

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular addressed to the investment services industry regarding the recent developments relating to the Capital Requirements Directive

23rd February, 2010

The purpose of this circular is to provide the investment services industry with an overview of the developments relating to the Capital Requirements Directive (**CRD**) which have been adopted by the European Parliament and the European Union and those which are currently being proposed by the Commission.

Background

The Capital Requirements Directive which consists of two European directives: [i] Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (recast) – Banking Directive; and [ii] Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions (recast), was adopted on 14th June 2006 by the European Parliament and the Council of the European Union. Its adoption represents one of the measures taken by the European Commission to complete the Financial Services Action Plan, which was adopted in 1999 to improve the single market in financial services. The objective of the CRD is to establish the capital adequacy requirements that apply to both credit institutions and investment firms in order to ensure the adequate solvency of financial institutions and to reduce the systemic risk of failure of financial institutions.

Second capital requirements directive – CRD II

During the year 2008, the European Commission (Commission) started proposing potential changes to the CRD with regard to large exposures, hybrid capital instruments, supervisory arrangements and adjustments to certain technical provisions. In part, the changes reflected a response to the credit market turmoil that emerged in mid-2007. The Commission referred to these changes as CRD II, which is made up of the following three Directives:

1. Commission Directive 2009/27/EC amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management. This Directive was adopted by the Commission through comitology procedure on 7th April 2009, with the approval of the European Banking Committee and is considered as a Level II implementing measure. The purpose of this Directive is to amend certain technical provisions of

Directive 2006/49/EC in order to be equivalent to the sound risk management practices of credit institutions.

2. Commission Directive 2009/83/EC amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council. This Directive was adopted by the Commission through comitology procedure on 27th July 2009, with the approval of the European Banking Committee and is considered as a Level II implementing measure. The purpose of this Directive is to ensure that certain technical provisions of Directive 2006/48/EC are equivalent to the sound risk management practices of credit institutions.
3. Directive 2009/111/EC amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. This Directive was adopted through co-decision procedure of the European Parliament and the Council of the European Union on 16th September 2009 and is considered as a Level I measure. The purpose of this Directive is to:
 - address some of the shortcomings revealed by the financial crisis such as the failure to focus on the macro-systemic risks of failure of financial institutions;
 - establish the criteria for hybrid capital instruments which could form part of the eligible capital of investment firms. This serves the purpose of enhancing the quality of the capital that is held by investment firms;
 - establish colleges of supervisors in order to increase cooperation between the competent authorities and to enhance the supervision of cross-border groups, particularly in emergency situations;
 - introduce the notion of significant branches in order to reinforce the rights of host countries to information; and
 - improve the management of large exposures undertaken by investment firms.

Member States are expected to transpose the provisions of CRD II by 31st October 2010, which shall be implemented by investment firms (where applicable) by 31st December 2010. The Authority recommends that stakeholders familiarise themselves with the provisions of CRD II which may be accessed through the Official Journal of the European Union at the following link: <http://eur-lex.europa.eu/en/index.htm>

The Committee of European Banking Supervisors which is an independent advisory committee to the European Commission on banking regulation and supervision, is responsible for contributing to the consistent implementation of the European directives such as the Capital Requirements Directive, through the issue of guidelines. With respect to CRD II, CEBS has issued *inter alia* the following guidelines:

- Implementation guidelines for hybrid capital instruments – 10th December 2009. CEBS expects its members to transpose the guidelines into their national legal framework and apply them by 31st December 2010 at the latest;
- Guidelines on the implementation of the revised large exposures regime – 11th December 2009. CEBS expects its members to apply the present guidelines by 31st December 2010, at the same time as the revised large exposures regime will come into force through the provisions of CRD II; and

- Guidelines on the reporting requirements for the revised large exposures regime – 11th December 2009. Given that the large exposures regime shall be applied from 31st December 2010 and the common reporting shall be applied from 31st December 2012, CEBS recommends that national supervisors incorporate the large exposures reporting as set out in the guidelines into their national reporting system during the two-year period during which the common large exposures reporting is not binding.

The Authority recommends that stakeholders familiarise themselves with the guidelines issued by CEBS which may be accessed through its website at the following link: <http://www.c-ebs.org/>

Third capital requirements directive – CRD III

During the year 2009, the Commission proposed further changes to the CRD in order to strengthen the prudential regulatory framework of the CRD with respect to certain areas which were relevant to the causes of the crisis. It was understood by supervisors and regulatory bodies, including the Group of 20 and CEBS that the failure of individual financial institutions during the recent crisis was caused by inappropriate remuneration structures which led financial institutions to take excessive and imprudent risk-taking. The remuneration structures of financial institutions related to poorly designed remuneration policies that rewarded short-term profit and gave incentives to financial institutions to take risks that exceed the general level of risk tolerated by the institutions. Further to this, the Commission proposed to make changes to the CRD to address this shortcoming. These changes which are being referred to as CRD III will be in the form of a Directive of the European Parliament and the EU Council. The proposed Directive also covers changes relating to the trading book, re-securitisations and the disclosure of securitisation exposures.

The Authority recommends that stakeholders familiarise themselves with the proposed provisions of CRD III which may be accessed through the European Commission's website at the following link:

http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

Fourth capital requirements directive – CRD IV

The Commission is currently discussing further possible improvements to the current legislative text of the CRD at the CRD working group (CRDWG). The objective of the CRDWG is to establish the draft legal text of the amendments to the CRD in order for the Commission to be able to issue the public consultation document with respect to the amendments to the CRD. The proposed changes which are being referred to as CRD IV relate to:

- Dynamic provisioning which is a countercyclical measure for capturing expected losses due to inherent credit risks that have not materialised as 'incurred' losses. It is different from countercyclical regulatory capital which provides a capital buffer for unexpected losses. This approach enables financial institutions to build up countercyclical buffers, which rise during good times and which could be drawn down during bad times. The Commission is proposing to apply dynamic provisioning to on balance sheet items (such as loans) and possibly off-balance sheet items (such as guarantees); and

- the removal of national options and discretions which give rise to differences in national implementing legislation from the current directives.

In this regard, the Commission issued a public consultation on CRD IV which may be accessed through the European Commission's website at the following link:

http://ec.europa.eu/internal_market/consultations/docs/2009/capital_requirements_directive/CRD_consultation_document_en.pdf

The Authority recommends that stakeholders familiarise themselves with the issues that are being presented in the consultation.

Contacts

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