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Basel III & CRD IV the impact for the Investment Firms

Link N' Learn

03rd November 2016

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
   - Implementation timetable
   - Deloitte CRD IV Services

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

4. **Solvency II: A short introduction on the indirect impacts for asset managers**

5. **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. Current Basel framework 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)
- Leverage requirements
- Large Exposures

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
- Internal Liquidity Adequacy Assessment Process (ILAAP)*

Pillar 3

Market discipline

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

* Not applicable to all EU countries yet

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 Art. 4 of the CRR, investment firm means a person which is subject to the following requirements

Firms that are authorized to provide one of the following investment services:
Dealing on own account
Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis
Placing of financial instruments without a firm commitment basis
Operation of Multilateral Trading Facilities

AND all firms authorised to provide the following ancillary service:
Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management;

	Investment firms with limited authorisation to provide investment services (Art. 95 of the CRR)	Investment firms which is subject to Art. 96 of the CRR	Investment firms with no limitations on activities
Definition	Investment firms that are **not authorized** to provide one of the following investment services: • Dealing on own account • Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis	Firms that **are authorized** to provide one of the following investment services: • Dealing on own account • Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis **AND do not** hold client money or securities, only undertake dealing on own account and have no external customers (Art. 96 of the CRR)	Investment firms that **are authorized** to provide one of the following investment services: • Dealing on own account • Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis
Scope of reporting	• Own funds + capital requirements (C01/C02/C03/C04/C05) • Exposures and losses from lending collateralized by immovable property (C15) + Asset encumbrance (C32)	• Own funds + capital requirements (C01/C02/C03/C04/C07/C09…) • Exposures and losses from lending collateralized by immovable property (C15) + Asset encumbrance (C32) • Liquidity reporting (LCR)	• Own funds + capital requirements (C01/C02/C03/C04/C07/C09…) • Exposures and losses from lending collateralized by immovable property (C15) + Asset encumbrance (C32) • Liquidity reporting (LCR, NSFR) • Leverage Ratio (from C40 to C46) • Large exposure (from C26 to C31)
Minimum Capital Requirement	Higher of ; • Fixed Overhead Requirement • Sum of Market and Requirement	The sum of: ▪ the Fixed Overhead Requirement ▪ market and credit risk requirements	The Sum of Market, Credit and Operational Risk as required by the rules in the CRR

