Banc Ceannais na hÉireann
Central Bank of Ireland
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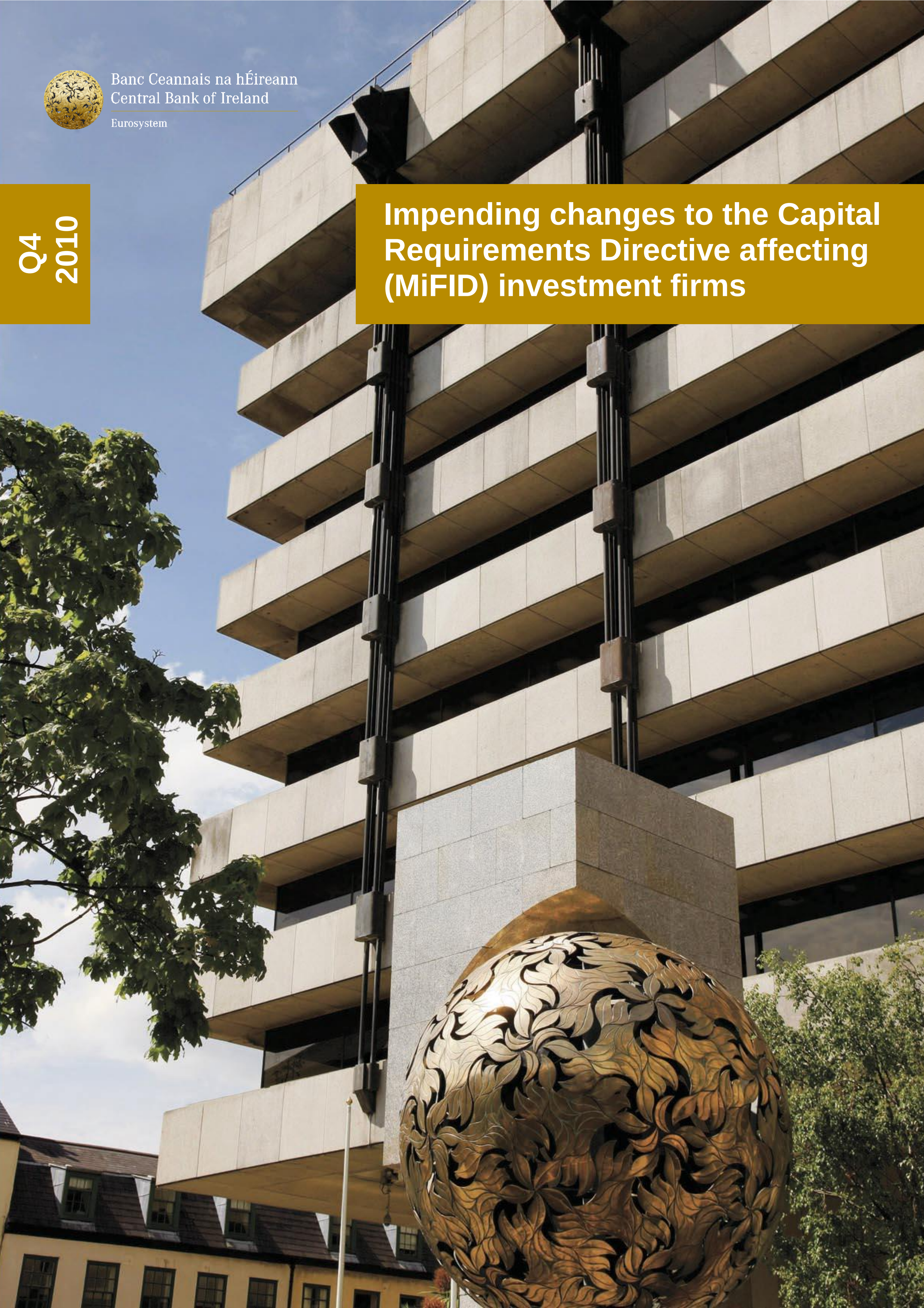
Impending changes to the Capital Requirements Directive affecting (MiFID) investment firms



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Introduction

1. This information note applies to those Irish investment firms authorised under Regulations 6 and 11 of S.I. No. 60 of 2007, the European Communities (Markets in Financial Instruments) Regulations 2007: the transposed "MIFID Regulations." A register of these firms is maintained under Regulation 9 and is available for viewing at http://registers.financialregulator.ie/.

