REPORT ON INVESTMENT FIRMS

RESPONSE TO THE COMMISSION'S CALL FOR ADVICE OF DECEMBER 2014

EBA/Op/2015/20

EUROPEAN BANKING AUTHORITY

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European Securities and Markets Authority



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Abbreviations

AIFMD	Alternative Investment Fund Managers Directive (2011/61/EU)			
BCD	Banking Consolidation Directive (2000/12/EC)			
BRRD	Bank Recovery and Resolution Directive (2014/59/EU)			
CAD	Capital Adequacy Directive (2006/49/EC)			
COREP	Common reporting			
CRD	Capital Requirements Directive (2013/36/EU)			
CRD IV	The entire framework encompassed by the CRD and CRR			
CRR	Capital Requirements Regulation (575/2013)			
EMIR	European Market Infrastructure Regulation (648/2012)			
EU	European Union			
FINREP	Financial reporting			
IMD	Insurance Mediation Directive (2002/92/EU)			
ISD	Investment Services Directive (93/22/EC)			
MiFID	Markets in Financial Instruments Directive (2004/39/EC)			
MiFID II	Markets in Financial Instruments Directive II (2014/65/EU)			
UCITS	Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC)			



Executive Summary

The European investment services landscape comprises various types of operators. There are a little more than 6 500 investment firms initially authorised and regulated by the Markets in Financial Instruments Directive (MiFID). In number, just over half of these are based in the UK. The United Kingdom, Germany and France are the main jurisdictions for over 70% of the investment firm population of the European Union (EU).

The MiFID lays down organisational, governance, consumer protection and market functioning regulations, as well as setting out the passporting process for those firms that provide one of the listed services in the MiFID (i.e. investment advice to clients, management of client portfolios, execution of clients' orders on financial instruments, reception and transmission of orders on financial instruments, dealing with own account, market making, underwriting, placing of financial instruments, and operating trading facilities). To reflect this wide array of services, which vary greatly in terms of their nature and size, the MiFID's scope is not straightforward and there are a number of exceptions. Finally, many MiFID investment services and activities may be performed by banks and, indeed, in certain countries it would appear—from the limited number of investment firms operating there—that investment services and activities are mainly offered by banks.

The prudential regulation that governs the exercise of investment services stems from the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR). Depending on the services they exercise, and their combination or size, some of the investment firms are exempt from prudential regulation, some are subject to lighter prudential regulations, and others are subject to the full CRD/CRR rules.

It is in this landscape that the EBA, in consultation with ESMA, has considered the Commission's recent call for advice on the suitability of certain aspects of the prudential regime for investment firms. This report presents the EBA's findings and makes certain recommendations that it believes will lead to a more proportionate and risk-based prudential regime for investment firms.

The rationale for investment firms' prudential requirements

At a high level, prudential standards aim to minimise the risk of harm to a wide range of stakeholders by helping to ensure that firms manage their business risks responsibly. The purpose of such standards is, first of all, to strengthen the soundness and stability of investment firms on a 'going concern' basis. Furthermore, the prudential regime also aims to avoid the failure of a credit institution or investment firm, which could result in a material impact on the current or future stability of the financial system. In addition, and more specifically for the vast majority of investment firms, prudential requirements also provide a means of dealing with investors' asset protection and the impact of failure and/or the time required to wind down a firm. Therefore, a prudential regulation framework for investment firms should ideally take into account the



threefold objectives of preserving financial stability, protecting investors, and ensuring orderly failure.

Currently, the prudential framework applied to investment firms depends on the firm's categorisation within the CRD IV framework. This categorisation is primarily determined by the MiFID investment services and activities the firm offers and undertakes, as well as its ability to hold money and securities belonging to its clients. Such a prudential regime results from the activity conducted by investment firms, and ensures consistency between different pieces of EU regulation. However, several issues stem from varying interpretations of these investment services and the appropriate treatment of client money and securities between EU Member States, as well as from this prudential regime's lack of sensitivity and its complexity, which is a consequence of the absence of a holistic approach to investment firms' prudential regulation.

The CRD/CRR categorisation of investment firms is based on MiFID activities and services. As a Directive, the MiFID is implemented by way of national transpositions of MiFID investment services and activities; holdings of client money and securities differ, and hence treatments of similar investment firms differ—for both MiFID and CRD/CRR purposes—across Member States.

The EBA identified the lack of risk sensitivity in the CRD/CRR regime for investment firms as being a primary issue to be addressed as part of the review. 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.

Since the adoption of the first Investment Services Directive (ISD), the prudential regime of the related services has been set via the CRD/CRR to ensure the full coverage of risks occurring from such activities and a level playing field among service providers, be such services extended on a standalone basis, or be they extended by firms belonging to a banking group or bank. Nevertheless, the application of the full CRD/CRR regime to investment firms has required many adaptations and exceptions. These firms vary in corporate structure and size, ranging from small owner-managed entities to subsidiaries of banks and large investment banks. The CRD/CRR capital treatments for these firms have evolved over time through a series of added exemptions and exceptions, culminating in the CRD/CRR regime categorising investment firms into at least 11 different types. It has also created a situation where investment firms are required to go through the same complex calculations and processes as banks—at significant human resource and system cost—in order to calculate capital requirements for risks that are not important to their business models. The relevance and the administrative burden of such categorisation are reviewed in detail in the report.



EBA recommendations

RECOMMENDATION 1: Recommendation for a new categorisation of investment firms distinguishing between systemic and 'bank-like' investment firms to which the full CRD/CRR requirements should be applied; other investment firms ('non-systemic') with a more limited set of prudential requirements; and very small firms with 'non-interconnected' services.

It is necessary to make a distinction between investment firms for which prudential requirements equivalent to the ones of credit institutions are necessary and investment firms that are not systemic or interconnected, for which specific requirements could be developed. Such a distinction would enhance proportionality and clarify the question of 'gone' versus 'going' concern supervision for investment firms.

It is recognised that a small minority of MiFID firms are substantial undertakings that run 'banklike' intermediation and underwriting risks at a significant scale. Such activities expose these institutions to credit risk, primarily in the form of counterparty risk, and market risk for positions taken on own account, be it for the purpose of external clients or not.

For other investment firms, however, a less complex prudential regime seems appropriate to address the specific risks that investment firms pose to investors and to other market participants with regards to investment business risks such as credit, market, operational and liquidity risk.

In the last tier, small and non-interconnected firms warrant a very simple regime to wind them down in an orderly manner. Such a regime could be based mainly on fixed overhead requirements (FORs) that fulfil the objective of setting aside sufficient capital for ensuring safe and sound management of their risks. These firms could also be subject to simplified reporting obligations.

The future categorisation of investment firms under the CRD IV should, then, be achieved with reference to the systemic importance of the investment firm or its ability to run 'bank-like' activities, expressed through consistent indicators, both qualitative and quantitative; this would lead to a clear cut in the population of investment firms within the EU. Indeed, a key tool for amending the current complex regime, which establishes rules that apply differently depending on the category to which the firm belongs, could be reducing the number of 'categories' and simplifying the regime by establishing greater use of proportionality, both upstream (strengthening rules for those firms that are deemed to pose more risks to financial stability) and downstream (simplifying requirements for the majority).

In order to set out detailed and well-researched and reasoned policy options for such a modified prudential regime for investment firms, more work is required. It is proposed that this work will be completed in a second phase with a second, more in-depth report, which is proposed to be initiated after the finalisation of this report. However, the complexity of the considerations concerning such a regime will require substantial time and resources.



RECOMMENDATION 2: Recommendation for the development of a prudential regime for 'non-systemic' investment firms.

For firms falling in the second and third tiers above, a specific prudential regime should be designed. In particular, specific rules could be developed with regards to investment business risks, such as credit, market, operational and liquidity risks taking particular account of the holding of client money and securities.

The CRD IV framework does not provide a definition of or clear guidance on what is meant by holding client money and securities, which gives rise to differences in the scope of its application across the EU. This is despite the ability to hold client money being a key factor of the current categorisation of investment firms for prudential purposes, making it of the utmost importance when analysing the risk profile of a firm.

The design of a prudential regime for 'non-systemic' investment firms should clearly reflect the risks associated with holding client money and securities.

The development of this modified regime needs to pursue the aim of improving the Single Rulebook endorsed by the EBA, defining harmonised regulatory developments across the EU. The modified prudential regime should represent a solid basis for supervision, ensuring an appropriate and uniform level of requirements in a Pillar 1 context.

An additional data collection exercise, to be conducted at firm level, shall support the calibration of this regime for investment firms with regards to credit, market, operational risk, large exposures, and fixed overheads requirements (FORs).

The EBA stands ready to complete this data collection and support these policy developments with a second, more in-depth report, which is proposed to be initiated after the finalisation of this report.

RECOMMENDATION 3: Extend the waiver for commodity trading firms until 31 December 2020.

According to the specific deadlines set out in the CRR, commodity dealers currently benefit from exemption from both the large exposures and capital adequacy provisions under Articles 493 and 498 of the CRR, respectively, which fall away after 31 December 2017. The EBA suggests that this exemption is extended until a new regime has been adopted or, at the latest, until 31 December 2020. This extension would allow for the possible development of a prudential regime for investment firms as a follow-up to the policy options and additional work of the EBA, as stated above. Commodities dealers falling under the scope of the MiFID would be included in this prudential regime; therefore, it appears more appropriate to wait for the implementation of this new framework by 2020 (at the latest) rather than apply the CRD/CRR regime to all commodity dealers falling under the scope of the CRR on 1 January 2018.



1. Introduction

1.1 Evolution of investment firms' prudential regime in the EU

The first EU legislation to harmonise the regulatory treatment of investment activities - and hence introduce a definition of a (non-bank) investment firm - was the Investment Services Directive (ISD) in 1993. This Directive set the conditions for the authorisation of an investment firm, as well as introduced various conduct provisions for undertaking investment services or activities across a range of investment instruments. Those authorisation conditions included the need to hold a fixed minimum amount of initial capital and to comply with various other prudential requirements (e.g. initial capital or own funds) and were set out in the original Capital Adequacy Directive (CAD), which was introduced in 1993 alongside the ISD.

One of the intentions of the original CAD was to establish uniform capital requirements for both banks and non-bank investment firms, particularly securities trading firms, albeit with various derogations for certain types of investment firms. This was because, in gaining the right to a passport under the ISD to perform investment services within other Member States, an investment firm was competing with credit institutions (banks) that were also able to conduct investment business under their banking passport (even though investment firms are not authorised to accept deposits).

Over time, the prudential requirements were gradually extended, and were made more specific and, consequently, more complex as a result of progressive changes to the global standards for internationally active banks agreed by the Basel Committee on Banking Supervision (the Basel Committee). These changes were then introduced in the EU under the twin measures of the Banking Consolidation Directive (BCD) and the CAD, before being replaced by the most recent legislation of the CRR and the CRD, which are together referred to as 'CRD IV'. Given that the original linkage between the prudential requirements for banks and those for investment firms had already been established in the EU, it was a natural consequence that investment firms were also impacted by all these changes.

Recognising that, with the Basel Committee's focus being on banks, the original concept of the link between prudential requirements for banks and those for investment firms had not been revisited for over 20 years, CRR provisions were included to allow for a fundamental review of the overall prudential framework for (non-bank) investment firms.

1.2 The European Commission's call for advice to the EBA for the purpose of the report on the prudential requirements applicable to investment firms

Several provisions of the CRR require the Commission to submit reports on the prudential requirements applicable to investment firms:



- Articles 493(2) and 498(2) of the CRR require the preparation of a report on the appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the commodity derivatives or derivatives contracts listed in points 5, 6, 7, 9 and 10 of Section C of Annex I of Directive 2004/39/EC ('commodities dealers');
- Article 508(2) of the CRR requires the preparation of a report on whether and how the liquidity coverage ratio (LCR) should apply to investment firms;
- Article 508(3) of the CRR requires the preparation of a report on what should be the appropriate regime for the prudential supervision of investment firms and firms referred to in points (2)(b) and (c) of Article 4(1) of the CRR (local firms, firms with a limited level of service ability, and firms that do not hold client money or securities);
- Article 508(1) of the CRR requires the preparation of a report on the application of Title II of Part One and of Article 113(6) and (7) of the CRR (disapplication of capital requirements at firm level in a banking group).

After having consulted with the EBA and its Expert Group on Banking, Payment and Insurance, the Commission decided to prepare a single report, covering the substance of all the abovementioned reports. In order to prepare this report, the Commission issued in December 2014 a call for advice to the EBA to assess whether the current prudential requirements applicable to investment firms (including exemptions therefrom) laid down in the CRR and the CRD are appropriate or whether they should be modified, and, if so, how.

This report, prepared by the EBA in collaboration with ESMA, presents a granular overview of the categorisation of investment firms in Chapter 2. Meanwhile, a detailed analysis of the risks faced by investment firms and the prudential requirements they are subject to is developed in Chapter 3. Based on this assessment of the current legal framework for investment firms and the analysis of the risks they are exposed to, Chapter 4 details the main recommendations of the EBA resulting from this analysis.



2. Categorisation framework for investment firms

2.1 The origin of investment firms' prudential requirements

The EU prudential regime for investment firms embeds capital requirements, including an initial capital requirement (set as part of the firm's authorisation under the MiFID) and own funds requirements related to solvency, liquidity, and large exposures. Capital buffers for size, systemic, and interconnectedness or cyclicality features may be added following the supervisory review process (Pillar 2), while other prudential requirements, such as leverage ratio and public disclosure (Pillar 3), complete the bulk of the applicable prudential framework.

2.1.1 Rationale for investment firms' prudential standards

At a high level, prudential standards aim to minimise the risk of harm to a wide range of stakeholders by helping to ensure that firms manage their business risks responsibly. The purpose of such standards is, first of all, to strengthen the soundness and stability of investment firms on a 'going concern' basis. Furthermore, the prudential regime also aims to (i) avoid the failure of investment firms resulting in a material impact on the stability of the financial system, (ii) prevent harming investors' rights and assets, (iii) deal with the impact of failure, (iv) and/or ensure there is enough time to wind down a firm.

Although investment firms may not present the same level of systemic threat to financial stability as banks, they pose other significant risks; chief among these are the risks they present to their customers and market integrity.

Customers may suffer losses where an investment firm provides unreliable investment advice or manages investments poorly. In the event of the failure of the firm, consumers may encounter loss of continuity of service due to investments having to be transferred to an alternative investment firm. In the event of failure, prudential requirements may enhance the ability of the investment firm to achieve a more 'orderly wind-down' and thereby most efficiently transfer customer investments.

Market integrity may be compromised where investment firms run into problems and/or fail, leading to erosion of confidence in the market and the firms participating in it. The footprint of a firm in the market, whether as a provider of investment products or as a provider of services relating to market infrastructure, should obviously be reflected in the adequacy of its risk management practices and the level of its available financial resources.



2.1.2 A prudential regime mainly based on the MiFID list of investment services

Currently, the prudential framework applied to investment firms depends on the firm's categorisation within the CRD IV framework. This categorisation is currently primarily determined by the investment services and activities it offers and undertakes, as set out in Annex I of the MiFID. The number of MiFID services and activities will increase to nine when MiFID II comes into force in January 2017.

Table 1.: Investment services and activities of the MiFID ¹	Table 1.:	Investment	services	and	activities	of the	MiFID ¹
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A1 Reception and transmission of orders in relation to one or more financial
instruments
A2 Execution of orders on behalf of clients
A3 Dealing on own account
A4 Portfolio management
A5 Investment advice
A6 Underwriting of financial instruments and/or placing of financial
instruments on a firm commitment basis
A7 Placing of financial instruments without a firm commitment basis
A8 Operation of multilateral trading facilities (MTFs)

2.2 Scope of investment firms subject to prudential requirements

2.2.1 MiFID investment firms

An investment firm is defined in Article 4(1) of the MiFID as any 'legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis'. The same Article then continues, defining 'investment services and activities' as 'any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I [of the MiFID]'. The MiFID definition, therefore, covers all persons who perform investment services and activities using the relevant instruments.

Article 2 of the MiFID provides exemptions to the scope of the Directive's application, in particular for captive investment providers within a group and persons strictly dealing on their own account without providing other services, and provided a list of sub-conditions are met. Firms that qualify under the various exemptions of the MiFID's scope of application should not be regarded as MiFID investment firms. The MiFID requirements, in particular the basic usual prudential requirement of initial capital, do not apply to them.

Article 3 of the MiFID also opens a national discretion for an optional exemption, whereby firms that only provide investment advice and/or receive and transmit orders may do so without being subject to the MiFID, provided that they comply with certain conditions, including only

¹ Annex I, Section A of the MiFID.



transmitting orders via a firm that is subject to the provisions of the MiFID. Where such an exemption is used, such firms may not use the MiFID passport and are not subject to Article 31 of the CRD, which sets the basic minimum requirements for institutions not holding client money or securities (firms excluded from the full CRD/CRR, point (c) of Article 4(1)(2) of the CRR.

MiFID II narrows certain exemptions contained in the provisions of the MiFID on scope. As a consequence, the application of MiFID II will widen the scope of the MiFID and is likely to increase the number of firms caught by the Directive. Since the CRR's definition of 'investment firm' makes use of the MiFID definition, changes in the scope of the MiFID definition are likely to also affect the scope of the CRR definition. Therefore, unless changes are introduced in the CRDIV framework before the entry into force of MiFID II, the number of investment firms subject to CRD IV will also likely increase when MiFID II comes into force in January 2017.

2.2.2 CRR investment firms

For consistency purposes, the term 'investment firm' is defined in the CRR by referring to the definition of the MiFID, albeit the legal definition that excludes upfront a number of firms and credit institutions themselves. This means that the CRR definition is a subset of those firms subject to the MiFID definition.

More precisely, a CRR investment firm is defined in subparagraph (2) of Article 4(1) of the CRR as a MiFID investment firm, excluding (i) credit institutions; (ii) local firms; and (iii) firms that do not hold client money and perform a combination of MiFID services (transmitting orders, executing orders, portfolio management, and investment advice). Credit institutions are excluded from the CRR definition of 'investment firm' because, even though they may provide investment services, they already fall within the regular scope of the CRR as credit institutions.² The exclusion of local firms was based on the assumption that local firms were small and would pose a minimal risk to the financial system or not be subject to competition issues.³

2.2.3 Investment firms covered in this report

All in all, the current total population of non-bank firms conducting any sort of investment business is not straightforward when it comes to prudential coverage: it comprises firms that are exempt from the MiFID, MiFID firms that are exempt from the CRR, and MiFID firms that are subject to different types of requirements under the CRR.

Also, given the changes to the MiFID mentioned above, the scope of investment firms subject to CRD IV will also likely expand when MiFID II is implemented in January 2017.

² Note: Article 1(2) of the MiFID also applies certain provisions of that Directive to credit institutions authorised under the (now) CRD, when providing one or more investment services and/or performing investment activities.

³ See Annex I.



Therefore, the scope of the investment firms considered in this report is not limited to the CRR definition of investment firms. Consequently, wherever the report refers to investment firms, the MiFID's scope is intended unless otherwise mentioned.⁴

2.3 Categories of investment firms in CRD IV

For consistency and proportionality purposes, the CRD IV framework uses the MiFID's list of investment services and activities, as well as the ability to hold client money and securities, as criteria and proxies for identifying the risks these firms pose.

Proportionality in the prudential framework applied to investment firms results from the application of provisions depending on the combination of the investment services and activities provided. The current framework reflects implicit and historic assumptions that certain activities inherently contain more prudential risk, and should thus be subject to more stringent prudential requirements than other activities.

The categorisation of investment firms in CRD IV has a direct influence on a firm's initial capital requirement, which remains the basic and most common prudential 'building block' for investment services providers; every investment firm should, by default, be subject to a EUR 730 000 requirement (Article 28 of the CRD), with this amount being reduced to EUR 125 000 (Article 29 of the CRD) if a firm neither deals on own account nor underwrites under firm commitment while still holding client money or securities.

Similar reasoning applies to a firm's solvency requirements: investment firms are subject to the full own funds requirement of Article 92 of the CRR (similar to credit institutions), unless they fall under the specific own funds calculations of Article 95 or Article 96 of the CRR.

Cutting across the services combination, investment firms are categorised according to whether they hold i) financial instruments or ii) securities, assets or money belonging to clients, as covered in Article 13(7) and (8) of the MiFID.⁵ It should be noted, however, that both the MiFID, in Article 13, and the CRD IV framework, in the definition of 'investment firm' in the CRR and the initial capital requirements in Article 28 of the CRD, do not provide a definition of or clear guidance on what is meant by holding client money, something that gives rise to differences in the scope of their application across the EU.

Based on the CRR, it is possible to identify at least 11 different prudential categories of investment firms. These are included in Table 2 below.

⁴ In particular, entities referred to in points (2)(b) and (2)(c) of Article 4(1) of the CRR are covered by this report.

⁵ See also section 3.3.5 for a further analysis on the specific risks of holding client money.



	Categories	Initial capital	Own funds requirements
1	Local firms (CRR 4(1)(4))	€50 000 (CRD 30)	Not applicable
2	Firms falling under CRR 4(1)(2)(c) that only provide reception/transmission and/or investment advice	€50 000 (CRD 31(1))	Not applicable
3	Firms falling under CRR 4(1)(2)(c) that only provide reception/transmission and/or investment advice and are registered under the Insurance Mediation Directive (IMD)	€25 000 (CRD 31(2))	Not applicable
4	Firms falling under CRR 4(1)(2)(c) that perform, at least, execution of orders and/or portfolio management	€50 000 (CRD 31(1))	CRR 95(2)
5	Investment firms not authorised to perform deals on own account and/or underwriting/placing with firm commitment that do not hold client funds/securities	€50 000 (CRD (29(3))	CRR 95(1)
6	Investment firms not authorised to perform deals on own account and/or underwriting/placing with firm commitment but hold client funds/securities	€125 000 (CRD 29(1))	CRR 95(1)
7	Investment firms that operate an MTF	€730 000 (CRD 28(2))	CRR 95(1)
8	Investment firms that only perform deals on own account to execute client orders	€730 000 (CRD 28(2))	CRR 96(1)(a)
9	Investment firms that do not hold client funds/securities, only perform deals on own account, and have no external clients	€730 000 (CRD 28(2))	CRR 96(1)(b)
10	Commodity derivatives investment firms that are not exempt under the MiFID	€50 000 to 730 000 (CRD 28 or 29)	CRR 493 & 498
11	Investment firms that do not fall under the other categories	€730 000 (CRD 28(2))	CRR 92

The CRD IV framework makes a distinction between:

- a) those firms that are included in the CRR definition of 'investment firm' (CRR investment firms, categories 5 to 11);
- b) those firms that are excluded from the CRR definition of 'investment firm' but are brought back into the scope of the own funds requirements for credit, market and operational risk (Article 95(2) of the CRR, category 4); and
- c) those firms that are excluded from both the CRR definition of 'investment firm' and the scope of CRD IV (categories 1 to 3), but are still subject to a minimum level of initial capital (for the purpose of receiving authorisation under the MiFID and the ability to use a passport under that Directive), as laid down in the CRD.