Improving the quality of Capital

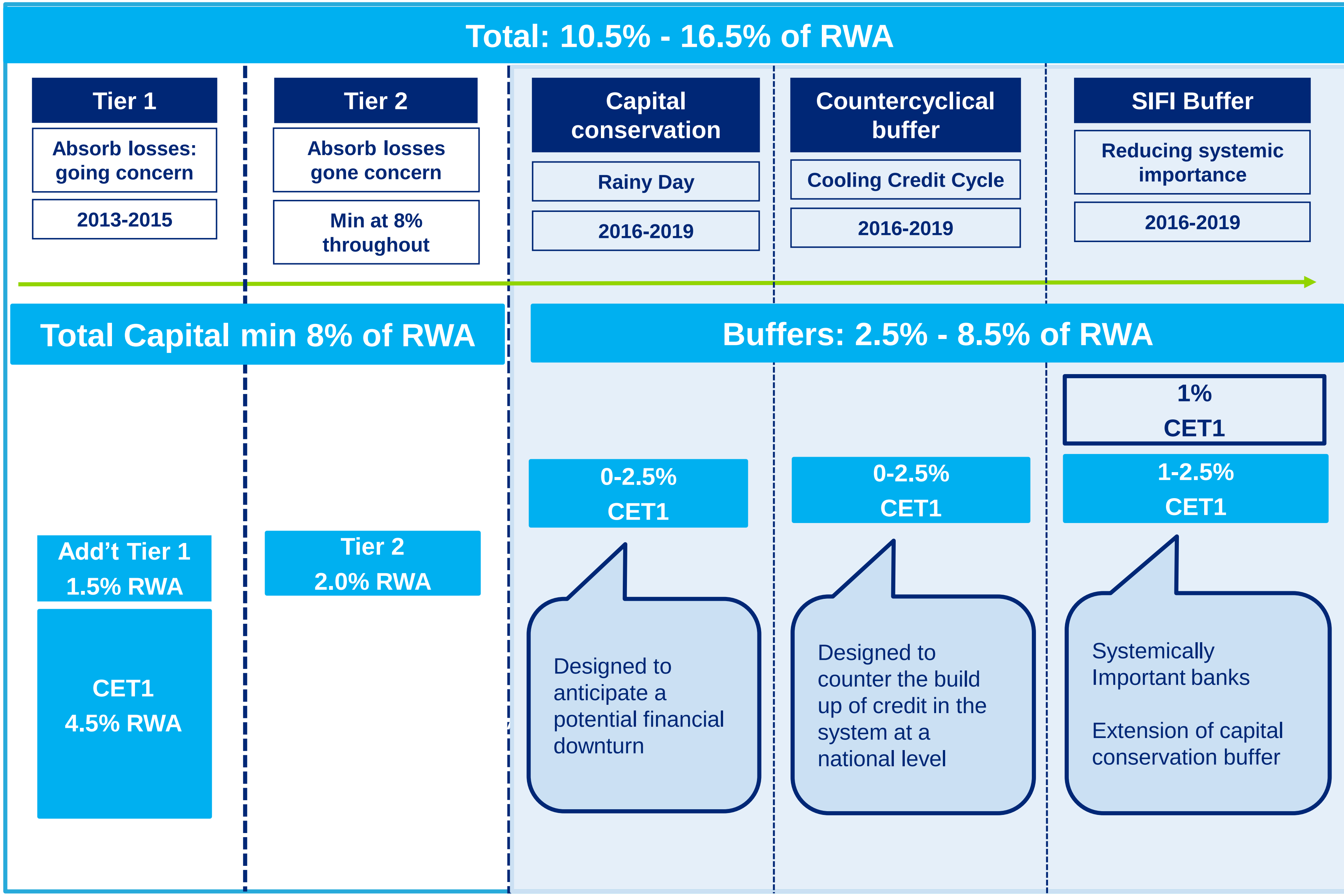
Basel III contains various measures aimed at improving the quality of capital, with the ultimate aim to improve loss-absorption capacity in both going concern and liquidation scenarios.

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 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



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)

$$\frac{\text{Stock of highly Liquid assets}}{\text{Net cash outflows over 30-day horizon}} \geq 100\%$$

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**
- **Monthly reporting** with the operational capacity to report daily
- Gradual implementation with a minimum LCR of 70% in 2016 to 100% in 2018

Net Stable Funding Ratio

Net Stable Funding Ratio (NSFR)

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding (Assets)}} \geq 100\%$$

Description

- Aims to strengthen **medium- to long-term funding profile**
- Assesses the adequacy of the resources of funding compared to the maturity profile of assets
- **Balance sheet** perspective
- **Quarterly reporting**
- Implementation date scheduled for **2018**

Additional Liquidity Monitoring Metrics (ALMM)

- The regulator also requires to report information on additional liquidity monitoring metrics in order to identify potential rising liquidity stresses in the financial markets.