2. Investment firms furnish to third parties certain investment services and activities listed in Schedule 1 of the MiFID Regulations (provided they have been authorised to do so).

3. Specific combinations of authorisations result in an investment firm being captured by the Capital Requirements Directive or "CRD," comprised of Directives 2006/48/EC and 2006/49/EC. The Directives are implemented in Ireland via S.I. No. 661 of 2006 (as amended) and S.I. No. 660 of 2006 (as amended).

4. Directive 2009/111/EC amends Directives 2006/48/EC, 2006/49/EC and 2007/64/EC[1] with regards to banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. 2009/111/EC and the amendments associated with it are commonly referred to as "CRD II."

5. An additional directive implementing a Commission of the European Communities proposal to amend Directives 2006/48/EC and 2006/49/EC with regards to capital requirements for the trading book and re-securitisations, and the supervisory review of remuneration policy will be published imminently. This directive and the amendments associated with it are commonly referred to as "CRD III."

6. CRD II and CRD III will be transposed into Irish legislation imminently. CRD II will be effective from January 1, 2011. Some of the CRD III provisions – notably those pertaining to remuneration policy – also come into effect on January 1, 2011. The remaining CRD III provisions will be implemented by December 31, 2011.

7. The CRD II and CRD III revisions will affect Irish investment firms in a number of specific areas. The purpose of this note is to highlight those amendments particularly applicable to Irish investment firms and to offer the Central Bank's views in relation to the changes. Links to important

[1] 2007/64/EC is the Payment Services Directive. 2009/111/EC amends a single article of 2007/64/EC.

related information are listed at the end of the note.

8. The principle of proportionality arises from Article 5 of the Treaty Establishing the European Community and is embedded in the Capital Requirements Directive. This means that implementation of the CRD provisions and related guidance should be proportionate to the nature, scale and complexity of the activities of individual Irish investment firms. The CRD II and CRD III amendments should be considered within the context of this principle.

9. This note is not necessarily exhaustive or comprehensive, nor does it exclude firms from complying with any element of the Capital Requirements Directive not mentioned in this note.

10. MiFID investment firms with queries or comments pertaining to this note should contact their Central Bank supervisor.

CRD II

11. CRD II introduces the following:

- Harmonised eligibility criteria for the inclusion of hybrid instruments in Tier 1 capital;
- New requirements for securitisation positions in relation to economic retention, due diligence and transparency;
- More formalised supervisory arrangements, establishing colleges of supervisors for cross-border groups and clarifying the respective roles of home and host country supervisors;
- Changes to the rules related to large exposures, and
- Enhanced liquidity risk management requirements.

12. Irish investment firms are most likely to be affected by the large exposure and liquidity risk amendments. We do however address hybrid capital below to emphasise the tightening of the definition of Tier 1 capital and the requirements in relation to Tier 2 capital, noting the language changes in the relevant articles of the amended Directive.

Hybrid capital

13. Hybrid capital has characteristics of both debt and equity. Preferred stock is a standard example. Other, more complex hybrid capital instruments with innovative features like step-ups and call options have grown in prevalence since the Basel Committee on Banking Supervision published an agreement on both the eligibility criteria of hybrids and limits on their inclusion in own funds in October 1998.

14. The CRD II amendments in relation to hybrid capital harmonise the instruments' eligibility criteria across Member States and set limits for their inclusion amongst the highest quality capital of institutions (i.e. Tier 1 capital). Irish-authorised investment firms do not currently hold hybrid instruments as Tier 1 capital. However, many do have hybrid instruments within their overall capital structure.

