Discussion Paper on Designing a New Prudential Regime for Investment Firms

EBA, London, December 2016

Introduction

Responding to this Discussion Paper

- Public consultation runs until **2 February 2017**
  - Responses only via EBA webpage (click on 'Send your comments')
  - Respond to the questions with clear rationale, describe alternatives and provide evidence to support your view
  - Indicate if your response can be disclosed or should be confidential
  - Late submissions will not be accepted
  - These **slides** will be available at: EBA website / Regulation and policy / Investment Firms
- Firms invited to respond:
  - MiFID firms that are subject to different types of requirements under the CRR
  - Not limited to the CRR definition of investment firms, MiFID firms that are exempt from the CRR, firms that are exempt from the MiFID

Discussion Paper on design of a new prudential framework for Investment firms

- Process so far:
  - ✓ First data collection (internal)
  - ✓ **EBA Report on MiFID investment firms** — December 2015
  - ✓ Second data collection (external / in progress)
  - ✓ Technical roundtables with industry (4)
  - ✓ **Received: CfA from the EU Commission** — June 2016
  - ✓ **EBA Opinion on the first part of the CfA** — October 2016
  - ✓ **EBA Discussion Paper MiFID investment firms** — November 2016
  - ✓ Public hearing
- Next steps:
  - ❑ **EBA Final Report in response of CfA** — due: June 2017
  - ❑ EU Commission legislative proposal

European Commission's Call for Advice

Reasons for publication:

- Call for advice from 13 June 2016 to provide technical advice on
  - the new **categorisation** of investment firms and
  - the **design and calibration** of a more appropriate prudential regime for investment firms.
- The EBA is required to further specify the criteria on the first two recommendations of the Report, namely:
  - The **exact criteria or indicators** and thresholds for allocating firms in each of the proposed classes (new categorisation); and
  - The appropriate design and calibration of **all aspects** of a new prudential regime specifically **tailored** to the needs of different business models of firms and the **risks** that their operations present.

Structure of the Discussion Paper

Structure of the Discussion Paper

4.2 General principles governing the categorisation of investment firms

4.3 Prudential regime for investment firms

4.4 Other prudential considerations

4.5 Corporate governance and remuneration

4.6 Alternative approach to a new regime

Annexes

On the classification of investment firms

Classification of investment firms

4.2 General principles governing the categorisation of investment firms

- 4.2.1 ‘Systemic and bank-like’ investment firms
- 4.2.2 Investment firms that are not ‘systemic and bank-like’
- 4.2.3 Very small, non-interconnected investment firms

Classification of investment firms

General principles governing the categorisation of investment firms

- **‘Systemic and bank-like’ investment firms (Class 1)**
    - EBA Opinion of 19 October that these firms should remain under full CRR
    - OSIIs/GSIIs criteria
    - To note: CRR2 proposal: ‘Systemic investment Firms’

