to relative priorities and some delays to work plans, but little reduction in regulatory outputs.**

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- Regulatory response to COVID-19
- COVID-19: Emerging risks
- MiFID II/MiFIR review: Started, but a way to go
- Shaping a digital finance strategy
- Spotlight on retail investment products



**IOSCO** has issued a [re-prioritised](#) 2020 work programme. It will address areas of market-based finance that are most exposed to heightened volatility, constrained liquidity and the potential for pro-cyclicality. This includes investment funds, as well as margin and other risk management aspects of central clearing for financial derivatives and other securities. It will also examine any specific investor protection issues, market integrity or conduct risks that are emerging.

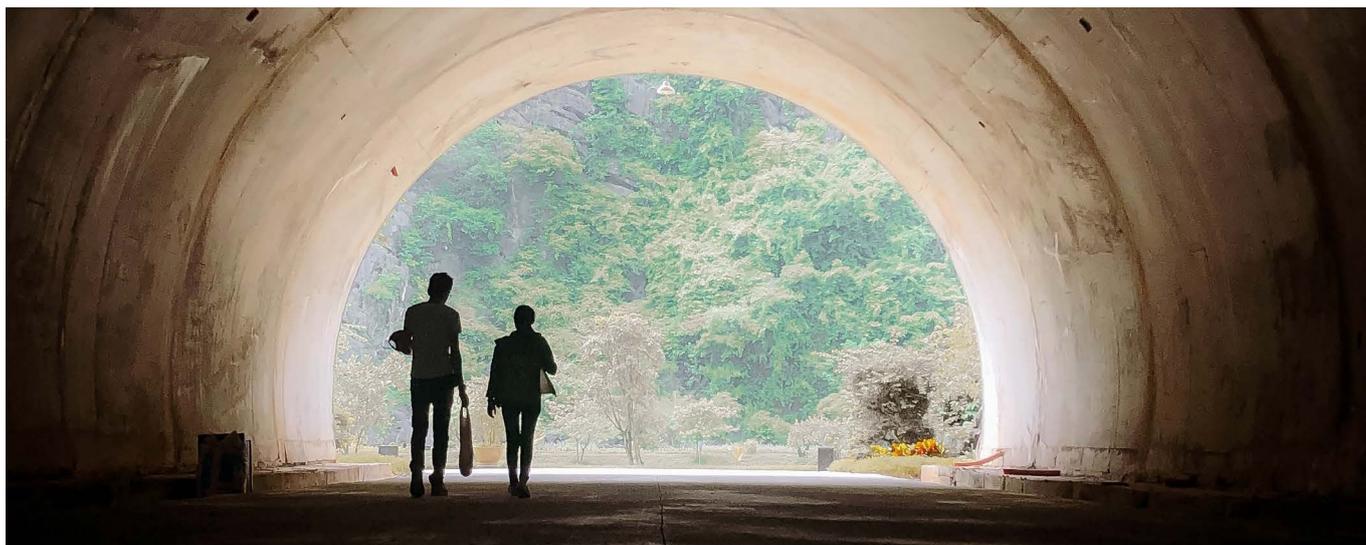
Achievement of the European Commission President's agenda for the **first 100 days of the new Commission** (see our October 2019 paper on [EU financial services regulation](#)) has been impacted but not derailed. It will have impacts beyond the EU/EEA.

In February, the Commission [issued](#) its **Data Strategy for Europe** based on four pillars: a cross-sectoral governance framework for data access and use; investments in data and strengthening Europe's capabilities and infrastructure; empowering individuals and investing in skills and SMEs; and common European data spaces in strategic sectors and domains of public interest. The last will include a European financial data space to stimulate innovation, market transparency and integration, sustainable finance and access to finance for European businesses. (See also the article on page 10.)

The regulatory push on **sustainable finance** will have significant implications for all financial services firms, within the EEA, in the UK and Switzerland, and wider. Following the December 2019 strategy document and the January 2020 Sustainable Europe Investment Plan, the Commission is now [consulting](#) until 15 July on a renewed Sustainable Finance Strategy, which includes that climate and environmental risks should be fully managed and integrated into financial institutions, and that social risks should be considered where relevant.

