



FINANCIAL REGULATOR
Rialtóir Airgeadais

Consultation Paper on the Implementation of the Capital Requirements Directive

3 October 2006

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1 Introduction

1.1 Overview

This Consultation Paper represents the Financial Regulator's proposals on certain key aspects of the implementation of the revised capital adequacy framework for credit institutions and investment firms. These are enshrined in two Directives: Directive 2006/48/EC [recast] relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC [recast] on the capital adequacy of investment firms and credit institutions. These Directives, taken together, are commonly referred to as the Capital Requirements Directive (CRD) and this consultation paper will use this terminology.

The CRD replaces two existing Directives (2000/12/EC and 93/6/EEC) that have formed the bedrock of the Financial Regulator's capital requirements regime for over a decade. Ensuring credit institutions and investment firms have adequate capital to support their undertakings – and monitoring this on an ongoing basis – is a key tenet of the Financial Regulator's prudential supervision regime. It serves the Financial Regulator's statutory objectives of promoting a safe and sound financial system and protecting depositors' interests.

The CRD will be transposed into Irish law via two statutory instruments. The Department of Finance issued draft Heads of Legislation in July and consultation on these recently closed. In line with provisions in the CRD, the Statutory Instruments are expected to delegate and assign certain decisions and responsibilities surrounding implementation of the CRD to the competent authority, in this case the Financial Regulator. This Consultation Paper communicates the Financial Regulator's proposals in this regard.

The CRD applies to both credit institutions and investment firms. These will be referred to collectively as 'institutions'. The terms credit institution and investment firm will be used only where a provision is uniquely relevant to one or the other.

1.2 How this Consultation Paper is organised

The Financial Regulator's consultation on the CRD is presented in three parts. For ease of reference these are presented as separate documents, though in reality they should be regarded as a package.

Part A presents the Financial Regulator's proposals in respect of areas where it must or is proposing to exercise discretion. Part B consults on the application process for institutions seeking to use the internal ratings based approach (IRBA) to capital requirements for credit risk. Finally, Part C presents a draft 'portal' through which credit institutions¹ are expected to submit details of their internal capital adequacy assessment process (ICAAP).

Many of the provisions of the CRD, and therefore of this consultation, are of a highly technical nature. As this consultation is primarily aimed at practitioners a glossary of terms or background to the provisions has not been provided.

1.3 The Financial Regulator's Approach to Implementation of the CRD

The Financial Regulator's approach to implementation of the CRD in Ireland has been and continues to be guided by a set of implementation principles. These are presented in Appendix 1.

A key aspect of the Financial Regulator's implementation is the status of the guidance of the Committee of European Banking Supervisors (CEBS). Over the last two years, CEBS has been extremely active in issuing consultation papers on both the policy and process aspects of implementation of the CRD. The Financial Regulator has been closely involved in both the formulation and drafting of many of these papers. These papers are now presented as guidance notes, in some cases addressed to competent authorities, in other cases to institutions themselves. An inventory of the guidance notes and consultation papers CEBS has issued to date is presented as Appendix 2.

From the start, the Financial Regulator has been clear in communicating to institutions that, unless specified explicitly to the contrary, they should regard CEBS

¹ Not applicable for investment firms. The operation of Pillar 2 for investment firms is presented in Appendix 3 to this paper.

consultations on the CRD effectively as its own, and also to treat any guidance issued in this light. Institutions therefore need to consider carefully the guidance from CEBS to date and to monitor any additional guidance as it emerges.

1.4 Discussions to date

The Financial Regulator has discussed a number of aspects of its approach to implementation of the CRD with the CRD Implementation Forum (“the Forum”). The Forum is a discussion group for raising and progressing issues of strategic importance regarding the implementation of the CRD in Ireland. Its membership consists of the Financial Regulator, the Department of Finance, the Irish Bankers Federation and a number of individual credit institutions. The Forum first met in July 2005 and has met six times since.

The Financial Regulator has also engaged in dialogue with investment firms. As not all aspects of the CRD, and consequently this consultation, are relevant to investment firms, a high-level outline of the framework and how it impacts on investment firms is presented in Appendix 3. This provides an entry point to the paper for investment firms, but they should also read the other sections of this consultation to the extent that the particular risk type or process under discussion is relevant to them.

This consultation does not cover the issue of prudential and financial reporting. The Financial Regulator’s approach in this regard was communicated to institutions earlier in the year.

1.5 Feedback to the Consultation Paper

Comments on the proposals outlined in this Consultation paper are invited. Comments should be sent, in writing, no later than 31 October 2006, addressed to:

Mr. Peter Walsh
Banking Supervision Department
Irish Financial Services Regulatory Authority
PO Box 9138
College Green
Dublin 2
Peter.Walsh@financialregulator.ie

Comments pertaining to investment firm specific issues should be addressed to:

Mr. Tom Meade
Investment Service Providers Supervision
Irish Financial Services Regulatory Authority
PO Box 9138
College Green
Dublin 2
tom.meade@financialregulator.ie

Comments received will be posted on the Financial Regulator's website unless correspondents explicitly request otherwise.

