

# Capital Requirements Directive

## Overview

The way in which investment firms assess and monitor their regulatory capital requirements will soon be changing when the Capital Requirements Directive ("CRD") comes into force. And although CRD does not apply until 1 January 2007, it is important that firm's who have not yet considered the impact on them do so now. The FSA are currently seeking responses from firm's on their approach to CRD and, as this factsheet goes on to explain, there are specific actions that some firms will need to take sooner rather than later.

This guide to CRD provides an overview of the changes to the capital adequacy rules and also highlights some of the key aspects for investment firms to consider. However, it is only a brief summary of the new rules. If you would like to discuss any aspect of CRD and the implications for your firm, please contact Moore Stephens for further guidance.

Moore Stephens LLP  
St Paul's House  
Warwick Lane  
London EC4M 7BP  
Tel: +44 (0)20 7334 9191  
Fax: +44 (0)20 7248 3408  
[www.moorestephens.co.uk](http://www.moorestephens.co.uk)

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## Background to the new rules

CRD amends two existing EU directives: the Banking Consolidation Directive ("BCD") and the Capital Adequacy Directive ("CAD"). Investment firms will be familiar with the requirements of CAD which are reflected in the FSA's current rules for capital adequacy.

CRD introduces a new prudential framework for firms, with an aim of relating capital more closely to risks. It involves a 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.

### Scope of CRD

Under the current FSA rules, a firm's capital requirements are governed by whether the activities it performs fall within the scope of the Investment Services Directive ("ISD"). ISD will be replaced by the Markets in Financial Instruments Directive ("MiFID") in November 2007 and those firms that fall within MiFID will be subject to CRD.

Broadly speaking, those firms that are currently ISD firms will be subject to MiFID, although there will be some circumstances where

non-ISD firms are caught. Accordingly, firm's should assess their categorisation carefully.

### Transitional arrangements

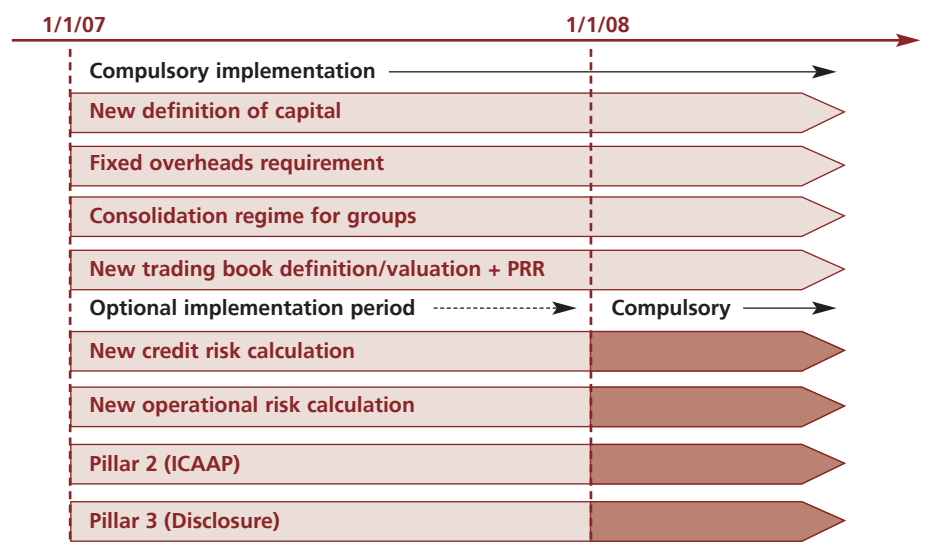
CRD comes into force on 1 January 2007. However, the following elements of the new rules do not have to be applied until 1 January 2008, with firm's having the option of when to adopt:

- the new credit risk and operational risk calculations (under Pillar I);
- Pillar II and Pillar III.

Importantly, this means that the following elements must be adopted from 1 January 2007:

- 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.

### Timeline



# Pillar I - Minimum capital requirement

This is a two stage process.

## Stage 1: Assess the category of the firm

The FSA will classify firms according to the following categories:

- own account dealer;
- broker/manager;
- advisor/arranger.

Depending on which of the above categories a firm falls into, coupled with whether it has permission to control client money and assets, a firm will have a base capital requirement of either €50k, €125k or €730k.

(The flowchart at the end of this guide will assist you in checking your firm's base capital requirement.)

## Stage 2: Assess method of calculating minimum capital requirement

This will depend on whether the firm is:

- a limited licence firm;
- a limited activity firm;
- a full scope firm.

### Limited licence firms

In general, firms who do not have permission to deal on own account or underwrite and/or place financial instruments on a firm commitment basis will be limited licence firms.

The minimum capital requirement will be the higher of:

- a) Base capital requirement.
- b) Higher of - the sum of the credit risk and market risk capital requirements;  
- the fixed overheads requirement ("FOR").