Meanwhile, the ESAs are [consulting](#) until 1 September on Level 2 rules to underpin the Disclosure Regulation. The proposals are prescriptive and will present significant challenges for firms, especially in the current operating conditions. There is no indication, however, that implementation will be delayed. Many policy makers argue that the current pandemic reinforces the need for these rules.

On **gender diversity**, the Commission's five-year [Gender Equality Strategy](#) includes a proposal for a Directive to introduce binding measures on improving the gender balance on corporate boards. Such measures already exist in a small number of countries, while some require gender pay disclosures.



In January, the Commission adopted its [2020 work programme](#), which includes 43 actions. Some of the work on financial services legislation may be delayed or postponed due to the impacts of the pandemic, but much will continue.

Germany will take over the **Council Presidency** from Croatia in July. As well as the above, its agenda will include completing Banking Union, progressing Capital Markets Union (CMU), more on sustainable finance and the long list of reviews of post-2008 crisis legislation (including MiFID II/MiFIR – see pages 8 and 9). However, the longer-term impacts of the pandemic will be front of mind. Berlin's Ambassador to the EU has already warned that a "radical prioritisation and reduction" of targets will be needed.

Meanwhile, the European Supervisory Authorities (ESAs) have been making increasing use of their extended supervisory powers and seeking to step up their international profile in global regulatory debates.

The **EBA**, in its new role to lead, coordinate and monitor the fight against money laundering and terrorist financing across the EU, [issued](#) in early February its first report on national regulators' approaches to the supervision of banks. It found that most are seeking to strengthen their approach and that supervisory

staff have a good understanding of international and European standards. However, significant challenges remain, including moving from tick box compliance to assessing the effectiveness of banks' systems controls, and taking more proportionate and sufficiently dissuasive measures to correct deficiencies.

**EIOPA's [2020 Supervisory Convergence Plan](#)** includes existing priorities and three new ones: supervisory technology (Sup-Tech), pension sector issues, and appropriate cyber underwriting and cyber risk management practices. Also, new priorities were added to the review of Solvency II – reporting requirements for internal models, technical provisions and group supervision.

**ESMA** has initiated Common Supervisory Actions (CSAs), under which national regulators are required to investigate specific practices within their jurisdictions and report back to ESMA (such as on liquidity management in open-ended investment funds). It has also updated its [statement](#) on consultation practices, which sets out when, whom and how it consults, and the roles of stakeholder groups. The statement contains no surprises but underlines the requirement on all regulators and supervisors to be fully transparent about their priorities and processes.

The ESAs have also continued their focus on **retail markets**, with new reports on the performance and costs in retail investment products (see page 11).

## In conclusion

In the January edition, we predicted that 2020 would be a busy year on the regulatory front and would herald a challenging decade, for firms and regulators, with new legislation to implement, more to come, and heightened supervisory expectations and scrutiny. That prediction is now set against the most challenging economic and operational backdrop in living memory. On pages 4 to 7 we comment on the emergency regulatory measures taken so far and emerging risks to financial services firms.

**The big question for policy makers and regulators is how to repair economies, businesses and livelihoods without creating a new set of unintended consequences.**



**James Lewis**

Head of EMA Financial Services Risk & Regulatory Insight Centre

# Regulatory response to COVID-19

## For financial regulators, the start of 2020 has been overshadowed by the pandemic.

Work plans and timelines have required swift and decisive reprioritisation, as regulators react to the extraordinary pressures confronting markets, firms and consumers.

### Focus of the regulatory response

Regulatory responses have fallen into three broad categories:

1. Concessions to rules, deadlines and requirements already in force.
2. Delays to the implementation of new requirements and consultation response deadlines.
3. New requirements, introduced purely in response to the pandemic, to protect markets and consumers.

### Concessions

Concessions have been wide-ranging, from reductions in bank counter-cyclical buffers, through supervisory leniency on reporting and non-critical activities, to specific assistance.

The ECB has said that it will allow banks temporarily to breach Pillar 2 guidance, the capital conservation buffer and the liquidity coverage ratio. Supervisory flexibility has been introduced around non-performing loans to allow banks to benefit fully from guarantees and moratoria put in place by public authorities.

