



The future shape of UK financial services regulation

Rule-taker or rule-maker?

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Contents

Executive summary	2
International influences on UK financial regulation	4
No 'bonfire of red tape'	6
The evolving international landscape	8
Domestic drivers	10
Conclusions	12



Executive summary

What will UK financial services regulation look like post-Brexit? Will the UK be a rule-taker or a rule maker?

To some extent this will be determined by the outcome of the Brexit negotiations. This might leave considerable scope for the UK regulatory regime to diverge from EU financial services legislation; or an agreement might be reached on a UK-EU relationship that constrains the degree to which the UK regulatory regime can diverge from EU legislation for the foreseeable future.

Other factors will also be at play over the short, medium and long-term.

The City of London's role in the global capital markets has been built largely on its relationship with the US and the US dollar and other reserve currency markets. For 20 years or more there has been agreement with other international financial centres on joint regulation and oversight of market infrastructure, and the use of English law, which is likely to continue. In turn, the £9 trillion of assets, papered and managed under English law contracts, under appropriate delegated authorities, have led to the UK being the second largest asset management centre, after the US.⁽¹⁾

The UK has often led the way within Europe on the regulatory response to conduct risk issues including

the fair treatment of retail consumers, payment for investment research and reform of interest rate benchmarks.

The wider regulatory landscape continues to evolve. Brexit is influencing the EU legislative and supervisory dynamic. At the global level there is a combination of 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 conduct, and interest and exchange rate benchmarks. Much of this is happening at different speeds and in different ways across sectors, as for example with the extension of financial stability concerns from the banking sector to the insurance and investment sectors.

This paper considers how the interplay of external and domestic drivers might shape UK financial services regulation. In particular:

- Despite calls from some commentators for a 'bonfire of red tape', UK financial regulation is more likely to become tougher post-Brexit, as is evident from the observed tendency of the UK to impose super-equivalent requirements, although this may be tempered by UK competitiveness concerns.
- In particular, supervisory priorities in the area of operational resilience (cyber, AML etc) are already increasing.

Source: (1) The Investment Association

- While the UK will lose its direct influence over EU legislation, it will remain an important player in setting international standards, even if its position within global standard-setting bodies changes once the UK is no longer a member of the EU.
- The UK may also be freer to work even more closely with the US and other international financial centres to develop capital markets regulations.
- There will be pressures for a divergence between the detail of UK and EU financial regulation, even where both regimes aim to deliver broadly similar outcomes, reflecting different regulatory and supervisory priorities and approaches.
- We identify six domestic drivers of UK regulation: financial stability, consumer protection and competition, fintech, UK competitiveness, review of the overall impact of the post-crisis regulatory reforms and the pursuit of social objectives.
- In responding to these drivers, there will be scope for striking different balances between principles and detailed rules, between resilience and resolution, and between the ways in which the principle of proportionality is applied.

Implications for firms

These developments will be of critical importance for financial institutions, which are likely to be faced with considerable uncertainty, complexity and cost as the UK

regulatory regime adjusts in the new post-Brexit world and as further divergences in regulatory and supervisory approaches inevitably emerge between the UK and the EU.

These adjustments and divergences are likely to take various forms:

- Even where the UK remains broadly in line with EU legislation, the act of transposing this into UK legislation and the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA) rule books will be a massive task. It will inevitably lead to a host of tweaks and changes, not least because even 'straight' copy-out will be impossible as the UK becomes a third country rather than an EU member.
- Areas where the UK moves in conjunction with other international financial centres.
- Areas covered by international standards where the UK and the EU follow divergent paths in their detailed implementation, even where the UK and EU regimes remain broadly equivalent.
- Areas where the UK pursues its own path, moving ahead of international standards, other financial centres and EU legislation.



International influences on UK financial regulation

The views of global standard-setting bodies have for many years influenced UK financial regulation, directly or through their adoption into EU legislation and guidelines (which are in turn transposed into UK rules and guidance or, in the case of EU Regulations, apply directly).

The extent of this influence varies between sectors and by topic. For example, the standards agreed by the Basel Committee, although a voluntary framework, are usually followed closely in EU legislation and therefore set the baseline capital requirements for EU banks. Similarly, the standards set by the Financial Stability Board in areas such as recovery and resolution have been adopted in EU banking legislation.