Consequently, the present regime starts identifying firms that carry out activities that justify their compliance with the entire set of prudential rules as set out in CRD IV, progressively decreasing the burden for those firms that undertake only certain activities or only operate in certain ways (depending on whether or not they hold client money). This results in a complex supervisory landscape, with all three groups of firms subject to some parts of the CRD IV framework.

Table 2 focuses solely on the combined provisions as set out in the MiFID and CRD IV. The table does not take into account national transpositions and options, which can apply to: i) the number of different categories of investment firms; ii) the definition of MiFID investment services and activities; and iii) the minimum level of initial capital applicable to each of the categories. The MiFID was implemented by way of national transpositions. The application of provisions to some services might give rise to diverging applications at the national level of MiFID investment services and activities. Because of this, it appears that there are some variations with respect to the required level of initial capital requested for particular types of investment services or activities, leading to different (e.g. more granular or, in some cases, fewer) categorisations depending on the jurisdiction where the investment firm actually operates.

Table 3 below is a simplified map showing these 11 categories and the legal sources of their prudential requirements. More details on the entities covered by these categories in the EU is provided in Section 5.1.



Table 3.: MiFID and CRD IV investment firm categorisations: simplified map





2.4 Main issues raised by the current legal framework

The categorisation framework, which is summarised in Table 3, raises several questions and issues with regards to the interpretation of MiFID investment services and activities between European Member States, the risk sensitivity of such categorisation, and the complexity of the framework. Finally, the expected evolution of its scope in light of the implementation of MiFID II in January 2017 questions the adequacy of this regime for commodity trading firms.

2.4.1 Application of MiFID investment services in the EU

Not all investment services and activities referred to in Annex I of the MiFID were defined in detail in that Directive. MiFID II maintains a similar approach and provides further guidance as to the preferred interpretation of investment services and activities. As a consequence, the implementation of provisions on some services might give rise to diverging applications of MiFID investment services and activities at the national level. This, then, gives rise to concerns when applying CRR categorisation of investment firms, since the CRR regime is heavily based on these investment services and activities.

For instance, it appears that the combination of MiFID investment services for which an authorisation is necessary and which is required in order to carry out certain activities differs between Member States. In most Members States, an authorisation to exercise reception and transmission of orders (MiFID A1) is mandatory for the execution of orders (MiFID A2), but there are exceptions.

Another example is that **order execution on behalf of clients may be assumed in those cases where the investment firm acts on behalf of the client but places the order on the market in its own name**. Being the only contractual partner of its client, the firm has an obligation against the client to deliver the financial instruments purchased on their behalf. Whereas this situation leaves the firm without any market risk, since the parties agree that the client would bear the economic risk of the transaction, the firm may remain in principle exposed to credit risk towards both the market counterparts and its client, leading to concerns about whether such a service would fall under the execution of orders (MiFID A2) or would be seen as a market 'risk free' form of principal trading. When execution on behalf of clients has been implemented as referred to above, the distinction between such firms and those that may be authorised to undertake deals on own account (MiFID A3)—but only for the purposes of executing client orders in accordance with the conditions set out in point (a) of Article 96(1) of the CRR—appears blurred. In such a context, stricter initial capital and own funds requirements could be necessary.

Finally, similar reasoning applies regarding holdings of client money and securities; different, and sometimes contradictory, interpretations of accounting and prudential practice can be observed across various jurisdictions. Holding client money may be seen as a clear prudential risk referring to on-balance-sheet exposures in certain Member States, whereas the 'conduct' risk characteristics prevail in some jurisdictions. There are thus different understandings of CRR requirements and the importance client money has in the categorisation of investment firms.



2.4.2 Inadequacy of risk sensitivity in the current framework

The current categorisation of investment firms resulting from the MiFID and CRD IV introduces a level of risk sensitivity primarily based on the underlying type of investment service and activities for which the firm is authorised. However, this risk sensitivity is crudely based on the relative prudential risks embedded in activities, and prudential requirements are set according to the array of services provided. There is some merit in setting prudential requirements according to the investment services offered by investment firms, but this approach is not without problems. Insufficiencies arise from issues related to the size and systemic importance of the institution.

Investment firms that do not hold client money and securities, only dealing on own account (MiFID activity A3) with no external clients, are currently captured under the full treatment in the CRD IV framework. Although trading for own account carries high risks when conducted within a banking group (due to contagion risk), the situation should be assessed differently for standalone firms. The insolvency of a firm without external clients generally affects only the owners of the firm (and, to some extent, the firm's counterparties and creditors). Under the broad financial stability objective set for prudential regulation, only when such firms are of a significant size and level of interconnectedness (with risks of adverse material impact upon other market participants and market confidence as a whole) should a case be considered.

The prudential treatment for MiFID investment firms executing the investment service of portfolio management, regardless of the size of the funds managed, is up for debate. A portfolio manager (investment firm falling under category 4) managing customer assets worth billions of Euro poses a greater risk than a portfolio manager managing a few million Euros. Yet the prudential policies applied to these two types of firms, and in particular their capital requirements, are the same. In some cases, investment firms being subject to the full banking requirements of Article 92 of the CRR (category 11), based on their combination of performed activities, might pose a smaller risk than some (large) asset managers in categories 4, 5 and 6. The risks that managers may pose to the wider financial system are currently a source of debate at the European and international levels.⁶

Regarding **the activity of placing financial instruments without a firm commitment basis**, this category of investment firm is only implicitly included in the current CRD IV framework because the activity of placing financial instruments without a firm commitment basis (MiFID A7) is not explicitly mentioned. An investment firm performing this activity for another entity actually performs only a 'sales' function in that the investment firm agrees to sell the financial instruments of a third party to the public, without the investment firm having an obligation to buy any of the financial instruments that could not be sold to the public. The prudential risk faced by the investment firm itself while performing this activity is therefore limited (although this is not necessarily the case for the firm's clients). Given the more limited prudential risk profile of this activity, one would expect that it deserves a less than full CRR prudential treatment as operated

⁶ E.g. *The asset management industry and financial stability,* IMF Global Financial Stability Report, April 2015 (http://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/c3.pdf).



under Article 29 of the CRD for this particular type of investment firm. This is, however, not the case. By default, such an investment firm is subject to the highest initial capital requirement of EUR 730 000 under Article 28 of the CRD, which seems irrelevant given the absence of risk to the firm and its customers. Level playing field issues arise too, since only minor differences actually distinguish placement agents from firms transmitting (or executing) orders, in that their service is connected to the issuance of financial instruments as opposed to the secondary market sales of these instruments. As a reminder, transmission of orders triggers a EUR 125 000 initial capital requirement.

Finally, **the operation of MTFs (MTF – MiFID A8)** is not explicitly considered in CRD IV and the specific risks of such activities are not addressed. By default, therefore, the full CRD IV capital requirements apply, despite not being tailored to the specific risks of these types of investment firms. MiFID II will also lead to authorisation requirements for investment firms operating an Organised Trading Facility (OTF), which should be reflected in the prudential framework.

2.4.3 Complexity of the legal framework

The categorisation of investment firms resulting from the application of CRD/CRR rules leads, in some cases, to inconsistencies.

The articulation of provisions dealing with initial capital and own funds requirements creates inconsistencies in the CRD IV regulations, with regards to the scope of Article 29(4) of the CRD. Under strict conditions, an investment firm that is not authorised to perform the activity of dealing on own account may be allowed by competent authorities to hold for its own account financial instruments used to execute orders on behalf of its clients. These investment firms are then still allowed to operate under an initial capital requirement of EUR 125 000 or EUR 50 000, but are subject to an own funds requirement mentioned in Article 95 of the CRR. If the investment firm were to have been authorised for dealing on own account, the initial capital requirement would increase to EUR 730 000 and the own funds requirement would be determined under Article 92 or Article 96 of the CRR.

There is also a difference in how investment firms are treated depending on the registration under the IMD, which does not appear justified. Investment firms that only provide reception/transmission of orders and/or investment advice services, falling under the exclusions from the definition of 'investment firm' in point (c) of Article 4(1)(2) of the CRR, are subject to the prudential requirements of Article 31 of the CRD and either have an initial capital requirement of EUR 50 000 or should have a professional indemnity insurance at a specified level or a combination of both. In addition, firms registered under the IMD that provide transmission of orders and investment advice are subject to a reduced initial capital requirements under the IMD. An insurance solution, as referred to in Article 31(1) of CRD IV, is usually considered a mitigant to some risks, especially operational risk, from a prudential point of view, though it has never justified an exemption from any kind of requirement concerning initial capital. Insurance policies are usually event driven, slow to pay out (and to pay off once), and very specific. These



are not conditions that are likely to add to timely loss absorption capacities and, therefore, recognition of such a mitigating role has been somewhat limited for prudential purposes. The current prudential regime allows the investment firm with PII to provide investment services even where it may be facing difficult financial conditions. Moreover, the CRD IV framework does not include any qualitative requirements to which the PII should comply. This is in direct contrast to the requirements in the Alternative Investment Fund Managers Directive (AIFMD) for PII, as the implementing regulation of the AIFMD has an extensive list of qualitative and quantitative requirements for PII. Furthermore, in respect of the firms operating under the IMD, the wider spectrum of products on offer (both investment services and insurance products under the IMD) does not really justify lower capital requirements. Compliance with the IMD does not provide a prudential policy safeguard, and nor, in particular, does it replace CRD IV requirements for initial capital.

The CRD IV framework for categories 4, 5 and 6 differ significantly even though these categories cover investment firms which perform similar activities with only minor deviations in the performed activities leading to similar investment firms being subject to different requirements. Firms in category 4, namely firms falling under point (c) of Article 4(1)(2) of the CRR, that perform at least execution of orders (A2) or portfolio management (A4) are excluded from the definition of an investment firm in the CRR, and are therefore not subject to, among others, any of the qualitative requirements set out in the CRD on risk management, governance, and consolidation, or the further provisions of the CRR. On the contrary, the full CRD IV framework applies to firms falling within categories 5 and 6. Category 4 investment firms were included in the definition of investment firm up until the CRD IV framework came into force. Because of these changes in definition, certain aspects of the CRD IV framework (most notably consolidated supervision) are no longer applicable to these investment firms.

2.4.4 MiFID II impact and CRR waiver for commodity derivatives firms

Most commodity derivatives firms can currently benefit from exemptions under the MiFID, and are therefore not subject to the CRD IV framework. However, there are some that are currently caught by the MiFID, and hence CRD IV does apply, although such firms can then benefit from a (time limited) exemption from both the large exposure and capital adequacy provisions (under Articles 493 and 498 of the CRR, respectively). These exemptions were originally included in CRD II to provide some time for the development of an appropriate regime for this more specialised population of firms, and have already been extended twice—the current exemptions are due to fall away after 31 December 2017.

Directive 2014/65/EU (MiFID II) and its Level 2 legislation extend the scope of when a licence should be applied to an investment firm, in particular by narrowing the exemptions available to firms dealing in commodity derivatives. This changed scope can mean that different commodity dealers will now become subject to the MiFID and, as a consequence, will also fall under the regulatory scope of the CRD/CRR.



The newly designed exemption under MiFID II is limited to firms whose dealing activity in commodity derivatives is ancillary to their main business.

'Ancillarity', in accordance with the draft regulatory standard published by ESMA on 28 September 2015, should be determined by using two tests. The trading activity test tries to determine whether the entity is a large participant in an asset class based on the size of the financial market in that asset class. The main business test calculates the size of the trading activity (excluding hedging) in all asset classes as a percentage of the overall trading activity of the firm (including hedging) in all asset classes, with the latter part being taken as a proxy for the overall business of the entity. This second test also includes a backstop mechanism to ensure that only sizable and relevant entities are caught.

The definition of hedging is consistent with the European Market Infrastructure Regulation (EMIR) and may include macro, portfolio or proxy hedging. As both commodity producers and commodity traders are typically active in both the physical and financial markets, a large share of their activity may not count towards the threshold. A firm that only engages in hedging in commodity derivatives markets, or has a trading activity deemed to be ancillary to its main business, will not be required to obtain a licence, regardless of its size.

ESMA's draft regulatory standard still has to be endorsed by the European Commission and scrutinised by the European Parliament and the Council of the European Union.

2.5 Conclusion: the need for a new categorisation

2.5.1 Introduction

The review of the current categorisation of investment firms under the CRD IV framework presented leads to several conclusions:

- the current categorisation relies solely on the investment services and activities performed by investment firms, as well as their ability to hold client money or securities, without allowing consideration of the risk of harm to customers, market impact, or clear risk to financial stability in normal conditions. Furthermore, the current categorisation does not contain an (inherent) analysis of the risks posed by investment firms and their various business models when imposing prudential requirements;
- ii) the prudential framework in the CRD IV package, which is built upon the (implicit) categorisation of investment firms, does not reflect the actual risks incurred and posed by investment firms and is therefore not sufficiently risk oriented and risk sensitive;
- iii) the MiFID was implemented by way of national transpositions. The implementation of rules on some services might give rise to diverging applications of MiFID investment services and activities at the national level. This may result in investment firms with similar activities being treated differently between Member States. Thus, any



categorisation based on MiFID investment services and activities faces the problem of potentially diverging interpretations and thus an uneven playing field across Europe;

- iv) inconsistencies, stemming from the actual wording and structure of the EU legislation, have led to difficulties in understanding and applying, in a proper and harmonised way, the prudential regulations applicable to investment firms; and
- v) the current framework is overly complex and requires considerable simplification, for the benefit of both firms and supervisors.

2.5.2 Replacing the list of investment services and activities with indicators related to systemic importance for the purpose of prudential categorisation

Based on these observations, this report calls for a fundamental change in the criteria that determine investment firms' categorisation. The aim is to pursue the general objective of enhancing proportionality through indicators related to systemic importance and the ability to run 'bank-like' activities.

The future categorisation of investment firms under CRD IV should then be achieved with reference to the systemic importance of the investment firm or its ability to run 'bank-like' activities, expressed through consistent indicators, leading to a clear cut in the population of investment firms within the EU. Indeed, a key tool for amending the current complex regime, which establishes rules that apply differently depending on the category to which a firm belongs, could be reducing the number of 'categories' and simplifying the regime by establishing a greater use of proportionality, both upstream (strengthening rules for those firms that are deemed to pose more risks to financial stability) and downstream (simplifying requirements for the majority).

2.5.3 A three-fold new categorisation for investment firms

This approach would lead to a categorisation involving:

- 1) Firms that are deemed systemic or otherwise present a clear risk to financial stability in normal conditions. It is recognised that a small minority of MiFID firms are very substantial undertakings that run 'bank-like' intermediation and underwriting risks at a significant scale. Such activities expose these institutions to credit risk, primarily in the form of counterparty risk, and market risk for positions taken on own account, be it for the sake of external clients or not.
- 2) Firms considered of lesser systemic importance, or not 'bank-like' investment firms. A less complex prudential regime seems appropriate to address the specific risks that investment firms pose to investors and to other market participants with regards to their investment business credit, market, operational and liquidity risk.
- 3) Small and non-interconnected firms warrant a very simple regime to wind them down in an orderly manner. Such a regime could be based mainly on fixed overheads and large exposure requirements, which would fulfil the objective of setting aside sufficient capital



for an orderly wind-down. These firms could also be subject to simplified reporting obligations.

Firms falling under the first tier would comprise any 'bank-like' investment firms that are systemic or would otherwise present a clear risk to financial stability in normal conditions.

2.5.4 Qualitative parameters

Following the proposed approach for a revised categorisation implies defining adequate qualitative parameters to assess the characteristics leading to a specific investment firm being deemed to have systemic importance or be running 'bank-like' activities, which do or would present a clear risk to financial stability under normal conditions. Further work needs to be done to identify the criteria, concerning interconnectedness and activities undertaken, to be met with the aim of adequately defining the part of the population that would need to comply with similar requirements to credit institutions.

2.5.5 Quantitative parameters: defining the adequate threshold

Although work on setting the actual parameters needs to be done, there are three ways to define the particular thresholds⁷ for each of the quantitative parameters at stake. Each of them should be explored thoroughly in order to assess their relevance in this context:

- agreeing on a flat and unique set of thresholds, which shall be applicable to all Member States in the EU (e.g. absolute nominal thresholds);
- defining unique relative amounts that are also applicable to all Member States in the EU (e.g. thresholds in per cent); and
- giving Member States some flexibility and allowing them to define the thresholds, taking into account the situation in their markets and the characteristics of the main players in their markets.

The first approach is clear and simple to operate and achieves a common result across the EU, but it may result in investment firms in some Member States never being deemed a risk to the financial stability of the EU as a whole, while a firm might still be of concern within the individual Member State that authorised it.

The second approach requires defining relative amounts that are to be applied across the EU in a uniform manner (it requires defining a figure for each of the parameters that is automatically triggered when a firm reaches that particular level or more, i.e. more than Y% of the total balance sheet of all firms). The advantage of this approach is that it does not distinguish between Member States according to size; the disadvantage is that it might still catch firms that are very small in

⁷ Thresholds may be defined in quantitative or qualitative terms.

⁸ Only those Member States with more than 200 investment firms are shown.



absolute terms, and it is quite challenging to identify the relevant figure that would cater to the shape of the market in each Member State (as also explained in option one above).

Under the third approach, consistency could still be achieved by setting out a common method for how Member State-specific thresholds are to be calculated. For example, a cumulative distribution for each parameter could be determined by ranking the firms authorised within each Member State from highest to lowest; this would show the marginal impact of capturing the next largest firm, and the next, and so on, so as to identify the point at which a given percentage of the national market (as measured by each parameter)—say two-thirds, 75%, or as agreed—would be captured.



Table 4.: Example of a cumulative distribution of investment firms based on total assets

The third approach would allow each Member State to work out which thresholds best account for the particular situation of their markets and firms and might be an easier option, because identifying the right thresholds for the entire EU may not be an easy task. However, Member State-specific threshold would be more complex to operate and could jeopardise the level playing field. Therefore, it is important to define at EU level common criteria for identifying such a threshold.

A concern with the second and third approaches, however, is the possibility of 'shopping around' (for example, with investment firms of a given size relocating to a larger Member State (and then using the passport to branch back in) to avoid being deemed a risk to stability in a smaller Member State). One possible solution to this can be found in the 'significant branches' provisions in Article 51 of the CRD, which is aimed at helping host Member States identify significant branches. The new regime could include a reference to the identification of significant branches (based on the criteria currently listed in Article 51 of the CRD)—or, indeed, it could also, if necessary, provide for cross-border business, giving the host Member State the option to request that the home Member State apply the full regime to firms that are considered 'minimum regime firms' in their home Member State, when the particular circumstances of the firm so require.



Irrespective of which approach is used, the size distribution of investment firms is likely to suggest that the threshold for capturing the majority of the overall impact from any given factor will be achieved by a relatively small segment of the overall population of investment firms (see the analysis presented below, which provides some balance sheet size conclusions using investment firm data submitted by Member States).

Further work will need to consider the most appropriate method and how to address any potential concerns with that method, as well as specific metrics. Indeed, due to the heterogeneity of the population, criteria only based on balance sheet size may not be sufficient and could provide incorrect insights when dealing with the risks an investment firm may pose to the financial system, since it does not capture, for example, intraday exposures, concentration risk, or specific business model activities. All the tables included below show, in an illustrative way, how heterogeneous the population of investment firms is with respect to size.



Table 5.: Cumulative representation of the MiFID firm population based on gross balance sheetfor all Member States combined



As a percentage of total gross balance sheet

Table 5 illustrates that about eight MiFID firms represent 80% of the total assets of all 6 000 MiFID firms, thereby highlighting that very, very few investment firms comprise the overwhelming majority of the investment firm population, as measured by assets. Consequently, the investment firm market is composed of many relatively small firms. This conclusion should, nevertheless, be treated with caution, since accounting rules may differ among jurisdictions, thus creating gaps between entities with regards to balance sheet size. For example, claims and liabilities related to the holding of client money and securities are treated differently and create artificial biases in the analysis.

Table 6 examines the balance sheet size distribution of investment firms in selected Member States (those with more than 200 investment firms) to see if the findings identified at an all-EU level are mirrored in individual Member States. In France, the Netherlands, Spain and the UK, fewer than 10 firms are responsible for more than 80% of the total investment firm assets.







⁸ Only those Member States with more than 200 investment firms are shown.



2.6 What prudential regime for each of the categories?

If posing material risks to the financial system or running 'bank-like' activities in a way similar to credit institutions, firms falling in the first tier would be subject to the current prudential requirements prescribed in the CRD IV framework, and thus subject to the full CRD IV package, similar to banks. Further work should, however, still consider whether there are any aspects of the CRD/CRR framework that need to be tailored for such firms given that their business models are, in some cases, very different to those of banks (for example, the LCR).

However, contemplating the outcome of the review undertaken by this report, firms falling under tiers 2 and 3 should be subject to a modified prudential regime, simplified and tailored in a way that enables a better consideration of proportionality and risk sensitivity. Achieving this will need further work on i) an analytical review of the risks presented by investment firms (on the basis of the investment services and activities they propose, and their ability to hold client money and securities); as well as ii) an analysis of the broader parts of the supervision tools and requirements that should apply to them, as included in Section 3 of this report.

The development of this modified regime needs to pursue the aim of improving the Single Rulebook endorsed by the EBA, defining harmonised regulatory developments across the EU. The modified prudential regime should represent a solid basis for supervision, ensuring an appropriate and uniform level of requirements in a Pillar 1 context.

The current prudential regime set out in CRD IV may be considered as putting investment firms in a disadvantaged position, as they have to comply with the same prudential rules that were created (in Basel III) for internationally active banks, something that is too onerous for smaller investment firms. One should note that the impact assessment of CRD IV does not contain a costbenefit analysis of the impact of the rules upon investment firms similar to the ones undertaken by credit institutions.