EIOPA is publishing extraordinary weekly calculations of the relevant risk-free interest rate term structures and the symmetric adjustment to equity risk (usually calculated

monthly), to support insurers in monitoring the pandemic's impact on their solvency and financial positions.

There has been industry-wide relaxation of regulatory reporting deadlines, such as: EIOPA on filing deadlines; IAIS on insurance capital standard confidential reporting; ESMA on publication of MiFID II best execution reports, disclosures on 10% falls in portfolios and investment funds' periodic reports. The EBA, ECB and national banking regulators have issued statements on permissible delays in the submission of regulatory reporting and Pillar 3 disclosures.

There have also been concessions on the deadlines for holding meetings required by law (such as AGMs), the holding of virtual meetings and digital-only communications.

### Delays

The Single Resolution Board has confirmed that, together with national resolution authorities, it will postpone less urgent information or data requests related to the upcoming 2020 resolution planning cycle and is willing to address any issues in relation to specific requirements on an individual bank basis.

For banks, significant delays include the Basel Committee's decision to defer implementation of its final reforms by one year, pushing the

delivery schedule out to 2023 (2028 for transitional arrangements for the output floor), and the decisions to cancel or postpone stress testing for 2020. The European Commission recently confirmed that it plans to postpone publication of CRR3, thereby providing further respite from impending implementation dates such as FRTB-SA reporting.

For capital markets, the Basel Committee and IOSCO have deferred the final two implementation phases of the framework for margin requirements for non-centrally cleared derivatives until 2022. ESMA has delayed both the SFTR reporting requirements and the MiFIR tick size regime for Systematic Internalisers by three months and does not expect national regulators to prioritise the supervision of these requirements until June/July 2020.

EIOPA has extended the deadline for the Holistic Impact Assessment for the 2020 Solvency II Review by two months, to 1 June 2020.

Many consultations have been delayed or postponed, which will inevitably result in delays to finalisation of policy. However, in a number of areas, regulators continue with existing plans (see the articles on pages 8 to 11).



## New requirements

There have been consistent requests from regulators to banks and insurers to rethink their dividend and distribution strategies. Large banks, insurers and reinsurers will now suspend dividends and refrain from share buy-backs aimed at remunerating shareholders until much later in 2020. Remuneration policies are also in the spotlight.

ESMA has supported the introduction of short selling requirements. Austria, Belgium, France, Greece and Spain have extended their bans until 18 May, and measures will remain in place in Italy until mid-June.

National regulators are requiring more frequent information from managers about the liquidity position of open-ended investment funds, so as not to be on the back foot if funds need to suspend in the interests of investors.

Responding to concerns that moratoria and other programmes for struggling borrowers could force banks to recognise losses and reduce capital, the EBA published guidelines for public or private sector repayment holidays that avoid triggering rules on non-performing loans.

There is a regulatory focus on consumers across all sectors – for example, EIOPA's expectations on insurers and intermediaries about the

fair treatment of customers. In the retail markets, a number of national regulators have emphasised the need for firms to assist individual customers and SMEs, and have underlined the importance of good governance and conduct at this time.

## Finding an exit strategy

The priority of the initial response phase has been, where possible, to stabilise economies and protect businesses and their customers. The breadth of measures and the compressed timeframe have been unprecedented. Whilst many firms are still grappling with how best to implement new measures, already attention is shifting to the future. The Financial Stability Board has noted that the depth of the downturn due to COVID-19, and the timing and shape of the recovery remain uncertain.

Officials at the Bank for International Settlements described the easing of bank rules as among the bold and extraordinary steps needed, but cautioned that it must be temporary and limited to avoid undermining financial stability post the pandemic. They noted that easing the rules too far could backfire by weakening the banking sector's ability to fund the economy in future.

Thinking further ahead, Ignazio Angeloni, former ECB supervisory board member, said that unwinding regulatory relief later will take courage, adding that "regulators and supervisors should not forget that their mandate to maintain safe and sound banking and finance extends beyond the present contingency".