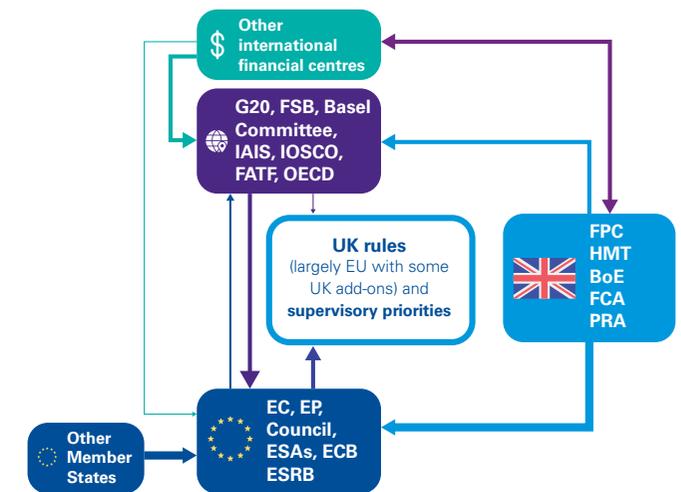
In other cases, EU or UK rules have significantly influenced or been a benchmark for the development of global positions. For example, the UK's risk-sensitive prudential regime for insurers, introduced in the early 2000s, became an important driver of the EU Solvency

Directive II (Solvency 2), which in turn was influential in the continuing development of an Insurance Capital Standard by the International Association of Insurance Supervisors (IAIS). Similarly, a number of the International Organisation of Securities Commission's (IOSCO) principles and guidelines cite EU legislation as examples of existing good practice, for example in its consultation on Open-ended Fund Liquidity and Risk Management.

Given the UK regulators' standing among their peers and the global importance of UK financial markets, the PRA and the FCA have played an important, sometimes central, role in the development of global regulatory thinking. They inform, shape and articulate debates. Examples of this include the UK's long-standing leadership in pushing forward the agenda for the regulation of retail and wholesale conduct, including most recently the reform of interest rate benchmarks.

Sometimes this has taken the form of the UK working with the US and other international financial centres to develop regulation, for example on financial market infrastructures and on resolution regimes. There may also be occasions where the UK joins a broader EU position, which can add further weight to its influence on the global stage, although it is not clear how often this has happened in practice.

Current influences on UK FS regulation



Likewise, while much UK financial services regulation is driven by EU legislation, the UK has been a key player in influencing the shape and detail of that legislation. 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 Members

No 'bonfire of red tape'

If there was greater scope for the UK regulatory regime to diverge from EU legislation, what form might this take? Despite calls from some commentators for a 'bonfire of red tape' there seems very little prospect of such a move. Indeed, most indicators point in the opposite direction.

In general, and in particular since the global financial crisis, the UK has been at the forefront of arguing for and implementing tougher regulatory standards. This has been across the regulatory spectrum – from market infrastructure and prudential regulation, through retail and wholesale conduct regulation, to aspects of corporate governance and individual responsibility. Moreover, this approach is not confined to the PRA and the FCA. It extends more widely to UK primary legislation and to the Bank of England in its capacity as a resolution authority and as a macro-prudential authority (through the actions and recommendations of the Financial Policy Committee (FPC)).

As a result, the UK has introduced a large number of regulatory measures that have gone beyond EU legislation, in terms of two types of 'super-equivalence' - a tougher approach to regulatory reforms covered by EU legislation and the introduction of requirements not (yet) covered by EU legislation.

