Finance for Europe

Association for Financial Markets in Europe

AFME response to EBA/ ESMA Discussion Paper on Call for Advice on the investment firms prudential framework

3 September 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA consultation on Draft Guidelines on the management of ESG risks. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the EBA/ ESMA Discussion Paper, which is followed by answers to the individual questions raised.

Executive Summary

We welcome the opportunity to respond to the EBA/ ESMA Discussion Paper.

We would stress that EBA/ ESMA should consider general principles around appropriateness and proportionality when considering changes to the investment firm prudential framework. In addition, we think that it is essential to provide optionality for firms to refer to the CRR3 framework, given that this provides an opportunity to consider firm size and complexity to determine an appropriate prudential approach.

In relation to the Market Risk components, we believe that the simplified standardised approach should be presented as a realistic option, rather than the current proposal where firms would be required to apply the multipliers set out in paragraph 2 of Article 325 of the IFR.

We also recommend that the current approach in the IFR where firms have the option to implement the FRTB should be maintained, rather than propose mandatory full implementation.

On the proposed application of CVA, we believe that this should only be mandatory if firms apply FRTB – but as previously stated, only if FRTB itself is optional.

We recommend that the approach to credit risk should continue to be covered in the Pillar 2 framework, to ensure a proportionate approach is maintained, while any Pillar 1 risks should be assessed through the current K-factor framework, rather than referring to the CRR framework.

On the proposals towards K-DTF, we would emphasise that the current IFR framework already contains appropriate risk mitigants, and therefore significant changes would not be merited.

IFR firms should also be able to apply credit risk mitigation to counterparty credit risk exposures in the same way that credit institutions do under the CRR, as to not disadvantage those firms regulated by IFR. This could be done by amending the K-TCD and K-CON frameworks.

Q16: The discussion paper envisages the possibility to rely on alternative methodologies with respect to the K-DTF. If the respondents suggest an alternative approach, how would this refer to the two activities addressed under the K-DTF (trading on own account and execution on own account on behalf of the clients)?

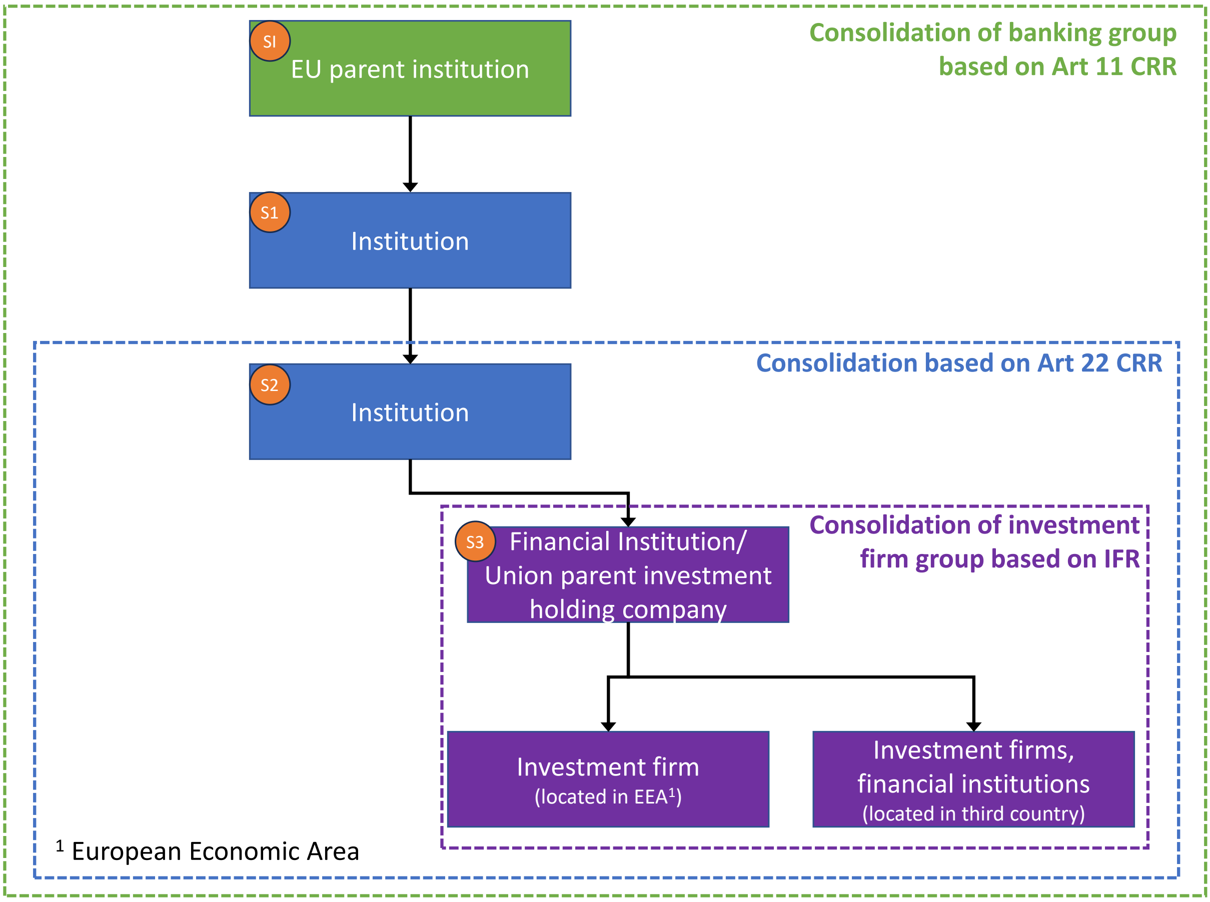
The operational risk related to all activities, including the ones covered by K-DTF are assessed under the Pillar 2 framework and investment firms must hold additional capital, if determined necessary. Competent authorities would perform reviews of investment firms to determine if investment firms are assessing this risk appropriately and set additional capital requirements, if necessary.

