

# Shaping Europe's Regulatory Framework to Ensure Future Financial Security

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To say that the current economic and financial crisis is a decisive and testing time for the European single market is an understatement. Since the crisis broke in late 2008, the institutions of the European Union (EU) in Brussels have lost little time in developing measures to restore confidence to the financial markets and reassure EU citizens and businesses alike. The European financial services industry has witnessed a relentless stream of draft legislation from the European Commission (EC) and European Parliament introducing greatly strengthened and rigorously applicable regulations covering not only the financial markets but also the key market actors.

## Safety-First Approach to Reform

No sector of the financial services industry has remained immune to new regulation, whether it is banking, securities or insurance. The list of existing and pending legislation is lengthy, and it is not finished. The efforts by the EU institutions to deliver “responsible and reliable financial markets for the future” – largely in cooperation with the financial services industry – represent, at best, a work in progress. Here are some

of the highlights of the EU’s “safety-first approach” to reform of financial regulation since early 2009.

## Capital Requirements Directive

The Capital Requirements Directive (CRD) was originally devised to establish uniform capital requirements for both banking firms and non-bank securities firms. It established the amount that a firm must have on hand in order to cover risk and protect its depositors. In May 2008, the European Parliament voted on part of the CRD, which required originators (financial institutions) to retain 5 percent of securitised products before selling them on the market. The revision tightens the definitions of core capital, limits the amount of short-term exposure banks can have to one another (maximum: 25 percent), introduces colleges for supervision of groups and places controls on the securitisation process.

Members of the European Parliament also called upon the EC to introduce legislative proposals to regulate the over-the-counter (OTC) derivatives market. The EC aims to improve the transparency and standardisation of OTC products and introduce



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a centralised counterparty clearing system, backed by pan-EU supervision. Separately, the EC is expected to produce a legislative proposal on derivatives and other complex structured products from a capital requirements perspective.

#### **Credit Rating Agencies**

The European Parliament adopted a regulation in April 2009 mandating registration and supervision of credit rating agencies. Essentially, this law also prohibits Credit Rating Agencies (CRAs) from providing advisory services and allows them to rate financial instruments only if they have sufficient quality information on which to base their ratings. It requires CRAs to disclose the models, methodologies and key assumptions on which they base their ratings, publish an annual transparency report and appoint at least three independent directors on their board to oversee the impartiality and quality of the work.

#### **Hedge Funds and Private Equity**

The EC has proposed a directive regulating the alternative investment fund manager (AIFM), which is expected to be approved, with amendments, in 2010. The draft law requires AIFMs to be registered with the financial regulator in their jurisdiction and to demonstrate that they are suitably qualified and can provide proof of

the valuations and safer-keeping of assets. Minimum levels of capital will be imposed, together with annual disclosure on the investments strategy and objectives.

The directive only applies to those AIFMs managing a portfolio of more than 100 million euros. A higher threshold of 500 million Euros applies to AIFMs not using leverage (and having a five-year lock-in period for their investors), as they are not regarded as posing a systemic risk. A threshold of 100 million Euros implies that roughly 30 percent of hedge fund managers, managing almost 90 percent of EU-domiciled hedge fund assets, would be covered by the directive.

#### **Solvency II**

A comprehensive law passed by the European Parliament requires insurance firms to conduct market-consistent valuations of their assets and liabilities annually and adhere to capital requirements based on the underlying risks as opposed to volume of business. It also stipulates that insurance groups recognise the importance of risk management in running their business by assessing the types of risk to which they are exposed and managing those risks more effectively through the establishment of risk management systems, processes and controls.

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A last-minute carve-out was negotiated deferring the need for a pan-EU supervisory “group support” structure for large cross-border insurance groups. Insurance firms will continue to have their capital assessed on a country-by-country subsidiary level.

