

Certified Hedge Fund Compliance Expert (CHFCE) - Part 14

International Association of Hedge Funds Professionals (IAHFP)



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Agenda

- Introduction
- The 8th Company Law Directive
- Regulatory Arbitrage Opportunities
- The Basel ii Accord
- Regulatory Arbitrage Opportunities



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Arbitrage

- Arbitrage is the practice of taking advantage of a ***difference*** between two or more markets
- Usually price difference...
- ... but every difference is an opportunity
- DIFFERENCE = ARBITRAGE OPPORTUNITY



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Arbitrage

- In order to have arbitrage opportunities, we need to find a difference
- Regulatory Arbitrage is the practice of taking advantage of a regulatory difference between two or more markets



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Arbitrage

- Basel ii is a mandatory framework which is full of differences ...
- ... *different approaches...*
- ... *different deadlines...*
- ... *different options...*
- ... *different national discretions etc.*
- Regulators need to guard against the unintended consequences of well-intended policies...
- ... **but they do not understand arbitrage**



Arbitrage

- When we have all these different approaches and options by design (Basel ii is proud of that)...
- ... we also have ****flexible countries**** that create opportunities...
- (where compliance is an opportunity)
- ... and ****non-flexible**** countries that increase the cost of the services provided by banks
- (where compliance is just an obligation)



Arbitrage

- Hedge Funds select the more favorable jurisdictions, playing one government off against another
- *Is it fair?*
- *Absolutely!*



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Arbitrage

- The flexible countries have a plan, to retain or attract foreign direct investments
- They know that hedge fund managers like shopping, especially regulator shopping
- They try to find the friendliest regime to do business...



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Arbitrage

- The non-flexible countries complain
- They say that a general easing of regulations is a race to the bottom
- And, they continue to lose money, jobs, investments



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Arbitrage

- Basel ii is supposed to be the framework that attempts to align economic and regulatory capital more closely...
- ... to reduce the scope for regulatory arbitrage
- At least, this is what they say
- But, you can not have so many differences and the same time to say that you try to reduce the scope of regulatory arbitrage
- *This is an oxymoron*



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Arbitrage

- **Differences:** The treatment of **non-investment-grade** credit under the standardized approach is **so different** from the treatment under the foundation or advanced internal ratings based (IRB) approach
- **Differences:** By providing **at least three** alternative capital calculation methods...
- ... Basel II creates **differences** that do not exist in Basel I



Differences...

Approach	The Standardized Approach	Foundation IRB Approach	Advanced IRB Approach
Complexity	Low	Medium	High
Accuracy	Low	Medium	High
Capital Charge	High	Medium	Low



Some banks will fail...

- UK's FSA has stated that credit risk models would be reviewed as part of its supervisory process...
- ... in order to assess the overall quality of banks' risk management
- Some banks will spend millions...
- ... to go advanced...
- ... but the supervisors will reject their model
- [Traders - Be Prepared]



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Regulatory Arbitrage...

- Has to do with the lowest regulatory burden ...
- ... in terms of capital requirements and...
- ... in terms of administrative burden
- Competition between regulators *vs.* tendency to over-regulation



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Regulatory Arbitrage...

- Today, we will NOT discuss how to...
- ... **evade** a regulatory requirement...
- ... **shift to another** regulatory regime...
- ...**or fly beneath** the regulatory radar
- There are some other ****legal**** opportunities



Banking, Securities and Insurance...

- After Basel ii...
- ...important differences amongst the segments of the financial sector - **banking, securities and insurance**
- We will have regulatory arbitrage amongst the three segments
- In Europe they develop Solvency ii - the Basel ii equivalent of Basel ii
- In the States and around the world the differences become important



Paul Boyle is astonished...

- Paul Boyle is the Chief Executive of the UK **Financial Reporting Council**
- (www.frc.org.uk/index.cfm)

The screenshot shows the homepage of the Financial Reporting Council (FRC). At the top, there is a navigation bar with a 'Welcome' message, a 'Go to' dropdown menu, a search box, and a 'Search' button. Below this is the FRC logo and the text 'Financial Reporting Council' and 'The UK's independent regulator responsible for promoting confidence in corporate reporting and governance'. The main content area is divided into several sections: 'About the FRC', 'Publications', 'Press Notices', and 'Recruitment'. On the left, there is a section titled 'Our Operating Bodies' with links to ASB (Accounting Standards Board), APB (Auditing Practices Board), and BAS (Board for Actuarial Standards). In the center, there is a 'Spotlight' section with a photo of people in a modern office and the text 'Promoting confidence'. On the right, there is a 'Latest Press Notices' section with three items: 'Financial Reporting Review Panel announces approach to qualified accounts' (05/06/2008), 'FRC appoints new Director, Actuarial Standards' (03/06/2008), and 'FRC to Update the Combined Code' (30/05/2008).



Paul Boyle is astonished...

- Paul told the **Daily Telegraph** that...
- ...he is ***astonished*** that few in the City have woken up to the ***impact* of the EU directive** governing...
- ... the use of **foreign auditors by companies *seeking to list*** on European exchanges



Paul Boyle is astonished...

- Paul told that...
- ... **"The Americans have discovered** if you introduce burdensome regulation **people will go elsewhere"**
- **"We have been the beneficiaries, but** that may not continue to be the case"
- The City is sleepwalking into a ***crisis*** that will threaten the **Stock Exchange's appeal to foreign companies** seeking to issue shares



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Paul Boyle is astonished...

- **If auditors of foreign** companies do **not meet** European standards...
- ... (which the FRC says is likely)...
- ... the companies using them would **have to *delist*** **their securities from European exchanges**
- **Extra compliance costs** imposed could encourage companies to move from London to other capital markets
- The **British Bankers' Association** had **"serious concerns"** over the EU's audit directive



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Paul Boyle is astonished...

- There are **228 non-EU companies listed on the London Stock Exchange**
- [This becomes an important part of **Analysis**]
- [**Event Driven Strategy**]



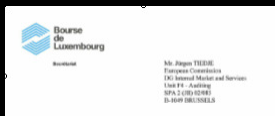
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To date 8380 companies from 77 countries are quoted on the Frankfurt Stock Exchange. Without the listings from countries of the European Economic Area we have 6036 international companies from 54 countries on our markets. In addition to German and international issuers' equities, investors can trade more than 18.000 listed fixed income securities.



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The Luxembourg Stock Exchange is committed to attracting international listings to Europe. The Luxembourg Stock Exchange is a major listing centre of international bonds, equities and investment funds. On 31 December 2006, 39.860 different securities were listed on the Luxembourg Stock Exchange with more than 4,100 issuers from about 105 jurisdictions. 42,5 % of these are not European issuers (0,9 % from Canada, 11,7 % from USA, 11,4 % from Asia, 17,1 % from Central America and South America, 1,1 % from Australia and 0,3 % from Africa). This provides evidence that the Luxembourg Stock Exchange has one of the most relevant experiences in the listing activities related to third country issuers on a EU regulated market.



