



CYPRUS SECURITIES AND EXCHANGE COMMISSION

**OVERVIEW OF THE DIRECTIVE OF THE
CYPRUS SECURITIES AND EXCHANGE
COMMISSION FOR THE CAPITAL
REQUIREMENTS OF CYPRIOT
INVESTMENT FIRMS**

10 October 2007

OVERVIEW OF THE DIRECTIVE OF THE CYPRUS SECURITIES AND EXCHANGE COMMISSION FOR THE CAPITAL REQUIREMENTS OF CYPRIOT INVESTMENT FIRMS

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1. ABSTRACT

The Cyprus Securities and Exchange Commission (the ‘Commission’) has issued the draft Directive for the capital adequacy of investment firms (the ‘Directive’).

For avoidance of doubt, it is clarified that this is not an official document, and it should not be read as a substitute for the Directive as issued by the Commission.

The purpose of this document is to:

- Provide a high level overview of the new requirements, and
- Provide a high level readers’ guide for the Directive as issued by the Commission.

2. OVERVIEW OF THE NEW REQUIREMENTS

2.1. Introduction to the Directive

The Directive is a revision of the existing framework, i.e. Directive IF 7/2003.

The Directive aims to make the capital adequacy framework more risk sensitive by applying sophisticated approaches to risk management. It seeks to identify internal risks and their alternatives in managing them to the amount of regulatory capital investment firms must sustain. According to this new framework investment firms must ensure that they have internal capital that, having regard to the risks to which they are or may be exposed, is adequate in quantity, quality and distribution. At the same time, special emphasis is given to the role of supervisory authorities and the importance of sound and comprehensive corporate governance practices.

The Directive is based on the “three Pillar concept” as follows:

- Pillar 1: Minimum Capital Requirements
- Pillar 2: Supervisory Review Process
- Pillar 3: Market Discipline

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Overview of the three Pillars		
PILLAR 1	PILLAR 2	PILLAR 3
Minimum Capital Requirements	Supervisory Review	Market Discipline
<p>Market Risk</p> <ul style="list-style-type: none"> • Policies and processes for the measurement and management of all material sources and effects of market risks shall be implemented. • No changes from the existing framework. <p>Credit Risk</p> <ul style="list-style-type: none"> • Three different approaches to the calculation of minimum capital requirements: <ol style="list-style-type: none"> Standardised Approach (SA) Foundation Internal Ratings Approach (FIRB) Advanced Internal Rating Approach (AIRB) • Flexibility given to investment firms as to the approach they intend to follow. • Sophisticated internal systems and controls to collect and analyse data from a risk management perspective. <p>Operational Risk</p> <ul style="list-style-type: none"> • Three different approaches to the calculation of minimum capital requirements: <ol style="list-style-type: none"> Basic Indicator Approach(BIA) Standardised Approach(TSA) Advanced Measurement Approach(AMA) 	<ul style="list-style-type: none"> • Investment firms should have a process for assessing their overall capital adequacy and strategy for maintaining capital levels. • Supervisors should review and evaluate that investment firms have good organization and adequate own funds. • Supervisors should expect investment firms to hold the minimum capital requirements proportionate to the risks addressed. 	<ul style="list-style-type: none"> • Investment firms must fulfill the Directive requirements for transparency and disclosing data.

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2.2. Pillar 1

The first Pillar sets out the minimum regulatory capital requirements that an investment firm is required to meet. The minimum capital adequacy ratio (capital over risk-weighted assets) an investment firm is required to maintain is set at 8%.

However, the Directive takes into account the diversity of investment firms and provides different approaches to the calculation of minimum capital requirements. The different approaches provide a flexible structure in which investment firms, subject to supervision, will adopt approaches that most suitably fit their level of sophistication and risk profile.

2.3. Pillar 2

The second Pillar emphasises the importance of supervisory review process and the provision of adequate capital to meet all inherent risks in an investment firm. Investment firms are required to have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. These strategies and processes are required to be subject to regular internal review in order to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the investment firm concerned.

2.4. Pillar 3

Pillar 3 focuses on transparency, the disclosure of information and market discipline. Appropriate public disclosure is required by investment firms in order to strengthen market discipline and stimulate investment firms to improve their market strategy, risk control and internal management organisation.

