



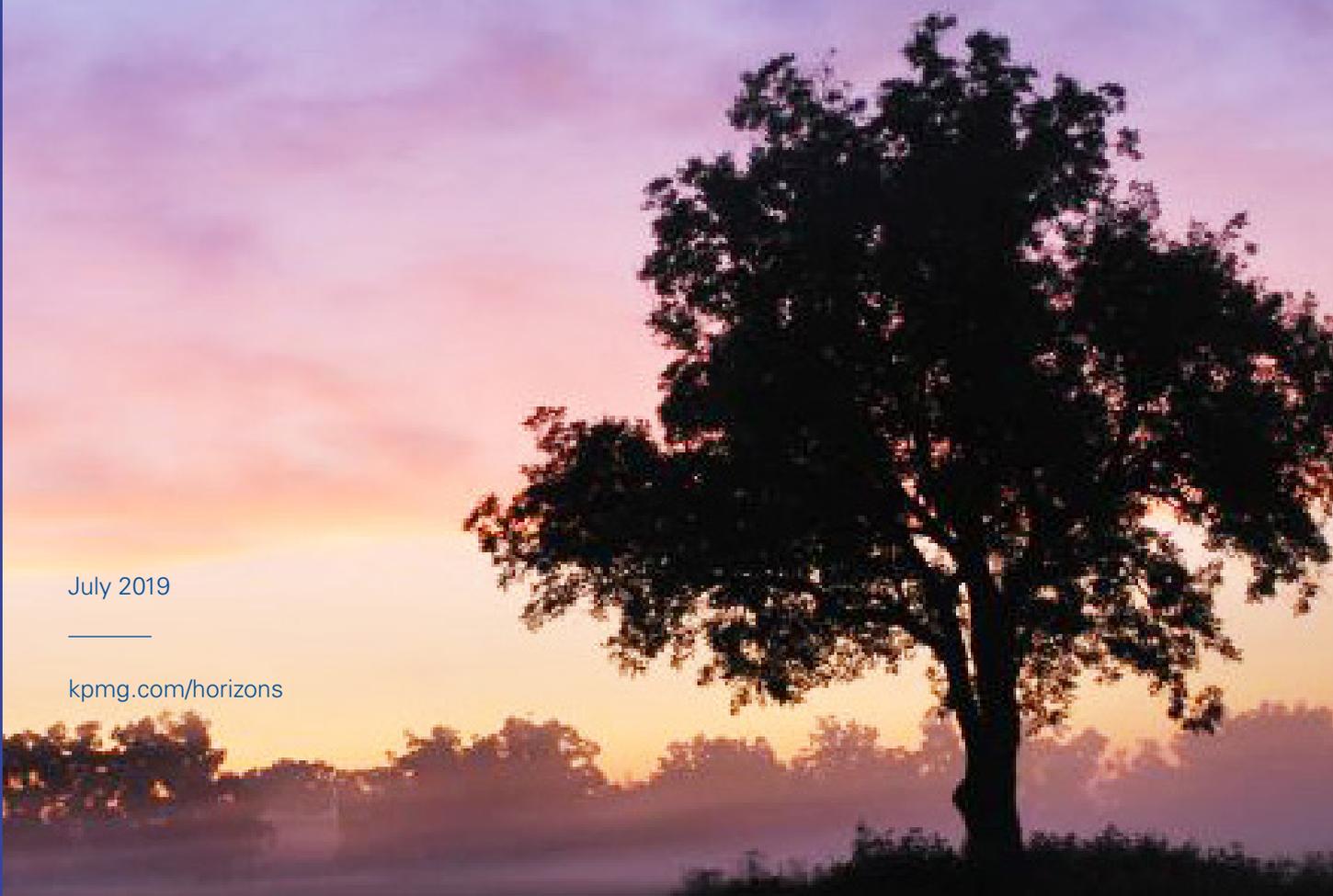
# Horizons

The outlook for financial  
services regulation

July 2019

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# Supervision takes the lead