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Fears in EU over auditors directive

- The reason behind the directive: Can investors trust...
- ... the financial information provided by companies based in "third countries" ...
- ... and have securities listed on the European Markets?



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The 8th Company Law Directive

The European Union's Sarbanes-Oxley Act (E-SOX)



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From SOX to E-SOX to J-SOX

- The business intelligence / corporate espionage risk
- The registration of the auditors
- (Regulatory retaliation?)



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EU and USA

- May 2003: Commissioner Bolkestein spoke ***against*** the US oversight measures on foreign audit firms
- **"I do not accept the imposition of US standards on our firms** and...
- ... that is why the European Union ***strongly opposes*** registration of EU audit firms with the United States' Public Company Accounting Oversight Board...
- ... The EU will regulate its own businesses"



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EU and the USA

- After the passage of the Sarbanes Oxley Act...
- ... EU finance ministers asked from the EU Commission to negotiate with the USA about:
- 1. Obtaining exemptions for EU corporations
- 2. Obtaining exemptions for EU audit firms (from registration with the Public Company Accounting Oversight Board)
- 3. The ability of the US agencies, PCAOB and SEC included, to have access to a foreign firm's audit work papers



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July 24, 2007 1799 firms registered with the PCAOB



Audit Conseil Holding	Paris, France
Audit et Conseil Union	Paris, France
AuditiA Barcelona, S.L.	Barcelona, Spain
AUDITING GROUP S.R.L.	Vicenza, Italy
Austin, Niester, Beauchamp & Finnegan	Port Huron, MI
AWT Horwath GmbH Wirtschaftsprüfungsgesellschaft	Munich, Germany
Babush, Neiman, Kornman & Johnson, LLP	Atlanta, GA
Badenhorst Auditors	Caledon, South Africa
Bader Martin, P.S.	Seattle, WA
Baerson, Witonski, Patel, Berkowitz & Rubin, LLC	Northbrook, IL
Bagell Josephs Levine & Company, LLC	Gibbsboro, NJ
Bain, Freibaum, Sagona & Co., L.L.P.	New Orleans, LA
Baker Newman & Noyes Limited Liability Company	Portland, ME
Baker Tilly (Switzerland) AG	Zurich, Switzerland
Baker Tilly Audit (Thailand) Limited	Sathorn, Thailand
Baker Tilly China Ltd.	Beijing, China
Baker Tilly Deutschland GmbH	Frankfurt Am Main, Germany
Baker Tilly Hong Kong Limited	Hong Kong, Hong Kong



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EU audit firms registered with the PCAOB

EU Member State	EU audit firms registered with the PCAOB	EU Member State	EU audit firms registered with the PCAOB
Austria	6	Luxembourg	3
Belgium	13	Malta	2
Cyprus	2	Netherlands	12
Czech Republic	6	Poland	6
Denmark	5	Portugal	6
Estonia	1	Slovakia	2
Finland	5	Slovenia	2
France	31	Spain	13
Germany	28	Sweden	6
Greece	4	United Kingdom	60
Hungary	5	Total EU registrants	241



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EU and USA

- *One year after, everything is different...*
- **March 2004:** Commissioner Bolkestein spoke (March 25, 2004) at a meeting at the European Policy Center (EPC):
- "I think you are probably all already aware that **we have been working very hard for nearly a year with our counterparts from the PCAOB ...**
- ...to work out a ***cooperative way* of regulating audit firms** which...
- ... audit listed companies in *both the EU and the US*"



EU and USA

- "Once the US Congress had adopted the **Sarbanes Oxley Act** - *at remarkable speed* - reflecting...
- ... the **pressure** congressmen and senators were under...
- ... after the collapse of Enron, WorldCom etc. - *but without consultation* - ...
- ...we **in the EU were faced with a simple choice:**



EU and USA

- Either – we could ***oppose tooth and nail*** the Sarbanes Oxley Act –and add yet another fiery dispute to our difficult post-Iraq bilateral relationship
- Or – we could try to **find a constructive, cooperative way** forward, jointly, respecting to the maximum degree possible our different legal traditions and cultures
- **We decided on the latter”**



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The 8th Company Law Directive

- E-SOX, EuroSOX, Statutory Audit Directive
- The 8th Company Law Directive aims at...
- ... **high-level** harmonisation...
- ... ****not full**** harmonisation of statutory audit requirements
- A Member State requiring statutory audit **may impose more stringent requirements**, unless otherwise provided for by this Directive
- (A “*minimum*” directive)



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The 8th Company Law Directive

- **In most** areas the approach of the Directive is based on **achieving minimum harmonisation**
- **Only in certain** specified areas, such as auditing standards, the approach of the Directive is based on **achieving maximum harmonisation**
- Member States will be allowed to exercise **options** open to them when transposing the Directive



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http://ec.europa.eu/internal_market/auditing/directives/index_en.htm

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5 Auditing

- News
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- Audit Regulatory Committee (AIRC)
- European Group of Auditors' Oversight Bodies (EGAOB)
- Auditors' Liability
- Auditors' Independence
- Quality Assurance
- International Standards on Auditing (ISAs)
- Relations with third countries
- Infringements
- Useful links
- Contact & help

Directives

- **Directive 2006/43/EC on statutory audit** of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC 83/349/EEC
 - [Text of the Directive](#)
 - [Charlie McCreevy welcomes the agreement reached in Council \(11.10.2005\)](#)
 - [European Parliament votes in favour of the Commission proposals for the 8th Company Law Directive on statutory audit](#) (28.9.2004)
 - [Press Release \(15.3.2004\)](#)
 - [Frequently asked questions](#)
 - [Memorandum from Mr Bolkestein](#)
 - [Text of the proposal](#)
- **Directive: 8th Council Directive 84/253/EEC** of 10 april 1984 on the **approval of persons responsible for carrying out the statutory audit accounting documents**
Full text available in all languages
- **Article 51 of the Fourth Council Directive** of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC)
Full text available in all languages
- **Article 37 of the Seventh Council Directive** of 13 June 1983 based on the Article 54(3) (g) of the Treaty on consolidated accounts (83/349/EEC)
Full text available in all languages



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Competitive Disadvantage for the EU

- All these new requirements could act as a significant *****regulatory deterrent***** to...
- ... non-EU companies
- *Dubai and Singapore are waiting...*
- *After the 8th Company Law Directive...*
- ... several international companies will choose the most friendly jurisdictions of the EEA



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Article 44 Approval of auditors from third countries

- Articles 44 and 45...
- ...the most important articles for “third countries”
- *Subject to reciprocity...*
- ... the competent authorities of a Member State ...
- ... **may** approve a third-country auditor as statutory auditor...
- ... **if** that person has furnished proof that he or she complies with requirements ****equivalent**** to those laid down in Articles 4 and 6 to 13



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Article 45 - Registration and oversight of third-country auditors and audit entities

- The competent authorities of a Member State shall...
- ... **register every third-country auditor and audit entity** that...
- ... provides an **audit report** concerning the **annual or consolidated** accounts of a **company incorporated outwith the Community** ...
- ... whose transferable **securities are admitted** to trading on a **regulated market of that Member State**



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Article 45 - Registration and oversight of third-country auditors and audit entities

- Member States **shall subject** registered **third-country auditors and audit entities**...
- ... **to their systems** of oversight...
- ... **their quality assurance systems** and...
- ... **their systems of investigation and penalties**
- (!!!)