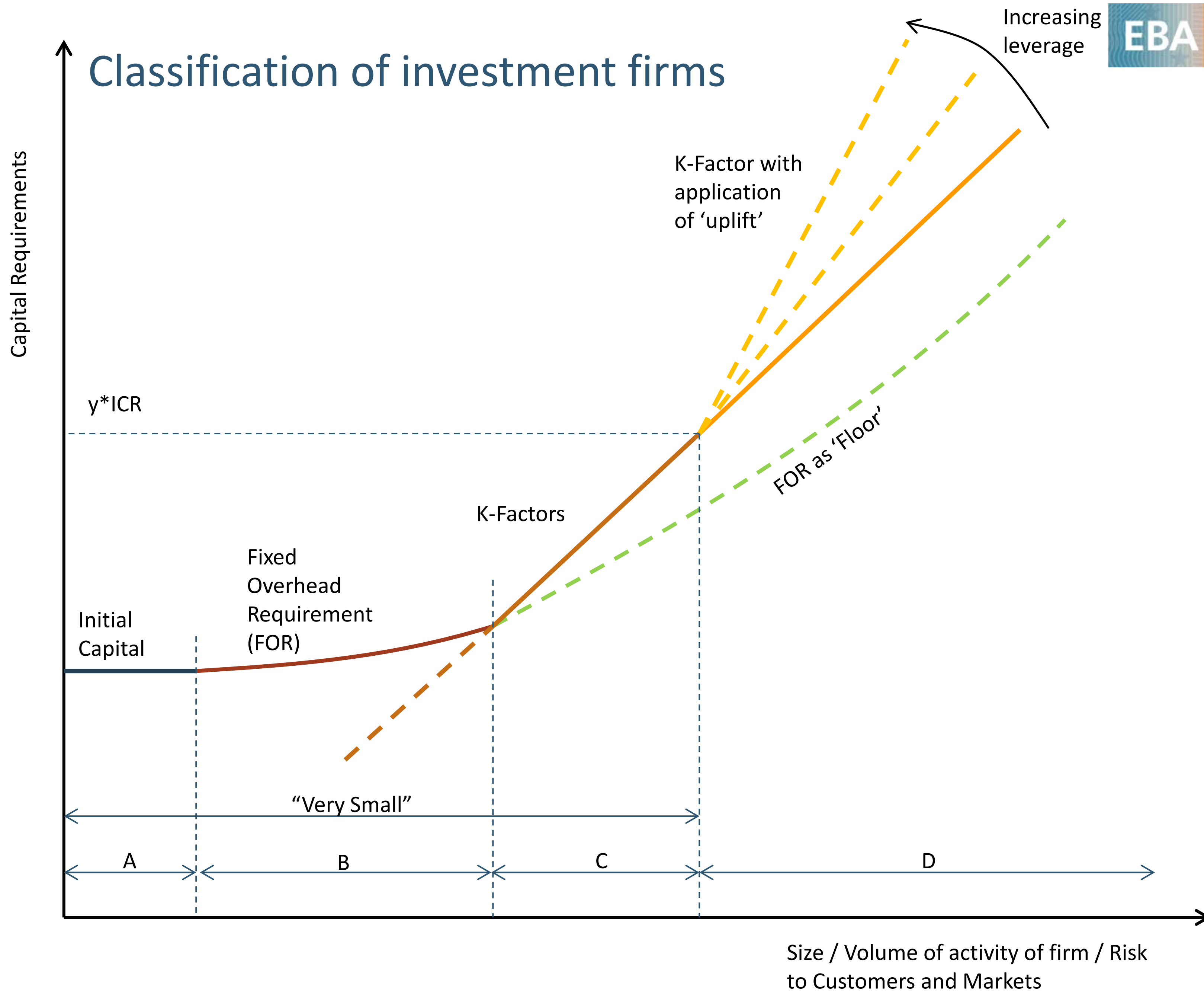
- **Investment firms that are ‘not systemic and bank-like’ (Class 2 and 3)**
    - Includes all other investment firms
    - Includes firms that have systemic importance but for which CRR is not appropriate or risk-sensitive

Classification of investment firms

Very small, non-interconnected investment firms (Class 3)

- Criteria that, if met, would **preclude** an investment firm from applying the simplest capital treatment:
  - holding client money or securities belonging to clients
  - the ancillary service of safekeeping and administration (B1)
  - dealing on own account (A3)
  - underwriting or placing with a firm commitment (A6)
  - granting of credits or loans to an investor (B2).
- Qualitative criteria, a range of **indicators and quantitative thresholds**:
  - balance sheet size
  - income/turnover
  - assets under management (AuM).

