TITHE AN OIREACHTAIS

An Comhchoiste um Airgeadas, Caiteachas Poiblí agus Athchóiriú

Tuarascáil Iniúchta AE Uimh. 1

Reachtaíocht CRD IV i ndáil le ceanglais maidir le baincéireacht chaipitiúl stuama faoi Basel III

14 Feabhra 2012

HOUSES OF THE OIREACHTAS

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

EU Scrutiny Report No.1

CRD IV legislation on prudential capital banking requirements under Basel III

14 February 2012

CONTENTS

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

EU SCRUTINY REPORT NO.1

1. INTRODUCTION

The Committee agreed at its meeting of 13 October to scrutinize the following 2 proposals in more detail

- ***COM (2011) 452*** *- Regulation on prudential requirements for credit institutions and investment firms*
- ***COM (2011) 453*** *- Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.*

The two proposals (CRD IV package) seek to amend the 2006 Capital Requirements Directive to give effect to the Basel III provisions. The overarching aim of the package is to strengthen the resilience of the EU banking sector so it would be better placed to absorb economic shocks while ensuring that banks continue to finance economic activity and growth. According to the Commission, CRD IV will apply to more than 8000 banks across the EU, amounting to 53% of global bank assets, and is estimated to lead to an extra €460 billion of new capital having to be raised by 2019.

To assist it with this further scrutiny, the Joint Committee decided to hold a public hearing with the Department of Finance on 24 November. The full transcript of that meeting is available on the Oireachtas website[1].

On the basis of the public hearing, the Commission's supporting material, other research and reports, as well as its own analysis, the Joint Committee has prepared the following report.

2. SUMMARY OF PROPOSALS

2.1 Background

The Basel Committee on Banking Supervision (BCBS) has the task of developing international minimum standards on bank capital adequacy. The European Commission and the European Central Bank are observers. The new proposals will implement the Basel III agreement into EU law. Basel III itself is not a law. It is the latest configuration of an evolving set of internationally agreed standards developed by supervisors and central banks. That has to now go through a process of democratic control as it is transposed into EU/national law. It needs to fit with existing EU/national laws or arrangements. As EU law takes precedence over national law, the Commission's proposal launches that process.

The 2006 Capital Requirements Directive (CRD) regulates the licensing and supervision of credit institutions and introduced into EU law the Basel II risk-sensitive capital framework to encourage better risk management by those institutions. The Directive was applied in Member States in 2007, with institutions required to implement its provisions no later than 1 January 2008[2]. There have previously been two substantial sets of amendments to the CRD in 2009 and 2010 (CRD II and III).

This is the third iteration of Basel and the package is referred to as CRD IV. It is structured slightly differently from other CRD directives in that there is a regulation and a directive. The regulation means that it will have direct effect across the European Union and will become European Union law.

[1] http://debates.oireachtas.ie/FIJ/2011/11/24/
[2] Ireland transposed the CRD by S.I. Nos. 660 and 661 of 2006

2.2 *The Proposals*

The CRD IV package of legislation comprises a full recast of Directives 2006/48/EC and 2006/49/EC (the existing CRD). The proposal divides the current CRD (Capital Requirements Directive) into two legislative instruments: a **directive** governing the access to deposit-taking activities and a **regulation** establishing the prudential requirements institutions need to respect.

While Member States will have to transpose the directive into national law, the regulation is directly applicable which means that it creates law that takes immediate effect in all Member States in the same way as a national instrument without any further action on the part of the national authorities. The European Commission states that this removes the major sources of national divergences (ie different interpretations, gold-plating). It also makes the regulatory process faster and makes it easier to react to changed market conditions. It increases transparency as one rule as written in the regulation will apply across the single market. A regulation is subject to the same political decision-making process as a directive at European level, ensuring full democratic control.

These might be in areas such as the powers and responsibility of the supervisory authorities, the rules governing authorisation, supervision, capital buffers (where flexibility is required), how sanctions will apply and issues such as internal risk management arrangements and the application of company law within states. This means there is a need for a national flexibility to deal with those kind of issues and they are therefore being prescribed by directive which member states will transpose into national law.