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Article 45 - Registration and oversight of third-country auditors and audit entities

- A Member State ****may exempt**** a registered third country auditor or audit entity ***from being subject to its quality assurance*** system...
- ... **if another Member State's or ...**
- ... **third country's system** of quality assurance that has been *****assessed as equivalent***** ...
- ... in accordance with Article 46 **has carried out a quality review ...**
- ... of the third-country auditor or audit entity concerned during the **previous three years**



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Article 45 - Registration and oversight of third-country auditors and audit entities

- **Audit reports** concerning annual accounts or consolidated accounts **issued by third-country auditors** or audit entities...
- ... that are ****not registered**** in the Member State...
- ... shall have *****NO legal effect***** in that Member State



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The Offshore Financial Centers and the 8th Company Law Directive

- Many Offshore Financial Centers (OFCs) **try to prove** that they have an “equivalent level of regulation”...
- ... to **protect their auditors**...
- ... that audit offshore companies with **EU listings** ...
- ... from **being subject to a tough oversight regime**



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News Release

GUERNSEY FINANCE 

- **Guernsey In Talks With EU Commission - 12 February 2007**
- “The introduction in 2008, of the 8th Company Law Directive amongst the 27 members of the European Union will ***directly* affect** local accounting firms...
- ... that **audit Guernsey companies listed on stock exchanges in EU Member States**



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- “In the *absence* of appropriate oversight ...
- ... each auditor would need to register in the EU member state...
- ... where the company they audit is *listed...*
- ... making themselves subject to that State’s oversight body
- This raises the possibility of *Guernsey auditors being inspected* by these EU Member States”



- “Guernsey plans to ***enact legislation*** that...
- ... would require local accountancy firms auditing Guernsey companies with EU listings to be...
- ... *subject to an oversight regime* which the Guernsey authorities would then delegate to the existing UK bodies
- This would ensure that a **relevant oversight regime would be in place** ...
- ... *without* the necessity for creating a new body on the island or elsewhere in the Crown Dependencies”



Cayman Islands - Cayman Islands Society of Professional Accountants

CISPA has significant concerns regarding the possibility that our member firms would be required to register with authorities in multiple EU Member States. Certain of CISPA's member firms are already registered with the US Public Company Accounting Oversight Board (and also the Canadian Public Accountability Board). We would encourage and support a system whereby recognition is given by other EU Member States to the fact that an audit firm is already registered (and subject to ongoing monitoring and oversight procedures) in another EU Member State.



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Arbitrage - Step 1

- Which countries have NO equivalent systems...
- ... for audit firms and auditors' oversight, quality assurance, investigation and penalties...
- ... and are the home countries of firms whose transferable securities are admitted to trading on a market regulated within the European Economic Area (EEA)
- [EEA - 27 EU Member States plus Iceland, Liechtenstein and Norway]



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Arbitrage - Step 1

- The European Commission has carried out a preliminary assessment of audit regulation in third countries
- The assessments have not allowed final equivalence decisions to be taken
- Transitional period
- 29 June 2008 to 1 July 2010
- There are 3 groups of countries:



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Arbitrage - Step 1

- GROUP 3: Argentina, Bahamas, Bermudas, Chile, Colombia, Kazakhstan, Mauritius, Mexico, Philippines, United Arab Emirates and Zambia...
- ... has in place an audit regulatory framework offering a perspective of moving towards a system of public oversight in a longer timeframe



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Arbitrage - Step 1

- For the second and third groups of third countries, further equivalence assessments WILL take place ...
- ... once each of such third countries has made a public commitment to comply with equivalence criteria



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Arbitrage - Step 1

- GROUP 2: Brazil, China, Croatia, Guernsey, Jersey, the Isle of Man, Hong Kong, India, Indonesia, Israel, Morocco, New Zealand, Pakistan, Russia, Taiwan, Thailand, Turkey and Ukraine...
- ... does not have such systems of public oversight but appears to offer a perspective of moving towards them within a reasonable timeframe



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Arbitrage - Step 1

- **GROUP 1:** Australia, Canada, **Japan**, Singapore, South Africa, South Korea, Switzerland and the **United States...**
- ... **have a system** of public oversight in place...
- ... although for the time being the information about the systems is **not sufficient for final** equivalence decisions to be taken



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Summary - Step 2

- Which ***countries*** have **NO equivalent** systems...
- ... for audit firms and auditors' **oversight, quality assurance, investigation and penalties...**
- ... and are the ***home*** countries of firms whose **transferable securities are admitted to trading on...**
- ... a market regulated **within the European Economic Area (EEA)**



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Arbitrage - Step 2

- Which ***firms*** from Group 2 and Group 3 countries...
- ... [that have **NO equivalent** systems]...
- ... **have transferable securities admitted to trading** on a market regulated **within the European Economic Area (EEA)**



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- http://www.londonstockexchange.com/en-gb/pricesnews/prices/International+companies/?wbc_purpose=bas

International regions:

Name/code:

List companies starting:



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London STOCK EXCHANGE

International regions: Africa & Middle East

International Retail Service companies and prices

Name/code

Search

List companies starting with:

0 9 A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

All data delayed by at least 15 minutes | as at 18:16

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Code	Name	Cur	Price	+/-	% +/-	
AFS	AMAD FL	GBX	203.50	-1.00 ▼	-0.49	
BVC	BATM ADVANCED	GBX	54.75	-1.00 ▼	-1.78	
DTC	DATATEC	GBX	164.75	-6.50 ▼	-3.80	
DMG	DORI MEDIA	GBX	122.50	0.00	0.00	
BLZ	EMBLAJE LD	GBX	38.00	-4.50 ▼	-10.53	
FTS	FTS-FORMULA	GBX	36.50	0.00	0.00	
QLT	GLAT	GBX	88.50	0.00	0.00	
KAKU	KAVUZI	GBX	40.00	0.00	0.00	
LEAD	LEADCOM	GBX	20.00	0.00	0.00	
MTT	METAL-TECH	GBX	62.50	0.00	0.00	
MME	MTI WIRELESS	GBX	21.00	0.00	0.00	
ORPK	ORPAK SYSTEMS	GBX	125.00	0.00	0.00	
PTMN	PETMN	GBX	29.25	+0.25 ▲	+0.85	