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

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

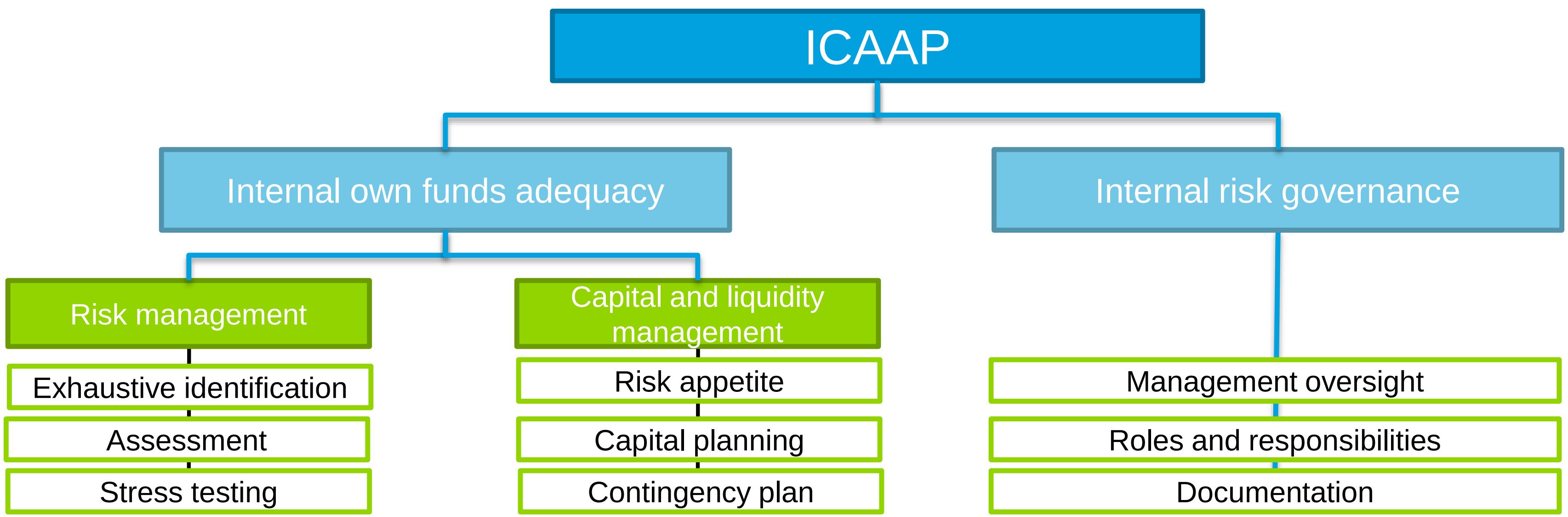
- Aim to limit risks to financial stability arising from excessive leverage
- The ratio measures the size of the total exposure (without risk measure) to the size of Tier 1
- Quarterly reporting
- Implementation date scheduled for 2018
- Proposition of a minimum of 3%

Definition and structure of the ICAAP (Pillar 2)

Definition of the ICAAP

"The ICAAP is a set of sound, effective and complete strategies and processes that allow institutions assessing and maintaining on an ongoing basis the levels, types and distribution of own funds that they consider adequate to cover the nature and level of the risks to which they are or might be exposed." (CRD, art. 73)

- While no formal structure of the ICAAP is yet defined by the CRD, a typical framework can be described as follows:



Public Disclosure Requirements (Pillar 3)