**Reviews of post-crisis regulation and new areas of rule-making remain priorities for policy-makers, but supervision and monitoring activities have moved into first place.**

## In this edition:

Supervision takes the lead

Insurance regulation: a watershed moment

EBA finds significant capital shortfalls

Sustainable finance: continuing regulatory focus

Resolution: disclosure and operational readiness

Recent alerts and insights

## Culture and conduct move up the regulatory agenda

It is in the area of conduct risk and culture that we are seeing the greatest increase in supervisory intent and activity. We describe on page 4 the new focus of the International Association of Insurance Supervisors (IAIS) on the conduct and culture of insurance companies. And the Chair of the Supervisory Board of the European Central Bank, Andrea Enria has [spoken](#) of the importance of culture and governance for “good” banking.

This emphasis on risk monitoring and the use of supervisory tools and co-operation is reflected in the recent outputs of global and EU policy-makers. And we are seeing supervisory action as well as words – the use by ESMA of its product intervention powers to ban the selling of binary options to retail customers is one example. See KPMG’s [“Transforming compliance in financial services”](#) for thoughts on how firms need to evolve their approach.

## Financial stability remains a key priority

Against a backdrop of stabilising global growth but intensified trade and geopolitical tensions, the June [G20 Communique](#) noted that “an open and resilient financial system, grounded in agreed international standards, is crucial to support sustainable growth.” The G20’s priorities remain largely unchanged, but the Communique draws attention to recent reports on market fragmentation and the need to address unintended, negative effects through regulatory and supervisory cooperation.

The Communique also notes that crypto-assets do not pose a threat to global financial stability at this point, but that the G20 remains vigilant to risks, including those related to consumer and investor protection, anti-money laundering and countering the financing of terrorism.

IOSCO’s examination of liquidity in the corporate bond markets and the work of its cyber task force, and ESMA’s work on data and reporting issues (including standardisation, the international adoption of legal entity identifiers, and the use and exchange of data cross border between regulators) are examples of this regulatory focus and drive for co-operation.

Meanwhile, the EBA has presented its findings on the impact of the December 2017 revised Basel Committee standards on EU banks (see page 6). We discuss on page 10 the FSB’s consideration of the resolution of large banks, an approach which might be extended to other banks and financial institutions. And KPMG’s [“Operational resilience in financial services”](#) comments on the emerging approach of regulators to this issue.

## Cross-border regulatory co-operation has come under strain, though

At the beginning of May, the Chair of the US Commodity Futures Trading Commission (CFTC), J. Christopher Giancarlo [criticised](#) changes to the European Market Infrastructure Regulation (EMIR), which bring non-EU clearing houses into EU supervision and provide for fees to be charged for the cost of that oversight. He was emphatic that US markets will stay under US regulation.



Giancarlo [supports](#) the use of deference tools (such as substituted compliance and exemptions) to promote the benefits of integrated global markets. “When properly calibrated, deference promotes open, transparent, and competitive markets without compromising market integrity while mitigating the risk of fragmentation in global cross-border markets”, he said. We wait to see whether his successor will take the same line.

In June, ESMA’s Chair, Steven Maijoor [acknowledged](#) that regulators are constrained by their legal frameworks and mandates, but said that they should “do their utmost to find and use tools to adequately address cross-border issues and support the functioning of global financial markets”.

The European Commission has issued draft equivalence decisions on a number of third-country credit rating agencies. However, the application of trading obligations in the context of Brexit and between the EU and Switzerland remains a major concern for market participants and reinforce continuing unease that equivalence judgements can effectively be torn up with little notice.

## Sustainable finance becomes the third leg of the regulatory stool

It is increasingly difficult to find any global, regional or national regulator that has not issued papers on this subject. Recent outputs include: [recommendations](#) by IOSCO’s Growth and Emerging Markets Committee; a [consultation](#) by EIOPA on the integration of sustainability risks, in particular those related to climate change, in the investment and underwriting practices of insurers and reinsurers; and a [survey](#) by ESMA on “short termism” in financial markets.

