Prudential Regulation Reform

Executive summary

In line with the agreement at the G20, prudential regulation1 is undergoing major reform. Globally, there are two sets of revisions to the Basel II Accord (2005) – July 2009 amendments and the December 2009 consultative package. These revisions are broadly paralleled in the EU by changes to the Capital Requirements Directive (CRD). The first set of changes, CRD 2, is already set for implementation in January 2011. CRD 3 is currently being discussed in the European Parliament, and the forthcoming CRD 4 was issued for consultation in February 2010. The changes are wide-ranging and complex and, in accordance with the G20 mandate, are intended to be phased in over a period until the end of 2012. Quantitative impact studies (QIS) have been undertaken/are underway to assess the consequences for banks and investment firms of these changes and broader analysis on the impact to the economy is also being taken forward.

A robust prudential framework fosters financial stability, and promotes market confidence, by providing an appropriate, but finite, degree of protection against bank/firm failure for consumers and other financial institutions. This is essential for rebuilding a strong global economy. Given the G20’s goals of achieving this recovery and ensuring balanced and sustainable growth going forward, changes must be:

- Appropriately calibrated,
- Implemented at an appropriate time,
- Globally convergent on substance and timing of introduction

It is essential that the final measures deliver this.

Overview

The Basel Committee’s December 2009 consultation/CRD 4 envisages: changes to the definition of capital; enhancing the risk coverage of the Pillar 12 capital requirements framework (in particular in relation to counterparty credit risk3); the

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1 Prudential regulation is the generic term used to describe the rules that relate to financial soundness of banks and investment firms. These rules cover, for example, definition of capital, capital required against specific risks, leverage ratio, minimum liquidity standards, individual capital assessments and supervisory review, and disclosure.
2 The prudential framework is underpinned by three pillars – Pillar 1 refers to minimum standards, Pillar 2 encompasses additional individual firm assessment of financial soundness and supervisory review thereof, Pillar 3 refers to market discipline provided by required disclosures.
3 Counterparty credit risk refers to the capital requirements associated with, for example, over the counter derivative transactions and securities financing transactions.
introduction of a leverage ratio; measures to address the procyclicality of the capital requirements framework; and a minimum liquidity standard. There will also be further review of measures to address systemic risk and interconnectedness for systemically important financial institutions (SIFIs). Further detail on the changes can be found in our briefing paper on the Basel December 2009 reforms/CRD4.

These proposed changes follow the Basel Committee’s July 2009 amendments/CRD 2 and 3. These revisions: amend the capital requirements associated with securitisation and re-securitisation5; introduce investor due diligence for securitisation exposures; change the capital requirements in the trading book; enhance the guidance on supervisory review under Pillar 2; and modify the disclosures required under Pillar 3. (CRD 2 also includes some EU specific regulatory changes, including the introduction of a retention requirement for originators of securitisation transactions.)

Challenges the proposals must address
In general the regulatory changes have been targeted at the areas where the recent crisis has highlighted market or regulatory failures. The industry agrees that failures identified must be tackled but the changes envisaged represent a seismic shift in prudential regulation and have had to be developed swiftly with an incredibly tight timetable for implementation, which brings serious risks that must be addressed satisfactorily.

For example, since the proposals have been developed in a piecemeal manner, the amendments may not deliver an entirely coherent framework resulting in the duplication of coverage of risks, undermining the risk sensitive nature of the Accord/CRD. Some activities may be unduly penalised, discouraging economically useful services. Inappropriate calibration of the requirements may also make certain activities uneconomic and therefore result in reduced availability of credit or risk management tools, or higher costs to customers.

The studies on the impact of the changes (QIS) - being undertaken by the Basel Committee and the European Commission - are therefore vital in determining the appropriateness of the risk coverage and the calibration of the reforms as a whole. As the QIS focus only on the impact on banks/firms they will provide only a partial answer. The broader analysis that is also being conducted by the Financial Stability Board, in conjunction with the Basel Committee, and the parallel exercise underway in the EU will be essential to provide an overall understanding of the reform package’s impact on the wider economy.

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4 Procyclicality refers to the potential amplification of economic and financial shocks resulting from the way a capital requirements framework may operate.
5 Re-securitisation means a securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is itself a securitisation.
Briefing note

Given the increasing fragility of the European economy there is also the risk that premature implementation of significant additional prudential requirements could damage economic recovery and therefore long-term balanced and sustainable growth. In relation to the July 2009 amendments and CRD 3, information on the full impact of the proposals is only now becoming available through the 2010 Trading Book QIS exercise, although the proposed date for implementation is as early as the end of 2010. Significant capital increases for the trading book (estimated in 2009 at €216bn for EU banks on just a part of the trading book changes) will be difficult to raise from investors. Firms will need to consider further divestment or curtailing of other activities. In the case of the Basel December 2009 package and CRD 4, the proposals have yet to be finalised in form or calibrated, yet are due to be phased in by the end of 2012.

The scale and speed of change also bring the risk that not all countries will be able to implement in a convergent manner and at the same time. The consequent risks of competitive and regulatory distortions would undermine financial stability and market confidence.

**AFME’s position**

AFME shares the regulatory objective of enhancing the prudential framework, in the context of rebuilding a strong global economy. But to secure both these enhancements must be appropriately calibrated, implemented at an appropriate time, and be globally convergent in substance and timing of introduction.

Given the extent of the changes proposed or in train, which will shape the financial landscape for years to come, AFME seeks:

- Targeted amendments, together with an appropriate timetable which takes account of the need for changes and convergent implementation across jurisdictions, for the July 2009/CRD 3 package.
- A longer timeframe for implementation than that currently envisaged for the December 2009/CRD 4 package and an appropriately sequenced introduction of those measures, to ensure that intended and unintended consequences are fully understood and economic recovery and future growth is supported.
- A timetable that can be met on a consistent basis by all major jurisdictions to avoid regulatory or market distortions.
- Commitment from national and regional regulators to adhere to internationally agreed proposals and resist gold-plating or divergent treatments.
Briefing note

- That supervisors and regulators continue to make use of fora such as the Basel Standards Implementation Group and the Committee of European Banking Supervisors to ensure consistent implementation of the substance.

Further information

December 2009/CRD 4 package
- AFME briefing note on December 2009 package and CRD 4
- BCBS 164
- BCBS 165
- GFMA response to BCBS 164 and 165
- Public responses to BCBS 164 and 165
- CRD 4 consultation
- AFME response to CRD 4 consultation
- Public responses to CRD 4 consultation

July 2009/CRD 3 package
- Basel Committee July 2009 package
- EC Proposal
- Council general approach
- UK implementation – FSA CP09/29
- AFME response to FSA CP09/29

CRD 2
- Directive text
- UK implementation – FSA CP09/29
- AFME response to FSA CP 09/29

Afme contacts

Diane Hilleard  Anita Millar  Cristina Rabbini
020 7743 9356  020 7743 9358  020 7743 9362
diane.hilleard@afme.eu  anita.millar@afme.eu  cristina.rabbini@afme.eu

Published: June 1st 2010

Association for Financial Markets in Europe
St Michael’s House
1 George Yard
London EC3V 9DH

Tel: +44 (0) 20 7743 9300
www.afme.eu