



Client Alert

Financial Markets Developments

EU regulatory measures in response to the financial and economic crisis

Since 1999, under its Financial Services Action Plan, the EU has radically reformed EU financial services legislation, modernising or introducing comprehensive legislation in areas such as banking, investment services, securities and insurance, as well as measures on corporate governance, economic crime, audit and accounting. A new pan-European supervisory structure has been implemented (the “Lamfalussy committees”). Significant progress has also been made towards convergence (or at least mutual recognition) of regulatory and supervisory systems between the EU and the US in the financial markets dialogue, as well as with other partners such as Japan, China, Russia and India.

In the field of securities trading in particular, but also in banking and insurance, this body of new legislation has been predominantly liberalising. Rules on regulatory capital have permitted the internalisation of risk assessment and management for major financial institutions, with national supervisory authorities playing a secondary role to the extent that they assess and approve the firms’ own internal models.

The current unprecedented financial crisis has prompted a rethink at least of the underlying premises of the legislation enacted over the last ten years. Even if it is now impossible in the short term to enact fundamental changes to the new rules (some of which have yet to enter into force in national law; for example, in insurance), the EU has been working toward an accelerated legislative procedure for reforms in areas such as the management of large exposures, securitisation, deposit protection schemes, rating agencies etc. to tighten up the new regime in order to address these weaknesses revealed by the market turmoil.

Seven new legislative measures will be considered by the European Council meeting on 11–12 December 2008. Agreement on a general approach in four of them has already been reached by Member States in the Economic and Financial Affairs Council on 1–2 December. If agreed texts can be negotiated with the European Parliament in the next couple of months, the measures should complete the legislative process early in 2009, ready for transposition into the national laws of the 27 Member States.

At the same time, work is continuing in the EU institutions to reinforce cooperation between financial supervisors in order to better manage risk in the financial services industry. Even if the creation of a “federal” European supervisor is premature, some tightening of supervisory control—especially of the multinational groups which are responsible for more than fifty percent of financial transactions in the EU—can be expected; for example by the creation of “colleges” of supervisors, bringing together the national supervisors in markets most concerned by the activities of the multinational group in question.



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Finally, at the international level, initial indications from the incoming Obama administration in the United States are that regulatory and supervisory reforms in the United States may well emulate those now in the pipeline in Europe. If this is the case, this will give added momentum to cooperation between regulators and supervisors on both sides of the Atlantic, thereby building on the existing EU-US Financial Markets Dialogue.

EU developments

In addition to the multibillion euro European Economic Recovery Plan, heads of state and government are expected to adopt at this week's summit positions on a number of draft directives¹ as follows:

■ Revision of the Capital Requirements Directive

These amendments to the EU capital requirements regime are not generally controversial, although the proposal relating to risk management and securitised products has attracted widespread criticism from financial institutions.

Management of large exposures

Large exposures—meaning any exposure to a client or group of connected clients the value of which is at least ten percent of the own funds of a credit institution—are already regulated under the capital requirements directive (“CRD”). Banks must report every large exposure to regulators, and are prohibited from incurring a large exposure to a particular client or connected group of clients that exceeds 25 percent of its own funds. The total large exposures of a bank are currently restricted to a maximum of 800 percent of its own funds. However, the CRD currently allows individual Member States to impose more stringent limits and contains discretionary exemptions from the large exposures’ regime that give rise to national differences in the implementing rules. These tend to distort the level playing field in the EU’s single market for financial services, but are the price of achieving agreement amongst 27 Member States on a *single* broad regulatory framework for the EU.

The proposed revisions, which retain a limits-based back-stop regime, on the recommendation of the Committee of European Banking Supervisors (“CEBS”), do not fundamentally change the current approach. Instead, they strengthen the requirements in some areas and simplify and harmonise the current regime by removing many of the discretionary exemptions. Exemptions from the large exposures regime relating to exposures to central and regional governments, local authorities and central banks are retained and made mandatory. A smaller number of discretionary exemptions remain, relating to certain intragroup exposures and undrawn credit facilities. The proposed revisions also harmonise the reporting obligations in relation to large exposures, by removing the current options as regards the method of reporting, requiring such exposures to be reported to regulators at least twice a year and expanding the information that must be provided.

Eligibility of hybrid capital instruments

Currently, the CRD does not contain harmonised criteria for assessing whether “hybrid” capital is eligible to be counted as part of the institution’s Tier 1 capital. Hybrid instruments are financial instruments issued by banks which combine debt and equity features (for example, subordination, loss absorption, deferral or cancellation of interest, perpetual nature), and are used by credit institutions to increase regulatory capital.

