FINANCIAL RISK MANAGEMENT

Regulatory changes in Europe due to the Financial Crisis

Implications and Need for Action
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Housing Finance beyond Subprime, Munich, May 17th – 19th

ADVISORY

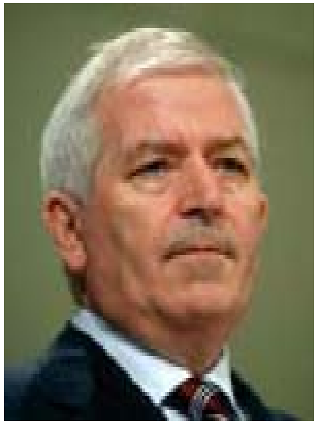
AUDIT ▪ TAX ▪ ADVISORY

Agenda

- Overview on regulatory changes on international level
- “Basel 2,5” - Potential topics for implementation until year-end 2010
- “Basel 3” - Potential topics for implementation until year-end 2012
- Implications on Banks
- Potential implementation approach
- KPMG Solution

Introduction

Changing minds - Pre- & Mid-Crisis Quotes



Charlie McCreevy

Commissioner Internal Market and Services

April 2005
"On balance, I incline to the view that (CRA) regulation is not at this time appropriate."

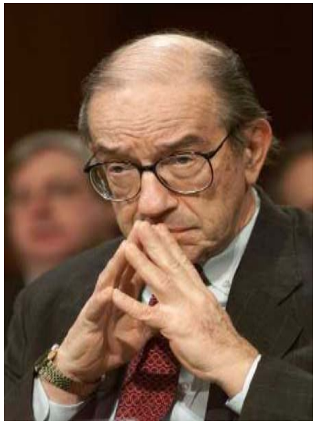
March 2007
"So we need regulation: good, slimline, principles-based regulation. Prescriptive, rules-based, heavy-handed regulation has no place in a market economy. Candidly, we must, where we can, get rid of it."

January 2009
"We need to remember that it was many of those same lobbyists who in the past managed to convince legislators to insert clauses and provisions that contributed so much to the lax standards and mass excesses that have created the systematic risks."

February 2009
"For the future, Member States will have to commit the necessary resources to ensure that oversight of risk management in financial institutions is more robust. It must be subject to much more detailed and frequent hands-on supervisory inspections."

May 2005
"Private regulation generally has proved far better at constraining excessive risk-taking than has government regulation."

26 March 2009
"It is clear that the levels of complexity … were too much for even the most sophisticated market players to handle prudently."



