COMMISSION OF THE EUROPEAN COMMUNITIES

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Brussels, 23 May 1990

Proposal for a

COUNCIL DIRECTIVE

on capital adequacy of

investment firms and credit institutions

(presented by the Commission)

EXPLANATORY MEMORANDUM

GENERAL CONSIDERATIONS

1. The present proposal for a Directive on the Capital Adequacy of Investment Firms and Credit Institutions is a necessary follow-up to the proposal for a Directive on Investment Services in the securities field, presented by the Commission to the Council on 3 January 1989 (on which there is already an amended proposal presented by the Commission on 8 February 1990 after the advice of the European Parliament and the Economic and Social Committee).

   The proposal for a directive on investment Services is intended to open the way for investment firms authorized in their home Member States to have access to all other Member States' financial markets - either by establishing branches, or by providing services, therein - on the basis of certain conditions that closely follow those established for credit institutions in the Second Banking Coordination Directive, adopted in December 1989. According to the programme set out in the White Paper "Completing the Internal Market", these freedoms should be based on coordination of key rules as regards the authorization and the on-going supervision of financial institutions.

2. The coordination must be such as to ensure that the main objective of the proposal - to ensure that both the health of the general financial system and individual investors are adequately protected in the new integrated European market - is achieved. It should also meet two

other goals. First, it should establish a broadly level playing field between non-bank investment firms and credit institutions trading in the securities markets. Consistently with this objective, the rules set out in the proposed Directive should not provide an incentive for an investment firm to opt for one institutional structure, e.g. that of a credit institution - rather than another. Second, the Directive should enhance, or at least not impair, the attractiveness of Europe as a financial centre.

Capital requirements for investment firms which are not credit institutions

3. The proposal establishes minimum initial capital requirements for investment firms which are not credit institutions, requirements for the latter being already fixed by the Second Banking Directive. These have been set at levels which ensure that when it starts its activities, an investment firm has sufficient, initial financial resources in view of the nature of its business and second, which do not form unnecessary barriers to the entry into the market of new firms. Accordingly, different amounts are established for different kinds of investment firms, taking into account the types of business carried out by them.

4. The initial capital requirements for firms which are not credit institutions are lower than those laid down for credit institutions in the Second Banking Coordination Directive. This is for two reasons. First, investment firms which are not credit institutions typically are more specialized than credit institutions; the latter engage in a wider variety of activities and thus need higher initial capital. Second, under Annex 5 of the present Directive, investment firms which are not credit institutions are also required to hold "base capital" equivalent to three months' of their fixed overheads, a requirement which takes account of the wide variation in the size of non-bank investment firms.

5. In order to provide for the ongoing financial soundness of such firms, capital requirements are set to cover the market risks to which they are exposed.

5.1 The first requirement is the position risk requirement (Annexes 1 and 2). According to the rules proposed, each firm must keep in the form of capital a certain percentage of its long and short positions, after allowance has been made for hedging and netting. This percentage varies according to the nature of the instruments in which the firm has a position and according to the credit-standing of the issuers concerned. This requirement is intended to cover the risk of adverse price movements in the underlying securities whatever their cause (e.g. interest rate risk changes or shifts in an issuer's credit worthiness).

5.2 Second, there is a foreign exchange risk requirement which is set in relation to a firm's vulnerability to losses arising purely from adverse exchange rate movements. This is laid down in Annex 4.

5.3 The third requirement relates to unsettled transactions, i.e. to transactions in which one or other party has not paid for the securities it has contracted to buy or not delivered the securities it has contracted to sell. In such a situation, there is a risk that the counterparty will not be able to carry out its obligations and also a risk of a malfunctioning of the settlement system itself; in either of these cases the firm may suffer a loss.

5.4 Finally there is the "base" requirement in Annex 5, under which each firm is required to hold own funds equivalent to one quarter of the previous year's fixed overheads. This requirement is intended to cover all other risks faced by investment firms, e.g. the risk that market turnover collapses reducing a firm's broking income to a level insufficient to cover its expenses.

Capital requirements for credit institutions

6. The scope of the proposed Directive extends to all credit institutions, including those which are not investment firms. This is because several of the main risks dealt with by the Directive, such as the risk of losses from interest rate and exchange rate movements, apply to their traditional activities such as deposit taking and lending, as well as to their investment business. In consequence not only should the entire business of credit institutions which are investment firms be supervised in respect of these risks, but also that of those which are not investment firms.

7. As regards provision against market risks on securities positions, the Directive has to take account of the capital requirements imposed by the Solvency Ratio Directive (Council Directive 89/647/EEC), which implicitly make some provision for risks other than credit risks. It would thus be inappropriate to require credit institutions already meeting the Solvency Ratio Directive to provide additional capital against market risk in general; to do so would put them at a disadvantage in comparison with non-bank investment firms from elsewhere in the Community and in third countries.

8. The Directive therefore offers a choice of two main options in respect of credit institutions. Under both of these options, all credit institutions are required to :-

(i) provide additional capital against foreign exchange risk in accordance with the rules laid down in Annex 4, unless their foreign currency open positions are subject to a limit calculated as a percentage of their own funds (Article 4 (2)). (This is necessary because the Solvency Ratio Directive does not explicitly take account of foreign currency risks);

(ii) set up their own systems to monitor and control market risks (other than foreign currency risk) on their overall business (Article 4 (3);

9. However, as regards market risk on open positions in equities and fixed-rate securities and counterparty risk, Article 4 (4) allows the supervisory authorities in each Member State to choose between two alternative approaches: -

   either (a) to continue to apply the requirements of the Solvency Ratio Directive;

   or (b) to set capital requirements on the short-term "trading books" of credit institutions, calculated in accordance with the rules for non-credit institutions as set out in Annexes 1 - 3 of the Directive in substitution for the requirements of the Solvency Ratio Directive. For this purpose a definition of the "trading book" is given in Article 2 of the Directive.

