WHITE & CASE

Insight: Financial Regulatory

July 2011

The Financial Regulatory agenda and timetable

The current Financial Regulatory agenda is largely being set by the G20 governments under the leadership of the Financial Stability Board and the Basel Committee on Banking Supervision (the "Basel Committee"). In Europe the Commission is engaged in a wide programme of reform of financial regulation both directly and through the newly established European System of Financial Supervision. As well, in the UK, institutional reform of financial regulation due to be implemented in 2013 will replace the existing regulators with a new 'twin peaks' structure focussed on prudential supervision and market conduct together with a new role for the Bank of England in respect of macro-prudential risks.

Prudential standards for banking organisations and investment firms

The most recent regulatory development is the publication by the EU Commission of the "CRD 4" package which will further amend the Capital Requirements Directive and, when finalised, will implement the Basel III package of reforms announced by the Basel Committee in December 2010. This follows the changes already implemented via "CRD 2" and "CRD3". The table below summarises the key changes and timelines.

Implementing measure	Key high level changes	Date for implementation
Technical Changes Directive (2009/83/EC)	Introduces a new definition of "significant risk transfer" in relation to securitisation positions and adjusts credit conversion factors for off-balance sheet items	31 December 2010 and see ***European Banking Authority ("EBA") Guidelines***
CRD 2 (2009/111/EC)	Adjusts and limits the definition of core capital and provisions for assessing the eligibility of hybrid capital as tier 1 capital Expands the CRD definition of "group of connected clients" so that it may include clients who are reliant on common sources of funding	31 December 2010
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	Introduces via new 122a, a 5% retention requirement as a pre-condition for investment by European banking organisations in securitisations – a provision intended to ensure that a lender, originator or sponsor retains 'skin in the game'	EBA Guidelines to article 122a issued 31 December 2010

Implementing measure	Key high level changes	Date for implementation
	Requires investor due diligence and investing banks must regularly perform due diligence and monitor performance of the underlying exposures	
	Enhances co-operation among regulators via new EU colleges of supervisors	
CRD 3 (2010/76/EU)	Requires banking organisations and investment firms to adhere to policies on remuneration for bank staff Introduces a new definition of and imposes higher risk weighting requirements for 're-securitisations' which would include for example a CDO of ABS.	Remuneration rules and EBA guidelines from 1 Jan 2011, other provisions from 31 December 2011

CRD 4

The European Commission published on 20 July 2011 its proposals for a "CRD 4" package of reforms comprising a Directive and a Regulation that will implement the Basel III framework issued by the Basel Committee in December 2010. It is estimated that the proposals will require banks operating in Europe to raise €460 billion in capital by 2019 or alternatively reduce their balance sheets and risk weighted exposures. The package will:

- re-order banking organisation capital into tier 1 and tier 2 and abolish innovative tier 1 capital and tier 3 capital;
- increase the minimum common equity component of bank capital from 2% to 4.5% of risk-weighted assets;
- impose an additional new capital conservation buffer of 2.5% to be made up of common equity which banking organisations may draw on but subject to restrictions on dividends, buy backs and other discretionary bonus payments;
- enable national authorities to impose a counter-cyclical buffer of up to 2.5% to address macro-prudential risks posed for example by the build up of undue credit in national economies or business sectors;
- significantly strengthen the provisions on deductions from capital, including for example deductions in respect of material holdings and investments in affiliates;
- enable national authorities to use as part of their 'Pillar 2' supervisory review tools a back-stop non risk-sensitive leverage ratio that must be calculated, reported on and, from 2015, published by banking organisations in accordance with the provisions of the Regulation (the Commission will further consider whether to introduce a specific mandatory minimum leverage ratio as proposed in Basel III);
- introduce new counterparty credit risk requirements;
- impose requirements to ensure the loss absorbency of financial instruments used to satisfy bank organisation regulatory capital requirements beyond common equity, for example through them being written down or converted to common equity; and
- make way for the eventual introduction (in 2015) of a fully harmonised and calibrated liquidity coverage ratio as proposed in the Basel III framework (in the meantime the Regulation will impose a general requirement for institutions to maintain adequate liquidity and common reporting standards).

Timing – The "CRD 4" package of reforms was published on 20 July 2011. The implementation timetable, which commences in January 2013, stretches over many years. Both of the "CRD 4" legislative instruments will, before becoming effective, need to be approved by the Council of Ministers and by the Parliament and will be the subject of intense scrutiny and lobbying. The extent to which the legislation in its final form will leave countries with national discretions is likely to prove contentious. The Commission has explained why it considers the legislation should be largely 'maximum harmonisation' leaving little room for national regulators to impose different or higher requirements.

For further information regarding the "CRD 4" legislation please ***click here*** and for a copy of our previous client alert on Basel III, published in January 2011, please ***click here***.

Beyond Basel III

Beyond these reforms the Basel Committee is also working on possible enhanced requirements for internationally significant banks and other institutions – global systemically important financial institutions - so called G-SIFIs. This could be combined with more extensive use of convertible or 'bail-in' instruments beyond a banking organisation's regulatory capital to potentially avoid such institutions entering a disorderly insolvency.

