BPFI response to EBA consultation on IFR

DATE
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SUBJECT
Response to the EBA second consultation on draft RTS on the calculation of the €30bn threshold under IFR/IFD

Introduction

Banking & Payments Federation Ireland (BPFI) is the voice of banking and payments in Ireland, representing over 100 domestic and international member institutions.

We welcome the opportunity to respond to the European Banking Authority (EBA) consultation on its second draft RTS on the calculation of the €30bn threshold under Art 8a of the Capital Requirements Directive (CRD). The final RTS will be fundamental to firms and supervisors in determining the category under which a firm will be classified within the new IFR/IFD regime, in particular whether firms would be required to be regulated as a credit institution (CI) under the Capital Requirements Regulation (CRR) and CRD.

During the initial EBA consultation launched in June 2020, BPFI did not submit a response as the draft RTS did not impact our members. However, in light of the significant changes introduced in the updated draft RTS, we wanted to provide the EBA with our views.

We are concerned that the approach adopted in the updated draft RTS will negatively impact a number of key EU policy objectives, like the development of a strong Capital Markets Union (CMU) and the incentivization of Euro denominated clearing inside the Union. Additionally, it is our view that, if adopted, the draft RTS would also raise the cost and complexity of establishing a presence and/or operating in the EU. We believe this runs counter to the objective of the IFR/IFD which was to develop a proportionate prudential regime for investment firms and we are concerned that this could lead to certain firms exiting the EU market as firms will not wish to bear the capital, liquidity, supervisory and prudential consequences of being regulated in the EU as if they were a bank.

Moreover, the proposed approach seems to mark a significant departure to how global assets of undertakings are looked at from a risk management perspective and the uncertainty of interpretation is an issue, especially for non-EU groups. We fear that by taking the approach of including the non-EU assets of non-EU entities, EU authorities (and most importantly EU firms) risk facing similar policies being adopted by other jurisdictions, undermining the global approach to financial regulation that has been so crucial since the financial crisis. **We propose amending the draft RTS so that it only includes in the calculation the assets of EU undertakings and the EU assets of non-EU firms, in each case where they are conducting the relevant MiFID 3&6 activities, but does not include the other (non-EU) assets of non-EU entities.**

As such, our response largely focusses on the change in the draft RTS relating to the €30bn threshold calculation and its impacts.

Key points

- The change in approach to the calculation of the €30bn threshold by looking at global assets will have a significant impact on investment firms operating in the EU, whether their global headquarters are based in the EU or elsewhere.

- And while we acknowledge the concerns around level-playing field considerations raised during the initial consultation, we are concerned that this new approach gives rise to new level-playing field issues between small and non-complex firms operating in the EU.

- **We therefore suggest amending the draft RTS so that it only includes in the calculation the assets of EU undertakings and the EU assets of non-EU firms, in each case where they are conducting the relevant MiFID activities, but does not include the non-EU assets of non-EU entities. This solution would ensure that the test focuses on the entities which present the greatest risk to the Union from a prudential perspective, whilst also ensuring that groups do not avoid the Class 1 authorisation requirement by establishing multiple entities or branches across the EU to avoid the 30bn threshold.**

- We would also like to underline our reservations with making such a fundamental change to the draft RTS without a full impact assessment to help better understand the consequences this measure could have more widely, particularly from a market liquidity perspective.

- If the updated draft RTS is not amended, many small and non-systemic investment firms may have to apply for a credit institution license, which in our view, is not proportionate to size and complexity of these firms EU operations and goes against the intention of the Investment Firm Review.

- The approach in the draft RTS will in our view act as a disincentive to EU and non-EU firms establishing operations in the EU and could negatively impact the development of a Capital Markets Union (CMU) and the internationalisation of the Euro.

- In turn, we also consider that this will have a negative impact on the wider political objective of incentivising clearing of certain products/asset classes inside the EU if less market making activity is carried out by EU based entities.

- This approach will put the EU at odds vis-à-vis other third country jurisdictions – like the UK, which has signalled it will not apply a similar approach to the thresholds used for credit institution authorisation. This will result in the EU becoming a less attractive destination for investment firms.

