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# Further Changes to the Capital Requirements Directive: CRD IV

Dr Bart P.M. Joosen\*

☞ Capital adequacy; EU law; Financial institutions; Risk management

## Major Overhaul of the Current European CRD Legislation to Adopt the Basel III Accord (P 1): Introduction

Since their adoption in 2006, Directives 2006/48<sup>1</sup> and 2006/49<sup>2</sup> have been amended numerous times. Some of the amendments were already in contemplation prior to the initial adoption, and formed part of the routine legislative program of the European Commission. A significant portion of the amendments were introduced as responses to the financial crisis which has unfolded since summer 2007. The two Directives are increasingly together referred to as the Capital Requirements Directive, or “CRD”. The CRD is the most significant piece of European legislation adopting Basel II, the capital accord for banks established in 2004 by the Basel Committee on Banking Supervision (BCBS).<sup>3</sup> The CRD extends many of the rules which had previously applied only to international banks to all banks with an establishment in the European Union or the European Economic Area (together referred to as “Europe”) no matter their size or where they operate. The CRD also applies to all investment firms established in Europe, setting out capital adequacy requirements for investment firms that are otherwise subject to the market entry, organisational and market conduct rules of the (laws implementing the) Markets in Financial Instruments Directive<sup>4</sup> (MiFID).

The BCBS started its work to revise Basel II in 2008. In July 2009, the first revisions were set out in “Enhancements to the Basel II framework.”<sup>5</sup> The most

notable changes were in respect of risk management procedures for securitisation positions, risk weighting of re-securitisation positions, certain internal governance and (executive) compensation principles and the pillar 3 disclosure process in respect of, among others, securitisation positions in trading books, sponsorship of off balance vehicles and pipeline and warehousing risks. Further changes to Basel II were introduced by “Revisions to the Basel II market risk framework” which was also published in July 2009. The value-at-risk based trading portfolio framework introduced in 1998 has been supplemented with a so-called “incremental risk” capital charge. For unsecuritised credit products an additional charge is introduced for default risk as well as migration risk. Securitised products are now, with a few limited exceptions, weighted in accordance with the rules for the banking book in order to prevent regulatory arbitrage between the banking book and the trading portfolio.<sup>6</sup>

In Europe, many of these changes to Basel II were promptly introduced via a series of changes to the CRD effected by the so-called CRD II<sup>7</sup> and CRD III<sup>8</sup> Directives on which the European Commission started work in 2008 in parallel with the discussions taking place within the BCBS.

In its press release of September 7, 2009, the oversight body of the BCBS, the Group of Central Bank Governors and Heads of Supervision, announced a significant number of changes, particularly addressing the requirements for bank capital. The announcement focussed on the development of a comprehensive regulatory framework for liquidity management, which would for the first time introduce internationally harmonised rules for the management of liquidity risks by banks and impose quantitative standards for the maintenance of liquid funds against liquid exposures. These proposals are referred to as “Basel III”. On December 17, 2009, the BCBS published two consultation documents setting out these significant changes to the 2004 Basel II accord<sup>9</sup> in more detail.

What followed was a consultation period in which the BCBS received a very significant number of responses to the consultation documents from industry participants. While the consultation period was underway, the BCBS was also working on a quantitative impact study (BCBSQIS) in order to measure the likely impact of the

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<sup>1</sup> Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1.

<sup>2</sup> Directive 2006/49 on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L177/201.

<sup>3</sup> The Basel II accord published in 2004 has been revised in respect of certain technical aspects and the final comprehensive version of the accord was published in 2006: *International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version*, June 2006, see: [www.bis.org](http://www.bis.org) [Accessed November 20, 2011].

<sup>4</sup> Directive 2004/39 on markets in financial instruments amending Council Directives 85/611 and 93/6 and Directive 2000/12 and repealing Council Directive 93/22 [2004] OJ L145/1.

<sup>5</sup> Published July 13, 2009, see: [www.bis.org](http://www.bis.org) [Accessed November 20, 2011].

<sup>6</sup> BCBS page <http://www.bis.org/publ/bcbs158.htm> [Accessed November 20, 2011].

<sup>7</sup> Directive 2009/111 amending Directives 2006/48, 2006/49 and 2007/64 as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] OJ L302/97.

<sup>8</sup> “CRD III” refers to 3 Directives that amended CRD, being: Commission Directive 2009/27 amending certain Annexes to Directive 2006/49 [2009] OJ L94/97, Commission Directive 2009/83 amending certain Annexes to Directive 2006/48 as regards technical provisions concerning risk management [2009] OJ L196/14 and Directive 2010/76 amending Directives 2006/48 and 2006/49 as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2006] OJ L329/3 and further.

<sup>9</sup> BCBS Consultation document *Strengthening the resilience of the banking sector* of December 17, 2009 and BCBS consultative document *International framework for liquidity risk measurement, standards and monitoring* of December 17, 2009, published on [www.bis.org](http://www.bis.org) [Accessed November 20, 2011].

introduction of the Basel III accord on the financial markets. The conduct of this BCBSQIS and the refining of the language of the Basel III accord took a further six months and in December 2010 the final text of Basel III was published in two main documents: "A global regulatory framework for more resilient banks and banking systems" and "International framework for liquidity risk measurement, standards and monitoring."<sup>10</sup> Some technical amendments have been made to the former, and the final comprehensive version of the document was published on June 1, 2011. The latter document remains unchanged.

In an unprecedented effort to match the pace of global political developments relating to adjustments to capital requirements for banks, in 2010, the European Commission (EC) submitted an extensive range of consultation papers mirroring principles established by the BCBS. Two months after the December 2009 publication of the consultation documents for Basel III, the EC published a detailed consultation document setting out further changes to the CRD.<sup>11</sup> That document captures part of the legislative proposals that are together referred to as "CRD IV". The EC consultation period mentioned above ran in parallel with that of the Basel III consultation and closed in April 2010. More than 100 separate responses were received, predominantly from European industry participants. In addition to the publication of the consultation document for CRD IV, the EC also organised a separate quantitative impact study (ECQIS) assessing the potential impact of the new capital requirements on European banks. The results of ECQIS were published in December 2010 at the same time as the results of the study conducted by the BCBS.

Since 2008, the EC has also been working on certain additional topics that in its view should form part of the comprehensive changes to the CRD. Some of these topics are similar to the Basel III proposals made by the BCBS. Other topics are distinct from the Basel III proposals, albeit that they address recommendations that have been made by the BCBS in the past. CRD IV will introduce:

- further changes to the corporate governance regime of banks and investment firms. The first recommendations on the revision of corporate governance rules stem from the Communication of the EC dated March 4,

2009<sup>12</sup> in which the EC responded to the recommendations of the High Level Group chaired by Mr Jacques de Larosière. In June 2010, the EC published a Green Paper on corporate governance in financial institutions and remuneration policies.<sup>13</sup> In the public consultation following publication of the Green Paper, wide support for the establishment of a new framework on corporate governance was noted;

- new rules to address the overreliance on ratings issued by credit rating agencies. The new provisions are the EC's response to the recommendations of the Financial Stability Board<sup>14</sup>;
- a harmonised body of laws on sanctioning regimes applicable to the financial sector, by introducing a common set of sanctions to be applied by the relevant authorities in each Member State. Such new rules follow the EC Communication issued in December 2010.<sup>15</sup> In addition to introducing new rules for banks and investment firms through the adoption of CRD IV legislation, it is likely that similar new rules will be introduced shortly in other sectors of the financial markets (e.g. insurers, collective investment schemes).

This article outlines the framework of Europe's new CRD legislation and looks at where Europe's approach diverges from the Basel III accord.

### **Splitting the CRD into the CRD Regulation and CRD Directive: towards a single rulebook for Europe**

In proposals published on July 20, 2011, the EC introduced the text of two European legislative instruments:

- a proposal for a "Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions

<sup>10</sup> In addition to the 2 main documents capturing the comprehensive and detailed provisions amending and supplementing the Basel II text, the BCBS also published a number of supporting documents that must be read in conjunction with the main body of language of Basel III. It concerns policy documents providing further guidance on the interpretation of the core principles. These documents are: the *Results of the comprehensive quantitative impact study and Guidance for national authorities operating the countercyclical capital buffer* (both published on December 16, 2010 together with the main documents), a *Consultative document on bank capitalisation against central counterparty exposures* (published on December 20, 2010), *Minimum requirements to ensure loss absorbency at the point of non-viability* (published on January 10, 2011) and a consultation document on *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (published on July 19, 2011).

<sup>11</sup> Commission services staff working document *Possible further changes to the Capital Requirements Directive*, published on February 26, 2010.

<sup>12</sup> European Commission Communication of March 4, 2009 COM(2009) 114 final, Preliminary EC assessment of the de Larosière report and EC contribution to the Spring European Council. Communication for the Spring European Council—*Driving European recovery*.

<sup>13</sup> COM(2010) 284 final. The recommendations of the EC are supported by the views of the European Parliament in the *Report on remuneration of directors of listed companies and remuneration policies in the financial services sector* (2010/2009 (INI) and by the Economic and Social Committee in the opinion *Corporate governance in financial institutions and remuneration policies*.