10. The supervisory authorities of credit institutions may choose either to apply one of the options to all the credit institutions in their charge, or to decide which of their credit institutions should apply which system on a case-by-case basis.

11. The provision of the "trading book" option allows credit institutions to have their capital requirements in this area of business measured in the same way as investment firms which are not credit institutions. In this way the trading book option is consistent with the goal of ensuring a broadly level playing field between those investment firms which are, and those which are not, credit institutions. It is also desirable on prudential grounds, because the requirements in Annexes 1 to 3 provide a more comprehensive treatment of the various risks in investment services business than the Solvency Ratio Directive, which is mainly concerned with credit, as opposed to market, risks.

Own Resources

12. The definition of "own resources" for credit institutions, and investment firms which are not credit institutions, is dealt with in Annex 6 of the Directive. In the case of credit institutions the definition is the same as that laid down in Council Directive No 89/299/EEC. This definition is dictated by the need to ensure the long-run solvency of credit institutions - a need based in part on the illiquid nature of most of their assets - in order to realize the fundamental supervisory goals of depositor protection and the stability of the financial system.

13. However Member States may permit credit institutions under the "trading book" option to use an alternative definition of "own resources" with regard to the requirements on their trading books. This includes a much higher proportion of subordinated debt than in the previous definition, though a ceiling is placed on such debt so that the key supervisory goals are not compromised. The provision of the alternative definition allows such credit institutions to more easily meet the volatile own resources requirements associated with their trading positions, and ensures that the nature of their own resources is broadly similar to that for investment firms which are not credit institutions using the "alternative definition" described in paragraph 14.

14. The competent authorities may apply the definition of "own resources" in Council Directive 89/299/EEC to this latter group, or an "alternative definition". This alternative definition is focussed more on liquidity than solvency; thus illiquid assets are deducted in full from capital, but a greater amount of subordinated debt is allowed. The highly liquid nature of such firms' assets means that requiring them to provide capital in this form against the risks they run is fully consistent with the fundamental objectives of securities market supervisors. It is also in line with the approach adopted by US securities market supervisors.

COMMENTS ON THE INDIVIDUAL ARTICLES

Article 1

15. This provides for all investment firms, as defined in the Council Directive on Investment Services (.../... EEC), and for all credit institutions subject to the requirements of the Council Directive on a Solvency Ratio for Credit Institutions 89/647/EEC, to be within the scope of this Directive.

Article 2

16. This Article defines certain terms used in the Directive, which are not defined or explained in the Investment Services Directive.

Article 3

17. Levels of initial and minimum capital are laid down here for investment firms that are not credit institutions. The purpose of such requirements is to ensure that such firms have enough starting capital to begin business in the provision of the services they have been authorized to supply. Two categories of such firms are, however, excluded from both these obligations and the business-related requirements referred to in Article 4. These are local firms and investment advisers. They are excluded because their failure poses no threat to investors, or to the general stability of the financial system.

18. Allowance is made for firms in existence at the time the Directive is implemented which fail to meet the minimum levels stipulated for them in the Article, and also for firms whose initial capital falls short after its implementation due to losses. These provisions broadly mirror those in the Second Banking Coordination Directive, although an additional clause allows very small firms to continue in existence in cases where, as a result of the death of the owner, control shifts to an heir.

Article 4

19. This Article describes in general terms the financial requirements for firms covered by the Directive. An important distinction is made between those investment firms which are not credit institutions and those which are. The former firms are required to put up capital against each of the risks identified in the Directive, in the manner laid down in Annexes 1 to 5. Their overall requirement is the sum of the requirements laid down in each of these Annexes.

20. The requirements for credit institutions differ in a number of respects from those for non-banks. First, by contrast to investment firms which are not credit institutions, they are not required to provide capital against the 'other risks' catered for in Annex 5, such as the risk of a fall in general market turnover and an individual bank's broking income falling with it. This exclusion is justified on the basis that such risks are de minimis for most credit institutions, whereas they are often of paramount importance for other investment firms. Second, in regard to their credit institutions, Member States may choose to impose a limits, instead of a capital requirements, system, to protect against foreign exchange risk. The provision of the limits option is justifiable because the capital requirements in the Solvency Ratio Directive already take some account of this risk. Third, all credit institutions are obliged to establish internal systems to monitor and control the market risks associated with their business in toto, and not simply those associated with their securities trading activities. Finally, Member States supervisors are given the choice of imposing either the Solvency Ratio Directive requirements to their credit institutions' trading activities in bonds and equities, or the requirements for non-banks detailed in Annexes 1 to 3.

Article 5

21. A mark-to-market valuation of positions on a daily basis is required by this Article, except in the case of credit institutions which are subject to the Solvency Ratio Directive requirements on all of their business.

Article 6

22. This Article lays down both the type, and the frequency, of the information a firm must provide its competent authorities.

Article 7

23. Under this Article Member States are required to nominate one or more authorities to grant authorizations and to carry out the various supervisory tasks envisaged by the Directive.

24. It stipulates that it is also open to a Member State to nominate professional associations to act in this role, provided that their status is recognized in the overall statutory scheme of supervision in the country concerned.

25. Where several authorities have been nominated in a given Member State for the purposes of the Directive they are required to cooperate closely in order to ensure an adequate level of supervision.

Article 8

26. This Article permits amendments to be made to the Directive's rules in certain areas by use of a committee procedure. It is modelled upon Article 22 of the Second Banking Directive.

THE ANNEXES

27. Annexes 1 to 5 describe how the risks in a firm's positions, and thus the capital required to safeguard it, are to be calculated, while Annex 6 deals with the composition of the capital that is to be provided.

Annex 1

28. This Annex explains how firms' net positions are to be measured, including the conditions under which gross positions in an instrument may be reduced by the holding of offsetting positions in either the same instrument or a derivative of it. Once measured, the net positions are subject to the capital requirements set out in Annexes 2 and 4.