The proposal marks a thorough review of EU banking legislation that has developed over decades. The Commission regards the result as a more accessible and readable piece of legislation.

What goes in which instrument?

Areas of the current CRD where the degree of prescription is lower and where the links with national administrative laws are particularly important will stay in the form of a directive. This concerns in particular the powers and responsibilities of national authorities (e.g. authorisation, supervision, capital buffers and sanctions), the requirements on internal risk management that are intertwined with national company law as well as the corporate governance provisions. By contrast, the detailed and highly prescriptive provisions on calculating capital requirements take the form of a regulation.

Directive (Strong links with national law, less prescriptive)	**Regulation** (Detailed and highly prescriptive provisions establishing a single rule book)
Access to taking up/pursuit of business	Capital
Exercise of freedom of establishment and free movement of services	Liquidity
Prudential supervision	Leverage
Capital buffers	Counterparty credit risk
Corporate governance	
Sanctions	

1. The draft Regulation will be directly applicable to credit institutions and investment firms, will contain the prudential requirements that currently exist in the 2006 Directives as amended, and will also implement the new requirements contained in the Basel III agreement.

   The Basel III Agreement sets out new standards for liquidity risk to promote the resilience of the liquidity risk profile of institutions:

   - it raises the minimum capital requirements for banks for common equity capital from 2% to 4.5% of risk-weighted assets and the Tier 1 ratio from 4% to 6% effective as of 2015
   - it additionally tightens existing risk-weights for different categories of exposures, providing for a more significant effective increase in regulatory capital. (*Subsequently, fully effective as of 2019, banks will be required to add a conservation buffer of 2.5% on top of the common equity and Tier 1 capital ratios, to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress*)
   - in addition, a counter-cyclical buffer, to be applied by adjusting the size of the buffer range established by the conservation buffer by up to additional 2.5%, will be required to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth.

   Basel III also introduces the following components:

   · measures to strengthen the capital requirements for counterparty credit exposures arising from institutions' derivatives, repo and securities financing activities; and
   · a leverage ratio to supplement risk-based minimum capital requirements by acting as a potential constraint on excessive growth in institutions' on- and off-balance sheet assets.

2. The Directive covers areas where the degree of prescription is lower and where there is greater need to take account of the links with national administrative laws. The main objectives of the directive are to implement Basel III, to effect consolidation of previous capital requirement directives and to address some additional supervision and governance arrangements. The main aspects of Basel III, which is being transposed here, are capital requirements. Across the EU, the directive raises the capital requirements to be held by banks against expected losses. This is being raised to a common level across Europe, which is seen as more consistent with requirements based on the experience of the financial crises of recent years. In addition, a capital buffer is provided for.

   The draft Directive re-states provisions in the existing CRD in relation to the establishment and undertaking of banking business and in relation to supervision of such businesses in the single market. It contains new proposals in relation to corporate governance and sanctions as well as enhancements to supervisory power for institutions operating on a cross-border basis, and some amendments to the 2002 Financial Conglomerates Directive in order to allow for technical standards to be developed to ensure that institutions that are part of a financial conglomerate apply the appropriate calculation methods for the determination of required capital on a consolidated basis.

2.3 Information Notes from the Department

The Department's information notes on these legislative proposals are contained in Appendix 2 to the report. The Department states that these proposals will have significant implications for both the capital structure and liquidity profile of all banks operating in the EU. As a full recast of existing EU legislation in this field, the proposals will also have a significant impact on domestic legislation.

In relation to Irish banks, following the 2011 Prudential Capital Assessment Review (PCAR), the Central Bank of Ireland has required additional levels of regulatory capital to be maintained by each of the covered institutions, as an essential prerequisite to building up the capital strength of Irish institutions, and which are well above the 10.5% target rate of the Basel III agreement (*minimum capital plus the capital conversation buffer*). The Department states that the two pillar banks were recapitalised in July 2011. Assuming these recapitalisations had taken place on 31 December 2010, their pro-forma Core Tier 1 ratios would have been: AIB 21.9% and BOI 16.1%. The pro-forma ratios for the other institutions would have been EBS 22.6% and ILP 32.4%.