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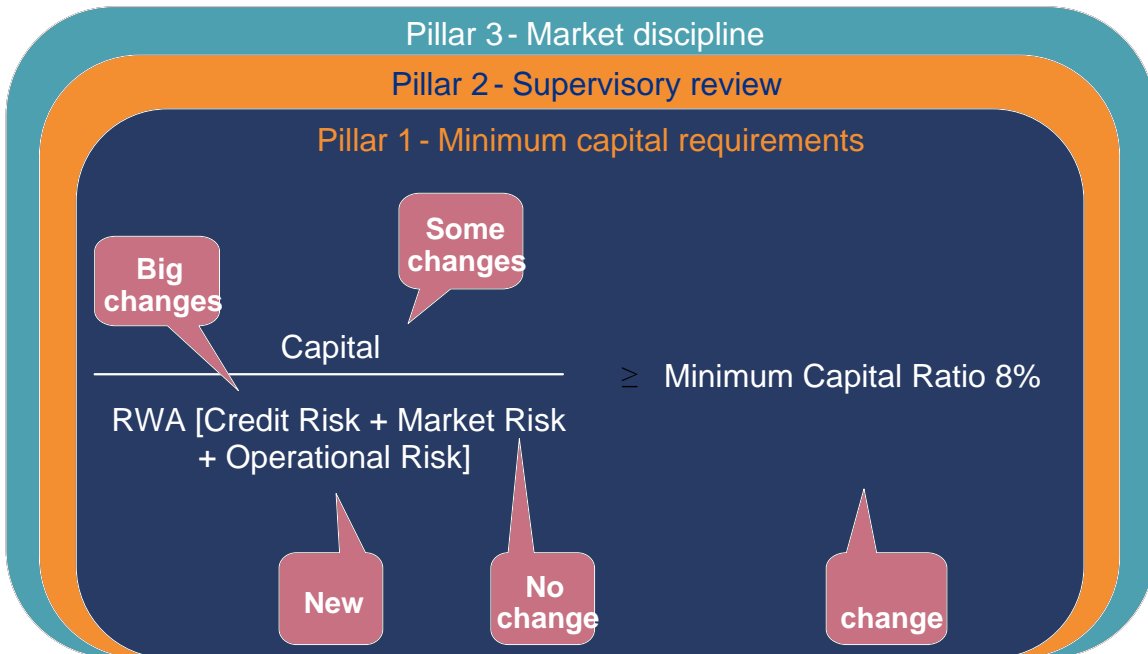
2.5. Differences between the Directive IF 7/2003 and the Directive

The difference between the current framework that is used by the investment firms (ie. Directive IF 7/2003) and the Directive is shown in the diagrams below:

Directive IF 7/2003



The Directive



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3. STRUCTURE OF THE DIRECTIVE

The Directive is structured in four Parts.

3.1. Part A

Part A of the Directive is an introduction to the calculation of capital base, capital adequacy ratio for credit and operational risk and also supervisory review and disclosure. This Part consists of three chapters.

The *first Chapter* denotes all definitions that apply for the purpose of this Directive.

The *second Chapter* describes the scope/level of application, such as the obligations of an investment firm on an individual basis, exemptions of subsidiaries from obligations on an individual basis, obligations on a partial consolidated, sub-consolidated and consolidated basis. Chapter 2 also denotes the information required by investment firms to be disclosed to the competent authorities and the calculation of capital requirement and own funds.

The *last Chapter* of this Part describes the calculation and submission of the capital requirements under this Directive, and the minimum level of own funds.

3.2. Part B

Part B explains how the capital base/ own funds of an investment firm is calculated. This Part consists of one Chapter and denotes the following:

- the meaning of own funds of an investment firm (original and additional own funds),
- the items that constitute own funds on an unconsolidated and consolidated basis, and
- an alternative determination of own funds for investment firms that meet certain requirements

3.3. Part C

Part C includes all information required with respect to the calculation of the capital requirement for credit and operational risk (Pillar 1 above),

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supervisory review (Pillar 2) and disclosure (Pillar 3). This Part consists of eight Chapters and thirteen Annexes.

3.3.1. Calculation of Credit Risk Requirements

<i>Relevant Chapter for Credit Risk</i>	<i>Topic</i>
<i>Chapter 1</i>	<i>The Standardized Approach</i>
<i>Chapter 2</i>	<i>The Internal Ratings Based Approaches</i>
<i>Chapter 3</i>	<i>Credit Risk Mitigation (for all approaches)</i>
<i>Chapter 4</i>	<i>Securitization</i>
<i>Annex I</i>	<i>Mapping of ECAIs credit assessment to credit quality steps (relevant for Ch 1 and Ch 4)</i>
<i>Annex II</i>	<i>Classification of off balance sheet items (relevant to Ch 1)</i>
<i>Annex III</i>	<i>Counterparty credit risk treatment for:</i> <i>Derivative instruments</i> <i>Repurchase transactions</i> <i>Securities or commodities lending or borrowing transactions</i> <i>Long settlement transactions</i> <i>Margin lending transactions</i>
<i>Annex IV</i>	<i>Types of derivatives (related to Annex III)</i>
<i>Annex VI</i>	<i>Details of the Standardised Approach</i>
<i>Annex VII</i>	<i>Details of the Internal Ratings Based Approaches</i>
<i>Annex VIII</i>	<i>Details on the treatment of credit risk mitigation</i>
<i>Annex IX</i>	<i>Details on the treatment of securitisation</i>

Chapter 1 and Annex VI explain the rules and formulas which must be used in order to apply the Standardised Approach (SA) for credit risk.

