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Basel III & CRD IV the impact for the Investment Firms

Link N' Learn

5th June 2014

Objectives of the presentation

1. **Give a brief overview of Basel III / CRD IV**

2. **Highlight the Regulatory implications of CRD IV for Investment Firms/ Managers of funds**
   - Defining the investment firm
   - Improving the Quality and Quantity of Capital
   - Corporate Governance
   - Liquidity Requirements
   - Leverage Ratio
   - COREP / FINREP Reporting
   - Implementation timetable

3. **Basel III / CRD IV direct and indirect impacts for investment funds**

4. **Q&A**

Basel III framework
The 3-pillar approach

Basel Accord are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel II uses a **3 pillars** concepts which are:

Pillar 1

Minimum Regulatory Requirement

- Eligible own funds should be sufficient to cover capital requirements for
  - Credit Risk
  - Operational Risk
  - Market Risk
- Liquidity requirements
  - Liquidity Coverage Ratio (LCR)
  - Net Stable Funding Ratio (NSFR)

Pillar 2

Supervisory review process

- Review from regulators
- Internal Capital Adequacy Assessment Process (ICAAP) to deal with all types of risks (not only Pillar I), including (but not limited to:
  - Concentration risk
  - Strategic risk
  - Reputation risk
  - Liquidity risk
  - Legal risk

Pillar 3

Market discipline

- To enhance transparency
- Public reporting/ information:
  - Capital structure
  - Capital adequacy
  - Risk profile
  - Remuneration
  - Others
- IFRS 7

What is Basel III / CRD IV ?

Overview and Scope

1. Basel III is the reaction by the Basel Committee of Banking Supervision (BCBS) to the 2008-2009 financial crisis

2. The proposal divided the current CRD into two legislative instruments: a Directive (**Capital Requirement Directive IV – “CRD IV”**) and a Regulation (**Capital Requirement Regulation – “CRR”**) – collectively known as the “CRD IV package”.

3. The final consolidated text was published in the Official Journal of the EU at the end of June 2013.

4. The new rules applied as of 1 January 2014.

5. There are a number of discretions available to competent authorities to not apply/amend certain parts of CRR.

6. CRD IV is not just about capital ...

7. CRD IV remains a work in progress …

Overview: CRD IV Package within the EU

Key components of the CRD IV package

1/. Improve the quality & quantity of the **Capital Base**	2/. Improved short & long term **Liquidity standards**
3/. Reduce **Leverage** in the banking system	4/. Enhancing **Risk Coverage,** notable counterparty risk

Regulatory Reporting : COREP / FINREP and other reporting requirements

Regulation – CRR (directly applicable)

+

Directive – CRD IV (transposition to national law)

Types of Investment Firm

According to Article 4 of the CRR an investment firm is

A person are defined by MiFID I (Directive 2004/39/EC) as an investment firm;

- Investment firm' means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis
- Which is not a credit institution, local firm or authorised to provide ancillary services.

Investment firms with limited authorisation to provide investment services (Article 95)

Firms which don't carry out these activities as defined by MiFID;

- Dealing on own account
- Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis

Minimum capital requirements

Higher of ;

- Fixed Overhead Requirement
- Sum of Market and Credit Risk

Investment firms which meet the requirements of Article 96.

Firms which;

- Deal on own account only for the purpose of fulfilling or executing a client order, or for the purpose of gaining entrance to a clearing and settlement system or a recognised exchange when acting in an agency capacity or executing a client order
- Do not hold client money or securities, only undertake dealing on own account and have no external customers

Minimum capital requirements

- The sum of the Fixed Overhead Requirement and market and credit risk requirements

Investment firms with no limitations on activities

Captured by all the relevant rules in the CRR such as liquidity and leverage reporting and the additional capital buffers.

Minimum capital requirements

- Sum of Market, Credit and Operational Risk as required by the rules in the CRR

Competent authorities have the discretion to set the own funds requirement for certain types of investment firms who don't hold client money and assets and only;

- Execute orders on behalf of clients
- Undertake Portfolio management

Improving the quality of Capital

Basel III contains various measures aimed at improving the quality of capital, with the ultimate aim to improve loss-absorption capacity in both going concern and liquidation scenarios.