<sup>14</sup> *Principles for Reducing Reliance on CRA Ratings*, FSB, October 27, 2010.

<sup>15</sup> Communication from the Commission to the European Parliament, the Council, the European Economic And Social Committee and the Committee of the Regions, *Reinforcing sanctioning regimes in the financial services sector*, December 8, 2010, COM(2010) 716 final. The recommendations contained in the preparatory report follow from the observations made by de Larosière: "Supervision cannot be effective with weak, highly variant sanctioning regimes. It is essential that within the EU and elsewhere, all supervisors are able to deploy sanctioning regimes that are sufficiently convergent, strict, resulting in deterrence", High Level Group chaired by Mr Jacques de Larosière, report of February 25, 2009 para.201 and Recommendation 20 contained in the report.

- and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate"<sup>16</sup> (the CRD Directive); and
- a proposal for a "Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms"<sup>17</sup> (the CRD Regulation).

The CRD Directive and the CRD Regulation will replace Directive 2006/48 and Directive 2006/49 in their entirety. The most significant ramification of this being the nature of the legislative instruments that will be employed going forwards. With the implementation of CRD IV, the principal European rules on prudential supervision will be by way of regulation, rather than directive. This new legal framework will also result in major changes to the laws and regulations of all 27 EU Member States, as all of the language of the legislation adopting Directives 2006/48 and 2006/49 (that introduced Basel II to Europe) will (need to be) be removed and replaced by one single uniform text at the level of a European regulation.

The EC justifies such a drastic and complex changes as follows:

"While Member States will have to transpose the directive into national law, the regulation is directly applicable, which means that it creates law that takes immediate effect in all Member States in the same way as a national instrument, without any further action on the part of national authorities. This removes the major sources of national divergences (different interpretations, gold plating). It also makes the regulatory process faster and makes it easier to react to changed market conditions. It increases

transparency, as one rule as written in the regulation will apply across the single market. A regulation is subject to the same political decision making process as a directive at European level, ensuring full democratic control."<sup>18</sup>

One rationale for the development of a single rulebook is to pre-empt and prevent situations arising where significant parts of the banking sector escape harmonised European regulation. Such escapes have been labelled as the shift to the "shadow banking" sector, or the development of "regulatory arbitrage".<sup>19</sup>

These viewpoints are consistent with the observations made by the De Larosi re Group in its February 2009 report. Recommendation 20 Pt 1 of the Group outlined the need for further harmonisation of laws across Europe on the supervision of the financial markets.<sup>20</sup> The development of a single rulebook for banks and a top down approach at a centralised European level have, since the establishment of the European Banking Authority (EBA), been promoted repeatedly by the EBA's chairman Mr Andrea Enria.<sup>21</sup> The concept of a single rulebook is also supported by the European Parliament. From a political perspective, the creation of the CRD Regulation where the substance of the capital requirements and liquidity requirements are set out and the CRD Directive with far fewer rules than the current framework contained in Directives 2006/48 and 2006/49 is likely to receive wide support.

The following table is an overview of the topics now regulated by Directive 2006/48 or Directive 2006/49 and where the relevant provisions are set out in the CRD Directive and the CRD Regulation. The table shows the changes of both the CRD Directive and CRD Regulation, which we have taken from the separated overviews.<sup>22</sup> The table also shows which parts of the proposed CRD IV legislative project are completely new and therefore not regulated or are replacing existing (shorter) rules and regulations (and these are also marked in the table as "not regulated").

Table 1: Overview of topics regulated in new CRD framework

Topic	Place in current legislative framework	Place in new CRD Directive or CRD Regulation
Scope	Directive 2006/48 and Directive 2006/49	CRD Directive and CRD Regulation
Definitions	Directive 2006/48 and Directive 2006/49	CRD Directive and CRD Regulation
Competent authorities and cooperation	Directive 2006/48	CRD Directive
Market access and authorisation credit institutions	Directive 2006/48	CRD Directive

<sup>16</sup> COM(2011) 453 final transmitted to the European Council and to the European Parliament on July 25, 2011.

<sup>17</sup> COM(2011) 452 final transmitted to the European Council and to the European Parliament on July 25, 2011.

<sup>18</sup> From CRD IV, *Frequently Asked Questions*, July 20, 2011, Memo/11/527 p.7.

<sup>19</sup> See the comments of the EC: "Maximum harmonisation is necessary to achieve a truly single rule book. Inappropriate and uncoordinated stricter requirements in individual Member States might result in shifting the underlying exposures and risks to the shadow banking sector or from one EU Member State to another. Moreover, the impact assessments conducted by the Basel Committee and the European Commission are based on the specific capital ratios adopted. It is uncertain what the potential impact in terms of costs and growth would be in case of higher capital requirements in one or more Member States, potentially expanded through a 'race to the top' mechanism across the EU", *Explanatory Memorandum to the CRD Regulation* p.10.

<sup>20</sup> See: report of February 25, 2009 p.51.

<sup>21</sup> See for instance: the speech of Mr Enria on February 1, 2011 in the session of the ECON Committee of the European Parliament, downloadable from [www.eba.europa.eu](http://www.eba.europa.eu) [Accessed November 20, 2011].

<sup>22</sup> See for instance: CRD IV, *Frequently Asked Questions*, July 20, 2011, Memo/11/527 p.8.

Topic	Place in current legislative framework	Place in new CRD Directive or CRD Regulation
<i>Qualifying holdings in credit institutions</i>	Directive 2006/48	CRD Directive
<i>Initial capital of credit institutions</i>	Directive 2006/48	CRD Regulation
<i>Initial capital of investment firms</i>	Directive 2006/49	CRD Directive
<i>Application of stricter requirements by institutions</i>	Not regulated	CRD Regulation
<b>Level of application of requirements</b>		
<i>1. Derogation to the application of prudential supervision on an individual basis</i>	Directive 2006/48	CRD Regulation
<i>2. Derogation to the application of liquidity requirements on an individual basis</i>	Not regulated	CRD Regulation
<i>3. Individual consolidation method</i>		CRD Regulation
<i>4. Application of requirements on a consolidated basis</i>	Directive 2006/48 and Directive 2006/49	CRD Regulation
<i>5. Methods for prudential consolidation</i>	Directive 2006/48	CRD Regulation
<i>6. Scope of prudential consolidation</i>	Not regulated	CRD Regulation
<b>Own Funds</b>		
<i>1. Definitions specific to own funds</i>	Not regulated	CRD Regulation
<i>2. Elements of own funds</i>	Not regulated	CRD Regulation
<i>a. Tier 1 capital</i>	Not regulated	CRD Regulation
<i>b. Common Equity Tier 1 Capital</i>	Not regulated	CRD Regulation
<i>c. Deductions from Common Equity Tier 1 items</i>	Not regulated	CRD Regulation
<i>d. Common Equity Tier 1 Capital</i>	Not regulated	CRD Regulation
<i>e. Additional Tier 1 Capital</i>	Not regulated	CRD Regulation
<i>f. Additional Tier 1 items and instruments</i>	Not regulated	CRD Regulation
<i>g. Deductions from Additional Tier 1 items</i>	Not regulated	CRD Regulation
<i>h. Additional Tier 1 Capital</i>	Not regulated	CRD Regulation
<i>i. Tier 2 Capital</i>	Not regulated	CRD Regulation
<i>j. Tier 2 items and instruments</i>	Not regulated	CRD Regulation
<i>k. Deductions from Tier 2 items</i>	Not regulated	CRD Regulation
<i>l. Tier 2 Capital</i>	Not regulated	CRD Regulation
<i>m. Own Funds</i>	Not regulated	CRD Regulation
<i>n. General requirements</i>	Not regulated	CRD Regulation
<i>3. Minority interest and Additional Tier 1 and Tier 2 instruments issued by subsidiaries</i>	Not regulated	CRD Regulation
<i>4. Qualifying holdings outside the financial sector</i>	Not regulated	CRD Regulation
<b>Capital Requirements</b>		
<i>1. General requirements, valuation and reporting</i>		
<i>a. Required level of own funds</i>	Directive 2006/48	CRD Regulation
<i>b. Calculation and reporting requirements</i>	Directive 2006/48	CRD Regulation
<i>c. Trading book</i>	Directive 2006/48	CRD Regulation
<i>2. Capital requirements for credit risk</i>		
<i>a. General principles</i>	Directive 2006/48	CRD Regulation
<i>b. Standardised approach</i>	Directive 2006/48	CRD Regulation
<i>c. Internal Ratings Based Approach</i>	Directive 2006/48	CRD Regulation
<i>d. Credit Risk Mitigation</i>	Directive 2006/48	CRD Regulation
<i>e. Securitisation</i>	Directive 2006/48	CRD Regulation
<i>f. Counterparty credit risk</i>	Directive 2006/48	CRD Regulation
<i>3. Own funds requirements for operational risk</i>		