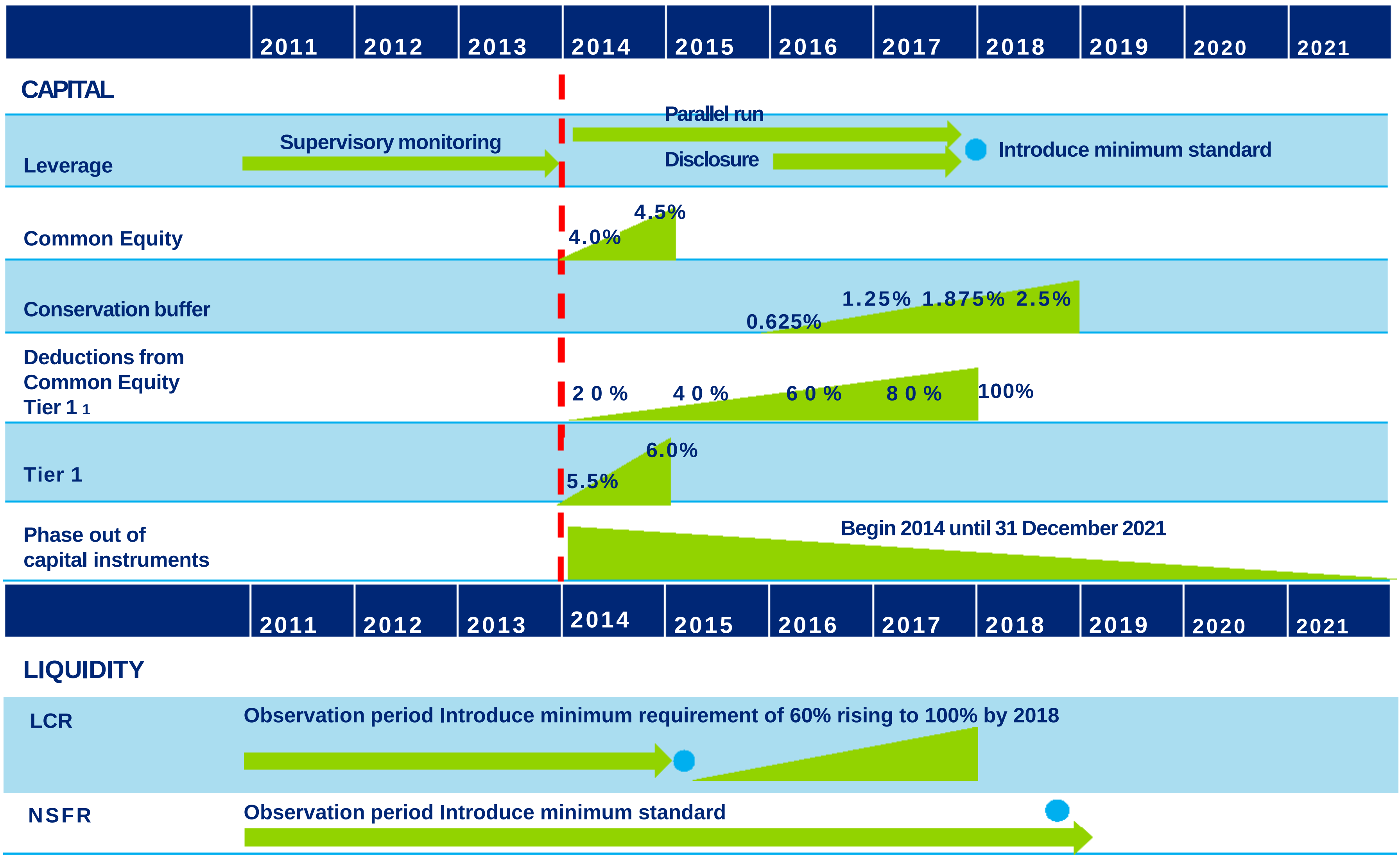
Annual disclosures to be published in conjunction with financial statements

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

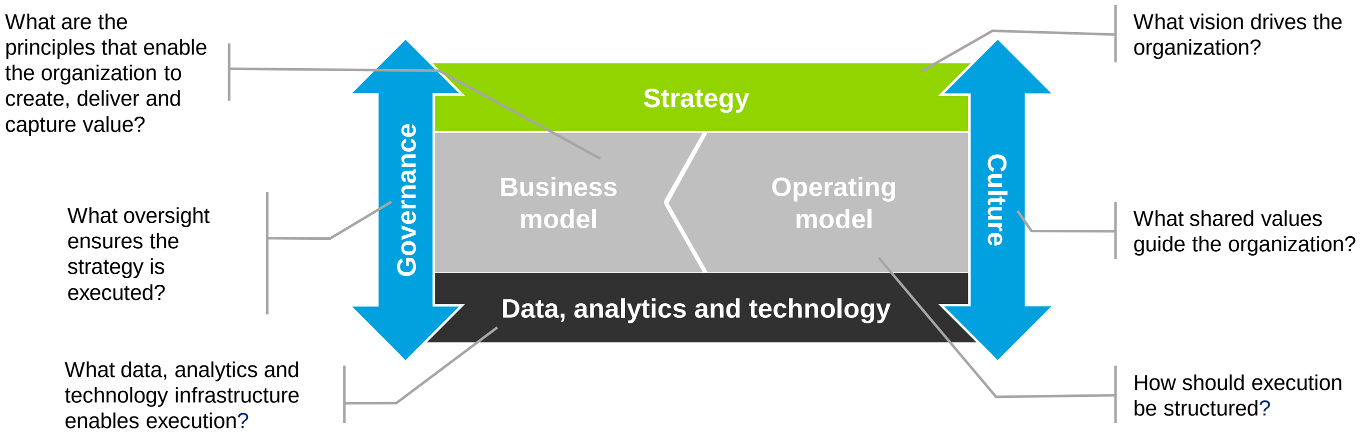
Disclosures on governance arrangements	More extensive disclosures on own funds	Disclosures on capital buffers
Summary results of the ICAAP subject to disclosure at discretion of the CBI	Exposure to credit and dilution risk, operational risk, counterparty credit risk, market risk, non-trading book equities,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