Reverting to the basic indicator approach, calculating the own funds requirement as a percentage of the average over the three years of the relevant indicator (as set out for banks in Article 316 of Regulation (EU) No 575/2013), may not be appropriate as this depends on accounting policies and there may be impact from different accounting practices, resulting in inconsistent outcomes.

We do not believe that adding K-NPR to the FOR is an appropriate approach. K-factors have been calibrated to be additive, while the FOR is a proxy for wind-down. The need for additional own funds to perform an orderly wind-down should be separately assessed by investment firms, in line with the IFD. In this assessment, investment firms should consider potential losses while winding down the trading book. However, this should be considered separate from the K-factor calculation, which should retain the current approach.

8. Prudential consolidation

The discussion paper raises a concern regarding overlapping prudential consolidation perimeters, see points 186 to 189. A similar issue arises for banking groups due to the parallel applications of CRR Art. 22 and IFR, see also the EBA Q&A 2021_6274 that is under review by the European Commission. The situation described in the Q&A is illustrated below.



The IFR requires a consolidation on the level of the union parent investment holding company. In addition, Art. 22 CRR requires a consolidation on the level of the institution S2. The consolidation based on Art. 22 CRR is triggered due to the presence of subsidiaries that qualify as financial institutions in third countries. The EBA Q&A suggests that a consolidation according to Art. 22 CRR is not required if this results in an undue multiplication in the number of sub-consolidating layers within a banking group. The Q&A raised in 2021 is not yet answered and is under review by the European Commission.

In a situation where all third country subsidiaries of the institution S2 are in scope of the consolidation of the investment firm group, an additional consolidation based on Art. 22 CRR is obviously an undue multiplication of sub-consolidation layers. This additional sub-consolidation layer results in a significant operational burden for banking groups. As the Q&A is unanswered, we would like to take this issue up as part of this Commission Call for advice. A proposed CRR amendment is outlined below.

