WHITE & CASE

Insight: Financial Regulatory

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European Commission publishes proposals for CRD 4

The European Commission published on 20 July 2011 proposals to radically overhaul the legislation governing the supervision of, and the prudential standards to be met by, banking organisations and investment firms. The new legislation takes the form of a revised Directive and an entirely new Regulation that, together, will implement sweeping reforms of the capital and liquidity standards with which banking organisations and investment firms will need to comply. This new legislative package will facilitate the implementation of the Basel III capital and liquidity standards for banking organisations published by the Basel Committee on Banking Supervision in December 2010.

When implemented, the Directive and Regulation will replace the existing Capital Requirements Directives (the "CRD" comprising Directive 2006/48/EC and Directive 2006/49/EC). The proposed use of a Regulation to in this context marks an important change of strategy by the Commission. When in force the Regulation will be directly applicable to banks and investment firms and will not require further separate implementation by national authorities. As explained below, the Regulation will curtail the existing powers of national authorities to set different and higher prudential requirements for banking organisations.

A copy of the Commission's press release and of the draft Directive and Regulation can be found by ***clicking here***.

White & Case will be distributing future client insights with further in-depth analysis of the Commission's proposals. Answers to some immediate questions are as follows:

Q The Commission has published its proposals, so what happens next?

A The EU legislative procedure will involve consideration of the Commission's proposals both by the Council of Ministers and by the European Parliament. The Council of Ministers for these types of measures is likely to comprise the Finance Ministers of each of the 27 Member States. Legislative measures can be approved in the Council by a qualified majority. The European Parliament will seek to adopt a position on the proposals through a Committee procedure and plenary voting. The Parliamentary process can take many months to complete and a failure to reach agreement could result in the adoption of amendments through a 'trialogue' involving the Council, the Commission and the Parliament. Once Parliament and the Council are in agreement the proposals will pass into law.

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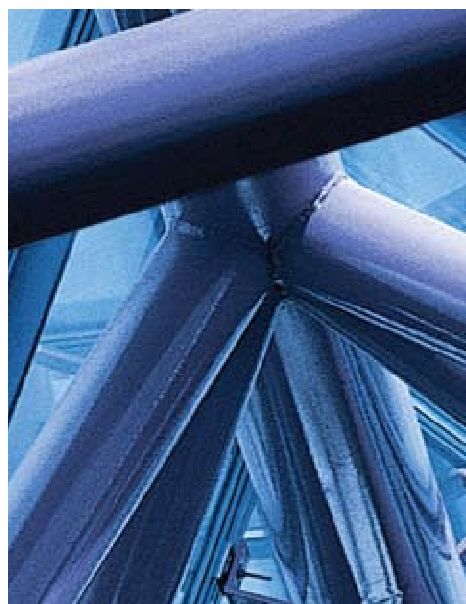

Q Assuming this legislation is adopted as drafted, when is it due to take effect?

A The legislation will begin to take effect from 1 January 2013 but this is subject to some significant and complex transitional provisions. In line with the expectations set down by the Basel Committee on Banking Supervision, these extend the timeline for the application in full of some measures by several years and in some instances to a date as far out as 1 January 2019.

Q What is the purpose of the Directive?

A The Directive re-casts the existing CRD and will contain the general prudential requirements that national supervisors will have to apply to banks and investment firms. This is the so called 'Pillar 2' supervisory framework within which national supervisors may, if judged necessary, impose more stringent institution specific prudential requirements.

The Commission is concerned that the sanctions and penalties that national authorities can impose for breaches of prudential requirements lack consistency across Europe and the Directive contains new provisions requiring a minimum set of sanctions and measures to be available. This extends to the level of financial penalties where, for example, the level must not be lower than 10% of the annual turnover of an institution.

The Directive contains some new enhanced provisions directed at the standards of corporate governance in banking organisations and investment firms. The Commission's proposals target the need for 'diversity' in the make-up of governing boards and the establishment of risk committees to deal specifically with risk issues and prepare management boards on risk issues.

Banking organisations and investment firms with material credit risk exposures or a significant number of counterparties will have to develop and use internal risk models rather the 'standardised' approach that relies on external credit ratings.

The Directive contains the new provisions which implement the Basel III capital conservation buffer and the counter-cyclical buffer.