On page 8 we provide a further update on the rapidly-evolving EU regulatory debate in this area, with the issuing of three reports by the Technical Expert Group and guidelines from the European Commission.

## And let’s not forget...

The ECB has [written](#) to bank chief executives, demanding that by end-July they submit their assessment of the risks to their firms of the transition to risk-free rates and their detailed plans to mitigate those risks, address pricing issues and implement process changes.

More generally, it will be interesting to see what change in agenda or tone is set by the new ECB chair, whose appointment awaits formal ratification. The new Commissioner covering Financial Services will also be of keen interest for the industry, together with his/her priorities for the next period and any consequent changes in key policy makers. And there is the small matter of Brexit – how and when?

“When properly calibrated, deference promotes open, transparent, and competitive markets without compromising market integrity while mitigating the risk of fragmentation in global cross-border markets.”



**James Lewis**  
Head of EMA Financial Services Risk & Regulatory Insight Centre

# Insurance regulation: a watershed moment

## The International Association of Insurance Supervisors (IAIS)'s new strategy shifts the emphasis from policy standards to supervision of an insurer's "culture".

The IAIS's 2020-2024 Strategic [plan](#) shows a marked and material change in focus, which will influence the approach adopted by insurance supervisors around the globe, including EIOPA.

### What does the plan say?

In the IAIS's own words, the strategic plan is "a watershed moment" with the key development being a shift of emphasis from finalising policy work as a result of the financial crisis to adopting a more proactive stance on conduct and culture – which is cited as a key strategic priority. In our view, it is this aspect that could have a material impact on the way in which insurers are supervised.

The strategy also includes an assessment of emerging trends and developments, some of which have been considered in previous editions of Horizons, such as: new lines of business (e.g. cyber insurance); market growth in emerging markets and developing economies (expected to exceed growth in developed markets); and emerging policy issues (e.g. climate change, ageing

population, InsurTech, cyber risk, financial inclusion and sustainable development).

And finally, business as usual activities such as finalising developing global standards, supporting implementation and contributing to global financial stability (e.g. Insurance Capital Standards and ComFrame).

### What does the focus on culture mean?

The IAIS's approach recognises the linkages between prudential and conduct supervision, and promotes a joined-up approach to insurance supervision, viewing culture as the thread that intrinsically and inherently links the two sides.

There have been many instances across the financial services industry where poor culture or conduct was

the main driver of poor customer outcomes. An emphasis on culture could prove difficult in jurisdictions where the letter of the law is king, but it could deliver a number of benefits for supervisors:

- It is efficient and can be gleaned from a number of sources (from direct regulatory interactions to how firms respond when things go wrong)
- It becomes apparent – culture is pervasive and a firm's true culture is always eventually revealed
- It places accountability on firms to ensure "tone from the top" and "echo from the bottom" are genuinely aligned
- It will generate good customer outcomes and satisfy a significant proportion of a firm's regulatory obligations

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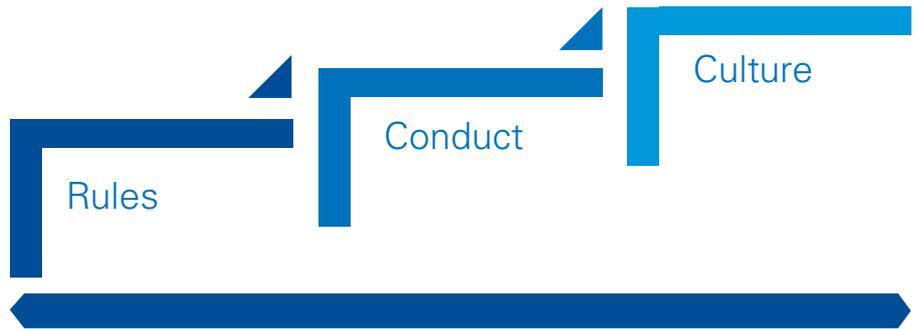
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## Why does this change matter?

