INVESTMENT COMPANY INSTITUTE

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EBA Issues Opinion and Report on New Prudential Regime for EU Investment Firms

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October 18, 2017 TO: ICI Global Members
ICI Global Regulated Funds Committee SUBJECTS: International/Global
Systemic Risk RE: EBA Issues Opinion and Report on New Prudential Regime for EU Investment Firms

The European Banking Authority (EBA) has issued its Opinion and a related Report containing final recommendations for the European Commission (Commission) regarding the design and calibration of a new prudential framework for European Union (EU) investment firms.[1] The Opinion and Report reflect refinements to the preliminary policy recommendations the EBA released in July, based in part on quantitative analysis the EBA performed following a supplementary data collection.[2] This memorandum briefly summarizes the EBA's final recommendations, which the Commission is likely to consider as it develops a legislative proposal setting forth a new prudential regime for investment firms.

EBA Final Recommendations

The final recommendations retain the same overall framework set forth in the EBA's preliminary recommendations. Thus, for example, the recommendations establish size-based thresholds—assets under management[3] and other quantitative measures—for purposes of categorising investment firms as Class 1, Class 2, or Class 3 firms (see Recommendations 3–7).[4] Initial Capital levels for the authorization of an investment firm are based on a firm's services and activities (see Recommendations 17, 18 and 20). The EBA further recommends requiring investment firms to meet Permanent Minimum Capital and Fixed Overheads requirements on an ongoing basis (Recommendation 19).

The EBA's approach to determining minimum Pillar 1 capital requirements for Class 2 investment firms is outlined in Recommendations 24–36. As in its preliminary recommendations, the EBA recommends that Class 2 firms be subject to a minimum Pillar 1 capital requirement equal to the higher of: (1) Initial Capital/Permanent Minimum Capital requirement; (2) Fixed Overheads requirement; and (3) capital requirements determined by a new "k-factors" formula. The k-factors formula is designed to take into account the risks to customers, the market, and the firm, respectively, presented by the firm's activities.

The Report provides additional information about the k-factors methodology, the individual k-factors, and the interaction between k-factors.[5] For example, with respect to K-AUM, the Report explains that this metric has been revised to fold in assets under advice (for which the EBA previously proposed a separate k-factor, K-AUA). K-AUM thus consists of assets under management relating to all investment management customers, managed on both a discretionary and a non-discretionary basis. The metric includes AUM that the firm in question has delegated to another firm, but excludes AUM that another firm has delegated to it. This exclusion applies "irrespective of whether the firm delegating the management of the assets or fund portfolio is a management company/manager submitted to the UCITS and AIFM Directive or an investment firm."[6] The Report indicates that the same principle should apply to investment firms that provide advice to support the performance of the portfolio management service. It states that the objective "is for the firm that holds the responsibility to the customer to hold the adequate level of capital related to this activity under either AIMD/UCITS or the new prudential regime."[7]

The EBA recommends that, "to ensure a stable transition to the new regime," capital requirements on an individual and consolidated basis be limited to twice the level of current capital requirements for three years after the new regime comes into force. For firms previously subject only to initial capital requirements, the limit would be twice the level of current initial capital. And for firms not previously subject to capital requirements, the EBA suggests that capital can be limited to twice the level of the fixed overheads requirements.

Like the preliminary recommendations, the final recommendations address other topics, including liquidity requirements (Recommendations 37–44), reporting and disclosure requirements (Recommendations 51–53), and remuneration and governance (Recommendations 58–59). Two new recommendations call for the new prudential regime for investment firms to include "a macroprudential perspective" (Recommendation 60) and assert the need to conduct a detailed analysis assessing the potential systemic impact of the three classes of investment firms (Recommendation 61). As discussed in the Report, these two recommendations are based on arguments drawn from a July 2016 European Systemic Risk Board (ESRB) strategy paper on "macroprudential policy beyond banking."[8]

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endnotes

[1] The EBA Opinion (EBA/Op/2017/11, dated 29 September 2017) ("Opinion") is *available at* http://www.eba.europa.eu/documents/10180/1976637/EBA+Advice+on+New+Prudential+Framework+on+Investment+Firms+%28EBA-Op-2017-11%29.pdf. The EBA Report (Annex to the EBA Opinion EBA-Op-2017-11, dated 29 September 2017) ("Report") is *available at* http://www.eba.europa.eu/documents/10180/1976637/Annex+to+the+EBA+Opinion+EBA-Op-2017-11.pdf.

[2] *See* ICI Global Memorandum No. 30773, "EBA Issues Preliminary Recommendations, Requests Data from EU Investment Firms Regarding Proposal on New Prudential Regime," dated 10 July 2017.

[3] As discussed further below, the final recommendations define AUM to include assets under management "under both discretionary portfolio management and non-discretionary (advisory) arrangements."

[4] Recommendation 3 describes these categories as follows: (a) systemic investment firms or investment firms which are exposed to the same types of risks as credit institutions (Class 1) to which the full CRD/CRR requirements should be applied ; (b) other non-systemic firms (Class 2) above specific thresholds that should be subject to a more tailored prudential regime based on k-factors; and (c) small and non-interconnected investment firms (Class 3) providing limited services in terms of number and size to which a very simple regime should be applied.

[5] Regarding the latter, the Report clarifies that to avoid double-counting, a firm that is already charged under K-AUM "will not be obliged to calculate K-COH [customer orders handled] if it transmits or executes orders on which it has given advice or it puts his [sic] discretionary decisions into effect (in the name of the customer), provided that this activity relates to assets under management or advice." Report at para. 143.

[6] *Id.* at para. 130.

[7] *Id.*

[8] *See* Report at paras. 370-374, referencing ESRB, Macroprudential policy beyond banking: an ESRB strategy paper, July 2016, *available at* https://www.esrb.europa.eu/pub/pdf/reports/20160718_strategy_paper_beyond_banking.en.pdf. *See also* ICI Global Memorandum No. 30376, "ICI Global Response to European Commission's Consultation on the EU Macro-prudential Framework," dated 1 November 2016 (ICI Global objected to the ESRB paper as "deeply flawed" and called it "a troubling example of bank-dominated regulatory bodies seeking to 'export' bank-oriented policies to the asset management sector.").