29. The Annex allows for a degree of flexibility in the way in which options and swaps are treated.

Annex 2

30. This Annex explains how capital requirements on fixed rate instruments and equities are to be calculated. Lower requirements are set on paper issued by 'qualifying' firms from the private sector than on that from other firms, in view of the lower price volatility of the former. Qualifying issuers include credit institutions, and private sector firms whose securities are listed on Member State, or recognized third country, stock exchanges. This Annex also permits the use of alternative systems for measuring capital requirements that are based on the mathematical concept of duration, in certain circumstances.

Annex 3

31. This Annex covers the risk to a firm of a deal it has entered into not being settled for whatever reason, for example the counterparty involved failing to meet its side of the bargain, or a malfunctioning of the settlement system. It explains the method of calculating the capital required to provide a buffer against the losses arising in such cases.

Annex 4

32. This Annex describes the calculation of the foreign exchange risk requirement. The purpose of this requirement is to provide a capital buffer against losses arising from adverse movements in foreign exchange rates when the credit institution or investment firm has an open position. The method of calculation is also used in calculating foreign exchange limits for credit institutions if the competent authorities so require under Article 4.

Annex 5

33. Capital requirements are set in this Annex to safeguard firms against the diverse risks that are not addressed by Annexes 2 to 4, for example the losses arising from a market-wide fall in turnover.

Annex 6

34. Annex 6 is concerned with the definition of this capital or 'own funds'. It gives the competent authorities in each Member State the option of applying the definition of own funds laid down in the Council Directive on the Own Funds of Credit Institutions (89/299/EEC) or the alternative definition set out in this Annex, to investment firms which are not credit institutions. Firms using the latter are allowed to include a

larger amount of subordinated debt in their own funds than under the former definition, but, unlike credit institutions, are strictly required to deduct their illiquid assets. Credit institutions are required to apply the definition in Council Directive 89/299/EEC, except in the case of those which are required to meet the capital requirements in Annexes 2 and 3. In this latter case the competent authorities may permit an alternative definition which is similar, though not identical, to the alternative definition for non-banks.

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THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular the first and third sentences of Article 57(2) thereof,

Having regard to the proposal from the Commission(1),

In cooperation with the European Parliament(2),

Having regard to the opinion of the Economic and Social Committee(3),

Whereas Council Directive ... of ... on investment services in the securities field(4) has as its main objective that of allowing investment firms authorized by the competent authorities of their home Member States and supervised by those same authorities to establish branches and provide services freely in other Member States; whereas it accordingly provides for coordination of the rules relating to the authorization and pursuit of business of investment firms;

(1) OJ No
(2) OJ No
(3) OJ No
(4) OJ No

Whereas Directive .... does not, however, establish common standards for the own funds of investment firms, nor indeed does it establish the amounts of initial capital of such firms; whereas it does not establish a common framework for the monitoring of market risks incurred by the same firms; whereas Directive .... makes reference, in several of its provisions, to another Community initiative, the objective of which would be precisely to adopt coordinated measures in those fields;

Whereas the approach that has been adopted is to achieve only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems; whereas the adoption of coordination measures as regards the definition of own funds of investment firms, the establishment of the amounts of initial capital and the establishment of a common framework for the monitoring of market risks of investment firms are essential aspects of the harmonization necessary for the achievement of mutual recognition and thus the completion of the internal financial market;

Whereas the Member States may also establish rules stricter than those provided for in the present Directive;

Whereas this Directive forms part of the wider international effort to bring about approximation of the rules in force in major countries regarding the on-going supervision of investment firms;

Whereas common basic standards for the own funds of investment firms are a key feature in the creation of an internal market in the investment services sector since own funds serve to ensure the continuity of investment firms and to protect investors; whereas such harmonization will strengthen the supervision of investment firms; whereas such standards must apply to all investment firms in the Community;

Whereas in a common financial market investment firms, whether they are credit institutions or not, engage in direct competition with one another;

Whereas the criteria for determining the composition of own funds must not be left to the sole discretion of Member States;

Whereas the adoption of common basic standards on the own funds of investment firms will be in the best interests of the Community in that it will prevent distortions of competition and will strengthen the Community financial system;

Whereas investment firms which are credit institutions already have the definition of own funds provided for in the Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions (1);

Whereas, there are reasons why the definition of own funds of investment firms may be adapted from that in Directive 89/299/EEC in order to take account of the particular characteristics of the activities of those firms;

Whereas, however, the basis for a definition of own funds for investment firms, which are not credit institutions, should be the definition of own funds of credit institutions;

Whereas it is necessary to establish at Community level the amounts of minimum initial financial resources that competent authorities must require from investment firms in order to grant them authorisation;

Whereas these amounts should be fixed at a level which should ensure that firms engaging in investment services have the capacity to fulfil their obligations without, at the same time, representing an inappropriate barrier to entry in the market by new firms;

(1) OJ No 124, 5.5.1989, p. 16.

Whereas it is appropriate to give Member States the possibility of reducing these amounts in cases where investment firms are not authorized to hold customers' monies or securities, nor to act as market makers, nor to underwrite, nor to take positions of their own;

Whereas existing investment firms should be permitted to continue their business even if they do not comply with the minimum amount fixed for new firms;

Whereas, as regards investment firms which are credit institutions, the amount of minimum initial capital is already established in the Second Council Directive 89/646/EEC of 15 December 1989 coordination of laws, regulations and administrative provisions relating to taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC)[1];

Whereas it is necessary to provide a common framework for the supervision and monitoring of market risks of investment firms;

Whereas such a framework must cover the main risks incurred by investment firms and, in particular, position risks, counterparty/settlement risks, interest rate risks and foreign exchange risks;

Whereas the best approach to ensure the financial soundness of investment firms is to impose on them the obligation to provide at all times a certain amount of own funds to cover each of the risks associated with their particular activities;

(1) OJ No 386, 30.12.1989, p. 1.