The change of focus and inclusion of culture as a supervisory tool represents a material departure from the approach that most supervisors currently adopt, which tends to fall into one of the following three categories:



**1. Rules-based:** Many supervisors oversee firms based upon their adherence to an explicit set of rules and guidance. Firms are expected to design and implement an appropriate control environment to monitor adherence to the rule. The supervisor will assess whether the control is working effectively.

**2. Conduct-based:** Some supervisors are more interested in firms meeting the spirit of a rule rather than adopting a narrow and legalistic application to the specific wording of a requirement. Firms are expected to take responsibility and to think more about the outcomes they generate rather than only on meeting the specifics of a requirement. The supervisor will assess whether the firm is delivering good customer outcomes.

**3. Culture-based:** A handful of regulators, including in the Netherlands and the UK, are now adopting a more cultural approach to supervision (alongside a conduct-based approach), which considers whether the firm has, and maintains, a customer-centric culture in everything it does. This is designed to ensure an appropriate balance between the commercial interests of the firm and delivering good (and fair) customer outcomes. The supervisor will assess whether the firm is culturally aligned to its customers needs and interests and treats them appropriately.

Characteristics of the different supervisory approaches		
Firm-focussed	Some customer considerations	Genuinely balanced between customer and firm
Legalistic	Outcomes-based	Behavioural-based
Rules-based	Regulatory intentions	Principles
Compliance mind-set	Accountability mind-set	Community mind-set

## What should firms be doing?

The IAIS’s approach is expected over time to change how supervisors view and oversee insurance firms, including in jurisdictions where the supervisors already adopt conduct-based or culture-based supervision. For example, EIOPA already considers conduct within its supervisory strategy but it does not include consideration of culture.

**Firms should consider the potential impact of supervisors adopting both a conduct and cultural lens and how material such a change could be.** For firms or groups operating in different jurisdictions, the direction of travel could be a convergence of supervisory approaches, but national variations will persist for some time.

### Case Study – The IDD

Implementation of the Insurance Distribution Directive (IDD) is a good example. The IDD aims to “ensure that the same level of consumer protection applies and that all consumers can benefit from comparable standards” across the single market. Those involved in IDD implementation programmes over recent months may have been more focused on reviewing the allocation of roles between undertakings and intermediaries, updating policy and procedure documents, or introducing new training programmes. It is important to remember, though, that this regulation primarily exists to drive good customer outcomes and should not be viewed as a set of prescriptive requirements. A customer-centric approach is essential to achieve the aims of the Directive, most notably that firms act in accordance with the best interests of customers.

# EBA finds significant capital shortfalls

## **The European Banking Authority (EBA)'s assessment of Basel 4 reveals significant capital shortfalls for large EU banks.**

The EBA has [published](#) the key findings from its assessment of the impact of the December 2017 revised Basel Committee standards on EU banks. It has also made a number of policy recommendations relating to the implementation of these Basel Committee standards in the EU.

### **Impact assessment**

The EBA's impact assessment is based on a sample of 189 EU banks, using data as at June 2018. It applies the December 2017 Basel Committee revised standards on credit risk, operational risk and the output floor; applies the January 2016 Basel Committee revised standards on market risk (not the later January 2019 market risk standards, which generally impose lower capital requirements on banks); and makes no allowance for credit valuation adjustment (CVA) exemptions.

For the entire sample, minimum capital requirements increased by 24.4 percent, and by 28.6 percent for the eight EU global systemically-important banks (G-SIBs). In terms of capital shortfalls against banks' June 2018 capital positions, almost all the overall shortfall of EUR 135 billion is concentrated in large EU banks, of which the G-SIBs constitute EUR 83 billion. The main drivers of these shortfalls are the output floor (increasing minimum capital requirements for large banks by 9.5 percent), CVA (4.1 percent), and operational risk (3.4 percent).

These shortfalls are much higher than those reported in the EBA's six-monthly Basel 3 monitoring exercise because that exercise does not take account of some capital buffer requirements or Pillar 2 capital additions.

The EBA notes that these impacts are reduced somewhat under alternative assumptions, such as using a proxy for the January 2019 market risk standards, applying the EU supporting factor for lending to SMEs, applying CVA exemptions (this reduces the CVA impact by 75 percent), and setting the internal loss multiplier to 1 in the operational risk calculation.