The existing Capital Requirements Directive and its amendments are principally transposed in Irish law by way of four Statutory Instruments. The full recast of the 2006 Directives into a new Regulation and a Directive will mean that many of the provisions will in future have direct effect in Irish law and so will require a repeal of most of the provisions of S.I.s 660 and 661 of 2006. The Department states in its note that the significance of these amendments presents an opportunity to undertake a consolidation exercise of existing legislation in this field. Up to 17 individual Statutory Instruments are expected to be affected.

2.4 *Negotiations at EU level*

It has been reported in the media that there is a split in Europe between those countries (led by the UK) advocating for higher capital requirements together with topped-up provisions on significant banks that exceed Basel III minima, and those (led by Germany and France) who believe Basel III should be the maximum standards to protect their banks' competitive position in global markets.

The Financial Times[3] reported that the EU had proposed that banks be allowed to circumvent part of a recent Basel accord on capital by allowing the use of hybrid securities and reserves from related businesses as equity. The move was seen as a sign that Berlin and Paris had pushed through demands for light-touch regulation.

The IMF is reported to have been disappointed with the legislative proposals in CRD IV to implement Basel III. It is calling for changes as the legislation is finalised in the coming months. Specifically, the IMF raised the following problems:

- *The common standards are too weak*: enforcing maximum harmonization at the level of Basel III minimum requirements is inappropriate given prevailing balance sheet uncertainties and the lack of EU-wide resolution arrangements
- *Definition of "capital" has been diluted*: the EU has softened its definition of core tier 1 capital in a number of areas relative to Basel III requirements. Basel III uses strict definitions of what counts as capital and the IMF underlined the importance of sticking to these definitions rigidly
- *Liquidity ratio*: the EU's proposal lacks a firm commitment to implement the leverage ratio by 2018, as was agreed under Basel III.

[3] 27 May 2011

3. MEETING WITH DEPARTMENT OF FINANCE

The Committee met in public session on 24 November with officials from the Department of Finance. The Committee is grateful to the Department for their assistance in going through the implications of the legislative package in detail. In relation to detailed questions by members of the Committee, the Department's position on certain matters is contained hereunder. The details of the discussion can be accessed in the transcript on the Oireachtas website[4].

3.1 Overall, the Department are reasonably satisfied with the proposal presented by the Commission. It reflects the fact that it has already been the subject of significant analysis and input among member states and industry stakeholders. It has been considered in the European Union and at a wider international level through the Basel and G20 processes.

There has already been considerable negotiation of this instrument, both in preparatory working groups and in Council working groups, where consideration is ongoing. At each stage the Department has been conscious of working with and trying to influence the process so that our interests are represented.

3.2 These proposals will require significant changes to the capital positions of European banks. The proposed new liquidity requirements will have significant implications for the funding profiles of many European banks. Obviously, they will have a further impact on Irish banks, to some extent. The Department claimed that Irish banks are reasonably well positioned in this respect as a result of the significant capital injections made through the Central Bank's prudential capital assessment review and the liquidity arrangements that resulted from the prudential liquidity assessment review. The Department is reasonably confident that the capital that has been provided will see us through any losses that do arise over the next few years. We are capitalised to deal with extensive stress levels and we should be able to meet the CRD capital requirements.

3.3 The Central Bank's requirement for significant deleveraging by the Irish banks has gone some way towards meeting the deleveraging and CRD requirements. The Department is continuing to work with the Council working committees and groups. As the process proceeds, they will work with the European Parliament to ensure the existing proposal can be further refined, where necessary, to enable the Central Bank to fulfil its regulatory functions. They will ensure the impact of the directive will be to provide for the necessary balance and flexibility.

3.4 A group of countries have disagreed with the European Commission's view on setting a maximum harmonised regulation which will prevent Member States from imposing stricter requirements. They argue that capital requirements are an issue where national states should be allowed to determine their needs, based on their particular interests. This is being championed by the UK, Sweden and a few other countries[5]. The position at working party level in Europe is that this debate is still a live one. Ireland is working with other member states to ascertain their views and is keeping its position open pending further developments.