Whereas, for credit institutions, one main part of the risk associated with their business is already covered by the Council Directive 89/647/EEC of 18 Decmeber 1989 on a solvency ratio for credit institutions(2);

Whereas, for that reason, it is appropriate to give the competent authorities the possibility to choose between either applying Directive 89/647/EEC to the whole book of credit institutions or applying the framework provided for in this Directive to their trading book;

Whereas, in any case, credit institutions must comply with the provisions of this Directive as regards the coverage of their foreign exchange risk;

Whereas the existence, in all credit institutions, of internal systems for monitoring and controlling the market risks on all their business is a particularly important way of minimizing such risks; whereas, consequently, it is necessary that such systems be approved by the competent authorities;

Whereas technical modifications to the detailed rules laid down in this Directive may from time to time be necessary to take account of new developments in the investment services sector; whereas the Commission shall accordingly make such modifications as are necessary within the limits of the implementing powers conferred on the Commission by the Treaty;

HAS ADOPTED THIS DIRECTIVE:

(2) OJ No 386, 30.12.1989, p. 14.

SCOPE

Article 1

1. Member States shall apply the requirements of this Directive to investment firms defined in accordance with the 3rd indent of Article 1 of Directive .../.../EEC, [relating to investment services] and to credit institutions as defined in Article 2.

2. A Member State may impose additional or more stringent requirements on the investment firms and credit institutions that it has authorised.

DEFINITIONS

Article 2

For the purposes of this Directive:

- "credit institutions" means all institutions meeting the definition in the 1st indent of Article 1 of the Council Directive 77/780/EEC(1) which are subject to the requirements arising from Council Directive 89/647/EEC(2);

- the "trading book" of a credit institution shall include its proprietary positions in transferable securities or derivative instruments, which are taken on by the credit institution in order to benefit from actual or expected differences between their buying and selling prices, or in order to hedge other elements of the trading book;

- "exchange-traded instruments" means instruments which are traded on, or under the rules of, a stock exchange, or financial futures or options exchange established and officially recognized in the relevant Member State, or established in a third country and recognized by the competent authorities of the relevant Member State. Instruments which are traded on such exchanges and markets shall be classified as equities, debt instruments, futures, options, convertibles and warrants, in this Directive;

- "over-the-counter (OTC) instruments" means all other instruments;

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(1) OJ No L 322, 17.12.1977, p. 30.

(2) OJ No L 386, 30.12.1989, p. 14.

- "qualifying issuer" means a credit institution, or a firm whose securities are listed on a stock exchange in a Member State, or in a stock exchange in a third country when this exchange is recognized by the competent authorities of the relevant Member State;

- "central government" refers to the central government or central bank of Member States and all other countries which are members of the Organization for Economic Cooperation and Development (OECD) and any country which has concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF General Arrangements to Borrow (GAB);

- "other public sector" means regional governments and local authorities in countries which are members of the OECD or which have concluded special arrangements with the IMF associated with the IMF's GAB;

- "convertible" means a security, which, at the option of the holder, can be exchanged for another security, usually the equity of the issuer;

- "warrant" means a security which gives the holder the right to purchase a number of shares of common stock, or bonds, at a stipulated price up until the warrant's expiration date;

- "repurchase agreement" means an agreement in which a firm sells securities subject to a commitment to repurchase them (or substituted securities of the same description) at a specified future time and price, according to the provisions of Article 12(2) of the Council Directive 86/635/EEC(1);

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(1) OJ No L 372, 31.12.1986, p. 1.

- "reverse repurchase agreement" means an agreement in which a firm buys securities from a counterparty and agrees to sell them (or substituted securities of the same description) back to that counterparty at a specified future time and price, according to the provisions of Article 12(2) of Directive 86/635/EEC;

- "clearing member" means a member of both the exchange and the clearing house, thus having a direct contractual relationship with the central counterparty (market guarantor). Non-clearing members must have their trades routed through a clearing member;

- "local firm" means a firm dealing only for its own account on a financial futures or options exchange or for the accounts of, or making a price to, other members of the same exchange, which is guaranteed by a clearing member of the same exchange, with this guarantee being taken into account in the setting of the guarantor's capital requirements;

- "delta" means the expected change in an option price as a proportion of a small change in the price of the instrument underlying the option;

- for the purposes of Point 5 of Annex 1, "long position" means a position in which a firm has fixed the interest rate it will receive at some time in the future, and "short position" means a position in which it has fixed the interest rate it will pay at some time in the future;

- "own funds" means own funds as defined in Directive 89/299/EEC. However this definition may be modified, for credit institutions, in the circumstances described in Point 2 of Annex 6. In the case of investment firms which are not credit institutions, the competent authorities may use the definition set out in Point 4 of Annex 6 instead;

- "initial capital" means capital as defined in Points (1) and (2) of Article 2(1) of Directive 89/299/EEC. The paid-up share capital component of this shall comprise all amounts regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed and paid by the shareholders or other proprietors.

INITIAL CAPITAL AND DEROGATIONS FROM CAPITAL REQUIREMENTS

Article 3

1. References to investment firms in Articles 3 to 6 denote only those investment firms which are neither credit institutions, nor local firms, nor firms engaged purely in the business of supplying investment advice.

2. Investment firms shall have initial capital of at least ECU 500 000.

3. Member States may reduce this amount to ECU 50 000 where a firm is neither authorised to hold customers' monies or securities, nor to act as a market maker, nor to underwrite except where the firm is involved only in the distribution of issues on a best efforts basis.

4. Member States may reduce the amount in paragraph 2 to ECU 100 000 in the case of firms who hold clients' monies or securities in acting as agents or portfolio managers, but who do not hold trading positions of their own.