Going-Concern Capital

Tier 1 Capital

- Tier 1 capital (i.e. common equity) as highest component of Capital
- Common equity = common shares (or equivalent for other legal forms) & retained earnings + other comprehensive income
- Minimum eligibility criteria for inclusion in common equity or additional Tier 1 capital
- Reduction of innovative capital components (e.g. step-up hybrids)

“Gone-Concern Capital”

Tier 2 Capital

- Tier 2 will be simplified (subcategories “upper & lower Tier 2” will be removed)
- One set of eligibility criteria (less stringent)
- Subordinated to depositors and general creditors
- Restriction that Tier 2 cannot exceed Tier 1 will be removed

Tier 3 Capital

- Tier 3 will be abolished

Capital Deductions – should also be considered

Implications

Assessment of current capital instruments required, along with an appropriate funding strategy.

Improving the quantity of Capital

Total: 10.5% - 15.5%

Tier 1	Tier 2	Capital conservation	Countercyclical buffer	SIFI Buffer
Absorb losses: going concern	Absorb losses gone concern	Rainy Day	Cooling Credit Cycle	Reducing systemic importance
2013-2015	Min at 8% throughout	2016-2019	2016-2019	2016-2019

Total Capital min 8% RWA

Buffers: 2.5% - 7.5%

				1% CET1
		0-2.5% CET1	0-2.5% CET1	1-2.5% CET1
Add't Tier 1 1.5% RWA	Tier 2 2.0% RWA	Designed to anticipate a potential financial downturn	Designed to counter the build up of credit in the system at a national level	Systemically Important banks Extension of capital conservation buffer
CET1 4.5% RWA				

Corporate Governance

OBJECTIVE: CRD IV strengthens the requirements with regard to corporate governance arrangements and processes and introduces new rules aimed at increasing the effectiveness of risk oversight by Boards, improving the status of the risk management function and ensuring effective monitoring by supervisors of risk governance

Regulatory Requirements	The new Directive introduces clear corporate governance arrangements and mechanisms for institutions: • These rules concern the composition of boards, their functioning and their role in risk oversight and strategy in order to improve the effectiveness of risk oversight by Boards. The status and the independence of the risk management function is also enhanced. Supervisors will play an explicit role in monitoring risk governance arrangements of institutions. • The measures adopted should help avoid excessive risk-taking by individual institutions and ultimately the accumulation of excessive risk in the financial system. The principle of proportionality, taking into account the size and complexity of the activities of the institution as well as different corporate governance models, applies to all measures. • Diversity in board composition should contribute to effective risk oversight by boards, providing for a broader range of views and opinion and therefore avoiding the phenomenon of group think. • Increased transparency regarding the activities of institutions which operate on a multinational basis
Transitional Arrangements	• Rules will apply when the Directive enters into force • The Directive introduces the concept of ‘significance’
Key Impacts	• Impact on board composition, diversity and segregation of duties • Impact on risk management, oversight and risk governance

Liquidity ratios

Basel III / CRD IV (CRR) introduces two new liquidity ratios with which some investment firms must comply as well as requiring additional data to be reported to regulatory for the purpose of identifying potential liquidity problems. These ratios represent minimum standards of liquidity risk management and must be met on a continuous basis

Liquidity Ratios

Liquidity Coverage Ratio

Liquidity Coverage Ratio (LCR) = **Stock of highly Liquid assets** / **Net cash outflows over 30-day horizon** ≥ 100%

Description

- Aims to strengthen **short-term liquidity profile**
- Defines level of liquidity buffer to be held to cover short-term funding gaps under severe liquidity stress
- **Cash flow** perspective
- Predefined stress scenario
- Time horizon: **30 days**
- Frequency: at least **monthly reporting** with the operational capacity to report weekly / daily
- Implementation date: phased-in gradually, starting at 60% in 2015 and reaching 100% in 2018. A
- review in 2016 will enable the Commission to delay the introduction of the 100% ratio, if justified by international developments

Net Stable Funding Ratio

Net Stable Funding Ratio (NSFR) = **Available amount of stable funding** / **Required amount of stable funding (Assets)** ≥ 100%

Description

- Aims to strengthen **medium- to long-term liquidity profile**
- Defines minimum acceptable amount of stable funding in an extended firm-specific stress scenario
- **Balance sheet** perspective
- Predefined stress scenario
- Time horizon: **1 year**
- Frequency: at least **quarterly reporting**
- Implementation date: scheduled for **2018**, however, the Commission will have to submit by 31
- December 2016 a legislative proposal aimed at ensuring that institutions use stable sources of funding

Monitoring Tools

- Regulators will also require information on the following additional metrics in order to identify potential liquidity problems.
- EBA is due to develop Implementing Tech Support on liquidity metrics by the end of 2014 with a Consultative Paper anticipated for H2 2014.