Topic	Place in current legislative framework	Place in new CRD Directive or CRD Regulation
<i>a. General principles governing the use of the different approaches</i>	Directive 2006/48	CRD Regulation
<i>b. Basic indicator approach</i>	Directive 2006/48	CRD Regulation
<i>c. Standardised approach</i>	Directive 2006/48	CRD Regulation
<i>d. Advanced measurement approaches</i>	Directive 2006/48	CRD Regulation
<b>4. Own funds requirements for market risk</b>		
<i>a. General provisions</i>	Directive 2006/49	CRD Regulation
<i>b. Own funds requirements for position risk</i>	Directive 2006/49	CRD Regulation
<i>c. Own funds requirements for foreign-exchange risk</i>	Directive 2006/49	CRD Regulation
<i>d. Own funds requirements for commodities risk</i>	Directive 2006/49	CRD Regulation
<i>e. Use of internal models to calculate own funds requirements</i>	Directive 2006/49	CRD Regulation
<i>f. Own funds requirements for settlement risk</i>	Directive 2006/49	CRD Regulation
<i>g. Own funds requirements for credit valuation adjustment risk</i>	Not regulated	CRD Regulation
<b>Large Exposures</b>	Directive 2006/48	CRD Regulation
<b>Exposures to transferred credit risk</b>		
<i>1. General provisions for this Part</i>	Directive 2006/48	CRD Regulation
<i>2. Requirements for investor institutions</i>	Directive 2006/48	CRD Regulation
<i>3. Requirements for sponsor and originator institutions</i>	Not regulated	CRD Regulation
<b>Liquidity</b>		
<i>1. Definitions and liquidity coverage requirement</i>	Not regulated	CRD Regulation
<i>2. Liquidity reporting</i>	Not regulated	CRD Regulation
<i>3. Reporting on stable funding</i>	Not regulated	CRD Regulation
<b>Leverage</b>	Not regulated	CRD Regulation
<b>Disclosure by institutions</b>		
<i>1. General principles</i>	Directive 2006/48	CRD Regulation
<i>2. Technical criteria on transparency and disclosure</i>	Directive 2006/48	CRD Regulation
<i>3. Qualifying requirements for the use of particular instruments or methodologies</i>	Directive 2006/48	CRD Regulation
<i>Delegated and Implementing Acts</i>	Directives 2006/48 and Directive 2006/49	CRD Regulation
<i>Freedom of establishment and freedom to provide services credit institutions</i>	Directive 2006/48	CRD Directive
<i>Prudential supervision</i>	Directive 2006/48	CRD Directive
<b>Review Process</b>		
<i>1. Internal Capital Adequacy Assessment Process</i>	Directive 2006/48	CRD Directive
<i>2. Procedures and internal control mechanisms</i>	Directive 2006/48	CRD Directive
<i>3. Oversight of remuneration policies</i>	Directive 2006/48	CRD Directive
<i>4. Treatment of risks</i>	Not regulated	CRD Directive
<i>5. Internal approaches for calculating own funds requirements</i>	Not regulated	CRD Directive
<i>6. Credit and counterparty risk</i>	Directive 2006/48	CRD Directive
<i>7. Residual risk</i>	Directive 2006/48	CRD Directive
<i>8. Concentration risk</i>	Directive 2006/48	CRD Directive
<i>9. Securitisation risk</i>	Directive 2006/48	CRD Directive
<i>10. Market risk</i>	Directive 2006/48 and Directive 2006/49	CRD Directive
<i>11. Interest risk arising from non-trading book activities</i>	Directive 2006/48	CRD Directive
<i>12. Operational risk</i>	Directive 2006/48	CRD Directive
<i>13. Liquidity risk</i>	Directive 2006/48	CRD Directive

Topic	Place in current legislative framework	Place in new CRD Directive or CRD Regulation
<i>14. Risk of excessive leverage</i>	Not regulated	CRD Directive
<b>Governance and remuneration</b>		
<i>1. Governance arrangements</i>	Not regulated	CRD Directive
<i>2. Management body</i>	Not regulated	CRD Directive
<i>3. Remuneration policies</i>	Directive 2006/48	CRD Directive
<i>4. Institutions that benefit from government intervention</i>	Directive 2006/48	CRD Directive
<i>5. Variable elements of remuneration</i>	Directive 2006/48	CRD Directive
<i>6. Remuneration Committee</i>	Directive 2006/48	CRD Directive
<b>Supervisory review and evaluation process</b>		
<i>1. Supervisory review and evaluation</i>	Directive 2006/48	CRD Directive
<i>2. Supervision of mixed financial holding companies</i>	Not regulated	CRD Directive
<i>3. Technical criteria of the supervisory review and evaluation</i>	Directive 2006/48	CRD Directive
<i>4. Application of supervisory measures to a type of institution</i>	Not regulated	CRD Directive
<i>5. Supervisory examination programme</i>	Not regulated	CRD Directive
<i>6. Supervisory stress testing</i>	Not regulated	CRD Directive
<i>7. On-going review of the permission to use internal approaches</i>	Not regulated	CRD Directive
<i>Supervisory Measures</i>	Directive 2006/48	CRD Directive
<i>Supervision on a consolidated basis</i>	Directive 2006/48	CRD Directive
<b>Capital buffers</b>		
<i>1. Definitions</i>	Not regulated	CRD Directive
<i>2. Requirement to maintain a Capital Conservation Buffer</i>	Not regulated	CRD Directive
<i>3. Requirement to maintain an institution specific countercyclical capital buffer</i>	Not regulated	CRD Directive
<i>4. ESRB guidance on setting countercyclical buffer rates</i>	Not regulated	CRD Directive
<i>5. Setting Countercyclical buffer rates</i>	Not regulated	CRD Directive
<i>6. Recognition of countercyclical buffer rates in excess of 2.5%</i>	Not regulated	CRD Directive
<i>7. ESRB recommendation on third country countercyclical buffer rates</i>	Not regulated	CRD Directive
<i>8. Decision by designated authorities on third country countercyclical buffer rates</i>	Not regulated	CRD Directive
<i>9. Calculation of Institution Specific Countercyclical Capital Buffer</i>	Not regulated	CRD Directive
<b>Capital Conservation Measures</b>		
<i>1. Restrictions on distributions</i>	Not regulated	CRD Directive
<i>2. Capital conservation plan</i>	Not regulated	CRD Directive
<i>Disclosure by competent authorities</i>	Directive 2006/48	CRD Directive
<i>Sanctions</i>	Not regulated	CRD Directive

In the remainder of this Pt 1 and in Pt 2 of this article, all of the new European capital requirements topics (marked “not regulated” in the table above) will be discussed in further depth. Topics that are already covered in the current CRD will not be discussed unless they are the subject of new proposals resulting in substantial change.

## New topics regulated in CRD IV

### General

As discussed, CRD IV will introduce new regulations for corporate governance, prevention of overreliance on credit ratings and sanctions. These new areas are not included in the Basel III accord or its underpinning documents. The three additional topics will be contained in new chapters of the CRD Directive. The proposed text of the Directive follows more or less the order of Directive 2006/48, albeit that a significant part of the current Title

V (Ch.2, *Technical Instruments of Prudential Supervision*) of that legal instrument has been moved to the CRD Regulation.<sup>23</sup> Also, some of the parts of Directive 2006/49 on the minimum own funds of investment firms have been moved to this new CRD Directive. What remains is a relatively compact document containing the following main areas of regulation:

Table 2: Structure of CRD Directive

	Subject matter of regulation
<i>Title I</i>	Subject matter, scope and definitions
<i>Title II</i>	Competent Authorities
<i>Title III</i>	Requirements for access to the activity of credit institutions
<i>Title IV</i>	Initial capital of investment firms
<i>Title V</i>	Provisions concerning the freedom of establishment and the freedom to provide services
<i>Title VI</i>	Relations with Third Countries
<i>Title VII</i>	Prudential supervision
<i>Title VIII</i>	Disclosure by competent authorities
<i>Title IX</i>	Delegated and implementing acts
<i>Title X</i>	Amendments of Directive 2002/87
<i>Title XI</i>	Transitional and final provisions

The CRD Directive will only have one annex which lists the activities (of credit institutions) subject to mutual recognition. This is the list that was originally developed when the home-state/host state supervision model for credit institutions with an establishment in Europe that wish to perform activities in one of the other Member States in Europe by means of establishment of a branch or by means of the provision of services<sup>24</sup> was introduced. The list has recently been expanded with the activity of “issuing electronic money,” in order to clarify that a licensed credit institution does not need to obtain a separate authorisation as an electronic money institution.

### Definitions in the CRD Directive

In art.4 of the CRD Directive explicit reference is made to the fact that the definitions of the CRD Regulation shall apply. If, when reading the CRD Directive, it is necessary to refer to the definitions contained in the CRD Regulation, the question arises as to how this will be dealt with in national legislation. The construction of the CRD legislative suggests that the definitions of the CRD Regulation form part of the single rulebook that will have direct application and that it will not need to be transposed

into or included in national laws. Repeating the CRD Regulation definitions in national laws implementing CRD IV would likely result in the inclusion of redundant language. Adopting variations of such definitions in national laws would result in conflicts with the single rulebook text as contained in the CRD Regulation, which suggests that the definitions currently incorporated in national laws implementing the current CRD should disappear together with provisions that will be included in the CRD Regulation.