3.5 The Department has briefed and consulted with the industry representative bodies in Ireland through the IFSC Clearing House Group, the Irish Banking Federation and the various other banking groups. The Department states that no crisis issues from an Irish perspective are being flagged by these bodies. The view is that the IFSC group would not be unhappy with a standard across Europe within which it can work.

[4] http://debates.oireachtas.ie/FIJ/2011/11/24/

[5] For example, the Vickers report in the UK has already set higher capital levels than those set here, and the British Government is arguing that it should be free to maintain higher capital levels.

3.6 The Department's view on our domestic banks is that in addition to that requirement for consistency, there should also be flexibility. There is flexibility in the proposals in respect of the counter-cyclical capital requirement which allows supervised central banks to increase the capital requirements depending on the circumstances. There is a provision under Pillar II of the directive which provides flexibility to national authorities to intervene in particular institutions, where there are particular risks identified. Between the counter-cyclical flexibility and the Pillar II flexibilities, the Department feel that there is probably sufficient flexibility to allow us deal with any situation that might arise which requires flexibility in capital requirements.

3.7 The CRD directives do not apply to the credit union movement, which is specifically exempt. Credit unions have a completely different capital structure from banks, so Ireland is retaining the credit union exemption in CRD IV.

3.8 It will be a sea change in terms of European regulatory architecture to have liquidity rules in place. The impact of liquidity ratios on the banks will be significant[6]. In addition, they have a significant impact on the likely balance sheet structure of banks across Europe. It will require them to hold significant banks of liquid assets and also to have a net stable funding ratio. It is the evolution of banks' balance sheets to meet those requirements which makes it a significant change.

3.9 This is only one of a comprehensive range of architectural changes being made at a national and international level to deal with the shortcomings that have been seen as contributing to the financial crisis emerging in 2007 and 2008. Complementary to this, there are in the region of 20 other EU directives or regulations which are at different stages of negotiation and which are coming through as a package of financial services measures to improve the context in which financial services operate and to improve the protection, safety and supervision of financial services across Europe.

4. Subsidiarity

Commission basis
The Commission sets out its justification in the explanatory memorandum as to why they think the proposals comply with the principle of subsidiarity. The Commission's assessment is that

- EU action is required to ensure that credit institutions and investment firms operating in more than one Member State are subject to the same prudential requirements and thereby ensure a level playing field, reduce regulatory complexity, avoid unwarranted compliance costs for cross-border activities, promote further integration in the EU market and contribute to the elimination of regulatory arbitrage opportunities

- EU action also ensures a high level of financial stability in the EU. Convergence of national sanctioning regimes is necessary to promote dissuasiveness and create a level playing field to ensure a uniform application of the CRD and full cooperation and mutual trust between banking supervisors across the EU. Better application of the existing sanctioning powers by national authorities would not be sufficient to achieve such convergence

- the choice of a Regulation for *COM (2011) 452* creates a more level-playing field since it is directly applicable and there is no need to assess legislation in other Member States before starting a business since the rules are exactly the same. This is less burdensome for

[6] Basel II and the 2006 Capital Requirements Directive (CRD I) had no real oversight of liquidity requirements

institutions. Delays with regard to the transposition of Directives can also be avoided by adopting a Regulation.

Reasoned Opinions

Three national parliaments submitted Reasoned Opinions (ROs) stating their view that the Regulation (452) does not comply with the principle of subsidiarity.

(i) The House of Commons found that the objectives of the Regulation (452) could be better achieved without precluding Member States from imposing stricter requirements. They stress the need to be able to able to take a flexible approach to address prudential concerns at national level. They also contend that the Commission should not be given the power (in Article 443) to adopt delegated acts to impose stricter requirements on a temporary basis. The House of Commons do not see this as an appropriate use of the Commission's delegated powers under Article 290 of the TFEU.

(ii) The Swedish Riksdag also found a problem with the full harmonization of maximum standards. They see this as a potential watering down of the content of the Basel III agreement if what were intended to be minimum regulations instead become an enforceable EU standard.

(iii) The French Senate also have an issue with the Commission being given powers under delegated acts to impose stricter requirements 'for a limited period of time'. They state that the delegated powers of the Commission as defined in Article 290, TFEU are supposed to be used to supplement or amend 'certain non-essential elements' of a legislative act.