The Directive will, as under the existing CRD, address the conditions to be satisfied for the authorisation of banks, the exercise of the freedom of establishment and the cross-border provision within Europe of banking services. Corresponding provisions for investment firms will however remain those found in the Markets in Financial Instruments Directive (Directive 2004/39/EC).

At a glance, the areas covered by the Directive and the Regulation are, respectively, as follows:

Directive (Needs to be implemented into national law, less prescriptive)	Regulation (Measures having direct effect. Detailed and highly prescriptive (single rule book))
Access to taking up/ pursuit of business	Capital
Exercise of freedom of establishment and free movement of services	Liquidity
Prudential supervision	Leverage
Capital buffers	Counterparty credit risk
Corporate governance	
Sanctions	

Q If the Directive contains general prudential requirements, what is the purpose of the Regulation?

A The proposed Regulation contains all of the detailed prudential standards that will apply to banking organisations and investment firms. In effect, the so-called Pillar 1 provisions by which institutions calculate the amounts of regulatory capital that they must hold have been moved into the directly applicable Regulation. There is no index to the Regulation, which is in ten parts as follows:

Part One – General Provisions (including scope and definitions)

Part Two – Definition of Own Funds

Part Three – Capital Requirements

Part Four – Large Exposures

Part Five – Exposures to Transferred Credit Risk

Part Six – Liquidity

Part Seven – Leverage

Part Eight – Disclosure

Part Nine – Delegated and Implementing Acts

Part Ten – Transitional Provisions, Reports and Reviews

A table at the end of the Regulation shows how the provisions of the Regulation correlate with the provisions of the CRD which it replaces. For example, Part Five – Exposures to Transferred Credit Risk contains the provisions on securitisation currently found in article 122a of Directive 2006/48/EC.

Q Will the European Banking Authority ("EBA") have a role?

A Both the Directive and the Regulation confer responsibilities on the EBA to develop binding technical standards to be issued by the Commission and to prepare advice to the Commission on Level 3 measures. Over 50 provisions of the Regulation require the EBA to prepare and submit regulatory and implementing technical standards. These measures will flesh out the detail of the proposals and facilitate their consistent application across Europe. The Commission is able, under the new system for financial supervision, to make such implementing and technical measures via a truncated legislative process. The EBA will be consulting on these 50 or so measures in parallel with the EU legislative process.

Q Does the Directive or Regulation leave any room for national authorities to apply higher standards?

A The Commission's intention appears to be that national authorities in Member States may apply more stringent prudential requirements but only on a case by case basis and as a result of a firm specific supervisory review and evaluation process undertaken in accordance with, and as contemplated by, the Directive. In its explanatory memorandum the Commission cite several reasons in support of this approach. It is concerned that if national authorities were free to impose generally higher requirements, market pressure would force a 'race to the top' resulting in the relocation of business in a particular country. The Commission points out that the framework will nevertheless leave national authorities with some important discretions. Notably, they can:

- adjust risk weights for lending secured by mortgage on residential property (see article 119(2) of the Regulation);
- impose additional capital requirements upon individual institutions;
- set the level of the counter-cyclical buffer; and
- during the transitional period apply the provisions more quickly.

Q How do the Commission's proposals affect banking organisations and investment firms that are established and licensed in other countries but which operate in Europe through branches and subsidiaries?

A The basic structure and approach under the CRD is not altered. A subsidiary of a third country banking group carrying on banking activities and established in a Member State will continue to need to be authorised under the legislation and, if so authorised, will be able to carry on business in other Member States with the benefit of the passport. Branches of third country banks will continue to be subject to the authorisation requirements imposed by national authorities under conditions that must not be more favourable than for branches of firms established in other Member States. Such branches may not however exercise the cross-border freedoms conferred by the passport.

Q Do the proposals differ from Basel III?

A As indicated, the proposals are designed to give effect to Basel II within Europe. They are not, however, simply a copy out of the Basel III text. Unlike Basel III, which applies to internationally active banks, CRD 4 will apply to all EEA banks as well as investment firms. The proposals also introduce a number of significant changes to the EU banking regulatory framework beyond the Basel III driven changes in the areas of corporate governance, sanction, enhanced supervision and by reducing banks' reliance on external credit ratings.

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