

Changing Regulatory Environment – Banks and Building Societies

Basel II and the implementation of the Capital Requirements Directive

The implementation of the CRD directive in the BIPRU rules, and the changes made to the liquidity management regime, have resulted in new opportunities for financial institutions to use AAA liquidity funds (also referred to as Qualifying Money Market Funds). AAA liquidity funds provide a safe and flexible alternative to bank deposits. The AAA rating is the highest rating available to liquidity funds.

Capital Requirements under BIPRU

Under the old regime investments in AAAM liquidity funds were risk weighted at 100% (as a corporate risk) whereas deposits with banks were risk weighted at 20%. This meant that the capital requirements for using liquidity funds were expensive for banks and building societies.

In October 2005 the FSA first allowed banks and building societies to look through to the underlying assets held by the liquidity fund in which they were investing. This ability to look through has been confirmed in the new BIPRU rules, which came into force in January 2007.

Under the standardised approach (BIPRU 3) the treatment of a AAA liquidity fund depends on whether the fund is held in the Banking Book or the Trading Book. The two treatments are summarised below.

Banking Book

In the banking book the institution may choose to use either the standardised approach or the internal ratings-based approach.

Standardised approach

Under the standardised approach the funds will have a risk weighting of 20%, as the funds are rated AAA.

Internal Ratings Based Approach

Owing to the high quality of the fund's underlying assets, this approach may result in a much lower risk weighting, possibly as low as 4%.

Trading Book

The trading book consists of positions in financial instruments, which are held for short-term resale or with the intent of benefiting from expected short-term price movements. If a AAA liquidity fund is held in the trading book the financial institution must-

- Be aware of the fund's underlying holdings on a daily basis
- The units must be redeemable as cash at the unit holder's request
- The investing institution must assess the credit risk of the fund.

If the fund is held in the trading book the capital requirement may be calculated on a standardised basis or using an internal risk management model (IRM).

Standardised Basis

Using the standardised method the capital requirement for position risk (specific and general) will be 32%, which equates to a risk weight of 400%. (This is clearly uneconomic for an investor.)

Standardised Basis – using Look-Through

Calculating the capital requirement using a look-through treatment will result in a much lower capital requirement. Using a fairly typical portfolio it has been calculated that the risk weighting might be around 12%.

IRM method

Using the IRM method the risk weighting will be lower again, possibly around 4%.

Liquidity Regime

The FSA views AAA liquidity funds as meeting the criteria for marketable assets as described in the Mismatch Liquidity (LM) chapters of IPRU (Bank) and IPRU (BSoc). These chapters remain in force for the foreseeable future and have not been superseded by BIPRU.

IPRU (Bank)

Under IPRU (Bank) AAA liquidity funds fall into the 0-8 Day Liquidity bucket (section 6.3.1) and are discounted by 5%. This is similar to a portfolio of CDs. The only securities with a discount less than 5% are short-term government securities. (IPRU (Bank) 6.3.2.)

IPRU (BSoc)

The FSA have confirmed that under IPRU (BSoc) AAA liquidity funds can be counted towards the prudential liquidity requirements as envisaged in paragraph 5.5.2 of IPRU (BSoc), without a discount.

Sterling Stock Regime

The sterling stock regime applies to UK clearing banks. Discussions with the FSA are still under way on allowing AAA liquidity funds into the sterling stock regime.

Large Exposures

Banks and building societies should treat the exposure as an exposure to a Collective Investment Scheme. They can then decide whether it is more prudent to treat the exposure as being to the Scheme or being to the underlying assets.

Prime Rate Capital Management

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Appendix 1 - Glossary

BIPRU – FSA Prudential Sourcebook for Banks, Building Societies and Investment Firms

CIU – Collective Investment Undertaking

ECAI – ‘External Credit Assessment Institution’. A credit rating agency

IPRU (Bank) – FSA Interim Prudential Sourcebook for Banks

IPRU (BSoc) – FSA Interim Prudential sourcebook for Building Societies

Appendix 2 – Extracts from FSA Handbook

‘3.2.9 Claim in the form of a CIU

3.3.1 An external credit assessment may be used to determine the *risk weight* of an *exposure* in accordance with BIPRU 3.2.20 R to BIPRU 3.2.26 R only if the *ECAI* which provides it is recognised by the *FSA* as an *eligible ECAI* for the purposes of the *standardised approach to credit risk*.

[Note: BCD Article 81(1)] ‘

‘BIPRU 3.4.116 **R**

Exposures in the form of *CIUs* for which a credit assessment by a *nominated ECAI* is available must be assigned a *risk weight* according to the table in BIPRU 3.4.117 R in accordance with the assignment by the *FSA* in accordance with the *Capital Requirements Regulations 2006* of the credit assessments of *eligible ECAs* to six steps in a *credit quality assessment scale*.

[Note: BCD Annex VI Part 1 point 75]

BIPRU 3.4.117 **R**

Table: Exposures in the form of *CIUs* for which a credit assessment by a *nominated ECAI* is available.

This table belongs to BIPRU 3.4.116 R.

<i>Credit quality step</i>	1	2	3	4	5	6
<i>Risk weight</i>	20%	50%	100%	100%	150%	150%

<http://www.fsa.gov.uk/Pages/About/What/International/basel/info/standardised/index.shtml>

‘ECAs recognised under the Capital Requirements Regulations 2006 (SI 2006/3221) for the purposes of BIPRU 3 The Standardised Approach and BIPRU 9 Securitisation:

- Fitch Ratings
- Moody's Investors Service
- Standard and Poor's
- DBRS ‘

http://www.fsa.gov.uk/pubs/international/ecais_standardised.pdf

‘External Credit Assessment Institutions (ECAs) recognised under the Capital Requirements Regulations 2006 (SI 2006/3221) for the purposes of BIPRU 3 The Standardised Approach: mapping of the ECAs' credit ratings

Collective investment undertakings (CIUs)

Credit Quality Step	Risk Weights	Fitch	Moody's	S&P	S&P
				Principal stability funds ratings	Fund credit quality ratings
1	20%	AAA to AA-	Aaa to Aa3	AAAm to AA-m	AAAf to AA-f
2	50%	A+ to A-	A1 to A3	A+m to A-m	A+f to A-f
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+m to BBB-m	BBB+f to BBB-f
4	100%	BB+ to BB-	Ba1 to Ba3	BB+m to BB-m	BB+f to BB-f
5	150%	B+ to B-	B1 to B3	B+m to B-m	B+f to B-f
6	150%	CCC+ and below	Caa1 and below	CCC+ and below	CCC+f and below