**It is clear that regulators will face many challenges in the coming months, not least how long to keep temporary measures in place and how best to withdraw them without creating further disruption.**



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# COVID-19: Emerging risks

**The COVID-19 pandemic is a global stress event that is testing all businesses' financial, operational and commercial resilience. Against this backdrop, the financial services sector is having to adapt rapidly and at scale to unprecedented constraints and market conditions.**

Firms have prioritised immediate financial and operational measures, such as protecting liquidity and cash flows and ensuring that they are able to keep core business activities going.

Recognising the strain on firms' resources, regulators have taken steps to alleviate the pressure (see the previous article), but a new wave of operational risks is emerging, encompassing issues such as fraud, anti-money laundering (AML) and customer due diligence (CDD).

## Fraud and cyber risk

Banks have reported sharp increases in cases of internal and external fraud as employees, customers and criminals adopt new behaviours. Regulators have issued warnings to firms and consumers on the increased risk of scams and cyber-related fraud, and internal fraud is more likely due to reduced oversight and challenge driven by remote working.

Cyber-attacks have surged, ranging from phishing attempts that play on people's concerns and desire for information, to more sophisticated attacks on networks and information flows. Cyber security experts and voluntary groups are mobilising globally to provide threat intelligence to combat these attacks.

Unexpected casualties are fraud prevention systems that rely on machine learning to analyse past patterns of behaviour. Whereas under normal conditions machine learning can improve fraud detection rates by identifying behavioural anomalies,

changes in data driven by new consumer and business behaviours are causing high numbers of false positives, thereby undermining such systems' effectiveness.

With escalating numbers of applications to access emergency support schemes, newly remote workforces, a reduction in ability to rely on automated processes and the need for greater operational scrutiny due to elevated threat, there is huge scope for substantial losses due to fraud.

## Data and security

Firms that did not have significant remote working capabilities have invested quickly in acquiring and implementing technology. Inevitably such rapid roll-outs are likely to be less robust than infrastructure changes planned and tested over a longer period.

As remote working has become the norm, employees are potentially working with sensitive data in less secure home-based environments. Extra consideration is required around data security profiles and ways in which data is accessed.

Regulations such as GDPR still apply, so Risk and Compliance heads will need to re-evaluate the associated risks accordingly and potentially deploy alternative mitigation measures.

## AML and CDD

With drastically downsized on-site teams due to remote working, usual checks and balances may not be operating as they should for a number of reasons:

- Controls may be weakened by disjointed processes and remote handovers.
- Sign-offs may be delayed due to technological constraints or availability of authorisers.
- With call centres overwhelmed and funding often required at speed, as firms work through rapidly changing guidance for support packages such as those for SMEs and large businesses, it may not be practicable to run all BAU checks.

The EBA has noted that measures to prevent money laundering and terrorist financial (ML/TF) remain crucial and has called on national regulators to support firms by sharing information on emerging ML/TF risks, setting clear regulatory expectations and using supervisory tools flexibly.



Source: <https://home.kpmg/uk/en/home/insights/2020/04/responding-to-covid-19/covid-19-guide-to-maintaining-enterprise-resilience.html>

## Market integrity

Surveillance teams are overloaded with market volatility alerts and are also being asked to consider new scenarios. In current conditions, the potential for market abuse is increased. Firms typically need a full range of alerts, based on voice communication records, trade data and employee behaviour, which may not be available with most employees working remotely.

Regulators have made temporary concessions to telephone requirements (for example, recording of calls and submission of regulatory data), but have stressed that firms should continue to take all steps to prevent market abuse risks. Some have alluded to the possibility of enhanced monitoring and retrospective reviews once current social restrictions are lifted.

## People and behaviour

For employees, the balance of trust and expectation may suddenly have shifted. Firms will need to consider the best way to support the mental well-being and connectedness of their workforce and, eventually, how best to return to office-based working.

Firms with an established model for home working will likely adapt better to the transition, whereas firms or functions which previously followed a more autocratic, sign-off driven model may struggle more. However, one should not underestimate the impact of sudden and complete remote working on the day-to-day operations of even the most forward-thinking firms.

