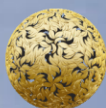

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Consultation Paper 81/2014

Discretion for exemption from capital buffers for SME investment firms from CRD IV/CRR

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1 Overview

1.1. This consultation paper signals the Central Bank of Ireland's (the Bank's) proposed approach and perspectives in relation to the possible exemption of SME Investment Firms from being subject to the capital conservation buffer and the countercyclical capital buffer being introduced by provisions contained within the Capital Requirements Directive IV (CRD IV) [1] and Capital Requirements Regulation (CRR)[2].

Context

1.2. In the wake of the global financial crisis, the Group of 20 (G20) major economies resolved to reform the international financial regulatory architecture and to considerably bolster substantive regulation across a number of key areas; including in relation to minimum capital and liquidity requirements for institutions. [3] Accordingly, the G20 mandated the Basel Committee on Banking Supervision (BCBS) to formulate a new framework in this area, culminating in the Basel III International Regulatory Framework for Banks (Basel III) and subsequent supplementary standards.[4] CRD IV and CRR represent the European Union's (EU) implementation of Basel III.

1.3. On 31st March 2014, the Minister for Finance, Mr. Michael Noonan T.D., signed into Irish law two regulations to give effect to CRD IV. The European Union (Capital Requirements) Regulations 2014 give effect to the Capital Requirements

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L 176/338.
[2] Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L 176/1.
[3] See, e.g., G20, *Declaration on Strengthening the Financial System* (London, 2 April 2009) [http://www.g20.utoronto.ca/2009/2009ifi.pdf].
[4] See, e.g., Basel Committee on Banking Supervision, *International Regulatory Framework for Banks* [http://www.bis.org/bcbs/basel3.htm].

Directive (Directive 2013/36/EU) and the European Union (Capital Requirements) (No. 2) Regulations 2014, give effect to a number of technical requirements in order that the CRR can operate effectively in Irish law.

1.4. Under Regulation 120 of S.I. 158 of 2014, the Bank is designated as the authority in charge of the application of the capital conservation and countercyclical capital buffers and may exempt small and medium-sized investment firms from the requirements set out in S.I 158 of 2014 if such an exemption does not threaten the stability of the financial system of the State.

The Bank's Statutory Powers and Responsibilities

1.5. In determining its approach towards the exercise of these competent authority discretions and options arising within CRD IV and CRR, the Bank has due regard to its statutory powers and responsibilities,[5] including its objective to prevent potential serious damage to the financial system in the State, to support the stability of that system and to protect the users of financial services.[6]

Scope of this Consultation Paper

1.6. This consultation document is only concerned with the specific discretions that have been made available to the Bank as the 'designated authority' in Regulation 120 of S.I. No. 158 of 2014. The Capital Requirements Directive provides for a number of capital buffers including the capital conservation buffer (CCB) and the countercyclical capital buffer (CCyB). The requirements for institutions to hold these two buffers are set out in Articles 129 and 130 CRD IV respectively. These requirements apply to investment firms that are authorised to provide the MiFID investment services and activities of 'dealing on own account' and/or 'underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis'.[7]

[5] See, e.g., *Central Bank Acts 1942-2013*; *Central Bank (Supervision and Enforcement)Act 2013* (No 26 of 2013).
[6] Long title, *Central Bank Reform Act 2010* (No 23 of 2010).
[7] The investment services listed in points 3 and 6 of Section A of Annex I of MiFID.

1.7. Such Institutions must maintain:

- a capital conservation buffer of Common Equity Tier 1 capital equal to 2.5 per cent of their total risk exposure amount, and

- an institution-specific countercyclical capital buffer equivalent to their total risk exposure amount multiplied by the weighted average of the countercyclical buffer Rates.

1.8. If the institution fails to meet either of the buffer requirements it shall be subject to specified restrictions on distributions.

