

MEMO# 30402

November 17, 2016

EBA Seeks Comment on Discussion Paper Regarding the Design of a New Prudential Regime for Investment Firms

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TO: ICI Global Members SUBJECTS: International/Global RE: EBA Seeks Comment on Discussion Paper Regarding the Design of a New Prudential Regime for Investment Firms

The European Banking Authority (EBA) recently issued a discussion paper^[1] on the design of new prudential requirements for investment firms. The paper focuses on investment firms that are not considered to be “systemic and bank-like.” The goal, according to EBA, is to “simplify the existing categorisation of investment firms and propose a single, more coherent approach to their prudential requirements. The proposed framework aims to be more proportionate and reduce the complexity compared to the existing framework while at the same time increasing the risk sensitivity.”

This memorandum begins with a short background discussion to put the EBA paper into context, followed by a brief description of the paper. ICI Global intends to submit a response during the comment period, which runs until 2 February 2017.

Background

In December 2015, EBA, in consultation with the European Securities and Markets Authority (ESMA), published a report in response to a call for advice from the European Commission (Commission).^[2] The call for advice was prompted by the Commission’s reporting obligations to the European Parliament and Council under the Capital Requirements Directive (CRD)^[3] and the Capital Requirements Regulation (CRR).^[4] In the call for advice, the Commission sought input on the suitability of the current prudential regime for investment firms.

The 2015 EBA Report recommended developing a new approach to categorize investment firms for prudential regulation based on systemic importance. It stated that such an approach would help to address the complexity and divergence in the regulatory treatment of investment firms and the applicability of prudential rules to these firms across the European Union. The 2015 EBA Report observed:

Investment firms present risks to their clients and counterparties, to the financial markets, and to financial stability. The nature, scale and complexity of their activities are very wide and remain only crudely captured in the current CRD/CRR categorisation. This has led to a situation where firms, such as asset managers, that are conducting very similar activities and posing similar risks to investors or other market participants are subject to varying prudential requirements.[\[5\]](#)

The 2015 EBA Report recommended three categories (or classes) of investment firms:

- Class 1: “Systemic and bank-like” investment firms for which prudential requirements equivalent to the ones of credit institutions are necessary.
- Class 2: “Non-systemic” investment firms for which a less complex prudential regime seems appropriate. The applicable prudential requirements would “address the specific risks that [those] firms pose to investors and to other market participants with regards to investment business risks such as credit, market, operational and liquidity risk.”
- Class 3: “Very small and non-interconnected” investment firms that “warrant a very simple regime to wind them down in an orderly manner.” That regime “could be based mainly on fixed overhead requirements that fulfill the objective of setting aside sufficient capital for ensuring safe and sound management of their risks” and also could include simplified reporting obligations.

In June 2016, the Commission issued a second call for advice[\[6\]](#) asking for EBA’s input on, among other things: (1) the indicators and thresholds that should determine which firms come within each of the three classes; (2) whether Class 1 firms should simply be subjected to the same rules as banks or if there is a need for any derogations for these firms; and (3) the appropriate design of a new prudential regime for Class 2 and 3 investment firms, including the appropriate initial capital requirements for both categories of investment firms and whether Class 2 and 3 firms should be subject to liquidity requirements. It also asks EBA to provide advice in relation to the application of the CRD/CRR remuneration requirements to the investment firm population. The Commission’s call for advice states that EBA should consult with ESMA staff on the substantive aspects of its advice. EBA must provide its input to the Commission by 30 July 2017.

EBA already has responded in part to the Commission’s call for advice.[\[7\]](#) The Opinion stated that EBA’s existing guidelines for identifying global systemically important institutions (known as G-SIIs) and other systemically important institutions (known as O-SIIs) are—for now—“appropriate and suitable” to identify the “systemic and bank-like” investment firms in Class 1. It further recommended that the suitability of the O-SII guidelines for this purpose be revisited after the new prudential framework for investment firms is completed.

The current consultation focuses primarily on the investment firms that would be categorized as Class 2 or Class 3. Following the comment period, EBA intends to prepare an opinion and accompanying report by the July 2017 deadline.

Discussion Paper

EBA acknowledges that the overall population of investment firms covered by this review “is both large and extremely diverse.” It includes UCITS management companies and AIF

managers authorised to conduct certain MiFID investment services or activities.