Arguably, the inclusion of investment firms in the full scope of CRD IV could be considered to run counter to the EU treaty principle of proportionality, which states that any measure by a public authority that affects a basic human right must be:

- appropriate to achieve the objective that is intended;
- necessary in order to achieve the objective that is intended (i.e. there are no less severe means of achieving the objective); and
- reasonable (i.e. the person concerned can reasonably be expected to accept the measure in question).

Therefore, it could be argued that a modified regime would, for most investment firms, safeguard the level playing field for investment firms, since all firms that share similar characteristics and undertake similar business would have to comply with similar prudential rules that were more appropriate for non-deposit taking businesses.



With regards to competition between investment firms and credit institutions undertaking MiFID investment business, both sets of institutions would be subject to meaningful prudential requirements that seek to cover broadly similar prudential risks, only in a more focused way to recognise that the impact and consequences may be different, without prejudice to the actual calibration of such a modified prudential regime. This would reflect the fact that it is credit institutions that may actually compete with investment firms for investment business (rather than investment firms competing with credit institutions for deposit-taking and banking business).



3. Analytical review of investment firms' risks

3.1 Introduction

The purpose of this chapter is to explore whether the need for prudential standards for investment firms is driven by different considerations to those for banks, and what needs to be done next to deepen prudential risk analysis for investment services. This part will consider risks relevant to any type of investment firm, regardless of how its current own funds and/or initial capital requirements are set out in the CRD/CRR (such as firms licensed under the AIFMD or the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) when performing MiFID investment services).

As noted, gaps and inconsistencies arise from the current regime, particularly from practical aspects directly linked to the structure and clarity of the content of CRD IV. Supervisory practice reveals that there may be merit in amending the regulations accordingly.

3.2 Analysis of investment firms' risks and risk-specific regulatory framework

The following sections consider both the existing risk metrics of the CRD IV package (e.g. market risk, operational risk, FORs, credit risk and large exposures requirements, etc.) and any other elements of prudential risk that may be deemed relevant. This would also include liquidity risk as a whole, having first explored the more narrow application of the LCR to investment firms.

3.2.1 Market risk

a. Concepts and definitions

For investment firms, especially those with a trading book, market risk can be a fundamental feature of their business model.

Market risk is generally defined as the risk of losses in on-and-off-balance-sheet positions arising from movements in market prices.

The CRR defines the trading book as 'all positions in [MiFID] financial instruments and commodities held by an institution either with trading intent, or in order to hedge positions held with trading intent' – Article 4(86). 'Positions held with trading intent' means either 'proprietary positions and positions arising from client servicing and market making', 'positions intended to be resold short term', or 'positions intended to benefit from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations' – Article 4(85).



Market risk is generally referred to as trading book risk. This reflects the fact that, under the market risk framework, own funds requirements for position risk are computed only for debt instruments and equity instruments booked in an institution's trading book. Naturally, this is subject to the institution having a trading book large enough to not be eligible for the derogation for small trading book business under Article 94.

Own funds requirements for foreign-exchange risk and commodity risk are computed based on an institution's overall net foreign exchange position and its positions in commodities or commodities derivatives, regardless of whether those positions are booked in the trading book or the banking book.

Furthermore, market risk is not the only trading book risk, as most counterparty credit risk, credit valuation adjustment (CVA) risk and settlement risk of a firm are expected to arise from instruments held in the trading book. In particular, derivative instruments, whether centrally cleared or non-centrally cleared, generate increased own funds requirements for counterparty credit risk and CVA risk. Those risks arising from trading activities are particularly relevant for investment firms.

b. Main specificities to consider

The need for market risk requirements

Firms that deal on their own account clearly need to manage market risk. Other forms of investment firm are not exempt from market risks under certain circumstances: an agency or execution broker may be left holding positions (due, say, to a failed trade); and portfolio managers may hold investments by virtue of their providing seed capital to funds, or running excessive manager box positions.

However, strict provisions on asset segregation may prevent the contagion affecting investors. When performing asset management functions, both the upside and downside potential of the portfolio are fully attributed to the client of the investment firm. As such, the investment firm faces no market risk on this portfolio since it is never the portfolio's economic owner.

Case for firms dealing on own account

Investment firms that solely deal on own account can face two distinct prudential regimes in the current CRD IV framework, depending on whether they are categorised as local firms or not. The full regime is set out under point (b) of Article 96(1) of the CRR. In practice, the distinction between the two categories, when it comes to the prudential risk incurred, is not based on the activities the firm performs, but rather on the markets in which the firm is trading.

Investment firms subject to point (b) of Article 96(1) of the CRR have no external customers. Local firms are not prohibited from having external customers, but they generally do not. Both types of firm perform only the activity of dealing on own account, with their transactions taking place under the responsibility of a clearing institution; the transactions of the firm are guaranteed by the clearing institution.



The guarantee by a clearing institution of all transactions of the investment firm should help prevent disruptions in the execution and settlement of those transactions, and should therefore prevent losses for the counterparties of the investment firm in the event of its failure. This guarantee by the clearing member, therefore, operates as a mitigation of the risk posed by the investment firm to the financial system. Although this risk to the financial system will be smaller than the risk posed by a large credit institution, it can still be significant. Indeed, some investment firms dealing on own account can, on a day-to-day basis, accrue a total trading position of several billion Euro. If such an investment firm should then fail before the settlement of those transactions could be finalised, the clearing member would (because of the guarantee) be ultimately responsible.

c. Possible options for an investment firm-specific market regime

In general, it appears that the current CRD IV regime on market risk is adapted to 'bank-like' investment firms, which can fulfil the requirements either because of their size and diversification of activities or because they are part of a banking group already subject to such requirements.

In contrast, smaller and/or more specialised investment firms are facing (or, due to changes under MiFID II, are about to face) difficulties with fulfilling these requirements because of the nature of the market risks they are taking on, which may be very specific and not necessarily captured properly by the current standardised framework. Moving to an internal model approach would potentially solve this issue, but these firms are generally not big enough to bear the costs of developing an approved internal model (which would also place additional demands upon supervisors). The CRD IV framework also raises issues regarding reporting, which is felt to be unnecessarily burdensome in some cases, particularly for small entities.

The Basel fundamental review of the trading book (FRTB), currently being defined in the Basel Committee to strengthen the market risk framework for large and internationally active credit institutions, includes proposals on revising the market risk standardised approach. There are three stated objectives of the FRTB:

- provide a method for small banks that do not require a more sophisticated measurement of market risk;
- allow for a credible fall-back for inadequate internal market risk model (i.e. value at risk (VaR));
- facilitate transparent, consistent and comparable reporting of market risk across banks and jurisdictions.

It is worth noting that the relative size of the trading books of the majority of investment firms and their complexity compared to credit institutions may not lead to adequate consideration of small- and medium-sized investment firms' specific issues, including the fact that they mostly do not use internal models. It is unclear whether the FRTB will deliver a standardised market risk



approach suitable for small- and medium-sized investment firms; therefore, alternative options could be explored.

Possible options to investigate in view of an investment firm-specific market risk approach include:

- assessing whether the FRTB sensitivity-based approach (SBA) is better suited to investment firms in a context where the SBA is likely to become the basis for the computation of initial margins exchanged worldwide for non-centrally cleared OTC derivatives;
- 2) developing a standardised 'basic' approach (e.g. based on a clearing house margin or other different requirements);
- 3) developing a standardised approach based on scenario matrices with more dimensions defined (e.g. price, vega, interest rates and time); and
- 4) developing an internal model approach that would be based on the internal approaches currently available in the CRR or discussed as part of the FRTB, but that would also be more proportionate to the scale of the business of small- and medium-sized investment firms.

If a basic approach is developed, it should be made clear that, in general, it may have the result of increasing the required amount of capital compared to the standardised or internal model, because such a basic approach would result in lower risk sensitivity as compared to the current market risk framework. However, it seems that, in general, the population of investment firms for which such a 'basic' approach would be developed prefers an increased amount of capital (compared to the implementation of the CRR Standardised Approach) rather than developing detailed reporting tools and/or internal models.

d. Specific options for firms dealing on own account

In line with the regulatory obligations faced by local firms and firms falling under point (b) of Article 96(1) of the CRR (and without prejudice of the upcoming removal of the local firm's exemption within the MiFID following the entry into application of MiFID II, which would see more such firms look to the CRD/CRR for their prudential requirements), **a newly defined prudential regime could build upon the guarantee offered by clearing members.**

Under the MiFID, firms dealing for their own account are exempt from being authorised and hence are not deemed to be investment firms for the purposes of the CRR. Under MiFID II, some of these proprietary trading firms will be required to be authorised and will be deemed to be 'investment firms', and may thus have to apply the CRR in full. Consideration should, however, be given to the fact that these firms pose limited, if any, systemic risk and they are currently policed by the margin requirements of their clearing member and also by the CCP.



When providing the guarantee to the investment firm, the clearing member requires the investment firm to provide a 'haircut' or 'margin'. This haircut is based on the positions taken by the investment firm and also on the counterparty risk of the investment firm towards the clearing member. Given that most clearing members will be subject to the CRD IV framework, they will have to calculate a CRR-based capital requirement for their guarantee of the investment firm. The investment firm will then, in order to have the clearing member assume responsibility for their transactions via the guarantee, provide the clearing member with the collateral/funds the clearing member is obliged to hold for that guarantee based on its own capital requirement. The haircut sought by the clearing member of the investment firm should provide the clearing member with enough resources to adequately execute and settle the transactions of the investment firm in the event of its failure. This haircut can, therefore, operate as a prudential requirement actioned by the clearing member towards the investment firm.

For the investment firm, this haircut operates as a capital charge based on its trading exposures and, subsequently, its market risk exposures. The haircut is based on the trading positions the investment firm takes and varies depending on changes in the total number of positions. Because of the relation between the capital charge and the activities of the investment firm, this haircut is analysed as a market risk capital charge.

For an investment firm solely dealing on own account, both the upside and the downside potential of a trading exposure are for the owners/traders of the firm. These investment firms have no external customers and, in most cases, the owners of the firm are also the main risk takers or traders. The haircut required by the clearing member reflects its detailed analysis of the specific risk of the guarantee given to the investment firm.

Depending on the estimated tail-end risk (i.e. the risk that the investment firm will fail and that this will cause the failure of the clearing member), the haircut requirement could be subject to a 'prudential' factor, with the resultant amount being held by the investment firm in own funds. Building in such a factor would also help provide for sudden future variations in the level of overall margin payments sought by a clearer. However, consideration would need to be given as to how clearing members would manage any potential conflict between setting margin calls at a sufficient (high) level that protects them from risk and setting them at a sufficient (low) level to compete for business from investment firms.

A possible prudential framework for investment firms solely dealing on own account could provide that:

 investment firms that have no external clients and perform only the activity of trading on own account, with their transactions taking place under the responsibility of a clearing institution and subject to a 'haircut' or 'margin' requirement by that clearing institution, could hold that haircut to be an 'own funds haircut requirement'. Depending on the expectation of the tail-end risk, the 'haircut' or 'margin' required by the clearing member can be multiplied by a percentage (i.e. 200%, 100% or 50%) to obtain the 'own funds haircut requirement';


• all transactions by the investment firm that do not take place under the responsibility of a clearing member (i.e. OTC transactions) should be subject to risk-sensitive, and proportionate, provisions on credit and market risk.

Such a prudential framework for investment firms solely dealing on own account should be explored further in order to assess whether it would need to be specific or if the general market risk prudential requirements for investment firms are sufficient to cover the needs of such a population.

3.2.2 Credit risk

a. Concepts and definitions

In general, the term 'credit risk' may be considered to comprise a number of elements that cover the holistic, underlying risk that a firm will not receive monies due from a creditor.

- Credit risk Covers exposures in a firm's banking book, including those arising from direct lending (e.g. loans).
- Counterparty risk Covers exposures in both a firm's trading book and its banking book arising from: (i) the risk of default, before the final settlement of all cash flows, of the counterparty to derivative transactions, repurchase transactions, securities, or commodities lending or borrowing transactions, long settlement transactions, and margin lending transactions (CCR default risk charge); (ii) the risk related to CVA losses, in particular due to the deterioration of the credit quality of the counterparty of OTC derivative transactions (CVA risk charge); and (iii) the risk caused by transactions unsettled after their due delivery date (settlement risk).
- Concentration risk Where material groups of exposures are subject to the same underlying risk factors, e.g. sectoral, geographical.

These elements cover all of the aspects of credit risk that arise from the range of activities that are typically be undertaken by credit institutions.

Some activities that investment firms undertake may be regarded as 'bank-like', e.g. where they make loans to staff or clients. Additionally, credit risk might arise from ancillary activities that investment firms provide to clients, e.g. 'granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction'. However, these are generally not the main activities of investment firms.

Below is a non-exhaustive list of some possible sources of credit risk that might be incurred by investment firms:

o 'bank-like' activities;



- other types of short-term or medium-term (less than two years' maturity) working capital loans or guarantees to some commodities clients, similar to a bank's trade finance business;
- direct loans to staff;
- intraday credit risk via overdrafts with market infrastructure;
- intragroup guarantees or other contingent credit exposures to group companies; and
- hold-to-maturity or illiquid bond positions or assets held as part of the liquid assets buffer (basically any bond positions that do not meet the trading book eligibility criteria).
- Investment firm activities:
 - margin loans to clients (i.e. direct funding to help clients meet margin calls, which effectively means that the clearer pays itself);
 - executing orders on a 'delivery versus payment' basis/settlement risk;
 - not all trades are 'delivery versus payment' for a variety of reasons, so some firms will definitely have settlement risk, arising from doing some extended or non-standard settlement (including free deliveries);
 - direct credit exposures to their managed funds via loans, seed investments (i.e. illiquid equity positions) and guarantees;
 - collateralised debt obligation (CDO), 'vertical slices' held to maturity on a CDO manager's own balance sheet, e.g. due to the CRR risk-retention rules; and
 - accruing, or unpaid, fees and commissions owed to the firm.

b. Main specificities for investment services activities

The CRR credit risk framework is less directed towards firms that primarily incur counterparty risk (whether that is in the trading book for firms that take proprietary positions, or 'settlement risk' where executing orders).

The original calibration relies on granular sets of exposures with no material risk concentrations and could suggest that requirements are too low for less diversified firms. On the other hand, the standard credit risk requirements (e.g. capital of 8% held against an exposure risk-weighted at 100%) in the CRR are high, given the nature of the credit-type risks incurred by the same firms, which is limited to cases when the execution of a 'delivery versus payment' transaction fails.



Internal model-based approaches for credit risk are not used by firms, which are usually too small, except where they are part of a banking group that has been granted approval to use a model on a group-wide basis or when they are themselves large bank-like companies.

A review of the Pillar 3 disclosures identified the following items to be considered by a sample of investment firms as of importance in respect of credit risk:

- cash deposits with banks, financial institutions and money market funds;
- credit exposure to debtors arising from outstanding receivables;
- credit risk on fees invoiced to, but not yet received from, clients;
- credit on unit trust debtors;
- accrued income;
- trade debtors;
- fee income debtors;
- cash deposits with counterparties, sales debtors;
- non-payment of fees by segregated fund clients;
- outstanding receivables;
- counterparty exposure;
- trading activities with counterparties; and
- delivery settlement risk (including within funds).

What this analysis suggests is that there can be different sources of possible credit risk for (all types of) investment firms (which may have the potential to create risk to the firm and, in turn, lead to risk to its customers), although these should tend to be far less intensive or important in determining overall capital requirements than credit risk is for credit institutions.

c. Policy options

Credit risk is not a significant issue for many investment firms, but such firms face a broad range of possible sources of credit risk. Nearly all investment firms currently use the so-called 'simpler' Standardised Approach to credit risk, which requires firms to track the external ratings of the creditworthiness of their exposures, termed 'credit assessments', where they are available. Most investment firms have made it well known that they struggle to cope with this Standardised Approach. A simplified approach to credit risk more attuned to the specific business of



investment firms, paying particular attention to intraday, settlement and counterparty risk, could be developed.

3.2.3 Operational risk

a. Concepts and definitions

While firms might (consciously) take on credit and market risks in order to make a return, operational risk is an unavoidable consequence of any business activity, including any investment service or activity, under the MiFID. As the size and/or complexity of a firm, or the products or services it handles, increases, often so too does its operational risk profile, reflecting the higher potential for failure or inadequacy within the organisation (e.g. within the complex systems needed to monitor business activity appropriately) or bad behaviour (e.g. rogue trading, poor treatment of clients, systematic non-compliance).

Operational risk may also be a hidden risk, the impact of which might hit the firm unaware. Examples include rogue trading, mis-marking of positions, theft, a corporate action not exercised on behalf of a client, and a new product being booked into inappropriate systems (or not at all), meaning its risk profile cannot be monitored. Operational risk can, therefore, give rise to both direct risk to the firm and risk to its counterparties and customers.

It is also important to note that the derivation of appropriate capital requirements under Pillar 1 does not have the same level of correlation to a quantum of 'exposure' that credit and market risks have, as the size of the exposure is not a direct input into the calculation of the operational risk capital requirement. Instead, 'gross income' is used as a proxy measure of the operational risks that an institution faces.

Taking all of these factors into account, and given the often idiosyncratic nature and uncertain capital impacts of operational risk events, the qualitative requirements are likely to be more critical here than in the case of other risks.

Under the Standardised Approach in the CRR, while designed with a diversified bank/group in mind, of the eight business lines described there are five that appear most relevant to the activities and services of various investment firms, namely: corporate finance, trading and sales, retail brokerage, agency services (safekeeping), and asset management. These business lines can give rise to both risks to an investment firm and/or risk of harm to its counterparties, customers and market confidence. However, very few investment firms to which the Pillar 1 operational risk provisions apply use the Standardised Approach (SA), with most using the simpler Basic Indicator Approach (BIA).

The CRR currently allows firms using an Advanced Measurement Approach (AMA) to recognise insurance to offset their regulatory capital requirement up to a maximum of 20%. Although few, if any, investment firms have approval to use the advanced approach for the purposes of Pillar 1, it is known that within their Internal Capital Adequacy Assessment Processes (ICAAPs) some



investment firms nevertheless internally model operational risk, and seek to claim such an offset to any Pillar 2 capital charge from their use of insurance.

The Basel Committee has been working on revising the current framework, which determines capital requirements for operational risk, given the apparent shortcomings of using gross income as an appropriate metric for that purpose. One conclusion of the research conducted into developing the Revised Standardised Approach that the Basel Committee has consulted on is that 'a bank's size was seen to be a dominant factor in distinguishing its operational risk exposure'.⁹

Basel now proposes using the aggregation of 'three macro-components of a bank's income statement' as the appropriate business indicator for deriving the capital requirement. The aggregate business indicator is, in turn, multiplied by one or more coefficients that are determined by the bank's size. These coefficients are:

- interest component = absolute value of (interest income income expense);
- services component = fee income + fee expense + other operating income + other operating expense; and
- financial component = absolute value of (net Profit and Loss (P&L) on trading book) + absolute value of (net P&L on banking book).

While the results of the Basel consultation have yet to be announced, it should be noted that, being banking driven, this work may not be appropriate for investment firms—for example, most investment firms are unlikely to generate much interest income.

b. Investment firms' specificities

A review of the Pillar 3 public disclosures of a sample of investment firms gives a broad picture of the most prevalent and material operational type risks that these firms perceive themselves to face.

These may be summarised as:

- staff, investment mandate and oversight, distribution and regulatory type risks;
- compliance risk, the risk of failing to meet regulatory or statutory obligations;
- failure to comply with regulatory requirements;
- oversight of overseas operations;
- availability and retention of staff;

⁹ http://www.bis.org/publ/bcbs291.htm



- internal or external fraud;
- data accuracy;
- trade/dealing errors;
- oversight of third party providers/error in outsourcing providers/failure of outsourcing provider;
- new/amended fund details incorrectly implemented;
- business and systems disruption, cyber security;
- inappropriate accounting practices and/or inadequate tax practices;
- failure to carry out internal administration procedures properly or to a client's instructions;
- monitoring of mandates;
- outsourced relationships, including internal audit;
- unauthorised trading;
- improper employment practices;
- incorrect financial promotions;
- product and performance or fund valuation errors, physical damage, and loss of premises;
- financial crime and fraud, systems outage;
- operational processing errors; and
- client litigation.

This shows that there can be a wide range of operational type risks that can arise for all types of investment firms, including those that might not otherwise be viewed as taking 'balance sheet' (e.g. credit or market) risk.

However, the issue with both the current CRD/CRR requirements and the new Basel Committee's proposals is that they rely on the 'banking book' having a disproportionate role as a source of risk. Moreover, income may not necessarily be the best metric to capture the risks across the wide range of diverse investment services and activities that different investment firms can undertake. This is borne out whenever investment firms assess their operational risk under ICAAP as part of Pillar 2.



Most supervisors and investment firms themselves identify 'operational risk' as perhaps the greatest single risk type to which such businesses are exposed; one that, in turn, has the potential to cause harm to customers and/or decrease confidence in the market. This possible imbalance between inappropriate Pillar 1 requirements, which also do not cover all types of investment firm, and the importance of managing the impact of operational risk is an issue that should be addressed in any revision of the prudential framework for investment firms.

c. Policy options

Basel is currently considering the use of a different, compound business indicator to that used in the BIA and SA (which is gross income) for banks, but there may be other metrics that could be investigated that are more appropriate for investment firms.

In identifying an alternative approach, the desirable features may be summarised as follows (where not entirely independent of each other):

- the approach must produce capital requirements that reflect, to a suitably high degree, the operational risk profile of the investment firm;
- the metrics must have a reduced or low possibility of being manipulated by investment firms in order to lower the related capital requirements; and
- the metrics should be as objective as possible and the opportunity for subjective inputs kept to a minimum.

With this in mind, it may be most appropriate to develop a range of different metrics that may be combined and deliver capital requirements on a proxy basis, thus better representing the operational risk profile of all the relevant types of investment business conducted by investment firms. This is especially true given that we have no directly observable variables of the level of 'exposure' to operational risk, unlike for credit and market risks, where the level of the exposure forms a direct input into the calculation of minimum capital requirements.

Such metrics might include both financial measures (e.g. assets under management, trade volumes) and appropriately calibrated non-financial ones (e.g. number of traders, number of settlement failures); further investigation would be needed to identify the metrics and determine how to turn this concept into a proposal.

If a size-related metric is sought as a basis for determining the amount of capital required (whether to deal with 'wind-down'/failure or to absorb losses from operational risk events and to keep trading), then there may be other alternatives to consider.