1.6 Next Steps

Once the consultation period has closed and any comments received have been evaluated, the Financial Regulator will finalise its proposals in respect of CRD implementation. This will take the form of a new administrative notice, which together with the statutory instruments and the guidance from CEBS² will form the basis of transposition of the CRD in Ireland. The revised administrative notice will be issued to institutions no later than 31 December 2006.

² The Administrative Notice will make clear that CEBS guidance should be regarded as the Financial Regulator's guidance, unless stated otherwise. The Notice will make reference to CEBS guidance but will not restate its content.

Appendix 1: The Financial Regulator's Approach to Implementation of the CRD

The Financial Regulator's approach to the implementation of the Capital Requirements Directive ('the Directive') in Ireland will be guided by nine key principles.

Principle 1: The Financial Regulator's overarching objective in implementing the Directive will be to maintain and promote the safety, soundness and reputation of the Irish financial services market.

This principle will underpin everything the Financial Regulator does. Two of the main objectives of the Directive directly support it – better alignment of regulatory capital with economic risk and the provision of greater regulatory incentives for improved risk management. The Financial Regulator will implement the CRD in a way that supports these two objectives.

Principle 2: The Financial Regulator will be open, transparent and consultative in its implementation of the Directive.

Where the Financial Regulator is presented with options in terms of implementation, either in a formal sense (e.g. certain national discretions) or an informal one (for example, an interpretation of a provision in the Directive) it will base its decisions on an open and transparent process of consultation.

Principle 3: The Financial Regulator will follow the guidance of the Committee of Banking Supervisors (CEBS) on all aspects of the Directive, unless it states explicitly to the contrary. This includes guidance on both implementation policy and process.

Principle 4: Beyond the Directive and CEBS guidance, the Financial Regulator will be principles-based.

As will be seen in this document, the Financial Regulator is not proposing much by way of additional guidance beyond the Directive and the guidance provided by CEBS. The Financial Regulator will propose guidance only where it believes there is a clear need for it. The Financial Regulator has attempted not to draft guidance for the sake of it; any guidance that it has proposed is intended to be clear and directional.

Principle 5: The Financial Regulator will not be ‘super-equivalent’ to the Directive unless it feels this is justified. Such instances are expected to be the exception rather than the rule.

The Financial Regulator will not be super-equivalent to the Directive (as amplified and clarified in CEBS guidance) unless it believes this to be justified, with particular regard to Principle 1. As can be seen from the rest of this paper, such instances are the exception rather than the rule, and in each case the Financial Regulator sets out the reasons for proposing a super-equivalent approach.

Principle 6: The Financial Regulator will be proportionate and risk-based in implementing the CRD.

These concepts are enshrined in the Directive and support the Financial Regulator’s principles-based approach. Where permitted by the Directive and CEBS guidance, our approach will emphasise the objectives or results we wish to see, rather than specify precisely the means by which these shall be achieved. Institutions should satisfy themselves that they meet the objectives in a manner, which is proportionate to the size, nature and complexity of their operations. The Financial Regulator will be ‘risk-based’ in integrating the supervisory actions and decisions arising under the CRD into its overall framework for risk-based supervision.

Principle 7: The Financial Regulator will not compel any institution to adopt a particular approach to Pillar 1 or Pillar 2, nor debar any institution meeting the requisite standards from adopting any approach.

What this means in practice is that any institution, regardless of size, is free to adopt the standardised approach to credit risk and the basic indicator or standardised

approach to operational risk. In parallel, any institution is free to apply for use of an internal ratings based approach for credit risk or an advanced measurement approach (AMA) for operational risk. While this represents the Financial Regulator's position, in deciding on their choice of approach institutions should also be mindful of the requirements and expectations, if any, of their external stakeholders, including their other regulators, shareholders, rating agencies and analysts.

Principle 8: The Financial Regulator expects institutions to hold capital commensurate with their risk. The Financial Regulator will not use Pillar 2 to impose blanket, additional capital charges, or automatically to reverse any reductions in capital requirements calculated under Pillar 1.

The Financial Regulator expects institutions to operate with levels of capital above the regulatory minimum. In evaluating the adequacy of a firm's ICAAP, the supervisory review and evaluation process (SREP) may lead to an additional capital requirement, but this process will be firm specific. This means it will be determined in the context of the Financial Regulator's assessment of the inherent risks of the institution, the adequacy of its controls and the need for regulatory capital.