Leverage ratio

OBJECTIVE: Introduce a simple, transparent, non-risk based leverage ratio, acting as a supplementary measure to the risk based capital requirements. It aims at avoiding excessive leverage by firms while still showing strong risk-based capital ratios.

Leverage Ratio

Leverage Ratio

$$\text{Leverage ratio} = \frac{\text{Tier 1 Capital}}{\text{Exposure}} \geq 3\%$$

- Tier 1 Capital
- Test during the transition period for CET1

- Exposure measure follows the accounting definitions
- Deduction of items deducted from capital (no double counting)
- Deduction of investments in financial institutions outside the scope of regulatory consolidation exceeding thresholds (same method as for the solvability ratio)

Transitional Arrangements

- The regulation will provide for the introduction of a leverage ratio from 1 January 2018, if agreed by Council and Parliament on the basis of a report to be presented by the Commission by 31 December 2016. This will follow an initial observation period that will run from 1 January 2013 until 1 January 2017. Based on the results of the observation period the BCBS intends to make any final adjustments to the definition and calibration of the leverage ratio in the first half of 2017, with a view to migrating to a binding requirement on 1 January 2018 based on appropriate review and calibration
- From 1 January 2015 institutions will be required to disclose their leverage ratio
- During the period from the date of application of this Regulation to 31 December 2017, competent authorities may permit institutions to calculate the end-of-quarter leverage ratio where they consider that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.

Key Impacts

- Only impacts certain investment firms dependent on Mifid activities.

EU regulatory reporting requirements: Overview

New reporting requirements	Scope	Main changes
COREP (1 January 2014) Capital/solvency, large exposures, liquidity (LCR and NSFR) and leverage	All CRD firms (including banks, and investment firms) on a solo and consolidated basis as applicable.	• Up to 60 additional returns. Substantial increase in granularity and number of reported data items compared with existing returns
FINREP (1 July 2014) Income Statement and Financial Position, detailed financial instruments and other disclosures	Listed groups subject to CRD and credit institutions preparing IFRS group accounts	• Up to 30 additional returns. Disclosure of financial instruments, derivatives and off-balance sheet exposures. Significant increase in reportable data.
Non-performing loans and forbearance	As for FINREP	• New returns analysing non-performing assets (including trading book) and assets where some form of forbearance either currently applies or has been applied • Disclosures are significantly more detailed than currently mandated by IFRS or other requirements
Asset encumbrance 30 June 2014 implementation date for institutions with assets > €30 billion 30 December 2014 implementation date for all other institutions subject to reporting requirements	As for COREP, subject to materiality thresholds for certain requirements	• New reporting for assets subject to repo/stock lending or otherwise pledged as collateral including “contingent encumbrance” • Significantly more detail required than that mandated by IFRS or currently provided as part of regulatory disclosure recommendations.

- The new reporting requirements represent a significant regulatory compliance, data management and operational process challenge (reporting to GABRIEL using XBRL, for example) over the coming months
- Investing in the underlying governance, control and assurance framework for FINREP and COREP will be important given the direction of travel towards increased external publication of regulatory data
- Ultimate responsibility for external regulatory reporting lies with the Board