As an example, it is expected that most investment manager firms who currently have a €125k or €50k own funds requirement are likely to be limited licence firms. And, as can be seen above, the 'higher of' approach means that such firms could have a lower minimum capital requirement under the new rules than that under the current 'additive' approach under CAD.

### Limited activity firms

Those firms who may deal on own account but only for the purpose of fulfilling or executing client orders, or to gain entrance to a clearing and settlement system or a recognised exchange will, in general, be limited activity firms.

The minimum capital requirement will be the higher of:

- a) Base capital requirement.
- b) Sum of the credit risk and market risk capital requirements, and the FOR.

### Full scope firms

All other firms will be full scope firms and the minimum capital requirement will be the higher of:

- a) Base capital requirement.
- b) Sum of the credit risk, market risk and operational risk requirements.

Firms should check their categorisation carefully and, in particular, the permissions that they possess. The category that a firm falls into under CRD depends to a large degree on its permissions, whether they are used or not. Therefore, this is a good time for firms to review their scope of permissions to see whether all of these are still appropriate.

**Fixed overheads requirement ("FOR")**

The FOR equals a quarter of a firm's relevant annual expenses calculated on the most recently audited accounts, and effectively replaces the current Expenditure Base Requirement ("EBR").

**Credit risk capital requirement**

The credit risk capital requirement is the sum of:

- credit risk capital component - deals with the credit risk of non-trading book exposures;
- counterparty risk capital component - deals with the credit risk of trading book exposures;
- concentration risk capital component - deals with large exposures.

**Market risk capital requirement**

The market risk capital requirement applies to those firms that hold positions. As with the current IPRU(Inv) rules, it involves the calculation of the following position risk requirements ("PRR"):

- interest rate PRR;
- equity PRR;
- commodity PRR;
- foreign currency PRR;
- option PRR;
- collective investment undertaking PRR.

Under CRD the definition of the trading book is amended to include all positions in financial instruments that are held with a trading intent or to hedge a position that has a trading intent.

## Pillar II - ICAAP and SREP

The purpose of Pillar II is to ensure that firms hold sufficient capital to reflect the risks facing their business, and therefore to identify any additional capital requirements not provided for under Pillar I. There are two parts to Pillar II:

### Internal Capital Adequacy Assessment Process ("ICAAP")

Firms are required to:

1. Carry out regular assessments of the amounts and type of capital it considers adequate to cover the nature and level of risks to which it is exposed.
2. Identify the major sources of risk to its ability to meet its liabilities as they fall due.
3. Conduct stress and scenario tests.
4. Ensure that the processes, strategies and systems required and used in its ICAAP are both comprehensive and proportionate to the nature, scale and complexity of the firm's activities.
5. Document its ICAAP.

### Supervisory Review and Evaluation Process ("SREP")

This is the FSA's process for assessing, reviewing and evaluating the compliance of a firm's ICAAP with the minimum standards set out in CRD. The FSA's approach to this will depend on the size and complexity of the firm. For smaller firms it is likely to involve questionnaires. Following the review process the FSA may issue Individual Capital Guidance ("ICG"), specifying the amount and type of additional capital that a firm should have.

## Pillar III - Integrated Regulatory Reporting

This requires firms to make public disclosures relating to their capital adequacy, risk assessments and management processes.

There is some flexibility as to what is reported and how, but the disclosures should be made annually at a minimum, and it is likely that many firms will choose to cover these requirements in their financial statements.

Pillar III will also see the introduction of mandatory electronic reporting and the replacement of IMRO, SFF and PIA returns with standardised returns.

## Other matters

### Waivers

One key issue firms should consider is whether they will be able to continue to rely on waivers granted under the current rules. In many cases these will not be automatically carried forward into the new regime. If your firm has any doubts in this area you should seek further guidance.

### Consolidated supervision

CRD also applies to firms that are members of groups on a consolidated basis. Consolidated supervision is undertaken by the FSA for all UK groups, including sub-groups of a larger EU or third country group.

The approach to calculating consolidated capital resources is similar to the existing method under CAD in that the starting point is the consolidated accounts. The group capital resources requirement is then calculated as follows:

- For a UK group containing a credit institution and/or an investment firm which is not a limited licence/activity firm:
  - The sum of the consolidated credit risk, market risk and operational risk requirements
- For a UK group containing an investment firm that is a limited activity firm:
  - The sum of the consolidated credit risk, market risk and fixed overhead requirements

- For a UK group containing only investment firms that are limited licence firms:

The higher of :

- a) The sum of the consolidated credit risk and market risk requirements
- b) The consolidated fixed overhead requirement

In addition to the above requirements it is also worth noting that under CRD, firms who are members of a consolidated supervision group will be required to prepare its ICAAP on a consolidated basis.