A wide range of Deloitte services to address CRD IV needs



CRD IV services and products proposed by Deloitte:

Strategy

What is risk to the strategy and risk of the strategy:

- Strategic optimisation toolkit (SOT)
- Investment strategy review (e.g. set up of trading book)
- Pillar I impact assessment: quick analysis of key changes introduced by CRD IV

Governance & culture

How are risk oversight ensured and behaviors guided by the risk culture:

- Review / enhance internal governance arrangements (Board risk oversight)
- Set up Risk Management function
- Updates of remuneration policies

Business & operating model

How is risk managed:

- Support in risk appetite definition
- Liquidity ratios: LCR / NSFR design and implementation
- RTP / FTP Implementation
- Pillar II and stress testing: ICAAP / ILAAP enhancement
- Collateral Management
- Risk model validation

Data, analytics and technology

How is risk measured and monitored

- Package selection
- Risk analytics – Improving internal dashboarding for risk oversight
- New regulatory reporting: FINREP / COREP (extended)
- Optimizing IT architecture (Treasury / Accounting) and data management
- Data aggregation, reporting and taxonomy

CRD IV Gap Analysis

CRD IV Implementation

Basel III / CRD IV impacts for investment funds

Impacts for investment firms

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

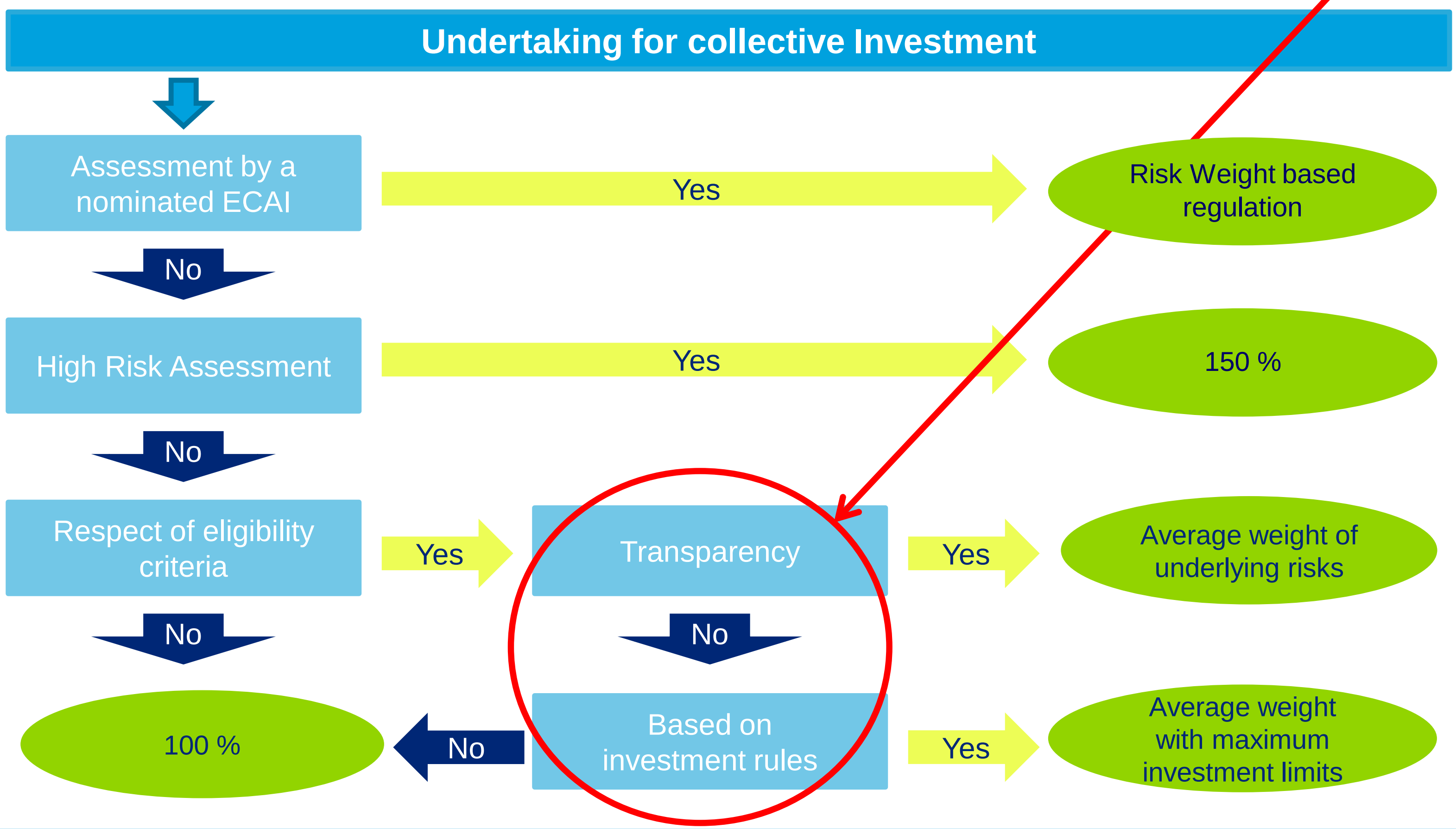
[1] Criteria are:
- UCI is managed by a company regulated in a member state or in a third country with equivalent supervision
- UCI prospectus indicates permitted assets and investment limits
- At least, annual activity report