Alan Greenspan

Former chairman of the US Federal Reserve

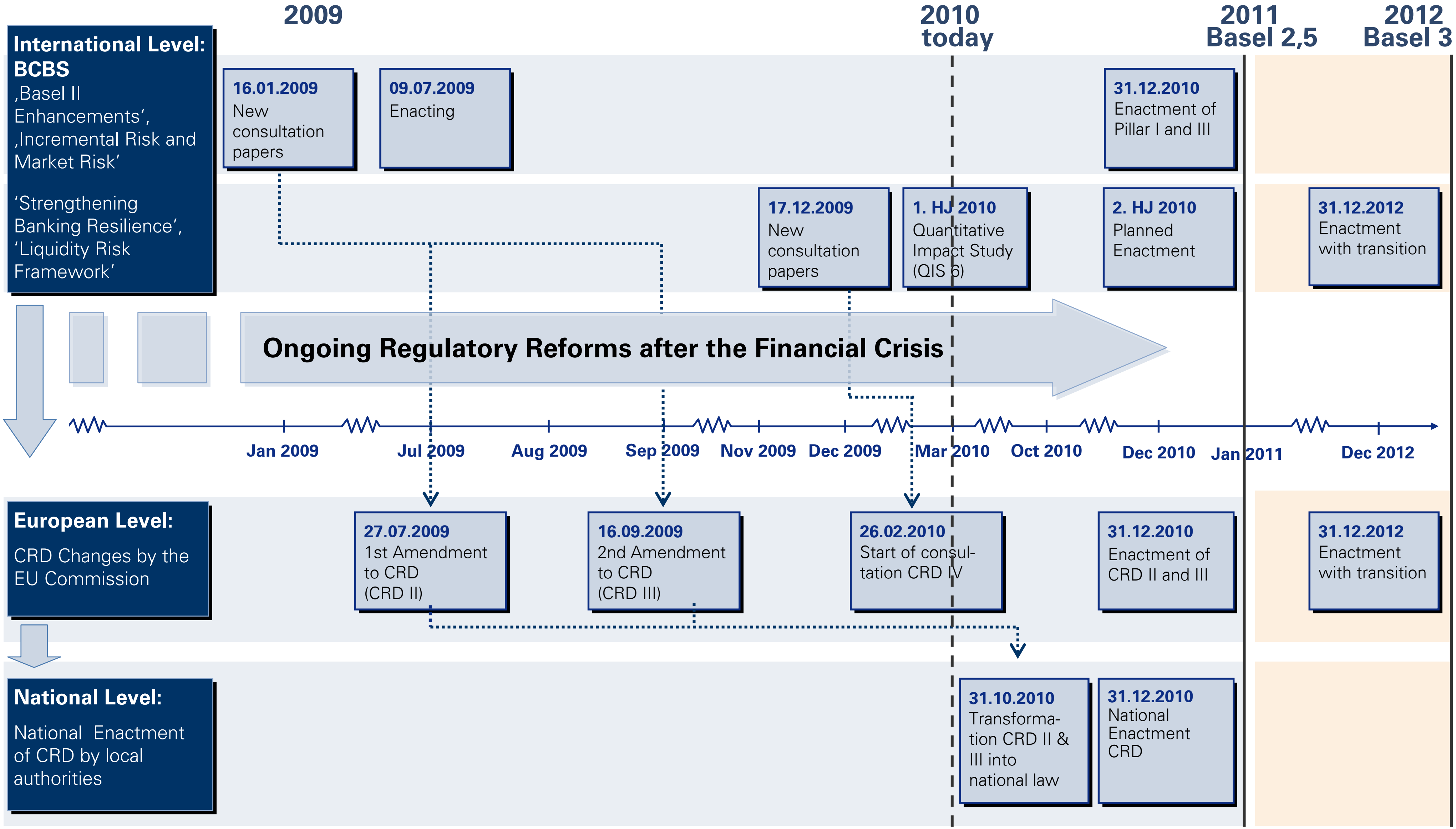
26 March 2009
"To address this (financial failures) will require comprehensive (regulatory) reform. Not modest repairs at the margin, but new rules of the game."

Timothy Geithner

US Treasury Secretary

Timetable of regulatory reforms until 2012

Overview of regulatory changes on international and national level



Essential Results of the G20 Summit in Pittsburgh in September 2009

G20 have made important decisions to strengthen the International Financial Regulatory System

Relevant G20 Agreements

- **Building high quality capital and mitigating pro-cyclicality**
- **Improving OTC derivatives markets**
- **Addressing cross-border resolutions and systemically important financial institutions**
- **Increasing efforts to develop a single set of high quality, global accounting standards**
- **Reforming compensation practices**

Selected topics of the 1st Amendment to the CRD ("CRD II")

until year-end 2010

Aim of the Directive

1. Harmonization and update of large exposure rules across Europe
2. Implementation of Sydney Press Release and recognition of innovative capital instruments
3. Implementation of more risk-sensitive approaches for capital calculation based on lessons learned from crisis
4. Promotion of enhanced cross-border cooperation of supervisors

Overview on important topics

- Precise identification of **large exposures** ("look-through")
- Extended definition of '**group of connected clients**'
- No privilege for **short term interbank loans** (<1year)
- Enhanced reporting of **CRMT** and **large exposures**
- Analysis of **risk concentrations**
- Principle-based definition of conditions for assigning **hybrids** to Core Tier 1 Capital
- Limitation of **hybrid capital** to 50% of Core Tier 1, and thereof further limits for certain types of hybrids
- Minimum capital requirement for **securitization** (5%)
- Definition of qualitative requirements for **securitization** transactions
- Transparency rules for **rating agencies**
- Adjustments of **risk weights** and **LGDs**
- **Disclosure** of further risk information
- Introduction of **"systemically relevant branches"**
- Creation of the '**consolidating supervisor**'
- Establishing **Colleges of Supervisors**