5. Notwithstanding paragraphs 2, 3 and 4, Member States may continue the authorisation of investment firms in existence before this Directive is implemented, whose own funds are less than the initial capital levels specified in those paragraphs. The own funds of such firms shall not fall below the highest level recorded after the date of notification of this Directive.

6. If control of an investment firm falling within paragraph 5 is taken, other than through inheritance, by a natural or legal person other than the person who controlled it previously, the own funds of that institution must attain at least the appropriate level prescribed for initial capital in paragraphs 2, 3 and 4.

7. However, in certain specific circumstances and with the consent of the competent authorities, where there is a merger of two or more investment firms, the own funds of the firm resulting from the merger need not attain the level of initial capital referred to in paragraphs 2, 3 and 4. However the own funds of the new investment firm may not fall below the total own funds of the merged firms at the time of the merger, as long as the appropriate levels pursuant to paragraphs 2, 3 and 4 have not been attained.

8. An investment firm's own funds may not fall below the amount of initial capital required under paragraphs 2, 3 and 4 or the amounts of own funds required under paragraphs 5, 6 and 7. However, if, in the cases referred to in paragraphs 2,3,4,5 and 7 the own funds should be reduced, the competent authorities may, where the circumstances justify it, allow an investment firm a limited period in which to rectify its situation or cease its activities.

PROVISION AGAINST RISKS

Article 4

1. Investment firms shall provide at all times a certain amount of own funds to cover each of the various risks associated with their particular activities. The sum of these amounts, which shall be calculated in accordance with the methods outlined in paragraph 5 below and Annexes 1 to 5, shall be their overall own funds requirement. They shall ensure that their overall own funds requirement is lower than or equal to the own funds that they hold.

2. Credit institutions shall provide, in addition to the requirements set in Directive 89/647/EEC and any set in paragraphs 4 and 5 below, own funds to cover their foreign exchange risk; this amount shall be calculated in accordance with the method outlined in Annex 4. Pending further harmonisation however, Member States may waive the application of this requirement in relation to credit institutions whose business is limited as follows: their overall net foreign exchange position, calculated in accordance with Annex 4, must not exceed the equivalent of 10% of own funds.

3. The competent authorities shall require credit institutions to set up systems, which need to be approved by the competent authorities, to monitor and control the interest rate, equity price and counterparty/settlement risks on all of their business.

4. The competent authorities shall require credit institutions - either on a general, or on an individual basis - to meet the capital requirements set out in Directive 89/647/EEC on all of their business, or may, instead of this, require them to meet the capital requirements laid down in Annexes 2 and 3 hereto on their trading books, and the requirements of Directive 89/647/EEC on the rest of their business.

5. The competent authorities in Member States shall require that investment firms have adequate own funds to cover the risks arising in connection with business that is outside the activities listed in Council Directive ../.../EEC [relating to investment services]. In addition they shall ensure that the own funds of investment firms, and those credit institutions that are required to meet the capital requirements in Annexes 2 and 3 hereto, protect them against the risks in those instruments that fall within the activities of Council Directive ../.../EEC [relating to investment services] but which are not explicitly catered for in this Directive, and, in the case of such credit institutions, are within the trading book. All cases covered by this paragraph shall be reported to the Commission by the relevant competent authorities.

EVALUATION OF POSITIONS FOR REPORTING PURPOSES

Article 5

1. Positions shall be marked to market daily by investment firms and credit institutions unless Annexes 2, 3 and 5 hereto do not apply to them.

2. In the absence of readily available market prices e.g. in the case of dealing in new issues on the primary markets, the authorities may waive the requirement under paragraph 1, and require firms to use alternative methods of evaluation provided that these methods are sufficiently prudent, and have been approved by the competent authorities.

REPORTING REQUIREMENTS

Article 6

1. Member States shall require that investment firms and credit institutions provide the competent authorities of the home Member State with all the information necessary to assess their compliance with the rules adopted in accordance with this Directive. Member States shall also ensure that investment firms' and credit institutions' internal control mechanisms and administrative and accounting procedures permit the verification of their compliance with such rules at all times.

2. Investment firms which are not credit institutions shall be obliged to report to the competent authorities in the manner specified by the latter at least once every month in the case of firms which are authorised to deal as principal, at least once every three months in the case of those firms described in Article 3(4), and at least once a year in the case of those firms covered by Article 3(3). Such reports must be received by the competent authorities within two weeks of the end of the reporting period.

3. Credit institutions shall be obliged to report in the manner specified by the competent authorities at the same time as they are obliged to report under Directive 89/647/EEC, and at more frequent intervals if the competent authorities so request.

COMPETENT AUTHORITIES

Article 7

1. Member States shall designate the authorities which are to carry out the duties provided for in this Directive. They shall inform the Commission thereof, indicating any division of duties.

2. The authorities referred to in paragraph 1 must be public authorities or bodies officially recognized by national law or by public authorities to be part of the supervisory system prevailing in the relevant Member State.

3. The authorities concerned must be granted all the powers necessary to carry out their tasks.

4. The competent authorities of different Member States shall collaborate closely to carry out the duties provided for in this Directive, particularly when investment services are provided on a services basis or by the establishment of branches in one or more Member States. They shall supply one another on request with all information likely to facilitate the supervision of the capital adequacy of investment firms and credit institutions and particularly the verification of their compliance to the rules laid down in this Directive. Any exchange of information between competent authorities which is provided for in this Directive in respect of investment firms shall be subject to the obligation of professional secrecy as set out in Article 20 of Directive .../.../EEC [relating to investment services] and, in respect of credit institutions, subject to the obligation set out in Article 12 of Council Directive 77/780/EEC.