The proposed changes will introduce criteria that need to be met by hybrid capital instruments in order to be eligible to be treated as Tier 1 capital of credit institutions. They build on the 1998 public statement on hybrid Tier 1 capital by the Basel Committee on Banking Supervision (the Sydney Press Release) and the “Proposal for a common EU definition of Tier 1 hybrids” published in April 2008 by CEBS. The proposed eligibility criteria focus on hybrid capital instruments that were set out in the Sydney Press Release—permanence, flexibility in payments and loss absorption. In addition, the amendments also set quantitative limits on the use of different types of hybrid capital instruments that may be used to satisfy Tier 1 capital requirements. The proposed changes provide for a “grandfathering” clause with regard

¹ Directives are the most usual form of EU legislation in the Single Market. After adoption by the European Parliament and Council of Ministers, directives must be transposed into the national law of 27 Member States by national legislation. In the current crisis, legislative procedures at both the EU and national levels are being accelerated.

to instruments already issued and prescribe a transitional period before compliance with the amended CRD provisions becomes mandatory for European credit institutions.

Supervision of cross-border banking groups

The aim is to reinforce the effectiveness of the supervision of cross-border banking groups and improve cooperation and information exchange between national supervisors. This is achieved by a range of measures which define the concept of significant branches; improve information rights of host supervisors of significant branches; clarify the legal framework for transmitting information to central banks and other monetary authorities; clarify the tasks and responsibilities of supervisors' and establish "colleges" of supervisors for EU banking and investment firm groups to coordinate supervisory activities both in the ordinary course of business and in emergency situations. The supervisors involved in a college would agree on the methods used by the group in question to calculate its capital requirements under Pillar 2 of Basel II and on the applicable reporting requirements. The proposed amendments favour a consensual approach, and establish a decision-making framework within the colleges to ensure that all the regulators involved are consulted.

Securitisation

The most controversial amendment concerns risk management in relation to securitised products. Under the Commission's proposal, which has been tentatively supported by Member States, EU regulated banks that hold securitised products in their trading or nontrading books will be required to ensure that originators, sponsors or the original lenders of the securitised debt retain an exposure of at least five percent to the securitised credit risk. On 11 December the Economic and Monetary Affairs Committee of the European Parliament supported an amendment that would increase the retention level to ten percent, although the Committee's draft report also proposes amendments that would widen the exclusions from the retention rule for securitisations where the originator or sponsor already retains an interest in the underlying assets.

If these amendments are approved by the full Parliament, a compromise will need to be negotiated between the Parliament and Member States.

The proposed retention rule will require regulated firms that invest in securitisations to conduct comprehensive due diligence on such investments or face capital penalties. It has been widely criticised by commentators on the grounds that it may be counterproductive as regards risk management, and could further inhibit lending and increase the cost of capital at a time when banks and regulators are trying to revive the credit markets. There is also a concern among industry that the amendment could place European firms at a competitive disadvantage as compared with credit institutions based outside the EU.

This requirement has, indirectly, an *extra-territorial effect* since it applies to any securitised product held by an EU regulated bank, irrespective of the nationality of the originator, sponsor or original lender. Non-EU firms that originate or distribute securitised products will therefore have to meet the retention requirements if they wish to be able to place the investments with EU banks.

■ Solvency II

Solvency II consolidates and modernises the 15 existing EU life and non-life insurance directives, and represents a fundamental review of the capital requirements and risk management standards that apply to EU insurers. Like the CRD, this new composite directive is structured around three pillars. Pillar 1 sets out a valuation standard for liabilities to policyholders and the capital requirements to meet insurance, credit, market and operational risk. As for banks, regulatory capital may either be calculated using a standard formula or, subject to supervisory approval, using insurers' own capital models. Pillar 2 concerns the supervisory review process, and will allow regulators to decide that insurers should hold additional capital against risks not adequately covered under Pillar 1. Pillar 3 deals with market disclosures. There is much interest around the world in Solvency II and its potential to set global standards in insurance regulation. The measure

is still under negotiation, but after formal adoption it will be supplemented by implementing measures to be enacted, after consultation, by the Commission, which would specify the technical details.

The draft directive contains (controversial) new rules for group supervision under which groups would be treated as a single economic entity, with a *streamlined approach to supervision* based on a college of supervisors led by a group supervisor with certain exclusive powers. This has proved contentious with supervisors, who have raised the practical and legal difficulties of this approach.

The proposal also contains provisions for *group support*, which originally allowed capital to be moved in an insurance group from subsidiaries to the parent company, if needed to cover a short fall in the regulatory capital of the parent. Whilst industry strongly favoured group support², this is a highly political issue for supervisors.

Finally, the proposal would allow a group to benefit from *diversification* of its risks across the group rather than of the risks held only in the subsidiary concerned.