COREP reports

	Reporting Area	FSA Report	COREP Report	
CAPITAL SUPPLY	**Capital Adequacy**	➢ FSA003	➢ 1.1 Own Funds ➢ 1.2 Own Funds Requirements ➢ 1.3 Capital Ratios ➢ 1.4 Memorandum Items ➢ 1.5 Transitional Provisions	
CAPITAL DEMAND	**Credit Risk**	➢ FSA004	➢ 3.2.Aandb Credit And Counterparty Credit Risks And Free Deliveries ➢ 3.3.A Credit And Counterparty Credit Risks And Free Deliveries: IRB Approach To Capital Requirements ➢ 3.4 Credit Risk: Equity - IRB Approaches To Capital Requirements ➢ 3.5 Settlement/Delivery Risk ➢ 3.6 Credit Risk: Securitisations - Standardised Approach To Own Funds Requirements ➢ 3.7 Credit Risk: Securitisations - IRB Approach To Own Funds Requirements ➢ 3.8 Detailed Information On Securitisations ➢ CR GB Geographical Breakdown Of Financial Exposures Subject To Credit Risk (IRB Approach) ➢ CR IP Losses ➢ CVA risk: reported in a separate template	
	Operational Risk	➢ FSA007	➢ 4.1 Operational Risk (General) ➢ 4.2 Gross Losses By Business Lines And Event Types In The Last Year	
	Market Risk	➢ FSA005	➢ 5.1 Standardised Approach For Position Risks In Traded Debt Instruments ➢ 5.2 Standardised Approach For Specific Risk In Securitisations ➢ 5.3 Standardised Approach For Specific Risk In The Correlation Trading Portfolio ➢ 5.4 Standardised Approach For Position Risk In Equities ➢ 5.5 Standardised Approaches For Foreign Exchange Risk ➢ 5.6 Standardised Approaches For Commodities ➢ 5.7 Internal Models	
	Large Exposures , Liquidity & Leverage	➢ FSA008 ➢ FSA047 - 054	➢ LE Limits ➢ LE1 Large exposures in the non-trading and trading book ➢ LE2 Detail of exposure to individual entities within groups ➢ LE3/LE4 Maturity buckets of the exposures ➢ LC1.1 Liquid Assets ➢ LC1.2 Liquidity Outflows ➢ LC1.3 Liquidity Inflows ➢ SF1.1 Items requiring stable funding ➢ SF1.2 Items providing stable funding	➢ LRCalc Leverage ratio calculation ➢ LR1 Alternative treatment of exposure measure ➢ LR2 On/Off-Balance Sheet items - Additional breakdown of exposures ➢ LR3 Alternative definition of capital ➢ LR4 Breakdown of Leverage ratio exposure measure components ➢ LR5 General Info ➢ LR6 Entities consolidated for accounting purposes , not within the scope of prudential consolidation

Disclosure Requirements

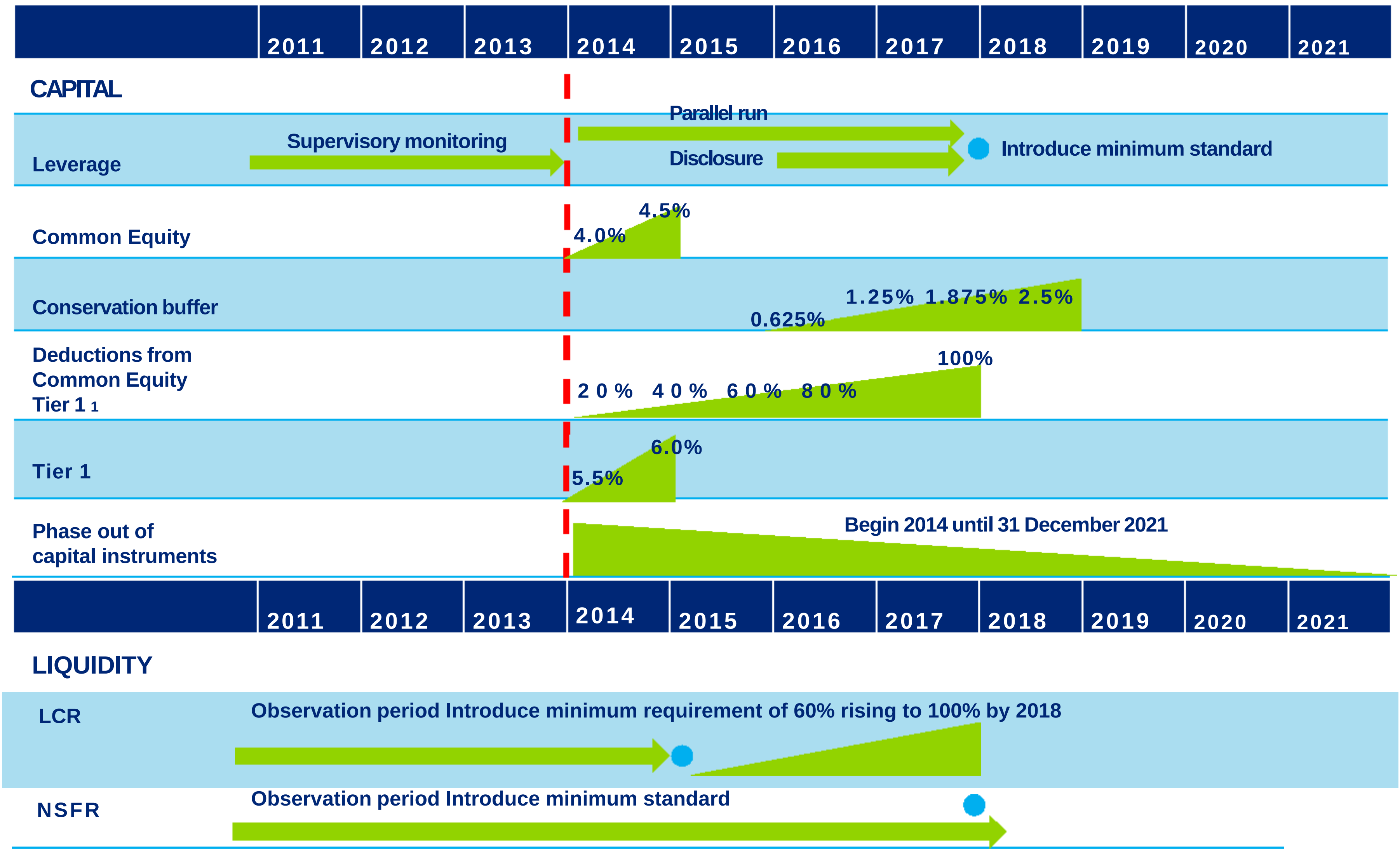
Annual disclosures to be published in conjunction with financial statements