- **Due to the way the new group test proposed by the EBA is constructed, we foresee two possible scenarios materializing 1) groups may artificially grow their non-EU balance sheets above €30bn threshold and reduce their EU balance sheets as a way to avoid class 1 authorisation; 2) small non-EU firms may decide to exit the EU market as it is no longer a viable option due to the associated costs involved with being authorised and regulated as a credit institution.**

- We are convinced that the Level 1 text is consistent with the alternative approach put forward by us and summarized above. We believe that our view is supported by Article 4 (1) (b) of CRR which would indicate that co-legislators only wanted to capture the assets of EU branches of non-EU firms in the threshold test, and not the global assets of such firms.

Comments on the changes to the calculation of the €30bn threshold

At the outset, we would like to underline that our members fully support the policy objective of creating a proportionate prudential regime for investment firms in the EU. This recognises that risks posed by investment firms is different to that of large credit institutions and that therefore the same rules should not apply to both types of entities.

As highlighted above in our summary, the change adopted towards the calculation of the €30bn group assets threshold in the updated RTS will have a significant impact on many investment firms operating in the EU presently and in our view, merits further detailed analysis in respect to a number of potential unintended consequences.

In particular, we believe that the approach adopted in the updated draft RTS could negatively impact a number of key EU policy objectives, like the development of a strong Capital Markets Union and the incentivisation of Euro denominated clearing inside the Union.

In addition to this, the new approach seems to mark a significant departure to how global assets of undertakings are looked at from a risk management perspective. We fear that by applying such an approach to non-EU entities, EU authorities (and most importantly EU firms) risk facing similar policies being adopted by other jurisdictions, undermining the global approach to financial regulation that has been so crucial since the financial crisis.

Below we have outlined in more detail our concerns to the draft RTS, along with a potential solution, which we believe is aligned to the Level 1 text and the intention of co-legislators to only capture EU assets.

I. The key problem – a disproportionate impact on small & non-complex investment firms

During the initial consultation, BPFI did not submit a response due to Chapter 3 and 4 of the draft RTS clearly indicating that the scope of undertaking relevant for the €30bn calculation would only focus on the EU assets of third country firms.

As the updated draft RTS now looks to scope in "the assets of all relevant undertakings of the [third country] group", we believe this will have a disproportionate impact on many small and non-complex firms operating in the EU, counter to the stated objectives of the IFR and in our view the wording and spirit of the Level 1 text.

Alongside this, we feel that the new draft RTS will have the impact of subjecting certain small firms to CI status purely depending on the overall size and structure of the parent entity and non-EU affiliates, whereas potentially larger or more complex EU firms would benefit from a more proportionate regime.

And whilst we agree that a group test threshold provides a sensible "anti-avoidance" measure to guard against the risk of groups dividing their EU activities in a way which keep individual entities below the threshold, we do not believe that it was the intention of co-legislators to capture non-EU activities of non-EU entities simply because they are part of the same group as an EU investment firm.

In our view, the knock-on impact of the new group test could lead to the following two scenarios:

1. EU and non-EU groups may artificially grow their non-EU balance sheets above €30bn threshold and reduce their EU balance sheets to avoid CI authorisation; or

2. Small non-EU firms may decide to exit the EU market as it is no longer a viable option due to the associated costs involved with being a CI.

It is therefore worth outlining an example of how the solo and group test will lead to unusual and in our view, unintended outcomes when we take into consideration the Class 1 minus test inserted into the IFR and the new definition of a CI.

CI authorization requirements (Article 8a – specific requirements for authorisation of credit institution referred to point (1)(b) of Article 4(1) of CRR)

(a) the average of monthly total assets, calculated over a period of 12 consecutive months, is equal to or exceeds EUR 30 billion; or

(b) the average of monthly total assets calculated over a period of 12 consecutive months is less than EUR 30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in the group that individually have total assets of less than EUR 30 billion and that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 30 billion, both calculated as an average over a period of 12 consecutive months.