1.9. There are transitional provisions for these capital buffers[8]

Year	2014	2015	2016	2017	2018	2019
Rate	0%	0%	0.625%	1.25%	1.875%	2.5%

1.10. Where it applies an exemption the Bank shall notify the Commission, the ESRB, the EBA and the competent authorities of any other Member States concerned. For the purposes of this derogation, investment firms shall be categorised as small or medium-sized in accordance with Commission Recommendation 2003/361/EC of 6 May 2003 which defines SMEs as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50m and/or an annual balance sheet total not exceeding €43m. However where a firm is linked to other enterprises, for example where a firm is part of a group, the criteria apply to the wider set of linked enterprises and not just to the firm on a standalone basis.

1.11. The Bank indicated in the Consultation on the CRR/CRD IV discretions (published last autumn) that it would consult on this exemption to the CCB and CCyB if it was made the designated authority.

[8]Where justified the Bank, as designated authority, may set a countercyclical buffer rate in excess of 2.5% of the total risk exposure amount.

Structure of this Consultation Paper

1.12. Chapter 2 contains a broad overview, for information purposes, of the new capital buffers provisions arising in CRD IV.

1.13. Chapter 3 indicates possible approaches towards the competent authority discretion pertaining to certain investment firms captured by the CCB and CCyB capital buffer provisions.

Feedback to this Consultation Paper

1.14. The Bank is committed to clear, open and transparent engagement with stakeholders in fulfilling its financial regulatory and supervisory objectives, particularly when introducing new codes, regulations, standards or guidelines. The Bank's Stakeholder Consultation Protocol can be found on the Bank's website: http://www.centralbank.ie/regulation/poldocs/documents/consultation%20protocol%20final.pdf

1.15. This consultation paper will be subject to the comment period of three months. Comments should be sent in writing, and if possible by e-mail, no later than 12 September 2014 to:

Mr Sean Walsh
Markets Policy Division,
Central Bank of Ireland,
Iveagh Court, Block D,
Harcourt Road,
Dublin 2.
invfirmspolicy@centralbank.ie

1.16. The Bank will send an email acknowledgement to all responses received. If you do not receive this acknowledgement, please contact us on 01-2246000.

1.17. It is the policy of the Bank to publish all responses to its consultations and such responses will be made available on our website. Institutions should thus not include commercially confidential information in consultation responses and the Bank accepts no liability whatsoever for the content of institutions' consultation responses

that are subsequently published by the Bank. We shall not publish any information which we deem potentially libellous or defamatory.

2 Capital Buffers

2.1. The global financial crisis exemplified the potential for damaging instability and market failures where macro-financial conditions amplify pro-cyclicality and credit bubbles. The global financial crisis has also demonstrated the negative externalities which can result from the inadequate capitalisation of, and pooling of risks within, systemically important ‘too-big and too-interconnected-to-fail’ institutions.

2.2. Therefore, to ensure that institutions are better positioned to counteract these risks in future, CRD IV introduces five new capital buffers that must only be met with the highest quality capital (Common Equity Tier 1). The capital buffers provide a greater ‘cushion’ to absorb losses and to help address the pro-cyclical mechanisms that contributed to its origins and aggravated its effect. This paper deals with two of these in the specific context of small and medium sized investment firms: the capital conservation buffer (CCB) of 2.5% of the total risk exposure amount and the countercyclical capital buffer (CCyB), which is variable (and can be zero where no specific amount is set). This latter buffer aims to ensure that firms accumulate capital during periods of economic growth that can then be released during less favourable economic conditions.

2.3. These two buffers apply – on an institution, sub-consolidated and consolidated level – to all investment firms that have permission to deal on their own account, and/or underwrite financial instruments and/or placing of financial instruments on a firm commitment basis.

Capital Conservation Buffer

2.4. The primary objective of the mandatory capital conservation buffer (CCB) of 2.5 per cent under Article 129 CRD IV[9] is to act as a supplementary capital cushion, conserving institutions’ core regulatory capital. It will be applicable at both the consolidated and individual levels. The CCB is subject to phase-in from 2016 – see Table hereunder.

