Finance Watch
Making finance serve society

Finance Watch comments on the European Banking Authority's Discussion Paper on Designing a New Prudential regime for Investment Firms

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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On November 04, 2016, the European Banking Authority (EBA) published a discussion paper on the design of a new prudential regime for investment firms, which responds to the European Commission's Call for Advice dated 13 June 2016. The discussion paper is based on the EBA's Report on Investment Firms dated 15 December 2015 and sets out its principal recommendations for, and technical features of, a new regulatory framework. Finance Watch is pleased to have the opportunity to share its comments and observations on the report and its recommendations.

1. General observations

Finance Watch supports, in principle, the primary objectives of the EBA's proposals. In particular, we agree that the categorisation of investment firms should be simplified and the burden on small, independent firms whose activities do not pose a risk to financial stability at the national or European level should be reviewed and, if found disproportionate, reduced.

We believe, however, that these objectives can be achieved within the existing CRR/CRD IV framework and disagree with the EBA's conclusion that only systemically important firms should be governed by that regime[1]. We doubt that a new prudential regime, standing alongside CRR/CRD IV, would be more effective in addressing the issues that have been identified but are very concerned that it would create yet another highly complex body of rules for firms to understand and comply with, and encourage regulatory arbitrage. Instead, the CRR/CRD IV regime should be amended to simplify categorisation and introduce a more granular approach to capitalisation for firms that fall outside of the full scope of CRR/CRD IV, which better reflects the specific risk profiles of these categories.

The original argument at the core of the CRR/CRD IV framework, that banks and non-bank investment firms should be subject to the same capital requirements to ensure a level playing field, still holds true, in our view. At present, at least, 'universal banking' is the predominant business model in the EU and a significant number of investment firms, in particular larger ones, are part of universal banking groups. It is not unreasonable therefore that this model has been used as the point of departure for designing the CRR / CRD IV framework. To the extent warranted by their risk profile particular categories of firms may be excluded from the full scope of CRR/CRD IV.

2. Categorisation of investment firms

2.1. Exemptions and national discretions

Arguably, divergences in the national transposition and/or interpretation of MiFID are a more pressing issue than a wholesale review of the capital adequacy regime as such. Material differences exist, in particular, in the definition of MiFID services and activities (Annex I), the categorisation of investment firms and the calibration of initial capital requirements for each category. A streamlining of exemptions and national discretions[2] and the harmonisation of definitions that are fundamental to the application of the CRR/CRD IV framework[3] across EU Member States, in particular, would likely do more to create a simpler regulatory

[1] Opinion of the European Banking Authority on the First Part of the Call for Advice on Investment Firms (Op-2016-16), 20 October 2016

[2] e.g. exemptions under Art.2 and optional exemptions under Art. 3 MiFID

[3] e.g. the definition of 'holding client money' (Art. 29/3 CRD IV); cf. European Banking Authority, Report on Investment Firms: Response to the Commission's Call for Advice of December 2014 ('EBA Report'), pg. 18

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environment and level the playing field than an entirely new regime that will be at least as susceptible to divergent interpretations as the existing one.

2.2. Advisory-only firms (Cat. 2 and 3)

The treatment of advisory-only firms should be simplified, in the first instance, by way of a further harmonisation of national options under Art. 3 CRD IV. A largely harmonised regime for advisory services would, in our view, be in the interest of improving the availability and competitiveness of such services across the internal market. For this reason we would also suggest that such firms should be able to qualify, subject to certain criteria, for a MiFID passport, or equivalent, in order to be able to offer cross-border services.

Similarly, we agree with the EBA that the exception in Art. 31/2 CRD IV for firms which are also insurance intermediaries and subject to the Insurance Mediation Directive (IMD) is questionable, both in respect of ensuring an equivalent level of prudential protection[4] and of maintaining a level playing field vis à vis similar firms that do not benefit from this exception. We would therefore be in favour of merging these two categories. The option of replacing initial capital with Professional Indemnity Insurance (PII) should, in our opinion, be removed and replaced with a common, lower minimum level of initial capital for both categories, supplemented by a Fixed Overhead Requirement (FOR) for larger firms that exceed a defined threshold.