Proposed amendment to Article 22 CRR

Amendment	
Article 22 (CRR3 version) **Sub-consolidation in case of entities in third countries**	*Article 22 (amended version)* **Sub-consolidation in case of entities in third countries**

1. Subsidiary institutions or subsidiary intermediate financial holding companies or subsidiary intermediate mixed financial holding companies shall apply the requirements laid down in Articles 89, 90 and 91 and Parts Three, Four and Seven and the associated reporting requirements laid down in Part Seven A on the basis of their sub-consolidated situation if they have an institution or a financial institution as a subsidiary in a third country, or hold a participation in such an undertaking. 2. By way of derogation from paragraph 1 of this Article, subsidiary institutions or subsidiary intermediate financial holding companies or subsidiary intermediate mixed financial holding companies may choose not to apply the requirements laid down in Articles 89, 90 and 91 and Parts Three, Four and Seven and the associated reporting requirements laid down in Part Seven A on the basis of their sub-consolidated situation where the total assets and off-balance-sheet items of the subsidiaries and participations in third countries are less than 10 % of the total amount of the assets and off-balance-sheet items of the subsidiary institution or subsidiary intermediate financial holding company or subsidiary intermediate mixed financial holding company.’;	1. Subsidiary institutions or subsidiary intermediate financial holding companies or subsidiary intermediate mixed financial holding companies shall apply the requirements laid down in Articles 89, 90 and 91 and Parts Three, Four and Seven and the associated reporting requirements laid down in Part Seven A on the basis of their sub-consolidated situation if they have an institution or a financial institution as a subsidiary in a third country, or hold a participation in such an undertaking. 2. By way of derogation from paragraph 1 of this Article, subsidiary institutions or subsidiary intermediate financial holding companies or subsidiary intermediate mixed financial holding companies may choose not to apply the requirements laid down in Articles 89, 90 and 91 and Parts Three, Four and Seven and the associated reporting requirements laid down in Part Seven A on the basis of their sub-consolidated situation where: **a)** the total assets and off-balance-sheet items of the subsidiaries and participations in third countries are less than 10 % of the total amount of the assets and off-balance-sheet items of the subsidiary institution or subsidiary intermediate financial holding company or subsidiary intermediate mixed financial holding company, or **b) all of the assets and off-balance sheet items of the subsidiaries and participations in third countries relate to subsidiaries that are already subject to the requirements of Regulation (EU) 2019/2033 on a consolidated basis.**

Q24: Do you have any views on the possible ways forward discussed above concerning the provision of MiFID ancillary services by UCITS management companies and AIFMs?

The EBA have stated their intention to recommend one of two actions, either;

i) imposing new capital requirements on UCITs / AIFMs providing ancillary services; or

ii) limiting levels of activity the UCITs/ AIFMs are able to perform.

We would question whether a change in the capital requirements is necessary given that UCITs/ AIFM entities are already subject to a separate capital regime which requires:
a) an Initial Capital Requirement to be held; plus
b) a Fixed Overhead Requirement; plus
c) (For AIFM's only) a capital requirement linked to the value of assets under management.

It is not clear whether the EBA intend to fully scope UCIT/ AIFM entities into the IFR, or to just impose additional capital on top of the UCIT/AIFM current requirements. If the proposal is to scope Firms into the IFR regime then we would point out that IFR firms are subject to the following capital requirements – and hence it is not clear that a Firm carrying out portfolio management activity would necessarily end up holding more capital than it does currently and could in certain circumstances end up holding less. IFR firms Capital regime is based on an initial capital requirement and b) either a Fixed Overhead Requirement or K-factor requirements[1].

Given the current level of information provided in the review it isn't possible for us to fully assess the potential change/ capital impact on UCIT/AIFM entities. We would however say at this time that we would prefer a capital-based approach than one which limits activity. This is because limits on activity (depending on calibration) are likely to more directly impact clients than an increase in capital, which if necessary can be managed internally/ indirectly passed on.

As mentioned above however, we believe that the existing capital regime that UCITs/ AIFM entities operate under is sufficient. We understand that there can be some overlap in services provided between UCITs/ AIFM entities and certain Investment Firms, as UCITs/AIFM entities are able to apply for MIFID Top-Up permissions in order to provide ancillary services such as portfolio management to clients. The scope of activities however, for which top-up permissions are available is limited, compared with the full range of activities that an Investment Firm might be permitted to undertake. Allowable top-up permission activities are relatively low-risk and do not include activities such as dealing on own account.