The complicated technical construction of the CRD IV proposal may have a significant impact on the construction of national laws in the many Member States that have adopted a consolidated legislative framework for the financial markets addressing topics on a cross-sector basis. In such laws the definitions often cover a number of sectors of the financial markets. For instance, the definitions also address insurance businesses, investment firms subject to MiFID rules, insurance mediation businesses, payment institutions and other financial (advisory) firms. There are also instances where laws provide for a common apparatus for the supplementary supervision of groups of insurers, consolidated supervision of banks and investment firms and supervision of financial conglomerates. Elsewhere, combinations are often made to address topics that are subject to common regulation for the various sectors, for instance supervision of holdings, increase or acquisition of qualifying holdings in banks, insurance companies and investment firms.<sup>25</sup> The definitions in national laws often contains joint definitions for such common themes, for instance by providing a common definition for “qualifying holding” which is applicable whether the entity it relates to is a bank, an insurance company or an investment firm.<sup>26</sup>

The change in approach may result in the need to split some national legislation or to add (duplicating) provisions to existing laws. This could result in lengthy definitions to address the fact that a defined terms as regards “banks” must be read taking into account the CRD Regulation definition and for all other regulated businesses the same expression is defined using the national law concepts. The definitions in the new CRD framework illustrate that by opting for a single rulebook, the CRD Regulation may result in unforeseen significant consequences for the technical legislative framework in many European jurisdictions. It also demonstrates the far reaching impact of this political choice.

<sup>23</sup> This Chapter of Directive 2006/48 together with Annexes II up to and including X contain the detailed rules and regulations and formulas for the calculation of credit risk, market risk and operational risk.

<sup>24</sup> Introduced in Europe by means of Directive 89/646 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780 [1989] OJ L311/42.

<sup>25</sup> Pursuant to the implementation in the national laws in Europe of Directive 2007/44 amending Council Directive 92/49 and Directives 2002/83, 2004/39, 2005/68 and 2006/48 as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector [2007] OJ L247/1.

<sup>26</sup> See for instance: the rules and regulations in Pt XII (Control over authorised persons) of the Financial Services and Markets Act 2000 of the UK that refrains from referring to the specific types of regulated businesses but generally speaks of “authorised persons”. The definition apparatus of this law has integrated the various rules and regulations for the various entities into one single common denominator definition apparatus. See also the regulations in Sweden in which an integrated approach can be observed from the relevant guidance regulations issued by the Swedish authority (Finansinspektionen’s regulations regarding ownership and management assessment, decided on October 7, 2009, FFFS 2009:3, published on October 14, 2009). See furthermore the definition of “qualifying holding” in art.1:1 of the Dutch Act on Financial Supervision that applies for all institutions for which supervision is exercised for the holding, increasing or acquiring of qualifying holdings.

CRD IV introduces a number of new definitions. The first is for “ancillary service undertakings”, used where a national supervisory authority makes enquiries of other national supervisors regarding businesses that provide for support (ancillary) services to credit institutions (for instance a shared service centre providing property management services). The second is for “risk of excessive leverage”, used in connection with a new aspect of risk management (which is discussed in more detail later in this article). The third is for “internal approaches”, used to address the increased scrutiny by authorities on the internal approaches taken by banks when calculating capital adequacy against the risks identified in the internal capital adequacy assessment process (ICAAP).

## Review process

### General

One of the most significant innovations of the CRD Directive is the expanded framework for the internal organisation of credit institutions and investment firms. Internal organisation is the administration of the institution, the scope, organisation and application of internal risk management procedures, corporate governance and the organisation of the risk management function, the ICAAP, the manner in which the institutions’ management considers risks and translates these to required levels of own funds and remuneration of executive officers within the institution. All these topics have now been grouped together in Ch.2 (Review Process) of Title VII (Prudential Supervision). Chapter 2 contains parts of the provisions of the current Directive 2006/48 but most importantly has moved the provisions that are currently contained in annexes to Directive 2006/48 (including the revisions to Annex V to the current CRD Directive addressing remuneration policies and governance as a result of the CRD III<sup>27</sup>) to the body text of the CRD Directive.

Chapter 2 of Title VII of the CRD Directive has also significantly expanded and consolidated the language of the current provisions on the organisation of internal risk management processes that thus far have been regulated in various parts of Directive 2006/48 to address specific processes for which proper risk management must be organised. The general risk management standards that are set out in art.22 and Annex V are supplemented with various provisions on specific risk management processes. For instance, banks applying risk mitigation as regards credit risk in the banking book are subject to the following provision of Annex VII (Credit Risk Mitigation) Pt 2 point 1 of Directive 2006/48:

“The credit institution must satisfy the competent authorities that it has adequate risk management processes to control those risks to which the credit institution may be exposed as a result of carrying out credit risk mitigation practices.”

Similar provisions on risk management can be found scattered throughout Directive 2006/48 and Directive 2006/49 addressing pillar 1 qualitative requirements for the organisation of risk management, for instance when applying internal models for the appraisal of collateral, for the use of volatility estimates in risk managing the use of financial collateral, when applying the “internal assessment approach” for positions in ABCP programmes, for the application of the standardised approach for operational risk and for the fulfilment of the disclosure requirements of pillar 2.

## Treatment of risks and independent risk committee

The language of the current art.22 and the whole of Annex V of Directive 2006/48 has been moved to the comprehensive Ch.2 of Title VII of the CRD Directive addressing the “Technical criteria concerning the organisation and treatment of risks”. The language of the current legislation has been expanded by concrete paragraphs on the organisation of an independent risk oversight function in the form of a separate risk committee of the non-executive board of the credit institution or investment firm. The requirements of this risk committee are contained in art.75 (Treatment of Risks) and can be summarised as follows:

Table 3: Organisation of the Risk Committee of the non-executive function

Subject matter	Requirement for which function of the institution
1. Devoting sufficient time to consideration of risk issues	Non-executive management (board)
2. Establishing risk committee	Non-executive management (board)
3. Possessing appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the institution	Risk committee
4. Advising the whole non-executive function on overall current and future risk appetite and strategy	Risk committee
5. Assisting in implementing risk strategy	Risk committee
6. Implementing risk strategy	Non-executive management (board)
7. Communicating regularly with risk management function of the institution	Risk committee
8. Accessing external expert advice	Risk committee

<sup>27</sup> Directive 2010/76 amending Directives 2006/48 and 2006/49 as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ L329/3.

Subject matter	Requirement for which function of the institution
9. Determinating the nature, the amount, the format, and the frequency of the information on risk it shall receive from senior management	Risk committee

The establishment of a separate risk committee shall not be required “taking into account the nature, scale and complexity of a credit institution’s activities.”<sup>28</sup> This means that no committee will be necessary for smaller institutions or institutions with a homogenous product portfolio with limited risks. It is noteworthy that the language of art.75 para.3 CRD Directive only suggests that competent authorities may allow credit institutions to refrain from establishing a separate risk committee; there is no mention of investment firms. The question arises whether this rule may also be extended to smaller investment firms or investment firms with a non-complex product or service portfolio. It is possible that this is an error in the draft CRD Directive that will be corrected in due course.

New provisions are included in art.75 CRD Directive covering the organisation of institutions’ risk management function. The need for risk management functions to be independent from operational and other management functions is emphasised. The independence should, among other factors, be realised by the ability of the risk management function to have a direct reporting line (independent from executive managers) to the oversight board or non-executive function of an institution. Furthermore, risk management must have sufficient “authority, stature, resources and access to the management body” and this function should be headed by an independent senior executive officer. This suggests that the end responsibility for risk management may not be borne by one of the executive officers that also has responsibility for other areas, such as the finance, accounting, commercial or operational functions within the institution. The independence requirement of risk management end responsible officer should be confirmed by internal governance arrangements that require approval of the non-executive board for dismissal or suspension of the activities of the risk management officer.

The risk management function should “be able to deliver a complete view of the whole range of risks of the institution.” This requirement makes clear that the risk management function must be organised in such a way that all of the various methods applied must be integrated into one single approach and that there should be a system in place that deals with all risks taking into account dependencies and correlating factors.

The EC explains this further emphasis on the internal organisation of the internal and independent risk committee and risk management function as follows:

“In order to have an effective risk oversight and control, the management body should be responsible and accountable for the overall risk strategy of the credit institution or investment firm and for the adequacy of the risk management systems, taking into account the credit institution’s risk profile. Given the importance of sound risk management in credit institutions, the management body in its supervisory function should set up a separate risk committee to deal specifically with risk issues and prepare management body decisions on risk issues. The risk committee should assist the management body in its risk oversight role but the management body should remain finally accountable for risk strategy.

