TO	:	**Cyprus Investment Firms**
FROM	:	**Cyprus Securities and Exchange Commission**
DATE	:	**16 May 2019**
CIRCULAR No	:	**C313**
SUBJECT	:	**Findings of desk-based reviews regarding capital adequacy Forms**

The Cyprus Securities and Exchange Commission ("the CySEC") performs desk-based reviews on a sample of capital adequacy forms ('COREP Forms') submitted to CySEC by Cyprus Investment Firms ('CIFs').

CIFs are required to submit on a quarterly basis the following COREP Forms within the timeframe due and based on the investment services and activities that they are authorised to provide and/or perform:

- Form 144-14-06.1 (calculation of own funds and capital adequacy ratio)
- Form 144-14-07 (Leverage)
- Form 144-14-08.1 (exposures to Institutions and Non-Institutions)
- Form 144-14-08.2 (exposures to Directors)
- Form 144-14-08.3 (exposures to Shareholders)
- Form 144-14-09 (Geographical breakdown of exposures)

CIFs that are within the scope of paragraph 2 of CySEC's Directive DI144-2007-16, should submit to CySEC on a yearly basis the Form 144-14-10 (calculation of own funds).

The purpose of the desk-based reviews is to assess the correctness and completeness of COREP Forms. The review identified common and recurring errors in COREP Forms, resulting in incorrect and misleading figures of own funds, capital adequacy ratio and exposures of the CIFs reviewed. In addition, some best practices adopted by CIFs were identified.

CySEC has already notified the CIFs reviewed and requested to rectify the errors identified, including to meet the required minimum limits for own funds and capital adequacy ratio, where applicable.

For the benefit of the market not sampled, CySEC has set out the findings of the desk-based review to enable accurate future submissions of the COREP Forms.

A. <u>Common and recurring errors identified</u>

1. Items wrongly classified as "Other reserves" and part of Common Equity Tier 1 capital

<u>Relevant provisions</u>
According to Article 26(1) of the Regulation (EU) No. 575/2013 ('the CRR') 'Other reserves' should be available to the CIF for unrestricted and immediate use to cover risks or losses as soon as these occur.

According to Article 4(1)(117) of the CRR, 'Other Reserves' means those under the applicable accounting standards, excluding any amounts already included in accumulated other comprehensive income or retained earnings.

Items classified as 'other reserves' by the CIFs commonly relate to non-refundable contributions from their shareholder or other connected parties.

<u>Errors identified</u>
Some CIFs classify as 'Other reserves' items that have not yet been settled, are payable to their shareholders and/or related parties or/and do not meet the definition of other reserves as per the applicable accounting standards. Thus, resulting in higher amounts of total own funds and capital adequacy ratio.

<u>Action to be taken</u>
CIFs should be in a position to demonstrate to CySEC that funds classified as other reserves meet the conditions of Article 26(1) of the CRR and if applicable, evidence that these funds are indeed non-refundable contributions to the CIF from their shareholders.

2. Inclusion of unverified profits as part of Common Equity Tier 1 capital

<u>Relevant provisions</u>
According to Article 26(2) of CRR:

"For the purposes of point (c) of paragraph 1, institutions may include interim or year-end profits in Common Equity Tier 1 capital before the institution has taken a formal decision confirming the final profit or loss of the institution for the year only with the prior permission of the competent authority. The competent authority shall grant permission where the following conditions are met:
(a) those profits have been verified by persons independent of the institution that are responsible for the auditing the accounts of that institution
(b) the institution has demonstrated to the satisfaction of CYSEC that any foreseeable charge or dividend has been deducted from the amount of those profits.

A verification of the interim or year-end profits of the institution shall provide an adequate level of assurance that those profits have been evaluated in accordance with the principles set out in the applicable accounting framework".

Note that:

- In case the independent external auditors of the CIF have expressed a modified qualified opinion or were not able to express an opinion in the latest audited financial statements of the CIF with regards to specific items included in the statement of comprehensive income and statement of financial position, then these shall be considered as unverified and thus cannot be part of Common Equity Tier 1 capital.

- In case a CIF wishes to include interim profits as part of its Common Equity Tier 1 these should be verified by their external auditor and the CIF should request CySEC prior approval as per CySEC's Circular C305.

Error identified
A number of CIFs include their unaudited/unverified interim profits as part of their Common Equity Tier 1 capital resulting in higher amounts of total own funds and capital adequacy ratio.