2.3. Portfolio managers and execution brokers (Art. 95 CRR)

We believe that a streamlining of the regime under Art. 95 CRR would be desirable and go some way towards a simpler, more proportionate regulatory framework. There is, however, still a need to differentiate between business models with different risk profiles. Brokerage firms that engage in trading on their own account and/or underwriting are, by definition, engaged in ‘bank-like’ activities and should remain subject to CRR/CRD IV. Execution-only firms that currently fall under Art. 95/2 CRR should be able to benefit from a simplified capital adequacy regime.

We note that the Financial Stability Board, jointly with IOSCO, is conducting a review of the potential systemic role of Non-Bank Non-Insurance (NBNI) institutions including, for instance, asset managers and other categories of investment firms. As pointed out by the EBA, the risk profile of these entities is different from banks and may require modifications to the current treatment under CRR/CRD IV. These modifications should, however, be made inside the existing framework and in full alignment with the work of international standard setting bodies.

3. Risk sensitivity of the capital adequacy framework

The Basel III framework, which underpins CRR/CRD IV is designed to comprehensively cover all of the main risk categories the EBA has identified to be critical for investment firms, i.e. market, credit and operational risk, liquidity and funding risk, large exposure and concentration risk. We are concerned that the effort to capture and quantify these risks by using different, simpler models and proxies, will absorb significant amounts of time and resources and sceptical that it will yield a result that is a significant improvement methodology while, at the same time, maintaining consistency with the existing body of relevant international standards.

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[4] cf. EBA Report, pg. 20-21

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3.1. Market risk

We agree with the EBA's observation[5] that the use of standardised or internal-model based approaches generally tends to result in firms holding less capital for a given level of exposure. The Basel Committee has recently undertaken a Fundamental Review of the Trading Book (FRTB) to address the treatment of market risk for capital adequacy purposes. Finance Watch has welcomed this initiative, subject to a number of reservations on some aspects of the proposed reforms, which we have already commented on in detail. We still believe, however, that any modifications to the market risk framework should be made in line with the Basel process to maintain a regulatory level playing field, both among firms and among jurisdictions.

The arguments highlight the dichotomy between "more risk sensitivity", which generally implies the use of detailed, complex, and costly internal models, and "more proportionality", which implies a less resource-intensive approach to risk management and reporting. Depending on their size and profile, firms pursue either one or the other of these approaches, always with the common objective of minimising capital requirements. It is this fundamental conflict that has caused the Basel III regime, and hence CRR/CRD IV, to grow into the convoluted behemoth it is today. It would be overly optimistic, in our view, to assume that a new regime outside CRR/CRD IV could evolve differently.

3.2. Operational risk

We acknowledge that the current approach to calculating Pillar 1 capital requirements for operational risk is suffering from materials shortcomings and has created significant practical issues for banks and supervisors. We note, however, that the Basel Committee has recently undertaken a comprehensive overhaul of its operational risk framework. We believe that the three 'macro components' which are outlined in the proposed framework, notably the services and financial components, should be applicable to most activities conducted by investment firms and we would therefore favour an approach whereby these international standards, in their final, agreed form, are incorporated into the CRR/CRD IV framework. We appreciate that supervisory authorities may still need to resort to the use of Pillar 2 to address specific risks not fully covered by the Pillar 1 assessment which is, in our view, a reflection of the multi-faceted nature of operational risk and the great diversity of investment firms' business models.

[5] cf. EBA Report, pg. 34

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4. Selected individual questions

Q1: ***What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of 'systemic and bank-like' investment firms? What are your views on both qualitative and quantitative indicators or thresholds for 'bank-like' activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects of the identification of 'systemic and bank-like' investment firms could be improved?***

Finance Watch believes that the current G-SII/O-SII regime already captures, to a large extent, those investment firms which are 'bank-like and systemic'. These firms tend to be part of G-SII/O-SII groups or, in particular in the case of some UK-based O-SIIs, subsidiaries of overseas G-SIIs. We do not agree with the EBA's recommendation, however, that the remit of CRR/CRD IV should be limited to 'bank-like and systemic' firms only.

