

NEW EU PROPOSALS ON CAPITAL ADEQUACY **Amendments to the Capital Requirements Directive**

The European Union has published its plans to amend the Capital Requirements Directive (CRD). The proposed amendments follow consultation held during the second quarter of 2008, and have thus been under development for some time. The changes also take into account recommendations of the G-7 Financial Stability Forum (April 2008) and are a direct response to current market conditions and financial stability problems.

1. BACKGROUND

The CRD was developed based on the 'Basel II' G-10 agreement and adopted in June 2006 (comprising Directives 2006/48/EC and 2006/49/EC). Inconsistencies have been identified during the transposition (implementation) phase of the CRD which have now been addressed to ensure that the effectiveness of the underlying goals of the CRD is not compromised. The majority of these are of a technical nature and have been covered by separate comitology measures. However, developments in world markets resulting in unstable financial conditions have also prompted the EU to act.

2. KEY POINTS

2.1 Summary of Proposed Amendments

The key revisions cover the following areas:

- rules that were brought forward from previous directives, such as the large exposures regime and derogations for bank networks from prudential requirements;
- establishment of principles and rules that had not been formalised at the EU level such as the treatment of hybrid capital instruments within original own funds;
- clarification of the supervisory framework for crisis management and establishing colleges for enhancing both efficiency and effectiveness of supervision.

2.2 Large Exposures to be restricted

Banks are to be restricted in lending beyond a certain limit to any one party. The Commission has proposed that the limit will be 25% of own funds or an alternative threshold of EUR 150 million, whichever is higher. As a result, in the inter-bank market, banks will not be able to lend or place money with other banks beyond the limits, while borrowing banks will effectively be restricted in how much and from whom they can borrow.

2.3 Supervision of Cross Border Banking Groups

The consultation paper circulated earlier in 2008 introduced the need to establish 'colleges' of supervisors for all cross border banks and required supervisors participating in those colleges to discuss and agree on specific issues. There would be a non-binding mediation mechanism via the Committee of European Banking Supervisors (CEBS). It was intended that this would not change the allocation of responsibilities between home and host supervisors. This proposal was seen as unsatisfactory by most stakeholders for different reasons, but the EU is to press ahead with the idea of colleges, saying that colleges are a big step forward in including branches and subsidiaries into the supervisory consultative and decision making processes. It has decided that hosts will be far more involved through colleges in receiving information and being involved in group-wide decisions. It has also accepted that this has to be counter balanced with some decisive capabilities. If for whatever reason this co-operation does not prove effective or efficient, a "last resort" decision-making power on certain key decisions (Pillar 2 capital requirements and reporting requirements) is imperative. The rights and responsibilities of the respective national supervisory authorities will be made clearer and their cooperation will become more effective.

2.4 Quality of Banks' Capital

There will be clear EU-wide criteria for assessing whether 'hybrid' capital, i.e. including both equity and debt, is eligible to be counted as part of a bank's overall capital – the amount of which determines how much the bank can lend.

2.5 Liquidity Risk Management

How banks fund their operations on a day-to-day basis will be discussed and coordinated within the colleges of supervisors. These provisions reflect the on-going work at the Basel Committee on Banking Supervision and CEBS.

2.6 Improving Risk Management for Securitised Products

Rules on securitised debt - which depends on the performance of a dedicated pool of loans – will be tightened. Firms (known as 'originators') that re-package loans into tradable securities will be required to retain some risk exposure (a minimum of 5%) to these securities, while firms that invest in the securities will be allowed to make their decisions only after conducting comprehensive due diligence. If they fail to do so, they will be subject to heavy capital penalties.

3. NEXT STEPS

The EU Commission would like to pass this legislation urgently, and has suggested political agreement is completed by April 2009. The draft Directive provides for transposition into national domestic law by 31st January 2010 and the provisions are expected to apply from 31st March 2010.

The EU has noted that the proposals are not intended to solve the current meltdown - rather, they are intended to strengthen the framework going forward. In terms of immediate reaction and problem fixing of European institutions, it says that the European Central Bank (ECB) and Member States have responded promptly to the problems that have come about, be they liquidity or solvency.

In the short term Member States or Groups of Member States will continue to respond on structural issues and the Central Banks will continue to address the liquidity problems. In the medium term, the Commission will continue to strengthen the regulatory framework to prevent the recurrence of such crises. It says that these practicalities come directly from the Treaty and as the events of recent days have shown, the provisions in the Treaty work.

4. FURTHER INFORMATION

The EU has provided a number of supporting documents as well as the draft directive:

The Proposal to amend the CRD is available at this link:

http://ec.europa.eu/internal_market/bank/docs/regcapital/crd_proposal_en.pdf

Frequently asked questions (FAQs) are available at this link:

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/599&format=HTML&aged=0&language=EN&guiLanguage=fr>

Draft comitology measures – these are technical changes, approved by the European Banking Committee (CEBS) and which have been submitted to the European Parliament for scrutiny.

- Amendments to Directive 2006/48/EC available at this link:
http://ec.europa.eu/internal_market/bank/docs/regcapital/comitology_crd%202006-48_en.pdf
- Amendments to Directive 2006/49/EC available at this link:
http://ec.europa.eu/internal_market/bank/docs/regcapital/comitology_crd%202006-49_en.pdf

Reference: RCUK/PTG/KG

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