Also, there were cases where the external auditors' of the CIFs were not able to express an opinion regarding a revenue item but it was included as part of the Common Equity Tier 1 capital.

Action to be taken
CIFs should be in a position to demonstrate to CySEC that items classified as Common Equity Tier 1 capital meet the conditions of art. 26(2) of CRR (ie verified by their external auditors). In relation to interim profits CIFs should also follow CySEC's Circular C305.

3. Deduction of unaudited losses when calculating Common Equity Tier 1 capital

Relevant provisions
According to Article 36(1) of CRR, CIFs should always deduct interim or year-end losses when calculating their Common Equity Tier 1 capital, irrespective of the fact that these losses may have been audited or not from the CIF's external auditors.

Note that, where interim losses incurred prior to the reporting period are followed by subsequent interim profits, these shall be netted off for the purposes of calculating the Common Equity Tier 1 capital. The same applies in the opposite situation (i.e. interim profits followed by interim losses). See EBA relevant Q&A.

Error identified
A number of CIFs do not deduct their unaudited losses when calculating their Common Equity Tier 1 capital thus resulting in higher amounts of total own funds and capital adequacy ratio.

Action to be taken
CIFs should always include/deduct losses when calculating their own funds in accordance with art. 36(1) of CRR.

4. Items wrongly classified as Tier 2 instruments and part of total own funds

Relevant provisions
The subordinated loans of the CIFs should meet the conditions set by Article 63 of CRR in

order for the CIF to be able to classify them as Tier 2 instruments.

Also, according to Article 64 of CRR, CIFs should amortise their Tier 2 instruments during the final five years of their maturity.

Error identified
A number of CIFs classify as Tier 2 instruments the balances due to their shareholders and/or other related parties which were not covered by a subordinated loan agreement or even if they did, their terms and conditions did not meet the provisions of Article 63 of CRR. In addition, a number of CIFs did not follow the amortisation principle of Article 64 of CRR.

The above errors resulted in higher amounts of total own funds and capital adequacy ratio of the CIFs concerned.

Action to be taken
CIFs should ensure that subordinated loans classified as Tier 2 instruments meet the abovementioned provisions of CRR, are fully paid up in cash and follow the amortisation principle.

5. **Repayment of subordinated loans classified as Tier 2 instruments without the prior permission of CySEC**

Relevant provisions
According to Article 63(j) of CRR, Tier 2 capital instruments may only be called, redeemed or repurchased or repaid early only where the conditions of Article 77 of the CRR are met and not before five years after the date of issuance, except where the conditions of Article 78(4) of CRR are met.

Error identified
A number of CIFs that have correctly classify their subordinated loans as Tier 2 instruments proceeded to their early redemption/repayment without requesting CySEC's permission.

Action to be taken
CIFs should ensure they follow the provisions of Article 63(j) of CRR regarding their Tier 2 instruments.

6. **Calculation of capital requirement for operational risk exposure**

Relevant provisions
CIFs that are authorised to provide the investment services of Dealing on own account and/or Underwriting (i.e. initial capital of €730.000) should calculate their capital requirement for operational risk exposure using either the Basic Indicator Approach (Article 316 of the CRR) or, if they qualify, the Standardised Approach (Article 312 of the CRR).

Error identified
A number of CIFs that are authorised to provide the investment services of Dealing on own account and/or Underwriting were wrongly calculating their capital requirement for

operational risk exposure using the methodology of Article 95 of CRR, resulting in higher own funds or capital adequacy ratio.

Action to be taken
CIFs that are authorised to provide the investment services of Dealing on own account and/or Underwriting should ensure that they calculate their capital requirements for operational risk exposure using one of the methods stated above.

7. **Calculation of operational risk exposure – basic indicator approach**

Relevant provision
As per Article 315 of the CRR, the CIFs that use the Basic Indicator methodology for the calculation of operational risk exposure, should calculate their own funds requirement as being equal to 15% of the average over three years of the relevant indicator set out in Article 316 of the CRR.

As per Article 316 of the CRR, the relevant indicator is the sum of the following items, either positive or negative:
- Interest receivable and payable and similar income/charges
- Income from shares and other variable/fixed-yield securities
- Commissions/fees receivable and payable
- Net profit or net loss on financial operations
- Other operating income

CIFs should note that the operational risk indicator shall be calculated before the deduction of any provisions and operating expenses.