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London STOCK EXCHANGE

QTED QATAR TELECOM (Q-TEL) Q.S.C. GDR (EACH REPR 0.5 ORD QAR10)(REG S)

Register | Log in

QATAR TELE. GDR | Currency USD | Secondary Listed DR
All data delayed by at least 15 minutes

As at 24-Jun-2008 18:19:49

Add to Portfolio Add to Watchlist Set Alert
 Get Real-time Prices

Bid	Offer	Volume	High	Low	Last Close
-	-	-	-	-	-

Results of opening auction		Results of closing auction	
Price:	Volume:	Price:	Volume:
Special conditions	-	Period name	-
NONE	-	EOA	-

Last 5 trades



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Third countries

Third country	Audit Firms concerned	MS where the audited companies are listed	Third country	Audit Firms concerned	MS where the audited companies are listed
Argentina	4	LUX, UK	Lebanon	6	LUX, UK
Aruba	1	UK	Malawi	1	UK
Australia	6	DE, LUX, UK	Malaysia	6	DA, IRL, LUX, UK
Bahamas	6	DK, IRL, LUX, UK	Morocco	4	FR, UK
Bahrain	3	LUX, UK	Mauritius	1	IRL
Barbados	1	LUX	Mexico	7	NL, LUX, UK
Bermuda	10	FR, IRL, SW, LUX, UK	Netherlands Antilles	6	B, DE, ES, FI, FR, IRL, NL, UK
Brazil	8	DE, NL, LUX	New Zealand	5	LUX, UK
British Virgin Islands	12	IRL, NL, LUX, UK	Nigeria	1	UK
Canada	7	BE, DE, FR, IRL, NL, SW, LUX, UK	Oman	1	LUX, UK
Cayman Islands	19	IRL, NL, LUX, UK	Panama	2	LUX, UK



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Third countries

Croatia	3	LUX, UK	Russia	7	LUX, UK
Egypt	4	LUX, UK	Saudi Arabia	1	UK
Guernsey	5	DA, IRL, LUX	Singapore	3	NL, LUX, UK
Honduras	1	LUX	South Africa	7	BE, DK, DE, FR, LUX, UK
Hong Kong	7	LUX, UK	South Korea	14	LUX, UK
India	54	LUX, UK	Switzerland	7	BE, DE, ES, FR, IT, NL, SV, LUX, UK
Indonesia	2	UK	Taiwan	11	LUX, UK
Isle of Man	2	IRL	Thailand	8	LUX, UK
Israel	7	BE, DE, LUX, UK	Tunisia	1	UK
Ivory Coast	1	LUX	Turkey	5	LUX, UK
Japan	18	BE, DE, FR, LUX, UK	Ukraine	1	UK
Jersey	8	DE, IRL, LUX, UK	United Arab Emirates	2	UK
Jordan	2	UK	Uruguay	1	LUX
Kazakhstan	2	LUX, UK	USA	47	BE, DE, FR, IRL, IT, NL, SW, LUX, UK



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Arbitrage - Step 3

- We now have a list of firms...
- ... incorporated in Group 2 and 3 countries...
- ...listed in the EEA...
- Fundamentals... Technical Analysis... Add to Shortlist



Arbitrage - Step 3

- We answer the question: What will happen if ...
- ... Paul Boyle is right...
- [... If auditors of foreign companies do not meet European standards...
- ... (which the FRC says is likely)...
- ... the companies using them would have to *announce* / *delist* their securities from European exchanges]



The Basel ii Capital Accord



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Basel I - Not Risk Sensitive

- Investors usually distinguish among commercial loans by demanding *higher yields for higher risks* - Basel I was different!
- A \$100,000 commercial loan with a AAA credit rating would necessitate $\$100,000 \times 100\% \times 8\% = \$8,000$ capital charge
- A \$100,000 commercial loan with a B credit rating would necessitate $\$100,000 \times 100\% \times 8\% = \$8,000$ - the same capital charge



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Basel I - Not Risk Sensitive

- **Basel II:** Credit rating in determining capital charges
- **A \$100,000 commercial loan** with a **AAA credit rating** would necessitate less capital charge, even \$370 (Advanced IRB)
- **A \$100,000 commercial loan** with a **B credit rating** would necessitate more capital charge, even \$42,000



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Arbitrage...

- So a **\$100,000 commercial loan** with a **AAA credit rating** would necessitate $\$100,000 \times 100\% \times 8\% =$ **\$8,000** capital charge **under BASEL I**
- **A \$100,000 commercial loan** with a **AAA credit rating** could necessitate less capital charge, even **\$370** (Advanced IRB) **under BASEL II**
- The difference is huge... and the cost of the service for the banks is very different... so we ~~will have~~ **arbitrage opportunities**



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Basel I - Not Risk Sensitive

- After Basel I - Banks used securitization to sell the least risky loans (which tied up regulatory capital) and keep the riskier ones
- Lower quality loans with higher *internal* capital charges are kept on the bank's books



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Citibank

- Greater risk sensitivity under Basel II means that...
- ... unsecured non investment grade assets in accrual portfolios...
- ... will have risk weights > 100%
- This is an incentive for regulatory arbitrage between banking and trading book



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Additional Concerns

- Some US Investment Banks, which are now subject to Basel rules, have essentially no banking book
- Basel ii - Policies And Procedures:
- Firms must have clear set of Policies and Procedures specifying what positions could be included in or excluded from trading book



Additional Concerns

- Some regulators are concerned about increasing number of illiquid, complex structured, transactions in trading portfolios...
- *... other regulators are not concerned*



Regulatory Capital Arbitrage

- YESTERDAY... SECURITIZATION
- TOMORROW... FINANCIAL INNOVATION
- The regulatory treatment of activities such as securitisation could be made tougher...
- ... to discourage regulatory arbitrage but...
- ...banks will achieve the same objective through financial innovation



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Rating shopping... what changes

- Outside the US most corporations do not have debt ratings
- After Basel ii ...
- ... to feel the benefit of the new accord...
- ... more companies *will need to be rated...*
- ...and more rating agencies will be born



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Rating shopping... what changes

- Supervisors will make different decisions...
- ... they have to decide whose ratings are robust...
- ... without discriminating *****too much***** against new entrants without track records
- Meanwhile the raters will come under more and more pressure to deliver good ratings to win business

- [And "local" agencies are much more polite...
- ... sometimes banks that rely on local agencies allocate half capital for their risks]



Differences...



Basel II and US Banks

- Core banks
- (i) consolidated total assets of \geq \$250 billion OR
- (ii) consolidated total on-balance sheet **foreign** exposure of \geq \$10 billion
- Only the advanced approach is currently planned to be adopted in the U.S.



