Department of Finance, Ireland, response to the Commission Services Staff Working Document on further possible changes to the Capital Requirements Directive

1. The Department of Finance welcomes the opportunity to respond to the Commission Services Staff Working Document on further possible changes to the Capital Requirements Directive.

2. The views expressed in this response take into account the comments previously conveyed to the Commission in January 2009 as part of the work of the CRD Working Group. The Department is broadly supportive of the ambition of these proposals, which will entail a significant further enhancement of EU prudential requirements, with the aim of contributing to more resilient financial institutions and enhancing financial stability.

3. The Department supports the consistent global application of the reforms agreed by the G20 as called for by the G20 in order to ensure a level playing field. In this context, it is worth noting that Basel II measures, that have yet to be implemented globally, should now be implemented globally to avoid further regulatory arbitrage.

4. It is recognised that the proposed package of reforms to the existing Basel II framework (and to the CRD in the EU) are substantial and will have significant implications for the capital structure of banks. In light of this, it is important, as stated by the G20, that the reforms are "phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012." It is also important that the reforms include an appropriate transitional period and do not inhibit a return to economic growth. The timeframe for the introduction of any proposed changes should therefore include appropriate transitional periods for individual institutions which will work to maintain the ambitious nature of the proposed reforms.

5. As set out in more detail in the Annex, Ireland's Financial Regulator, through its Prudential Capital Assessment Review, has already determined the necessary forward-looking prudential capital requirements of certain of the Irish credit institutions covered by the Irish Government's guarantee. The Department considers this assessment to be an essential prerequisite to building up the capital strength of Irish institutions in anticipation of the changes being proposed in the current consultation.

6. The Department also looks forward to the publication of the impact assessments being undertaken by both the Basel Committee on Banking Supervision (BCBS) and by the Committee of European Banking Supervisors (CEBS), which will be essential to understanding the broad impact of the proposals. Given the anticipated scale and scope of these proposals, it will be important that these assessments and the Commission's own impact assessment accompanying the forthcoming legislative proposal, set out both the individual and cumulative impacts of all elements of the proposals. Crucially, the impact of the timing of the introduction of these reforms should

also be analysed. Ideally, stakeholders should be provided with sufficient opportunity to consider these analyses and to respond in advance of the Commission finalising its legislative proposal.

7. It is also essential that the Commission, in further developing these proposals, takes into account the diversity of EU credit institutions and investment firms covered by the CRD, in particular distinguishing between the larger cross-border banks and smaller banks operating at a domestic level. In the Irish context, the implications of the proposed changes to the definition of capital should, in particular, take into account the position of non-joint stock companies such as building societies.

8. Ireland looks forward to continuing to engage constructively with the European Commission in the coming months in the discussions arising out of its consultation.

9. The Annex contains a more detailed analysis of the key areas.

William Beausang
Assistant Secretary
Department of Finance
April 2010

Annex

Section 1. Liquidity Standards

The Department agrees with the Commission objectives to promote the short-term resilience of the liquidity risk profile of institutions by ensuring, through the introduction of a Liquidity Coverage Requirement, that they have sufficient high quality liquid assets to survive an acute stress scenario lasting for 30 days. The Department also supports the promotion of resilience over the longer term by imposing a Net Stable Funding Requirement and requiring institutions to fund their activities with more stable sources of funding on an ongoing structural basis.

Of key importance will be the determination of liquid assets that are eligible for inclusion in both the Liquidity Coverage Requirement and the Net Stable Funding Requirement. The parameters for each eligible instrument should be defined with due regard to the short- and long-run liquidity profile of the instrument and the new liquidity requirements should be implemented in such a way as to avoid creating unforeseen price impacts in the market for such instruments.

Section 2. Definition of Capital

The Department agrees with the Commission's proposals to strengthen, harmonise and simplify the definition of capital and with the Commission's view that it is essential that a bank's capital must be permanently available to absorb losses on a going concern basis.

The current crisis has demonstrated that many institutions either held insufficient regulatory capital or inadequate quantities of capital which were to be permanently available to absorb losses on a going concern basis. By seeking to eliminate or limit those types of capital which are unable to meet this essential requirement, the Commission's proposals are therefore prudent. For this reason, the Department welcomes the elimination of the distinction between upper and lower Tier 2 Capital and the elimination of Tier 3 Capital.

In this regard, it is worth noting that in Ireland and in the context of the Dáil Statement by the Minister for Finance on 30 March 2010 concerning the commencement of the transfer of certain loans from Irish banks to the National Asset Management Agency, the Financial Regulator published details of its Prudential Capital Assessment Review (PCAR). The PCAR exercise was undertaken to determine the forward-looking prudential capital requirements of certain of the Irish credit institutions covered by the government guarantee[1]. The exercise assessed the capital requirements arising for expected base case and potential stressed loan losses scenarios, and other financial developments, over a 3-year (2010-2012) time horizon.

[1] The Prudential Capital Assessment Review (PCAR) process for Allied Irish Bank, Bank of Ireland and EBS has been concluded and the review for Anglo Irish Bank, Irish Nationwide Building Society and Irish Life and Permanent is underway.