In addition, the following items shall not be deducted when calculating the relevant operational risk indicator:
- Realised profits/losses from the sale of non-trading book items
- Income from extraordinary or irregular items
- Income derived from insurance

Note that, the ‘extraordinary or irregular items’ shall not be used in the above calculation only if they have been classified as such in the audited financial statements of the CIF**.**

Error identified
A number of CIFs using the ‘Basic Indicator’ methodology for the calculation of operational risk exposure do not calculate the relevant indicator based on the provisions of art. 316 of the CRR, as they omit or erroneously deduct from the calculation the items mentioned above.

Action to be taken
CIFs should ensure they follow the provisions of Article 316 of CRR when calculating the relevant operational risk indicator.

8. **Deduction of Investors Compensation Fund Contribution (“ICF”) from Common Equity Tier 1 Capital**

Relevant provisions
According to CySEC's Circular C162, CIFs should deduct their ICF contribution when calculating their Common Equity Tier 1 Capital.

Error Identified
A number of CIFs failed to deduct their ICF contribution when calculating the Common Equity Tier 1 Capital which resulted in higher amount of own funds and capital adequacy ratio.

Action to be taken
CIFs should ensure that they apply the provisions of CySEC's Circular C162 regarding the treatment of ICF contribution.

9. Exposures with the Shareholders, Directors and their connected parties

Relevant provisions
According to paragraph 61(3) of the CySEC's Directive DI144-2014-14, CIFs should report through Forms 144-14-08.2 and 144-14-08.3 their exposures to their Directors and Shareholders, including their connected persons as well, as these are defined in Article 4(39) of the CRR.

Error identified
A number of CIFs report the exposures of their directors and shareholders without including the exposures of their connected persons and as a result, their total exposures are undervalued.

Action to be taken
CIFs should ensure they follow the abovementioned provisions.

10. Consistency of figures between the COREP Forms, Quarterly/Yearly Statistics Forms and management accounts

Relevant provisions
CIFs are obliged to submit to CySEC on a quarterly basis the COREP Forms and the Quarterly Statistics Form (QST-CIF) through TRS and their management accounts through CySEC portal. In addition, CIFs submit on an annual basis the yearly Form RBSF-CIF through TRS.

Error identified
In some cases figures reported in the COREP Forms do not coincide with the corresponding figures of the same reporting period that CIFs submit to CySEC via Forms QST-CIF/ RBSF-CIF and /or the management accounts submitted via CySEC's Portal.

Action to be taken
CIFs should ensure that all the information reported to CySEC is consistent, where applicable.

11. Reporting figures in absolute values instead of thousands

Relevant provisions

All COREP Forms should be completed in the reporting currency of the CIF and the amounts reported should be in thousands.

Error identified

A number of CIFs completed their COREP Forms using the absolute value of the figures instead of in thousands. For example, if the share capital of the CIF amounted to €50.000, then the CIFs should report it as ‘50’, excluding the three last digits of the figure.

Action to be taken

All COREP Forms should be completed in the reporting currency of the CIF and the amounts reported should be in thousands.

B. Best practice

CySEC has identified that a number of CIFs adopted the following best practice:

- The internal or external auditor or another independent person reviews the CIF’s regulatory reporting to give assurance on its accuracy and completeness;
- Reconciling the regulatory reporting with the management accounts and data from other internal systems;
- Adopted an automated system for the calculation of own funds, capital adequacy ratio and monitoring of large exposures, where possible and appropriate to the nature and complexity of their activities. For example, a number of CIFs have integrated their systems and developed/ acquired software applications to automatically calculate the own funds, capital adequacy ratio and large exposures.

C. Next steps

Using the reviews’ observations as a basis, the publication of the common/recurring errors and best practice identified is designed to assist CIFs in ensuring full compliance with their regulatory obligations.

CIFs are recommended to undertake a full review of their regulatory reporting practices to ensure that they fit to their business, comply with the relevant reporting provisions and produce materially accurate data. CIFs must, at all times, fully comply with the provisions of CRR and DI144-2014-14. In the event of non-compliance, CIFs will be subject to the administrative sanctions applicable.

CySEC will continue its desk-based reviews regarding the COREP Forms to ensure CIFs have in place proper mechanisms for their completion.

Sincerely,

Demetra Kalogerou
Chairman of the Cyprus Securities and Exchange Commission