As mentioned previously, the FSB and IOSCO are conducting a review of the potential systemic role of Non-Bank Non-Insurance (NBNI) institutions including, for instance, asset managers and other categories of investment firms. The risk profile of these entities is different from banks and may not be properly reflected in the current scoring schemes for identifying systemic importance. Risk factors such as interconnectedness and concentration risk could be of particular relevance for this segment and may need to be given more weight in the overall risk assessment of this type of firms. We believe, however, that any such review should be aligned with, and draw on the findings of the ongoing work by the FSB and IOSCO on Non-Bank Non-Insurance (NBNI) institutions.

We also believe that the rules and practical implementation of the existing G-SII/O-SII regime under CRR/CRD IV, should be further tightened, in particular in respect of O-SIIs. Within the SSM, for example, we see obvious discrepancies between the designation of O-SIIs by Member State competent authorities and the designation of 'significant institutions' by the ECB. We would welcome a more consistent and comprehensive approach to the designation practice of O-SIIs, which we consider as an area of particular concern for financial stability in the EU.

Q3: ***What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')? IF, for example, such class was subject to fixed overhead requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?***

We are sceptical about the likelihood of finding a simple yet workable definition of "very small and non-interconnected firms". The current approach, which reflects the diversity of business models among investment firms, is correct, in our view, although we agree that there is a strong case for simplifying categories and allowing for more proportionality.

As mentioned previously, we would prefer an approach which creates a simpler and more harmonised regime for advisory-only firms (Cat. 2 and 3) firms. We agree that these firms pose only very limited risks to investors (especially private investors) and financial stability and may not need to be covered by the full scope of CRR/CRD IV. Similarly, firms that act as execution-only brokers (Cat. 4). In both instances, exemptions from full CRR/CRD IV compliance should be subject to size thresholds and limited to firms dealing with

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professional customers and counterparties only. Firms that trade on the markets on their own account, engage in (firm) underwriting or deal directly with private investors are susceptible to a much broader range of risk factors and should therefore remain subject to CRR/CRD IV.

Q6: ***What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?***

We are concerned that the proposed K-factor-based calculation lacks granularity. We would, for instance, expect that any measure of 'Assets under Management' differentiates between a) private and professional investors and b) client asset held in segregated and non-segregated (pooled) accounts. Each of these scenarios implies a different type of risk profile and should be reflected accordingly. It is also debatable whether K-factors need be calibrated differently depending on the category of financial instruments a firm trades in. We would expect many more, similar issues to be raised, both by market participants and users, with the likely effect that the new framework would turn out no less complex and cumbersome as the one it was intended to replace.

Q9: ***Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how should it be improved?***

We acknowledge that the FOR is a relatively crude proxy for the size and complexity of a firm and the funding required to wind it down in an orderly manner. While its simplicity makes it very useful as a generic indicator it is known to be susceptible to being 'gamed'. We would feel comfortable with the FOR being used as a complementary factor to initial capital for firms which fall outside of the full scope of CRR/CRD IV.

Q11: ***Do you think that the K factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?***

We have doubts about the adequacy of the 'k factor' approach in capturing the systemic importance of a firm and, in particular, about the consistency of the proposed approach with the existing framework for 'systemically important' institutions, as outlined by the FSB. As mentioned previously, we would strongly encourage the EU to engage in the FSB's ongoing review of systemically important NBNIs and to ensure that any resulting findings are incorporated into the existing regulatory framework.

Q12: ***Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole traders)?***

In some EU jurisdictions it is not uncommon to require certain business activities to be limited to entities that have certain legal forms (e.g. plc). Given the importance of capital in the context of financial markets activities one should arguably restrict CRR/CRD IV firms to being constituted as firms that have a fixed capital. This would also close the door on some of the more egregious forms of tax optimisation and regulatory arbitrage.

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Q 16: ***What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?***

For firms that are subject to full CRR/CRD IV compliance initial capital should conform with regulatory capital. For all other firms capital should, as a general principle, be fixed and fully loss-absorbing.

Q 27: ***In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?***

In cases where capital requirements for the investment firm are lower than the group average under CRR/CRD IV we would expect group management to be strongly incentivised to devise a corporate structure which would preserve that advantage, e.g. by allowing the respective entity to be deconsolidated for regulatory purposes.

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