Classification of investment firms



Caveats on the classification

- EBA is not dismissing the possibility of maintaining the existing CRR treatment for investment firms, at least for **some firms**, although in a manner that is more specifically targeted towards these firms.
- There can be some investment firms that **although not large** enough to be categorized as 'systemic and bank-like' may
  - conduct similar 'bank-like' activities (for example underwriting on a firm commitment basis and proprietary trading) and
  - take on a significant amount of exposure risk.
- Especially for those that are deemed as large and important in terms of the potential for their failure to create a significant adverse impact upon market confidence
- One possibility that might be appropriate for such firms is to keep an approach to setting risk-based requirements that is more **consistent to the one they currently use** but subject to substantial simplifications

Capital requirements for investment firms

Capital requirements for investment firms

Key principles:

1. Investment firms are not ‘systemic and bank-like’ and therefore the purpose of a prudential regime for investment firms **is not to provide the same level of assurance** as is provided for firms that are systemic and bank-like
2. These capital requirements should ensure the **continuity** of the provision of services by ensuring that investment firms:
   i. can absorb a degree of loss, including in respect of correcting any **harm caused to customers and markets**, and continue in business;
   ii. have appropriate **liquidity** measures;
   iii. have enough own funds and liquid assets to **wind down** in an orderly fashion in the event of failure.

Capital requirements for investment firms

Key principles:

3. In addition to the organisational rules applicable further to MiFID, the prudential regime should address the specific risks associated with **holding client money and securities**.
4. The prudential regime applicable to investment firms should ensure a **harmonised** set of requirements for these firms across the EU
5. The prudential regime for investment firms should ensure that firms that pose **more risk** to customers or markets hold **more capital** than those that pose less risk
6. Among firms that pose similar risk to customers or markets, firms with **more risky balance sheet** or off-balance sheet exposures should hold **more capital** than those with less risky positions, as they present more of a risk of disruption to customers and/or markets.

Capital and liquidity requirements for investment firms

4.3 Prudential regime for investment firms

- 4.3.1 Capital requirements
- 4.3.2 Definition and quality of capital for investment firms

Capital requirements for investment firms

Definition and quality of capital for investment firms

- Overarching **principles** and **need for simplification**
  - Permanence and non-joint stock investment firms
  - Capital instruments and items (tiers of capital)
  - Deductions, filters and other elements

- Two **options** for way forward:
  1. Exactly the same provisions as in CRR (consistency with banks)
  2. Introduce new standards for investment firms

Capital requirements for investment firms

Risk to Customers (RtC): risk of potential harm they may pose to their customers

- for example, where they do not carry out the relevant investment services correctly

Risk to Market (RtM): impact an investment firm can have on the markets in which it operates.

- for example, should the firm fail or otherwise need to exit that market, particularly if this occurs suddenly, a temporary dislocation in market access or market liquidity may be observed and market confidence or integrity could be questioned.

Risk to Firm (RtF): Risk to the firm itself

- for example from its balance sheet assets and off balance sheet exposures (and where this is not already captured by an RtC or an RtM).
- These are the sorts of exposure risks that might give rise to a firm suffering the potential for loss arising from market price movements, counterparty defaults and credit deterioration etc.

Capital requirements for investment firms (‘Class 2’)

Capital requirement = a K_1 + b K_2 + … + n K_n

where:

- a, b, …, n are scalars
- K_1, K_2, …, K_n are observable ‘K-factors’ or proxies

1. Assets under management (AUM)
2. Assets under advice (AUA)
3. Assets safeguarded and administered (ASA)
4. Client money held (CMH)
5. Liabilities to customers (LTC)
6. Customer orders handled (COH)

Risk to Customers

7. Proprietary Trading Activity (PTA)

Risk to Market

Capital requirements for investment firms

Up-lift factor / leverage

- There may not necessarily be any **direct** impact on others (beyond shareholders/proprietors, who in any event should have an interest in good risk management to protect their own franchise), there could, nevertheless, be an **indirect impact** on customers and/or markets
- A firm that is financially weak or in trouble itself can be more susceptible to poor behaviour, weaker controls and greater risk-taking as it seeks to correct its fortunes
- This in turn suggests that any RtF could increase the probability that RtC occurs, and/or amplify its impact if it does occur, and so should not be overlooked

Capital requirement = Uplift factor * Sum (K-factors)

Capital requirements for investment firms

- **Fixed overheads requirement (FOR)** – as a floor to the K-factors
  - 25% of annual fixed overheads
- **Initial capital**
  - 'Initial capital', which represents one of the conditions for authorisation of an MiFID investment firm
    - Capital requirements may not fall below the amount of initial capital required at the time of time authorisation > should be **retained as a further floor**
    - **Not adjusted** since 1993
    - Possible harmonisation of all levels.