COMMITTEE

Article 8

1. The technical amendments to be made to this Directive in the following areas shall be adopted in accordance with the procedure laid down in paragraph 2:

- definitions in Article 2;
- initial capital requirements in
- Article 3;
- ceiling referred to in Article 4(2);
- treatment of instruments within the scope of Directive ../.../EEC relating to investment services , but not covered in this Directive;
- calculation of net open positions in Annex 1;
- Annex 2;

- counterparty/settlement risk weights in Annex 3;
- foreign exchange risk weights in Annex 4;
- time period used in Annex 5;
- definition of own funds in Points 2, 4 and 5 of Annex 6.

2. Whenever the technical amendments referred to in the first paragraph are to be made to this Directive, Article 23(2), of Council Directive ../.../EEC [relating to investment services] shall apply.

FINAL PROVISIONS

Article 9

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 1 January 1993 at the latest. They shall forthwith inform the Commission thereof.

   The provisions adopted pursuant to the first paragraph shall make express reference to this Directive.

2. Member States shall communicate to the Commission the texts of the main laws, regulations and administrative provisions which they adopt in the field covered by this Directive.

Article 10

This Directive is addressed to the Member States.

Done at Brussels, For the Council

The President

ANNEX 1

CALCULATION OF NET OPEN POSITIONS

Equity and debt instruments

1. The firm's long and short positions in the same equity, debt and convertible issues shall be netted. In calculating the net position the competent authorities may allow positions in derivative instruments to be treated as the underlying (or notional) security/securities. The competent authorities shall allow the netting of identical financial futures, options and warrants, contracts.

2. Debt instruments denominated in the same currency shall be grouped by maturity (according to Annex 2) in reflection of the residual maturity of fixed rate instruments, and the period to repricing of other instruments.

3. Debt instruments shall be categorised by issuer as follows: central government, other public sector, qualifying and other.

Convertibles

4. No netting is allowed between convertibles and offsetting positions in the underlying instrument itself, unless the competent authorities adopt an approach under which the likelihood of a particular convertible being converted is taken into account, or have a capital requirement to cover any potential loss which could be incurred on conversion.

Other instruments

5. Interest rate futures and forward rate agreements (FRAs) which are not based on an underlying instrument, will be treated as combinations of long and short positions. Thus a long futures position will be treated as a combination of a borrowing maturing on the delivery date of the futures contract and a holding of an asset maturing on the expiration date of the future. The opposite holds for a short position. Both the borrowing and asset holding will be included in the central government column of Table 1 in Annex 2. A future or a forward which is based on an underlying debt instrument will be treated as either a long or short position in the underlying instrument. Its maturity will be taken to be the period until delivery or exercise of the contract, plus the life of the underlying security, or, if the life of the underlying security exceeds a year, as this life itself. The competent authorities may allow the requirement for an exchange-traded future to be equal to the margin held at the exchange if they are fully satisfied that it provides an accurate measure of the risk associated with the future.

6. Options on interest rates, debt instruments, equities, financial futures, swaps and foreign currencies, are treated as if they were positions in the delta multiplied by the amount of the underlying instrument to which the option refers. The delta used should be that of the exchange concerned, or, where this is not available or for OTC options, that calculated by the firm itself, subject to the competent authorities being satisfied that the model used by the firm is reasonable. The competent authorities shall require that the other risks, apart from the delta risk, associated with options are safeguarded against. The competent authorities may allow the requirement against

a written, exchange-traded option to be equal to the margin held at the exchange if they are fully satisfied that it provides an accurate measure of the risk associated with the option, and for the requirement on a bought, exchange-traded or OTC option to be the same as for the instruments underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement against a written OTC option will be set in relation to the instrument underlying it.

7. Swaps will be treated for interest rate risk purposes on the same basis as on-balance sheet instruments. Thus an interest rate swap under which a firm receives floating rate interest and pays fixed rate interest will be treated as equivalent to a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing, and a short position in a fixed rate instrument with the same maturity as the swap itself. Competent authorities may however set alternative requirements to these for firms using swap models which provide, to the satisfaction of the competent authorities, a more accurate measure of the risks in swaps.

8. Warrants shall be treated in the same way that options are treated in paragraph 6.

Currency conversion

9. All net positions, irrespective of their sign, must be converted on a daily basis into the firm's reporting currency at the prevailing spot exchange rate before their aggregation.

ANNEX 2

Position risk

1. Investment firms shall calculate their net positions as defined in Annex 1.

2. Investment firms will apply the weights shown in Table 1 to their net, fixed interest rate positions, whether in their own or foreign currencies, as calculated in Annex 1, and thus calculate their weighted long positions and their weighted short positions.

Table 1

Residual maturity	Central government and European Community	Other public sector and qualifying	Other
	%	%	%
up to 3 months	0.3	0.5	8.0
more than 3 up to 6 months	0.5	1.0	8.0
more than 6 up to 12 months	1.0	1.6	8.0
more than 1 up to 2 years	1.6	3.6	8.0
more than 2 up to 5 years	2.9	4.9	10.0
more than 5 up to 10 years	3.8	5.8	15.0
more than 10 up to 20 years	4.8	6.8	15.0
Over 20 years	5.8	7.8	15.0

3. The capital requirement will be :

the sum of the weighted long positions
plus the sum of the weighted short positions
less any hedging allowances, calculated as follows:

- 150% of any weighted long (or short) position in central government bonds which can be offset in part or fully against a weighted short (or long) position in central government bonds in the same or an adjacent maturity band;

- 100% of any weighted long (or short) position in central government bonds which can be offset in part or fully against a weighted short (or long) position in central government bonds in the next-but-one maturity band;

- In the case of hedges between positions in the 'other public sector and qualifying' bonds (the second category in Table 1), the respective percentages are 120% and 80%, rather than the 150% and 100% used for central government bonds.

- In the case of a hedge between a position in central government bonds and a position in 'other public sector and qualifying' bonds, the respective percentages are also 120% and 80%.

  (Note that the unused portion of partially offset weighted positions can be employed in this process.)