**The capital shortfalls for large EU banks imply the need for significant capital raising (full profit retention over the transition period would still leave a shortfall of EUR 59 billion). As has been the pattern for EU banks since 2008, the response of banks may also be to reduce their balance sheets to reduce risk weighted exposures.**

## Policy recommendations

**The EBA's policy recommendations suggest a generally hard-line stance to the EU implementation of the revised Basel standards.** Its main recommendations are:

### Credit risk

- to support the revised Basel standardised approach, including the generally higher risk weights on equity, subordinated debt and other capital instruments, but:
- to provide a series of clarifications on issues such as due diligence requirements in loan granting, the role of government support elements in the ratings of institutions, specialised lending, equities, continued use of the 'hard test', and alignment to the valuation framework
- to address a set of detailed issues relating to: the internal ratings-based approach to credit risk, including removing the use of a definition of default of 180 days past the due date; the treatment of sovereign exposures, specialised lending, covered bonds and high-volatility commercial real estate; the introduction of loss-given default input floors in line with the Basel framework; and credit risk mitigation
- to remove the SME and infrastructure finance supporting factors, since no further adjustments are needed to the more risk-sensitive Basel 3 treatments

### Operational risk

- not to apply the discretion to set the internal loss multiplier (ILM) to 1 for all 'bucket 2 and 3' banks (so ILMs would be bank-specific)
- to retain the discretion to allow 'bucket 1' banks to use a bank-specific ILM
- to improve the qualitative requirements on definitions, governance and loss data
- to introduce a transitional phasing-in of the standardised measurement approach to operational risk, to smooth the potential cliff-edge effects of moving from the current approaches and to allow more time to improve data quality and completeness

### Output floor

- to introduce the output floor in line with the Basel standards, including the long transition period
- to require the full stack of capital requirements to be calculated on the basis of each bank's minimum risk-weighted assets (RWAs), including the counter cyclical buffer, the G-SIB (and domestic SIB) buffers, capital conservation buffer, systemic risk buffer and Pillar 2 requirements
- to apply the output floor at solo and consolidated levels
- to take due account of the new output floor requirements when setting Pillar 2 requirements and systemic risk buffer

### Securities financing transactions

- not to apply the minimum haircut floors for SFTs – this should be for market regulation to determine

## Next steps?

These recommendations come at an early stage in the process, so some of them may not survive the final cut. The EBA will send its recommendations to the Commission at the end of July, then the Commission will undertake further public consultation before issuing its proposals for a CRR3, which will only be finalised after trilogue with the European Parliament and Council. So, there is still a long way to go.

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# Sustainable Finance: continuing regulatory focus

**The regulatory momentum on sustainable finance is maintained by the European Commission's new [guidelines](#) designed to improve how firms report climate-related information.**

As part of the EC's Sustainable Finance Action [plan](#), and consistent with the Non-Financial Reporting Directive, the EC guidelines provide practical recommendations on reporting the impact of economic activities on the climate, as well as the impact of climate change on businesses. They build on the recent recommendations of the Technical Expert Group (TEG).

## Technical Expert Group reports

Three reports have been published by the EC's TEG on Sustainable Finance, one year since it was set up. The reports include key recommendations on the types of economic activities that can make a real contribution to climate change mitigation or adaptation:

- [A classification system \(taxonomy\) for environmentally-sustainable economic activities](#), which aims to provide practical guidance for policy makers, industry and investors on how best to support and invest in economic activities that contribute to achieving a climate neutral economy. Although not exhaustive, the report compiles a comprehensive classification system for sustainable activities based on extensively-screened events across a wide range of sectors.
- [An EU Green Bond Standard](#) that is largely unchanged from the TEG's interim proposals on clear and comparable criteria for issuing green bonds. In particular, the Standard determines which

climate and environmentally-friendly activities should be eligible for funding via an EU green bond. The report makes ten recommendations, three of which relate to the establishment of the Standard, and the others to the ways in which European governments and institutions, market participants and other stakeholders can support and monitor implementation of the Standard.