Class 1 minus test (Art 1 (2) IFR)

"By way of derogation from paragraph 1, an investment firm authorised and supervised under Directive 2014/65/EU, which carries out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU, shall apply the requirements of Regulation (EU) No 575/2013 where the undertaking is not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking, and any of the following conditions apply:

*(a) the total value of the consolidated assets of the investment firm is equal to or exceeds EUR 15 billion, calculated as an average of the previous 12 months **excluding** the value of the individual assets of any subsidiaries established outside the Union that carry out any of the activities referred to in this subparagraph;*

*(b) the total value of the consolidated assets of the investment firm is less than EUR 15 billion, and the investment firm is part of a group in which the total value of the consolidated assets of all undertakings in the group that individually have total assets of less than EUR 15 billion and that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 15 billion, all calculated as an average of the previous 12 months, **excluding** the value of the individual assets of any subsidiaries established outside the Union that carry out either of the activities referred to in this subparagraph;"*

The consequence of the updated draft RTS is that there could be firms located in the EU with limited assets yet be subject to CI authorisation and CRR/CRD requirements due to their group structure, whereas similar size firms with a different group structure would fall under a more proportionate IFR regime. For illustrative purposes, let us take the following examples based on the updated draft RTS and the Level 1 text (we have assumed that there is one entity operating in each jurisdiction region and that it undertakes the relevant MiFID 3&6 activities):

a) Firm A – Headquartered in the EU

EU assets	US assets	APAC	Total assets	Classification
20bn	50bn	5bn	75bn	Class 1 minus

b) Firm B – non-EU Headquartered firm

EU assets	US assets	APAC	Total assets	Classification
1bn	19bn	11bn	31bn	Credit institution

c) Firm C – Headquartered in the EU

EU assets	US assets	APAC	Total assets	Classification
29bn	0bn	0bn	29bn	Class 1 minus

Under this approach, the only firm subject to CI authorization is firm B based purely on the fact that its non-EU affiliates each have assets below €30bn– which brings them within the group test calculation –

and the group's overall assets are over €30bn. In contrast, Firm A would fall under the Class 1 minus category due to a) having EU assets below €30bn and b) having non-EU assets above the €30bn threshold for the group test, while Firm C would fall into the same category despite having the largest EU asset, just because its individual assets are less than €29bn and it is not part of a group with large non-EU operations.

Subjecting a firm with only €1bn of EU assets to CI authorization is disproportionate to the business activities conducted and will lead to an un-level playing field between certain investment firms operating in the EU. In our opinion, activities conducted by non-EU affiliates outside the EU do not pose a risk to the EU markets, consumers or market participants serviced by the EU Investment Firms and should therefore not be taken into consideration for the threshold calculation.

To take another example, if a non-EU firm had both an EU entity with €1bn of assets and an APAC entity with €50bn of assets this firm would not be required to register as a CI. However, if the parent entity decided to restructure its balance sheet between two entities in order to deploy assets into a new asset class or emerging market, then the firm's EU entity would need to register as a CI. Similar to the comments above, we strongly believe the construction of the RTS and the "automatic" nature of the re-classification would draw into question the viability of the EU firm's long term operation because of the costs involved.

Further, if the same firm had to register as a CI after the group restructure but the group had ambitions to build-up its balance sheet in the two entities to €35bn each within 18 months, this firm would then be permitted to operate as a class 1 minus firm.

As we believe it was never the intention of co-legislators to scope-in non-EU assets of non-EU undertakings, we would urge the EBA to consider amending the draft RTS so that it only looks to capture the assets of EU firms and the EU assets of non-EU firms.

Unless amended, we believe there is a real possibility that these small non-EU firms may decide to exit the market and relocate operations elsewhere. At the same time, this approach might also incentivise EU headquartered firms scaling back EU operations and choosing to grow activities in other jurisdictions. It should be added that the UK has indicated that it will not be adopting this approach in its own Investment Firms Prudential Regime.

II. Operational & Enforcement Challenges

- *Operational*

While potentially impacted firms are currently subject to CRR/CRD for certain requirements such as capital, they are not subject to the entire prudential framework in many instances due to existing exemptions in the areas of liquidity, large exposures and leverage. The IFR/IFD further was developed specifically to provide an appropriate prudential regime for small and non-complex investment firms, a policy aim which we fully support.