Progress on Solvency II may be stymied by Member States' opposition to the provision for "group support" that was proposed by the Commission. At a Council meeting on December 2nd, Member States amended it to enable the local regulator of the subsidiary to block capital transfers. The amendment has been criticised by the insurance industry as failing to recognise the reality of how cross-border groups need to operate, and will almost certainly be opposed by the European Parliament that had approved the Commission's proposal for group support in October. The Parliament will dissolve in April 2009 for elections in June, so if agreement cannot be reached between the Council and the Parliament by April³ negotiations will not restart before September, casting doubt as to whether adoption before the end of 2009 is feasible.

■ Revisions to the EU system of deposit protection

The current directive requiring EU Member States to maintain a depositor protection scheme dates from 1994 and leaves considerable scope to Member States to vary the nature of the scheme and the level of protection conferred. The current regime has proved insufficient to maintain depositor confidence during the ongoing financial crisis. First, it requires Member States to cover savings of only €20,000 (although they are permitted to guarantee a higher level). This required minimum has proved inadequate in the current crisis, and on 7 October all Member States committed to raise the level to € 50,000 and many undertook to cover €100,000. Second, the current directive allows Member States to cover only 90 percent of savings under the deposit guarantee, which has added to the uncertainty and loss of depositor confidence. Finally, the time allowed for Deposit Guarantee Schemes to pay depositors after the bank has failed, is generally three months, while many retail depositors would suffer financial difficulties after a few days if denied access to the funds in their accounts.

In order to address these problems, the Commission proposal would revise the Deposit Guarantee Schemes Directive in the following ways:

- by requiring Member States to increase the coverage level to at least €50,000 and, within a year, to at least €100,000
- by ensuring that eligible deposits are reimbursed up to the coverage level (rather than currently ninety percent)
- by reducing the period for payment to three days.

Member States will probably seek to extend the payment period to several weeks, since the proposed three days is considered to be administratively impossible in the event of the failure of a large bank with millions of retail deposits. Furthermore, the proposed revisions do not address the

² See 13 November Joint CEA-PEIF-CFO Forum-CRO Forum Letter on Current Solvency II Directive Negotiations.

³ Under Article 251 EC (establishing the "co-decision" procedure), agreement between the Council (deciding by qualified majority voting (QMV)) and the Parliament (also deciding by majority vote) is required for all financial services legislation.

problems that became evident during the recent collapse of the Icelandic banks, where depositors did not know whether the presence of a foreign bank in their country was a branch or subsidiary, and the different implications this distinction may have.

The rapid adoption of these revisions may, however, be jeopardised by a potential disagreement between Member States and the European Parliament. On 8 December the Parliament's economic committee supported the doubling of deposit insurance to a minimum of €100,000 by the end of 2009. This amendment will be voted on by the full Parliament in the coming weeks, and could represent a point of conflict with Member States that are seeking to delay the increase in the minimum level of coverage by two years.

Other measures in the pipeline—the EU financial services legislative agenda for 2009

The Czech Republic, which holds the Presidency of the EU during the first half of 2009, must maintain momentum in this politically-sensitive and technically-complex legislative programme in a year of institutional change in the EU. The election of a new Parliament in June and the nomination of a new Commission in November will inevitably hamper the legislative process in the EU in 2009. Nevertheless, the following items are, or are expected to be, on the agenda

- Proposal to regulate credit rating agencies

The Commission published a draft regulation on credit rating agencies on 12 November 2008. Neither the Council nor the Commission believe the IOSCO Code of Conduct, to which the CRAs have agreed to adhere, is a sufficient response to the credit crisis, and both indicated earlier this year that there should be an enhanced European approach including an EU registration system. The Commission proposal contains the following elements:

- A registration and external oversight regime for rating agencies. Unless rating agencies are registered under the proposed regime, their ratings cannot be used for regulatory purposes in the EU (whether under the CRD or otherwise).
- Rating agencies will be required to comply with extensive rules, intended to ensure that the ratings they give are not affected by conflicts of interest, which require them to avoid or adequately manage and disclose conflicts, and to maintain proper organisational and compensation arrangements to safeguard the independence of employees involved in ratings. The proposed rules require rating agencies to create an internal function to review the quality of their ratings and to have at least three independent directors whose remuneration cannot depend on the business performance of the ratings agency.
- Rating agencies will also be required to disclose the methodologies, models and assumptions used in the rating process, and to publish an annual transparency report. They will not be permitted to rate instruments if they do not have sufficient information on which to base the rating.