Building on best market practices, the proposed Standard encompasses critical elements such as alignment with the taxonomy, mandatory reporting (on use of proceeds/environmental impact) and verification of the Green Bond Framework. It is expected to boost the green bond market, allowing investors to scale up sustainable and green investment.

- [EU climate benchmarks and benchmarks' ESG disclosures](#) – interim recommendations on the methodology and detailed technical guidance on minimum standards for the two types of climate benchmark already

adopted by the co-legislators: EU Climate Transition Benchmarks (EU CTBs) and EU Paris-aligned Benchmarks (EU PABs). See the [May](#) edition of Asset Management Regulatory Insights for further information.

The report also sets out minimum disclosure requirements to improve transparency and comparability of information across benchmarks, not only regarding climate-related information but also on a variety of environmental, social and governance (ESG) factors and their alignment with the Paris agreement.

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The aim is to enable investors to adopt a climate-conscious investment strategy and to address the risk of “greenwashing” – making an unsubstantiated or misleading claim about a product, so that it appears more environmentally-friendly.

### The EC guidelines

The EC’s guidelines integrate the recommendations of the Financial Stability Board’s taskforce on climate-related financial disclosures and build on the TEG’s recommendations. They are intended for use by firms that fall under the scope of the Non-Financial Reporting Directive. They include a limited number of recommended climate-related disclosures for each of the five reporting areas under the Directive: business model, policies and due diligence, outcome of policies, principal risks and risk management, and key performance indicators. Firms are expected to follow the recommended disclosures to the extent they are necessary for an understanding of the development, performance, position and impact of their activities.

Firms are expected to disclose information in accordance with widely-accepted reporting standards and frameworks to maximise comparability for stakeholders. To facilitate consistent reporting at EU and global levels, the guidelines refer to a number of recognised reporting frameworks and standards.

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### Next steps

The next Commission will decide whether to take the TEG’s recommendations forward and, if so, how. In the meantime, the TEG’s mandate has been extended until the end of 2019, allowing time for further refinement and development of the proposals.

The European Parliament and Council have still to come to agreement on the Taxonomy Regulation. In the Council in particular, it is understood that there are strong views for and against mandating requirements in Level 1 regulation. Sustainable finance will continue to be a key objective of the EC. However, with many new faces in the Parliament, a very different mix and balance of political groupings, the new Finnish Council Presidency and a new Financial Services Commissioner awaited, the path to adoption of the Regulation is not clear.

Meanwhile, the demands of institutional investors are driving change for asset managers and capital-raising enterprises. A pan-European [survey](#) by the Chartered Financial Analysts Institution sums up the challenge: most, but by no means all, institutional investors believe sustainability should be incorporated into portfolios. However most, but not all, investors believe that ESG measures should not be mandated.

# Resolution: disclosure and operational readiness

## Pressures on large banks to enhance their resolvability will be reinforced by two Financial Stability Board (FSB) discussion papers on measures to improve the resolvability of global systemically-important banks (G-SIBs).

The FSB's [discussion papers](#) focus on public disclosures and on operational preparedness for solvent wind-down in resolution. The FSB's focus is on G-SIBs, but national authorities are encouraged to consider extending resolution requirements to all banks (and other types of firm) subject to resolution planning.

Although these are early stage discussion papers, the direction of travel is clear – and it is consistent with the approach being taken by the Single Resolution Board and the Bank of England, for example, to resolvability assessments. For more on resolution see KPMG's "[Resolution: pressures build on European banks](#)".

### Disclosure

Most G20 countries disclose their general approach to resolution, including resolution powers and frameworks, resolution planning and resolvability assessments, and how resolution tools such as bail-in would operate.