For example, (non-exhaustive) requirements could be set according to:

- value of assets/funds under management—similar to the AIFMD and UCITS;
- volume of client money/assets;



- number/type of clients;
- market share;
- operational risk modelling; and
- breadth of business lines.

The use of a fixed overheads- or expenditure-based metric could be combined within the design for a revised approach to operational risk (as per the proposal above), especially if the emphasis for the vast majority of investment sector firms is on winding down the business and/or managing the impact of failure on customers and the market.

In general, the use of a fixed overheads requirement (FOR) for certain investment firms has been around for over 20 years, although prior to this review there does not appear to have been any formal consideration as to whether or not it continues to be relevant. In addition to providing a simple, common, minimum size-related capital requirement, it would seem intended to serve two possible purposes: to help provide time to wind down a firm, and to serve as a Pillar 1 'proxy' to absorb losses that might arise through operational risk events.

However, there would appear to be various questions to answer in order to determine whether fixed overheads (i.e. an expenditure-based metric) are still the most appropriate size-based measure to use to achieve the desired purpose identified above. If so, at what (percentage) level should a requirement then be set (e.g. is one quarter still appropriate, or is it inadequate for the purpose intended)? For example, experience with some investment firms has shown that the amount of own funds required to fund an orderly wind-down of a business can be much higher than the current one quarter of fixed overheads and can also vary significantly. It can also be 'gamed' (where expenditure booked by owners within the investment firm itself can be kept artificially low and so does not reflect underlying needs/risk).

Any own funds requirement that seeks to address operational risk (however designed) would need to consider: (i) any potential recognition of insurance and other risk transfer mechanisms against the occurrence of operational risk events; and (ii) whether or not there should be any diversification allowed, whether within any operational risk element itself, or across this and any other risk elements (e.g. market risk).

3.2.4 Liquidity and funding risk

a. Concepts and definitions

Definition of liquidity risk

Recently introduced in international regulations, liquidity risk has become a key aspect of financial supervision in light of the consequences of the financial crisis of 2007-2008 on markets and the financial system as a whole. There are a number of lenses through which liquidity can be considered: first, there is a time element to the requirement for liquidity; second, there is a core



(or shorter term) component that can be defined as the ability to meet commitments when they fall due, particularly under adverse market conditions; and finally there is a broader (or longer term) component that consists of having sufficient, available and cost-effective funding through long-term financing and an improved asset mix to continue to pursue business strategies. Different businesses will require different liquidity cycles and funding maturities.

Secondly, liquidity is often distinguished by whether it is on the asset side or the liability side of the balance sheet. Liability liquidity tends to refer to funding sources obtained from third parties, including group entities. This funding can be in a variety of forms (secured and unsecured), from a variety of sources, including committed lines of credit, and for various maturities. In contrast, asset liquidity is cash or near-cash resources that can be sold for cash (usually with a haircut) or assets that can be used as collateral in secured funding transactions (for example, through repurchase agreements and securities lending).

These descriptions of liability and asset liquidity show how they can both contribute to short-term and long-term liquidity needs; the essence of the matter is how quickly that liquidity can materialise when it is required. Effective liquidity risk management should use liquidity potential from both sides of the balance sheet and optimise its use, taking into account the firm's business and the characteristics (cost, availability, maturity etc.) and risks associated with each type of liquidity source.

CRR provisions on liquidity are restricted to investment firms trading on own account and/or the placing of financial instruments on a firm commitment basis, authorised for MiFID services A3 (dealing on own account) and/or A6 (underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis). Competent authorities may exempt investment firms, and groups only containing investment firms, from the application of such requirements (Part Six of the CRR), taking into account the nature, scale and complexity of the investment firm's activities.

The Delegated Act of the Commission (Regulation 2015/61) specified the legally binding European LCR Pillar 1 ratio and was adopted on October 2014 to apply to credit institutions only. Investment firms are not subject to the LCR unless they are part of a prudential consolidation group.

To complement these requirements, the Basel Committee has introduced, and the European authorities have proposed¹⁰ additional liquidity monitoring metrics (ALMM) reporting obligations. These obligations facilitate deeper supervisory monitoring of firms' liquidity risk profiles. In particular, ALMM submitted reporting covers the information gap between 30 days (which is the LCR time horizon) and 12 months (the Net Stable Funding Requirement (NSFR) time horizon). At the European level, the ALMM consists of the following reporting templates: contractual maturity ladder (to identify liquidity gaps of up to 10 years), concentration of funding by product type and

¹⁰ See the EBA final draft implementing technical standards on additional liquidity monitoring metrics under Article 415(3)(b) of the CRR.



counterparty, concentration of counterbalancing capacity, and prices and rollover of funding. These templates are intended to apply to any investment firms that are subject to Part Six of the CRR.

Domestic liquidity regimes

Pending the full harmonisation of liquidity by 2018, some Member States have domestic quantitative liquidity requirements that are akin to Pillar 1 requirements, which apply to some or all of their investment firms. The methods used differ across jurisdictions, but they all have the overarching requirement for firms to maintain adequate sources of liquidity to cover contractual and/or potential outflows over a certain horizon. Domestic liquidity standards also highlight the importance of regular liquidity reporting, especially because investment sector firms can become susceptible to liquidity problems very quickly. The different liquidity requirements used in different jurisdictions illustrate that there are several potential ways in which liquidity standards can be introduced.

b. The liquidity questions in the Commission's call for advice

Relevance of the LCR to investment firms providing MiFID activities (3) and (6)

The question of the applicability of the LCR to investment firms providing MiFID activities (3) and (6) is based on the Delegated Act (DA) definition of the LCR, since this is the only fully formed LCR requirement that can provide a baseline.

The Delegated Act LCR focuses on credit institution business model issues where many provisions do not apply. These include: outflows on deposits; inflows on loans to retail, wholesale and financial customers; and the interplay with central bank funding. In this context, the current Delegated Act LCR standard does not appear to adequately consider investment firm business model issues. The same observation prevails for the ALMM templates and the NSFR.

The LCR is designed for business models that hold inventory as part of their daily business. For some firm types, such as *spread betting* firms, the requirement to hold a buffer of liquid assets based on stressed scenarios is wholly inappropriate and could make their business activities unsustainable. Equally, the DA LCR specifies what constitutes liquid assets; equities are excluded from that definition. This means that firms that solely trade equities (and thus hold equities as inventory to support that business) are severely impacted by an LCR where the time horizon is one month sustainability. Either the investment firms should then be forced to hold debt-based instruments, or the liquidity horizon should be shortened under such activities.

Relevance of Pillar 1 liquidity standards for investment firms

The importance of liquidity to investment firms is compounded by the fact that investment firms may, in general, be more exposed to price- and credit risk-sensitive sources of liquidity than credit institutions. Whereas banks are presumed to enjoy a relatively stable source of core funding through unsecured customer deposits, investment firms are not deposit-taking institutions.



Similarly, investment firms do not have access to central bank funding on a regular basis or as lenders of last resort. Consequently, they must rely on their own capital and on their ability to raise funds from external sources, which leaves them exposed to the price and credit risk sensitivities of funds providers. Other aspects of investment firms' business that make them very susceptible to liquidity risk are:

<u>Contingent commitments</u> – These can arise from, for example, derivatives with optional or eventdriven components or the granting of committed loan facilities. Periodic cash flows from such commitments are a potential source of liquidity risk if the nature of the exposure is not well understood.

<u>Leverage</u> – The use of leverage (for example, through the use of derivatives, margins and other forms of unsecured or collateralised borrowing) can give rise to liquidity risk. For example, a decline in the market value of a position can trigger the need for additional collateral or margins, potentially resulting in the forced liquidation of securities under adverse conditions if the firm does not have access to other readily available liquid resources.

Liquidity in a wind-down situation

With both the current FOR and the relevance of resolution/wind-down for investment firms, requiring a firm to hold a certain amount of capital (own funds)—effectively on the 'liabilities' side (of the balance sheet)—is only one part of the story. If one of the key purposes of a prudential regime for investment firms is to help them manage the impact of failure (on customers and markets)—ideally through a more orderly wind-down of the business—then one also needs to consider the 'asset' side of the equation: what does the firm have on the assets side of the balance sheet? In other words, an investment firm should also be expected to have sufficient cash or other liquid assets in order to pay for its obligations while winding down.

c. Issues to consider when designing a quantitative liquidity regime for investment firms

Quantitative measures

There are numerous options for constructing an investment firm quantitative liquidity measure. These can be summarised under three categories (stock-based measures, flow-based measures and a combination of stock- and flow-based measures). Examples of possible measures are listed below and it is evident that thresholds can be set for any of these measures. Any measure, depending on the ratio that is set, can be used to create liquidity buffers (over and above the firm being liquidity self-sufficient from day-to-day operational cash flows). As explained in Chapter 3 of the report, liquidity buffers may not be appropriate for many types of investment firm.

Stock-based liquidity measures

These measure assets and liabilities at a point in time. Examples include:



- short-term assets/short-term liabilities;
- borrowing value of unencumbered assets/short-term unsecured obligations;
- (cash + un-hypothecated marketable securities)/(short-term unsecured funding + long-term debt);
- used borrowing capacity/available borrowing capacity; and
- holding your own funds requirement in liquid assets (as is specified in the AIFMD).¹¹

Flow-based liquidity measures

These measure cash inflows and outflows over specified time periods. The typical example is a liquidity mismatch report, where cash inflows and outflows are put into maturity buckets. The number and size of maturity buckets can vary to reflect the time horizon over which regulatory authorities want to monitor firms' liquidity profiles. So, for example, the overall time horizon for investment firms is likely to be shorter than the overall time horizon for credit institutions, because investment firms' liquidity is very credit sensitive, making them more likely to experience rapid liquidity problems. Required ratios can be set for one or more of the maturity buckets, and, depending on supervisory requirements, the ratios can differ for different maturity buckets.

A combination of stock- and flow-based measures

These incorporate elements from stock-based and flow-based components. The Delegated Act LCR ratio could be seen as a combined approach, because it compares the current stock of liquid assets to the net cash outflows over a determined time period (in the case of the LCR this is 30 days, but it could conceivably be any appropriate time period). A key issue with combination approaches, similar to one facing flow-based approaches, is determining an appropriate timespan for the flow component.

In addition to there being a number of possible options to measure liquidity, and therefore set quantitative requirements, there are further elements that can be incorporated into a liquidity regime.

Incorporating stressed lenses

Liquidity can be considered through **normal and stressed environment lenses**; so, firms may have excess liquidity in normal market conditions, which can be called upon or drawn down in more difficult market conditions. A key liquidity management question is how easy it is to monetise assets or access contingent funding in more challenging, firm-specific or systemic trading conditions. In this context, it may be appropriate to include stress scenario elements when

¹¹ See Article 9(8) of the AIFMD.



deciding if investment firms have adequate liquidity. The outcomes from the stress scenarios could be used to require firms to hold liquidity buffers. Alternatively, the stress scenarios could be used to monitor firms' susceptibility to liquidity stresses, without requiring a hard and fast liquidity buffer.

So, a key liquidity regime design question is whether liquidity quantitative requirements are set based on normal and/or stressed environments. Conceivably, this could differ depending on the type of investment firm in question.

Reporting

Evidence from domestic liquidity regimes and the CRR is that **regular reporting** is very important when monitoring liquidity risk, including whether firms are meeting any associated Pillar 1 liquidity requirements. Most domestic liquidity regimes, as well as the common reporting (COREP) Implementing Technical Standard (ITS) on supervisory reporting, contain monthly reporting obligations that support Pillar 1 requirements and, in some cases, ask for further liquidity information to form perspectives on firms' liquidity profiles (e.g. maturities and currencies).¹² In addition, if an orderly wind-down approach is the foundation for investment firm resolution, then it would be desirable to receive regular liquidity reporting data (e.g. future maturity mismatch information) in order to identify firms' main sources of liquidity inflows and outflows.

The importance and value of regular liquidity reporting could even raise the question: would a 'reporting only' liquidity requirement suffice for some investment firms, even if for those firms it is decided that it is not necessary to have a binding Pillar 1 liquidity requirement? In this way, a 'reporting only' liquidity solution may, for some investment firms, be seen as a form of proportionality.

d. Applicability of the LCR to investment firms providing MiFID activities (3) and (6)

As mentioned earlier, the Delegated Act LCR has several limitations (conceptually and in the detailed rules) were it to be applied to investment firms providing MiFID activities (3) and (6). Consequently, some possible ways to resolve these issues are:

 Adapt the current Delegated Act LCR framework by removing banking activity-related items and inserting additional provisions on investment firm-specific issues, which guide investment firms on how to calculate their requirements. These could include issues such as: the encumbrance of assets held in credit institutions; the treatment of segregated compensation; links with clearing members; and the relevance of liquidity needs for transactions operated on behalf of clients.

In addition, the calibration of the LCR ratio itself might also need to be reviewed to take into consideration investment firm business models, proportionality, and ensuring a level playing field with credit institutions.

¹² Examples are the German and UK domestic liquidity regimes and the ALMM templates in the CRR.



Finally, and assuming that the current LCR framework could be sufficiently tailored to investment firms' needs, similar reasoning might be applied to ALMM reporting-only templates in order to benefit from the information made available for supervision purposes in a way that enables true consideration of investment firm-specific issues.

- 2) Do not to apply the LCR to in-scope investment firms. This option has some drawbacks for the largest investment firms (which are akin to banking institutions) because the buffer concept can be appropriate for their banking models and may lead to arbitrage opportunities.
- 3) Apply proportionality provisions stipulating that only the very largest investment firms are subject to the Delegated Act LCR, while other investment firms are subject to another liquidity standard (the concepts of which are discussed in the section above and would be designed in phase 2 of the review). This option is appealing, because, as Chapter 3 of the report indicates, the Delegated Act LCR is not an appropriate liquidity standard for all investment firms that undertake MiFID activities (3) and/or (6), and nor would it be appropriate for the vast majority of other types of investment firm.

Option 3 could be tailored so that those investment firms that are subsidiaries of banking groups **may**, subject to supervisory approval, choose to have their individual liquidity requirements calculated based on the Delegated Act LCR, as opposed to an investment firm's liquidity regime.

3.2.5 Large exposures and concentration risk

a. Concepts and definitions

Large exposure risk may be particularly relevant for investment firms that operate in small niche markets and are thus more susceptible to client concentrations. In addition, the typically smaller balance sheet and equity of investment firms (when compared to banks) create the potential for large exposure risk in activities such as depositing the firm's cash with a bank. It may be burdensome and expensive for investment firms, in particular the smaller firms, to diversify such relationships in order to avoid large exposure risk.

Many investment firms are part of larger groups and may, in some cases, solely be performing activities for group companies. Therefore, large exposure risk may arise for investment firms on intra-group exposures that are not settled in a timely manner. However, the current CRR provisions allow competent authorities to fully or partially exempt intra-group exposures from a consolidation group.

The CRR applies the large exposures regime on a consolidated as well as an individual firm basis. In fact, even where an investment firm group has been granted a waiver from consolidated supervision under the CRR, there still remains a requirement to monitor large exposures at the group level.



As identified in the credit risk section, there are a broad range of possible sources of credit risk for investment firms. Below is an attempt to identify the types of exposures that are most likely to create large exposure risk for investment firms:

- exposures to CCPs;
- exposures to exchanges/regulated markets;
- exposures to clearing members;
- margin loans to client;
- client fees and commission owed to the firm;
- deposits with institutions;
- intra-group exposures;
- exposures to securitisations;
- loan/liquidity facilities provided by an asset manager to a fund; and
- underwriting exposures regarding the portion underwritten not being taken up.

The CRR manages some modifications of the large exposures regime that are well tailored for investment activities and firms:

- a particular treatment for trading book exposures allowing an exception to the threshold limit of 25%;
- investment firms not authorised to deal on own account or underwrite on a firm commitment basis, or only authorised to deal on own account in certain limited circumstances (i.e. in the CRR these are the firms falling under Article 95(1) and Article 96), are exempt from the large exposures regime by the CRD II amendments package;¹³
- an exemption from the threshold limit for exposures to institutions with a maturity of one year or less was removed in CRD II. However, in order to avoid requiring an unnecessarily burdensome amount of diversification from smaller banks and investment firms depositing cash in banks, an alternate threshold limit of EUR 150 million (rather than 25% of own funds) was introduced where the exposure is to an institution or to a group of connected counterparties that includes an institution. At the same time, Member State discretion was also included, allowing

¹³ Note that the Commission actually undertook an impact assessment specifically in support of this 'negative scope' provision to exempt certain investment firms from the large exposure provisions.



Member States to reduce the EUR 150 million limit where the Member State felt that this was too high (for example, for small investment firms); and

• the CRR introduced a number of new exemptions to the threshold limit, relating, for instance, to exposures to CCPs and recognised exchanges.

b. Upcoming developments

There are a number of reviews and developments of the large exposures regime ongoing at both the EU and Basel levels. As required by Article 507 of the CRR, the Commission is reviewing a number of exemptions set out in the current large exposures regime, including the exemption for trade exposures and default fund contributions to central counterparties, as well as all of the (discretionary) exemptions set out in Article 400(2) of the CRR.

With regard to these developments, the following points are relevant for investment firms:

- whereas the current EU regime allows firms to exceed the 25% limit on their trading book in certain circumstances, the Basel standard does not include this option;
- the CRR introduced an exemption from the large exposure limit for trade exposures and default fund contributions to central counterparties (CCPs). This is one of the exemptions currently under review by the Commission (point (j) of Article 400(1) of the CRR). The Basel standard notes that the Basel Committee will consider the appropriateness of applying a limit to CCPs after an observation period to be concluded in 2016. In the meantime, the Basel standard stipulates that exposures to CCPs can be exempt from the large exposure limit, provided they relate to clearing activities; and
- CRD IV also introduced a discretionary exemption (point (k) of Article 400(2)) for exposures to recognised exchanges, i.e. regulated markets that have a clearing mechanism whereby derivative contracts are subject to daily margin requirements providing appropriate protection. Under the new Basel standard, it would appear that such exposures would be subject to the large exposure threshold limit.

The current large exposures regime includes a discretionary exemption from the large exposure limit for certain intra-group exposures (point (c) of Article 400(2) of the CRR), whereas the new Basel standard does not address the treatment of intragroup exposures due to the various complexities involved.

c. Main issues

The following aspects of both the current large exposures regime and the impending changes to the regime require consideration in the context of an appropriate prudential regime for investment firms.



Scope

CRD II exempted certain investment firms from the CRD large exposures regime, with the goal of avoiding 'unwarranted compliance costs for certain types of investment firms'. Responses to the public consultation had noted concerns that the regime was not fit for purpose for investment managers, whose large exposures normally take the form of accrued fees from their clients. The argument was that the better the investment performed, the larger the fee and therefore the larger the exposure—thus the regime was punishing success. In addition, it was noted that client assets would be safeguarded in the event of the failure of such a firm because they would be segregated.

A number of points arise from this for consideration. Firstly, in relation to accrued client fees, it is possible that the client may fail and the firm may not receive payment of the fees. In addition, such firms may also incur large exposures by depositing funds with banks, making them vulnerable to a bank failure. The question arises as to whether it remains appropriate to give these categories of firms a blanket exemption from the large exposure rules.

Client money

As part of their business model, certain investment firms hold client money. This client money is generally deposited in bank accounts set up by the firm. These are sometimes accounts set up by the firm for individual clients, and they are sometimes pooled bank accounts. The firm is generally the legal owner/operator of the bank account in both scenarios; however, the account should be identifiable as holding client money rather than the firm's own money, and therefore segregated in the event of insolvency of the investment firm.

Accounting rules are not prescriptive in relation to how firms should account for client money. Certain investment firms do not record client money on their balance sheet, whereas other firms recognise an asset for client money—reflecting the cash the firm has deposited in a bank account—and simultaneously record a corresponding liability to reflect their obligation to the client for the amount concerned.

Among others, this creates an issue in relation to the large exposure rules under the CRR. Article 389 of the CRR defines 'exposures', for the purpose of the large exposure rules, as 'any asset or off-balance sheet item referred to in Part Three, Title II, Chapter 2, without applying the risk weights or degrees of risk'. As this definition includes 'any asset', it would appear to include any client money if the investment firm recognises this as an asset. Firms may hold large amounts of client money and may deposit this money with the same bank or banks that they use for their own money; thus, if a firm accounts for client money by recognising it as an asset on its balance sheet, it is likely that large exposures will arise when this application of the current large exposures regime is used.

In reality, in this type of scenario, the nature of the large exposure risk that exists for the investment firm depends on the extent of the firm's specific obligations to the client under national law and, when applicable, under the terms of the agreement between the firm and the



client. For instance, if or when the firm is legally and/or contractually obliged to make good any loss to the client upon the failure of the bank where the client's money is held, then there certainly is a large exposure risk to the firm. However, there are in practice circumstances where neither the national law nor the contractual arrangements entered into between the firm and its client include such an obligation for the firm; in these cases, it is the client who is to suffer loss in the event of the failure of the third-party depositary bank. Arguably, there may still be an impact on the investment firm; for instance, on its reputation. Although not legally obliged to make good on the loss to the client, the firm may choose to do so to protect its reputation.

The question arises, then, of whether there should be an addition or change to the current large exposure rules for investment firms in order to provide clarity on how client money should be treated.

Trading book

The current large exposures regime allows trading firms to exceed the 25% threshold limit on their trading book provided they meet certain criteria, including holding additional capital. This treatment allows smaller trading firms (and banks) to compete with larger banks and investment firms. It is noted that the new proposed Basel standard does not include this option.

The question arises as to whether it is appropriate to continue to afford investment firms this treatment in light of the new Basel standard. The CRR currently allows this exception for banks as well as investment firms that meet the relevant criteria.

Exposures to clearing members

Currently, the CRR large exposures regime includes an exemption from the threshold limit for trade exposures and default fund contributions to CCPs and includes competent authority discretion to exempt exposures to recognised exchanges. (It may be difficult for institutions to diversify exposures sufficiently given the limited number of CCPs and exchanges and, where it is possible, it may be burdensome and costly.)

A similar situation arises for investment firms that deal on own account in relation to their exposures to clearing members.