Basel III for investment funds

Decision tree to assess risk weights

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)

Solvency II for asset managers

What is Solvency II?

Impacts for Assets Managers / Services

- Solvency II is based on three guiding principles which cut across undertaking risks, market, liquidity, operational…
- The new system is intended to offer insurance undertaking incentives to better measure and manage their risk situation - i.e. lower capital requirements, lower pricing etc.
- The new solvency system will include both quantitative and qualitative aspects of risks. Each pillar focusing on a different regulatory component.

SOLVENCY II

PILLAR I

Capital requirements

- Assets & liabilities valuation
- Technical provisions
- Own funds
- Solvency capital requirements
- Minimum capital requirement
- Investment rules

Two thresholds:
- Solvency capital requirements (SCR)
- Minimum capital requirements (MCR)

Harmonised standards for:
- Valuation of assets and liabilities
- Eligibility criteria of own funds

PILLAR II

Governance & supervision

- Governance system
- Supervisory review
- Groups control

- Effective risk management system
- Own risks and solvency assessment (ORSA)
- Supervisory review & intervention

PILLAR III

Disclosures

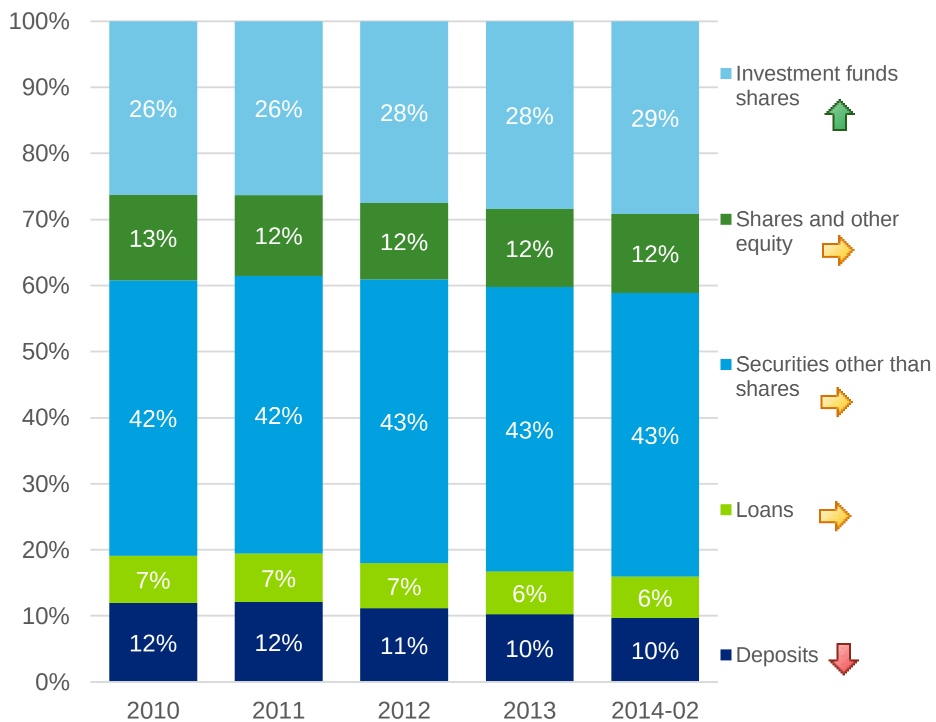
- Public information
- Supervisory reporting

