

As Member States confront the impact of the global credit crisis individually, at EU level, work is continuing to develop a common framework to protect business and move forward effectively. David Doyle reports



# MANAGING THE CREDIT CRUNCH: THE EU RESPONSE

**In the carnage of the past few months on the financial markets, there has been an inevitable call for a re-ordering of EU priorities. Much of this is led by the EU Member States themselves, and in particular France, which holds the EU Presidency until the end of 2008. It seems a long way away from the ambitious, but largely-business friendly EU priorities set in July of this year when France took over the Presidency. The**

**top issue to the end of the year, and into the ensuing Czech Presidency, is the redesign of the global financial system.** National industry trade bodies have spoken with a common voice, signalling fears of over-regulation and, even, a shift into protectionism. The message coming from industry and financial service bodies in the capitals, and in Brussels, is clear; do not abandon the free market as Europe struggles to resolve the

problems that created the global financial crisis.

Long before the current storm broke, the EU institutions had already mapped out a number of measures, such as credit rating agencies, to improve the financial stability of banks, insurance companies and intermediaries. The past months have added a sense of urgency to these measures and the moves made by the Commission and EU Parliament have been bold and decisive.

### Banking supervision and capital adequacy

Central to these concerns is the EU Capital Adequacy Directive (CRD), devised to establish uniform capital requirements for both banking firms and non-bank securities firms, i.e., 'own financial resources' banks and investment firms must have, in order to cover their risks and protect their depositors. The EU institutions agree that the financial institutions framework needs to be regularly updated and refined to respond to the needs of the financial system as a whole. The main changes proposed on 1 October were as follows:

- Improving the management of large exposures: banks will be restricted in interbank loans. As a result banks will not be able to lend or place money with other banks beyond a certain amount, while borrowing banks will effectively be restricted in how much and from whom they can borrow. Under CRD there will be a 25 per cent limit on all interbank exposures.
- Improving supervision of cross-border banking groups: 'colleges of supervisors' will be established for banking groups that operate in multiple EU countries. Negotiations are under way to define the rights and responsibilities of the respective national supervisory authorities to enable more effective cross-border cooperation.
- Improving the quality of banks' capital: there will be clear EU-wide criteria for assessing whether 'hybrid' capital, i.e. including both equity and debt elements, is eligible to be counted as part of a bank's overall capital and the amount which determines how much the bank can lend. This provision may, controversially, be extended to insurance companies under the draft Solvency II directive, given the importance of pension funds inherent in this sector.
- Improving liquidity risk management: for banking groups that operate in multiple EU countries, their liquidity risk management – i.e., how they fund their operations on a day-to-day basis – will also be reviewed and coordinated within 'colleges of supervisors'.
- Improving risk management for securitised products: rules on securitised debt will be tightened up. Firms or 'originators' that repackage loans into tradable securities will be required to retain some risk exposure to these securities – at least five per cent of the exposures they securitise – while firms that invest in securities will be allowed to make their decisions only after undertaking due diligence. Failure to do so will result in them being subject to heavy capital penalties.

The proposed amendments are, in the main, a direct follow-up to the roadmap for the current financial turmoil agreed by EU Finance Ministers. The European Council has expressed a strong sense of urgency emphasising that the measures should be adopted by April 2009.

### Solvency II Directive

Agreement has yet to be reached during the French Presidency on the pan-EU Insurance initiative, the Solvency II Directive, an important piece of legislation that includes ambitious and far-reaching proposals for a new, principles-based and risk-sensitive solvency regime. The Solvency II directive has a deadline for implementation of 31 October 2012.

The core of the Solvency II directive will require insurance companies, of all sizes, to:

- Conduct market-consistent valuations of their assets and liabilities on an annual basis;
- Adhere to capital requirements based on underlying risks and not simply volumes of business; and,
- Recognise the importance of risk management in running their businesses by assessing all types of risk to which they are exposed and to manage those risks more effectively, through the establishment systems, processes and controls of risk management.

Two points remain contentious: the amount of equity that would have to be held by insurance companies and who supervises insurance companies with multiple cross-border activities. On the first issue, under present proposals, insurance companies would have to value their equity holdings once a year when assessing their balance sheet. The current presidency is pushing for a longer-term approach to valuation, to reflect the accounting reality, as they see it, that equity assets match the longer-term liabilities. In terms of regulatory oversight, the Solvency II regime envisages that a lead or group insurance regulator would be appointed in the company's home state to oversee the insurers EU-wide activities and set the capital requirements. This plan has been opposed by some of the smaller EU states who fear that they will be over-dependant on biggest regulatory structures in larger EU states, such as the UK, Germany and France.

### Fair value accounting

Following calls by many mainland EU heads of state for a partial relaxation of the mark-to-market accounting rule for assets – reacting to pressure from the EU banks that it should

be used more flexibly in line with US practices – the IASB announced on 13 October amendments to IAS 39 (financial instruments: recognition and measurement) and IFRS 7 (financial instruments: disclosures), permitting reclassifications.

### Corporate Governance

French President Sarkozy will no doubt urge EU Member States to adopt the French code of conduct on directors' remuneration packages, announced in Paris in mid-October, which proposes measures for listed companies to link pay with performance. Few EU states have embarked on statutory measures in respect of directors' pay, with the exception of the Netherlands who introduced higher corporate taxes on generous 'golden parachutes' and large pension contributions. The EU finance ministers agreed, however, to review national legislation and industry best practices in respect of disclosures and performance criteria.

### Credit Rating Agencies

The Commission is likely to announce on 12 November a legislative framework for credit rating agencies comprising both a set of legal obligations to be complied with by CRAs as well as independent external oversight. The proposed directive/regulation will aim to achieve the following objectives:

- Appropriate management of conflicts of interest;
- Improvements in quality of output;
- Increased transparency of CRAs' activities; and,
- Establishment of a supervisory and enforcement regime on the territory of the EU.

It is understood that the draft EC proposals will include measures to block some non-executive directors at credit-rating agencies from earning pay-boosting share options and to set strict time limits on their appointments. CESR – the Committee of European Securities' Regulators – contributed extensively to the new legislation.

### Conclusion

A common approach to the financial crisis that besets its Member States is the best option for the EU. The largely business-friendly EU priorities initiated under the current presidency and hopefully continued by the Czech Presidency in 2009 should ensure that the EU financial system is as robust as circumstances allow.

**Dr David P. Doyle is the ACCA's Head of EU Parliamentary Affairs**