Selected topics of the 2nd Amendment to the CRD ("CRD III")

until year-end 2010

Aim of the Directive

1
- Enhanced assessment of trading book risks

2
- Strengthening of the capital base for resecuritizations

3
- Higher disclosure requirements for securitization risks

4
- Sustainable compensation schemes including disclosure requirements

Overview on important topics

- **Additional capital buffers** based on stressed VaR and certain scenarios
- Strengthening of capital base for **specific interest rate risks** in the trading book
- Use of capital approach for banking book for **securitization** positions in the trading book
- Higher risk weights for **resecuritizations**
- Reinforcing of due diligence requirements and the supervisory process for complex **resecuritizations**
- Enhancing disclosure requirements, especially for **securitization** positions in the **trading book**
- Obligation for banks to implement **compensation policies** that are consistent with risk profile and long-term corporate development
- Imposing **penalties** against banks that fail to comply with this obligation
- Enhanced disclosure of **compensation schemes**

Selected topics of the Basel Consultation Papers from December 17th, 2009 (Basel 3)

until year-end 2012

Aim of Consultation Paper

1. Increasing quality of capital base
2. Improved counterparty credit risk management
3. Introduction of a leverage ratio to complement Basel 2 framework
4. Reducing pro-cyclicality of Basel 2
5. Improved liquidity base and create internationally consistent framework

Overview on important topics

- Enhancement of capital requirements (e.g "common equity")
- Introduction of minimum level for **common equity** to strengthen the capital basis
- Strengthening the capital requirements and risk management standards for **counterparty credit risks**
- Increased **risk weights** due to a higher correlation ratio for large international banks
- Adjustment of EAD of **OTC derivatives** and **RPA**
- Introduction of a **leverage ratio** with specific definitions for exposure and capital
- Proposals to reduce volatility in the **PDs**
- Promotion of stronger forward looking **provisions**
- Build-up of **capital buffers** above the minimum
- Introduction of a global minimum **liquidity standard** for internationally active banks

  - short-term: 30 days related to stress scenarios;
  - longer-term: 1year; stable core funding ratio

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Important Results of the 3rd Amendment to the CRD ("CRD IV")

until year-end 2012

Aim of Consultation Paper

1. Implementation of the latest Basel consultation papers
2. Limitation of systemic risks through individual institutions
3. Harmonization of supervision in Europe
4. Introduction of a dialogue with the branch regarding unresolved questions

Overview on important topics

- Introduction of a **liquidity cover ratio** and a long-term **structural liquidity ratio**
- Improvement of quality, consistency and transparency of the capital base
- Introduction of a **leverage ratio** as enhancement to a risk-based approach of Basel 2
- Enhancement of capital basis requirements for **counterparty risk** at derivatives, repurchase agreements and securities transactions
- Introduction of **anti-cyclical measures** with respect to capital requirements
- Proposal of measures against the **systemic risks** generated by individual institutions
- Discussion of **other topics**, which possibly have to be regulated more strictly or consistently (e.g. Pillar II) as well as discussion of treatment of real-estate lending

Definition of relevant topics as starting point for the up-coming implementation

Regulatory Reforms

- CRD Transformation into National Law
- Basel Consultation Papers from December 2009
- Other Consultation (e.g. CEBS-Guidelines)

Need for coordination

Essential topics related to the implementation of regulatory changes

Hybrid Capital	Securiti-zation	Large Exposure	Trading Book	Dis-closure	Procycli-cality	Counter-party Risk	Leverage Ratio	Liquidity Risk	Core Capital

Finance, Risk, Credit, Treasury, IT

Planned implementation: Dec 31, 2010	Planned implementation: Dec 31, 2012

Potential topics for implementation until year-end 2010 - 2012

Essential topics for the implementation of ‘Basel 2.5’ and ‘Basel 3’

until year-end 2009

National Pillar II Enhancements

- Risk reporting
- Concentration risks
- Monitoring on group level
- Stress testing
- Etc.