While the Financial Regulator will not use Pillar 2 automatically to reverse any reductions in capital requirements under Pillar 1, an institution will see its regulatory capital requirement fall if, and only if, it can demonstrate (through its ICAAP) that its risk profile and its management of those risks is commensurate with such an outcome.

Principle 9: The Financial Regulator's approach to 'home-host' will be mindful of the implementation principles of other regulators, but will ultimately reflect its statutory responsibilities.

The Financial Regulator's approach to home-host will be fully consistent with Article 129 of the Directive and the guidance from CEBS, but will ultimately recognise its statutory responsibility for all licensed entities in Ireland. The Financial Regulator will, however, be mindful of the implementation approaches, philosophies and timetables of other regulators when it comes to making practical implementation decisions for internationally active institutions for which the Financial Regulator is

the consolidating regulator, or subsidiaries of institutions headquartered in another country.

Appendix 2: CEBS Consultations on the CRD³

Topic	CP Reference	Date[s] of Consultation	Finalised	Guidance Reference
Validation and Assessment of the Risk Management and Risk Measurement Systems	CP 10	20 Jan 2006 & 11 July 2005	4 April 2006	GL 10
Supervisory Cooperation for Cross-Border Banking and Investment Firm Groups	CP 09	8 July 2005	25 Jan 2006	GL 09
Supervisory Review Process	CP 03	20 June 2005	25 Jan 2006	GL 03
Recognition of External Credit Assessment Institutions	CP 07	29 June 2005 & 1 Nov 2005	20 Jan 2006	GL 07
Common Reporting	CP 04	26 Jan 2005	13 Jan 2006	GL 04
Financial Reporting	CP 06	7 April 2005	16 Dec 2005	GL 06
Supervisory Disclosure	CP 05	23 March 2005	1 Nov 2005	GL 05
Stress Testing under the Supervisory Review Process	CP 12	9 June 2006		
Technical Aspects of the Management of Interest Rate Risk arising from Non-Trading Activities and Concentration Risk under the Supervisory Review Process	CP 11	23 March 2006		

³ The guidance papers are available on: <http://www.c-eps.org/>

Appendix 3: Issues for Investment Firms in the Implementation of the Capital Requirements Directive

The Capital Requirements Directive (CRD), while applying to credit institutions, will also apply to all authorised investment firms, under the Investment Intermediaries Act 1995, and to authorised stockbrokers, under the Stock Exchange Act, 1995 (referred hereafter as firms⁴). The CRD will replace the current Capital Adequacy Directive requirements (CAD) for all firms.

The purpose of this document is to provide a brief overview of the CRD for firms and also a navigation tool to both the Directive and aspects of the consultation paper that will be of relevance to each firm. This document does not purport to cover all issues relevant to all firms and should not be taken as formal guidance.

It is each firm's responsibility to ensure that it is fully aware of the potential implications and timelines of the CRD and to ensure it has appropriate plans in place to be in compliance with the CRD when the firm switches to the CRD. Although proportionality is key, relative to a firm's nature, scale and complexity, the relevant issues of the CRD for firms, especially Pillar II and the ICAAP, cannot be ignored and it is recommended that firms should read the consultation document to the extent that the particular risk type is relevant to them.

3.1 National Discretions

The attached consultation document (Part A) provides details of the various National Discretions available under the CRD for both credit institutions and investment firms together with the proposed approach by the Financial Regulator. While the majority of National Discretions relate to credit institutions, firms that carry credit risk and/or market risk should review each of the discretions in order to be aware of the approach

⁴ There are approximately 130 investment firms authorised under the Investment Intermediaries Act (1995), as well as authorised stockbrokers, under the Stock Exchange Act, (1995) which will be subject to the new CRD.

adopted. For smaller firms the most relevant national discretions are numbers 3, 66, 107-111.

3.2 Pillar 1

Pillar 1 of the CRD outlines the new methodology for the calculation of a firm's capital requirement. It is noted that for the majority of small firms the CRD will not significantly impact on their regulatory capital requirement as they will continue to be required to hold the higher of the minimum level of capital per their authorisation or the amount as calculated under the Expenditure Based Requirement. However, firms which conduct trading activities and/or which carry credit risk will be required to calculate their capital requirement per the new CRD requirements. These firms are responsible for ensuring that they are fully aware of the changes in the calculation of the capital requirements under Pillar 1 of the CRD and also to ensure that they will have sufficient capital to meet with the revised capital requirements when the firm switches to the CRD. Firms should refer to the various chapters in the consultation paper on credit risk and market risk.

3.3 Internal Models

Firms that are planning to use internal models under the CRD should notify the Financial Regulator of their plans and estimated date of submission of their applications as soon as possible. The Financial Regulator has drafted an IRB (Internal Ratings Based) model validation application pack for model recognition that is also part of the consultation documents (Part B). Given that a significant number of applications are expected from credit institutions in respect of IRB models, it is recommended that those firms planning to use any of the models under the CRD notify the Financial Regulator as soon as they are satisfied that they can fully comply with the requisite requirements.