On the other hand, being reclassified as a CI would entail significant resource requirements, a much-enhanced level of regulation including the volume of regulatory reporting, thematic reviews, and level of supervision, which we do not believe is proportionate to the level of risk or the business model of investment firms.

A key regulatory challenge for small and non-complex firms to meet will be the liquidity regime (NSFR) as part of the CRD/CRR framework. As many small firms are active in assets classes like equities, Securities Financing Transactions (SFTs) and derivatives, our members are concerned about the knock-on impact these rules could have on liquidity pools in the EU, as well as the associated increase in costs for meeting stable funding requirements (RSFs). In this regard, it is important to recognise that

Class 1 minus firms are subject to Part 6 Liquidity requirements under CRR since June 2021, so the particular risk posed by larger investment firms has already been addressed.

Additionally, these small and non-complex investment firms would need to comply with bank recovery and resolution rules (and associated resolution fund contributions), along with bank specific regulations like Basel iii. It should also be noted that many of these small and non-complex firms do not operate internal models, unlike large banking groups. Subjecting them to the same level of supervision without having the capacity to develop and operate internal models further undermines the level playing field within the EU.

This, in our view, seems at odds with the spirit of the introduction of the IFR/IFD, which was to design prudential rules appropriate to the risks posed by investment firms and create a more level playing field between these entities across Member States. We would also be concerned about the potential for Member States to look at introducing national discretions or lighter regimes for Class 1 investment firms, creating potential fragmentation and further level-playing field issues.

- *Enforcement*

By taking a global approach to the calculation of the threshold, we have concerns with the EBA and relevant EU NCAs getting the necessary support outside their jurisdiction scope to enforce compliance with the RTS, e.g. where non-EU entities fail to provide information to their EU investment firm affiliates.

Given the limited resources the EBA and NCAs have – including the lack of direct oversight of the non-EU entities – we believe this requirement will distract from these organisations' core duties and could raise doubts over the credibility and accuracy of the authorisations within the EU if the relevant data cannot be sourced or verified.

According to the updated draft RTS Article 3, entities under scope would be required to use the most recent audited accounts prepared in accordance with IFRS. In situations where these accounts are not available or used by EU Member States or third countries, firms are permitted to use alternatives so long as they are "adjusted" and lead to the "same outcome". Given that many entities in a group may use both GAAP, IFRS or an adjusted IFRS version, it will be very cumbersome to consolidate such an overview in accordance with the draft RTS' quarterly reference dates, and in our view, not proportionate.

It should also be noted that EU entities with a non-EU parent, could find it challenging to receive the relevant information in order to comply with the classification and subsequent reporting requirements, while the parent or other group entities may not publish audited annual accounts. Having to identify MiFID activities 3&6 in non-EU undertakings could similarly be challenging due to differences in legal definitions and group structures. We also envisage that this could lead to varying interpretations by firms as to what should or should not be considered as MiFID activities 3&6. Consequently, this could result in further undermining the level playing field between investment firms operating in the EU due to the discretionary nature of this assessment. Undertaking this approach on an ongoing basis will also be very resource intensive.

To summarise, we believe the following will become problematic for firms and EU/national authorities:

I. EU entities with a non-EU parent may find it very challenging to be provided with access to annual accounts for the calculation requirements both initially and on an ongoing basis;
II. EU/national authorities could find it very challenging to ensure entities comply with the requirements given the lack of supervisory oversight they have over non-EU entities;
III. Non-EU entities may not always publish audited annual accounts;
IV. EU entities could find it very challenging to identify what activities within non-EU undertakings are subject to the calculation requirement due to legal definitions not being aligned; and

V. The use of various different accounting standards by undertakings within groups will present a clear operational challenge to calculating assets on a global basis and in a consistent manner.

III. Negative impact on EU financial services policy objectives

As outlined above, we firmly believe that by adopting a global approach to the calculation of the CI threshold, it will damage the attractiveness of the EU for investment firms, which in turn, will negatively impact a number of key policy objectives at a European level.