Timing – On 19 July 2011 the Basel Committee published for consultation a paper setting out a methodology to identify global systemically important banks ("G-SIBs") as well as additional capital measures that might be applied to banking organisations that are determined to pose risks to international financial stability, including the conversion or 'bail-in' of financial instruments at the point of non-viability. The consultation closes on 26 August 2011. Further work on the wider population of G-SIFIs which extends to investment banks and broker-dealers is continuing both under the auspices of the Basel Committee and the Financial Stability Board.

The UK Independent Banking Commission

The Commission has published an interim report setting out options for the reform of the UK banking sector designed to promote financial stability and competition. A lead option would be to require structural changes so that 'retail' banking would be ring-fenced from other banking activities and in particular from investment banking. This has similarities with the so-called US Volker rule.

Timing – The Independent Banking Commission is due to publish its final report in September 2011.

EU Bank crisis resolution

In January 2011 the Commission published a discussion paper advocating that all Member States should put in place new uniform crisis management tools to enable failing banks to be resolved in an orderly way and without leading to instability of the financial system or the need for bail-outs from public funds. Several of the Commission's proposals are similar to the banking organisation resolution powers available to the UK authorities in the Banking Act 2009 and to the US authorities under the Dodd Frank Act 2010.

Timing – The Commission is understood to be planning to publish firm policy proposals together with a draft legislative instrument this autumn.

Markets in Financial Instruments Directive (MiFID)

The Commission published a consultative document in December 2010. It canvassed some reforms of securities trading markets, including the introduction of pre- and post-trade transparency for bond markets.

Timing – The Commission is expected to come forward with a legislative proposal in October 2011.

European Markets Infrastructure Regulation (EMIR)

This is the Commission's response to the G20 call for OTC derivative trading to be migrated onto trading platforms and clearing by a central counterparty. EMIR contains provisions that are designed to improve the position of end users where firms that are clearing members default by mandating the segregation of client's margin and the portability of client positions.

Timing – The draft Regulation is currently being negotiated between the Parliament and Council as part of the EU legislative process.

Alternative Investment Fund Managers Directive (AIFMD)

This directive will require the authorisation and supervision of hedge fund managers and the managers of private equity funds. It will also impose a new liability regime upon depositaries and custodians of such funds. ESMA is now consulting on a range of implementation measures and guidelines. For further information on this matter please ***click here*** to see our previous alert on this topic.

Timing – Due to be implemented across Europe from July 2013.

Short Selling Regulation

A regulation that requires the disclosure of short positions in financial instruments and which will give both national and European authorities powers to ban short selling in certain circumstances.

Timing – The draft Regulation is still in the course of negotiation between the Parliament and the Council but is likely to be finalised before the end of 2011.

Securities Law Directive

A directive that will apply a harmonised legal regime governing the holding and management of securities accounts including the governing law, the rights of customers, taking security over such accounts and the liability of account providers for the loss of securities from accounts.

Timing – It is not clear how quickly this Commission proposal will progress but it has huge potential for securities brokers and custodians.

Market Abuse Directive (MAD)

On 25 June 2010 the European Commission published a working document consulting on changes to the directive that would extend its scope to include instruments that are admitted to trading on a multi-lateral trading facility and adapt the definition of inside information in connection with commodity derivatives and extend the offence of market manipulation so that it

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covers attempted manipulation. The review also contemplates new provisions on enforcement and co operation with ESMA.

Timing – A legislative proposal is due in October 2011.

Credit Rating Agencies

The regulation of credit rating agencies in Europe has passed to the European Securities and Markets Authority. This was brought about by amendments made to Regulation (EC) 1060/2009 that became effective on 31 May 2011. The Regulation generally made it necessary for banking organisations that use or rely upon credit ratings only to do so if the rating has been given by an agency that is registered in the EU or by a third country agency that satisfies an equivalence test. In November 2010 the Commission published a consultation on further potentially far reaching measures including reducing reliance on ratings, introducing a civil liability regime for agencies and addressing the "issuer-pays" model.

Timing – The most recent consultation closed on 7 June 2011 and the Commission can be expected to adopt a legislative proposal before the end of 2011. The European Parliament on 8 June 2011 published its own initiative resolution calling for additional measures.

UK Regulatory Reform

The UK government has published policy proposals and draft legislation that will fundamentally reform the structure of financial regulation. This will involve the creation of a new prudential supervisor for banking organisations and insurance companies, the Prudential Regulation Authority, that will be a subsidiary of the Bank of England. The supervision of markets and business conducted with consumers will be the responsibility of the Financial Conduct Authority. Both of these bodies will have new powers including a power to ban financial products. At the same time a new committee of the Bank of England – the Financial Policy Committee – will be charged with powers of direction over both regulators in order to avoid instability of financial markets and systems.

Timing – Legislation to bring about these changes may be introduced to Parliament by the end of 2011 with a view to implementation during the first quarter of 2013.

The New European Financial Regulators

Three new supervisory agencies have been established under European legislation:

- the European Securities and Markets Authority (ESMA), based in Paris;
- the European Insurance and Occupational Pensions Authority (EIOPA), based in Frankfurt; and
- the European Banking Authority (EBA), based in London.

Each have powers to formulate implementing measures and guidance, to intervene directly in emergency situations and to mediate if there are disputes involving national regulators or if it appears one or more national regulator is not correctly applying European law.

Timing – The new system of European financial supervisors came into force on 1 January 2011.

This Newsletter is only a high level guide and should not be relied upon when considering the application of the new provisions to particular circumstances.