



FINANCIAL MARKETS NEWS

Wilkins Kennedy Financial Markets News is for FSA authorised investment firms

FSA CAPITAL REQUIREMENTS DIRECTIVE

The FSA issued the final rules implementing the Capital Requirements Directive (CRD) on 25 October 2006. Their main aim is to relate capital levels more closely to risk and will affect significantly most investment firms' capital adequacy requirements. Robin Haslam, Partner in our London office and head of our Financial Markets Group, outlines the practical implications.

Deadline looming

The new rules will be effective from 1 January 2007. Firms may however elect to remain on the existing rules for credit risk during 2007. This would have the effect of delaying the application of some of the rules until 1 January 2008. Firms need to be clear about how they will be categorised under the new arrangements, which approaches they will use, and at what point in 2007 they will switch over to new arrangements.

Three pillar approach

CRD introduces a new framework for firms, involving a risk sensitive, three pillar approach:

Pillar I: deals with minimum capital requirements for credit, market and operational risks.

Pillar II: requires firms to assess the need for additional capital not covered under pillar I by implementing an individual Capital Adequacy Assessment Process (ICAAP).

Pillar III: deals with disclosure requirements, designed to give market forces more of a role in shaping the level of firms' capital.

FIRMS AFFECTED

The extent to which an investment firm will be impacted by CRD depends on the investment activities undertaken and the firm's FSA permissions. Currently a firm's capital requirements are largely determined by whether or not the firm comes within the scope of the Investment Services Directive (ISD). The ISD will be replaced in 2007 by the markets in Financial Instruments Directive (MiFID). Generally, those firms that are currently ISD firms will be subject to MiFID, although there will be some circumstances where non-ISD firms are caught. Firms should therefore assess their categorisation carefully.

Timing and transitional provisions

CRD comes into force on 1 January 2007. This means that the following elements must be adopted from that date:

- The new rules for the calculation of base capital, fixed overhead requirement and market risk (under Pillar I)
- Changes to the definition of the trading book
- Changes to consolidated supervision rules

However, the following elements of the new rules do not have to be applied until 1 January 2008, with firms having the option of when to adopt:

- The new credit risk and operational risk calculations (under Pillar I)
- Pillar II and Pillar III





Actions

It is important for all firms to ensure they are fully prepared for the new regime and to assess how they are going to deal with the new requirements.

In particular firms should be working through the following processes:

- Assessment of whether firm falls within the scope of CRD
- Ascertaining the firm's category for minimum capital requirements under CRD
- Reviewing permissions to ensure that there are none that are not required which could increase the firm's minimum capital requirement
- Deciding on the timing of adoption of CRD
- If CRD adopted from 1 January 2007, deciding which transitional rules should be applied
- If appropriate, making application for a waiver from consolidated capital resources requirements
- Consideration of existing waivers and whether they will apply under the new regime

Wilkins Kennedy have extensive experience of the practical application of FSA rules. In the first instance, please speak to Robin Haslam, Head of Financial Markets Group, or your usual contact partner.

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