Both individuals and firms may now be under significant new financial pressures, which may translate to uncharacteristic behaviours and, in the most extreme cases, enhanced risk-taking or internal fraud.

Customer behaviour will naturally impact firms' business and planning. COVID-19 may provoke stress responses that will add to the challenges that firms face in managing their operations and delivering good customer outcomes.

## Next steps

It is uncertain how long current restrictions will be in place or how lasting impacts will be.

Permanent adjustments to working practices and culture may be desired or required. We may also see a temporary relaxation of regulatory focus on promoting competition across all industries as firms and industry bodies are encouraged to collaborate in order to facilitate effective crisis-management.

Although there will undoubtedly be further regulatory guidance in many areas, firms will need to be proactive in assessing and addressing the new emerging risks and changing priorities.



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# MiFID II/MiFIR review: Started but a way to go

**Given the size of the task and the impact of COVID-19 on resources, it will be sometime before the MiFID II/MiFIR review is concluded, but there are already indications of possible rule changes.**

On 17 February, the European Commission launched its long-awaited public [consultation](#).

It seeks feedback on the broad impact of MiFID II/MiFIR and on specific aspects: the product distribution process; the introduction of the consolidated tape; impact on SME research coverage; and recalibration of the commodity derivatives framework to increase Euro-denominated trading.

The consultation does not give a clear indication of probable changes, but ESMA has proposed various changes, including to Level 1. These would require agreement by the Parliament and Council and would not likely come into force until at least 2021. Earlier changes could be made to Level 2 and Level 3.

There may be further delays in some areas due to the impact of **COVID-19**. Also, given the size of the UK capital markets, **Brexit** brings a complicating factor to some of the more technical proposals.

## Recommendations so far

The debate about whether a total ban on **inducements** should be introduced, as exists in the Netherlands and the UK, has re-opened. In its [advice](#) to the Commission of 1 April, ESMA finds that the rules have not had the positive impact intended or encouraged the development of independent financial advice, but

notes that a total ban would have different impacts between member states and that there should first be a review of the impact of current inducement rules on distribution.

ESMA supports the current requirements for individualised **cost disclosures** (on the basis that the MiFID I generic disclosures did not provide sufficient information for clients) and that inducements should be presented as service costs. Also, “MiFID-like investment products, such as certain insurance products, should be subject to similar inducement rules to the MiFID II ones”, it says.

On **telephone trading**, ESMA suggests alignment with the PRIIP KID Regulation and the Distance Marketing Directive, which permit *ex-ante* disclosures to be made immediately after the transaction is concluded.

ESMA argues against a new category of “**semi-professional**” clients, but favours reconsideration of the criteria for opting up to professional status and flexibility for professional investors to opt out of certain disclosures.

In December 2019 ESMA [agreed](#) with market participants that so far MiFID II has not delivered on its objective to reduce the **price of market data**.

“Reasonable Commercial Basis” provisions are not working, with value of the data for users appearing to be one of the key drivers for setting the price of data.

ESMA proposes improvements in supervisory guidance and targeted changes to Level 1 or Level 2, to strengthen the aim that market data should be charged based on the costs for producing and disseminating the information. MiFIR should be amended to remove any doubt about the obligation of trading venues to provide market data, real-time and delayed, allowing for fast access and in easily accessible and usable formats.

The December report also addressed the main reasons for a **consolidated tape** (CT) of market data not yet emerging: limited commercial rewards for operating an equity CT alongside strict regulatory requirements; competition by non-regulated entities such as data vendors; and lack of sufficient data quality.

ESMA believes that a real-time CT would bring investor benefits and contribute to establishing CMU and a single market for equity trading. However, establishing a CT would require amendments to Level 1 and 2 measures and take at least five years from the decision to go-live.

A fundamental change brought by MiFID II was the introduction of position limit and position management regime for **commodity derivatives**. ESMA's April [report](#) states that, alongside transaction reporting, the regime can contribute to the prevention of market abuse. It found no evidence of a shift of trading in commodity derivatives from on-venue to OTC trading.