Capital requirements for investment firms

- **Final formula should look like this:**

$$\text{capital requirement} = \mathbf{MAX}[\ \mathbf{ICR}, \mathbf{FOR}, (\textstyle\sum_{i=1}^{p} a_i K_i) * \mathbf{f}(\mathbf{RFUM})\ ]$$

Where:

- **RFUM** (or Risk to Firm Up-lift Measure) represents a leverage measure
- **f** is a function of the RFUM, initially proposed as a square root (√).

- A **coefficient "y"** allows a smoother transition between FOR and K-factors
  - Which leads to the chart on p. 30 (or slide 10)

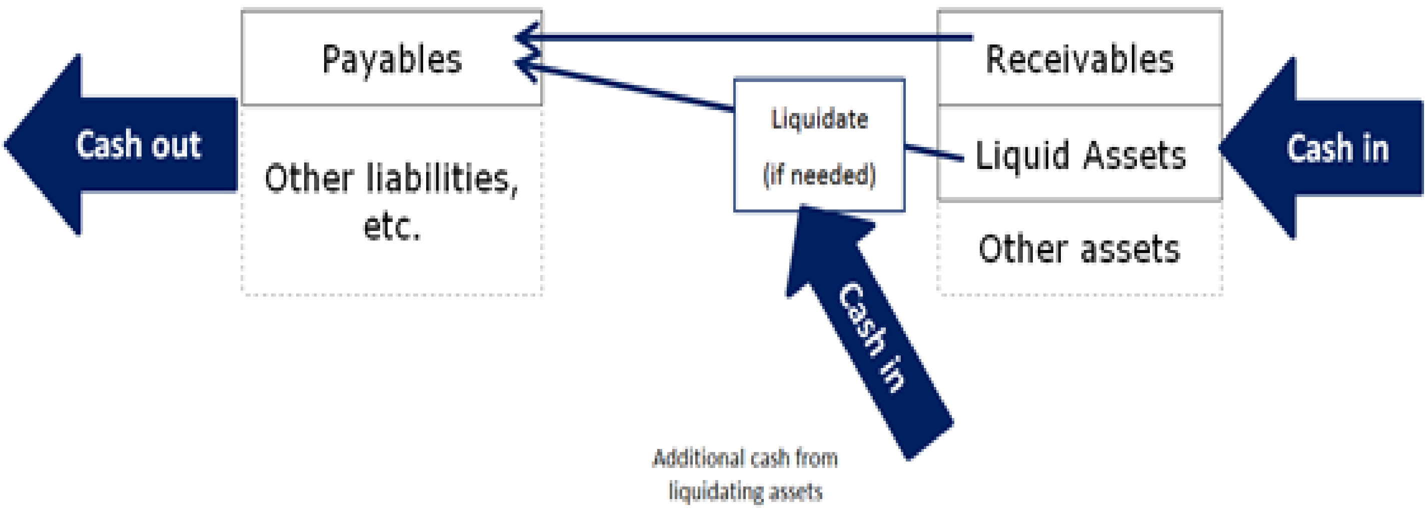
Liquidity requirements

Liquidity requirements for investment firms

- Three options to measure liquidity risk of investment firms:

1. **Counterbalancing capacity**

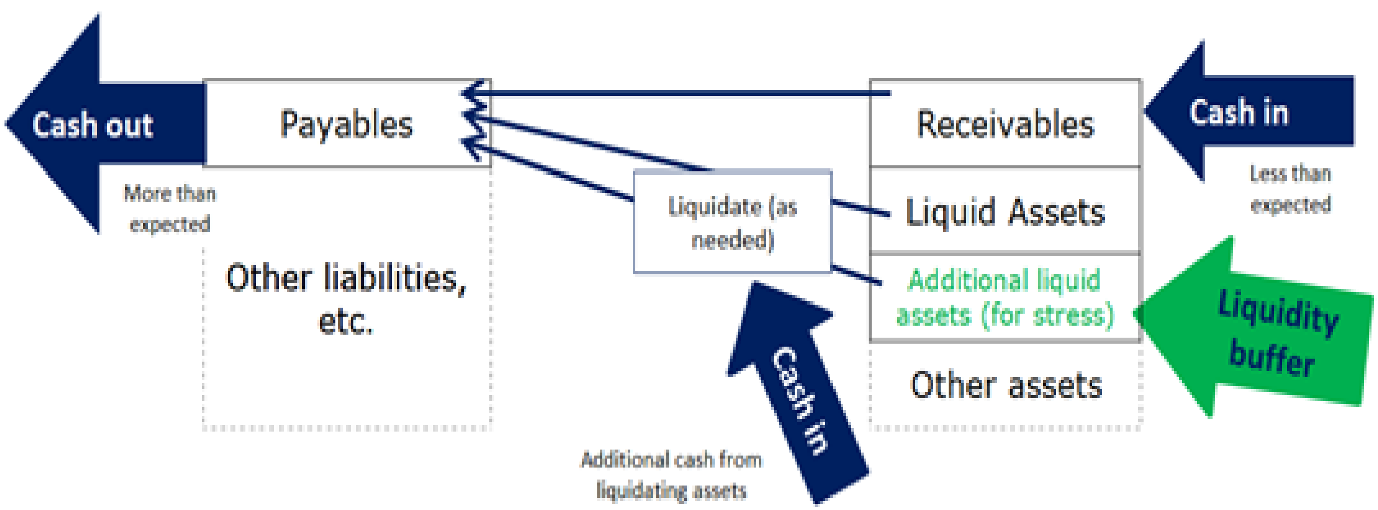
   The total payables over a given time period are balanced by the total receivables over the same period, with liquid assets making up any projected shortfall



Liquidity requirements for investment firms

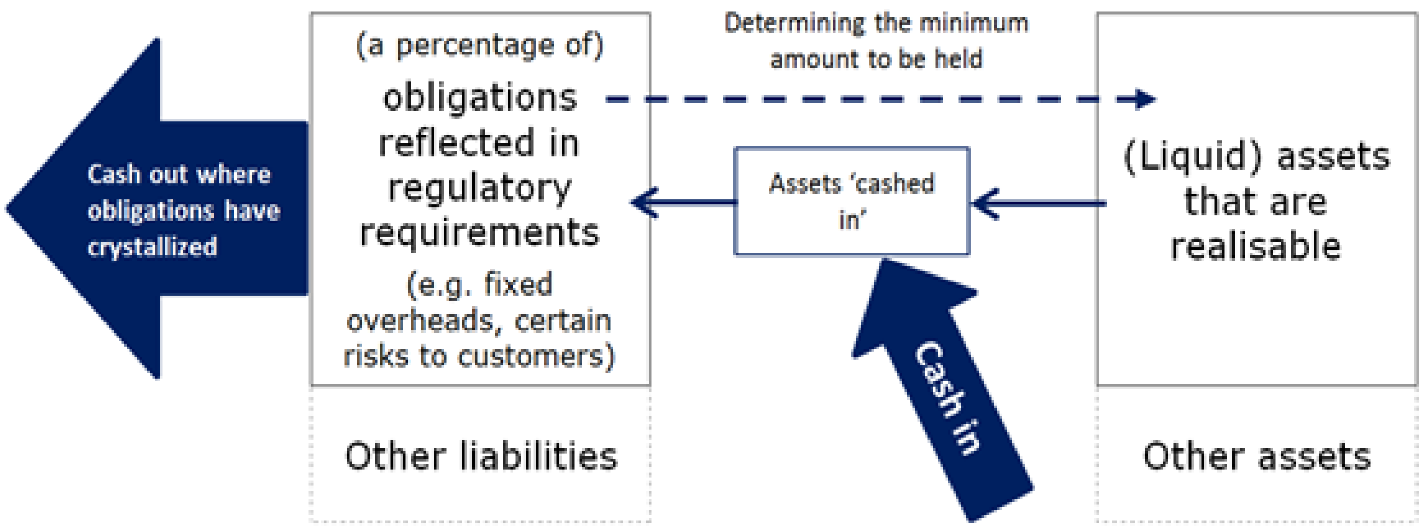
2. Liquidity buffer

If a firm suffers an unexpected increase in payables and/or an unexpected decrease in receivables in any given timeframe it can still meet its liquidity requirements by cashing in its liquid assets.