There is also a separate consideration concerning investment firms' exposures to clearing members. As part of the operational relationship between an investment firm dealing on own account and its clearing member(s), the clearing member(s) will sometimes hold the investment firm's assets (cash and financial instruments) in custody for the firm. In this type of arrangement, the firm's cash and assets should be bankruptcy remote from the clearing member's assets, thus in the event that the clearing member fails the investment firm's assets should be returned to the firm (although there would potentially be a delay and therefore disruption for the investment firm). It should be noted that, in certain cases, an investment firm's assets held with a clearing member may be re-hypothecated by that clearing member—in this situation, the investment firm's assets would not be bankruptcy remote from those of the clearing member. The CRR large



exposures regime is currently silent in relation to the treatment of an investment firm's assets held in custody by a clearing member, and it may be necessary to provide clarity on the treatment of these assets in any new proposed regime.

d. Scope

The question is whether it is appropriate to give an exemption from the large exposure rules to certain categories of investment firm (e.g. investment managers). A potential way forward on this may instead be to consider certain exposures of these firms for which an exemption may be warranted; for instance, large client fees that are accrued but not yet paid within a particular time limit, such as 30 days.

The appropriate approach to take for large exposure risk for investment firms may depend on whether a 'going concern' or 'gone concern' prudential model is being applied to these firms. The CRD II exemption is consistent with a 'gone concern' regulatory approach. It was considered that, in the event of such a firm failing and winding down, client assets are still safeguarded as they are bankruptcy remote. In reality, however, there may still be disruption for clients, in particular in the case of a larger asset manager. As such, the appropriate application of the large exposure rules is linked here to the other risk components, the general categorisation of firms, and the overall prudential approach for each category.

Further policy options to be considered may include applying a lighter large exposures regime to firms in tiers 2 and 3, with an emphasis on large exposures reporting, while applying a full large exposures regime to firms in tier 1.

e. Securitisations

Given the potential for increasing exposures in securitisations by MiFID investment firms and AIFMD management firms, possible ways forward to address this **may include aggregating 'retentions' or even other holdings if arising from securitisations with a common 'originator' or 'original lender' (albeit separate SPVs each time)**.

f. Client money

With regards to the question of whether there should be an addition or change to the current large exposure rules for investment firms in order to provide clarity on how client money should be treated, it may be appropriate to explicitly link the treatment to the firm's specific obligations to the client under applicable national legislation and the terms of the relevant agreement between the firm and the client.

g. Trading book

The proposed new Basel standard on large exposures does not include the trading book treatment allowed under the current large exposure regime, whereby trading firms may exceed the 25% threshold limit on their trading book provided they meet certain criteria, including holding additional capital. It is noted that this treatment allows smaller trading firms (and banks)



to compete with larger banks and investment banks, and so **consideration could be given to introducing firm/trading size criteria as a prerequisite for using this exception**.

h. Exposures to clearing members

The issue of an investment firm's exposures to clearing members raises two questions. Firstly, whether there should be an exemption/exception for investment firms' exposures to clearing members, similar to the treatments allowed in the current large exposures regime for exposures to CCPs and recognised exchanges. Secondly, whether there should be clarity provided with regard to the treatment of investment firms' exposures to clearing members where the clearing member is holding the investment firm's assets (cash and financial instruments) in custody for the firm.

On the first question, potential ways forward may include introducing a particular treatment for investment firms' exposures to clearing members. This could perhaps be in the form of a higher limit than 25%. It could also potentially be limited to smaller firms or firms that have no external clients or both, and in that regard it links to the categorisation of the firm and other risk papers, as it depends, to an extent, on the prudential approach we are adopting for such firms.

On the second question, potential ways forward may include an exemption from the large exposures threshold limit for these assets where they are bankruptcy remote from those of the clearing member, similar to the treatment allowed for the calculation of credit risk under Articles 305 and 306 of the CRR.

3.2.6 Leverage risk

a. Concepts and definitions

Excessive leverage can be said to occur when a firm over extends the amount of business it conducts (on or off balance sheet) relative to the amount of capital it holds.

b. Overview of the current framework

According to Article 6(5) of the CRR, only investment firms that may act as proprietary traders (but also have external clients), and are subject to capital requirements in accordance with Article 92, are subject to the obligations on leverage. Those obligations are initially to report on, and subsequently disclose, the calculation of a leverage ratio. However, it is intended that final adjustments to the definition and calibration of the leverage ratio will be made by 2017, with a view to migration to a binding minimum or a Pillar 1 type treatment on 1 January 2018.

c. Main issues

The use of a leverage ratio might help constrain an institution from over extension of credit where the traditional risk-weighted own funds ratio might not.



Some investment services and activities are not exempt from leverage, especially via trading positions. Initial experience with reporting on leverage suggests that the calculation of a leverage ratio may be rather volatile for (non-systemic) investment firms, whereas the 'deleveraging' of the majority of trading assets could be achieved in a fairly short time.

3.3 Analysis of investment firms' prudential regime

3.3.1 Capital requirements

a. Initial capital

Differences between initial capital and own funds

The prudential capital requirements for credit institutions and investment firms are divided into two separate requirements: the initial capital requirement, and the own funds requirement.

The distinction between initial capital and own funds is especially relevant when applying Article 93 of the CRR. This Article states that the own funds requirement of an investment firm (or credit institution) may never be lower than the applicable amount of initial capital. This leads to difficulty in determining which definition of capital should be used. The initial capital of an investment firm is only defined as the positive instrument without deductions. For the own funds requirement of an investment firm, the firm has to apply deductions. Given that Article 93 is formulated as a minimum level of the own funds requirement, one has to make the assumption that the amount of initial capital has to be met with regulatory capital that complies with Part Two as a whole, including the deductions. The CRR text, however, does not make it explicit which capital definition should be used for compliance with Article 93.

The current way of calculating the available initial capital does not capture all (prudential) valuations and deductions of balance sheet items that are included in the calculation of available own funds. The result is such that, especially given Article 93 of the CRR, supervisors are left with an initial capital requirement that can be met with items that may not meet supervisory expectations.

Levels of initial capital requirements

The initial capital requirements in the CRD IV regime (i.e. the EUR 50 000, 125 000 or 730 000 requirements) contain fixed amounts. These levels have been set in the Directive itself and are therefore not necessarily reflective of the risks taken by an investment firm. The levels of the initial capital requirement were only originally set on the assumption that the activities performed by the investment firm are a measure of risk. This also raises the question of whether different levels of initial capital would still be required should any 'simplified' regime be introduced for the vast majority of investment sector firms. To this extent, it should be noted that a common practice across the EU has been to tailor the level of initial capital required, often requiring higher amounts to be held by investment firms to be granted an authorisation. This state of play leads to



a fragmented landscape, and may stem from national understanding and appreciation of the risks underlying each investment service or activity, and through that their proper definition.

Moreover, the levels of the initial capital requirement were introduced in the first version of the CAD, which was published in 1993¹⁴ and has never since been corrected for, say, the applicable inflation within the EU or any other metric; thus, the relative level of the initial capital requirement has since become increasingly lower.

b. Quality of capital

Prior to the CRR, the BCD and the CAD were less restrictive with regards to the quality of capital (in terms of the items that could count as own funds, the 'tiers' that these fell into, and the relative maximum proportions of total own funds that could comprise each tier). In particular, there was less emphasis on what the CRR now calls Common Equity Tier 1 (or CET 1), and hence it was possible for a greater proportion of an institution's minimum capital requirement to be met with 'lower' quality tiers of capital, such as subordinated loans.

The CAD also provided for investment firms (through various derogations and competent authority discretions) to calculate their own funds in a number of slightly different ways¹⁵ (that were not available to credit institutions) intended to better reflect their different business models and risk profiles; these methods included the deduction of illiquid assets (as defined) and the ability to use much greater proportions of subordinated loan capital.

One of the features that some investment firms, such as proprietary traders, made use of under the CAD was the ability to use Tier 3 capital—short-term (up to two years' maturity) subordinated debt. The idea was that short-term capital was sufficient to support the changing level of short-term risk associated with the marketable assets held within the firm's trading book.

CRD IV: strengthening quality of capital and loss-absorbing capacity

The strengthening of the quality of capital and the emphasis on CET 1 under CRD IV reflect the lessons of the banking crisis, where various credit institutions had to receive public/taxpayer support to prevent them from failing. In some cases it was not actually a question of the bank not having enough capital overall, but rather that it did not have the 'right' type of capital—namely enough capital that could be loss absorbent while allowing the bank to continue to trade.

This was because while lower quality capital, such as subordinated debt, does help a firm meet its obligations to its creditors (i.e. the claims of the holders of such instruments would be subordinated to those of all other creditors other than the holders of higher quality capital

¹⁴ See Article 3 of Directive 93/6/EC, where the initial capital requirements are defined in ECU.

¹⁵ See Articles 13-15 of the (now repealed) Directive 2006/49/EC. Article 22 of the CAD also mandated the method of calculating own funds for investment firms granted a waiver from consolidated supervision.



instruments, such as shares), and coupon payments can be forgone, the principal amount of lower quality capital could really only absorb losses once a firm had become insolvent.¹⁶

One of the key questions to answer for investment firms, therefore, is to what extent the quality of capital is important compared to the focus on CET 1 for credit institutions under the CRR.

Focus on providing for impact of failure/wind-down of investment firms

For the vast majority of investment firms, prudential requirements can also serve a different purpose; as well as providing some security against sudden failure from unexpected risks, on the general assumption that investment firms may nevertheless be allowed to fail, capital also helps to provide a means of dealing with the impact of failure and/or time to wind down a firm.

With this in mind, one possible option may be to view the quality of capital as being less important for an investment firm since it should rather be used for a 'gone concern' perspective; from this perspective, Tier 2 capital—subordinated to the claims of other (non-capital) liabilities when a firm has failed—remains helpful. This view was previously reflected in the various discretions on the composition of own funds for investment firms allowed by the CAD, which is nowadays taken on board with the minimum requirement of eligible liabilities (MREL) of the Bank Recovery and Resolution Directive (BRRD).

On the other hand, an alternative view is that the quality of capital is just as important for an investment firm. If a firm needs to be allowed time to manage the impact of its failure and ensure an orderly wind-down of its affairs, then it is reasonable to expect that the firm will experience operating losses during this (wind-down) period, and hence having sufficient loss absorbent capital will be important.

In considering the capital quality appropriate for investment firms, it may then be necessary to in turn consider the relevant proportions that can be allowed between different types or tiers of capital (e.g. the extent of 'gearing' permissible between, say, CET 1, AT 1 and Tier 2 items).

Deductions, prudential filters, and conditions for capital items

In order that the EU may implement the Basel III agreement for banks, the move to the CRD IV definitions of capital has also meant that there is now a stricter set of deductions from own funds, and, moreover, predominantly from CET 1. However, some items already had to be deducted under the BCD/CAD—notably intangible assets such as goodwill—and this particular treatment would still seem appropriate for investment firms even under a wind-down approach (as failure would mean there was no longer time for such an asset to generate its implied value).

¹⁶ A more recent development has been the issuance by some banks of contingent capital—essentially lower quality capital instruments that can either be converted into higher quality capital instruments or written-down, thereby helping to absorb losses while the firm continues to trade. However, such developments add to the overall complexity and cost of capital, and do not of themselves necessarily justify examining quality of capital for investment firms separately.



The change has also seen the removal of the ability to use prudential filters (for example, under the BCD/CAD it was possible to use an actuarial adjustment for deduction of a defined benefit pension scheme deficit, rather than the full IFRS market value now required). Furthermore, capital items must now meet stricter criteria to qualify for use as own funds under CRD IV.

It is difficult to generalise on these issues for investment firms; as with credit institutions, some individual firms may experience difficulties with individual aspects of these changes. A more detailed analysis across the individual provisions in these areas may be necessary to determine whether there are any aspects that may not be justified within a new framework for investment sector firms.

Non-joint stock investment firms

Article 13(1) of the CAD ensured that the provisions specifying the quality of capital (own funds) should also apply to investment firms that do not have one of the legal forms specified in the relevant accounting directives that apply to limited companies. This was in recognition of the fact that it is not uncommon for investment sector firms (which also tend to be smaller enterprises) to operate in other legal forms, such as partnerships and limited liability partnerships (LLPs), or even as a single natural person. However, under the CRR this provision does not exist, and the emphasis is only on joint stock companies and mutual credit institutions (as may be seen in the requirements surrounding CET instruments and their conditions).

It was obviously not the intention of CRD IV to require non-joint stock firms (and there are also some jurisdictions with partnership banks as well as investment firms) to have to convert legal form or cease trading. But for the avoidance of doubt, it will be important to ensure that any subsequent proposals on own funds for investment firms properly recognise the valid existence of non-joint stock entities.

3.3.2 Fixed overhead requirement

The fixed overhead requirement (FOR) was first introduced under the original CAD as part of the prudential requirements for investment firms subject to the then ISD. It has been carried forward since then, essentially unchanged, first through the subsequent versions of the CAD and now into the CRR. Under this legislation, the FOR has only ever applied to certain investment firms and not to credit institutions.

Under Article 97 of the CRR, the requirement is for the relevant firms to hold eligible capital of at least one quarter of the fixed overheads of the preceding year. Commission Delegated Regulation (EU) No 488/2015 of 4 September 2014 amends Delegated Regulation (EU) No 241/2014 with regards to own funds requirements for firms based on fixed overheads, specifying conditions for FOR calculations¹⁷.

¹⁷ OJ L 78, 24.3.2015, pp.1-4.



It should be noted that, under the CAD, the use of the FOR was via a derogation from firms having to apply the sum of credit, market, foreign exchange, commodities and operational risk requirements, and was only available at the discretion of a competent authority. Under the CRR, however, this discretionary use of the FOR has become a mandatory treatment.

a. Purpose of the FOR

The FOR is used for several sets of firms. While it is possible that the original intended purpose may have been different for each population, the same arguments may apply to most or all types of investment firm.

Firstly, we consider those subject to the provisions of Article 95 of the CRR. Here, the requirement is essentially the higher of the risk-based requirements set out in Article 92(3) of the CRR and the FOR. The origins of this suggest that the FOR was viewed more as a way of dealing with these firms on a 'when they fail' basis (sometimes referred to as a 'gone concern' basis) and where they did not have much balance sheet risk (i.e. where the risk-based requirements were lower than the FOR component, although this is not always the case for all relevant investment firms, since for a minority the risk-based requirements can exceed the FOR).

In other words, it may be more of a way to ensure that such firms hold capital to help them 'fail' in a more orderly/less disorderly manner. The FOR would ensure that there is capital to support a wind-down of the business. This would seem directly relevant to mitigating the risk to investors.

Secondly, we consider investment firms subject to the provisions of Article 96 of the CRR. Here, the requirement is the sum of the risk-based requirements set out in Article 92(3) of the CRR—excluding operational risk—and the FOR. Here, the FOR effectively substitutes for operational risk, which might suggest that the former is viewed as a 'proxy' for the latter. This would seem directly relevant to mitigating the 'risk of loss to firms', but, depending upon how operational risk is treated, it could also help to mitigate 'risk to investors' and 'risk to market confidence'.

Thirdly, the FOR, as set out in the CRR, also has to be applied by AIFMD and UCITS management firms, as part of calculating their overall capital requirements; for such firms, their own funds requirements under those respective pieces of EU legislation can never be less than the FOR as calculated under the CRR. It is not entirely clear whether this is intended for the purposes of any wind-down, although if the assumption that the FOR is intended as a wind-down requirement for investment firms is accepted, then the same assumption should hold for AIFMD and UCITS management firms. Any change in the application of the FOR proposed for investment firms should, therefore, also be considered when applying FOR to AIFMD and UCITS management firms.

b. Why one quarter's worth of overheads?

The FOR has always been set at one quarter of the fixed overheads of the preceding year (i.e. three months' worth). If one accepts that the purpose of the FOR is to help ensure that the investment firm can wind down, then the assumption has always been that a minimum of three months is a sufficient period during which the firm can deal with its affairs and those of its



clients/investors, without causing harm, before closing its doors. This can provide a period of time to deal with risk to investors before a firm fails/closes.

However, the regulatory experience of some, but not all, competent authorities has shown that, in practice, firms do not necessarily wind down in a simple, orderly manner. In this context, it may not be unusual for a well-prepared analysis from a firm that adopts a prudent approach to risk management to suggest that the firm would require between at least nine and twelve months' worth of current expenditure to meet all its obligations to stakeholders if winding down/closing under stressed conditions.

c. Is fixed overheads (expenditure) the most appropriate metric?

The use of fixed overheads, which is essentially an expenditure-based method, has drawbacks:

- basing prudential standards upon expenditure/fixed overheads can discourage firms from investing in their business, as they will face an increased capital requirement (before such an investment can bear fruit);
- this metric can also lead to different treatment being afforded to different firms according to their business model and how they structure their firm, rather than the risks they run (for example, a firm could operate with self-employed staff or through tied agents); and
- it can also be 'gamed' fairly easily, with firms reporting figures much lower than what would be realistic for operating the business; for example, it may be booked in a group service company or even borne by an entity outside a consolidation group (although the regulatory technical standard on the FOR seeks to mitigate this risk).¹⁸

The use of the FOR also has advantages:

- notwithstanding any discussions on which costs should be deemed fixed and which costs should be deemed variable, it represents a relatively easy and straightforward minimum Pillar 1 capital requirement;
- for firms falling under Article 96 of the CRR, the FOR alleviates the need to apply the current Pillar 1 operational risk requirements (although it does not remove the need to consider, assess and quantify operational risk under Pillar 2); and
- under the AIFMD, the use of the FOR is combined with a liquidity requirement, whereby capital must be held in liquid assets, which helps ensure AIFMD management firms keep funds readily available with which to make good any harm arising in respect of 'risks to investors' (albeit that this approach is not tailored to address the specific liquidity risks of an individual firm).

¹⁸ See the Delegated Act here: <u>http://ec.europa.eu/transparency/regdoc/rep/3/2014/EN/3-2014-6200-EN-F1-1.Pdf</u>



These examples would suggest that, if accepting the use of the FOR as a continuing requirement, modifications would need to be made to better capture the costs of a firm (for helping to ensure a more orderly wind-down or to manage the impact of the firm's failure on customers). The FOR should, for instance, better account for the costs of the group to which the investment firm belongs, to prevent it from effectively outsourcing expenditure on overheads by booking the cost to another group entity outside any consolidation group. The period for which the firm might need to continue to exist to take care of both its affairs and those of its customers would also need to be further explored.

3.3.3 Qualifying holdings outside the financial sector

a. Concepts and definitions

Basel Committee/Joint Forum guidance states that, for the purposes of conglomerate capital assessments, supervisors must ensure that all group-wide risks are appropriately captured, including those arising from non-regulated entities. It also recommends that risks arising from non-regulated entities should be captured either through a capital charge, which represents a proxy of these risks, or through a deduction of the amount invested in those entities. Where risks have been transferred from a regulated entity to a non-regulated entity of the group, supervisors must be able to look through and assess the size and quality of the underlying risk exposures.

Examples of situations where additional capital requirements could be considered are:

- insufficient sector-level capital requirements;
- concerns about contagion risks caused by the complexity of the group structure;
- concerns about the risks posed by any specific investments that a financial conglomerate has entered into.

But that brings us back to the question of why are we keeping securities firms alive? Is the CRR's treatment of qualifying holdings outside the financial sector appropriate for such firms, which are often part of smaller financial or mixed activity groups, rather than part of financial conglomerates? In keeping securities firms alive, we seek to protect investors, promote fair, efficient and transparent markets, and, where relevant, reduce systemic risk. The sections below consider whether and how the CRR's treatment of qualifying holdings outside the financial sector helps to achieve these goals.

Qualifying holding rules limit the ability of institutions to invest in certain entities. On the other hand, these rules limit the amount of financial sector capital used to support non-financial sector entities and, as with banks, there is the potential that an investment firm may be part of a wider mixed business activity group—therefore, the risks that the qualifying holding rule seeks to mitigate can be relevant for investment firms as well as banks.



In this regard, it should be noted that the CRR consolidated supervision rules apply at the level of a parent financial holding company or a parent mixed financial holding company (of a conglomerate). In practice, the holding companies of some investment firms are mixed activity holding companies (Article 4(22) of the CRR) and these may contain substantial and varied groupwide risks. Consolidated supervision would not apply in the case of a mixed activity holding company serving as a parent. In addition, it should be noted that, even where consolidated supervision does apply, non-financial entities are out of the scope of the actual consolidation because prudential consolidation is different to accounting consolidation, so consolidation is not necessarily going to capture the risks that those entities may pose. Therefore, there may be a reason for keeping the CRR treatment of qualifying holdings outside the financial sector for investment firms, or at least for seeking to address these prudential risks in another way.

b. Policy options

The question of whether the CRR's treatment of qualifying holdings outside the financial sector is suitable for investment firms was raised in Chapter 3, particularly in relation to smaller firms that do not pose systemic risk, given that investment firms were not within the scope of this rule prior to the introduction of the CRR and that the Basel framework was designed with internationally active banks in mind. As previously noted, the rule limits investment firms' ability to invest in certain entities, or makes it expensive for them to do so, and it is unclear whether this is justified for smaller investment firms.

Potential policy options include considering whether the cost-benefit analysis justifies applying the CRR treatment of qualifying holdings outside the financial sector to investment firms or whether a lighter regime may be more appropriate. A lighter regime could include reporting requirements and monitoring exposures and transactions between investment firms and nonfinancial entities in which investment firms have qualifying holdings.

3.3.4 Deductions from capital for non-significant holdings in financial sector entities

a. Concepts and definitions

Where a bank or investment firm has an investment in a financial sector entity (a banking, financial or insurance entity) and that entity is outside the scope of regulatory consolidation, there arises a risk that capital will be double counted in the financial system. If losses are simultaneously incurred by both the investor and investee in this scenario, there may not be adequate capital to cover these losses and to support both entities on a 'going concern' basis.

In order to address this risk of double counting of capital and limit contagion risk in the financial system, the CRR requires that banks and investment firms make deductions from their own funds for any investments in financial sector entities that are outside the scope of regulatory consolidation. Deductions are made for both significant and non-significant investments in such entities, with the main distinguishing factor in relation to 'significance' being whether or not the level of the investment amounts to more than 10% of the issued share capital of the financial sector entity.



While it is clear that this risk is relevant for investment firms and is an important risk to mitigate to ensure the stability of the financial system, this section addresses a particular issue with the rules on deductions for non-significant investments in financial sector entities that arises for certain securities firms.

b. Overview of the current legislative framework

Article 36 of the CRR requires that banks and investment firms shall deduct from Common Equity Tier 1 any significant and non-significant investments in the Common Equity Tier 1 instruments of financial sector entities. Financial sector entities are defined in subparagraph 27 of Article 4(1) of the CRR and include banking, financial and insurance entities.