Examples of UK super-equivalence include:

- The ring-fencing of large retail deposit-taking banks, which is due to come fully into force on 1 January 2019.
- Resolution requirements for large UK banks, including the setting of Total Loss Absorbing Capacity requirements and of Minimum Requirements for Own Funds and Eligible Liabilities (MREL) under the Bank Recovery and Resolution Directive (BRRD), valuation preparedness requirements, and requirements for operational continuity in resolution – for more detail on these requirements see the KPMG International paper on "Resolution: an evolving journey in Europe"
- The general stance of the FPC in the setting of capital requirements for the large UK banks, and the setting of a positive counter-cyclical capital buffer, even in 'normal' periods.
- The annual stress testing of large banks and of the banking system by the FPC and the PRA, using a wider range of stress scenarios and usually more severe stress scenarios than the biennial stress tests run by the EBA, and the PRA's biennial general insurance stress tests.
- The setting of Pillar 2 capital and liquidity requirements.
- The application by the FCA of the Individual Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP) to a wide range of investment firms and to asset managers.
- The Senior Managers and Certification Regime (SMCR), introduced for banks and (in part) for insurers from March 2016, and now being rolled out to almost all regulated financial institutions in the UK – for more details see the KPMG International paper on "Individual Accountability"
- The 'front-running' of EU retail consumer protection legislation, in particular MiFID II, through regulatory requirements in areas such as commission payments to financial advisers, the responsibilities of product manufacturers and distributors, and transparency of costs and charges.
- Some actual or prospective UK regulatory requirements have been driven by the FCA's objective to promote efficient competition, which has underpinned its reviews of the mortgage market, the high cost credit market, the asset management market, personal investment platforms, wholesale financial markets, and pension fund investment consultants; and is in part a driver of the FCA's focus on 'value for money' considerations across a range of financial products and services.
- The establishment and implementation of the Fair and Effective Markets Review, covering standards of behaviour in fixed income and commodities markets.
- The introduction of fintech-related regulatory requirements, such as the FCA's restrictions on various forms of peer-to-peer lending and the PRA's Supervisory Statement on algorithmic trading.

These measures are consistent with public pronouncements on the UK's approach to regulation:

"Once the UK leaves the EU, we will maintain strong and appropriate regulation of our sector, given the exposure of our economy to the fiscal risk it represents."
UK Government Framework for the UK-EU partnership: Financial Services, July 2018

"... irrespective of the particular form of the United Kingdom's future relationship with the EU, and consistent with its statutory responsibility, the FPC would remain committed to the implementation of robust prudential standards in the UK financial system. This would require a level of resilience to be maintained that was at least as great as that currently planned, which itself exceeded that required by international baseline standards." Minutes of FPC meeting, September 2016

"In arriving at what is, at this stage, necessarily initial FCA thinking on an 'optimal framework', we are mindful of our statutory objectives and therefore seek an arrangement that maximises competition in the interests of consumers, while preserving and deepening market integrity and retaining high conduct standards and protecting consumers across all relevant financial markets." Andrew Bailey letter to Andrew Tyrie, chair of the Treasury Select Committee, October 2016

It should, however, also be recognised that there have been some cases where the UK has argued for a lighter EU regulatory regime or implemented a more accommodating approach.

Examples of UK sub-equivalence include:

- Arguing against limits on the ratio between variable and fixed remuneration for individuals.
- Arguing against the need for many of the provisions of the Alternative Investment Fund Managers Directive (AIFMD).
- Under Solvency 2, taking a less restrictive approach to the calibration of the risk margin for insurers, taking a more flexible approach to the matching adjustment, the volatility adjustment and the treatment of illiquid assets, simplifying the calculation of the transitional measure on technical provisions and reducing the reporting burden on firms.
- Using the FCA's competition objective and the PRA's secondary competition consideration to drive a more accommodating approach to new bank entrants.
- The FCA's 'regulatory sandbox' for fintech start-ups to encourage and foster innovation, now being extended globally.

KPMG papers:



Resolution: an evolving journey in Europe



Individual Accountability





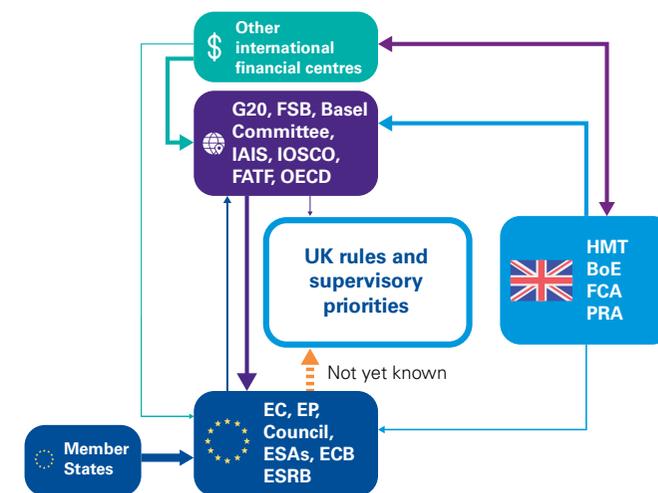
The evolving international landscape

As the UK government and regulators turn to consider the post-Brexit (and post-transition) world, they will find that the context for those deliberations is not static. The wider regulatory landscape, within which the UK regulators and UK regulated firms operate, is evolving.

By their actions and words, UK regulators and other policy-makers are indicating that they intend the UK to remain a key player at the global level and to adhere to internationally-agreed standards. But there are signs that the post-crisis commitment to co-operation and convergence of standards is breaking down in some areas.

The US has reviewed the raft of post-crisis rules and is reining back some of its earlier adherence or super-equivalence to international standards. The EU, on the other hand, continues to propose new rules – for example on sustainable finance and EU Capital Markets Union – and its reviews of post crisis regulation are piecemeal. 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. The KPMG International paper EAMR 2018 discusses this further in the context of the asset management sector.

New world influences on UK FS regulation



Width of arrow indicates level of influence

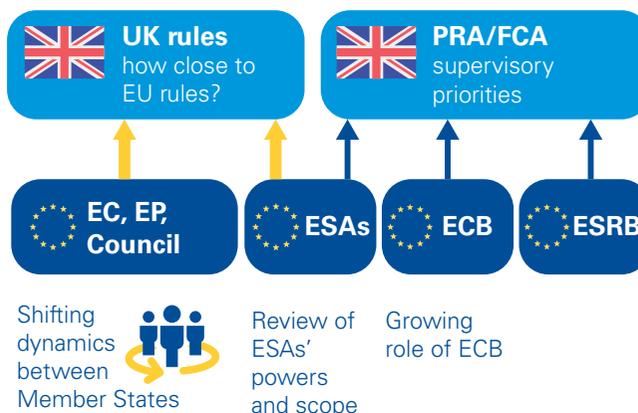
Will the degree of the UK's influence within global debates change when it acts solo? In many areas, it already acts alone. Perhaps the more pertinent question, therefore, is how different the EU's positioning will be without the direct influence of the UK. This will have an impact on global outcomes and it may also have a direct bearing on UK rules, depending on the extent to which the UK is tied in future to EU regulation.

The loss of the UK as a major actor in the shaping of EU legislation will change the dynamic in EU legislative debates. Indeed, this has already been happening, for example in the EU approaches to euro clearing outside the EU, booking models and centralised risk management, the delegation of portfolio management by investment funds to outside the EEA, and the proposed centralisation of further regulatory and supervisory responsibilities in the ESAs, in particular ESMA.

Even if the UK is not in future constrained in any way by EU legislation – which seems unlikely – many UK-based firms have operations within the EU and will have to manage potentially divergent requirements, over and above divergence with other parts of the world. Divergence inevitably means additional costs for firms and potentially conflicting requirements.

The changing dynamic will also be felt in supervisory activity. The role of the European Central Bank (ECB) is evolving. It is already issuing guidance and “supervisory expectations”, which some regard as tantamount to rule-making. The ECB will not have a direct role in the supervision of UK banks, but large pan-European banking groups already come under its purview, which includes some EU-owned UK banks and some EU subsidiaries of UK-headquartered banks. The extent of interactions and cooperation between the ECB and the Bank of England will therefore be an important driver of the prudential supervision of UK banks and UK supervisory priorities.

The future European dynamic?



KPMG papers:



EAMR 2018:
Parting of the
ways?



EAMR 2018:
An end-to-post
financial crisis
consensus

Domestic drivers

While the UK can be expected to maintain its generally tough approach to financial services regulation, there are choices to be made that may lead to the UK taking a distinctive approach that increasingly differentiates it from the EU.