Increased disclosures on risk management include

- Declaration by the management body on the adequacy of risk management arrangements
- Statement of risk profile vis-à-vis risk appetite approved by the Board including key ratios and figures
- Description of the flow of risk information to the Board

Disclosures on governance arrangements	More extensive disclosures on own funds	Disclosures on capital buffers
Summary results of the ICAAP subject to disclosure at discretion of the CBI	Exposure to credit and dilution risk, operational risk, counterparty credit risk, market risk, non-trading book equities, interest rate risk, securitisations	Disclosure on remuneration policy

CRD IV package timetable



1. As proposed in PRA CP 5/13, all CRR deductions are expected to be introduced with immediate effect, except for own funds instruments issued by financial sector entities subject to consolidated supervision. FCA proposal is to retain CRR transitional timetable.

Basel III / CRD IV impacts for investment funds

Impacts for investment funds

Impact on financial system	
Reduced risk of systemic banking crisis	• The changes should make a safe system
Reduce lending capacity	• Despite the extended timeline expect reduced lending
Reduced investor appetite for bank debt and equity	• Reduced RoE equals Reduced Dividends
Inconsistent implementation of the Basel III proposals leading to international arbitrage	• Already been seen with excess capital reserves

Impact on investment firms	
Additional reporting requirements for investment firms	• COREP, LCR, NSFR
Additional disclosure requirements for investment funds	• Fund managers will need to provide additional information to their institutional investors (e.g. RWA, CVA-risk, exposure to financial sector entities)
Re-design of investment funds offering	• Understanding the impacts of funds offering on the capital structure of institutional investors (use of OTC derivatives, high risk items, use of leverage, exposure to credit institutions of financial sector entities)

Basel III for investment funds

Look-through approaches

The supervisor has given the possibility under some criteria[1] to define the risk-weight of an UCI through to the Look-Through Approach. There are two methods:

The **Full Look-Through** Approach calls for the risk-based capital requirement to be calculated by determining the requirement for **each underlying exposure**. Therefore, by using the Standardized Approach in order to assess the capital requirement related to the credit risk, assets are grouped into a few categories based on the type of obligor (or type of obligation) and assigned risk-weights ranging from 0% to 100%.

Determine the risk weight of each line of the portfolio

The **Partial Look-Through** Approach calculates capital based on the **highest risk weight** that applies to any exposures in the fund. Where **Fund's documents** indicate maximum percentages that may be invested in different types of exposures, you may use the Partial Look-Through approach, which assumes that the fund will invest the maximum amount permitted in the highest risk weight exposure, and works backward until 100% of the fund is accounted for.

Determine the risk weight according the fund's document

[1] Criteria are:

- UCI is managed by a company regulated in a member state or in a third country with equivalent supervision
- UCI prospectus indicates permitted assets and investment limits
- At least, annual activity report