In order to provide a complete view on risk to senior management and to the management body, credit institutions and investment firms should have an independent risk management function which should be able to form an effective and holistic view of the whole range of risks in a credit institution. Risk management function should possess sufficient stature and authority to influence strategic risk-management decisions and have direct access to the management body.”<sup>29</sup>

Typically, these changes to the current language of Directive 2006/48 confirm a further involvement of the policy makers and authorities in shaping corporate governance and remuneration of and by regulated banks and investment firms. They are largely consistent with the detailed guidance provided by the BCBS in October 2010.<sup>30</sup> The CRD Directive provisions on corporate governance and remuneration are a result of the preparations made by the EC in its Green Paper on corporate governance in financial institutions and remuneration policies discussed in the introduction to this Pt 1 of this article. Europe’s first concrete binding legislation was adopted with the introduction at the end of 2010 of the rules on remuneration of executives of banks and investment firms by means of the provisions of CRD III. As regards the requirements of the internal organisation of institutions those CRD III provisions are now contained in the body of the CRD Directive, namely arts 88 up to and including 91 CRD Directive. Other provisions of the CRD Directive deal with the oversight to be exercised by the competent authorities (discussed in more detail below).

In many European jurisdictions rules comparable to the provision of art.75 CRD Directive have already been introduced in national laws.<sup>31</sup> They often supplement the

<sup>28</sup> See: art.75 para.3, last sentence CRD Directive.

<sup>29</sup> Paragraph 5.3 (Corporate Governance) of the *Explanatory Memorandum to the CRD Directive* p.11.

<sup>30</sup> BCBS *Principles for Enhancing Corporate Governance*, October 2010, available from <http://www.bis.org> [Accessed November 20, 2011].

<sup>31</sup> See for instance for the United Kingdom: the FSA’s Policy Statement 10/15 of September 2010 *Effective corporate Governance—Significant influence controlled functions and the Walker Review*; for Germany: BAFIN Circular 4/2010 (WA)—*Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency pursuant to ss.31 of the Securities Trading Act (Wertpapierhandelsgesetz—WpHG) for Investment Services Enterprises and*

corporate governance arrangements in place for listed companies.<sup>32</sup> For instance, for listed companies mandatory establishment of separate audit committees of the non-executive oversight function is often a common element of governance frameworks. The organisation of corporate governance within regulated banks is therefore in most instances based on the combination of requirements of generic corporate law and of banking regulation. Upon the CRD Directive being implemented in Europe a harmonised model for the organisation of the governance within listed banks and investment firms will exist.

The risk commerce and the remuneration committee of the non-executive function/board of a bank or investment firm has oversight of the risk management and executive performance and remuneration functions of their institution. This organisational approach follows from the mandatory regulations on supervision for such institutions. How the audit committee is or other oversight bodies are organised is dependent on national (corporate) laws on corporate governance with (listed) legal entities. Finally, it is noteworthy that the BCBS suggested in its October 2010 report on enforcement of corporate governance that, apart from establishing separate and independent risk management function, similar independent functions should be organised for the compliance and internal audit departments within banks. Whether the provisions of the CRD Directive impose this requirement on banks or investment firms and whether they are subject to such organisational requirements will depend on national laws.

## Governance arrangements and management bodies

In addition to the provisions on establishing independent risk committees and the risk management function, the CRD Directive also introduces additional and comprehensive provisions on the organisation of governance and the management body of banks and investment firms. These provisions are contained in art.86 and 87 CRD Directive.

In order to ensure “effective and prudent management of an institution, including segregation of duties in the organisation and prevention of conflicts of interest” the following principles must be met in accordance with art.86 para.1 of the CRD Directive:

- the management body shall have the overall responsibility for the institution, including approving and overseeing the

implementation of the institution’s strategic objectives, risk strategy and internal governance;

- the management body shall be responsible for providing effective oversight of senior management;
- the chairman of the management body of an institution shall not exercise simultaneously the functions of a chief executive officer within the same institution, unless justified and authorised by competent authorities.

Monitoring and periodic assessment of these principles being met must be embedded in the oversight exercised by the management body of institutions and they should properly follow-up in case of conflict or breaches of the principles. Furthermore, art.86 CRD Directive prescribes detailed rules on the organisation of appointments, monitoring of the fit and properness of candidates and other organisational features of the management body.

The provisions of art.87 CRD Directive provide for (very) detailed rules on the requirements on individual members of the management body for them to meet the required standards of good reputation, knowledge, skills and experience and commitment of sufficient time to perform their duties. Among other requirements, this provision prescribes the limits of the number of executive and non-executive functions that members of the management board may hold in order to ensure that they are able to devote sufficient time in performing their function with the regulated institution.

All of the requirements set out in arts 86 and 87 CRD Directive are more or less equivalent to principles of corporate governance regimes introduced for listed companies as they are based on the OECD principles for good governance of April 2004. In many instances, banks and investment firms in Europe that have a listing will already have organised their internal management structures in a manner that meets the new requirements of the CRD Directive. Also, some Member States have introduced those principles as part of their domestic laws on supervision of banks and investment firms, even if these institutions are not listed on regulated markets.

Nevertheless, it may be concluded that these provisions will introduce further detailed requirements in many instances impacting the (corporate) organisation of banks and investment firms. For instance, a complete new element of the CRD Directive relates to the topic of the diversity of composition of the management board, as part of the EC policy to promote the appointment of more women in the management bodies of regulated entities.<sup>33</sup>

Circular 15/2009: *Minimum Requirements for Risk Management for banks*; and for the Netherlands the recommendations of the Committee chaired by Mr. Maas in the report *Restoring Trust: the report of the Advisory Committee on the Future of Banks in the Netherlands (Maas Committee)* of April 2009 and the self-regulation agreed by the banking industry set forth in the Banking Code adopted in September 2009.

<sup>32</sup> Those corporate law regimes follow often from the OECD guidance developed in the last decades and the most recent version of which are laid down in OECD Principles of Corporate Governance, revised April 2004.

<sup>33</sup> See the following comment of the European Commission in the *Explanatory Memorandum to the proposal for the CRD Directive* (para.1.4 p.5): “The Commission has launched a horizontal initiative to encourage industry to increase the representation of women on boards, that after one year it will assess whether self-regulatory initiatives have had the desired effect and if not it will consider legislative approaches. Given that the impact assessment shows that this issue is pertinent for the banking sector, the approach taken at this stage is consistent with a bottom up approach. However, if the wider evaluation in one year finds that there is a need to legislate, then the approach taken in this sector will need to be adapted.”

The exact detail of the requirements will only be known after the publication of the regulatory technical standards by the EBA on the various topics listed in para.5 of art.87 CRD Directive. These (binding) technical standards will be available by December 31, 2015 and should cover the following items:

Table 4: Corporate governance topics subject to issue of technical standards from the EBA

Subject matter	Basis in art.87 CRD Directive
(a) The notion of sufficient time commitment of a member of the management body to perform his functions	Paragraph 1(a)
(b) The notion of adequate collective knowledge, skills and experience	Paragraph 1(b)
(c) The notions of honesty, integrity and independence of mind	Paragraph 1(c)
(d) The notion of adequate human and financial resources devoted to the induction and training of members of the management body	Paragraph 2
(e) The notion of diversity to be taken into account for the selection of members of the management body	Paragraph 3

The Commission has chosen to draft the relevant principles of good governance and the organisation of the management board taking a one-tiered management board as model for drafting the relevant organisational rules. Clearly, the provisions of arts 86 and 87 CRD Directive will need to be adapted to the prevailing corporate organisation models in jurisdictions that have a two-tiered organisation model for the management of companies. In these two-tiered models the executive and non-executive function are contained in separate corporate bodies. Jurisdictions that will be required to further adapt the provisions of arts 86 and 87 CRD Directive to their domestic corporate law include Germany, France or Luxembourg (if a bank or investment firm is organised as a *société anonyme* with a separate supervisory board) and the Netherlands.

### Internal approaches for calculating own funds requirements for exposures that are material in absolute terms

An additional measure of risk management is introduced in art.76 CRD Directive concerning the application of internal ratings based approaches for the calculation of own funds requirements for credit risk for exposures that are “material in absolute terms.” Furthermore an internal model is to be developed by banks and investment firms for the calculation of own funds requirements for specific risk of debt instruments in the trading book, together with internal models for default and migration risks in case the exposures to debt instruments are material in absolute terms and these exposures are vis-à-vis a large number of material positions in debt instruments of different issuers.

These requirements do not follow from the language of the Basel III accord as regards capital requirements and they also do not relate to the new regime for liquidity management. In its nature this provision of the CRD Directive seems to be an additional measure introduced at European level only. The background to this provision has not so far been clearly explained in the various documents published by the EC.

The provision of art.76 CRD Directive imposes two separate requirements on all banks and investment firms as regards the holding of positions in debt instruments, both addressing capital adequacy for the credit risk as well as for market risk. The requirements are outlined in the first two paragraphs of this new art.76 as follows:

- “1. Competent authorities shall ensure that institutions take appropriate steps to develop internal ratings based approaches for calculating own funds requirements for credit risk where their exposures are material in absolute terms and where they have at the same time a large number of material counterparties.
2. Competent authorities shall ensure that institutions take appropriate steps to develop and use internal models for calculating own funds requirements for specific risk of debt instruments in the trading book, together with internal models to calculate own funds requirements for default and migration risk where their exposures to specific risk are material in absolute terms and where they have a large number of material positions in debt instruments of different issuers.”