Irish Position

The Department of Finance indicated in their information note and oral evidence to the Committee that they do not see any particular subsidiarity implications for Ireland from the proposals.

In considering its position on subsidiarity, the Committee was mindful that the Oireachtas has only agreed one reasoned opinion to date on the proposed Directive for a CCCTB. Subsidiarity is a essentially a matter of political opinion rather than a legal concept that can be measured uniformly across 27 different member states.

In the case of the CCCTB proposal, it was clear that it would involve losses for a number of member states, and had the potential to be politically divisive for that very reason. There was also a significant range of public opinion in favour of supporting the independence of Ireland's corporation tax system.

The CRD IV package has not led to any feedback from Irish stakeholders in relation to subsidiarity concerns. The Committee had regard to the serious points raised by three other parliaments. But the Committee will await the response from the Commission on those concerns and will also be very interested to see how these matters are negotiated on in the Council and European Parliament in an attempt to find an agreed package.

5. OBSERVATIONS AND RECOMMENDATIONS

Based on its analysis of the information gathered, the Committee's main observations and recommendations on the CRD IV package are set out in this section. As the measures are due to come into effect from 2013, the next year is critical in terms of banks being prepared for such changes.

5.1 One of the main lessons since 2008 has been that, without sufficient regulation and control, the capital funding of the Irish banking model became completely unsustainable. Some of the background data in the Commission's impact assessment[7] is very instructive

- between 2005 and 2008, Ireland was one of a small group of countries whose banking sector was over 4 times their GDP[8]
- by 2008, Ireland's banking sector had risen to over 7 times to the size of Ireland's GDP[9]
- by the end of 2009, Ireland was ahead in very different EU27 tables – it had the highest rate of public capital interventions in the banking sector (as % of GDP) at almost 7%
- while most Member States had to provide guarantees on bank liabilities of between 1 and 10% of GDP, Ireland's guarantee was effectively 167.5%[10]

There are 9 EU banks specified whose capital instruments did not live up to the expectations as regards their loss absorption, permanence and flexibility of payments capacity (which had to be reinforced through Commission state aid decisions). Despite Ireland's small relative size as part of the EU banking system, 2 of the 9 banks cited are Irish – Bank of Ireland and Allied Irish Banks[11].

5.2 The Irish State is now carrying a large debt burden due to decisions taken to publicly bail out banks, particularly Anglo\INB. The most controversial element of this is the promissory notes for the former Anglo-Irish Bank which will cost the State €3.1 billion per year until 2023. There is nothing in the CRD IV package, or the overall single rulebook proposals, which can turn back the clock to lessen the burden caused to the Irish State by the actions of its own banking sector.

5.3 The overall provisions set out in the CRD IV package are clearly necessary now, as part of the wider single rulebook proposals to put EU banking on a more secure footing in the long term. Obviously, it is very unfortunate that it took a financial crisis of the current magnitude to bring this clarity of purpose.

5.4 The Committee is mindful that there have been some concerns expressed in relation to the CRD IV package as published. These matters need to be taken into account by the Minister for Finance to ensure that Ireland achieves the optimum result from the negotiations on CRD IV, and indeed on the overall package of EU measures for a single rulebook on banking requirements. Some of the main concerns are set out in paras 5.5 to 5.7.

5.5 A report for the European Parliament[12] suggests that

- there is a sound chance of increasing stability of the banking sector resulting in net benefits for the overall economy. Nevertheless, these findings are surrounded by a high degree of uncertainty in connection with the actual behaviour of the involved market participants
- empirical evidence for the EU shows that the links between the proposed restrictions and the portfolio choice of banks are weak.

---

[7] http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_directive_en.pdf
[8] The only more exposed states were Luxemborg and Malta.
[9] In 2008, the average size of the banking sector in EU27 was 3.4 times its GDP.
[10] The highest was Denmark at 205.3%
[11] This statistic is provided in the FAQ produced by Europa for the CRD IV press release on 20 July 2011
[12] CRD IV – Impact Assessment of the Different Measures within the Capital Requirements Directive IV, Paper by EP Policy Dept, June 2011

- the new capital regulation will increase the stability of the banking system, but only in the sense of bank failure absorption. The likelihood of bank failures is not necessarily directly reduced
- the likelihood of bank failures will decrease only if the capital regulations restrict the banks' investment portfolio decisions aswell.