until year-end 2010

“Basel 2.5”

- Large Exposures
- Securitizations
- Trading Book
- Disclosure & Reporting
- Hybrid Capital

until year-end 2012

“Basel 3”

- Capital ratios
- Leverage ratio
- Pro-cyclicality
- Liquidity ratios
- Counterparty risks

Implications on Banks resulting from ongoing regulatory changes

Guidelines & Strategies

Methodology

Organisation & Processes

Data & IT-Systems

Need for action until year-end 2010: Large Exposures and Securitizations

Large Exposures

Implications of regulatory changes	Need for action
▪ Diversification at refinancing & banking portfolio ▪ New requirements with respect to the management of concentration risks ▪ Adjustment of definition of borrower unit ▪ Adjustments regarding the consideration of credit risk mitigation techniques ▪ Enhanced data warehouse ▪ Enhanced requirements regarding 'look-through'	▪ Examination banking portfolio & refinancing sources ▪ Development of a strategy for the management of concentration risks ▪ Integration of new borrower unit definition into the organisation ▪ Methodical Implementation of adjustments at credit risk mitigation techniques ▪ Examination of the data availability for 'look-through'

Securitizations

Implications of regulatory changes	Need for action
▪ Implications on business strategy with respect to profitability, feasibility and marketability of originator securitizations and re-securitizations ▪ Introduction of inter-risk stress tests and integration into risk models ▪ Implications on process flows ▪ Enhanced responsibility of management for risk taking / 'look-through'	▪ Examination of consequences of minimum self-retention and new risk weightings on capital base ▪ Assessment of feasibility of qualitative requirements to risk management ▪ Enhanced data provision (originators) & information processing (investors) ▪ Provision of data for reporting, risk analysis ▪ Enabling 'look-through' on parts of the IT architecture

Need for action until year-end 2010: Trading Book and Hybrid Capital

Trading Book

Implications of regulatory changes

- Possible effect of capital intensive strategies
- Increased forward looking of models
- Enhanced requirements for planning and governance with respect to crisis scenarios
- New requirements for measurement of market risk
- Focus on the integration of trading book risks into governance
- Implications on IT (requirements internal model)

Need for action

- Review of trading strategy
- Adjustment of internal model (stressed VaR)
- Implementation of enhanced requirements regarding methodology and valuation (e.g. mark-to-market)
- Ensuring consistency of trading strategy, limitation, governance & reporting
- Determination & monitoring trading book definition
- Adjustment software for risk models & reporting

Hybrid Capital

Implications of regulatory changes

- Enhanced requirements concerning the capital base
- Introduction of interim rulings (transitions)
- New requirements with respect to integrated capital planning

Need for action

- Examination criteria for recognition of hybrid capital
- Assessment of impact on capital ratio
- Optimization of the capital base
- Examination of impacts on “leverage ratio” & re-definition of Tier 1 capital
- Adjustment of capital components for reporting
- Establishment of integrated planning systems for mid- and long-term capital planning

Need for action until year-end 2010: Disclosure / Reporting

Disclosure & Reporting

Implications of regulatory changes

- Enhanced requirements related to disclosure strategy & capital market communication
- Further integration of information for external & internal reporting
- Increased linkage between regulatory law & accounting
- Enhanced reconciliation process for regular disclosure
- Advanced IT standards & interfaces for regulatory reporting
- Increasing necessity of an ad-hoc reporting for regulatory purposes

Need for action

- Adjustment of internal reporting
- Enhancement and redesign of reporting processes
- Identification of data sources for enhanced disclosure and reporting obligations
- Introduction of new releases for standard software & timely testing
- Possibly optimization of reporting architecture also with regard to other changes (e.g. COREP)

Core capital and Leverage ratio: Implications for banks and recommended activities

Core capital

Implications of regulatory changes

- Enhanced requirements regarding core capital & introduction of a minimum level for *'common equity'*
- Compliance with qualitative criteria for the inclusion of capital into the core capital
- Enhanced disclosure requirements in different areas (e.g. description of all limits and minima)
- Improvement of quality, consistency and transparency of the minimum capital base