Articles 46, 47 and 48 specify the exact amount that must be deducted from Common Equity Tier 1 for both significant and non-significant investments; however, the first step is determining whether or not an investment in a financial sector entity is significant.

Article 43 of the CRR sets out the criteria for determining whether an investment in a financial sector entity is significant or non-significant. Non-significant investments are generally those where the investing firm does not own more than 10% of the issued share capital of the financial sector entity; however, in certain cases—where the financial sector entity is an affiliate of the investing firm—ownership of less than 10% can constitute a significant investment.

Articles 45 and 75 of the CRR specify rules on exactly how to calculate the level of the investment. It is the net long position across both the banking and trading book that is to be included. When calculating this net long position, long positions can only be offset by short positions according to very specific criteria. These criteria effectively exclude short call option positions with a residual maturity of less than one year, unless the maturity date exactly matches that of the long position.

c. Main issues

The above rules around the calculation of net long positions in order to determine the level of investment in a financial sector entity create difficulties for certain securities firms, particularly market making firms. Market making firms buy and sell positions on a daily or intra-day basis, trading in large volumes and typically not holding positions to maturity. Given this business model, they may not seek to maturity match their hedges. Consider the following example:

As part of its market-making requirements, a firm may sell a call option (on the stock of a financial company) that matures in three months' time and hedge it delta neutral by buying the appropriate amount of that same stock. This structure contains no residual exposure to the financial sector entity. However, for the purposes of the financial sector entity deduction, this structure translates into a long physical holding in a financial sector entity, which can only be offset by a short position with a residual time to maturity of one year. As the short call position matures in three months' time, it cannot be used to provide offset. Therefore, even though the position contains no residual exposure to the financial sector entity, a deduction may need to be



made from the firm's Common Equity Tier 1 (depending on the level of this investment and other investments in financial sector entities).

As market making firms trade in large volumes, they may have many investments in financial sector entities that they must monitor and, depending on the individual and aggregate level of these investments, deduct from their own funds (these typically fall under the non-significant investment rules). The maturity matching requirement for hedges to be allowed to offset positions creates a large amount of complexity and a high system cost for these firms, as well as an additional capital cost where a deduction must be made. This raises the question of whether the cost–benefit balance is correct here for positions that are delta neutral at a point in time and are not intended to be, nor in practice are, held to maturity.

d. Policy options

Potential policy options for consideration include allowing the net long exposure to a financial sector entity to be calculated as the simple net delta exposure, thereby allowing all longs and shorts written on the same underlying instrument to be netted irrespective of the expiration date of the various instruments. This treatment could be limited to trading book positions and/or to certain categories of firm, such as market making investment firms.

3.3.5 Client money and securities requirements

Up until 31 December 2013, for the purposes of prudential requirements, Article 3 of Directive 2006/49/EC of the CAD defined an 'investment firm' with reference to institutions that met the definition of that same term in Directive 2004/39/EC of the MiFID and that are subject to the requirements of that Directive. A series of exclusions are then applied (in the CAD).

The introduction of the CRD IV package then saw those exclusions extended in Article 4(1)(2)(c) of Regulation 575/2013 of the CRR. One of the key features of this change is that any firms that hold client money (or securities belonging to their clients) remained 'investment firms' under the CRR and hence subject to its requirements. However, certain other businesses that conducted the same activities and services under the MiFID, just without holding client money, did not fall under the (full) CRR, and so may benefit from different (lesser) prudential treatment.

This section seeks to explore this distinction, which was introduced under the CRR, and whether or not it might be justified.

a. Analysis of EU requirements

First, it should be noted that while holding client money is not per se a MiFID service or activity, it is a modality through which several such services or activities may be performed (depending upon the possibility for an investment firm to do so under national law).

Up until the implementation of CRD IV, the holding of client money was never a distinguishing factor that determined the own funds (or other prudential) requirements that would apply to a MiFID investment firm that was also required to apply the relevant requirements of the CAD,



other than simply in respect of the minimum level of initial capital required as a condition for (continued) authorisation.

According to Article 28(2) of the CRD—and previously under the CAD—the 'default' requirement for all investment firms not otherwise mentioned is an initial capital of EUR 730 000, with CRD Article 29(1) then providing for the initial capital of particular types of investment firm (which do not deal on own account or underwrite) that also hold client money to be the lower amount of EUR 125 000. CRD Article 29(3) then provides for Member State discretion to reduce this sum (EUR 125 000) to EUR 50 000 where the same type of firm does not hold client money. What this may suggest is that (up until CRD IV):

- the only (additional) prudential requirement specifically related to client money has been to have additional initial capital (of EUR 75 000);
- even this may not be 'additional' where a Member State has not exercised discretion (which could suggest that some did not see a meaningful distinction at the time of the original CAD as far back as in 1993); and
- there are some MiFID services and activities (e.g. placing without a firm commitment, operating an MTF) that are not explicitly covered by Article 29 of the CRD, and so a firm conducting those has to hold the higher amount of initial capital of EUR 730 000, without necessarily any clearly articulated reasoning for this.

It seems as if the only prudential relevance (prior to the CRD IV change in the definition of 'investment firm') of holding client money was in terms of the conditions for authorisation, via the level of initial capital, which do not vary irrespective of the amount of client money that a firm holds (hence it could not properly be said to be 'risk-based').

The prudential requirements of CRD IV (and previously the BCD/CAD) are designed more for institutions, which tend to have material balance sheet risk and address the risk of losses arising from this; by definition, client money does not belong to the firm. Therefore, the CRR requirements, such as credit risk or market risk, relate to the former and are not designed for the latter.

Instead, client money has been viewed as a 'conduct' risk rather than a prudential one, and as such the relevant (minimum) EU protections for this are set out in the MiFID.¹⁹ These include requirements around the safeguarding (segregation) of client funds. The discussion over these requirements needing to be supplemented by capital ones has only been raised recently. Even though conduct risk is considered within the operational risk calculations, the current prudential framework does not deal with client money risk in the whole CRR despite this risk being of a financial nature and becoming increasingly significant. The EBA has taken the conduct risk into

¹⁹ In particular, Articles 13(7) and 13(8) of Directive 2004/39/EC and Section 3 of implementing Commission Directive 2006/73/EC.



account when developing Regulatory technical standard (RTS) on prudential requirements for central securities depositories (CSDs).

b. Client money as a prudential risk

As an indication of the above point about the use of conduct requirements to address client money risk, other than initial capital (see above), the capital requirements have never contained anything specific to the risks attached to a firm holding client money. That risk might be said to be that upon the 'failure' of the firm there is found to be a shortfall in the client money balance.

Considering client money as a prudential risk depends largely on the emphasis put on the investment firm's own liability towards the holdings of its clients. This may vary significantly among jurisdictions and lead to diverging prudential treatment across the EU. Indeed, for those national regimes where holdings of client money and securities require an investment firm to assign claims and liabilities to corresponding client accounts on its balance sheet, and to contribute to a mandatory institutional guaranty scheme, those holdings do materialise prudential risk, which is thoroughly taken into account in the event of the failure/wind-down of the business. Holding client money and securities may thus be of the utmost importance when defining the appropriate prudential regime and the adequate supervisory scrutiny of investment firms, no matter their absolute size or systemic importance.

In the absence of clear insight into the treatment of holdings of client money and securities, defining a uniform prudential treatment for holdings of client money may not be an easy task.

It was deemed desirable to seek to somehow cover this risk with prudential requirements as well as conduct ones—by, say, making a firm hold capital from which to make good any shortfalls in client balances. This could require the development of a new treatment that the CRR does not address specifically for the above-mentioned reasons.

Furthermore, across the EU, depending upon national law, some firms carry out MiFID services and activities, such as portfolio management or execution of orders on behalf of clients, without holding client money, while other firms hold client money when performing those services. However, firms that decide not to or are not allowed to hold client money often structure their contractual relationships with their clients in a way that enables them to have a certain level of control over client money held by a third party.²⁰

Consequently, both firms that hold client money and those that do not, but otherwise conduct the same MiFID services and activities, have the potential to cause different, yet material, harm to consumers and/or dislocation in their markets; this is 'outside' of risks on/to their own balance sheet, and therefore even a smaller firm has the potential to 'gear-up' the level of client risk it can create.

²⁰ The UK trade body, the Investment Association, even provides template documentation for such contractual arrangements on its website.



c. Supervision aspects

None of the above is necessarily intended to suggest that there are no additional risks for firms holding client money, nor to prejudge whether such firms do or do not require adequate levels of capital. But rather this is not something that the CRR capital requirements currently address, either consciously or by default. However, there is the more general point that setting prudential requirements for any type of firm allows for a more consistent and simple way (e.g. alerts based upon reporting) for supervisors to monitor the financial health of firms.

To the extent that a firm holds client money, this may present an additional reason to detect financial problems at the firm that might then drive risk-taking and non-compliant behaviour—such as, say, the temptation to 'borrow' client funds for the firm's own purposes (leading to supervisors being justified to take mitigating action through, say, a visit to the firm to check on controls around client money reconciliations). But, equally, the same can be said of other regulatory/conduct risks—such as the temptation to mis-sell or mis-price a trade, not deliver the best execution, not ask potential clients questions about the source of their business/funds, etc.

3.3.6 Consolidation- and group risk-related requirements

a. EU legislative requirements

The requirement to apply consolidated supervision to an investment firm group stretches back to the original CAD in 1993. This is now carried through into Article 11 of the CRR.

Also dating back to the original CAD, and now carried through to Article 15 of the CRR, is an optional derogation pertaining to the application of own funds requirements on a consolidated basis for groups that contain only certain types of investment firm. This derogation contains a set of detailed conditions that have to be met; these conditions are designed to ensure that the investment firm or firms are not unduly exposed to risk from elsewhere in the group to which they belong, even without the application of actual consolidated supervision.

Where a competent authority waives the application of consolidated supervision, Article 17 of the CRR also provides that the requirements of Part Eight (disclosure) then only apply (to the investment firm(s) in the group) on an individual basis.

b. Purpose of consolidated supervision and relevance to investment firms

Consolidated supervision serves to supplement the supervision of an individual authorised entity, providing a view of the wider risks that the firm may be exposed to by virtue of its membership of a group. It effectively treats the group (i.e. its component entities) as if it were a single firm and applies the own funds—and, if applicable, the large exposure²¹—requirements accordingly.

²¹ Article 388 of the CRR ('negative scope') dis-applies Part Four (large exposures) to a group on the basis of its consolidated situation if the group only includes the investment firms referred to in Article 95(1) or Article 96(1) of the CRR.



In short, there are several main issues that can be addressed by the use of consolidated supervision as a regulatory tool. It can be used:

- to identify financial risks created by other group entities that have the potential to create losses within the other group entity, which subsequently looks to the group as a whole (including the authorised investment firm(s)) for support, or where the investment firm may already have exposure(s) to other group entities;
- to detect and provide for situations where a parent issues debt and downstreams the proceeds in the form of equity, which can result in excessive leverage; and
- to guard against situations of double or multiple gearing (i.e. where the same capital is
 used simultaneously as a buffer against risk in two or more legal entities). (Double gearing
 occurs whenever one entity holds regulatory capital issued by another entity within the
 same group and the issuer is allowed to count the capital in its own balance sheet.)

The first of these points might be viewed as being more concerned with risk to the firm itself (arising from losses on its business activities). However, there could be a 'knock on effect', especially if the investment firm is exposed to other group entities (for example, it could have placed the proceeds of its own funds with a group entity). Furthermore, it could create the risk of contagion and loss of confidence across the group as a whole, thereby leading to possible risk to the firm's customers.

Meanwhile, the second point can be more clearly linked to the potential to create risk to the firm's customers, as excessive leverage/debt burden can put a group—and its constituent firms under undue pressure to perform financially (with less regard for how it is to conduct its business in a compliant manner).

And the third point might give rise to either direct financial risk to the firm or, indirectly, risk to its customers.

Therefore, the same sort of structural issues and risks that being part of a group can present when supervising a bank prudentially can also occur when there is an investment firm group.

c. Waiver from consolidated supervision

As noted, the consolidating supervisor has always had the ability to 'waive', on a case-by-case basis, the application of own funds requirements on a consolidated basis where all investment firms in the group fall within the categories in Articles 95(1) and 96(1) of the CRR. This granting of permission for such a waiver is, however, subject to a set of conditions being fulfilled, as set out in Article 15 of the CRR. In addition, CRR Article 17 contains further provisions for the supervision of investment firms where an Article 15 waiver has been granted. All investment firms in a group must continue to meet their own funds requirements on an individual basis.



One of the conditions is designed to ensure that the financial holding company holds at least as much capital as the sum of the full book value of its holdings of own funds instruments in its subsidiaries (including the investment firms). In other words, there is still a form of group capital adequacy test. This group capital test should help to address the issue of 'double gearing', and potentially also the issue of 'leverage'. However, the extent to which it addresses 'financial risk' within the group will depend upon whether or not the amount of capital held is greater (or less) than the underlying financial risk (or notional own funds requirement) for each unregulated entity/non-CRR firm in the group.

However, there is an alternative approach to calculating the above group capital test, by way of a further competent authority discretion:²² apply the waiver if the financial holding company holds a lower amount of own funds than that required if calculated as described above, but no lower than the sum of the own funds requirements for each relevant entity in the group, including the financial holding company itself (as a financial institution). As this alternative group capital test includes notional requirements for some unregulated/non-CRR firms, it should help to address the issue of 'financial risk' in the group. Hence (contrary to the text) it cannot be said that this alternative discretion would always lead to the group holding less externally generated capital than if the waiver from consolidated supervision were applied without it.

In addition, even where the more objective criteria are met, there is also a more qualitative requirement that each EU investment firm shall have in place 'systems to monitor and control the sources of capital and funding' of all relevant entities within the group. This suggests that an element of supervisory judgement is required, for which a decision (about a 'waiver') is required on a case-by-case basis. This is reinforced by the provisions of Article 17 of the CRR, including the provision that competent authorities should 'take other appropriate measures to monitor the risks ... of the whole group'. This illustrates further that the waiver of Article 15 of the CRR is not about 'group risk' not being relevant to investment firm groups, but is rather more an alternative means of dealing with it.

So, while group risk can occur within investment firm groups, it is also possible to mitigate these risks in a proportionate yet sound manner by using the additional flexibility provided by use of an alternative waiver approach, subject to permission, under Articles 15-17 of the CRR.

d. Changes in conditions for the waiver under the CRR and the issues arising

It should be noted that there has been a consequential but material technical change in how the waiver conditions were carried across from the CAD to the CRR, on account of the latter's more general changes to the definition of capital to align with Basel III for banks. Previously, under the CAD, investment firms that were granted a waiver from consolidated supervision were required to use an alternative definition of own funds that includes illiquid assets (e.g. amounts due after 90 days) as a deduction from capital (which provided an additional element of prudence, if not also an aspect of liquidity). This is not the case under the CRR, although it is possible that this

²² In paragraph 2 of Article 15 of the CRR.



relaxation may be offset by the other prudent changes from the CRR that strengthen the definition of capital.

Another partial, material technical change in how the waiver conditions were carried across from the CAD to the CRR is in respect of how the capital of the group holding company is determined and arises as an indirect consequence of the Basel changes to the definition of capital and hence the construction of the CRR text. Under the CAD, the requirement to hold capital was without provision for deductions and, in particular, goodwill and other intangibles.²³ This (non-deduction of intangibles, etc.) also holds for the group capital test as set out in point (d) of Article 15(1) of the CRR, which only defines 'capital' with reference to various items.

In contrast, for the purposes of the alternative group capital test under the competent authority derogation in Article 15(2) of the CRR, the requirement to make deductions from group capital does apply.²⁴ This highlights a key difference in treatment between the two alternatives to this part of the waiver conditions in the CRR text, for which there is no obvious explanation.

e. Other general issues arising

One general problem with the application of either consolidated supervision or the waiver that can be particularly relevant for investment firm groups is that it is possible that a group could seek to 'game' the requirement by 'booking' items that otherwise lead to regulatory capital requirements into entities that it claims are excluded from the text, e.g. because they are not 'financial institutions'.

f. Policy options

Under one of the two alternative group capital tests (i.e. paragraph (1) of Article 15 of the CRR) for the waiver from consolidated supervision, there is no requirement for any items to be deducted from total capital; this includes goodwill, an intangible asset that can be adversely correlated to market stresses and that would otherwise be prudently deducted if consolidated supervision were applied. On the other hand, removing this constraint effectively removes a regulatory barrier to what could otherwise be sound business acquisitions and growth in investment business. Consequently, a binary approach of either full or zero deduction may not necessarily be considered proportionate.

To address this balance, a further condition could be added to the granting of the waiver under Article 15 of the CRR permission; the new condition could require the amortisation of goodwill over a reasonable period (say five years), to be rebased for any subsequent impairment of goodwill. The planned goal would be to protect customers and market confidence, while still allowing investment firm groups to make acquisitions, just in a prudentially sound manner that

²³ For these purposes, point (d) of Article 22(1) of CAD defines group capital as the sum of points (a) to (h) of Article 57 of the BCD, which is without the deductions required under Article 66 of that Directive. The same applies if using the alternative group capital test under Article 22(2) of CAD.

²⁴ This is because paragraph 2 of Article 15 of the CRR introduces the words 'own funds', which did not previously appear in Article 22 of CAD.


achieves the rebuilding of the group's balance sheet through an appropriate treatment of goodwill over a reasonable period of time.

Furthermore, debt used to fund such acquisitions creates a liability within the group. The fact that the liability may be in an unregulated group company, usually the parent company, should not obscure the economic substance of a clear commercial link with the business activity of regulated firms within the same group. Specifically, the responsibility to generate sufficient cash to meet these liabilities, as and when they fall due, is likely to be placed on these regulated entities. Such an arrangement is likely to have been a fundamental consideration as part of the due diligence conducted ahead of any such acquisition, as these regulated firms are usually the main, if not the sole, source of income for the unregulated parent entity. Relying on management actions, such as being able to renegotiate terms (e.g. extending debt maturity) so they do not become unduly burdensome, is not considered consistent with good risk management practice.

This prudential risk can be mitigated to the extent that the business has the capacity to accumulate sufficient cash in advance of liabilities as and when they fall due, in particular principal repayments. To capture this, **another condition can be added to the waiver that requires cash accumulation, such that the full amount of principal is built up in advance of the earliest contractual repayment date.** The planned outcome would be for any investment firm group that is highly leveraged (e.g. as a result of an acquisition) to accumulate cash at a reasonable rate sufficiently in advance of significant cash outflows (repayment of principal).

Furthermore, it is also recommended that the definition of what forms part of an investment firm consolidation group should be examined, with a potential widening (e.g. beyond the current CRR definition of 'financial institution') occurring to reflect the more diverse nature of investment firm groups and the non-MiFID business that they can conduct.

3.3.7 Pillar 2 requirements

The concept of Pillar 2 is to help ensure that firms have both adequate risk management systems and capital to support all the prudential risks to which their business may be exposed.

a. Why is Pillar 2 important for the supervisors of investment firms?

The ability to use Pillar 2 can be particularly important for supervisors of investment firms, since their activities may give rise to a diverse set of risks not covered adequately under Pillar 1. Of course, with respect to the provision of investment services, Pillar 2 requirements come in addition to requirements set out in the MiFID, which, together with the conduct of business rules, focus on investor protection and market integrity.

For example, this is especially true for operational risk—a key risk for all types of investment firms—where the derivation of appropriate capital requirements under Pillar 1 does not have the same level of correlation to the quantum of 'exposure' that credit and market risks may have.



The ability of Pillar 2 to deliver 'upwards proportionality', especially in recognising where an investment firm might cause particular harm to customers if it were to fail—even if it does not present a significant threat to financial stability²⁵—is one of its key attributes.

b. Why is Pillar 2 important for investment firms?

Although investment firms may not present the same level of systemic threat to financial stability as banks, they pose other, significant risks, chief among these being the risks to (i) their customers and (ii) market integrity. This can be particularly beneficial for investment firms, given their wide range of different activities, where they provide key services for others (e.g. perhaps they operate a 'platform' that offers customers a single point of access to all their investments).

Customers may suffer losses where an investment firm provides unreliable investment advice or manages investments poorly or, in the event of the failure of the firm, where consumers encounter loss of continuity of service due to investments having to be transferred to an alternative investment firm. In the event of failure, prudential requirements may enhance the ability of the investment firm to achieve a more orderly wind-down and thereby most efficiently transfer customer investments.

Market integrity may be compromised where investment firms run into problems and/or fail, leading to confidence in the market and its participating firms being eroded. The footprint of a firm in the market, whether as a provider of investment products or services relating to market infrastructure, should obviously be reflected in the adequacy of its risk management practices and level of available financial resources.

It is clear, therefore, that investment firms themselves need to monitor their risk profile appropriately, identifying material risks and managing them under the umbrella of Pillar 2, with this being both supplementary and complementary to their obligations under Pillar 1. This will ensure that they reduce the likelihood of their failing or, in the event that they do fail, would limit the threat that their failure would pose to their customers and the wider market, whether other institutions, market infrastructure, or the market as a whole.

c. Supervisory risk appetite

Supervisors may have different approaches regarding the extent of risk appetite they are prepared to accept within their jurisdiction. If the desire is to guard against the failure of a firm, then the setting of higher capital requirements that protect the firm against unexpected losses—which might cause the firm to get into financial difficulty, or to become insolvent—can be achieved through Pillar 2, which supplements the Pillar 1 minimum capital requirements to achieve the required degree of protection.

²⁵ The primary focus of CRD IV is on financial stability, but its tools, in this case Pillar 2, may be used for other purposes: 'This Regulation should, inter alia, contain the prudential requirements for institutions that relate strictly to the functioning of banking and financial services markets and are meant to ensure the financial stability of the operators on those markets as well as a high level of protection of investors and depositors' (CRR).



If the risk appetite is to allow investment firms to fail, this may generally be subject to managing the impact of any such failure, i.e. in most cases the failure, or wind-down, of the firm should occur in an orderly manner. This would reflect the desired outcome that there should be no market disruption that might impact on the firm's counterparties and no harm to the firm's customers. Again, the regulatory requirements might take the form of appropriate capital requirements—generally termed wind-down costs—that allow the firm to continue in business for as long as it takes for it to unwind its market transactions and transfer its customers to replacement firms. There may be several components, therefore, of any capital requirement related to the wind-down costs:

- i) The operating costs that permit the firm to continue to function at a level that allows for the smooth wind-down of its business.
- ii) The potential balance sheet impacts as assets potentially lose their market value during the wind-down period and can only be realised at reduced values.
- iii) The maintenance of financial resources that enable a firm to meet its liabilities (including during a wind-down) as they fall due.

d. Stress testing – regulatory and firm

Pillar 2 also covers the situation that a firm might find itself in if its business model were to encounter a period of stress. There are qualitative and quantitative aspects to this, i.e. respectively, the management actions that the firm might take, and the additional 'buffer' capital requirements that it should have in place to mitigate any potential impact of a stress situation.