The FSB is looking to enhance this through greater cross-country consistency in disclosures:

- by banks about their resolution preparedness
- by resolution authorities of their resolvability assessments of individual banks
- by banks of their loss-absorbing capacity

- by resolution authorities of bank-specific loss-absorbing capacity requirements (TLAC and MREL)

**This would require major banks to disclose information on their readiness for resolution, including any remaining impediments to resolution and how they are being addressed. Most major banks are already disclosing their loss-absorbing capacity.**

### Operational readiness

The FSB sets out a long list of possible requirements on a bank's operational capabilities – ahead of any resolution - to achieve a solvent wind-down of derivatives and trading portfolios, including:

- produce management information in a clear timely manner
- demonstrate a comprehensive understanding of how risk is managed and deployed across the group
- access financial resources to ensure that the firm maintains solvency during a wind-down, particularly where losses have to be realised when exiting positions
- identify unencumbered collateral and mobilise unencumbered collateral
- retain operational staff and trading capabilities
- support the operational continuity of critical shared services

- support continued access to financial market intermediaries
- have in place measures to mitigate the risk of financial contract close-out due to resolution
- enable a robust and timely valuation
- estimate financial resource impacts of a solvent wind-down on both liquidity and capital
- model operational costs, hedging costs and the costs of exiting positions in a solvent wind-down
- perform sensitivity analysis
- model and analyse a range of exit strategies and options
- model the residual portfolio of derivative or trading book positions remaining after a solvent wind-down

**This would be costly and burdensome for some banks to meet** and resolution authorities would be expected to test these capabilities as part of their resolvability assessment.

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# Recent alerts and insights

## Recent insights published by the **EMA Financial Services Risk & Regulatory Insight Centre (RRIC)** and others include:



### **Evolving Asset Management Regulation 2019**

June 2019

The 2019 Evolving Asset Management Regulation report finds that the scope and shape of regulators is changing, driven by the rise of external voices – demanding investors and consumer groups, clamoring political and economic needs, changing priorities and hopes of civil society, an increasingly noisy press, the explosion in social media and the rapid growth of new technologies. This sea of voices is directly influencing the regulatory agenda and increasing expectations on the industry. A fundamental rethink of firms' mind-set and investment offerings is required.



### **LIBOR to RFR Transition**

June 2019

US and UK regulatory authorities 'rang the bell' in June 2019. Both left the market in no doubt that firms need to ensure they have completed the transition to alternative reference rates by the end of 2021 – effectively, calling time on LIBOR. The PRA/FCA released feedback from the 'Dear CEO' letter sent in September 2018. Overall the message is clear. Accelerate. Firms cannot sit back and adopt the 'wait and see' approach. They need to have adequate preparations in place, with in-built flexibility to adapt to change, to meet an end of 2021 LIBOR cessation date.



### **Transforming Compliance**

June 2019

Compliance functions have gone through a major period of growth and investment since the financial crisis. Many firms have seen a massive growth in their Compliance functions since 2008. But there are now growing pressures for change to improve both the effectiveness and the efficiency of the Compliance function. In this paper we focus on how Compliance can meet the twin objectives of effectiveness and efficiency, and what firms need to do to transform their compliance function.



### **Operational resilience in financial services: Seizing business opportunities**

June 2019

Operational resilience is usually defined as the ability of an organisation to adapt rapidly to changing environments. This includes both the resilience of systems and processes and more generally the ability of the organisation to continue to operate its business in the event of disruptive events. 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.



### **Dear CEO letter**

June 2019

The ECB has written to CEOs of significant institutions asking them to present an IBOR reform risk summary and a detailed plan of action for the transition. The letter requests that firms provide a board-approved summary of key risks relating to the benchmark reform and a detailed action plan to mitigate such risks; address pricing issues; and implement process changes. The ECB have also requested contact points at a management level who are in charge of overseeing the implementation of these action plans. Deadline: 31 July 2019.



### **Investors' ESG demands drive regulation**

May 2019

This quarter we have looked at recent ESMA updates which included a report on the performance and costs of retail investment products, draft guidelines on liquidity stress testing in funds and a report on the PRIIP KID. In March we explored the opportunities and associated costs with the pan-European personal pension product (the PEPP). And in the most recent update, we discuss the impact the new capital requirements will have on the industry.

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## Further insights:

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