The paper briefly touches on Class 1 firms. It notes EBA's recent Opinion on using existing guidelines to identify such firms, observing that "consistency between the criteria for identifying systemic credit institutions and systemic investment firms" is important for purposes of "ensuring stability, integrity and sound competition in the EU financial market and to avoid regulatory arbitrages." On the question of what constitutes "bank-like" activities, the paper suggests that such activities "possibly include underwriting and/or placing of financial instruments on a firm commitment basis, provided it exposes the firm to a significant amount of market and/or counterparty credit risk" and "proprietary trading . . . if carried out at a very large scale." The paper asks for comment in this area, including on the qualitative and quantitative indicators or thresholds for "bank-like" activities.

In attempting to distinguish between Class 2 (not systemic and bank-like) and Class 3 ("very small and non-interconnected") investment firms, EBA suggests that the following criteria should *preclude* an investment firm from being in Class 3:

- holding client money or securities
- ancillary service of safekeeping and administration
- dealing on own account
- underwriting or placing with a firm commitment
- the granting of credits or loans to an investor
- operating a multilateral trading facility
- the MiFID II activity of operating an organised trading facility
- being a member of a wider group
- using a MiFID passport
- using tied agents

With regard to prudential requirements, the focus is on the risks that investment firms would pose to customers and to market integrity and liquidity. EBA suggests that ongoing capital requirements should be calculated based on capital factors (referred to as "K-factors") that are attributed to one of these two broad types of risks. The paper suggests several K-factors relating to risks to customers, including customer assets under management and customer assets under advice.

The paper discusses other aspects of the proposed prudential framework, including the policy options for designing a new liquidity regime for investment firms. It also addresses considerations such as concentration risk, regulatory reporting and consolidated supervision. Among other things, EBA is reviewing the notion of consolidated supervision for investment firms that belong to a group. EBA intends to "identify financial risks created by another group entity that have the potential to create losses within that other group entity, which subsequently looks to the group as whole – including the authorised investment firm."

The paper also contemplates the future potential development of "macro-prudential tools" for investment firms. It states that "the prudential regime for investment firms should take into consideration that investment firms could, potentially (and according to circumstances), also pose a source of systemic risk collectively, even if individually they are not assessed as 'systemic and bank-like.'" EBA posits that system-wide risks could derive from, among others, the use of leverage linkages with the banking system, and securitization. The paper also suggests that "even when investment firms are small, they

may be 'systemic as a herd' and pose a 'too many to fail' risk to financial stability due to common exposures to the same type of shock."

Finally, the paper notes that Class 1 investment firms would be subject to CRD IV remuneration requirements. It asks for comment on the appropriate remuneration framework for investment firms that are categorized as Class 2 or Class 3.

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endnotes

[1] EBA, Discussion Paper: *Designing a new prudential regime for investment firms* (4 Nov. 2016), available at

<https://www.eba.europa.eu/documents/10180/1647446/Discussion+Paper+on+a+new+prudential+regime+for+Investment+Firms+%28EBA-DP-2016-02%29.pdf/cf75b87e-2db3-47a3-b1f3-8a30fa6962da>.

[2] EBA, *Report on Investment Firms: Response to the Commission's Call for Advice of December 2014*, EBA/Op/2015/20 ("2015 EBA Report"), available at

<https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-20+Report+on+investment+firms.pdf>.

[3] Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (26 June 2013), available at

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:En:PDF>.

[4] Regulation (EU) 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (26 June 2013), available at

<http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex%3A32013R0575>.

[5] 2015 EBA Report at 6.

[6] European Commission, Call for advice to the EBA for the purposes of the report on the prudential requirements applicable to investment firms (13 June 2016), available at

<http://www.eba.europa.eu/documents/10180/1321242/CfA+Investment+firms.pdf/9d8f89ab-720a-4ebf-8db7-6e5ebcddb07>.

[7] Opinion of the European Banking Authority on the First Part of the Call for Advice on Investment Firms (19 Oct. 2016), available at

<http://www.eba.europa.eu/documents/10180/1639033/Opinion+of+the+European+Banking+Authority+on+the+First+Part+of+the+Call+for+Advice+on+Investment+Firms+%28EBA-Op-2016-16%29.pdf>.

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