The Financial Regulator has decided that it will require an 8% core tier 1 capital requirement, after taking account of the realisation of future expected losses and other financial developments under a base case scenario for each NAMA participating institution. This test is designed to ensure the credit institutions are capitalised to a level which reflects prudential requirements and current market expectations, after taking account of forecast loan losses through to 2012. The Regulator has additionally determined that capital used to meet the 8% target must be principally in the form of equity, with 7% equity as the target level. The capital to meet these new requirements must be in place in each of the institutions by the end of 2010. A further target of 4% core tier 1 capital has been imposed on NAMA- participating institutions to meet a stress scenario or a portfolio level sensitivity analysis.

In relation to non-joint stock companies, such as building societies, the Commission consultation proposes to only allow capital if the instruments can absorb losses on a going concern basis and in liquidation pari passu with the loss absorption characteristics of common stock of a joint stock company. This appears to be generally consistent with Recital 4 of Directive 2009/111/EC which specifies that instruments issued by non-joint stock companies 'which are deemed equivalent to ordinary shares in terms of their capital qualities in particular as regards loss absorption' should be included in core capital. However, it will be important that due consideration is given to the diversity of characteristics of non-joint stock companies, for example, in relation to legal ownership, access to reserves and distribution of profits.

Clearly, there is a need to improve the quality of capital but the impact of the proposed changes across the capital base must be fully understood and managed carefully. In particular, it will be necessary to await the outcome of the quantitative impact study to fully understand and appreciate the impacts of the proposed changes to prudential filters.

The Department has some concerns in relation to the proposals on prudential filters and the potential impact they may have on Core Tier 1 capital. Specifically, the proposal that no filter would apply to defined benefit pension scheme liabilities, so that the full accounting deficit would be deducted from Core Tier 1 capital, could create an unlevel playing field as a result of differing national accounting treatments. This was explained in more detailed in our submission to the Commission in January 2010.

Section 3. Leverage Ratio

The Department supports the Commission proposal to introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework. This recognises that the years preceding the financial crisis saw a significant build up in leverage in the financial system. The losses made during the crisis forced institutions to reduce significantly the extent of their leverage in a very short period, which adversely impacted the availability of credit to the real economy and further compounded the adverse effects of the crisis. The Irish experience has shown that such a model is required to mitigate against both over-reliance on an individual bank's modelling and measurement of risk, and excessive, unsustainable growth in absolute balance sheet size that might risk diluting the impact of capital requirements over time.

The Department has an open view as to whether a leverage ratio should be introduced as a binding Pillar 1 requirement or whether it should form part of the supervisory toolkit under Pillar 2. There will, of course, be a trade-off between making it a binding, backstop Pillar 1 requirement and the supervisory flexibility afforded under Pillar 2 which would enable both national and individual institutions' circumstances to be taken into account. The results of the CEBS' impact assessment study should help inform decisions in this regard.

Section 4. Counterparty Credit Risk

The broad purpose of this element of the proposal is to strengthen the capital requirements for counterparty credit exposures arising from institutions' derivatives, repo and securities financing activities. The Department broadly agrees with the objective of raising capital buffers backing these exposures, reducing procyclicality and providing additional incentives to move over-the-counter (OTC) derivative contracts to central counterparties, thus helping reduce systemic risk across the financial system.

Section 5. Countercyclical measures

The Department agrees that it is important to reduce excessive pro-cyclicality within the financial system. A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. To this end, the Department agrees with the a move towards through-the-cycle provisioning to ensure that credit institutions make timely and adequate provisions for all credit risks they are exposed to in a countercyclical way and the introduction of instruments that will move in a counter-cyclical fashion to the capital levels of banks to provide for supplementary buffers in addition to minimum capital requirements aimed at ensuring the financial soundness of institutions throughout the economic cycle.

The Department would, however, remain cautious about the capacity of national supervisors to implement such measures in the short term prior to gathering relevant additional data.

Section 6. Systemically important financial institutions

In their Pittsburgh statement of September 2009, G20 Leaders recommended action by the end of 2010 to address the issue of systemically important financial institutions to reduce the probability and the impact of their distress or failure. The Financial Stability Board (FSB) has been asked to present a range of possible measures by October 2010 including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.

A report was presented by the FSB to G20 finance ministers in November 2009 on methodologies for determining whether a financial institution is of systemic importance. This FSB guidance proposes three key criteria on how national authorities can assess the systemic importance of financial institutions:

(1) Size: the volume of financial services provided by the individual component of the financial system;
(2) Substitutability: the extent to which other components of the system can provide the same services in the event of a failure; and
(3) Interconnectedness: the linkages with other components of the system.

However the FSB recommends that an assessment based on these three criteria should be complemented with reference to financial vulnerabilities and the capacity of the institutional framework to deal with financial failures.

The Department looks forward to the outcome of the FSB's work including in relation to the proposal to limit the size of systemically important financial institutions. In considering action in this area it is important that the principles of the EU Single Market for Financial Services, which will serve to assist the recovery of the European banking system from the current crisis, are used to validate any proposals within the EU.

Section 7: Single rule book in banking

The Department is supportive in principle of a reduction in the number of national options and discretions within the CRD where these are consistent with the proposals of CEBS advice. The Department would expect that this process should continue to provide for necessary differentiation according to national or product circumstances. In Ireland, as in other Member States, particular national market characteristics may be incompatible with a fully harmonised single rule book.

This is the case, for example, in relation to the differentiated nature of national real estate markets within the EU. Ireland differs significantly from many other Member States in this respect, with a significantly higher owner-occupation rate and a prevalence of mortgage products with variable or short-term fixed interest rates rather than those which are fixed for a longer-term.