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Basel II and European Banks

- The Capital Requirements Directive will apply...
- ... to *ALL credit institutions, investment firms and financial institutions that offer similar financial products*
- Supervision at *stand alone and consolidated level*
- The balance sheet of the **group** is subject to supervision



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Basel ii in EU - The players

- 1. The **Bank of International Settlements - Basel ii papers**
- 2. The **European Parliament and the Council of the European Union** (plus the European Economic and Social Committee, and the European Central Bank) – the **Capital Requirements Directive**
- 3. The **Committee of European Banking Supervisors** (<http://www.c-eps.org>)...
- ... that “**promotes cooperation and convergence of supervisory practice across the EU ...**”
- ... and reviews **common implementation** and **consistent application** of EU legislation”



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Basel ii in EU - The players

- 4. The ***national* supervisors** and their choices – they have “**options**” and they can (must) **exercise “national discretions”**”
- **4.1. Laws and regulations** adopted by **each Member State** to implement the Basel II provisions of the Directives 2006/48/EC and 2006/49/EC
- The national legislative and regulatory framework
- **4.2. Administrative rules** that **instruct supervised entities** on ***how* to** satisfy legislative and regulatory requirements



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Basel ii in EU - The players

- 5. The Home/Host countries bilateral or multilateral agreements - for the supervision on a consolidates basis
- (Or, how to avoid a new Bank of Credit and Commerce International - BCCI)
- 6. Institutions have approaches, choices and options
- (Example: Have the option of remaining under many of the provisions of the existing CAD until 31 Dec 2007)
- (Example: Basic or Advanced approach?)
- Looks like a nightmare?



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Differences... Bahrain

Basel 2 is therefore forcing harsh strategy decisions on some investment banks:

- Can we raise the extra capital necessary to remain a well-capitalised bank, but simultaneously make an acceptable return to shareholders?
- Must we sell off some investments?
- Should we cease to be a bank?
- Should we restructure and house these investments in a non-banking part of the financial group?



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Differences... UK

Capital Modelling Points

FSA

- Models typically based on scenarios
- Trade-off between few, real, data points and 2-3 judgmental estimates?
- What 1/ 1,000 really means
- Questions over number of scenarios and how they “tessellate” the risk universe
- Questions over integrity of all the data types



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Differences... EU

New Investments are required to:

- | | | |
|--|---|----------------------------------|
| ▴ Manage internal data | → | More reliable data repositories |
| ▴ Analyze data | → | Statistical and analytical tools |
| ▴ Empower internal audit and external stakeholders | → | Reporting |
| ▴ Enhance internal Controls | → | Process monitoring |
| ▴ Streamline and automate Business processes | → | Workflow management |
| ▴ Deal with IT complexity | → | Security & business continuity |



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Differences...USA

"Fixed" and "risk-sensitive" don't belong in the same sentence

Five regulators jointly implementing Basel II (including SEC along with Fed, OCC, FDIC and OTS)

Rule out two approaches (Foundation and Standardized) and invent a third (IA)

Arbitrage - Incentive is to book low-risk assets outside U.S. jurisdiction through 2010 at least



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Options and National Discretions

for Competitive Advantage



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Options and National Discretions

- CEBS (Committee of European Banking Supervisors)
- High level representatives from the banking supervisory authorities and central banks of the European Union
- <http://www.c-ebs.org/sd/Options.htm>
- “The 2006/48/EC and 2006/49/EC Directives contain a **large number of national discretions and options** which may be applied on the basis of national circumstances”



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Options and National Discretions

- Directives 2006/48/EC and 2006/49/EC contain a number of different **options** and **discretions**
- According to Article 144(b) of Directive 2006/48/EC competent authorities are **required to disclose** the manner of exercise of the options and discretions
- “**Differences** that result from **different supervisory practices, national circumstances or even individual strategies** are allowed for in the Europe-wide implementation of Basel II”
- **Austrian Financial Market Authority**



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Options and National Discretions

- Some options or discretions are **exercised not by competent authorities** or Member States, but by the **institutions themselves**
- The authorities **do not make disclosures** concerning discretions that **do not have the power to exercise**



Example: Operational Risk, Alternative Standardised Approach

	Area	Dir. 2006/48 (unless indicated 2006/49)	Denomination	Description
1	OPERATIONAL RISK	Annex X, Part 2, Para. 3 and 5	Alternative Standardised Approach	The Competent Authorities may authorise institution to calculate its capital requirement using an alternative standardised approach.
64				



UK FSA - Answer: YES

- Firms are allowed to adopt the alternative standardised approach
- "It is in line with our general approach of **offering firms as wide a range of options** for calculating their capital requirements **as possible**, so that...
- ... they may select the **approach most appropriate** to their operations and business mix"
- www.fsa.gov.uk/pubs/cebs/options.pdf
- VERY GOOD APPROACH!



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www.fsa.gov.uk/pubs/cebs/options.pdf

OPERATIONAL RISK	Annex X, Part 2, Para. 3 and 5	Alternative Standardised Approach	The Competent Authorities may authorise institution to calculate its capital requirement using an alternative standardised approach.	Applied by allowing firms to adopt the alternative standardised approach, providing certain conditions are met. It is in line with our general approach of offering firms as wide a range of options for calculating their OR capital requirements as possible, so that they may select the approach most appropriate to their operations and business mix.
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Answer: NO

- **Denmark**, Finanstilsynet (The Danish FSA)
 - www.finanstilsynet.dk/sw29704.asp
- **France**, Banque de France
 - www.banque-france.fr/gb/supervi/telechar/disclosure/options.xls
- **Ireland**, Irish Financial Services Regulatory Authority
 - www.ifsra.ie/frame_main.asp?pg=/industry/in_sdi_ond.asp&nv=/industry/in_nav.asp



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Answer: PERHAPS

- Malta Financial Services Authority
 - "On a case by case basis"
 - www.mfsa.com.mt/mfsa/files/banking/supervisory%20disclosure/files/PDF/options.pdf



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Example: Exemption from Pillar 3

SCOPE OF APPLICATION	Article 72.3	Exemption from Pillar III	The Competent Authorities may decide to exempt, fully or partially, a credit institution from Pillar III requirements provided such institution is included within a group complying with comparable disclosures on a consolidated basis in a third country.
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Example: Exemption from Pillar 3

- “The Competent Authorities may decide to exempt...
- ... fully or partially...
- ... a credit institution from Pillar III requirements...
- ... provided such institution is included within a group complying...
- ... with *comparable* disclosures ...
- ... on a consolidated basis...
- ... in a third country”



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UK FSA: Yes

- “Applied...
- ... but **not as a wholesale exemption by country**
- Rather, a **firm should be able to prove** that the disclosures they wish to **rely on in a third country** are...
- ... **comparable...**
- ... and **notify us of the location of the comparable disclosures”**



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Poland, National Bank of Poland: No

- “Not Applied”
- Period
- **Question:** If you are a **financial group in a third country...**
- ...do you call **Poland a “friendly” jurisdiction?**



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www.c-ebs.org/sd/Options.htm

Options and national discretions table

CEBS Options national discretions

Important notice: The information shown in this table is subject to terms and conditions and is aimed at quick and meaningful comparison of general lines of articles applied in the EU regarding the issues referred to. Countries that state certain policies may differ significantly when they come to details with regard to issues marked with an asterisk (*). More detailed information is available by clicking each country on top of each column.