15. CRD II also amends Article 57(a) of Directive 2006/48/EC in relation to capital eligible for inclusion in an institution's own funds. The amended article now reads (with the added language ***emphasised***):

Subject to the limits imposed in Article 66, the unconsolidated own funds of credit institutions shall consist of the following items:[2]

(a) *Capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus* ***the related*** *share premium accounts,* ***it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims.***

16. Thus, only capital that can fully absorb losses in going concern situations and ranks after all other claims in the event of bankruptcy or liquidation, can be included in an institution's own funds.

17. **Irish investment firms should consider whether their own funds are fully available to absorb losses in going concern situations. A firm's own funds should not be subject to prior claims in the event of a firm bankruptcy or liquidation. Those own funds which do not meet either of these criteria cannot be included as capital under the amended Article 57(a).**

18. Firms are also reminded that the utilisation of hybrid instruments in Tier 2 is typically limited by Article 66(1) of 2006/48/EC (as amended) which requires that:[3]

- **Tier 2 capital** (i.e. those items set out in Article 57 (d) to (h) in 2006/48/EC) **not exceed 100% of the firm's (net) Tier 1 capital** (i.e. those items set out in Article 57 (a) to (ca) less the items for deduction listed in Article 57 (i) to (k)), and

- The items set out in Article 57 (g) to (h) including **fixed-term cumulative preference shares and subordinated loan capital not exceed 50% of the firm's (net) Tier 1 capital** (i.e. those items set out in Article 57 (a) to (ca) less the items for deduction listed in Article 57 (i) to (k))

19. Irish investment firms should also note the change in Article 66(4) of 2006/48/EC (as amended) which states that the Central Bank may authorise the two limits above to be exceeded "temporarily during emergency situations." **The onus is therefore with investment firms to inform their supervisor if and when these limits will be exceeded, why the situation constitutes an emergency, and how and in what time**

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[2] Article 57(a) of Directive 2006/48/EC (as amended) is applicable to investment firms due to Article 13 of Directive 2006/49/EC (as amended).

[3] Article 13(2) of Directive 2006/49/EC (as amended) sets out a discretion – applied by the Central Bank – that allows an alternative determination of own funds for certain investment firms. Under this alternative determination, subordinated loan capital meeting certain criteria *"may approach"* 150% of an institution's original own funds.

frame the limit breach will be rectified. In the normal course of business, the Central Bank will expect investment firms to comply with the CRD's Tier 2 limits.

Large exposures

20. CRD II exempts a significant number of Irish investment firms from monitoring and controlling their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC. The amending directive does not however exempt these firms from monitoring and controlling their large exposures altogether.

21. **The Central Bank reminds investment firms of their obligations under Annex V, Point 5 of 2006/48/EC, and intends to scrutinise individual firm policies in relation to concentration risk and large exposures during our Supervisory Review and Evaluation Process (SREP).**[4]

22. For those investment firms required to monitor and control their large exposures in accordance with Articles 106 to 118 – typically due to their authorisation(s) to deal on own account and/or underwrite on a firm commitment basis – the amended directive introduces a differentiation between institutional and non-institutional clients (and groups of connected clients).

23. An increase in the allowed exposure level to an institutional client or group of connected institutional clients was tabled in Article 1(22) of the amending Directive 2009/111/EC, with the prerequisite that the sum of exposures to all connected clients that are not institutions does not exceed 25% of the firm's own funds.

24. If the sum of exposures to all connected clients that are not institutions does not exceed 25% of the firm's own funds, then the value of an institutional exposure is limited to 25% of the firm's own funds or €150million, *whichever is higher*. Notwithstanding this limit, an institutional exposure cannot exceed 100% of the firm's own funds.

25. A Member State discretion to lower the €150million limit is also contained within Article 111(1) of the amended Directive 2006/48/EC.