5.6 As noted in section 2.4 earlier, the IMF is reported to have been disappointed with the legislative proposals in CRD IV to implement Basel III. Specifically, the IMF raised the following concerns:

- *the common standards are too weak*: enforcing maximum harmonization at the level of Basel III minimum requirements is inappropriate given prevailing balance sheet uncertainties and the lack of EU-wide resolution arrangements
- *definition of "capital" has been diluted*: the EU has softened its definition of core tier 1 capital in a number of areas relative to Basel III requirements
- *liquidity ratio*: the EU's proposal lacks a firm commitment to implement the leverage ratio by 2018, as was agreed under Basel III.

5.7 The House of Commons EU Committee[13] has cited a number of significant concerns in relation the package:

- the Commission's proposals deviate significantly from the Basel III requirements, thereby weakening the agreement reached
- the proposals may risk regulatory arbitrage by diluting the minimum standards agreed internationally for global banks and increasing the taxpayer's potential exposure to future losses
- the maximum harmonized requirements will considerably hamper the ability of individual member states to respond flexibly and in a timely manner to systemic risks in their jurisdiction
- they also question the functioning of the single market as the main legal base for the proposals. They feel that the primary aim of the legislation is prudential supervision, with the single market as a secondary objective.

5.8 The Committee notes that the CRD directives will not apply to the credit union movement. Credit unions have a completely different capital structure from banks, so Ireland is retaining the credit union exemption in CRD IV. However, the Committee will return in a future report to consider the long term capital needs of credit unions. We note that the deliberations of the Governmental Commission on Credit Unions continue towards agreeing a comprehensive strategy around a restructuring of the credit union movement in the Republic of Ireland. The Commission will report to the Minister in March 2012.

6. DECISION OF THE JOINT COMMITTEE

It was agreed on 8 February 2012 that the report of the Joint Committee will be laid before the Houses of the Oireachtas, published and put on the Oireachtas website, and copies will be forwarded to the Minister for Finance, relevant stakeholders, and the Irish MEPs. It was also agreed to seek a debate on the Report in the Dáil and Seanad.

____

Alex White TD
Chairman
14 February 2012

[13] 42nd Report of EU Scrutiny Committee, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmeuleg/428-xxxvii/42803.htm

Appendix 1 – Membership of Joint Committee

List of Members

Chairman:	Alex White (LAB)
Deputies:	Richard Boyd-Barrett (IND) Michael Creed (FG) Jim Daly (FG) Pearse Doherty (SF) Stephen Donnelly (IND) Timmy Dooley (FF)* Sean Fleming (FF) Joe Higgins (IND) Heather Humphreys (FG) Kevin Humphreys (LAB) Peter Mathews (FG) Pádraig Mac Lochlainn (SF)* Mary Lou McDonald (SF) Michael McGrath (FF) Michael McNamara (LAB)* Olivia Mitchell (FG) Kieran O'Donnell (FG) Arthur Spring (LAB) Billy Timmins (FG) Liam Twomey (FG) (Vice-Chair)
Senators:	Sean D. Barrett (IND) Thomas Byrne (FF) Michael D'Arcy (FG) Aideen Hayden (LAB) Tom Sheahan (FG) Katherine Zappone (IND

Notes:
1. Deputies appointed to the Committee by order of the Dáil on 9 June 2011
2. Senators appointed to the Committee by order of the Seanad on 16 June 2011
3. *Deputy Timmy Dooley appointed on 21 June 2011 in place of Deputy Seán O' Fearghaíl
4. Deputy Alex White elected as Chairman on 23 June 2011
5. Deputy Liam Twomey elected as Vice Chairperson on 23 June 2011
6. *Deputy Michael McNamara appointed on 8 December 2011 in place of Deputy Thomas P. Broughan
7. *Deputy Pádraig Mac Lochlainn appointed on 14 December 2011 in place of Deputy Jonathan O'Brien