National supervisors in the Committee of European Securities Regulators ("CESR") have expressed their reservations over the Commission's approach, and industry has been very critical. The proposal deviates from the IOSCO approach and therefore breaks with the growing international consensus that regulatory measures should converge as far as possible. A divergent approach in an international market such as that for credit ratings may undermine the aim of encouraging globally comparable ratings as well as producing competitive distortions and the risk of regulatory arbitrage. There is particular criticism of Article 4 of the proposal, which prohibits EU regulated firms from using credit ratings for regulatory purposes other than those issued by ratings agencies that are established in the EU and registered in accordance with the Regulation. This would effectively preclude the use of non-EU ratings, and the US authorities have already raised their concerns in the context of the EU/US financial markets dialogue.

- In October 2008, the Commission established an industry working party to look into the derivatives markets, which met for the first time in November 2008 and agreed to produce a roadmap, by the end of 2008, containing concrete proposals as to how the risks from credit derivatives can be mitigated—principally by ensuring OTC credit default swaps are channelled through a central clearing counterparty.
- In December, following pressure from the European Parliament, the Commission unveiled plans for a “wide-ranging” public consultation on the oversight and regulation of hedge funds. This was presented as a response to supervisory questions arising from the current financial crisis, as well as the G20’s recent call for the development of best practice standards for private capital pools and hedge funds. The review will cover the adequacy of existing transparency measures, oversight responsibilities, capital requirements, risk management and the assessment of systemic risk. It is not expected to cover private equity. The public consultation will be launched by mid-December and will continue until the end of January. The results will be published in a conference in February 2009, and legislative proposals will almost certainly follow.
- Accounting standards

The market turmoil has raised questions over accounting for financial instruments when markets become inactive. Progress in accounting standards to mitigate the perceived rigours of fair value accounting, that has obliged firms to write down their assets, will depend to a large extent on the work of the IASB: formally, the role of the Commission, assisted by the Accounting Regulatory Committee, is to endorse (or not) international accounting standards issued by the IASB for use in the EU. The rapid adoption in October of the amendments to IAS 39 and IFRS 7 indicates significant political will in this area. The IASB and FASB recently announced the creation of a high-level advisory body to look at this matter in greater depth. IFRS guidance on fair-value measurement will be published in 2010.

- Financial supervision

There is a growing consensus that the national system of cross-border supervision of multinational groups that is currently in place in the EU is no longer appropriate for the systemic importance and economic reality of such entities. Although the financial services industry has rapidly integrated across Europe, supervision remains mainly national, although supported now by cooperation between supervisors. The current crisis has highlighted the need for intensified cooperation in cross-border supervision, if not for the establishment of a single EU supervisor for multinational groups.

The de Larosière group, set up by the Commission in mid-November to put forward recommendations for future European supervision, will report to the European Council next spring. The Group has a wide mandate to examine the possibilities for revision of the EU supervisory landscape, but so far there has been no indication as to whether its recommendations will be as radical as some commentators hope that they will be. The timing of the group’s work coincides with the next G20 meeting in London, where negotiations on changes to international economic institutions and the global financial system, initiated in Washington at the G20 meeting in November, will be considered.

Conclusion

In the last ten years, the EU has virtually replaced the 27 Member States as the legislative authority for financial services in Europe. We now have a single core rule-maker in the EU, although supervision of financial institutions is still mainly conducted at national level. At the regulatory level, the 27 Member States are responsible for implementing EU legislation and, to the extent allowed by Community law, supplementing it in order to take account of differences in national financial markets. With 50 major multinational financial institutions now being responsible for more than 50 percent of financial transactions in the EU, there is clearly a need for enhanced

4 There are thought to be 15-20 multinational banking groups in Europe with an aggregated market share of more than fifty percent of total banking activity in the Euro area.

cross-border supervisory cooperation, if not a “federal” European supervisor, at least in banking and insurance.

The current unprecedented crisis has prompted a review of the adequacy of EU financial law and supervisory practice. A significant number of short-term reforms are in the pipeline, due for adoption in the weeks and months to come. More far-reaching reforms may be agreed in 2009, although progress may be hampered by the institutional changes which will take place next year with the election of a new European Parliament and the nomination of a new Commission. Similarly, the “running-in” of the Obama administration in the US will inevitably cause a hiatus in EU-US cooperation on financial services.

Even though imperfect, the EU regulatory system for financial services has been called a model for the rest of the world. EU regulation is possibly more advanced than that in the United States and other jurisdictions, at least as regards the implementation of Basel II and ongoing work to address the loopholes revealed by the current crisis. In 2009, the EU will seek to accelerate and deepen cooperation with the Obama administration on all aspects of the crisis, including regulatory and supervisory reforms. Financial institutions both inside the EU and in third countries therefore need to monitor these developments closely.

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