The most important issue on the respective chapter and annex is the separation of the exposure classes i.e. exposures to central banks and government, exposures to other investment firms and banks, retail exposures, past due exposures, off balance sheet exposures, etc.

Annex VI consists of three Parts:

- **Part 1** denotes the risk weight the investment firm must assign to the various exposure classes (portfolio) as defined by this Directive.
- **Part 2** explains the methodology of the recognition of External Credit Assessment Institutions (ECAIs) and the mapping of their credit assessments.
- **Part 3** of this Annex denotes how the credit assessments of ECAIs can be used for the determination of risk weights under the SA.

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The mapping of ECAIs credit assessments to credit quality steps can be found in *Annex I*.

In addition, *Annex II* explains the risk profile of the off balance sheet items which will be used for the allocation of credit conversion factors for these exposures.

Chapter 2 and Annex VII explains the requirements and the formulas which must be used in order to apply the *Internal Ratings Based Approach (IRB)* for credit risk.

This approach is more advanced than the SA and is divided into two sub-approaches: the *Foundation IRB Approach* and the *Advanced IRB Approach*.

Annex VII consists of four Parts:

- *Part 1* denotes the formulas used under this method in order to calculate the risk weighted exposure amounts and expected loss amounts under the IRB Approach.
- *Part 2* analyses the concepts of *Probability of Default (PD)*, *Loss Given Default (LGD)* and *Maturity*.
- *Part 3* explains how exposure values (*Exposure at Default*) are calculated under the IRB Approach, and
- *Part 4* sets the minimum requirements than an investment firm must fulfill in order to be eligible for the IRB Approach.

Chapter 3 and Annex VIII explains the methods that an investment firm may use in order to mitigate credit risk.

In summary, eligible credit risk mitigants are the following:

- On balance sheet netting;
- Financial collaterals (funded credit protection); and
- Guarantees and credit derivatives (unfunded credit protection).

Annex VIII consists of six Parts:

- *Part 1* describes which credit risk mitigation means are eligible per credit risk approach.
- *Part 2* explains the minimum requirements for the use of each of the credit risk mitigation means.
- *Part 3* explains the formulas that should be used in order to calculate the effects of credit risk mitigation, whereas
- *Part 4* denotes what should be done in cases where maturity mismatches arise, and

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- *Part 5* and Part 6 explain how combinations of CRM techniques should be used under the SA for credit risk and the use of basket CRM techniques respectively.

Chapter 4 and Annex IX of this Part is applicable to investment firms that have securitisation positions and explain the rules and treatment of these exposures.

Annex IX consists of four Parts:

- *Part 1* denotes the definitions that apply for the purposes of that Annex;
- *Part 2* states the minimum requirements for recognition of significant credit risk transfer and calculation of risk-weighted exposure amounts and expected loss amounts for securitized exposures;
- *Part 3* denotes the requirements that must be met by the credit assessments of ECAs and explains how these assessments can be used for securitisation positions;
- *Part 4* explains the formulas that an investment firm shall use in order to calculate the risk weighted exposure amounts for credit risk under all available approaches for securitisation positions.

Lastly, *Annex III* explains the treatment of the counterparty credit risk for a number of exposures, namely:

- *Derivative instruments (listed in Annex IV of this Part)*
- *Repurchase transactions*
- *Securities or commodities lending or borrowing transactions*
- *Long settlement transactions*
- *Margin lending transactions*

The calculation of the risk weighted assets for the above mentioned instruments can be calculated with a number of methods:

- **Mark to market method:** explained in *Part 3* of the Annex;
- **Original exposure method:** explained in *Part 4* of the Annex;
- **Standardised method:** explained in *Part 5* of the Annex; and
- **Internal model Method:** explained in Part 6 of the Annex.

3.3.2. Calculation of Operational Risk Requirement

Chapter 5 and Annex X of this Part explain the approaches that an investment firm may use in order to calculate the capital requirements for operational risk.