** Subject to recognition means the possibility of a country allowing its banks to apply the treatment of another country for their operations in the latter.

See Options and discretions -> Mutual recognition tables.

As apply
Further apply

EU	AT	BE	CY	CZ	DK	EE	FI	FR	D
104-2006/125 Article 104	Discretionary	Discretionary							
Article 104	Inclusion of assets eligible	Member States may permit the inclusion of assets previously excluded as financial assets, subject to conditions.							
Article 104	Waiver on certain deductions*	Member States may permit the inclusion of assets previously excluded as financial assets, subject to conditions.							
Article 104	Alternatives to deductions**	Member States may permit the inclusion of assets previously excluded as financial assets, subject to conditions.							
Article 104	Deductions for certain assets requirements	Member States may permit the inclusion of assets previously excluded as financial assets, subject to conditions.							

Links to national page



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Guernsey, Isle of Man and Jersey All corporate claims 100% - YES

Basel II paragraph reference (June 2006 version)	Summary of the Basel II National Discretion	Approach
Claims on corporates		
67	Increase the standard risk-weight for unrated claims when a higher risk-weight is warranted by the default experience of the jurisdiction	No, not warranted by the default experience in the Crown Dependencies
68	Allow all corporate claims to be risk-weighted at 100% without regard to external ratings	Yes, available as an option on a bank-by-bank basis, subject to the relevant Commission's approval in writing



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Options and National Discretions for Competitive Advantage

- Countries and banks use Basel ii to be different – to be better, to attract investors and counterparties
- Markets become more sophisticated...
- ...the “local” clients have more and more opportunities to choose jurisdiction and bank



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Competition

- The rules of the game are different
- Example: Competition among banks for highly rated corporates



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Options and National Discretions for Competitive Advantage

- Bank regulators and supervisors must ensure that their country does not fall behind
- Too much focus on regulatory compliance becomes counterproductive
- Stay in tune with business practice
- Be flexible and give options



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Options and National Discretions for Competitive Advantage

- Monitor the other EEA countries – we do not have a “single market”
- Minimise the cost of regulation
- Do not kill innovation because “they do not do that in London”
- Basel II and the CRD has the potential to provide significant benefits to countries and banks...
- ... or to become a disaster



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Hedge Funds

and the Capital Requirements Directive



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Hedge Funds and *Basel I*

- **Hedge funds** are among the largest users of over-the-counter (OTC) derivatives...
- ...especially **credit derivatives**
- [An OTC derivative is **a contract** between two parties - to **transfer risks** from one party to another, in exchange for a fee
- **Lenders** use credit derivatives to hedge the risk that a **borrower** might default or have its credit rating downgraded]



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Hedge Funds and *Basel I*

- The growth of credit derivatives was one of the *unintended consequence* of Basel I
- Basel I created incentives for banks to use credit derivatives to manage their exposure to corporate loans
- *Banks transferred credit risk to entities that were NOT subject to Basel I (no capital requirements* ...
- ... while retaining ownership of and returns on such loans
- Hedge Funds and structures like collateralized debt obligations (CDOs) helped banks to allocate NO capital



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Hedge Funds and *Basel I*

- Non-bank counterparties such as hedge funds...
- ... insurance companies...
- ... financial guarantors...
- ... securities firms...
- ... and asset managers...
- ... were used by banks to transfer credit risk



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Hedge Funds and *Basel I*

- Basel I – even Basel I as amended in 1996 – was **NOT** well suited to deal with exposures to hedge funds
- Basel I **did not provide differentiation** of capital requirements in terms of credit risk levels...
- ...and resulted in the application of a **maximum risk weight of 100 %**
- Exposures to hedge funds could be **significantly more risky** than those to corporates...
- ...if we take into account that **hedge funds use leverage and do not like transparency**



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Papers from the Basel Committee

- After the **near collapse** of the hedge fund Long-Term Capital Management (LTCM), in September 1998...
- ...the Basel Committee on Banking Supervision (BCBS) issued a **report** on **banks' interactions with Highly Leveraged Institutions (HLI)** - January 1999...
- ... and **sound practices** for such interactions
- The report described different approaches which included ***indirect supervisory approaches***...
- **Basel ii is just one of these indirect supervisory approaches**



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By regulating banks... ... they try to regulate hedge funds

- The hedge funds' counterparties and creditors are usually regulated entities...
- ... like **banks and securities firms**
- Banks must have a "robust internal risk management system" ...
- ... that means access by banks to more information on their Highly Leveraged Institutions (HLI) counterparties...
- ... improvements of complex products exposures' measurement...
- ... *liquidity stress testing*



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By regulating banks... ... they try to regulate hedge funds

- Stress tests:
- "Capture full exposure (direct and indirect) to hedge funds - including second round effects like the failure of one or several hedge funds"
- Banks must demonstrate that they hold enough capital to cover the risks associated with the results of stress testing



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Indirect regulation and indirect supervision

- The US President's Working Group (PWG) on Financial Markets concluded in its report published in April 1999...
- ... that there is need for improve credit risk management by hedge funds' counterparties
- They called the approach "indirect regulation" or "indirect supervision" of hedge funds
- Other groups had the same ideas...
- ... like the Financial Stability Forum (FSF), the BCBS, the International Organization of Securities Commissions (IOSCO), the Multidisciplinary Working Group on Enhanced Disclosure (MWGED), the Counterparty Risk Management Policy Group (CRMPG)



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Indirect regulation and indirect supervision

- Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO)
- "Review of issues relating to Highly Leveraged Institutions (HLIs)" March 2001
- Joint Basel/IOSCO group: The Highly Leveraged Institutions Working Group (HLIWG) established in 2000



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Hedge Funds and *Basel II*

- Basel II does **not** provide *directly* for a specific treatment of exposures to hedge funds...
- ... but is one of the **indirect supervisory approaches**
- The spectrum of **risk weights** in Basel II is **much broader**



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Hedge Funds and *Basel II*

- Under **Basel ii, Standardized Approach**, supervisors have the option to assign a **150%** risk weight to high risk asset categories
- Under **Basel ii, IRB Approach**, the bank can use its own estimates for risk weights
- We have application of risk weights of **over 100%** to...
- ... positions that are **less liquid** or...
- ... present a **high default risk**, such as some hedge funds exposures
- Value at Risk, the Probability of Default (PD) the bank assigns to the hedge funds and the Loss Given Default (LGD) associated - **drive to more capital allocation**



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Hedge Funds and *Basel II*

- Pillar 2, Basel II:
- Explain what you do about *risks associated with hedge fund exposures...*
- ...like liquidity risk, concentration risk, tail risk, model risk...