ESMA suggests the regime could operate more efficiently by refocusing the position limit rules on the most important commodity derivatives contracts, through Level 1 measures, and improving convergent implementation of position management controls by trading venues, through Level 2 measures.

Promoting **market transparency** and a robust price formation process is a main objective of MiFID II. In its February [consultation](#), ESMA found that, contrary to the expectations of the share trade obligation (STO), a large portion of **equity trading** volume is still executed off-venue. Trading executed on-venue has increased but less than the increase in volume executed under the waivers. Consequently, a large share of equity trading volume is not subject to pre-trade transparency.

ESMA proposes targeted changes to MiFIR in the areas of pre- and post-trade transparency requirements, the Double Volume Cap mechanism (DVC) and the STO, to simplify the regime and improve transparency. To promote a level playing field between execution venues, it proposes enhancements to the **Systematic Internalisers** regime.

In its March [consultation](#), ESMA found that the market structures prevalent in many **non-equity markets**, the complex structure of the non-equity waivers and the multiple choices to waive pre-trade transparency turns real-time transparency into "*the choice of last resort*". It proposes reducing the complexity of Level 1 rules and the number and scope of waivers.

ESMA also finds limited real-time **post-trade transparency**, exacerbated by the complex deferral regime, which is subject to national discretion and has led to inconsistent rules across the EU. It proposes reducing the number of waivers and moving to a single regime for post-trade deferrals but sees no need to amend the derivatives trading obligation.



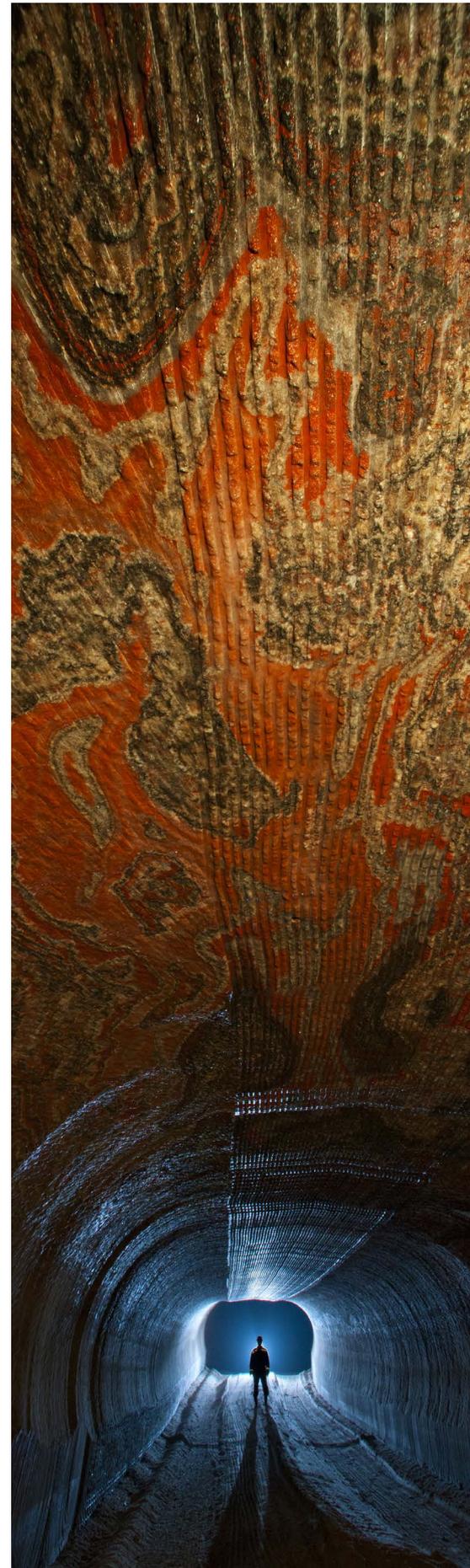
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# Shaping a digital finance strategy

## The European Commission is seeking views on a new digital finance strategy for Europe and on a retail payments strategy.

As set out in its 2020 work programme, the Commission will publish, in Q3 2020, a new digital finance strategy/FinTech action plan that will set out areas that public policy should focus on in the coming five years.