The adoption of a stress testing programme might be desirable for some investment firms as it allows them to identify particular aspects of their business model that may give rise to vulnerabilities. This allows such firms to decide whether to put in place appropriate mitigants, whether qualitative (such as reducing their level of activity in particular business lines), or quantitative (e.g. additional own funds, above and beyond those required by regulators).

e. Reverse stress testing

Reverse stress testing is a tool that allows a firm to identify a range of extreme adverse circumstances that would cause its business plan to become unviable and to assess the likelihood of such events crystallising and causing it to fail. It allows firms to have frank discussions with their supervisors about any critical vulnerabilities they may be subject to, and develop courses of action (termed 'management actions') to reduce the irrevocable impact of those vulnerabilities.

The outputs from reverse stress testing can be used for various purposes, including contingency planning (management actions during extreme events) and the assessment of sector-wide issues (e.g. the dependence of a number of different firms on a particular service provider).

f. Current work on Pillar 2



The EBA has published guidelines²⁶ on how supervisors should undertake the Supervisory Review and Evaluation Process (SREP), and this is being supplemented by various Binding Technical Standards, such as strengthening and applying greater consistency through supervisory colleges. As things stand, the guidelines apply to the supervision of all institutions subject to the CRD/CRR, providing a common framework for supervisors to assess risks to institutions' business models, solvency and liquidity.

The role of Pillar 2 regarding investment firms will need to be revisited, in light of the overall shape and composition of any modified prudential regime for investment firms, where a better tailored and risk-sensitive regime would reduce the need to apply large adjustments to the regulatory capital.

3.3.8 Macroprudential concerns for investment firms

The European Systemic Risk Board (ESRB), in its recommendation on the intermediate objectives of macroprudential policy, set out that the main objective of macroprudential policy is to contribute to the safeguarding of the stability of the financial system as a whole.

As a consequence, the ESRB identified five intermediate objectives of macroprudential policy, which are: (i) to limit excessive credit growth and leverage; (ii) to mitigate excessive maturity mismatch and market illiquidity; (iii) to limit direct and indirect exposure concentrations; (iv) to limit the systemic impact of misaligned incentives with a view to reducing moral hazard; and (v) to strengthen the resilience of financial infrastructures.

The ESRB is trying to clarify to national authorities how to best achieve each of the above objectives by making use of the tools provided in the CRD/CRR, which can be used for addressing both firm-specific risks (the traditional use of prudential tools) and risks that the firm poses to the system as a whole. Examples of this could be sectorial risk weights for real-estate exposures or the calibration of liquidity surcharges.

However, although relevant to banks, none of the five objectives listed above would seem particularly relevant to the vast majority of investment firms (which are not 'bank-like' in nature).

3.3.9 The case for capital buffers

As a response to the financial crisis, the CRD/CRR formally introduced a range of capital buffers, both to provide a greater cushion to absorb losses and to help address the pro-cyclical mechanisms that contributed to its origins and amplified its effect. It establishes that Member States are requested to require firms that meet certain criteria to hold all or some of the following buffers: the capital conservation buffer (Article 129 of the CRD); the countercyclical capital buffer (Article 130 of the CRD); the systemic risk buffer (Article 133 of the CRD); the global systemically

²⁶ Guidelines on Supervisory Review an Evaluation Process (SREP) and Pillar 2



important institution buffer; and the other systemically important institution buffer (Article 131 of the CRD).

Many investment firms²⁷ are currently exempt from the capital buffer requirements (under Article 128 of the CRD), which might be due to recognition that these are the key activities that are less likely to create risks of interconnectedness between firms and, in the event of failure, the risk of contagion. Furthermore, Member States also have discretion to exempt small investment firms that would otherwise be caught from the capital conservation buffer and the countercyclical capital buffer (under Articles 129(2) and 130(2) of the CRD, respectively); again, this could be seen as an acknowledgement by legislators that such firms are less likely to pose risks to the system or to create contagion. But for those that are not exempt, one of the buffers that needs to be particularly considered is the capital conservation buffer, which is set at the fixed amount of 2.5% and must be composed of CET 1 capital.

One view could be that the setting of such a simple 'fixed' amount of additional capital removes the need for any additional assessment; however, this should be weighed against the greater flexibility of individual assessment and variable capital 'add-ons' that can accompany the qualitative aspects of greater risk management under a Pillar 2 regime. Indeed, it is also questionable why any investment firm that is neither systemic or a clear risk to financial stability in normal times should be subject to a fixed (conservation) buffer, especially if the firm does not have to be preserved as a 'going concern'. Otherwise, the fixed element might only end up being measured and used against the total amount of variable capital 'add-on' determined under the Pillar 2 process.

Some of the buffers are to be set up or calibrated by the Member State (designated authority or competent authority) depending on the country-specific circumstances; in some cases, the CRD also prescribes mandatory recognition of the buffers set out in other Member States for firms that carry out business in that Member State. The regime of each of the buffers differs and the CRD defines a prescriptive procedure to be followed by competent or designated authorities in order to set up, calibrate, and implement the buffers.

Consequently, the current CRD text already recognises that not all firms are likely to be systemic; only those that carry out certain activities and/or are of a considerable size might create the risks that the buffers aim to prevent.

Simplifying the categorisation of investment firms for the purposes of applying capital requirements should also mean reconsidering the approach to buffers and whether these are tools that should be maintained in the Pillar 1 set of requirements for non-systemic firms.

Also, non-systemic investment firms are usually less likely to cause a great shock to the system in the event of failure. As per their size and/or types of business, they are usually less

 $^{^{27}}$ I.e. investment firms that are not authorised to deal on own account and/or to underwrite and place financial instruments.



interconnected with other financial institutions, and the effect of their failure would thus be less likely to be sensed by other firms, as recognised by the CRD text in its current form.

3.3.10 Recovery and resolution requirements

The BRRD is scoped to apply to both credit institutions and to investment firms that are required to hold initial capital of EUR 730 000 (i.e. proprietary traders, firms that fall under Article 96(1) of the CRR and operators of MTFs). Although other types of investment firms do not themselves fall directly under the BRRD, some of its provisions may still apply to them once the Directive is triggered (by the presence of a credit institution or a EUR 730 000 investment firm within the same group).

The BRRD provides measures for:

- the recovery of a firm should it get into financial difficulty;
- early intervention should a situation deteriorate (e.g. certain triggers be broken); and
- resolution of a failing firm.

The first and second of these points are clearly aimed at keeping a firm 'going', reflecting that the BRRD is designed with banks in mind, whereas the third deals with how to mitigate the cost/impact of failure, without recourse to taxpayer funds.

The vast majority of investment firms, irrespective of their activity (i.e. whether or not they are subject to the EUR 730 000 authorisation requirement), do not present either the same type or scale of consequences as banks do should they fail. As such, there should be less need for the types of 'going concern' recovery—or even early intervention—measures as laid out in the BRRD to be applied to investment firms. The exception to this would be those extremely large proprietary trading firms that are systemic or otherwise present a clear and material risk to financial stability; for these firms, the same recovery and resolution measures as for banks seem more appropriate.

Furthermore, if the impact of the failure of most investment firms is not as great, or is more concerned with ensuring that the needs of customers are dealt with in a more orderly manner (before a firm fails), then the resolution tools of the BRRD may generally be overly complex and less relevant to them; for example, being relatively small and without holding deposits, it is more difficult to envisage many situations where, say, *bail-in* or *bridge bank* tools would be required. Rather, in practice the 'resolution' tool of choice for the vast majority of investment firms is most likely to be to allow the firm to enter insolvency, or any particular national administration regime that applies to investment firms, with regulatory attention focused more on wind-down and managing the impact of failure.



3.3.11 Remuneration requirements

It is important to consider the overarching aim of remuneration requirements for prudential purposes—i.e. creating a strong link between remuneration policies and risks—when considering their relevance to investment firms; other than the largest 'bank-like' proprietary trading firms, most investment firms commonly have different risk profiles, based on differing investor bases, risk appetites and risk horizons. Similarly, business models and structures typically vary from those in large banks, and correspondingly investment firms can have different pay structures.

Therefore, one of the more specific challenges is related to the application of the proportionality principle, which could arise from the full application of the CRD/CRR remuneration requirements to investment firms. For instance, to take into account the case of:

- agency brokers, where pay is structured primarily in the form of commission on matched trades, meaning the broker acts as an intermediary and does not risk the firm's own capital. Commissions are only paid on trade completion;
- private equity firms, certain asset managers and other investment firms operating carried interest plans (where bonuses are agreed upfront in line with the management fee);
- wealth managers that may have few employees (less than 100) and may be structured as LLPs.

On the application of the proportionality principle, the EBA is investigating the impediments to a full application of the CRD remuneration provisions, with the view that specific exemptions could be introduced for certain institutions, including investment firms under certain conditions, in particular regarding the application of deferral arrangements and payment in instrument. In this regard, the EBA intends to send its advice to the European Commission, suggesting legislative amendments that would allow for a broader application of the proportionality principle.

In addition, some issues regarding the investment firms may also be raised within the review of the remuneration provisions foreseen in Article 161 of the CRD, which might explicitly include legal proposals.

3.3.12 Pillar 3 disclosure requirements

a. Concept

Basel II, and in the EU the BCD/CAD, introduced the concept of Pillar 3—or market discipline—to complement both the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). Pillar 3 requires firms to publicly disclose information that will allow market participants to assess key pieces of information on scope of application, capital, risk exposures and risk assessment processes, and hence the capital adequacy of the firm.



In short, Pillar 3 may be described as 'disclosure by the market, for the market' and should be consistent with how senior management and the board of directors assess and manage the risks of a firm.

b. Main issues

The range of information to be disclosed is quite extensive and can be quite burdensome for many investment firms to provide. It also covers many areas of risk that may not be directly relevant to investment firms, including new areas of requirements introduced under the CRD/CRR, such as requirements on the leverage ratio and asset encumbrance.

Furthermore, the nature of the investment firm industry is such that, for the most part, there will not be the same type of market investor or counterparty as for banks that wish to assess the information that needs to be disclosed before investing in or conducting investment business with the firm. (For example, most investment firms will make little use of public issuance of equity or debt instruments for either capital or funding purposes.) Therefore, the demand for such public disclosure may be less (than it is for banks).

c. Options

The use of extensive public disclosure for prudential purposes, under the current Pillar 3 requirements, is questionable for investment firms, both in terms of the cost of gathering the information and the net benefit to market participants and potential investors.

One option would be to remove any need for public disclosure of prudential information from investment firms. Alternatively, in order to make them more relevant, the nature of the required disclosures could be tailored to the nature of investment firm business models; for example, greater focus could be given to the nature of the operational risk that arises across investment services and activities. Investment firms may benefit from specific guidance in this area. Ultimately, though, the benefit that may be derived from any use of public disclosure of prudential information will depend upon the overall design and content of any new prudential regime as a whole for investment firms.

3.3.13 Prudential and financial reporting

a. Overview of the current legislative framework

Investment firms' Pillar 1 prudential reporting requirements depend on whether the firm is subject to the CRR own funds requirements or not. To illustrate this, using the investment firm categories presented in Chapter 2 of the report, investment firms in categories 5-10 have to report prudential information using the COREP requirements specified in the ITS on supervisory reporting.²⁸ Investment firms in categories 1-3 and category 10 do not use COREP templates and

²⁸ See European Commission implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down how to implement technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013.



may be required to submit reporting templates created in each Member State. Investment firms in category 4 will be required to submit COREP templates if they are an Article 95(2)(2) firm, or domestically created templates if they are an Article 95(2)(3) firm.

As COREP is limited to Pillar 1 reporting requirements, investment firms typically have to submit financial reporting templates (balance sheet and profit and loss financial statements) to competent authorities on a regular basis, as well as prudential reporting templates. Those firms that are subject to COREP prudential returns may or may not have to report the financial reporting (FINREP) templates specified in the ITS on supervisory reporting (see footnote 37 above). The criteria for determining whether an investment firm has to submit FINREP templates are extremely complex.²⁹ Investment firms that are not subject to COREP prudential returns will submit financial reporting data to their competent authority based on domestically determined templates.

The remainder of this section will focus on the CRR COREP and FINREP requirements.

b. Main issues

A key comment concerning COREP/FINREP is the vast amount of reporting that some investment firms have to submit, making it extremely complex, onerous and costly to comply with. Numerous examples support this:

- The number of COREP templates that a firm has to submit is based on their permissions. This can lead to reporting obligations that do not in any way reflect the risks posed by firms. For example, small Article 92 firms may have to report up to 60 templates (most of them on a quarterly basis). This can be doubled if the firm is part of a group. In contrast, extremely large investment firms in the other categories may have no more than nine templates to submit on a quarterly basis (again, double this if the firm is in a group).
- The level of detail required in many of the reporting templates can be extremely onerous and complex for those investment firms that have very few of those exposures. Examples are the asset encumbrance, securitisation, credit risk and market risk templates. Consequently, the supervisory benefit is not commensurate with the time and cost incurred by such firms to complete these templates.
- The criteria that determine whether a firm has to report FINREP templates are unrelated to the riskiness of an investment firm. The criteria mean that quite small firms (which happen to be publicly listed) could end up reporting a lot of FINREP material while by contrast, a large, privately owned firm would not be subject to FINREP. Furthermore, the FINREP criteria mean that firms could move in and out of the FINREP schedules depending on changes in corporate structure. This results in supervisory authorities having data fields with broken series, which hampers risk monitoring.

²⁹ The criteria are specified in CRR Article 99(2).



• FINREP applies to consolidated financial reporting only, so investment firms subject to FINREP will have to report individual firm-level financial reporting templates based on domestically determined financial reporting requirements. This leads to inconsistent data series for consolidated and individual reporting.

Criticism of COREP/FINREP is not restricted to how much investment firms have to report, and how risk insensitive and complex the rules are. Firms experience technical challenges posed by the regular introduction of new and complex taxonomies (these are typically introduced biannually). If firms are unable to manage this process on their own, they have to purchase reporting system updates from external suppliers or hire consultants to do the work for them (in both instances, high costs can be involved). Furthermore, competent authorities can also incur considerable set-up and ongoing information systems costs in ensuring that firms can submit their COREP templates using the latest taxonomies.

The criticisms of COREP/FINREP identified above lead to the overall impression that a reporting system that is designed for credit institutions has been imposed on investment firms without adequate recognition of the risks that investment firms pose to the financial system, and thus without ensuring that the requirements are proportionate. Furthermore, the criticisms raise questions over the criteria used to determine proportionality. Basing investment firms' COREP obligations on their investment activities is severely penalising small Article 92 firms. Equally, firms that have very few exposures to a particular risk category have to report as much detail as large institutions with numerous such exposures. The level of detail is not commensurate with the supervisory benefit of receiving that detail, and this suggests that simpler templates would be desirable for some firms.

c. Options

Further work should lead to the proposal of a reporting regime where supervisory authorities can obtain sufficient detail from the components that make up the proposed prudential regime in order to monitor and supervise investment firms' risks, while at the same time considering the reporting costs incurred by investment firms. This should include: 1) whether it is possible to introduce proportionate provisions based on a firm's size as opposed to its activities; 2) whether it is possible to design simpler templates; and 3) the mechanism by which investment firms should submit their prudential returns, because one of the criticisms of the current COREP framework concerns the costly impact the regular taxonomy updates have on firms.

3.3.14 Expression of capital adequacy

Prior to CRD IV, the CAD permitted investment firms to calculate their capital requirements (regardless of whether driven by the risk-based requirements or the minimum initial capital required for ongoing authorisation) as an absolute amount (of EUR or local currency). The firms then knew that they should hold at least that amount of own funds. In other words, [amount of] capital (own funds) > [total amount of] capital requirements. And the amount of any surplus above the minimum could easily be represented as a percentage, e.g. if the total amount of



requirements was, say, EUR 5 million, but the firm held own funds of, say, EUR 10 million, then the firm would have cover of 200% (100% representing only holding the minimum requirements).

However, with the advent of Basel III/CRD IV—and the consequential change in how own funds are now determined under the CRR—investment firms were forced to calculate and express their capital adequacy using the same banking-style Basel ratios as credit institutions (i.e. maintain a minimum total capital ratio of 8%, with further ratios for total Tier 1 and CET 1 capital).

In considering a new prudential approach for investment sector firms, it is therefore relevant to also consider how capital adequacy should be expressed. One of the main reasons for credit institutions using CRD IV ratios is the application of the Basel 8% ratio, and the fact that credit risk is calculated by the use of risk weights³⁰ (compared to, say, market risk or FOR being expressed as absolute amounts). Whereas it is reasonable to expect credit risk to be the main risk for most banks, the main risk for the vast majority of investment firms is likely to fall under other risk types—such as FOR or market risk—that are more clearly expressed as absolute amounts.

Therefore, it adds further complexity to require investment firms to 'scale up' most of their absolute risk amounts by 12.5, only to then require them to maintain 8% of the total (as is currently required under Article 92(3) of the CRR). What this method does allow, however, is the proper division of the capital requirement into CET 1, AT 1 and Tier 2 capital. If the focus for investment firms is more on how to deal with the impact of failure, then the possible counterpoint about comparison with credit institutions becomes less relevant (as the objectives are different), and thus all a new framework for investment firms requires is the ability to compare the levels of comfort/surplus among investment firm peer groups (which can be done as was the case under the CAD, by simply looking at the position of each firm relative to its requirements, e.g. 200% in the example above).

However, ultimately the way in which investment firms might best be required to express their capital adequacy will depend upon decisions concerning the quality of the capital required (such as the relative importance of loss absorbing CET 1 during wind-down). This will help determine if there is then a need to limit the use of different 'tiers' of capital, and, if so, how this might be presented (e.g. whether by 'gearing' limits, as in the BCD/CAD, or 'banking-style' ratios, as in the CRR).

3.3.15 Wind-down analysis

Investment firms can present various risks to customers, as well as to the integrity of the market (including the 'too many to fail' aspect, which can lead to loss of investor confidence, to the general detriment of both individuals and the economy). Therefore, it is desirable to ensure that, if and when investment firms fail, they do so in an orderly manner; this requires provision for time and resources to help ensure that investment firms meet their commitments to customers and that no undue harm is suffered by customers as a result of unexpected failure.

³⁰ Assume for these purposes that, other than the largest 'bank-like' firms, investment firms do not make use of (IRB) internal models, and so do not calculate equivalent risk weights.



Agency-based portfolio or asset managers do not generally undertake any trading for clients. Investments will be held in the name of the client (individual segregated mandates), or in the name of the fund (pooled vehicles). Even so, there will be a need to ensure that there can be a timely handover of the discretionary management of segregated mandates as instructed by the firm's clients—either to a new fund manager or liquidating the investments to cash on their behalf, and that there can be an orderly wind-down of the pooled vehicles.³¹

The BRRD is scoped to apply (directly) to both credit institutions and to investment firms that are required to hold initial capital of EUR 730 000 (i.e. proprietary traders, firms that fall under Article 96(1) of the CRR and operators of MTFs), but not to all other types of investment sector firm.

Therefore, it is suggested that all investment firms falling outside the scope of the BRRD should be required to draw up and maintain a wind-down plan; this would document how the firm could be wound down in such a way as to lessen the impact of its closure. This would include the quantification of the financial resources—both capital and liquidity/cash flow—necessary to achieve this, taking into account that a wind-down or failure is more likely to occur under stressed conditions.

Capital will be required to ensure the firm is able to continue to operate lawfully (i.e. is not insolvent) and that all additional expenses can fall to the owners of the business. Meanwhile, holding liquidity will be important to ensure that there are sufficient liquid resources/cash flow available at all times to fund the business through to the cessation of its regulatory activities.

a. What might a wind-down analysis include?

Any own funds requirement that seeks to address operational risk (however designed) would need to consider: (i) any potential recognition of insurance and other risk transfer mechanisms against the occurrence of operational risk events; and (ii) whether or not there should be any diversification allowed, whether within any operational risk element, or across this and other risk elements (e.g. market risk).

A suggested outline for the possible content of a wind-down plan should include:

- the likely period required to wind down regulated activities, including notice periods in relevant contracts with clients and suppliers, with an additional period to allow for the practicalities of the wind-down;
- the likely costs to be incurred during the regulatory wind-down period, including additional costs for the closure of the business;
- appropriate cash inflows and outflows taking account of the stressed conditions; and

³¹ There is a link here to group risk and the application of consolidated supervision, as, in practice, the issues around the failure or wind-down of an investment firm may not be that distinguishable from the failure of other parts of the investment firm group (which could, for example, include a collective portfolio management firm).



• appropriate provision for additional losses or liabilities that could crystallise during the wind-down period (including operational risk events, which could become more likely during this period).

Experience with some supervisors suggests that it can take considerably longer than three months to wind down an investment firm (and any investment firm group to which it belongs), e.g. a period of up to 12 months would not be unusual. Therefore, the amount of own funds required to fund an orderly wind-down of a business can be much higher than the current amount of one quarter of fixed overheads, depending upon the products/services offered. However, it will ultimately depend upon the actual activities undertaken, the nature and scale of the client base, and the individual circumstances of the firm. In this context, the possibility of appointing a temporary administrator to a failing firm where it was adjudged that such an action was necessary to protect client assets and/or to ensure an orderly wind-down of the firm (similar to the intervention measures in Articles 27-30 of the BRRD) could be further examined.

b. Interaction with Pillar 2

An effective wind-down analysis and plan includes both qualitative (e.g. an operational plan to be followed in the event of the need to wind down) and quantitative (e.g. capital and liquidity) aspects, and hence an element of judgement. As such, it lends itself to forming part of an overall Pillar 2 process—individual assessment by the firm and then supervisory review by the regulator.

The total quantitative requirements (capital and/or liquidity) for the firm would then be set as the higher of its:

- Pillar 1 plus any additional amounts determined by assessment and review under Pillar 2 for risks not covered, or only partially covered, by Pillar 1; and
- the amounts (of capital and/or liquidity) required to support the wind-down (as per point (ii) above).