The exact meaning of “exposures which are material in absolute terms” and the thresholds for large numbers of material counterparties and positions in debt instruments of different issuers will be clarified in technical standards to be developed by the EBA and published by January 1, 2014.

The language of the proposed art.76 CRD Directive is puzzling from a number of perspectives. First, the provision suggests that banks and investment firms will be subject to capital requirements for certain risks related to positions in debt instruments that seem to be additional to the capital requirements framework set out in the CRD Regulation. The place for including this provision in the CRD Directive is, therefore, not clear, consistent or logical.

The requirement also suggests that all banks, whether they maintain internal ratings based approaches for the calculation of risk weights for positions or whether they apply the standardised method should put in place an internal ratings based approach for this particular risk. A similar comment may be made as regards the calculation of the exposure value for market risk concerning the relevant debt instruments. The way this provision is

drafted, ignores the fact that some institutions may not have any market risk models in place, absent the maintenance of a trading book in the business.

Finally, this provision seems to address the subject matter of “large exposures” and concentration risk for which a separate regulation is contained in the CRD Regulation. It is not clear how this provision relates to the large exposure rules of the CRD Regulation.

It will, therefore, be of the utmost importance that the EC further clarifies its intentions with respect to the provisions of art.76 CRD Directive in order for the market to properly understand the correlation with other risk management provisions, own funds requirements and the need for changes to the qualitative environments of institutions. This is particularly relevant for all institutions that, thus far, do not apply internal ratings based approaches for the calculation of credit risk exposures and/or do not apply comprehensive models for the calculation of market risk.

## Risk of excessive leverage

Article 85 CRD Directive is another provision relating to the required risk management procedures addressing the contingencies that may arise when an institution is building up excessive leverage. In art.4 CRD Directive, the expression “risk of excessive leverage” is defined as follows:

“means the risk resulting from an institution’s vulnerability due to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets.”

Article 85 prescribes that institutions must have policies and procedures in place for the “identification, management and monitoring of the risk of excessive leverage.” One of the ways to monitor leverage is by reference to the leverage ratio that banks and investment firms will be obliged to maintain once the provisions of art.416 of the CRD Regulation (see the further paragraphs below for a discussion of this topic) have entered into force. Another indicator of excessive leverage, according to the provision of art.85 CRD Directive, is constituted by the “mismatch between assets and liabilities.”

The key obligation for institutions in addressing the risk of excessive leverage is formulated in para.2 of art.85 CRD Directive. This provision imposes on the institution that it:

“shall be able to withstand a range of different stress events with respect to the risk of excessive leverage.”

The precautionary measures that institutions must take into account are limited in art.85 CRD Directive to the reduction of own funds of the institutions as a result of expected or realised losses.<sup>34</sup> When reading this provision in combination with the definition of “risk of excessive leverage” a number of important questions arise.

It should be borne in mind that all of the provisions of this Directive, with the exception of the provisions on capital buffers (see Pt 2 of this article), need to be transposed into Member States’ national laws by January 1, 2013. This means that there will be no transitional provision applicable in respect of art.85 CRD Directive on the (measurement of) risk of excessive leverage. One of the ways to measure whether leverage is excessive or not is to be based, according to art.85 para.1 CRD Directive, on the leverage ratio of art.416 CRD Regulation. The requirements on the preparation of calculations as regards the leverage ratio will only apply as from January 1, 2015. Therefore, there is a mismatch between the ability of an institution to apply an indicator for the measurement of the risk of excessive leverage and the requirement to make the measurements as required by art.85 CRD Directive.<sup>35</sup>

Secondly, when reading the various parts of art.85 CRD Directive and the definition of the “risk of excessive leverage” the language seems somewhat vague in places. If the definition of risk of excessive leverage—which in itself is very broad—is applied in the body text of art.85 CRD Directive it seems that there is an intrinsic conflict in the subject matter of regulation. The definition of “risk of excessive leverage” suggests an exposure by the institution to sudden events, to unexpected developments in the (external) markets that also have an impact on the business of the institution. Paragraph 2 of art.85 CRD Directive, however, speaks of decrease of own funds as a result of expected losses or realised losses as a factor contributing to a decrease of own funds and therefore a potential treat that the “leverage ratio” will no longer be met. A close reading of these provisions indicates that the legislator has struggled with the concepts of unexpected and expected developments that may impact or influence the financial soundness of an institution if the soundness is measured by the ability to meet the leverage ratio.

Unlike many other provisions of the CRD Directive and CRD Regulation, this provision does not (directly) provide for the possibility that EBA will provide further guidance to the markets by issuing technical standards. We recommend that the EBA be given the option to deliver such guidance, particularly on the following:

<sup>34</sup> Expected or realised losses being as such also qualified in art.85 CRD Directive to the application of accounting rules, which may in some instances therefore mean that banks may need to provision for expected losses in an earlier stage than a bank subject to different accounting rules where losses need only be provisioned on the realisation thereof.

<sup>35</sup> In addition to this, we observe that in art.483 CRD Regulation it is provided that the EBA shall, no later than October 31, 2006, report to the European Commission whether the (i) risk management measures taken by institutions on the basis of article 85 CRD Directive ensure sound management of the risk of excessive leverage and (ii) whether the calculation methodology for the leverage ratio is adequate so as to ensure that the leverage ratio is an appropriate indicator for the building up of excessive risk. It seems that the whole regime and that different dates of entry into force of provisions are not properly aligned.

Table 5: Interpretation of art.85 CRD Directive

Article 85 CRD Directive, expressions requiring further guidance
1. Mismatches between assets and obligations
2. Potential increases in the risk of excessive leverage caused by reductions of the institution's own funds
3. To withstand a range of different stress events

As regards the expression listed at point 1 of table 5, the lack of clarity is about the proportion of mismatches between assets and obligations. There will always be mismatches in a banking institution (e.g. temporary mismatches as a result of differences in the duration of assets and liabilities). As regards the expression listed at point 2 of table 5, there should be a measure of the proportion of permitted decreases of own funds and decreases that pass the threshold requiring additional funding or assets sale from a regulatory perspective. For the expression at point 3 of table 5 we suggest that this language be reconsidered and made more concrete. In order for institutions to be able to properly comply with this provision, further clarifications is necessary in our view.

### Supervisory review and evaluation process

#### General

Since the introduction in 2006 in Europe of the three pillar model for supervision on capital adequacy of banks (and investment firms) based on the framework of Basel II, a number of changes have been processed in the provisions of European law in respect of the pillar 2 framework, being the ICAAP and supervisory review and evaluation process (SREP). These additions addressed the need for inclusion in the ICAAP and the SREP the adequacy of measures, procedures and quantity of liquidity held by the relevant institutions. This resulted, in particular, to the revision of Annex V of Directive 2006/48 (*Technical Criteria Concerning The Organisation And Treatment Of Risks*) in which CRD II introduced a para.10 (Liquidity Risk) that now includes a new and comprehensive list of technical criteria that need to be comprised in the ICAAP performed by institutions. CRD III introduced para.11 (Remuneration Policies) to the same Annex V giving detailed rules on remuneration policies and practices to be developed by institutions and the accountability of implementation thereof towards the supervisory authorities. As with other provisions contained in the Annexes to Directives 2006/48 and 2006/49, these important parts of the Annexes to the Directives have now been "promoted" to the body text of the CRD Directive.

Basel II contains extensive and detailed guidance on the organisation of the ICAAP and the SREP, the objectives of these processes and roles of the parties concerned. Also, Basel II contains quite detailed language as to the "toolkit" that supervisory authorities could apply when exercising the roles and responsibilities in the SREP. Basel II is embedded in a framework of policies, recommendations and conclusions derived from "field research" performed by BCBS over the last decades giving further guidance on the methods, objectives and organisation of supervision of regulated banks.<sup>36</sup> So far, European law has not had this level of detail on this subject matter and it was therefore more or less a matter of self-regulation how supervisory authorities in the various Member States exercised their duties in connection with application of the SREP. In practice, many differences in approaches and levels in scrutiny could be observed throughout Europe. Convergence of supervisory practices is one of the objectives of the new CRD Directive. This has resulted in the introduction of a number of completely new provisions which are discussed in more detail below.

### Identification and monitoring systemically important institutions

Article 92 CRD Directive is in most respects identical to the current provision of art.124 Directive 2006/48. This article establishes the core authority for the performance of the SREP by the relevant national authorities. The text of the current art.124 is supplemented, however, with a new provision on the review of:

"the risks that an institution poses to the financial system taking into account the identification of systemic risk under Article 23 of Regulation (EU) No 1093/2010."