Six domestic drivers of UK regulation can be identified. In addition to these drivers, there are three broad questions about regulatory approach that could influence the design of UK regulation:

- the choice between the use of principles and the use of detailed rules (or the closely related debate between simplicity and complexity);
- the scope to introduce greater proportionality in the setting of regulatory requirements for smaller firms; and
- the balance between resilience and resolution (would the development of a credible resolution regime allow for a relaxation in prudential requirements?)

Domestic drivers of UK financial regulation

1. Financial stability

There is every indication that financial stability will remain one of the two main drivers. The UK will also continue to follow international standards in areas such as risk-sensitive capital frameworks, anti-money laundering, countering terrorist financing and cyber security.

2. Consumer protection and conduct

Consumer protection will remain a key driver, along with fair and effective markets. Largely in the absence of detailed international standards on retail consumer protection, UK consumer protection regulation will continue to be driven primarily by consumer behaviour and competition concerns, and by the continuing debates led by the FCA over the appropriate balance between consumer and firm responsibilities and between manufacturer and distributor responsibilities.

3. Fintech

Regulators and supervisors worldwide are beginning to respond to fintech developments by introducing new regulatory requirements and by changing the scope of regulation and supervision to cover a different and wider range of firms. This follows the initial responses of observing technological and market developments, and of identifying not only the opportunities but also the risks posed by these developments to consumers, financial stability and to firms themselves. Operational resilience is a major theme.

Striking a balance between encouraging innovation and mitigating the risks is already proving difficult and is likely to lead to different countries adopting significantly different approaches, as is already evident even within Europe. In the UK, there are already some signs of a relatively intrusive approach to the regulation and supervision of fintech-driven products and services.

There is also a potential link between the second and third drivers here, as discussed in the KPMG International

publication "Regulation 2030 what lies ahead?": Fintech developments provide an opportunity to redraw some lines around the extent to which consumers should be expected to take responsibility for their decisions and actions, for example by enabling consumer information and risk warnings to be delivered in new and imaginative ways. It is important that this discussion is properly pursued at an early stage in the development of fintech regulation.

4. UK competitiveness

The impact of regulation on the competitiveness of UK financial services is back on the policy agenda. As memories fade of the impact of the pre-financial crisis attempts to increase the size of the UK financial services sector, and if the sector contracts significantly post-Brexit, there may be political and industry pressures on UK regulators to take a more accommodating approach. The evaluation of future UK measures in the light of developments in other regulatory regimes might therefore, at least for a period, be more explicit. It seems unlikely, though, that UK competitiveness will over-ride the first two drivers.

5. Overall impact of the post-crisis regulatory reforms

Depending on the nature of any agreement between the UK and the EU, there may be more or less scope for the UK to undertake a wide-ranging review of the individual and collective impacts of the post-crisis regulatory reform agenda, and to adjust the UK regulatory regime accordingly.

KPMG papers:



Regulation 2030 what lies ahead?