- Insurers are required to publish details on risks, capital adequacy and risk management
- Transparency and open information are intended to assess market forces in imposing greater discipline to the industry

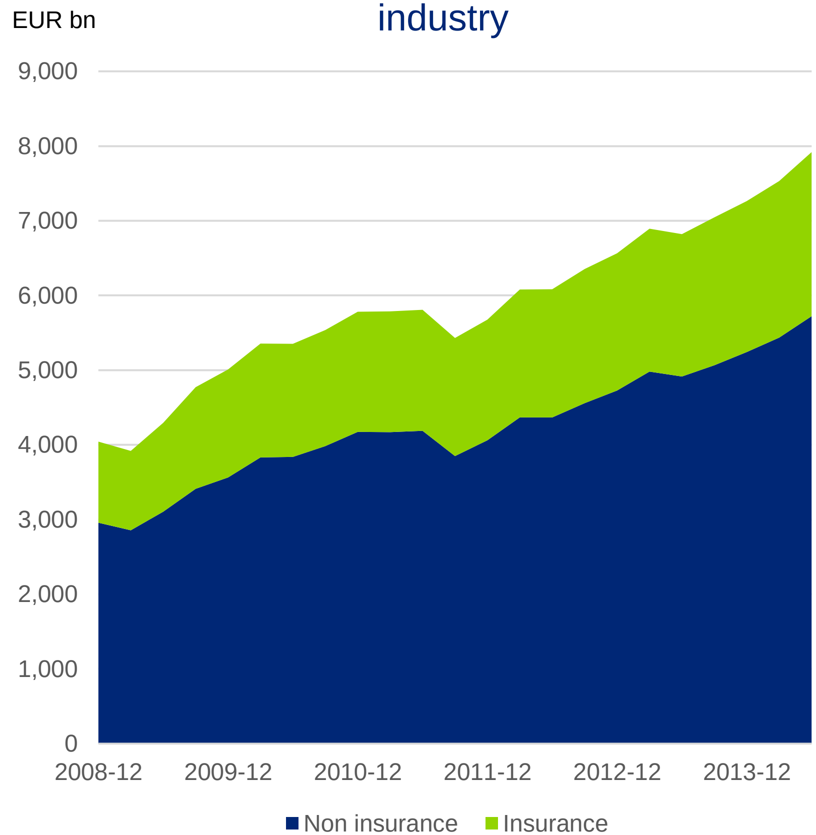
Insurance market share in the investment funds industry

- **29%** of life Insurance undertaking's portfolios are composed of investment funds
- The share of investment funds in the insurer portfolio increased of 11 % over the last four years
- Assets under management for the life insurance sector (Euro area) > EUR 8,5 bn