3.4 Operational Risk

The CRD introduces, for the first time, a specific capital charge for firms in respect of operational risk. For smaller firms, the CRD permits competent authorities to exempt these firms from this operational risk capital charge. It is proposed that the Financial Regulator will exercise this exemption under the National Discretions and it will be granted automatically to those firms which comply with the criteria noted in the

Article 20 of CRD (2006/49/EC). Firms should consider if they would be able to avail of this exemption. For those firms who cannot avail of the exemption they will be subject to the operational risk capital charge in addition to their current capital requirement covering market, counterparty foreign exchange, position and non-trading book risks, etc.

Firms have three approaches from which to choose for calculating their capital requirements for operational risk. For those firms planning to use The Standardised Approach, please note that there is a requirement to give advance notice to the Financial Regulator. For any firm for which is planning to use the Advanced Measurement Approach (AMA) approach they should also advise the Financial Regulator of its plans as soon as possible. Firms should plan to ensure that they have sufficient capital to comply with any additional regulatory capital requirement. Firms, including those that can avail of the exemption from the operational risk capital charge, will where applicable, be subject to the qualitative requirements contained in the Article 22 and Annex V of the CRD (2006/48/EC). Firms should satisfy themselves that they comply with these requirements in a way that is proportionate to the nature, scale and complexity of their activities.

3.5 Pillar II

When a firm switches to the CRD the full requirements under Pillar 2 of the CRD will apply. Under Pillar 2 all firms will, amongst other things, have to regularly assess the amount of internal capital they consider adequate to cover all risks to which they are exposed. The process, known as the Internal Capital Adequacy Assessment Process (ICAAP), is the firm's responsibility and will form an input into the Financial Regulator's Supervisory Review and Evaluation Process (SREP). This review process will determine, amongst other things, whether the firm considers the amount of capital held to be adequate to support the risks. Pillar 2 also encourages an active dialogue between competent authorities and firms such that when deficiencies are identified decisive action can be taken.

The rationale of the ICAAP is to ensure that firms assess that the level of capital they hold is consistent with their risk profile and operating environment. Given the different activities conducted by firms and also given that the ICAAP is the

responsibility of each firm, the Financial Regulator will not be providing guidance to firms regarding what risks it should be considering in compiling its ICAAP. The ICAAP should be seen as a continual process subject to annual review. The Financial Regulator shall be adopting the CEBS guidelines as published in CEBS paper (CPO3) in its implementation of ICAAP.

The Financial Regulator has developed a submission portal, which provides a mechanism by which institutions can convey the key elements of their ICAAP to the Financial Regulator (Part C). The Financial Regulator recognises that smaller firms will not have all the processes in place that are expected under the CEBS guidelines. Accordingly, our approach to implementation of the ICAAP for firms will be proportionate to the size, nature and complexity of the firm and the Financial Regulator is considering a proportionate method for firms to submit their ICAAPs.

3.6 Pillar III

Pillar 3 of the CRD requires firms to make certain public disclosures in order to allow stakeholders understand certain aspects of the firm's activities. While the majority of firms will not be subject to the provisions of Pillar 3, certain firms will and they should ensure that they are aware of the obligations in the CRD. Initial reference should be made to the chapter on Pillar 3 in Part A of the consultation papers.

3.7 Switchover to the CRD/Transitional Arrangements

The CRD comes into effect on 1 January 2007. However, under Article 152(8) of the CRD, firms have the option of remaining under many of the provisions of the existing CAD treatment until 31 December 2007. Firms are free to exercise this option. Firms who wish to remain on the current CAD may continue to calculate their regulatory capital requirements under the current CAD requirements and they will not be subject to the requirements of Pillars 2 and Pillar 3 and the majority of Pillar 1 requirements. They will however be subject to some of the provisions that will apply from 1 January 2008. The option to avail of this discretion rests with individual firms, however, firms are required to notify the Financial Regulator as soon as possible of their intended switch over date. An overview of the transitional arrangements that will apply from 1 January 2007 are provided in Part A of the

consultation papers. Firms are encouraged to study these requirements and also the provisions in Article 157 carefully.



FINANCIAL REGULATOR
Rialtóir Airgeadais

PO Box No 9138
College Green,
Dublin 2, Ireland

T +353 1 410 4000

Consumer help-line

lo call 1890 77 77 77

Register of Financial Service Providers help-line

lo call 1890 20 04 69

F +353 1 410 4900

www.financialregulator.ie

www.itsyourmoney.ie

Information Centre: 6-8 College Green, Dublin 2