We would therefore encourage the EBA to ensure that UCITs/ AIFMs entities remain subject to their current proportionate regime rather than being scoped into the investment firm regime. If the EBA do believe additional capital measures are required we would suggest rather than looking to scope such firms into the full requirements of the IFR, implementing an approach similar to that recently taken by the Central Bank of Ireland (CBI), whereby additional K-factor requirements based on provision of services, are applied and included within the overall capital requirements of the entity. This approach may allay the EBA concern of ensuring that firms undertaking similar activity are subject to similar costs (calibration work may be required to ensure this is the case between the two regimes), while at the same time remaining proportionate given the risk profile and overall activities that the entities are providing.

Q27: Is the different scope of application of remuneration requirements a concern for firms regarding the level playing field between different investment firms (class 1 minus and class 2), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

[1] Applicable K-factors for a UCIT/AIFM entities undertaking portfolio management will in the main be AUM driven

There remains a significant gap between entity level de minimis thresholds under CRD (EUR 5bn increasing to EUR 15bn under certain conditions) when compared to the IFD threshold (EUR 100m). It is understood that different thresholds apply to take into account the different characteristics of an investment firm vs a credit institution, however by moving from CRR to a Class 2 investment firm under IFR, MRTs are subjected to more onerous remuneration requirements in relation to variable remuneration in instruments, meaning reclassification to a lower-class investment firm can lead to additional remuneration requirements.

Q28: Are the different provisions on remuneration policies, related to governance requirements and the different approach to identify the staff to whom they apply a concern for firms regarding the level playing field between different investment firms (class 1 minus under CRD or class 2 under IFD), UCITS management companies and AIFMs, e.g. in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

Compared to IFD and other remuneration policies, AIFMD/UCITS generally gives greater flexibility about how firms should identify Material Risk Takers, and when involvement from the regulator is required. This tailored approach can be helpful given the established relationship between firms and their regulators, allowing firms to use their judgement and experience and regulators to intervene depending on the individual circumstances.

Q29: Are the different provisions, criteria and thresholds regarding the application of derogations to the provisions on variable remuneration, and that they apply to all investment firms equally without consideration of their specific business model, a concern to firms regarding the level playing field between different investment firms (class 1 minus under CRD and class 2 under IFD), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for applying the deferral and pay out in instruments requirements? Please provide a reasoning for your position and if possible, quantify the impact on costs and numbers of identified staff to whom remuneration provisions regarding deferral and pay out in instruments need to be applied.

Overall, AIFMD/UCITS offers less flexibility in the structuring of variable remuneration instruments, which could lead to situations of misalignment for Identified Staff / Material Risk Takers. In addition, there is no formal 'de minimis' rule for remuneration, meaning that Identified Staff with lower levels of compensation are negatively impacted.

A significant gap exists between entity level 'de minimis' thresholds under CRD (EUR 5bn increasing to EUR 15bn under certain conditions) compared to the IFD threshold (EUR 100m). Different thresholds apply in line with differing characteristics of investment firms vs credit institutions, however by moving from CRR to a Class 2 investment firm under IFR, Material Risk Takers / Identified Staff are subjected to more onerous remuneration requirements in relation to variable remuneration in instruments, meaning reclassification to a lower class can lead to additional remuneration requirements. We wonder whether this may be an unintended consequence of a legal entity being considered an IFR regulated investment firm but positioned within a broader credit institution, as opposed to a standalone investment firm.

ADDITIONAL POINTS

Market risk (K-NPR)

We understand there are changes in the market risk framework for firms subject to the CRR3. However, it is our view that the impact of these changes for investment firms should be considered by taking into account the principles of appropriateness and proportionality, in line with the development of the IFR framework. Investment firms do not receive deposits and do not pose systemic risk. Our views cover three specific items:

- Introduction of the simplified standardised approach for investment firms (with multipliers)
- Definition of trading book
- Fundamental review of the trading book (FRTB)

Simplified standardised approach for investment firms

It is our view that investment firms should be allowed to calculate the K-NPR based on the approach set out in Chapters 2, 3 and 4 of Title IV of Part Three of Regulation (EU) No 575/2013, as per the current requirements set in Article 22 of the IFR.