Duration

4. Competent authorities in a Member State may use a system for applying capital requirements to the interest rate dependent business of investment firms, which reflects duration, instead of the rules set out in paragraphs 2 to 3 above, so long as the requirements emanating from it are broadly equivalent to those resulting from the application of the rules in paragraphs 2 to 3.

Equities

5. The capital required against a long or a short equity position shall be 10% of its value in the case of a qualifying equity and 25% for any other equity.

6. The competent authorities may allow a reduction in the requirement for any reduction in risk due to diversification, whether through the investment firm holding a large number of long, or short, positions in equities or equities derivatives, or from its holding long and short positions in different equities and equities derivatives. However any such reduction shall only be allowed on the basis that the resulting capital requirement is sufficient to cover the firm against a 10% change in the general level of equity prices on its main markets.

Underwriting of debt and equity instruments

7. In the case of underwriting of issues of debt and equity instruments, the competent authorities may allow the weights referred to in paragraphs 2 and 5 above to be reduced by 60% during the first week, by 35% during the second week, and by 20% during the third week following the day on which the underwriting firm entered into an irrevocable commitment to purchase the securities, provided that the securities in question are to be traded on a regulated market recognised by the competent authorities.

Risk concentration

8. An investment firm which has, or is committed to, a long or short position in a particular issue of securities which exceeds 25% of the total issue, shall meet an additional capital requirement equivalent to 100% of the requirement against the unhedged position set out in paragraphs 2 and 5 above.

9. An investment firm's total exposure to an issuer cannot exceed 25% of its own funds without the investment firm notifying the competent authorities: the firm shall meet an additional capital requirement against such exposures, calculated by summing the requirements against each unhedged position in the overall exposure.

ANNEX 3

Counterparty/settlement risk

1. In the case of transactions in which bonds and equities (excluding repurchase and reverse repurchase agreements) are unsettled after their due delivery dates, a firm must calculate the price difference to which it is exposed. This is the difference between the agreed settlement price for the bond or equity in question, and its current market value, where the difference could involve a loss for the firm. It must multiply this difference by the appropriate factor in Column A of Table 1 in order to calculate its capital requirement.

2. Notwithstanding paragraph 1, a firm can, at the discretion of its competent authorities, calculate its capital requirements by multiplying the agreed settlement price of every transaction which is unsettled between 5 and 45 days after its due date, by the appropriate factor in Column B of Table 1. From 45 or more days after the due date it shall take the requirement to be 100% of the price difference to which it is exposed, as in Column A.

Table 1

Number of days after due settlement date	Column A	Column B
5-15	8%	0.25%
16-30	50%	0.5%
31-45	75%	2.0%
46 +more	100%	see para. 2

Repurchase and reverse repurchase agreements

3. In the case of repurchase agreements the firm shall put up the difference between the market value of the securities, and the amount borrowed by the firm (which is their original sale value) where this difference is positive. In the case of reverse repurchase agreements the firm shall put up the difference between the amount it has lent plus accrued interest, and the market value of the securities it has received (which is their original sale value plus accrued interest) where this difference is positive. In the case of both repurchase agreements and reverse repurchase agreements the competent authorities may reduce the requirement to the extent that the borrower provides the lender with the margin that is normally required in the market in question.

OTC derivative instruments

4. The requirement shall be calculated as follows: first the firm will sum (i) the total replacement cost (obtained by marking to market) of all its contracts, including bought equity option contracts, with positive values and (ii), in the case of interest rate and exchange rate contracts, an amount for potential future credit exposure, calculated by multiplying the total notional principal amount of its contracts by the following weights, as appropriate:

Residual maturity	Interest rate contracts	Exchange rate contracts
less than one year	-	1.0%
one year and over	0.5%	5.0%

The capital requirement will be 4% of the sum of (i) and (ii) where the counterparty is in the non-bank private sector, 2% of the sum where it is in the banking sector and/or in the regional government or local authority sector, and zero if it is the central government.

ANNEX 4

Foreign exchange risk

1. The overall net foreign exchange position, calculated in accordance with the procedures set out below, shall be assigned an 8% capital requirement.

2. A two-stage calculation shall be used.

3. First, the firm's net open currency position in each currency (including the reporting currency) shall be calculated. This position shall consist of the addition of the following elements (positive or negative):

- the net spot position (i.e. all asset items less all liability items, including accrued interest, in the currency in question);

- the net forward position (i.e. all amounts to be received less all amounts to be paid under forward exchange transactions, including currency futures and the principal on currency swaps not included in the spot position);

- guarantees (and similar instruments) that are certain to be called;

- net future income/expenses (at the discretion of the reporting institution; when this discretion has been used, it may not be changed without the prior approval of the competent authorities);

- the net delta (or delta-based) equivalent of the total book of foreign currency options.

4. Second, net short and long positions in each currency other than the reporting currency, shall be converted at spot rates into the reporting currency. They shall then be summed separately to form respectively the total of the net short positions and the total of the net long positions. The higher of these two totals will be the firm's overall net foreign exchange position.

5. Net positions in composite currencies may be decomposed into the component currencies according to the quotas in force.

ANNEX 5

Other risks

1. Investment firms, excluding credit institutions, shall be required to hold own funds equivalent to one quarter of their previous year's fixed overheads. The competent authorities may adjust this requirement in the event of a material change to a firm's business since the previous year. When the firm has not completed a year's business, including on the day it starts up, the requirement will be a quarter of the fixed overheads figure projected in its business plan, unless an adjustment to this plan is required by the authorities. For firms that are starting up, own funds shall be greater than or equal to this amount, and initial capital at least equal to the requirements laid down in Article 3.