### Results of de Larosière

The de Larosière group, named after its chairman Jacques de Larosière, was commissioned by the EC President in Oct. 2008 to develop a plan including “a new regulatory agenda, stronger coordinated supervision and effective crisis management procedures.” The group produced the de Larosière report. It included a framework of supervision for the EU financial institutions and markets that would strengthen European cooperation related to financial stability and oversight, early warning and crisis mechanisms, and cooperation with global players. Several high-level regulatory issues arose as a result of the de Larosière report.

### A European Systemic Risk Council

A systemic risk council, chaired by the European Central Bank but encompassing representatives from central banks and the European Commission, will monitor cross-border macro-prudential issues and put in place an early risk warning mechanism. The EC is expected to act on this in June with a crisis prevention white paper

discussing tools for early intervention to prevent a crisis.

### A European System of Financial Supervision

The future system will comprise a decentralised structure with national regulators overseeing individual financial institutions. This will strengthen the powers of the three coordinating bodies at the EU level for banking, insurance and securities (CEBS, CESR and CIOPS). These reinforced bodies will become the regulatory authorities covering banking, securities, and insurance and occupational pension, respectively.

The EU financial market landscape will be subject to increased oversight by international colleges of supervisors for large cross-border financial groups, but with greater attention paid to banks’ internal risk management. One aspect of the new supervisory structure with greater emphasis on information-sharing between national supervisors and much welcomed by member states is the need to establish a far more consistent set of cross-border supervisory rules to avoid divergent interpretation of directives, reduce gold plating and promote prompt transposition of directives at the national level. All of this will be accompanied by a fundamental review of Basel II, gradual increase to capital requirements and an introduction of stricter rules for off-balance sheet items.

## FUTURE LEGISLATURE AND INITIATIVES

### Prudential Capital

Legislative proposals will be introduced to increase the quality and quantity of trading-book activities, tackle complex securitisation and address liquidity risk and excessive leverage.

### Updating MiFID and Market Abuse Directives

The Markets in Financial Instruments Directive (MiFID) review will embrace provisions affecting exchanges, including business codes related to investment banks, dealers and brokers; client categorisation requirements; best execution requirements; and trade transaction reporting. The Market Abuse Directive review will include revisions such as expanding the scope of the rules covering share, commodity and energy dealers; widening controls covering the new trading platforms and non-traditional stock exchanges; and extending rules to cover certain types of derivatives.

### Retail Investment Products

The EC Communication on Retail Investment Products is expected to aim at improving citizens’ accessibility to long-term savings products, access to credit and rights to financial products. An important dimension will be the need for wider



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protection of investors and financial consumers: Further measures will be proposed to reinforce bank depositor, investor and insurance policy-holder protection, as well as the effectiveness of marketing safeguards. Measures are also being drafted to ensure responsible lending and borrowing, all of which are due in autumn 2009.

## Conclusion

The impact of these legislative changes on the financial services industry – banking, insurance and securities – can be best encapsulated in two key features: actively managing risk and prompt tracking of regulatory changes. Both factors are fundamental to compliance and increasingly enforceable on a cross-border scale in Europe. Avoiding asymmetrical risk assessment across frontiers, whilst identifying timely opportunities for growth, means that financial service companies need to review and update their information and communication technology processes and techniques to effectively monitor emerging EU regulatory measures to bring their governance, risk and compliance programmes in line. Assessing and managing risks in this environment with the right business analytics is no longer a luxury and cannot be left until economic recovery takes place.

**BIO Dr. David Doyle** is a Senior Policy Adviser with Brunswick Group, Brussels, specializing in European Union (EU) financial services. He joined Brunswick in 2009 as a seasoned lobbyist and public affairs expert in the EU financial services environment, operating between Brussels, Paris and London. Doyle is a former diplomat with more than 20 years of service spanning bilateral and multilateral postings on mainland Europe. He is a member of the joint Members of the European Parliament-EU industry body The Kangaroo Group and is active in the TABD Taskforce on Capital Markets.

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