[9] Article 117 of S.I. 158 of 2014

Year	2014	2015	2016	2017	2018	2019
Rate	0%	0%	0.625%	1.25%	1.875%	2.5%

Countercyclical Capital Buffer

2.5. Article 130 CRD IV provides for a countercyclical capital buffer (CCyB), the precise calibration of which will be contingent upon the deviation of the ratio of credit-to-GDP from its long term trend and other variables that are considered relevant for addressing cyclical systemic risk. Accordingly, the CCyB is 'countercyclical' in the sense that it should be activated when excess aggregate credit growth is judged to be associated with a build-up of systemic risk. However, such requirements can also be eased during stressed macro-financial periods.

2.6. In general, jurisdictions may establish a CCyB requirement of between 0 and 2.5 per cent of total risk exposure amount on an individual and consolidated basis, calibrated in steps of 0.25 per cent and set quarterly. Institutions will be required to calculate their own specific CCyB rate as the weighted average of the CCyB rates applicable across the geographical locations (jurisdictions) of their relevant credit exposures. The CCyB is also subject to phase-in from 2016 – see Table hereunder.

Year	2014	2015	2016	2017	2018	2019
Rate	0%	0%	0.625%	1.25%	1.875%	2.5%

2.7. Institutions that breach their combined buffer requirement will, before calculating their Maximum Distributable Amount (MDA),[10] be obliged to retain a portion of earnings and to restrict dividends, share buybacks, payments on Additional Tier 1 (AT1) capital instruments, discretionary bonuses and discretionary pension benefits. Institutions in breach of their combined buffer requirement will also have to submit a capital conservation plan to their competent authorities.

[10] Article 141 CRD IV.

3 SME Investment Firms Exemption

3.1. As discussed in Chapter 2, CRD IV introduces a number of capital buffers including the Capital Conservation Buffer (CCB) and the Counter-cyclical Buffer (CCyB). The requirements for institutions to hold these two buffers are set out in Regulations 117 and 118 of the European Union (Capital Requirements) Regulations 2014 (S.I. No. 158 of 2014) respectively[11].

3.2. The discretions in question are relevant for SME investment firms authorised under S.I. No. 60 of 2007, the European Communities (Markets in Financial Instruments) Regulations 2007 ('MiFID'). In particular, these requirements apply to investment firms that are authorised to provide the MiFID investment services and activities of 'dealing on own account' and/or 'underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis'[12].

Nature of Exemption

3.3. Regulation 120 of S.I. 158 of 2014 gives the Bank the discretion to exempt small and medium-sized investment firms from the requirement to hold, respectively, a CCB and a CCyB provided such an exemption does not threaten the stability of the financial system of the Member State.

3.4. If the discretions are to be exercised, in order to qualify for the exemption, investment firms must meet the definition of 'small or medium-sized' as specified in the European Commission Recommendation 2003/361/EC of 6 May 2003 ('Commission Recommendation').

3.5. The Commission Recommendation defines small and medium-sized enterprises as those that employ fewer than 250 persons and which have an annual turnover not exceeding €50m and/or an annual balance sheet total not exceeding €43m. However

[11] Article 119 of S.I 158 of 2014 details the transitional provisions for CCB and CCyB.
[12] Paragraph 2 of Article 128 of Directive 2013/36/EU

where a firm is linked to other enterprises, for example where a firm is part of a group, the criteria apply to the wider set of linked enterprises and not just to the firm on a standalone basis. The specific rules for the calculation of the data for determining if the criteria are met are set out in the Commission Recommendation. It is important to note that the CCB and the CCyB will remain at 0% until 2016.[13]

3.6. If a firm is a linked enterprise within the frame of the SME definition then the question of them being exempted as an SME does not arise. A linked enterprise is defined in the 2003 Commission Recommendation as one where the other enterprise is a majority shareholder and can appoint/remove members of the administrative, management or supervisory body or exercises "dominant influence" or "controls alone" by way of an agreement with shareholders or otherwise the majority shareholding or voting rights.