Firms that are part of a group that does not contain credit institutions, or investment firms that are not limited licence/activity firms, may be able to obtain an exemption from the consolidated capital requirements rules if they can satisfy certain requirements. However, unlike under the existing CAD rules where firms can rely on the exemption rule and simply notify the FSA of this, under CRD, firms must apply for a waiver. This waiver should be applied for as soon as possible and the FSA recommend that this is done by September 2006. It is also worth noting that the exemption rules are stricter than those under CAD.

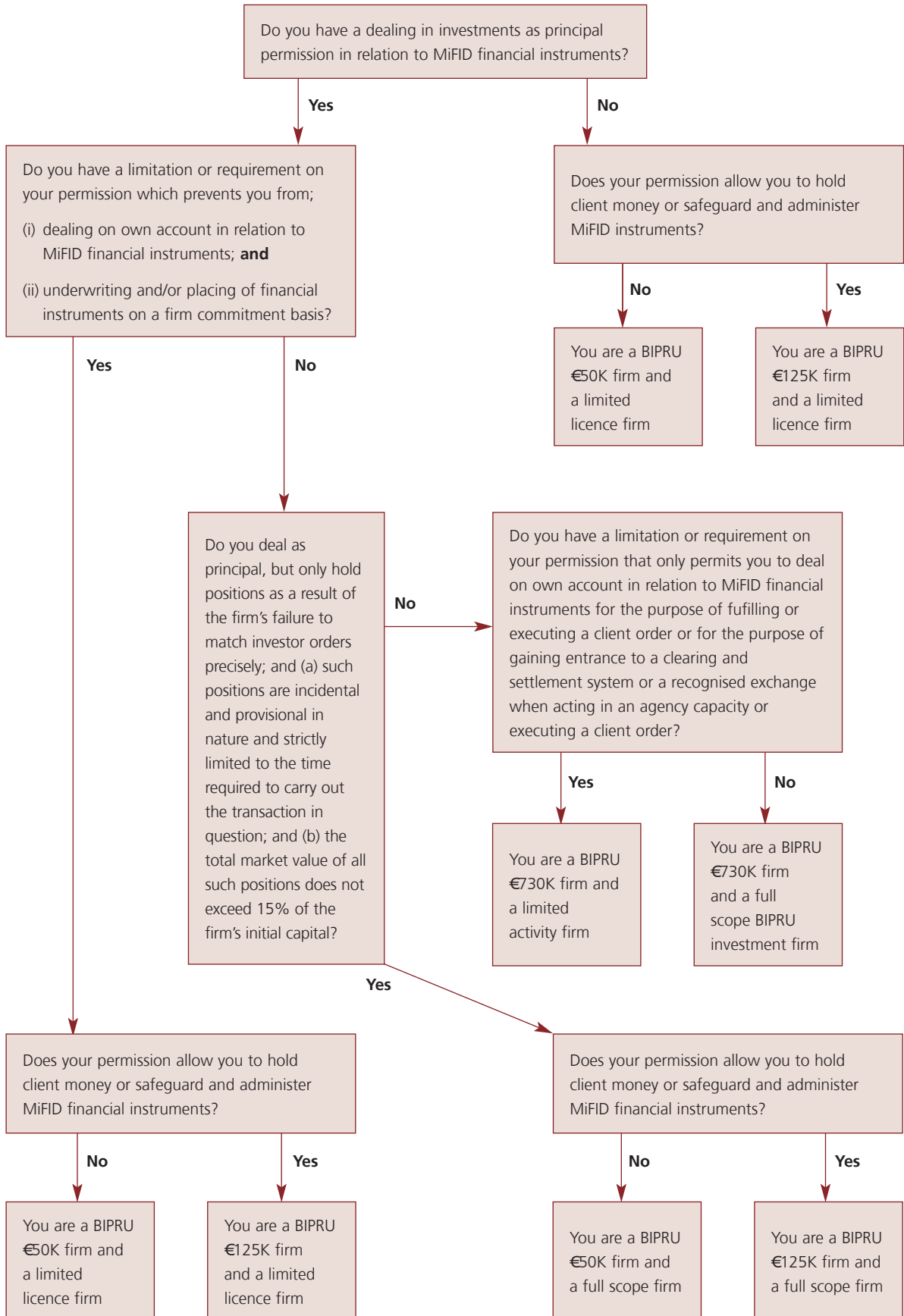
## Summary

This guide provides only a brief overview of the significant changes that will be affecting investment firms following the implementation of CRD. It is important that all firms assess the implications for them and how they are going to deal with the new requirements.

In particular firms should be considering the following:

- Assess whether firm falls with the scope of CRD
- Ascertain the firm's category for minimum capital requirements under CRD
- Review permissions to ensure that there are none that are not required which could increase the firm's minimum capital requirement
- Decide on the timing of adoption of CRD
- If appropriate, apply for a waiver from consolidated capital resources requirements
- Consider existing waivers and whether they will apply under the new regime

# Working out your Base Capital Requirement



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