Appendix 2 – Information Note from Department

Com (2011) 452 Com (2011) 453

1. Proposal
The Information Note covers the two proposals jointly as they are part of the same package of legislation, known as the 'CRD IV' package. These are:

- *Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (Com (2011) 452)*

- *Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Com (2011) 453)*

2. Date of Commission document - 20/07/2011

3. Number of Commission document - Com (2011) 452, Com (2011) 453

4. Number of Council document - 13284/11, 13285/11

5. Dealt with in Brussels by - Ecofin Council & Financial Services Working Group

6. Department with primary responsibility - Department of Finance

7. Other Departments involved - None

8. Background to, Short summary and aim of the proposals
The Capital Requirements Directive (CRD), adopted in 2006, regulates the licensing and supervision of credit institutions and introduced into EU law the Basel II risk-sensitive capital framework to encourage better risk management by those institutions. The Directive was applied in Member States in 2007, with institutions required to implement its provisions no later than 1 January 2008. Ireland transposed the CRD by S.I. Nos. 660 and 661 of 2006. There have previously been two substantial sets of amendments to the CRD in 2009 and 2010.

The CRD IV package of legislation comprises a full recast of Directives 2006/48/EC and 2006/49/EC (the existing Capital Requirements Directive**)**. It is made up of a draft Regulation and a draft Directive, which will do the following:

- The draft Regulation will be directly applicable to credit institutions and investment firms, will contain the prudential requirements that currently exist in Directives 2006/48/EC and 2006/49/EC as amended, together with the annexes to these directives, and will also implement the new requirements contained in the Basel III agreement.
- The draft Directive re-states provisions in the existing Capital Requirements Directive in relation to the establishment and undertaking of banking business and in relation to supervision of such businesses in the single market. It contains new proposals in relation to corporate governance and sanctions as well as enhancements to supervisory power for institutions operating on a cross-border basis, and some amendments to Directive 2002/87/EC (the Financial Conglomerates Directive) in order to allow for technical standards to be developed to ensure that institutions that are part of a financial conglomerate apply the appropriate calculation methods for the determination of required capital on a consolidated basis.

Background on the Basel III Agreement

- The Basel III agreement raises the minimum capital requirements for banks for common equity capital from 2% to 4.5% of risk-weighted assets and the Tier 1 ratio from 4% to 6% effective as of 2015. It additionally tightens existing risk-weights for different categories of exposures, providing for a more significant effective increase in regulatory capital. Subsequently, fully effective as of 2019, banks will be required to add a conservation buffer of 2.5% on top of the common equity and Tier 1 capital ratios, to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. In addition, a counter-cyclical buffer, to be applied by adjusting the size of the buffer range established by the conservation buffer by up to additional 2.5%, will be required to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth. The calibrations are set out in the table below.

Calibration of the Capital Framework Capital requirements and buffers (all numbers in percent)			
	Common Equity Tier 1 (after deductions)	**Tier 1 Capital**	**Total Capital**
Minimum	**4.5**	**6.0**	**8.0**
Conservation buffer	**2.5**		
Minimum plus conservation buffer	**7.0**	**8.5**	**10.5**
Additional countercyclical buffer range	**0 – 2.5**		
All elements above are net of the associated regulatory adjustments and are subject to the following restrictions: Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times. Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times. Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times.			

Basel III also introduces the following components:

- new standards for liquidity risk to promote the resilience of the liquidity risk profile of institutions;
- measures to strengthen the capital requirements for counterparty credit exposures arising from institutions' derivatives, repo and securities financing activities; and
- a leverage ratio to supplement risk-based minimum capital requirements by acting as a potential constraint on excessive growth in institutions' on- and off-balance sheet assets.

9. Legal basis of the proposals

Article 114(1) TFEU (Com (2011) 452)
Article 53(1) TFEU (Com (2011) 453)

10. Voting Method - QMV

11. Role of the EP - Co-decision

12. Category of proposals

As described above these proposals will implement the Basel III agreement into EU law. They will therefore have significant implications for both the capital structure and liquidity profile of all banks operating in the EU.