3. Regulatory requirement obligations

A firm's capital requirements determines the amount of capital that has to be held as 'own funds'. To ensure the firm can pay out on the obligations reflected by these requirements, should they crystallise, **a proportion (of capital requirements)** should be held invested in liquid assets.



Liquidity requirements for investment firms

- Please note:

  - What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements - **Annex 4**

  - Additional **operational requirements** for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm

Other prudential requirements

Other prudential requirements

- 4.4.1 Concentration risk
- 4.4.2 Consolidated supervision
- 4.4.3 Additional requirements on an individual firm basis
- 4.4.4 A macro-prudential perspective for investment firms
- 4.4.5 Reporting and any other prudential tools

Other prudential requirements

- **Requirements on Concentration risk**
  - To help protect an authorised firm from experiencing significant distress, or even sudden failure, due to the failure of another entity (a counterparty or group of connected counterparties) to which the authorised firm has a significant or large exposure relative to the size of its own capital.
- **Reporting scheme** basic information on concentration risk in:
  - earnings (quantities that could be more relevant for certain investment firms)
  - where client money held is deposited or securities belonging to clients are segregated from the firm's own assets (regardless of whether the firm is required to account for such client assets on or off its balance sheet) and
  - the amount of assets held with custodians (on behalf of customers).

Other prudential requirements

Requirements on Concentration risk (caveats)

- That there could still be some significant 'bank-like' proprietary trading firms that, although not systemic, also merit further attention:
  - 'pillar 2' approach,
  - a common 'soft limits' framework where larger trading-book exposures are still permitted
  - supported by additional capital, or
  - a hard limits based large exposures regime

Other prudential requirements

- **4.4.2 Consolidated supervision**

The main issues addressed by the use of consolidated supervision as a regulatory tool:

- to identify financial risks created by another group entity that have the potential to create losses within that other group entity - including the authorised investment firm
- Excessive group leverage: to detect and provide for situations where a parent entity issues debt and either down-streams the proceeds in the form of equity, or uses it to fund acquisitions (which may create large amounts of goodwill at parent or holding company level).
- To guard against situations of double or multiple gearing, where the same capital is used simultaneously as a buffer against risk in two or more legal entities.

Other prudential requirements

Supervisory review and evaluation

- Competent authorities to review of risk management arrangements, strategies and mechanisms implemented by investment firms

Additional requirements on an individual basis

- Competent authorities have the ability to take actions based on the outcomes of their assessments and
  - impose measures aimed at improving a firm’s risk management arrangements, strategies and mechanisms,
  - reduce its risk profile, and to
  - require it to hold additional capital or liquidity resources.

Other prudential requirements

4.4 Other prudential considerations

- **Reporting and any other prudential tools**
  - Current regime is an excessive burden especially for small firms
  - To be developed when the new regime is in place

- **Macro-prudential perspective for investment firms**
  - ESRB recommendation: to safeguard the stability of the financial system as a whole to ensure economic growth.
  - IFs can potentially also be a source of systemic risk collectively (even if individually not assessed as systemic and bank-like)

Other topics covered by the discussion paper

Other topics covered by the discussion paper

Remuneration

- Views on a prudential remuneration framework for Class 2/3 investment firms that should mainly aim to
  - counteract against conduct related operational risks and
  - would aim at the protection of consumers
- Challenges arising from the full application of the CRD/CRR remuneration requirements as regards Class 1 investment firms
- Relevance of CRD governance requirements to (Class 2/3) investment firms

Any further question?

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