3.7. It should also be noted that, as it is based on a macro-prudential rule, the discretion exempts all SME firms (or none); the Bank does not intend to pick and choose as to whom amongst the SME class of MiFID firms it may exempt.

3.8. In the context of the foregoing (i.e. the small relative size and turnover of the firms involved) and the phased introduction of the buffers and the upcoming review of an appropriate prudential regime for the investment firm sector, which the European Commission must undertake by end 2015, the exercise of the two discretions could be argued to be sensible at this time. It may be noted that, if this were to be done, the Bank may withdraw this exemption at its discretion.

3.9. On the other hand, given the accepted need for these capital buffers to protect investors and connected parties from the effects of an investment firm failure and the acknowledged financial stability issues that arose in the recent past, it may be considered that the application of these buffers to these firms is reasonable, in all the circumstances. It is also the case that, for these SME investment firms, the size of these capital buffers is not likely to be substantial in absolute terms.

[13] Countercyclical capital buffer could remain at 0% beyond 2016 depending on a Member State's Economic Cycle.

3.10. The Bank is consulting on this discretion with an open mind on the matter and in particular would like to be advised of the estimated impact of the application or non-application of these buffers to these firms.

Appendix A – Competent Authority Discretions in Regulation 120 of the European Union (Capital Requirements) Regulations 2014 (S.I. No. 158 of 2014)

Discretion for exemption from capital buffers for SME investment firms from CRD IV/CRR

Directive Reference	S.I. 158/2014 Reference	Text	Area	Type of Discretion/ Option	Nature	Exercise	Comment
Article 129(2)-(3) (Requirement to maintain a capital conservation buffer)	Regulation 120 (Derogation from requirement to hold certain buffers)	120. (1) The Bank is designated as the authority in charge of the application of Regulations 117 and 118 and may exempt small and medium-sized investment firms from the requirements set out in those Regulations if such an exemption does not threaten the stability of the financial system of the State. (2) A decision on the application of an exemption referred to in paragraph (1) shall— (*a*) be reasoned, (*b*) include an explanation why the exemption does not threaten the stability of the financial system of the State, and (*c*) specify the small and medium-sized investment firms which are exempt. (3) Where it applies an exemption under paragraph (1), the Bank shall notify the Commission, the ESRB, the EBA and the competent authorities of any other Member States concerned. (4) For the purposes of this Regulation, investment firms shall be categorised as small or medium-sized in accordance with Commission Recommendation 2003/361/EC of 6 May 2003.	Capital Buffers/ Investment Firms	Competent Authority	General	Yes/No	

Discretion for exemption from capital buffers for SME investment firms from CRD IV/CRR

Directive Reference	S.I. 158/2014 Reference	Text	Area	Type of Discretion/ Option	Nature	Exercise	Comment
Article 130(2)-(3) (Requirement to maintain an institution-specific countercyclical capital buffer)	Regulation 120 (Derogation from requirement to hold certain buffers)	120. (1) The Bank is designated as the authority in charge of the application of Regulations 117 and 118 and may exempt small and medium-sized investment firms from the requirements set out in those Regulations if such an exemption does not threaten the stability of the financial system of the State. (2) A decision on the application of an exemption referred to in paragraph (1) shall— (*a*) be reasoned, (*b*) include an explanation why the exemption does not threaten the stability of the financial system of the State, and (*c*) specify the small and medium-sized investment firms which are exempt. (3) Where it applies an exemption under paragraph (1), the Bank shall notify the Commission, the ESRB, the EBA and the competent authorities of any other Member States concerned. (4) For the purposes of this Regulation, investment firms shall be categorised as small or medium-sized in accordance with Commission Recommendation 2003/361/EC of 6 May 2003.	Capital Buffers/ Investment Firms	Competent Authority	General	Yes/No	

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