- **CMU.** With Europe's largest capital market – London – now outside the single market for financial services, it is welcome that the European Commission (EC) is looking to further develop its CMU ambition, particularly in a post-COVID recovery phase where many companies may require new sources of funding. Investment firms which provide liquidity in asset classes and support with placements will be key to drive this policy agenda. Our concern, however, is that the updated draft RTS could hamper the development of the CMU by disincentivising small and non-complex investment firms from operating and growing EU operations. This would impact market liquidity, leading to higher prices for end investors, both retail and wholesale.

- **Incentivising EU clearing.** Similarly, we are concerned that the political objective of reducing dependence on UK CCPs – while building up capacity inside the EU – could be challenged if market makers are not incentivised to grow operations in the EU. Many investment firms are key providers of liquidity in Euro IRS and other assets classes that fall under the EU's clearing obligation. Having a diverse trading and clearing landscape in the EU will ensure that Europe's markets are commercially competitive to attract deep pools of liquidity, which will be essential to compete with other jurisdictions. Without this, we fear that EU and non-EU clients will look to continue clearing Euro denominated products outside the EU, splitting liquidity pools and impacting the attractiveness of the EU.

- **Strengthening the international role of the Euro.** Having a strong international Euro brings many added benefits to the EU economy, particularly from the perspective of foreign exchange shocks, lower transaction costs and a more resilient global economy because of a diversified currency system. And while the Euro presently is the second most widely used global currency, boosting its use internationally will help bolster the EUs ability to withstand asymmetric shocks and chart its own path on the global stage. The implementation of the Next Generation EU fund is a clear example of how the EU can become an active debt issuer globally. As outlined by the European Commission in its communication on economic and financial resilience from January 2021, developing Euro-denominated financial instruments can support this objective. The reduction in volume of smaller investment firms throughout Europe risks reduced access to such instruments across all segments of the European market. As investment firms will be key to the development of such markets, we are concerned that the updated RTS could have a negative impact on realising this political ambition.

IV. Timing challenges

We fully welcome the EBA's recent Opinion on the application of Art 8 IFR/IFD and its advice that NCAs take a pragmatic approach towards firms until the subsequent delegated act is in place and not to prioritise any supervisory action against firms until six months after this date.

In our view, this flexibility is essential as many firms had been working under the basis of the initial draft RTS considering applications for authorisation were due to be completed by 27 December 2020 as laid down in the Level 1 text.

However, notwithstanding the flexible approach called for by the EBA, by proposing an alternative methodology to the threshold calculation 12 months after the initial RTS and only three weeks before the entry into force of the IFR/IFD, it is resulting in significant uncertainty for firms given the impact it will have on their EU business operations. Firms welcome consistency and clarity around regulation given its links to future business decisions.

Without a full impact assessment, it is challenging for firms to understand the true impact of the updated RTS at this current juncture, particularly from an overall market perspective. As mentioned previously, we are concerned about the impact the RTS could have on liquidity in certain assets classes/products. And while we are aware the IFR/IFD may be reviewed by 2024, the impact on the EU market in the interim could be significant.

A CI authorisation process and future regime would also require considerable resources to implement and come at a time when investment firms are in the process of delivering on many other change programmes (e.g. Libor cessation, EU Taxonomy Regulation, EU Sustainable Finance Disclosure Regulation etc). From a level playing field perspective this timing is also challenging in terms imposing significant additional requirements on EU firms compared to the timing for registration in other jurisdictions for similar requirements, e.g. US Swap Dealer rules with several years of lead-in only coming into force this year for SEC.

V. Proposed Solution

Addressing the concerns outlined throughout this paper and in the initial consultation process is possible through minor adjustments to the draft RTS. We are of the view that such adjustments are permissible within the Level 1 text and in line with the broader objectives of creating a proportionate prudential regime for small investment firms.

Our approach, we believe, will help ensure that neither EU investment firms or small and non-complex firms are put at a disadvantage or compete on an unlevel playing field with each other. Just as importantly, it will help ensure that key EU political objectives in financial services – like CMU – are not unintentionally impeded.

We therefore propose that the RTS is amended in the following manner:

- **For the group test for the Class 1 threshold only assets of relevant EU undertakings and EU assets of non-EU undertakings should be assessed; the non-EU assets of non-EU entities should be excluded.**

This approach will safeguard the level playing field between EU and non-EU firms, while we also believe it will help address many of the concerns laid out in this paper.