Responses to the [consultation](#) will inform the Commission's forthcoming work. The paper seeks input by 26 June in three key areas:

1. **How to ensure that the regulatory framework is technology neutral whilst, at the same time, being innovation-friendly.** The Commission is seeking specific examples where innovation is hindered and whether the level of current consumer protection available is appropriate.
2. **How to remove fragmentation of the Single Market for digital financial services.** The Commission is seeking views on suggested actions it could take to address this fragmentation, and whether there is merit in establishing an innovation hub or regulatory sandbox.
3. **How best to promote a well-regulated data-driven financial sector.** The Commission seeks opinions on the advantages and challenges of extending "Open Banking" to other sectors where the sharing of data could increase competition and customer outcomes.



Although this is described as a consultation paper, it takes the form of a questionnaire/survey and is more like an initial call for evidence or white paper. It seeks views about the relative importance of a number of initiatives, how the market might evolve, and the associated prudential and conduct risks, rather than asking for detailed comments on fully-formed policy views. Therefore, it provides a greater opportunity to influence the areas of future focus within the Commission's Fin Tech action plan.

The Commission is also [consulting](#) on a **retail payments strategy**. It notes that digitalisation and new technologies have prompted the emergence of innovative payments, but that Europeans are not fully benefitting, because faster, more innovative payments remain domestic or are not yet available on a large or European scale.

It therefore wishes to develop a strategic vision to ensure that consumers and companies fully reap the benefits of an integrated market, offering secure, fast, convenient, accessible and affordable payment services.

The debate about **Open Banking** or **Open Finance** is taking place at national level as well but is at different stages. The UK FCA, for example, has issued a [Call for Input](#) and it has already considered, at a more granular level, what some of the risks and opportunities may be.



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# Spotlight on retail investment products

## The regulatory focus on performance and costs of retail investment products continues.

ESMA's and EIOPA's latest reports reveal continued issues around data availability in some sectors.

ESMA's second annual [statistical report](#), based on data from 2009 to 2018, found that while costs in funds remain stable, performance is highly variable and retail investors continue to pay on average 40% more than institutional investors. Actively-managed UCITS outperformed passively-managed funds on a gross basis, but the difference was not enough to compensate for the higher costs charged by active funds.

For retail alternative investment funds (AIFs) – which are mostly open-ended and account for 16% of the total AIF population – no data were available for costs, but gross returns were found to be negative for funds with large retail investor bases.

The market for structured retail products (SRPs), at EUR 400bn in 2018, is significantly smaller than the retail funds market. ESMA notes that analysis of SRPs' performance and costs is complicated by the large variety of SRPs available and their pay-off features. Also, given that regulatory data are not available and data from commercial providers are limited, the scope for conclusive analysis is severely constrained.

EIOPA's [report](#) states that, overall, performance in 2018 of insurance-based investment products (IBIPs) was the lowest for five years. The key findings were:

- Unit-linked products can offer high returns but also pose risks for consumers during periods of poor market returns.
- Costs remain high, but profit-participation products continue to have lower costs than unit-linked products.
- Ongoing costs continue to be the most prominent cost component, representing 80% of total costs of unit-linked products and 70% of total costs of profit-participation products.
- Of ongoing costs, administration costs are the largest, followed by distribution costs. Higher-risk products on average have higher net returns, but also higher variability of net returns; and average costs increase with the level of riskiness of the product.

Trends of personal pension products follow those of IBIPs, but the analysis needs to be interpreted cautiously given differences in national regimes and the study's coverage.

No further analysis of the structured deposit market has been issued by the EBA (see the May 2019 [edition](#)).

**The reports' findings underline the continued regulatory focus on the level of costs and charges. It is again notable that lack of data prevented detailed analyses for some sectors, despite mandatory disclosures having been in place for some time.**



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## Coming soon

**COVID-19: regulatory perspectives on recovery and the new reality**

The focus by regulators to date has been on **responding** to immediate issues and on the **resilience** of firms and markets. Policy makers are now turning their attention to the **recovery** phase.

Look out for our forthcoming publications on that issue and on what the **new reality** may look like, along with the ongoing regulatory agenda.

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