In this provision reference is made to the Regulation of November 24, 2010 establishing the EBA (EBA Regulation). The EBA has, pursuant to art.23 of the EBA Regulation, the obligation to develop criteria for the identification and measurement of systemic risk and to develop a stress testing regime. This regime is intended to monitor the development of systemic risk in situations of stress posed by certain financial institutions that are considered as "systemically important".<sup>37</sup> The international authorities have established further reports on the definition of what constitutes a "systemically important institution" in order to develop objective criteria for the selection of those institutions and internal groups of regulated entities that are considered systemically important. In particular, the work of the Financial Stability Board published early October 2011 as a preparation for

<sup>36</sup> The most important reports being: *Core Principles for Effective Banking Supervision*, BCBS (September 1997 and October 2006), and *Core Principles Methodology*, BCBS (October 1999 and October 2006).

<sup>37</sup> See: the full provision of art.23 of Regulation 1093/2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision 716/2009 and repealing Commission Decision 2009/78 [2010] OJ L331/12.

the policy decisions to be taken in the G20 summit of November 3–4, 2011<sup>38</sup> forms an important basis for a global definition. This definition is a first step in identifying those institutions in Europe that will be subject to intensified and extended supervisory review.

Article 92 CRD Directive establishes the authority of national supervisors to perform the additional oversight of systemically important institutions where the main place of establishment is in their jurisdiction. This article completes the network of provisions set out in the EBA Regulation and the regulation establishing the European Systemic Risk Board<sup>39</sup> (ESRB Regulation). This additional and new dimension of the task of the national supervisory authorities is embedded in the larger and comprehensive framework of supervisory oversight on systemically important institutions constituted in recent years in response to the lessons learnt from the financial crisis. The outcome of the review performed by national authorities based on art.92 para.1 CRD Directive is related to the authorities contained in para.3 of the same article where the following provision is set out:

“On the basis of the review and evaluation referred to in paragraph 1, the competent authorities shall determine whether the arrangements, strategies, processes and mechanisms implemented by the institutions and the own funds held by these ensure a sound management and coverage of their risks.”

Should it appear that, as a result of the SREP of a systemically important institution, that the own funds held by such an institution are deemed to be too low, the national supervisory authority concerned may give binding directions to that institution to increase the level of its own funds or to take other measures based on the provision of art.100 CRD Directive. The relevant definition of what constitutes a sufficient level of own funds for systemically important institutions is not contained in the CRD Directive nor will it at the outset be set out in the text of the CRD Regulation. The political accord on the exact numbers of additional capital charges for systemically important institutions is, at the time this article was prepared, still underway.<sup>40</sup>

## Supervisory examination programme

Article 96 CRD Directive contains detailed provisions regarding the manner in which national supervisory authorities have to establish supervisory examination programmes. The level of detail of this provision is new for the European framework on supervision of regulated entities and indicates the wish of the EC to ensure that there are minimal deviations in supervisory practice across Europe.

National supervisory authorities are required to develop an examination programme mandating examinations on at least an annual basis. This programme must include the planning of resources devoted to the supervision of entities established in their own jurisdiction and indicate which institutions will be subject to enhanced supervision. The CRD Directive requires authorities to conduct on-site inspections of institutions in their jurisdictions and also into an institution's subsidiaries and branches in other European jurisdictions.

As regards the scope of the examination programme, this new provision of the CRD Directive reflects the desire of policymakers which has been expressed numerous times over the last 2–3 years, that authorities must pay particular attention to systemically important institutions. Furthermore, this provision also emphasises the need to develop different levels of scrutiny in supervisory practice. It confirms that intensified supervision for institutions must be applied if, based on the outcome of stress tests or the outcome of the SREP, such institutions:

“indicate significant risks to their on-going financial soundness or indicate breaches of the requirements of this Directive and Regulation.”<sup>41</sup>

This language suggests that supervisory authorities will tailor their approach to supervision by classifying institutions into those which need intensive treatment and those that do not need to be so closely supervised. Determining which institutions fall into which category will be one of the most aspects of this provision. Typically, the classification of institutions as “problematic” is not information that can be shared with the public as there is a risk that depositors or clients lose trust in the institution.

Article 96 CRD Directive also specifies which measures supervisory authorities must take in order to align the examination programme with the output of information on individual institutions retrieved from the SREP, stress tests or other manners of collecting information. Following completion of the SREP, pursuant to art.96 para.3 CRD Directive, supervisory authorities must take one or more of the following measures, when it is deemed appropriate:

- “(a) An increase in the number or frequency of on-site inspections of the institution;
- (b) A permanent presence of the competent authority at the institution;
- (c) Additional or more frequent reporting by the institution;
- (d) Additional or more frequent review of the operational, strategic or business plans of the institution;

<sup>38</sup> Financial Stability Board, *Understanding Financial Linkages: A Common Data Template for Global Systemically Important Banks*, Consultation Paper, October 6, 2011 and Financial Stability Board, *Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks*, October 10, 2011, both documents to be consulted at [www.financialstabilityboard.org](http://www.financialstabilityboard.org) [Accessed November 20, 2011].

<sup>39</sup> Regulation (1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1.

<sup>40</sup> See for a discussion on the establishment of the macro prudential supervision and the role of the ESRB: Bart P. M. Joosen, “The limitations of regulating macro-prudential supervision in Europe” [2010] J.I.B.L.R. Issue 10, 493–501.

<sup>41</sup> Article 96 para.2(a) CRD Directive.

- (e) Thematic examinations monitoring specific risks that are likely to materialise.”

European authorities will need to carefully consider the combined application of the various parts of the examination programme in order to avoid turbulence in the markets and unintended stress by individual institutions. Europe’s policymakers are keen to have a harmonised supervisory practice throughout Europe and also want authorities to take a firmer approach when supervising institutions. But the combination of the various elements of the supervisory examination programme may also result in risks. The examination programme should lead to the development of a list of systemically important institutions, “problematic institutions” and all those institutions for which the authorities consider intensified supervision appropriate. Once this information on individual institutions is developed, specific measures should be considered. Most, if not all of the specific measures (listed above) have an associated risk of confidential information getting into the public domain. For example, if a supervisory authority intensifies on-site inspections at an institution and that institution is not deemed to be “systemically important”, third parties may draw the conclusion that the institution is “problematic”.

The application of the enhanced supervision and the measures as listed here above cannot be avoided obviously, but with the implementation of the CRD Directive in national laws of Member States, it should certainly be considered how the introduction of this enhanced system of supervision fits into the duties of authorities to keep information on individual institutions secret. This is certainly relevant in current climate, where many politicians disagree with regulatory agencies on the need to keep certain information relating to institutions confidential.

### *Supervisory stress testing*

Based on art.32 para.2 of the EBA Regulation, the EBA shall “initiate and coordinate Union-wide assessments of the resilience of financial institutions to adverse market developments.” The EBA shall make available to the national authorities:

- “(a) common methodologies for assessing the effect of economic scenarios on an institution’s financial position;
- (b) common approaches to communication on the outcomes of these assessments of the resilience of financial institutions;

- (c) common methodologies for assessing the effect of particular products or distribution processes on an institution’s financial position and on depositors, investors and customer information.”

These measures reflect recent practice whereby European authorities have conducted industry wide stress tests to measure which institutions pose an increased risk to the system and for which specific measures must be developed to address the risk. Industry wide stress tests were carried out at a European level in 2009,<sup>42</sup> 2010<sup>43</sup> and 2011.<sup>44</sup> The provisions of the EBA Regulation on Europe-wide stress testing are supplemented with provisions in the CRD Directive. The CRD Directive addresses the situation where national authorities decide to perform stress tests at a national level.

Article 97 CRD Directive suggests that further in-depth national stress testing should be employed if the outcome of the SREP shows there is a need for development of a specific stress test and where the coordinated approach in Europe based on art.32 EBA Regulation does not sufficiently address the specific (domestic) pressures on the resilience of institutions established in that particular jurisdiction.

We fail to understand how the possibility that national supervisory authorities may decide to organise a stress test for the domestic market only will be beneficial to the convergence of supervisory practices across Europe. This convergence is one of the main objectives of CRD IV. We view this as an example of CRD IV provisions that, once transposed into national laws may result in different supervisory practices across Europe.

### *On-going review of the permission to use internal approaches*

Since the 2006 adoption of the three pillar model for the measuring of capital adequacy of banks and investment firms following the Basel II accord, firms have been entitled to apply internal approaches for the calculation of risk-weighted exposures for the credit risk and market risk (the “Internal Ratings Based Approach” or “IRB Approach”). The basis of this method to organising risk management is set out in art.84 of Directive 2006/48. The Directive contains the assumption that institutions are granted explicit permission to utilise the IRB Approach. The relevant provisions of the directive do not provide for a mechanism of on-going evaluation. As a result of the adoption of the Omnibus I Directive<sup>45</sup> art.84 para.1 of Directive 2006 was changed to introduce the authority of EBA to draft regulatory standards to specify the assessment methodology under which the national authorities permit institutions to use the IRB approach.

<sup>42</sup> See the CEBS’s press release on the results of the EU-wide stress testing exercise, dated October 1, 2009.

<sup>43</sup> See the CEBS’s press release on the results of the 2010 EU-wide stress testing exercise, dated July 23, 2010.

<sup>44</sup> See the EBA’s press release Results of the 2011 EU-wide stress test of July 15, 2011.