- **Consistent with existing EU approaches to prudential calculation.** Currently under CRR for deposit taking institutions only EU assets are taking into consideration when determining the systemic importance of the institution. And although such institutions would need to apply for CI authorisation, their non-EU assets are not taken into account when determining their systemic importance (e.g., EU subsidiaries of non-EU CIs only take EU assets into account when determining whether the institution should be a Systemic Institution or Less Systemic Institution). By looking to calculate the EUR 30BN threshold on a global basis for only MiFID activities 3&6, would mark a significant departure from current practice in the EU, while it would also create a distinction between CIs within the EU itself.

- **Consistent with the Level 1 text.** In our view, only capturing assets of relevant EU entities and EU assets of relevant non-EU entities is in accordance with the Level 1 text as can be demonstrated throughout. For example, the final sub-paragraph of Art 4(1) (b) CRR would suggest that the primary text only wanted to focus on EU assets of relevant non-EU firms. If, on the other hand, co-legislators wished to capture the global assets of non-EU firms, we would expect this to be specifically outlined in points (b) (ii) and (iii) of Art 4 (1) CRR. From our perspective, this is further supported by point (iii) (b) of Art 4 (1) which permits the consolidating supervisor to require a firm to re-authorise as a CI on financial stability grounds or in the event of circumvention. By incorporating this provision, we believe co-legislators principal objective was to include a fall-back anti-avoidance mechanism into the legislation in the event some firms attempted to evade the rules.

- This perspective is reinforced when one also considers the flexibility included in Art 5 of the IFD which permits NCAs to subject firms above EUR 5bn to full prudential requirements if they could have a systemic impact in the EU. Having such discretionary powers would suggest that co-legislators in-built the possibility to subject firms to full CRR/CRD status even if their EU assets (on a solo or group basis) did not breach the EUR 30bn threshold. For example, if a non-EU firm had EU assets of EUR10bn and its USA undertaking had EUR 25bn the in-built discretion provides for the NCA to subject this firm to CRR/CRD on financial stability grounds, leading one to believe that the intention of the EUR30bn group test was only to focus on EU assets.

- During the initial negotiations on the legislative proposal, it is our firm understanding that co-legislators specifically requested that the perimeter of assets to be captured in the calculation should refer only to the consolidated assets of EU undertakings and the assets of branches of non-EU firms authorized in the EU. We believe this intention was documented at the time and was influenced by the ECB's Opinion which also clearly details the scope to only capture EU assets: *"the proposed regulation should provide clarification as to how the assets are to be calculated, i.e. including the assets of Union branches of third country groups and third country subsidiaries of undertakings in the Union arising from their consolidated balance sheet".*

- More broadly, this approach seems to be aligned with the scope of activities that fall under the Art 4 (1) (b) (ii) and (iii) (e.g., MiFID 3& 6). As this is an activity-based test, it would suggest that co-legislators only wanted specific EU regulated activities and entities authorized to carry out these activities (e.g., an EU regulated entity) to be included in the threshold calculation. Otherwise – and has been laid out in other pieces of EU legislation – the text would have said that the assets of entities conducting activities "equivalent" to MiFID activities 3&6 should be considered.

- In addition, by using the EUR30bn threshold for both the solo and group test would indicate that it was intended that only the assets of EU entities and EU assets of non-EU entities are relevant. The group test is rightly included as an anti-avoidance mechanism, but with the focus of the solo test on EUR 30bn of EU assets, it would indicate that the group test is purely included to avoid firms splitting up their EU balance sheet as a way to avoid CI authorisation, but not to capture global assets. By not taking into consideration assets above EUR 30bn in the group as outlined in the Level 1 text, it would further seem to suggest that only EU assets are relevant.

- **Reduces complexity of the calculation.** By looking at EU assets, it will also support NCAs in the enforcement and supervision of the rules and ensure that their resources are used in the most efficient manner. On the other hand, from an investment firm perspective, by only having to calculate EU assets will support with the ongoing reporting obligations as it will not be required to consolidate different account standards globally.