We believe that requiring investment firms to apply the multipliers set in paragraph 2 of Article 325 of the IFR is disproportionate and inappropriate, in terms of the market risks investment firms are exposed to. We understand that the multipliers exist as a backstop and with the objective to 'force' banks that have a material trading book to implement FRTB. When comparing the outcomes of FRTB and the simplified standardised approach, with the multipliers, the outcomes of the latter are much higher, in particular for positions in equities.

Definition of trading book

We support the general alignment of the IFR definition of trading book with the CRR3 definition of trading book. In addition, we believe specific consideration should be given to positions in collective investment undertakings (CIUs), where firms should be allowed to include these in the trading book, even when the investment firm is not able to do the full look through of underlying positions.

The full look through of underlying positions in CIUs may not be available due to lack of data or due to a burdensome implementation for smaller investment firms. This means that a fall-back approach, such as the current capital requirements approach should be retained.

FRTB

We support maintaining the current approach in Article 22 of the IFR, which provides investment firms with the option to implement FRTB. This is included in point b) of Article 22 of the IFR. However, we do not believe that, as mentioned in point b) of paragraph 145 of this discussion paper, this should be subject to approval of the NCA. A notification would be more appropriate and proportionate.

We believe that, unless the multipliers for the simplified standardised approach are not applicable for investment firms, the option in point c) of paragraph 145 of this discussion paper must not be considered as it would impose disproportionate capital requirements on investment firms, without providing these with an alternative option. Noting that the alternative internal model approach is very burdensome for most investment firms to implement.

The option provided in point a) of paragraph 145 of this discussion paper can be considered as an alternative. However, we note that with K-TCD, the IFR includes an approach that has been tailored to investment firms, which, in line with what was described in the section 5.7.2 of the EBA-OP-2017-11, is derived from the new standardised counterparty credit risk (SA-CCR) rules for banks with trading books, but aims to provide material simplification in the calculations and so provide greater proportionality for investment firms.

The same approach should be considered for K-NPR, in case there is the intention to make FRTB or a FRTB-like methodology mandatory for investment firms above a certain threshold. Implementation of full FRTB may be too burdensome for most investment firms to implement.

Funded and Unfunded counterparty credit risk mitigation (K-TCD and K-CON)

IFR firms should be able to apply credit risk mitigation to counterparty credit risk exposures in the same way that credit institutions do under the CRR. It is common practice for investment firms to manage their counterparty credit risk exposures arising from derivatives activity by entering into credit protection arrangements with third parties. This can be on unfunded basis or a funded basis where a firm receives cash collateral via a funded guarantee or credit derivative. Such protection arrangements should be recognised under the K-TCD and K-CON frameworks.

Where a firm buys unfunded protection, it should have the option of substituting its exposure to the protection provider, and thus able to apply a beneficial risk factor under K-TCD to the extent the risk factor attributable to the protection provider is more beneficial than the original exposure risk factor. The risk substitution should also be recognised for the purposes of the limits pertaining to concentration risk – i.e. the exposure to the original borrower should be shifted to the protection provider for the purposes of the concentration limit under Article 37.

Where cash collateral received via a funded guarantee or other credit protection agreement is used to secure present and future obligations associated with the counterparty credit risk exposure to the derivatives counterparty, such collateral should be recognised as a mitigant to the exposure value for the purposes of computing K-TCD and the concentration limit under Article 37.

We believe this could be done by making some amendments to the current K-TCD and K-CON frameworks by incorporating elements of the CRR CRM framework.

Credit Valuation Adjustment (CVA)

With regard to CVA, we believe it is important to note that the current CVA approach in Article 32 of the IFR was implemented, despite the CRR2 approach, with a view for a more proportionate approach for CVA across all investment firms. We believe the principle of proportionality should be retained in this review of the IFR.