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Hedge Funds and Basel ii

- The Basel ii framework does not really understand hedge funds
- There are many problems, like the use of Value at Risk (VaR) for hedge funds
- VaR is not an appropriate measure for the market risk posed by hedge funds (due to illiquidity, fat tails and relative non-transparency)



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The CRD applies to Hedge Funds

- The CRD applies to banks and investment firms, including hedge funds
- Hedge fund managers are directly affected by the directive
- Hedge fund managers need to determine their capital requirements
- Parent companies are also affected



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The CRD applies to Hedge Funds

- Key changes for firms operating in the EEA:
- New rules for the calculation of regulatory capital
- Control governing outsourcing
- Controls governing conflicts of interest
- Reporting and transparency requirements
- The risk management and corporate governance elements of Basel ii and the CRD



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The CRD applies to Hedge Funds

- Under Pillar ii of Basel ii (supervisory review process):
- A. The management of the bank is obliged to allocate adequate capital to support the risks
- (And, to persuade the supervisors)
- B. The supervisors will examine carefully if this happens
- Supervisors have to understand if the bank adequately addresses the risks resulting from hedge funds
- Basel ii allows supervisors to take all the measures necessary to address such risks, including additional capital requirements



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Example for the complex environment: Hedge Funds Management in UK

- The UK is the leading European centre for hedge fund management (70% market share of hedge funds managed by European based managers)
- The UK FSA authorises and regulates hedge fund managers who are located in the UK
- But the hedge funds themselves are not in UK...
- ...they are offshore...
- ...usually at the Cayman Islands or...
- ... Bermuda , the British Virgin Islands and Delaware



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Example for the complex environment: Hedge Funds Management in UK

- The hedge fund administrators too are also usually offshore...
- ... most commonly in Ireland or...
- ... the Cayman Islands and the Dutch Antilles
- If in Ireland...
- ... the Irish Financial Services Regulatory Authority is responsible for the regulation of the administrators of UK managed hedge funds
- Prime brokers are in London - execute trades, for financing, stock lending and the provision of research



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Example for the complex environment: Hedge Funds Management in UK

- The administrators are usually appointed...
- ... by the offshore funds themselves...
- ...and not from the hedge fund managers
- Managers do not "delegate" responsibilities to the administrators...
- ... and are not responsible (to the regulator) for the administration services, estimates etc
- A complex world...
- ... by design!



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The Standardised Approach for securitisation exposures

Long-term rating category ⁹⁵					
External Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ and below or unrated
Risk Weight	20%	50%	100%	350%	Deduction

Short-term rating category				
External Credit Assessment	A-1/P-1	A-2/P-2	A-3/P-3	All other ratings or unrated
Risk Weight	20%	50%	100%	Deduction



Ratings-Based Approach (RBA) Short Term

RBA risk weights when the external assessment represents a short-term credit rating and/or an inferred rating derived from a short-term assessment

External Rating (Illustrative)	Risk weights for senior positions and eligible senior IAA exposures	Base risk weights	Risk weights for tranches backed by non-granular pools
A-1/P-1	7%	12%	20%
A-2/P-2	12%	20%	35%
A-3/P-3	60%	75%	75%
All other ratings/unrated	Deduction	Deduction	Deduction



Annex IX, Tables 1 and 2 Standardised Approach

Table 1 Positions other than ones with short-term credit assessments					
Credit quality step	1	2	3	4	5 and below
Risk weight	20 %	50 %	100 %	350 %	1 250 %

Table 2 Positions with short-term credit assessments				
Credit quality step	1	2	3	All other credit assessments
Risk weight	20 %	50 %	100 %	1 250 %



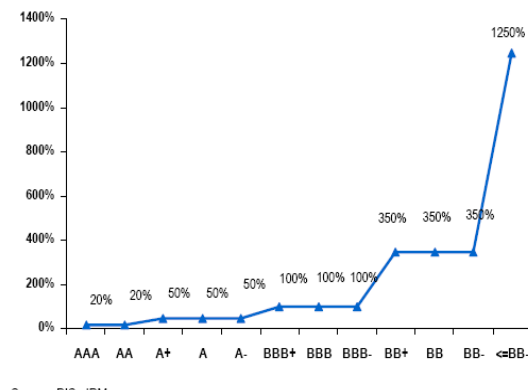
Securitisation Standardised approach Mapping of ECAIs' credit assessments to credit quality steps

Credit Quality Step	Risk Weights	Fitch	Moody's	S&P
1	20%	AAA to AA-	Aaa to Aa3	AAA to AA-
2	50%	A+ to A-	A1 to A3	A+ to A-
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	350%	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
5	1250%	B+ and below	B1 and below	B+ and below



Standardised Approach

Figure 1 : Risk Weights under Standardised Approach



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Annex IX, Part 4 Securitisation - Standardised Approach

- The risk-weighted exposure amount of an unrated securitisation position shall be calculated by applying a risk weight of 1 250 %



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Securitisation IRB approach

Mapping of ECAIs' credit assessments to credit quality steps

Long term mapping: IRB approach

Credit Step	Quality	Risk Weights			Credit Assessments		
		Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P
1		7%	12%	20%	AAA	Aaa	AAA
2		8%	15%	25%	AA	Aa	AA
3		10%	18%	35%	A+	A1	A+
4		12%	20%	35%	A	A2	A
5		20%	35%	35%	A-	A3	A-
6		35%	50%	50%	BBB+	Baa1	BBB+
7		60%	75%	75%	BBB	Baa2	BBB
8		100%	100%	100%	BBB-	Baa3	BBB-
9		250%	250%	250%	BB+	Ba1	BB+
10		425%	425%	425%	BB	Ba2	BB
11		650%	650%	650%	BB-	Ba3	BB-
Below 11		1250%	1250%	1250%	Below BB-	Below Ba3	Below BB-



Basel I and securitisation

- **Risk Weight: 100%**
- **Basel I encouraged banks to retain *low quality* assets**
- **Basel I encouraged securitisation** and credit derivatives in capital markets
- Securitisation **reduced risks**, improved return on capital and led to **less regulatory capital allocation**



Basel II and securitisation

- Basel II eliminates some regulatory arbitrage opportunities...
- ...but there are **always** opportunities for arbitrage
- **Regulatory capital arbitrage**
- Basel II requires banks to determine regulatory capital requirements based on the economic substance of the transaction...
- ... rather than the legal form