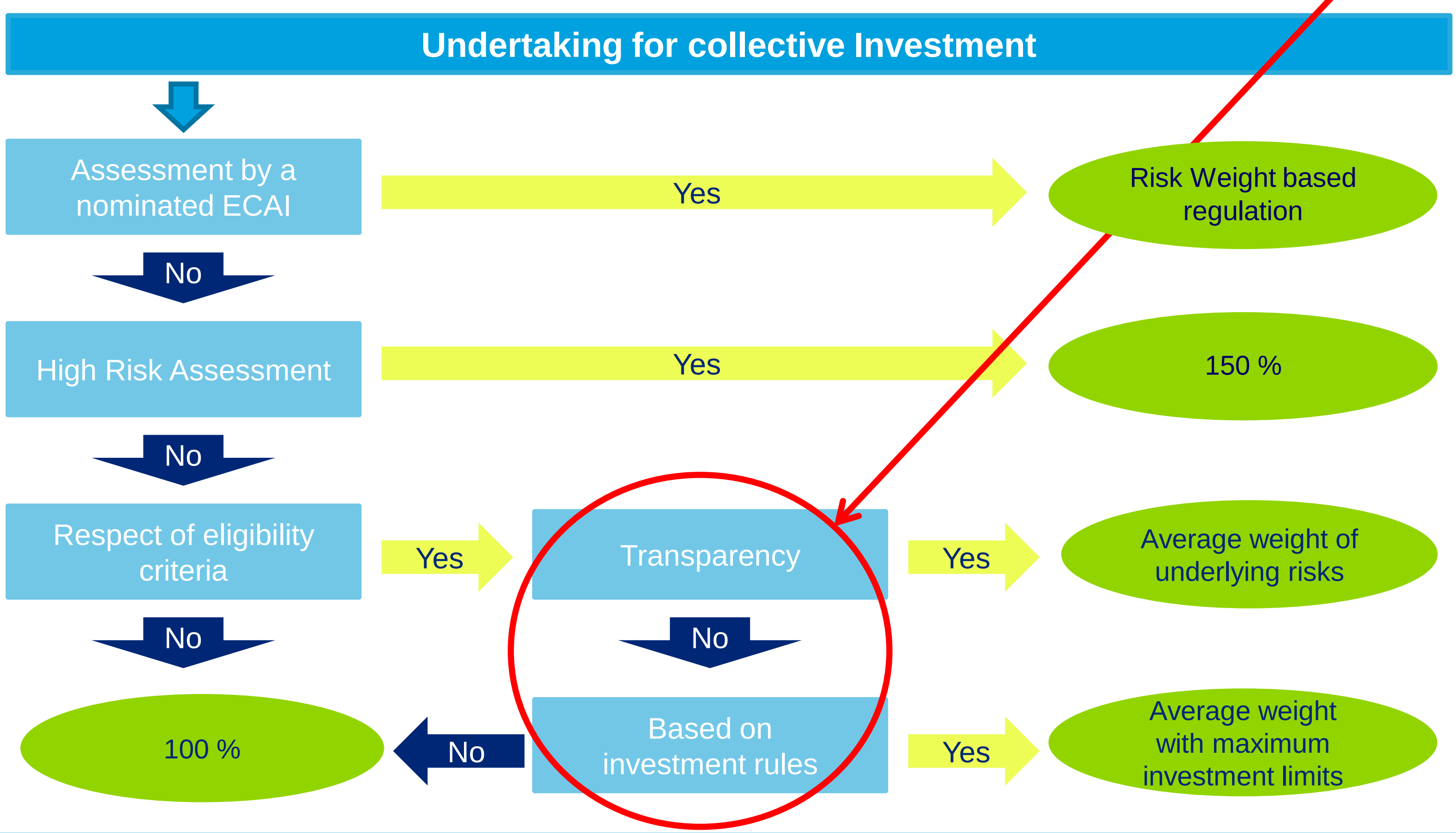
Basel III for investment funds

Decision tree to assess risk weights

Look through approaches

But in order to **reduce** this risk weight, UCI can have different alternatives:

- Being **rated** by a recognized ECAIs
- Apply the **look-through** approach.



Basel III for investment funds
Examples under Standardized Approach

For example, the document of the fund stated that it invests in 40% in Shares and 60% in sovereign bonds rated between AAA to A.

Partial look-through

We take the highest risk weight for each asset class:

Composition (Fund document)	Risk Weight
40% in shares	100%
60% sovereign bonds (AAA – A)	20% (A sovereign bonds)

Solvency ratio : 52%

Full look-through

We assess the risk weight for each line of the portfolio:

Composition (Fund portfolio)	Risk Weight
40% in shares	100%
30% Govt. bonds AAA	0%
25% Govt. Bonds AA	0%
5% Govt. Bonds A	20%