<sup>45</sup> Directive 2010/78 amending Directives 1998/26, 2002/87, 2003/6, 2003/41, 2003/71, 2004/39, 2004/109, 2005/60, 2006/48, 2006/49, and 2009/65 in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority of November 24, 2010 [2010] OJ L331/120.

This stricter approach was introduced to minimise the different methods applied by supervisory authorities when permitting application of the IRB Approach.

The CRD Directive imposes a stricter regime in this area, by requiring national authorities to evaluate the IRB Approach of individual institutions every three years. Article 98 CRD Directive gives detailed guidance as to which criteria must be applied by the national authorities in evaluating the IRB Approach of individual institutions. First, the evaluation should address whether the institution applies up-to-date techniques and practices in the internal models, suggesting that authorities should have a view to market developments in the relevant models for calculation of risk weightings and, furthermore, it suggests that authorities should also consider whether institutions have adequately dealt with stress testing the outcome of calculations. In this respect, art.98 CRD Directive must be read in conjunction with the other parts of the CRD Directive dealing with the SREP.

If the IRB Approach does not adequately measure the required quantity of capital needed to address risks, supervisory authorities must require a transition is made to either (i) improvements of the model or (ii) application of alternative methods for calculating risk weighting (which may include a directive issued by the authorities that the institution returns to the standardised method). The transition should be clearly defined and a timeline towards the application of the new methodology must set. If in the interim period, prior to transition being completed, the authorities consider the own funds held by the institution inadequate to address risks, they may impose (on a temporary basis) a higher level of own funds on that particular institution. See art.98 para.4 CRD Directive for the further details of this regime.

Article 98 CRD Directive gives a direction as to when authorities must withdraw the permission to (a part of the) IRB Approach. This concerns the application of internal models for market risk. If the model results in numerous 'over shootings' within the meaning of art.355 CRD Regulation, this should be considered as an indication that the model is insufficiently accurate and permission to use it must be withdrawn in such instances.

## Sanctions

One of the main innovations that the CRD Directive will introduce is the detailed regulation of sanctions on institutions that fail to comply with the rules imposed on them when exercising permanent supervision. The EC justifies this particular new element of regulation as follows:

"Effective, proportionate and dissuasive sanctioning regimes are key to ensure compliance with EU banking rules, protect users of banking services and ensure safety, stability and integrity of banking markets. The analysis of national sanctioning regimes in the areas covered by this Directive and the Regulation has revealed divergences and weaknesses in the legal framework of sanctioning powers and the investigative powers available to national authorities."<sup>46</sup>

The purpose of the European sanctions regime is to avoid weak supervision and pressures on the level playing field for institutions established and operating in Europe.

The relevant sanctions apparatus is contained in different provisions of the CRD Directive and addresses different topics. The sanctions addressees are also different in a number of respects. The following table is an overview of the various provisions addressing sanctions:

Table 6: Sanction regime CRD Directive

Subject matter of enforcement	Sanction addressee	Provision of CRD Directive	Sanction
<i>Holdings in capital breaching qualifying holdings rules</i>	Management and/or shareholders	Article 26	Includes injunctions to suspend voting rights
<i>Generic breach CRD Regulation</i>	Institutions, financial holding companies, mixed financial holding companies and mixed-activity holding companies as well as members of management body and individuals responsible for the breach	Article 65	Not specified
<i>Authorisation requirements and requirements for acquisitions of qualifying holdings</i>	Institutions, financial holding companies, mixed financial holding companies and mixed-activity holding companies as well as members of management body and individuals responsible for the breach	Article 66	<ul style="list-style-type: none"> <li>• Make public statement about breach;</li> <li>• Orders to cease the conduct;</li> <li>• In case of legal persons: administrative pecuniary sanctions of up to 10% of the turn over of the institution;</li> <li>• In case of natural persons: administrative pecuniary sanctions of up to EUR 5,000,000;</li> </ul>

<sup>46</sup> Explanatory Memorandum to the CRD Directive p.2. The analysis to which the EC refers is contained in the EC communication *Reinforcing sanctioning regimes in the financial sector*, COM(2010) 716 final.

Subject matter of enforcement	Sanction addressee	Provision of CRD Directive	Sanction
			• administrative pecuniary sanctions of up to twice the amount of the benefit derived from the breach where that benefit can be determined.
<i>Failures to disclose information/submit reports on breaches of authorisation requirements and requirements for acquisitions of qualifying holdings</i>	Institutions, financial holding companies, mixed financial holding companies and mixed-activity holding companies as well as members of management body and individuals responsible for the breach	Article 67	<ul style="list-style-type: none"> <li>• Make public statement about breach;</li> <li>• Orders to cease the conduct;</li> <li>• Withdrawal of the authorisation</li> <li>• In case of legal persons: administrative pecuniary sanctions of up to 10% of the turn over of the institution;</li> <li>• In case of natural persons: administrative pecuniary sanctions of up to EUR 5,000,000;</li> <li>• administrative pecuniary sanctions of up to twice the amount of the benefit derived from the breach where that benefit can be determined.</li> </ul>
<i>Breaches of governance requirements, requirements on reporting own funds and other capital requirements, reporting on large exposures, liquidity, leverage ratio, exposures to credit risks of securitisation positions in breach of the risk retention rules and other provisions regarding capital adequacy</i>	Institutions, financial holding companies, mixed financial holding companies and mixed-activity holding companies as well as members of management body and individuals responsible for the breach	Article 67	<ul style="list-style-type: none"> <li>• Make public statement about breach;</li> <li>• Orders to cease the conduct;</li> <li>• Withdrawal of the authorisation</li> <li>• In case of legal persons: administrative pecuniary sanctions of up to 10% of the turn over of the institution;</li> <li>• In case of natural persons: administrative pecuniary sanctions of up to EUR 5,000,000;</li> <li>• administrative pecuniary sanctions of up to twice the amount of the benefit derived from the breach where that benefit can be determined.</li> </ul>

The level of detail now contained in the CRD Directive is a completely new feature of the European financial markets regulatory landscape. There is a clear desire on the part of European authorities to align the sanctions regime for all Member States and national authorities will have to implement a sanctions regime that is more or less aligned with the maximum penalties and measures that need to be included in the national laws, but these sanctions need also to deal with breaches of the CRD Regulation.

The inclusion of the sanctions regime in national laws will evidently need to be tested against existing national pecuniary sanctions, administrative measures and the manner in which this all fits into the domestic civil or common law, criminal law and administrative law environment. Ultimately it will depend on the application of sanctions by the domestic judiciary and courts as to whether or not a harmonised and level playing field will be created. Notwithstanding an harmonised body of statutory law throughout Europe, uniform sanctions for regulated institutions will depend on consistent application of domestic courts of such harmonised laws. It will take many years before it is clear as to whether or not a uniform approach throughout Europe is feasible.

## Part I—Closing remarks

In this part of the article on the CRD IV proposals, particular attention has been given to the parts of the CRD Directive that deviate from the Basel III accord. The introduction of an enhanced framework for internal governance and risk management of banks and investment firms follows from the separate actions taken by the EC in parallel with the discussions on revision of capital adequacy rules. The same comment may be made for the provisions on the SREP and sanctions, in that all additional texts are not included in the Basel III accord. The topics evaluated in this part will introduce drastic changes to the regulatory environment for banks and investment firms. It is likely that many smaller and medium sized institutions will find the comprehensive package for changes of the governance and qualitative risk management environment quite burdensome. Apart from the additional capital requirements that will follow the implementation of Basel III in Europe, there is also the cost of additional compliance measures caused by the overhaul of some of the organisational principles introduced by CRD IV.

CRD IV also brings with it challenges for regulatory agencies and European national legislators from the perspective of the proposed legislative framework. The introduction of an extensive regulation for the adoption

of a single rule book for capital requirements will require an extraordinary complex change process of the national laws and regulations in all of the European Member States. European politicians have seized the opportunities of the financial crisis to move towards a common regulatory framework for this significant part of the financial industry. Together with the regulations introduced effective January 1, 2011 on the European System of Financial Supervisors and the introduction of the European Systemic Risk Board, the CRD Directive and CRD Regulation will constitute a rulebook of gigantic proportions where only very few practitioners will find

their way. The recent proposals on the changes to MiFID follow conceptually the same approach as in the CRD IV proposal. The EC introduced the Markets for Financial Instruments Regulation.<sup>47</sup> This substantial additional proposal will not decrease the challenges for banks with a securities business and investment firms.<sup>48</sup>

In Pt 2 of this article we will look at the various proposals contained in CRD IV for the quantitative capital requirements, the introduction of rules on capital buffers, a leverage ratio, liquidity (management) and addressing risk weighting using external ratings.

<sup>47</sup> Proposals submitted by the EC on October 20, 2011 for, among others, for a Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories, COM(2011) 652 final.

<sup>48</sup> Obviously, there is much more changing in the European legislative environment than we are noting here. But we observe that the combination of CRD IV proposals and MiFIR itself will already be a very heavy burden for practice and the markets and an almost insurmountable compliance task for smaller industry participants.