Brisbane G20 Summit – A new agenda for financial services

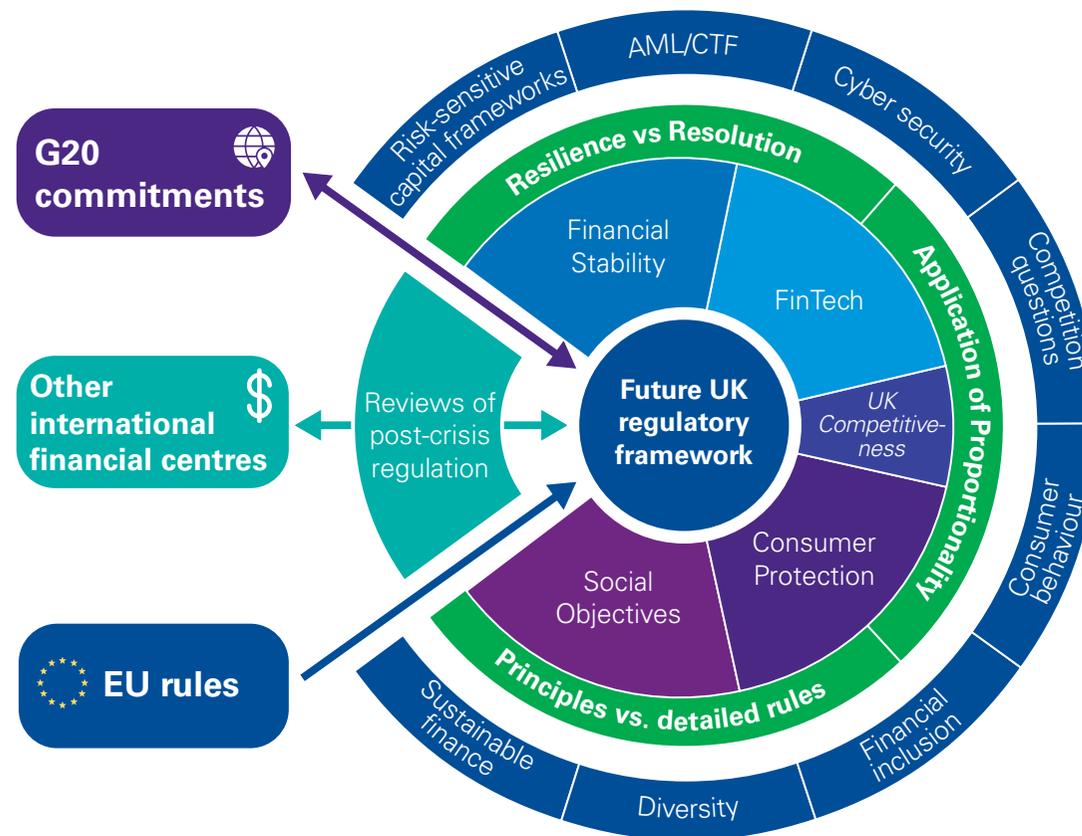
As far back as 2014, KPMG International argued in its paper “Brisbane G20 Summit – A new agenda for financial services” that regulators should be brave and bold in adjusting the capital and liquidity requirements on banks undertaking long term financing and trade finance; treating the issuers and holders of high quality securitisations more like the issuers and holders of covered bonds; reducing capital charges, improving market liquidity and providing a more predictable tax regime for insurers and other long-term investors in infrastructure and the corporate sector; developing capital markets, in particular in countries and regions where non-bank intermediation plays a small role; and providing mechanisms for greater long-term investment through managed funds. Some of these recommendations have since been taken up.

6. Social objectives

Financial services regulation is increasingly faced with pressures to take into account a range of social objectives. This has already been a driver of the regulatory treatment of lending and investment in SMEs and in infrastructure investment, and is spreading to considerations of how to support and facilitate sustainable (green) finance, financial inclusion and greater diversity in the senior management and boards of financial institutions.

There are tensions here concerning whether these aims could and should be pursued using interventions other than financial services regulation, and more narrowly concerning the purity of a ‘risk-sensitive’ approach to regulation. But in both respects the separating walls have already been breached in a number of ways and these pressures on regulation are likely only to intensify.

New world influences on UK FS regulation



Conclusions

Although in part dependent on the outcome of the Brexit negotiations, UK financial services regulation will be different post-Brexit.

This paper has identified three main influencers for this change:

1. pressures for a divergence between the detail of UK and EU financial regulation, even where both regimes aim to deliver broadly similar outcomes;
2. domestic drivers of UK regulation, such as financial stability, consumer protection and competition; and
3. the evolution of the wider regulatory landscape.

Despite calls from some commentators for a 'bonfire of red tape', UK financial regulation is more likely to become tougher post-Brexit given domestic drivers. While the UK will lose its direct influence over EU legislation, it will remain an important player in setting international standards, leading conduct debates and influencing supervisory priorities. And it may deepen further its relationship with other international financial centres.

Financial institutions are therefore likely to have to respond to considerable uncertainty, complexity and cost as the UK regulatory regime adjusts in the new post-Brexit world.

This adjustment will include re-writing the PRA and FCA rule books to reflect the position of the UK outside the EU; the divergent paths followed by the UK and the EU in the detailed implementation of international standards; and the UK following its own path, in some areas moving ahead of international standards and EU legislation.





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