Latham & Watkins
Finance Department

A Guide to Regulatory Capital Requirements for European Banks

Regulatory capital requirements for European banks are in a state of flux, with recently proposed amendments and recently enacted changes to various rules materially altering the existing framework. In addition to the overview set forth below, Latham & Watkins and Goldman Sachs have co-authored a definitive guide to the latest bank regulatory capital rules, summarising their effect on bank balance sheets. A link to the guide is available at the end of this *Client Alert*.

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Implications of Changing Markets and a New Regulatory Environment

Originally published in June 2004, the objective of the Basel II Regulatory Capital Accord was to eliminate regulatory capital "arbitrage" by aligning capital more closely with risk. The EU Capital Requirements Directive (CRD), published two years later, incorporated the Basel II Accord into EU law with the same objective. However, the 2007-2009 credit crisis showed that the Basel II Accord and the CRD gave undue benefit to some risks and failed adequately to address other risks: The originate-to-distribute model was too loosely regulated, risk weights for off-balance sheet liquidity commitments remained too low, banks' trading books (with lower capital charges) were used to hold illiquid exposures and VaR and market risk models failed to capture the full risks of such positions, and disclosure of off-balance sheet structured funding activities was too limited.

Recently proposed amendments to the Basel II Accord and the CRD, and recently enacted changes to the CRD, will address certain perceived "failings" of the Basel II Accord and the CRD. The overall effect of these changes will be to increase materially the regulatory capital required to be held by banks and increase materially public disclosure by banks of their structured funding activities.

The revised Basel II Accord and CRD will affect bank behaviour materially:

Risk management
Banks will remain motivated to adopt more sophisticated risk management systems in order to qualify for the lower capital afforded to Advanced IRB Banks.

Balance sheet
Banks will be motivated in the current environment to reduce overall risk-weighted assets:

- Required regulatory capital will increase in many areas — whether due to ratings migrating on banking book assets, proposed increases in capital charges for "re-securitisations", proposed changes to trading book capital charges or otherwise

- Necessary additional capital-raising by banks is and will likely remain difficult and expensive in the aftermath of the 2007-2009 credit crisis
- The greatest reductions in regulatory capital are available via banks divesting (or creating and then divesting) junior risk positions in banking book exposures

Off-balance sheet structured funding activities
Banks will be motivated to reduce off-balance sheet funding activities:

- Off-balance sheet treatment of exposures will become more difficult to achieve economically due to proposed increases in re-securitisation risk weights
- All off-balance sheet activities will be subject to materially enhanced public disclosure of banks' commitments to structured finance vehicles

A New Guide to Regulatory Rules and Changes

Latham & Watkins is pleased to co-publish with Goldman Sachs a definitive guide to the existing regulatory capital rules under the Basel II Accord and the CRD, the prospective and contemplated changes to those rules, and an analysis of the effect of those rules on the balance sheet of a "typical" bank.

Click here for a link to the guide or visit http://www.lw.com/upload/pubContent/_pdf/pub2719_1.pdf

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