As a full recast of existing EU legislation in this field, the proposals will also have a significant impact on domestic legislation (see section 17 below).

13. Implications

In relation to Irish banks, following the 2011 Prudential Capital Assessment Review (PCAR), the Central Bank of Ireland has required additional levels of regulatory capital to be maintained by each of the covered institutions, as an essential prerequisite to building up the capital strength of Irish institutions, and which are well above the 10.5% target rate of the Basel III agreement (minimum capital plus the capital conversation buffer).

The two pillar banks were recapitalised in July 2011. Assuming these recapitalisations had taken place on 31 December 2010, their pro-forma Core Tier 1 ratios would have been:

- AIB 21.9%
- BOI 16.1%

The pro-forma Core Tier 1 ratios for the other institutions would have been:

- EBS 22.6% On 27 June 2011, the Minister for Finance approved the proposed acquisition by Allied Irish Banks, plc (AIB) of EBS Building Society (EBS). Following the Minister's decision, the acquisition of the EBS by AIB took place on 1 July 2011.

- ILP 32.4% Following an application by the Minister for Finance, the High Court made a Direction Order under the Credit Institutions (Stabilisation) Act 2010 to facilitate the necessary recapitalisation of ILP by 31 July 2011 to meet with the Central Bank's regulatory requirements. The Direction Order will facilitate the recapitalisation of ILP in the sum of €4 billion, €2.9 billion of which must be in place by 31 July 2011. On 2 August 2011, a group of shareholders in ILP began a legal challenge against the State's recapitalisation of the financial institution. The case is due to be heard on 19 September 2011.

14. Are the any subsidiarity issues for Ireland?

The assessment of the Commission set out in the proposal is that it complies with the subsidiarity principle.

As regards the draft Regulation, the Commission's assessment is that EU action is required to ensure that credit institutions and investment firms operating in more than one Member State are subject to the same prudential requirements and thereby ensure a level playing field, reduce regulatory complexity, avoid unwarranted compliance costs for cross-border activities, promote further integration in the EU market and contribute to the elimination of regulatory arbitrage opportunities. The choice of Regulation creates a more level-playing field since it is directly applicable and there is no need to assess legislation in other Member States before starting a business since the rules are exactly the same. This is less burdensome for institutions. Delays with regard to the transposition of Directives can also be avoided by adopting a Regulation.

As regards the draft Directive, the Commission's assessment is that EU action is required to ensure that credit institutions operating in more than one Member State are subject to the same requirements and thereby ensure a level playing field, reduce regulatory complexity, avoid unwarranted compliance costs for cross-border activities, promote further integration in the EU market and contribute to the elimination of regulatory arbitrage opportunities. EU action also ensures a high level of financial stability in the EU.

The Department of Finance agrees with this assessment.

15. Anticipated negotiating period

Expected adoption in the first half of 2012

16. Proposed implementation date

1 January 2013

17. Consequences for national legislation

The existing Capital Requirements Directive and its amendments are principally transposed in Irish law by way of four Statutory Instruments, together with a number of amendments to those instruments:

- European Communities (Licensing and Supervision of Credit Institutions) Regulations 1992 (S.I. No. 395 of 1992);
- European Communities (Capital Adequacy of Investment Firms) Regulations, 2006 (S.I. No. 660 of 2006);
- European Communities (Capital Adequacy of Credit Institutions) Regulations 2006 (S.I. No. 661 of 2006);
- European Communities (Credit Institutions) (Consolidated Supervision) Regulations 2009 (S.I. No. 475 of 2009).

The full recast of Directives 2006/48/EC and 2006/49/EC into a new Regulation and a Directive will mean that many of the provisions will in future have direct effect in Irish law and so will require a repeal of most of the provisions of S.I.s 660 and 661 of 2006.

The significance of these amendments presents an opportunity to undertake a consolidation exercise of existing legislation in this field. Up to 17 individual Statutory Instruments are expected to be affected.

18. Method of Transposition into Irish law

It is expected that the proposals will be transposed by way of Statutory Instruments to be made under the European Communities Acts.

19. Anticipated Transposition date

31 December 2012

20. Consequences for the EU budget in euros annually - None