Recommended activities

- Review/ adjustment of core capital components
- Re-definition and ascertainment of 'Tier-1 Capital'
- Examination of criteria and limits for the inclusion of capital components
- Review of capital components for reporting
- Description & monitoring of all limits & minima
- Poss. adjustments reporting templates & disclosure
- Explanation of calculation methods of capital ratios

Leverage ratio

Implications of regulatory changes

- Introduction of a leverage ratio with definitions for the ascertainment
- Gross display of exposures
- Enhanced requirements regarding the inclusion into Tier 1 (e.g. quantitative limits, qualitative requirements)
- Enhanced monitoring and sanctions through national supervisory bodies

Recommended activities

- Ascertainment of leverage ratio as well as continuous monitoring
- Analysis of consequences of the leverage ratio
- Review of definition for capital and exposure
- Adjustments with respect to accounting systems, financial reporting / disclosure
- Possible adjustment of business models and reduction of exposure

Counterparty and Liquidity risk: Implications for banks and recommended activities

Counterparty risk

Implications of regulatory changes

- Additional capital requirements for fair value losses
- Enhanced capital requirements for derivatives, repurchase agreements and securitisations
- Improved requirements for back- and stress testing
- Increased risk weights for large international banks
- Enhanced requirements for collateral management
- Increased due diligence requirements & supervision

Recommended activities

- Ascertainment of capital requirements for fair value losses
- Adjustment of EAD of OTC derivatives and RPA
- Examination of settlement via central counterparties through adjustment of risk weights
- Implementation of enhanced requirements related to validation, stress- and back testing
- Increase of risk weights through the increase of the correlation of exposure in the IRB approach

Liquidity risk

Implications of regulatory changes

- Introduction of liquidity ratios:
  - ‘*Liquidity coverage ratio*“ (LCR) for short-term liquidity (30 days rel. to stress scenarios)
  - ‘*Net stable funding ratio*’ (NSFR) for mid-/ long-term liquidity
- Supplement by other monitoring tools
- Sanctions through supervisory bodies in case of non-compliance

Recommended activities

- Ascertainment of the new liquidity ratios LCR and NSFR as well as monitoring (e.g. stress tests)
- Development of contingency plans, identification of liquid assets, ensuring permanent access to refinancing sources, adjustment of stress testing
- Modelling of positions at long-term liquidity consideration
- Enhancement of data amount

Procyclicality: Implications for banks and recommended activities

Procyclicality

Implications of regulatory changes

- Requirements related to the build-up of capital buffers above the minimum capital base
- Binding dividend payment constraint
- Introduction of ant-cyclical measures with respect to capital requirements
- Full deduction of a reduction of risk provisioning for expected losses from ‘Tier 1-Capital’
- Measures against systemic risks of individual institutions
- Empowerment of supervisory bodies to apply sanctions in case of non-compliance

Recommended activities

- Ascertainment/ definition of a buffer above the minimum capital base
- Build-up of risk provisioning / capital buffers in form of core capital
- Analysis of decrease of the volatility of PDs
- Adjustments related to valuation allowances
- Examination of consolidation of material subsidiaries
- Analysis of group-wide business and risk strategy and ongoing reconciliation with strategies of individual institutions

The various regulatory changes result in far-reaching implications for banks in the areas of strategy and business models, organisation and processes as well as methodologies and IT systems. Especially the risk management and capital base of banks are affected.

Excursion: Main interfaces between regulatory and IFRS Accounting

Considering the current consultation papers from Basel and the projects of the IASB the following areas can be derived, for which a future reconciliation or transition has to be ensured:

Key subjects

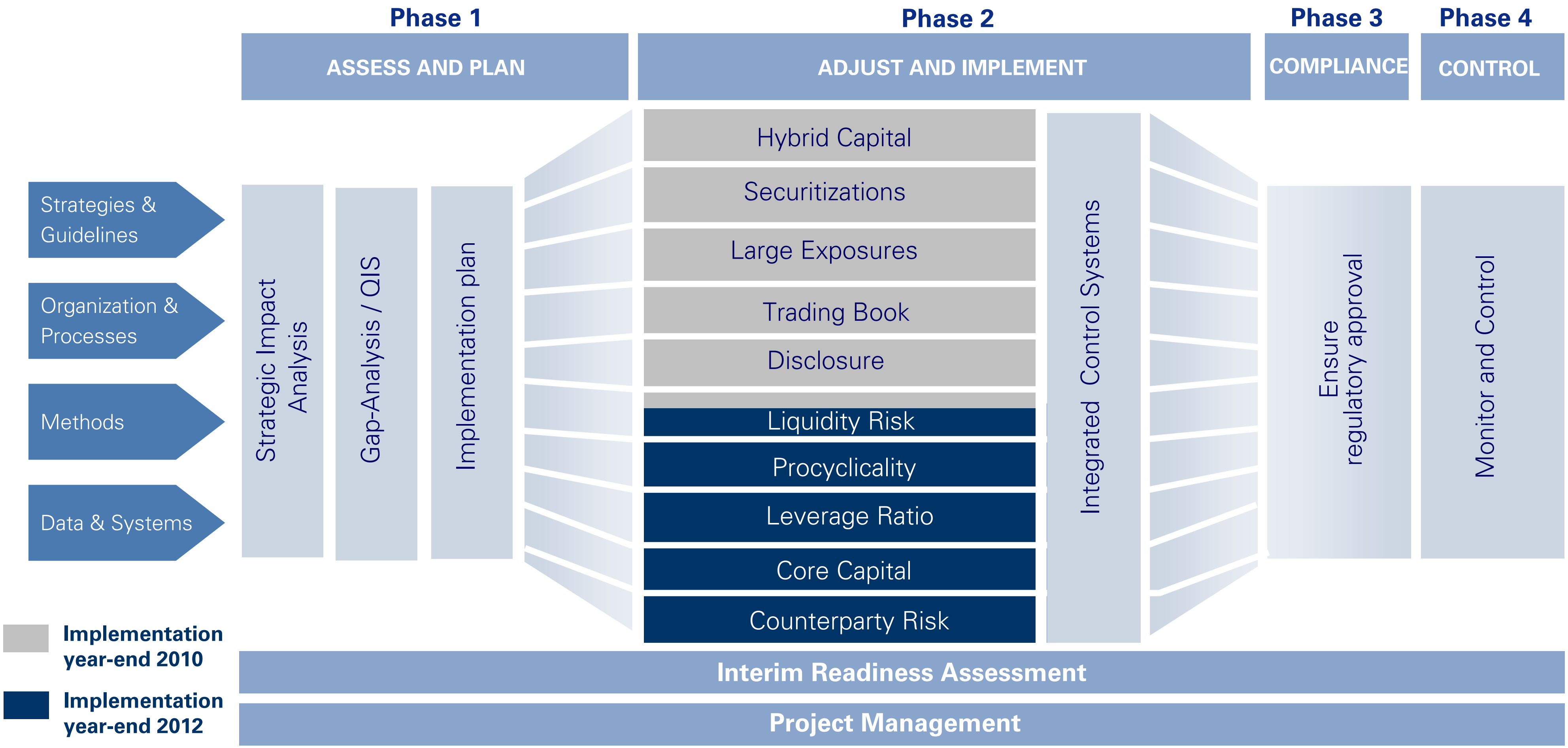
1. Definition of regulatory vs. IFRS capital as well as a proper reconciliation
2. Risk provisioning vs. impairment
3. Basis of ascertainment of leverage ratio
4. Consideration of counterparty credit risk
5. Establishment of capital buffers
6. Liquidity risk disclosures

Further interfaces between regulatory law and accounting standards:

- Mapping of IFRS financial statement presentation to integrated regulatory reporting

Structured Approach to implement regulatory changes

The impact of EU CRD should be thoroughly assessed and implementation measures planned (Phase 1). Adjustments to existing processes and methodologies will be done in Phase 2. In Phase 3 consistency with regulatory approvals needs to be achieved whereas Phase 4 ensures the monitoring and maintenance of the established measures of all relevant CRD issues.



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