26. In the Central Bank's view, the €150million Article 111(1) limit is not necessarily commensurate with the size of Irish investment firms or their

[4] CEBS GL03 details the Supervisory Review Process and one of the Central Bank's obligations pertaining to it: the SREP. The guidelines are found here: http://www.c-ebs.org/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx

level of own funds: the effect of this limit would be to significantly increase – and in many cases quadruple – the permitted level of institutional exposures for those firms captured by the 2006/48/EC regime. Thus, the Central Bank has recommended to the Department of Finance that it consider utilising the Member State discretion in order to permit a lower Article 111(1) limit to be imposed on investment firms.

27. Firms captured under the revised CRD large exposure regime should note the Member State discretions related to specific exposures as outlined in Article 1(24)(c) of the amending Directive 2009/111/EC. A number of the current exemptions related to specific types of exposures have been augmented or eliminated. The proposed Member State CRD II discretions related to specific exposures are detailed in a recent Department of Finance consultation paper. [5]

28. Attention is drawn to the amended 2006/48/EC, Article 113(4)(c) discretion to exempt exposures to related entities provided equivalent consolidated supervision is in effect. **The Central Bank will consider this exemption on a case-by-case basis. Investment firms must pre-apply to the Bank in order to utilise this exemption. Supervisory measures may result if firms are found to have large exposures with related entities in excess of the CRD limits.**

29. Article 1(21) of the amending Directive 2009/111/EC establishes new reporting requirements, frequencies, and a harmonised reporting regime for those institutions required to monitor and control their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC.[6]

30. Irish investment firms captured by the (amended) Articles 106 to 118 of Directive 2006/48/EC will be required to report the following in relation to their large exposures, including their exempted large exposures:

- The client or group of connected clients to which the institution has the exposure;

- The exposure value before taking into account the effect of credit risk mitigation, where applicable;

[5] The Department of Finance invited comments on the national discretions contained within Directive 2009/111/EC in a November 2010 consultation. The consultation paper is found here: http://www.finance.gov.ie/viewdoc.asp?DocID=6573.

[6] Further information on the implementation of this regime can be found in CEBS' December 2009 *Guidelines on the implementation of the revised large exposures regime*, found here: http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx

- Where used, the type of funded or unfunded credit protection; and
- The exposure value after taking into account the effect of credit risk mitigation.

31. The harmonised large exposure reporting mechanism for Irish investment firms captured by the (amended) 2006/48/EC large exposures regime will be in place no later than December 31, 2012. **In the interim, captured firms should report their large exposures twice yearly to their Central Bank supervisor as set out in Article 110 of the amended 2006/48/EC.**

32. At present, large exposure reporting for investment firms is non-standard and sometimes requires firms to notify the Central Bank on an exceptional basis. This means that potential breaches of limits and the reporting of large exposures when they do arise may be overlooked. Therefore, the Central Bank will be engaging with stakeholders and reviewing the large exposure reporting requirements for investment firms during 2011.

Liquidity risk

33. Directive 2009/111/EC adds a number of requirements in relation to liquidity risk to Annex V of Directive 2006/48/EC. Investment firms should note in particular the revised language of 2006/48/EC, Annex V, Point 14, and the addition of Point 14a, which explicitly ties the level of liquidity risk mitigation to the principle of proportionality. The liquidity risk mitigation of Irish investment firms should be proportionate to:

- The firm's complexity;
- The firm's risk profile;
- The firm's scope of operation;
- The firm's risk tolerance as set by its management body; and
- Should reflect the importance of the institution within the Member State.

34. Firms should have an established view regarding the five characteristics above and implement Annex V, Points 14 to 22 accordingly. For instance, investment firms with large, complex and/or important operations within Ireland should carefully consider and likely

implement each of the Annex V liquidity risk provisions, whereas some of these newly introduced requirements may be less relevant to smaller, lower-risk, less complex firms. Nevertheless, the Central Bank would encourage all investment firms to consider liquidity risk in their Internal Capital Adequacy Assessment Process (ICAAP).