Solvency ratio : 41%

Basel III for investment funds

Illustration with a fixed income fund

Description	Nominal	Currency	Price	Dirty Market Value	Rating	Risk-Weight	Risk-Weighted Asset
Austria 2020 MTN 144A	3,000,000.00	EUR	103.69	3,165,133.15	AAA	0%	-
HSBC Cov BOND 10/17	4,000,000.00	EUR	99.84	4,121,572.60	AAA	10%	412,157
TELECOM ITALIA 09/14 MTN	1,000,000.00	EUR	108.04	1,133,270.41	BBB	100%	1,133,270
TELEFONICA EM. 09/19 MTN	1,000,000.00	EUR	97.75	984,057.34	A-	50%	492,029
RHEINL.PF.SCHATZ.V.2004	10,000,000.00	EUR	106.10	10,896,623.29	AAA	0%	-
SPANIEN 14-25	1,000,000.00	EUR	87.77	897,446.58	BBB-	0%	-
GRIECHENLAND 10-17	5,000,000.00	EUR	66.70	3,552,410.96	B-	0%	-
EIB EUR.INV.BK 05/37 MTN	4,000,000.00	EUR	98.68	3,981,471.78	AAA	0%	-
7.875 % BRESIL -GLOBAL-05/15	3,958,871.30	USD	119.75	3,584,153.14	BBB	50%	1,792,077
FNMA TBA 4.5%	2,850,000.00	USD	102.27	2,158,940.97	AAA	20%	431,788
Current Account	398,732.31	EUR	100.00	398,732.31	A	20%	79,746

Net Asset Value: 34,873,812.53 Total Risk-Weighted Assets: 4,341,067.57

Solvency Ratio **12.45%**

Basel III for investment funds

Illustration with a fund of funds

Description	Nominal	Currency	Price	Dirty Market Value	Rating	Risk-Weight	Risk-Weighted Asset
DONG ENER 4.63% 21/06/14	300,000.00	EUR	101.34	311,347.79	BBB	100%	311,348
BP CB COVERED REGS 06/15 3.875	500,000.00	EUR	100.42	507,954.21	AAA	10%	50,795
BARCLAYS BANK PLC COVERED 01/15 3.125	500,000.00	EUR	100.44	504,146.20	AAA	10%	50,415
EURO BUND FUTURES MAR15	5.00	EUR	125.31	30,000.00	AA	20%	7,880
ITALY 3.5% 15/03/15	2,000,000.00	EUR	100.38	2,025,634.88	BBB	0%	-
Bond fund	49,966.00	EUR	9.86	492,664.76	NR	12.45%	63,672
Absolute Retrun Fund	155,000.00	EUR	10.56	1,636,800.00	NR	57.64%	121,599
Global Balanced Fund	31,800.00	USD	11.73	500,532.00	NR	19.27%	373,101
Dynamic	149,900.00	EUR	9.59	1,437,541.00	NR	100%	1,437,541
SPAIN 5.4% 30/07/14	1,000,000.00	EUR	101.09	1,033,642.06	BBB-	0%	-
Current Account	20,000.00	EUR		20,000.00	AA	20%	4,000

Net Asset Value:	8,500,262.90	Total Risk-Weighted Assets:	2,420,350.48
		Solvency Ratio	**28.47%**

Additional impact of Basel III on the asset management industry

Credit Valuation Adjustment

- Basel III / CRD IV will have further impacts on the Credit Counterparty Risk (CCR) exposure and related capital requirements. More precisely, institutions will be required to calculate the **own funds requirements for Credit Valuation Adjustment** (or CVA) risk for all **OTC derivative instruments**. CVA means an adjustment to the mid-market valuation of the portfolio of OTC transactions with a counterparty. That adjustment reflects the current market value of the credit risk of the counterparty to the institution
- Own funds requirements for CVA risk are calculated either according to the advanced method (IRB) or to the standardized one. Impact in the standardized approach is assessed to be around 4% of total Risk Weighted Assets (RWA)
- The CVA can be reduced through hedging, with two types of eligible hedges: Single Credit Default Swap (CDS) or Index CDS
- Note that transactions with a **central counterparty are excluded** from the own funds requirements for CVA risk
- These requirements are in force since **January 1, 2014**

Eligibility of CIU's shares as "liquid assets" in the calculation of the forthcoming Liquid Coverage Ratio (LCR)

Shares or units in CIUs may be treated as liquid assets up to an **absolute amount of 500 million EUR** in the portfolio of liquid assets of each institution if:

- CIU is managed by a company that is subject to supervision in a Member State or equivalent in the case of a third country CIU
- The CIU discloses documents (prospectus, …) that details the categories of assets in which CIU invests as well as the investment limits (if any) and the way to calculate them
- The CIU reports, at least on an annual basis, information to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period
- The CIU only invest in **liquid assets** or **derivatives to mitigate its risks** (interest rate, credit, FX)

What are Investment Firms currently doing ?