ANNEX 6

Own funds

1. The own funds of credit institutions shall be defined in accordance with Council Directive 89/299/EEC.

2. Notwithstanding paragraph 1, the competent authorities may permit those credit institutions which are obliged to meet the capital requirements on their trading book that are laid down in Annexes 2 and 3, to use an alternative definition of own funds when meeting these requirements. This alternative definition shall include share capital and reserves as defined in Points (1) and (2) Article 2(1) of Council Directive 89/299/EEC, and subordinated loan capital subject to the following conditions. First, this subordinated loan capital shall not exceed 250% of the share capital and reserves included in this definition. Second, the use of this alternative definition shall not result in adding more than 25% to the total amount of own funds which would result from applying Council Directive 89/299/EEC to the credit institution as a whole. Third, the conditions laid down in 5(2) below must apply to this subordinated loan capital.

3. The own funds of investment firms which are not credit institutions shall be defined in accordance with Council Directive 89/299/EEC.

4(1) Notwithstanding the requirements of paragraph 3, the competent authorities may permit investment firms which are not credit institutions an alternative definition of own funds. This shall include:

(2) share capital and reserves as defined in 1(1) and 1(2) of Article 2 of Council Directive 89/299/EEC;

(3) minus intangible assets within the meaning of Article 4(9) ('assets') of Council Directive 86/635/EEC;

(4) plus net profits (or minus net losses) after allowance for all anticipated tax liabilities;

(5) plus subordinated loan capital subject to the conditions set out in paragraph 5(2);

(6) minus illiquid assets.

5(1) Firms shall be required to satisfy their auditors and competent authorities that they have adequate systems to calculate with reasonable accuracy at any time the financial position of the firm.

(2) The subordinated loan capital referred to in 4(5) shall have an initial maturity of at least two years. It shall be fully paid-up and the loan agreement shall not include any clause providing that, in specified circumstances, other than the winding-up of the investment firm, the debt will become repayable before the agreed repayment date, unless the supervisory authorities agree to it having been given two days' notice. Subordinated debt may not be repaid if such repayment would mean that the own funds of the firm in question would then stand at below 120% of the firm's overall requirement.

(3) The subordinated loan capital referred to in 4(5) may not exceed a maximum of 250% of the sum total of items 4(2) plus 4(4) less 4(3) and should only approach this maximum in particular circumstances acceptable to the relevant competent authorities.

(4) Illiquid assets include:

- fixed assets (except to the extent that land and buildings are allowed to count against secured loans);

- investment in connected companies if these companies are subsidiaries or if the shares are not readily realisable investments;

- deposits made, other than those which are with a credit institution, local authority or regional government and available for repayment within ninety days, and also excluding margin payments in connection with futures or written options contracts;

- guarantees given;

- deficiencies in subsidiaries;

- all other assets (including physical stocks) unless they are subject to the capital requirements set out in this Directive, or pursuant to Article 4(5).

COMPETITIVENESS AND EMPLOYMENT IMPACT STATEMENT

PROPOSAL FOR A COUNCIL DIRECTIVE ON CAPITAL ADEQUACY OF INVESTMENT FIRMS AND CREDIT INSTITUTIONS

I. What is the main reason for introducing the measure?

The main reason for introducing the measure is to ensure that consumers of financial services are adequately protected by imposing minimum capital requirements on investment firms.

II. Features of the businesses in question

The scope of the proposal covers credit institutions and non-bank investment firms which are dealers or brokers in securities, as well as portfolio managers and investment advisers.

a) There are many SMEs, mainly in the United Kingdom.

b) There is no particular regional concentration.

III. What direct obligations does this measure impose on businesses?

Businesses are required to comply with requirements relating to minimum start-up capital which varies with the type of risk resulting from the activities the firm is carrying out.

For low-risk activities, such as investment advice only or "locals", there is no initial or on-going capital requirement. (Locals are members of financial futures or options exchanges whose transactions are guaranteed by other member firms of the exchange.) The general start-up capital is set at ECU 500 000. Member States may reduce this requirement to ECU 50 000 for firms which do not hold customers' money or securities, or to ECU 100 000 for brokerage firms which hold customers' money or securities but who do not take trading positions for their own account. Firms already in existence before implementation of the directive may be granted an exemption (grandfathering clause) from these initial capital requirements.

Firms will also have to meet on-going capital requirements based on an expenditure measure and on their position risk, counterparty risk and foreign exchange risk. These risks are strictly proportional to the size of each business and to the size of the risk taken.

IV. What indirect obligations are local authorities likely to impose on businesses?

None

V. Are there any special measures in respect of SMEs?

Implicitly SMEs will be the main beneficiaires of the "grandfathering clause" concerning initial capital, as well as of the exception for "locals" and pure investment advisers.

VI. What is the likely effect on:

a) the competitiveness of businesses?

Investment firms' own funds should reflect the risks taken and the size of their transactions. This should improve their performance and reduce their failure rate.

b) employment?

Because of the "grandfathering clause" there should be no reduction in the number of already existing firms. There is likely to be some reduction in the number of new entrants as not all candidates would be able to meet the initial capital requirement of ECU 50 000 or ECU 100 000. This effect might, however, well be compensated for by the fact that all authorised firms could engage in securities business throughout the Community on the basis of home country authorisation and supervision. In addition, consumers of financial services should have more confidence in small and medium-sized investment firms, knowing that they are likely to be sufficiently capitalized in relation to the size of their business. The survival rate of new entrants should increase because of a larger capacity to absorb losses.

VII. Have both sides of industry been consulted?

There have been no consultations with representatives of employees.

As far as the business sector is concerned, there have been requests made to the Commission by representatives of the financial futures and options exchanges in France, the Netherlands and the United Kingdom in favour of "locals". These demands have been met by the exclusion of "locals" from initial and on-going capital requirements.

In addition, there have been requests made by FIMBRA concerning the level of the initial start-up requirements. These demands have been met, as far as compatible with consumer protection, by excluding pure investment advisers from any capital requiremnets, by providing an intermediate level of start-up capital of ECU 100 000 for brokers who do not take positions, and by the "grandfathering clause" for existing firms.

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