35. The Central Bank's view is that all investment firms face a degree of liquidity risk. While this liquidity risk may not be as overt or potentially systemically relevant as the funding liquidity risk associated with the demand deposit liabilities of credit institutions, investment firms – particularly in stressed scenarios – may suffer from a lack of available funding, an inherent lack of liquidity due to their own business models and/or direct or indirect market liquidity risk.

36. **During our SREPs, the Central Bank will ascertain whether investment firms are sufficiently considering liquidity risk within their ICAAPs and scrutinise the degree of proportionate implementation of the CRD II provisions related to liquidity risk**.

CRD III

37. CRD III introduces the following:

- Strengthened capital requirements for assets held in an institution's trading book;
- Capital requirements for re-securitisations that are both higher than the capital requirements of other securitisation positions and tied to the level of due diligence undertaken on the re-securitisations;
- Enhanced disclosure requirements in relation to securitisations in the trading book and sponsorship of off-balance sheet vehicles; and
- Binding remuneration policy principles.

38. Irish investment firms are most likely to be affected by the trading book capital requirement changes and the remuneration policy provisions. Firms should nevertheless take note of the enhanced securitisation regime, and of the disclosure requirements in particular.

Trading book capital requirements

39. The Capital Requirements Directive divides the position risk of financial instruments into two components: general risk and specific risk. General risk is the risk of a price change in an instrument due to a change in broader-market factors not specifically attributable to an individual security. Specific risk is the risk of a price change in an instrument due to factors related to its issuer, or in the case of a derivative, the issuer of the underlying instrument.

40. For equity instruments, the general risk capital requirement is currently calculated by multiplying the difference between an institution's net long equity instrument positions and net short equity instrument positions by 8%. The current specific risk capital requirement is generally calculated by multiplying the sum of an institution's net long equity instrument positions and net short equity instrument positions by 4%. However, a discretion - currently applied by the Central Bank - allows firms to reduce the 4% specific risk capital requirement to 2% for certain equity positions.

41. CRD III raises the specific risk capital requirement for equity instruments in the trading book to 8%, and removes the discretion to allow the reduced 2% specific risk capital requirement for certain highly liquid equity instruments.

42. The revised specific risk capital requirement and other CRD III revisions related to the trading book are expected to be in place by December 31, 2011. Irish investment firms are encouraged to anticipate these revisions through their Internal Capital Adequacy Assessment Process.

Remuneration policy

43. CRD III places an obligation upon firms to have remuneration policies that are consistent with effective risk management by establishing remuneration guidelines for staff whose professional activities have a material impact on an institution's risk profile. Disclosure requirements related to remuneration policies and practices are also introduced.

44. The application of the guidelines is explicitly linked to the principle of proportionality. Institutions should comply with the remuneration principles in a way that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. The application of the principle of proportionality in relation to remuneration policy is examined in-depth in CEBS' *Consultation Paper on Guidelines on Remuneration Policies and Practices (CP42)*.[7] Firms should note the level of application proposals listed in Annex 2 of the consultation.

45. Guidelines on remuneration policies and practices will arise from the CEBS consultation. The guidelines are due to be published imminently and will form the basis of additional remuneration-specific guidance to be published by the Central Bank in 2011.

46. The CRD III remuneration principles include:

- Management body responsibility for the establishment and implementation of an institution's remuneration policy;
- Where remuneration is performance-related, the total amount of remuneration should be based on a combination of the individual's performance, the business unit's performance, and

[7] CEBS CP42 can be found here: http://www.c-ebs.org/documents/Publications/Consultation-papers/2010/CP42/CP42.aspx

the overall performance of the institution;

- The appropriate balancing of the fixed and variable components of total remuneration; and

- Deferring a major part of a significant bonus for an appropriate period, linking it to the future performance of the firm.