It is our view that the current approach in Article 32 of the IFR, or a similar approach, should be retained, with investment firms having the option to implement CRR3 CVA methodologies. In line with our view regarding FRTB for the purpose of K-NPR, we do not believe that the option in point a) of paragraph 154 of this discussion paper, would deliver a proportionate outcome for investment firm, as it may require a burdensome implementation.

Non-Trading Book

We understand that risks related to non-trading book positions have deliberatively and explicitly been kept outside the Pillar 1 requirements for investment firms as part of creating a proportional regime customised to the specific nature of investment firms, which focuses on risks related to MiFID activities. These risks, if material to some investment firms, are then covered within the Pillar 2 framework, which should ensure that all **material** risks to investment firms are appropriately captured and capitalised for.

It is our view that these principles of proportionality and appropriateness should be kept as part of the review of the IFR regime.

We do understand that some investment firms may be exposed to risk outside trading book, and that it may be the view of the EBA, ESMA and other relevant national competent authorities, that risks outside the trading book should be captured within the Pillar 1 framework. Although we believe that this is not necessary, as these risks are already captured in Pillar 2, if these risks are to be captured in Pillar 1, this should be done in a way that integrates with the current K-factors framework and not by simply cross referring to or introducing a specific CRR framework. For example:

- This can be done by changing the scope of Article 25 of the IFR, in order to include loans to customers, or other specific items that are believed to be a material risk to investment firms. The Replacement Cost to be based on asset value or potentially Notional amount.

- The point above would require an amendment to Article 24 of the IFR, in order to include specific points of Article 25 of the IFR, even if outside the trading book. We note that the FCA has done this in MIFIDPRU 4.14.1 and 4.14.2, where, other than for derivative contracts, K-TCD applies to transactions outside the trading book, as long as the investment firm has permissions to deal on own account.

- In line with the point mentioned above, Article 30 of the IFR could then be amended to include unfunded credit protection, such as guarantees, and apply certain adjustments derived from the CRR framework in order to allow investment firms to apply a different risk factor in Table 2 of Article 26 of the IFR.

- Some specific amendments could then be made to the calculation of exposure value in Article 36 of the IFR, in order to include non-trading book items in scope of K-TCD. We do not believe any additional 'hard limits' should be put in place. Investment firms would capture additional capital requirements in line with the current framework.

Operational risk for firms calculating the K-DTF

We understand that in the opinion of some competent authorities, K-DTF results in disproportionally low own funds requirement and we understand these concerns. However, it is our view that the overall IFR framework has been designed with this in mind and includes components that mitigate the risks related to these activities, as follows:

- The operational risk related to all activities, including the ones covered by K-DTF are assessed under the Pillar 2 framework and investment firms must hold additional capital, if determined necessary. Competent authorities would perform reviews on investment firms to determine if investment firms are assessing this risk appropriately and set additional capital requirements, if necessary.

- Reverting to the basic indicator approach, calculating own funds requirement as a percentage of the average over the three years of the relevant indicator (as set out for banks in Article 316 of Regulation (EU) No 575/2013), may not be appropriate as this depends on accounting policies and there may be impact from different accounting practices, resulting in inconsistent outcomes.

- We do not believe that adding K-NPR to the FOR is an appropriate approach. K-factors have been calibrated to be additive, while the FOR is a proxy for wind-down. The need for additional own funds to perform an orderly wind-down should be separately assessed by investment firms, in line with the IFD. In this assessment, investment firms should consider potential losses while winding down the trading book. However, this should be considered separate from the K-factor calculation, which should retain the current approach.

Liquidity

Investment firms have varying degrees of complexity and regulatory requirements for reporting should be proportionate to the size and nature of risk in investment firms. Firms should consider appropriate scenarios in their internal stress testing frameworks to capture specific risks and accordingly socialize the same with regulators. Investment firms should include the internal stress testing framework in ICARAP submission and discuss with regulators on a case-by-case basis.

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