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Basel II and securitisation

- **New legal, accounting and capital regulations**
- Complex legal structures, tax avoidance and tricks
- True sale or "true sale"?
- [If the originator "sells" the assets to a special purpose vehicle as a **"true sale"** ...
- ...does not necessarily mean that the originator has no risk (**possible financial support after the sale**)]



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Basel II and securitisation

- Basel II dramatically reduces the capital requirement for highly rated tranches
- For AAA tranches: *From the 100% risk weights of Basel I to the amazing 7%*
- *(Do you see the arbitrage?)*

- Basel II gives banks a regulatory capital incentive to invest in rated securitized notes rather than...
- ... holding assets directly on balance sheet



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Basel II and securitisation

- **Investment banks** find this low 7% risk weights **very attractive**

- After Basel II, banks securitize more – especially commercial mortgages and credit card receivables...
- ... but minimize their exposure to sub-investment-grade tranches



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CRD paper: Annex IX, Tables 1 and 2 Standardised Approach

Table 1					
Positions other than ones with short-term credit assessments					
Credit quality step	1	2	3	4	5 and below
Risk weight	20 %	50 %	100 %	350 %	1 250 %

Table 2				
Positions with short-term credit assessments				
Credit quality step	1	2	3	All other credit assessments
Risk weight	20 %	50 %	100 %	1 250 %



Basel ii paper: The Standardized Approach Risk weights: more than 150%

- **Securitization** - gathering a group of debt obligations such as mortgages into a pool... .. dividing that pool into portions... that can be sold as securities
- **Converting** loans, leases, mortgages, car loans, credit card debt into securities
- Securitization rated between BB+ and BB- will be risk weighted at 350%



Citigroup, JPMorgan/Chase, Wachovia and Washington Mutual

- Comment letter on the Basel II
- The Federal Banking Agencies have Added Provisions that are inconsistent with the objectives of the Basel II Capital Accord...
- ... and will give foreign banks a competitive advantage over all U.S. banks...
- ... in lending and investment activities



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Citigroup, JPMorgan/Chase, Wachovia and Washington Mutual

- The Provisions:
- A. Foreign Competitors Are Not Subject To An *Aggregate* Floor
- 10 percent decline in *aggregate industry-wide* minimum capital at Base1 ii banks during the parallel run and transition period would constitute a material reduction warranting modifications to the capital framework



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Citigroup, JPMorgan/Chase, Wachovia and Washington Mutual

- It subjects individual banks to potential changes in capital requirements as a result of actions of other banks
- Additional excess capital that could otherwise support loans and investments that would contribute to economic growth
- **Foreign banks are not subject** to any similar requirement



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Citigroup, JPMorgan/Chase, Wachovia and Washington Mutual

- **B. Foreign Banks Are Not Subject To A Leverage Ratio**
- The U.S. is almost alone in imposing an additional minimum capital requirement known as the “leverage ratio”
- This will cause the safest U.S. banks either to hold more capital than required and give their foreign counterparts a capital advantage...
- ... or will cause U.S. banks to increase the risk of their portfolios in order to earn a market return on the higher capital requirements



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- C. Foreign Banks Have A Shorter And More Flexible Transition Period
- Under the Accord *foreign* banks are subject to a two-year transition period during which capital may decline by 10 percent in the first year and by an additional 10 percent in the second year
- Three-year transition period for U.S banks, and only permits a 5 percent decline in capital in each of these years



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- FIRST YEAR: U.S. banks will be required - for a minimum of 12 months - to maintain regulatory capital equal to at least 95% of their Basel I capital requirement...
- ... whereas non-U.S. banks must maintain only 90% of their Basel I capital during the first year of the Framework
- **IT IS QUITE A DIFFERENCE**



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- **SECOND YEAR:** *U.S. banks* if permitted by its regulator, required to maintain **at least 90%** of their minimum Base1 I capital requirement...
- ... non-U.S. banks are subject to an **80% limitation** and...
- ... *non-U.S. banks* **do not have to seek the agreement of their regulator to move to this lower level**



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- **THIRD YEAR:** If a U.S. bank is again been permitted to move to the next level by their U.S. regulator...
- ... they are still restricted to maintaining **at least 85%** of their Basel I capital...
- ... *non-U.S. banks* are not subject to any restriction



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- Not only do U.S. banks have more restrictive transitional arrangements...
- ... (longer and higher minimum requirements)...
- ... but they also must seek the permission of their U.S. regulator to move to the next transitional floor...

- In addition, U.S. banks will have the cost of maintaining the calculation of an equivalent Base1 I minimum capital requirement for at least 12 months longer



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- This difference in transition rules will artificially provide a competitive benefit to foreign institutions for at least 3 years and ...
- ... the ramifications of this advantage could be enjoyed by foreign banks for a considerably longer period



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- **D. Different Measurements of Equities and Loans**
- The NPR measures equity investments and loans differently than the Accord in several respects
- These include
 - (i) **a definition of default** that deviates from customary U.S. practices
 - (ii) a **more conservative treatment of loans** to small- and medium-sized businesses
 - (iii) **different measures for LGDs**
 - (iv) a **different treatment for equity investments**



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- A **foreign bank operating a branch** or agency in the U.S. will be able to comply with the capital standards of its **home** country...
- ... not the higher U.S. standards
- Thus, for example, a foreign bank that has a branch office in California...
- ... will have a **capital advantage** over any U.S. bank in offering loans to U.S. companies and consumers
- **WE HAVE DIFFERENT COST OF THE SAME SERVICE**



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- Even a **foreign bank** that owns a subsidiary bank in the U.S. will gain a competitive advantage over U.S. banks...
- ... not withstanding the fact that the foreign bank's U.S. ****subsidiary**** (not branch) will be subject to U.S. rules
- When the subsidiary bank's capital and assets are **consolidated at the foreign parent ...**
- ... the parent's capital ratio will increase...
- ... and it will be able to exploit that **higher reported capital ratio through additional investments** at the parent level



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- **D. Compliance Options**
- We strongly recommend that the federal banking agencies offer all U.S. banks the option to use **any** of the approaches authorized under the Accord
- [Not only the Advanced Approaches]
- Any concerns about the adequacy of the Standardized requirements for individual portfolios are properly handled through the **Pillar 2** process



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- G. Disadvantages Small and Medium Size Business Credit
- The international framework recognizes the lower risk in small and medium size business (SME) lending and reflects this in a lower level of required capital than under Basel I
- US - The lower risk of loans to small- and medium-sized businesses is not recognized and...
- ... thus, the required capital is higher than the international version for these loans



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- This will place U.S. banks at a competitive disadvantage compared to foreign banks when lending to small- and medium-sized businesses
- To the extent small-and medium-sized businesses *rely on domestic credit sources...*
- ... the availability of such funding will decrease



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