In general, there are three approaches that can be used for the calculation of the operational risk capital requirement:

- The **Basic Indicator Approach:** where the investment firm does not have to meet any criteria in order to use this approach;
- The **Standardised Approach;** and

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- The **Advanced Measurement Approach**.

The investment firm should meet certain criteria in order to use the last two approaches.

Annex X consists of four Parts:

- *Part 1* explains the formulas to be used in order to calculate operational risk requirements under the Basic Indicator Approach (BIA) which is the simplest method for calculating operational risk capital requirements.
- *Part 2* denotes the formulas and qualifying criteria that an investment firm must fulfill in order to calculate the operational risk requirements under the Standardised Approach (TSA). This method is slightly more complex than the BIA and requires approval from the Commission.
- *Part 3* explains the formulas and qualifying criteria that an investment firm must fulfill in order to calculate the operational risk requirements under the Advanced Measurement Approach (AMA). This approach is the most complex method for calculating operational risk capital requirements and it also requires approval from the Commission.
- Lastly, *Part 4* defines all event type categories for operational risk.

3.3.3. Supervisory Review

Chapter 6 and Annex XI explain the supervisory review process to be performed by the Commission. This part of the Directive is also known as *Pillar 2*.

Under Pillar 2 requirements, investment firms are required to have in place an *Internal Capital Adequacy Assessment Process* (ICAAP). ICAAP shall be comprehensive and proportionate to the nature, scale and complexity of the activities of the investment firm concerned.

In addition, *Annex V* sets the technical criteria for the treatment of risks faced by the investment firms such as governance, treatment of risks, credit and counterparty risk, residual risk, concentration risk, securitisation risk, market risk, interest rate risk arising from non-trading activities, operational risk and liquidity risk.

3.3.4. Disclosure requirements

Chapter 7 and Annex XII (Pillar 3) discuss the disclosure requirements and market discipline that investment firms must comply with.

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Annex XII consists of 3 Parts:

- *Part 1* explains the general criteria of disclosure, i.e. when information is regarded material and proprietary;
- *Part 2* sets out the general requirements of disclosure; and
- *Part 3* discussed the qualifying requirements for the use of particular instruments or methodologies.

3.3.5. Transitional Provisions

Chapter 8 of this Part explains some transitional and final provisions for the implementation of this Directive.

3.4. Part D

Part D of this Directive relates to the calculation of *market risk*. This Part consists of two Chapters and eight Annexes.

The rules have not changed significantly from the existing regime.

Chapter 1 analyses the composition of the trading book of an investment firm, defines the trading book and explains the valuation methods of trading book positions.

Chapter 2 of this Part relates to large exposures in the trading book, explaining how investment firms should monitor and control such large exposures, how exposures to individual clients and overall exposures to individual clients or group of clients are calculated, the obligations of an investment firm in cases where the limits of large exposures are exceeded and procedures the Commission shall have in place in order to ensure prohibition of investment firms from deliberately avoiding additional capital requirements.

Annex I explains how an investment firm should calculate capital requirements for *position risk*, explaining the treatment of the protection seller and buyer, traded debt instruments, equities, underwriting, general criteria and specific methods.

Annex II explains how an investment firm should calculate capital requirements for *settlement and counterparty credit risk*. In this Annex the capital treatment for settlement/delivery risk, free deliveries and counterparty credit risk is included.

Annex III explains how an investment firm should calculate capital requirements for *foreign-exchange risk*.

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Annex IV discussed how an investment firm should calculate capital requirements for *commodities risk*. An explanation of the items that are to be included in the calculation of this capital requirement and particular instruments are given in this Annex. Details regarding the maturity ladder approach, simplified approach and extended ladder approach are also denoted in this Annex.

Annex V explains how an investment firm can use internal models to calculate capital requirements. This method is subject to approval by Commission. Details regarding the qualitative standards for recognition by the competent authorities, the review of the overall risk-management system the investment firm must conduct at least annually, the processes the investment firm must have in place to ensure model validation, the monitoring the investment firm must perform can be found in this Annex.

Annex VI explains how an investment firm should calculate capital requirements for large exposures.

Annex VII of this Part denotes details regarding Trading. This Annex consists of four Parts. Part A relates to trading intent, stating the requirements that need to be met by positions held with trading intent. Part B describes the requirements of systems and controls that an investment firm shall have. Part C refers to internal hedges and Part D discuss the contents of the trading book policy of an investment firm.

Annex VIII sets the contents of the trading book policy statement that each investment firm should have. The policy should be agreed with the Commission. Details regarding the procedure for agreeing such a statement can be found in this Annex.