47. In relation to remuneration policies and practices, CRD III amends Directive 2006/48/EC, Annex XII *Technical Criteria on Disclosure*, requiring institutions to at least annually publicly disclose the following:[8]

- Information concerning the decision-making process used for determining the remuneration policy;

- Information on the link between pay and performance;

- The most important design characteristics of the remuneration system;

- Information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

- The main parameters and rationale for any variable component scheme and any other non-cash benefits;

- Aggregate quantitative information on remuneration, broken down by business area; and

- Aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution.

48. As the CRD III remuneration policy provisions come into effect from January 1, 2011, the Central Bank encourages investment firms to consider their own remuneration policies and practices in light of the CRD principles. Firms should have an established position regarding the appropriateness of the individual CRD III remuneration principles

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[8] 2006/48/EC, Annex XII details the "Pillar 3" disclosure requirements. Some subsidiaries of institutions supervised on a consolidated basis are exempt from making Pillar 3 disclosures. For further information see Section 6.4 of the Central Bank's December 2006 *Implementation of the CRD* notice, available here: http://www.centralbank.ie/regulation/industry-sectors/investment-firms/mifid-firms/documents/crd%20implementation%20notice%20dec%202006.pdf

given their size, internal organisation and the nature, scope and complexity of their activities. **Remuneration practices that are not consistent with effective risk management and/or run contrary to the CRD III remuneration principles will be scrutinised by the Central Bank.**

COREP

49. A number of changes to the Common Reporting (COREP) templates will arise from the changes to the Capital Requirements Directive. The latest COREP templates have been amended to incorporate the CRD II revisions and will be in use from December 31, 2010 (i.e. for the reporting of data related to the December 2010 reporting period). These amended templates will be available to firms via the Central Bank's Online Reporting System in January 2011. The COREP templates will be further amended during 2011 to incorporate the relevant CRD III provisions.

50. The latest and previous versions of the COREP templates, and guidelines pertaining to them, are available at: http://www.c-ebs.org/Supervisory-Reporting/COREP/COREP-framework.aspx.

51. A colour-captioned version of the CRD II-revised templates (specifying the changes from the current templates) is available here: http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Corep-GL04/GL04rev2Documentationofchanges.aspx. Irish investment firms are encouraged to review the changes prior to compiling their December 2010 COREP submissions.

Future developments

52. Irish investment firms should be aware that further changes to the Capital Requirements Directive are pending. CRD IV, incorporating the recently revised Basel framework - "Basel III" - will likely be finalised in 2011. Many of the changes associated with Basel III are credit institution-specific, but further strengthening of the loss absorbency requirements of capital instruments and of the capital requirements related to counterparty credit risk, amongst other changes, may impact some Irish investment firms. Firms are encouraged to familiarise themselves with the Basel III framework detailed here: http://www.bis.org/bcbs/basel3.htm.

53. The Central Bank will shortly introduce a "Latest Information" heading on the MiFID investment firm section of its website. Here, links will be provided to internally and externally-produced policy papers directly relevant to MiFID investment firms. Once the development is completed, firms will be contacted and encouraged to regularly refer to this section of the website.

Important related information

54. The following is a list of important, related information, links to which have not already been provided above. Firms are encouraged to review pertinent, related information prior to contacting their Central Bank supervisor with queries concerning this note.

Legislation

- Directive 2009/111/EC: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF
- Consolidated version of the CRD (incorporating CRD II): http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF and http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0049:20091207:EN:PDF
- European Commission CRD III proposal: http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf

Guidance

- CEBS Guidelines on instruments referred to in Article 57(a) of the CRD: http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2010/Guidelines_article57a/Guidelines_article57a.aspx
- CEBS Guidelines on the management of concentration risk under the supervisory review process: http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-revised-Guidelines-on-the-management-of-conce.aspx
- CEBS Guidelines on common reporting of large exposures: http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-Exposures-reporting.aspx

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