1

Programme set up (Completed)

- Owner & stakeholders identified and engaged
- Regulatory expertise incorporated
- Extend current Basel II work
- Confirm business unit buy-in
- Mobilise gap assessment

2

Conduct gap analysis (Competed)

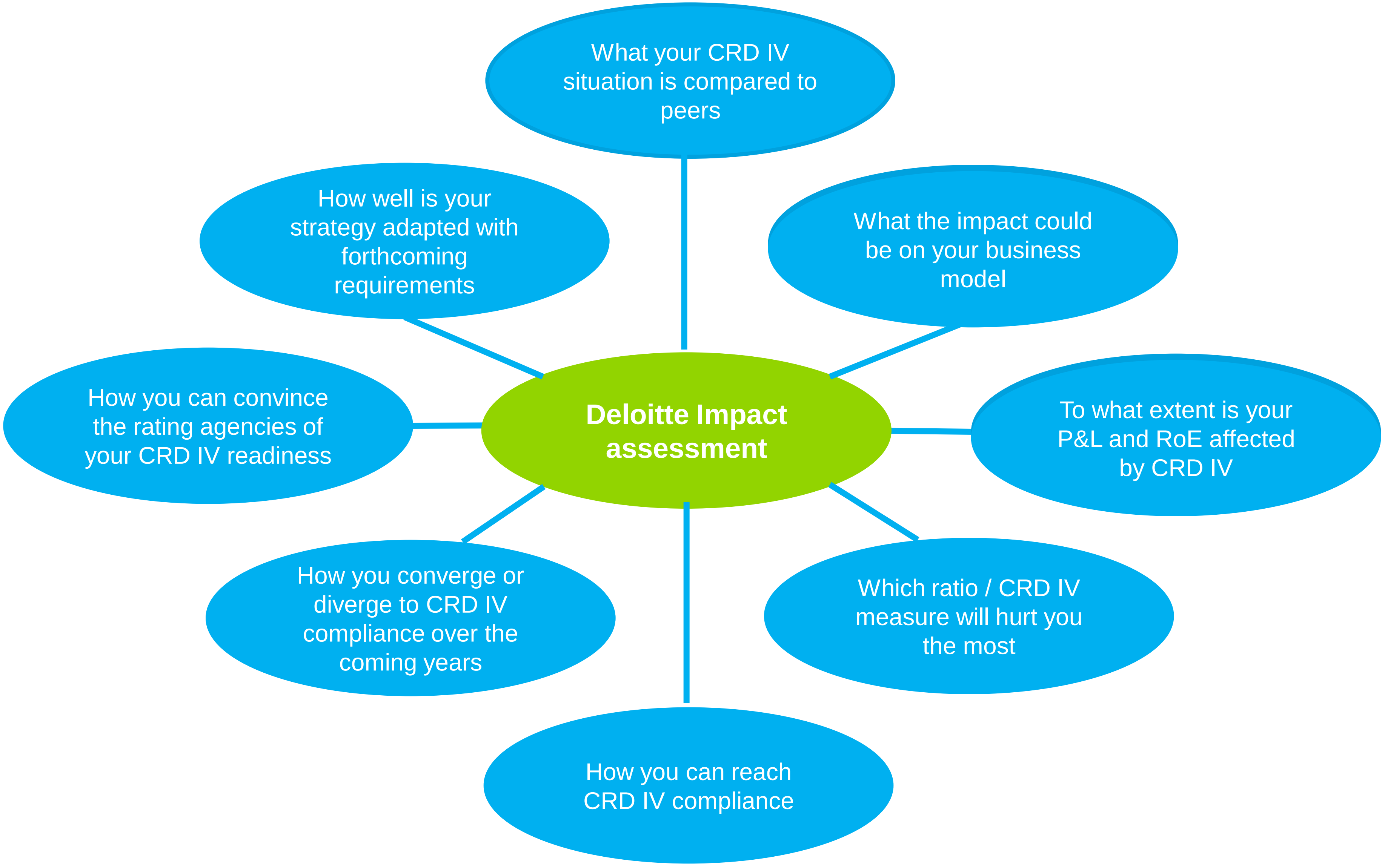
- Assess applicability of changes
- Compare changes
- Confirm impact of changes
- Prioritise implementation against other regulatory imperatives

3

Execution / Implementation

- Identify and confirm likely source of information for calculations
- Assess likely availability and accessibility of data
- Agree governance process for review of impact assessment
- Use these principles to shape programme of work

What the Deloitte Impact assessment will answer ?



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Questions ?

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