Structure life insurer's investment portfolio Euro area



Weight of the life insurance in the funds industry



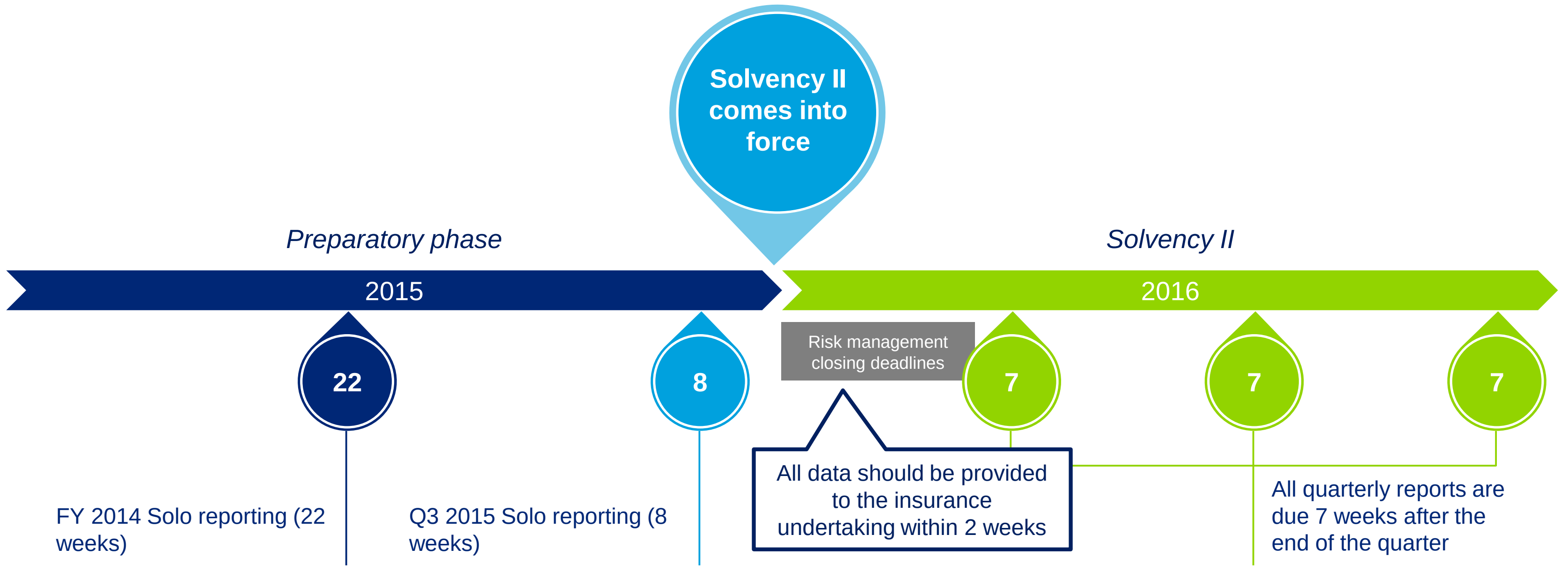
Source: ECB

Solvency II – Implementation phase and reporting frequency

One of the major challenges for Asset Managers is to be able to cope with the frequency and timeframe of the reporting imposed on insurance undertakings.

There are two different frequencies for the reports:

- **Annual Reports** – to be provided within 22 weeks after the end of the year. The first annual report should be produced beginning 2015 during the preparatory phase of Solvency II
- **Quarterly Reports** – to be provided within 8 weeks after the end of the quarter beginning Q3 2015. In 2016, the reports will have to be provided within 7 weeks



Solvency II for investment funds

Challenges & opportunities for asset managers

Pillar 1
Quantitative Requirements

Opportunities

- **Creating bespoke products**

  Insurers will need tailor made products that reflect their risk tolerances and minimise capital requirements

Challenges

- **Availability and quality of input data**

  Updated quantitative methodologies may require more detail on investment strategy and investments data from the investment manager which may require new processes with custodians and administrators

- **Granularity of data and analysis**

  The regulation requires more detailed analysis of risks and sensitivities, which increases the volume of modelling data that needs to be processed by actuaries

- **Different requirements**

  Different Insurers are likely to have different information requirements for their models

Pillar 2
Supervisor Review

Opportunities

- **Insurers will want to invest with managers that can evidence minimal operational risks**

  Insurers are required to understand and manage all risks including outsourced services

Challenges

- **Evidencing risk management to clients**

  ISAE 3402 generally cover financial reporting risks, so evidencing risk management over investment risks will be a challenge (regular DD reviews are not likely to fulfil this requirement). Insurers need to quantify the risks embedded in the asset manager

- **On-going risk management**

  Insurers will need to monitor asset managers and their products on an on-going basis

Pillar 3
Market Discipline

Opportunities

- **Insurers need managers who can provide quality data in a timely fashion**

  Providing quality data in a timely fashion is a business imperative for attracting insurance business

Challenges

- **Report delivery time and frequency**

  In general, the current report delivery timelines are not satisfactory for public disclosure requirements and the frequency does not allow the management to react quickly to changes in business or environment. Insurers will need quality data within days of quarter end to meet current proposed reporting requirements to regulators of 20 business days

- **On-demand capability**

  A compliant insurer must be able to answer supervisor’s queries promptly and provide supportive quantitative information

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