While the normal risk-based requirements of Pillar 1 and assessment and review under Pillar 2 might be said to be sufficient to deal with the firm as a 'going concern', the addition of the winddown analysis and any subsequent capital and/or liquidity deals with the 'resolution' aspect and is, therefore, felt to be more relevant for the vast majority of investment firms (where the focus should be on minimising the impacts of failure on both consumers and/or the integrity of the market).

c. Liquidity in a wind-down situation

Section 3.2.6 of the report explains how requiring firms to hold the equivalent of their own funds requirement in liquid assets can support the wind-down concept.



4. EBA recommendations

RECOMMENDATION 1: Recommendation for a new categorisation of investment firms distinguishing between systemic and 'bank-like' investment firms to which the full CRD/CRR requirements should be applied; other investment firms ('non-systemic') with a more limited set of prudential requirements; and very small firms with 'non-interconnected' services

It is necessary to make a distinction between investment firms for which prudential requirements equivalent to the ones held of credit institutions are necessary and investment firms that are not systemic or interconnected, for which specific requirements could be developed. Such a distinction would enhance proportionality and clarify the question of 'gone' versus 'going' concerning supervision for investment firms.

It is recognised that a small minority of MiFID firms are substantial undertakings that run 'banklike' intermediation and underwriting risks at a significant scale. Such activities expose these institutions to credit risk, primarily in the form of counterparty risk, and market risk for positions taken on own account, be it for the purpose of external clients or not.

For other investment firms, however, a less complex prudential regime seems appropriate to address the specific risks that investment firms pose to investors and other market participants, with regards to investment business risks such as credit, market, operational and liquidity risk.

In the last tier, small and non-interconnected firms warrant a very simple regime to wind them down in an orderly manner. Such a regime could be based mainly on fixed overheads requirements (FORs) that fulfil the objective of setting aside sufficient capital for ensuring safe and sound management of their risks. These firms could also be subject to simplified obligations with regards to reporting obligations.

The future categorisation of investment firms under the CRD IV should, then, be achieved with reference to the systemic importance of the investment firm or its ability to run 'bank-like' activities, expressed through consistent indicators, both qualitative and quantitative; this would lead to a clear cut in the population of investment firms within the EU. Indeed, a key tool for amending the current complex regime, which establishes rules that apply differently depending on the category to which the firm belongs, could be reducing the number of 'categories' and simplifying the regime by establishing greater use of proportionality, both upstream (strengthening rules for those firms that are deemed to pose more risks to financial stability) and downstream (simplifying requirements for the majority).

In order to set out detailed and well-researched and reasoned policy options for such a modified prudential regime for investment firms, more work is required. It is proposed that this work will be completed in a second phase with a second, more in-depth, report, which is proposed to be initiated after the finalisation of this report. The complexity of the considerations concerning such a new regime will, however, mean substantial time and resources are required.



RECOMMENDATION 2: Recommendation for the development of a prudential regime for 'non-systemic' investment firms.

For firms falling in the second and third tiers above, a specific prudential regime should be designed. In particular, specific rules could be developed with regards to investment business risks such as credit, market, operational and liquidity risks taking particular account of the holding of client money and securities.

The CRD IV framework does not provide a definition of or clear guidance on what is meant by holding client money and securities, something that gives rise to differences in the scope of its application across the EU. This is despite the ability to hold client money being a key factor in the current categorisation of investment firms for prudential purposes, making it of the utmost importance when analysing the risk profile of a firm.

The design of a prudential regime for 'non-systemic' investment firms should clearly reflect the risks associated with holding client money and securities.

The development of this modified regime needs to pursue the aim of improving the Single Rulebook endorsed by the EBA, defining harmonised regulatory developments across the EU. The modified prudential regime should represent a solid basis for supervision, ensuring an appropriate and uniform level of requirements in a Pillar 1 context.

An additional data collection exercise, to be conducted at firm level, shall support the calibration of this regime for investment firms with regards to credit, market, operational risk, large exposures and FORs.

The EBA stands ready to complete this data collection and support these policy developments with a second, more in-depth report, which is proposed to be initiated after the finalisation of this report.



RECOMMENDATION 3: Extend the waiver for commodity trading firms until 31 December 2020.

Given the specific deadlines set out in the CRR regarding commodity dealers, which currently benefit from exemption from both the large exposures and capital adequacy provisions (under Articles 493 and 498 of the CRR, respectively, which fall away after 31 December 2017), the EBA suggests that this exemption is extended until 31 December 2020. This extension would allow for the possible development of a prudential regime for investment firms as a follow-up to the policy options and additional work of the EBA as stated above. Commodities dealers falling under the scope of the MiFID would be included in this prudential regime; therefore, it appears more appropriate to wait for the implementation of this new framework by 2020 (at the latest) rather than apply the CRD/CRR regime to all commodity dealers falling under the scope of the CRR on 1 January 2018.



5. Annex

5.1 Description of the categories

The categories summarised in Table 2 are scrutinised here for their prudential risks. The analysis includes comments on the implementation difficulties faced by supervisory authorities.

5.1.1 Category 1: Local firms

According to subparagraph (4) of Article 4(1) of the CRR, 'local firm' means 'a firm dealing for its own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets, or dealing for the accounts of other members of those markets and being guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such a firm is assumed by clearing members of the same markets'.

Historically, when there was still a physical presence or 'open market outcry' on an exchange, futures (derivatives) trading floors included a type of individual trader, known as the 'local', who made their living by buying and selling and seeking a profit from the spread. In effect, they were market makers, providing intra-day liquidity to the market. With trading taking place physically on the floor of the exchange, 'locals' sought to place themselves in close proximity to the traders working for the major proprietary houses, so that they could benefit through such relationships and from being part of larger orders. They were, therefore, genuinely local in terms of their presence and their business with the relevant exchange.

However, with the advent of electronic/screen trading and the opening up of the single market, the nature of 'locals' evolved and they became incorporated businesses. In some cases, they also became more international in their outlook, accessing other exchanges beyond their national market and growing in size as a result. More recently, the availability of algorithmic programs has made it easier to trade larger volumes in a short space of time, with a relatively low number of employees.

Overall, therefore, the concept of a 'local firm' is no longer simply equivalent to an individual making a margin on derivatives trades taking place on the floor of an exchange; instead, it has become a financial business dealing for its own account while the firm continues to provide the 'local' liquidity of the market, given that the hedging, dealing and clearing membership all pertain to the same 'market'.

However the 'local firms' definition contains gaps as it is possible that local firms could have external customers (they may undertake 'dealing for the accounts of other members of those markets'). There is also no stipulation in the CRR local firm definition that such firms may not hold client funds or may not undertake other services or activities. The local firm definition does, however, have a restriction on the markets in which these firms can deal (futures, options or



other derivatives, along with cash markets for the sole purpose of hedging positions on derivatives markets).

The assumption has been that local firms are small enterprises with a limited risk profile. The definition of 'local firm' in the CRR has remained virtually unchanged from the definition in the original version of the CAD in 1993. Local firms were, indeed, originally small firms (usually self-employed traders), only active on a single exchange. However, over time these small trading firms have grown, resulting in firms that are, to all intents and purposes, no longer local despite still being able to qualify under the 'local firm' definition. Some local firms are active in multiple jurisdictions and across all continents, employing hundreds of employees and having average trading positions of several billion. The assumption that a local firm is small and relatively low risk firm is, therefore, becoming more and more obsolete.

5.1.2 Category 2: MiFID investment firms providing only reception/ transmission of orders and investment advice

Only an initial capital requirement is applicable to firms that solely receive and transmit orders and/or give investment advice and therefore do not hold client money and securities. These investment services and activities are seen as having relatively low prudential risk because the investment firm has no access to the funds or securities belonging to its clients.

5.1.3 Category 3: MiFID investment firms providing only reception/ transmission and investment advice registered under the IMD (MiFID – Directive 2002/92/EC)

This category contains firms carrying out similar activities to those in category 2. These firms are, however, also registered under the IMD and are, therefore, subject to the prudential requirements of that Directive. Because of the applicable prudential requirements of the IMD— which mandates the use of PII—and the choice given to a firm between additional PII and capital where it also falls under the CRD, the initial capital requirements in the CRD were reduced to EUR 25 000 (as compared to category 2 investment firms, for which an initial capital of EUR 50 000 is required). The amount of additional PII required (on top of that required under the IMD) is also halved (from what would otherwise be required if they were a category 2 firm not also undertaking insurance mediation) where the option to use PII instead of capital is chosen.

In respect of investment firms also operating under the IMD, it is questionable whether lower capital requirements are justified given the wider spectrum of products on offer (including insurance products). In addition, compliance with the IMD might not be seen as offering equivalent prudential comfort to the CRD IV requirements for initial capital.



	Number of firms	EUR mns		Gross balance sheet EUR mns		
	iiriis	Mean	Median	Mean	Median	
Austria	26	2.7	0.8	5.2	1.3	
Belgium	3	1.3	1.1	1.2	0.8	
Cyprus	12	0.4	0.1	0.4	0.2	
Germany	48	2.2	0.7	2.8	0.9	
Denmark	1	12.3	12.3	7.5	7.5	
Spain	148	0.6	0.1	4.1	2.5	
Finland	7	1.4	0.4	0.7	0.4	
France	18	4.5	1.7	5.8	2.2	
United Kingdom	1 330	5.6	0.7	16.8	0.6	
Greece	11	0.2	0.2	1.4	0.8	
Croatia	1	0.2	0.2	0.9	0.9	
Ireland	7	13.9	1.2	4.2	3.5	
Liechtenstein	120	1.7	0.7	2.3	0.8	
Luxembourg	11	8.1	3.8	7.0	3.9	
Malta	14	3.6	0.1	1.6	0.2	
Netherlands	35	24.7	0.9	256.7	1.8	
Norway	20	1.0	0.6	0.8	0.5	
Poland	3	1.3	1.5	0.7	0.9	
Portugal	10	0.2	0.1	0.1	0.1	
Sweden	4	6.4	0.4	16.1	2.0	

Table 7.: Main descriptive statistics for categories 1, 2 and 3

5.1.4 Categories 4, 5 and 6: Investment firms with limited authorisation to provide investment services

Firms falling into these categories are performing (a combination of) the services of (individual) portfolio management, execution of orders on behalf of clients, reception and transmission of orders, and investment advice. Firms falling under categories 5 and 6 can also provide the investment service of placing financial instruments without a firm commitment basis. These firms perform similar activities, but the applicable prudential regime differs significantly. Firms in category 4 are excluded from the CRR definition of 'investment firm', whereas the full CRD IV framework applies to firms falling within categories 5 and 6.



	Number of		ual income 8 mns	Gross balance sheet EUR mns		
	firms	Mean Median		Mean	Median	
Austria	48	2.0	0.7	2.9	0.8	
Belgium	15	3.0	1.6	3.4	2.0	
Cyprus	6	1.4	0.3	1.9	0.7	
Germany	596	3.0	0.5	3.1	0.4	
Denmark	32	4.0	1.7	3.1	1.6	
Spain	12	3.3	1.7	5.7	2.1	
France	20	10.9	1.3	14.2	1.4	
United Kingdom	1 172	16.3	1.3	38.7	1.3	
Greece	11	0.7	0.4	2.0	0.6	
Hungary	2	0.1	0.1	0.1	0.1	
Ireland	40	17.3	2.5	47.5	2.5	
Italy	6	4.1	3.2	12.1	2.4	
Liechtenstein	120	1.7	0.8	2.3	0.9	
Luxembourg	52	3.6	1.5	4.6	1.2	
Netherlands	160	7.0	0.8	858.8	0.6	
Poland	10	5.3	0.8	6.7	1.5	

Table 8.: Main descriptive statistics on category 4

5.1.5 Category 7: Investment firms that only operate an MTF

This category contains investment firms that only operate an MTF (MiFID investment service A8). The CRD IV framework does not explicitly mention this activity, and no prior identification of the prudential risks of this activity to firms or the financial system has been undertaken, since service A8 was not in the original ISD in 1993, which was the point of reference for the CAD, and now the CRD IV framework. This highlights that the current CRD IV framework is not adequately tailored to investment firm business models.

5.1.6 Category 8: Investment firms dealing on own account for client purposes only

These firms have activities similar to those of the investment firms in categories 4, 5 and 6, but additionally cumulate own account activity. However, to qualify for the treatment afforded to this category, the investment firm is only allowed to trade for own account if the trade is directly related to the activities of its clients. It is expected that these exposures may be limited in amount and time since they are initiated based on the activities of the clients of the firm. Because the firm trades on own account, it is subject to the credit and market risk prudential requirements set out in CRD IV.



	Number of firms	Gross ann EUR		Gross balance sheet EUR mns		
	nrms	Mean Median		Mean	Median	
Cyprus	6	47.2	3.3	22.2	2.9	
Czech Republic	1	0.3	0.3	23.8	23.8	
Spain	1	14.8	14.8	10.7	10.7	
Finland	1	19.7	19.7	8.8	8.8	
United Kingdom	46	68.6	20.0	1 413.2	68.6	
Ireland	1	95.9	95.9	64.7	64.7	
Liechtenstein	1	8.1	8.1	248.5	248.5	
Poland	1	6.1	6.1	100.1	100.1	
Sweden	15	-59.0	0.6	65.1	10.2	
Slovakia	4	0.4	0.5	1.7	1.7	

Table 9.: Main descriptive statistics for category 8

5.1.7 Category 9: Investment firms dealing on own account with no external customers

This category describes firms that deal on own account, have no external customers and do not hold client money; the execution and settlement of their transactions takes place under the responsibility of a clearing institution and their transactions are guaranteed by that clearing institution.³² These criteria closely resemble the definition of local firms; however, they are even more restrictive as these firms may not have external customers-a requirement not imposed by the local firm definition. These firms have been put under the regime of Article 96 of the CRR, which provides the option to apply a simplified operational risk framework (fixed overheads multiplicative factor) but requires the application of the full CRD/CRR otherwise. This is under the assumption that the activity of trading on own account is a high risk activity that needs to compare to the same activity as provided within a banking group. However, for a firm that has no external clients, it has to be acknowledged that its insolvency can only affect the owners of the firm, which are often also the traders, and the risks involved are different from those incurred by a bank. A 'bank-like' own funds requirement may not be appropriate when addressing the risks of investment firms that only deal on own account and have no external clients. Only size and interconnectedness via market transactions may justify prudential requirements designed for financial stability purposes. Also, in comparison with local firms subject to an additional restriction limiting the types of products they can trade, the question arises of whether the existing difference in regime is justified.

³² Point (b) of Article 96(1) of the CRR.



5.1.8 Category 10: Commodities derivatives dealers subject to partial CRR requirements

This category contains firms that are specialised in commodity derivatives and do not benefit from any of the exemptions in the MiFID.

According to the MiFID, the definition of a commodity derivative instrument encompasses:

- options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
- options, futures, swaps, and any other derivative contracts relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
- options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned above and not being used for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls; and
- options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

These investment firms can conduct any of the MiFID services and activities in respect of commodity derivatives instruments. Therefore, while many will be proprietary trading, others will only be dealing on behalf of clients (executing orders, managing portfolios, or providing advice, etc.). In this respect, if they were not a separate category then the commodity derivative investment firms concerned would be spread across a number of the other categories of firms identified in Table 2.



	Number of firms		u al income mns	Gross balance sheet EUR mns		
	IIIIIS	Mean	Median	Mean	Median	
Germany	6	2.6	2.2	19.3	5.1	
Finland	4	1.2	1.0	1.5	1.4	
France	4	71.8	4.7	6 736.1	59.8	
United Kingdom	85	7.3	0.4	142.0	0.6	
Hungary	3					
Norway	5	4.0	1.2	5.2	1.5	

Table 10.: Main descriptive statistics for category 10

5.1.9 Category 11: Investment firms subject to CRR requirements

This category contains all the investment firms that are not included in any other category and are subject to similar own funds requirements to those facing credit institutions (Article 92 of the CRR). This category includes large 'bank-like' investment firms that can provide a full range of investment services and activities/investment banking.



	Number of	Gross annual income EUR mns			n ce sheet mns
	Tirms	Mean	Median	Mean	Median
Belgium	11	17.3	3.5	278.9	48.2
Cyprus	54	10.5	2.9	394.7	6.3
Czech Republic	12	2.1	0.6	48.2	25.7
Germany	30	6.6	1.7	14.1	4.1
Denmark	8	36.4	22.0	27.2	11.4
Estonia	2	10.1	10.1	31.7	31.7
Spain	38	123.1	15.1	219.2	38.3
Finland	11	6.6	4.2	5.9	3.8
France	28	39.9	17.6	11 618.8	106.1
United Kingdom	172	191.2	9.6	14 482.7	39.9
Greece	11	9.3 5.7		62.1	40.1
Croatia	2	1.2 1.2		5.9	5.9
Hungary	10	10.4	2.3	40.6	6.6
Ireland	11	51.6	22.9	131.4	34.1
Italy	16	17.6	7.7	65.1	15.6
Liechtenstein	16	55.1 12.3		3 307.2	424.2
Lithuania	1	0.1	0.1	4.1	4.1
Luxembourg	8	7.9	5.0	348.6	9.0
Malta	9	5.2	2.1	5.1	2.7
Netherlands	5	3.5	4.1	7.0	3.3
Norway	34	14.5	5.3	30.4	6.3
Poland	23	12.4	7.0	69.6	37.8
Portugal	2	4.7	4.7	16.5	16.5
Romania	17	1.9	0.7	2.5	1.5
Sweden	4	6.0	5.2	83.1	57.7
Slovenia	3	2.9	2.5	5.3	5.4

Table 11.: Main descriptive statistics for category 11

Table 11 is a simplified map of the categorisation of investment firms resulting from the MiFID and the CRD/CRR regulatory framework.

Tables 12 and 13 below show the number of investment firms under the current CRD IV categorisation in the CRD IV framework by category and country, based upon national interpretation.³³ Additional data related to those firms with a licence according to the AIFMD and UCITS—which are allowed to perform certain MiFID investment services, but do not fall within the CRR definition of 'investment firm' (the MiFID cross reference does not extend to other texts)— have been included in order to highlight those portions of investment service providers undertaking MiFID investment services and activities. In turn, AIFMD and UCITS texts require certain CRR provisions to apply to such firms.

³³ CRD IV does not provide a defined or clear categorisation of investment firms. These categories are the result of the interpretation of different pieces of regulation by national competent authorities.



Table 12: Population of investment firms, by category, by country³⁴

	Local CRD30 [1]	CRD 31(1) [2/3]	CRR 95(2) 1st cat. [4]	CRR 95(2) 2nd cat. [4]	CRR 95(1) [5/6/7]	CRR 96(1)(a) [8]	CRR 96(1)(b) [9]	Commodity CRR 493 & 498 [10]	Full auth. CRR 92 [11]	All MiFID	AIFMD doing MiFID	UCITS doing MiFID	Total no. of firms doing MiFID
Austria		26		48						74	12	11	97
Belgium		3		15	9				11	39		5	44
Cyprus		12	6		83	6			54	161	1	7	169
Czech Republic					7	1			12	20			20
Germany		48	596		14			6	30	694			694
Denmark		1	32	•	•	•	•	•	8	41	3	4	48
Estonia					1				2	3			3
Spain		148	12		24	1			38	223		31	254
Finland		7			32	1		4	11	55	1	10	66
France		18	20		28			4	28	233	312	145	690
United Kingdom	2	1 328	•	1 172	553	46		85	172	3 358	295	38	3 691
Greece		11		11	27	•	•	•	11	60	•	11	71
Croatia		1			5				2	8		7	15
Hungary				2	7			3	10	19	16	3	38
Ireland		7		40	35	1			11	94	8	4	106
Italy			•	6	44			•	16	81		39	120
Liechtenstein		120		120	•	1			16	16	1	3	20
Lithuania					5				1	6	•	10	16
Luxembourg		11		52	24				8	96	2	30	128
Latvia		•	•		2		3	•	•	5		11	16
Malta		14			38				9	61	5	5	71
Netherlands	9	26	160		30		•	•	5	230	22	14	266
Norway		20			42			5	34	100	9	20	129
Poland		3	10		14	1	•	•	23	51	3	17	71
Portugal		10			12				2	24		9	33
Romania					11				17	28		6	34
Sweden		4			94	15			4	135	8	22	165
Slovenia					2				3	5		4	9
Slovakia		•	•	•	10	4	•	•	0	14	2	3	19
All	11	1 822	867	1 466	1 178	77	3	103	637	6 051	700	469	7 220

Note: The number in brackets denotes the category number, as described in Table 2.

Table 12 highlights that there are over 6 000 MiFID firms in the EU. Once AIFMD and UCITS firms that undertake MiFID activities and services are added, there are over 7 200 firms in the EU undertaking MiFID activities and services. All Member States have some MiFID firms, with the majority being in the UK (51% of the population), Germany and France (each with 10% of the population). An analysis of the number of firms by category illustrates that there is a very broad spread of firm types across the 11 categories, with firms in categories 2 and 3 ('advisers') and

³⁴ The data displayed in this report are provided on a best effort basis by national competent authorities. For Belgium, France, Hungary, Italy and Sweden, the reported total number of MiFID firms differs from the sum of investment firms assigned to each category, as this categorisation cannot be aligned with the national regulatory regime.



categories 4, 5, 6 and 7 ('portfolio managers' and 'execution brokers') forming almost 90% of the total population.

Table 13 provides another dimension according to which it is possible to analyse the population of European firms by showing the number of firms that are authorised to offer or undertake the various MiFID investment services and activities, and the number of firms that are only authorised to perform one specific investment service or activity. The data in Table 13 were determined according to how each Member State may have transposed and implemented such services and activities under its national authorisations or permissions regime.

	Number	Of which: authorised only for this activity
1 Reception Transmission	5 867	39
2 Execution	3 629	5
3 Dealing On Own Account	709	16
4 Portfolio Management	3 609	64
5 Investment Advice	5 934	2 366
6 Placing With Firm Commitment	545	0
7 Placing Without Firm Commitment	1 389	6
8 Operating An MTF	90	40

Table 13: Population of investment firms by MiFID investment services





This table shows that investment firms mostly request authorisations allowing them to conduct brokerage/intermediation activities with third parties (reception/transmission and execution of orders). It seems that the majority of these firms are not only transmitting or executing orders on behalf of clients, but are advising them and managing their assets (portfolio management and investment advice, which is by far the investment service that is most frequently authorised when only one investment service authorisation is requested). By comparison, the proportion of investment firms dealing on their own account appears much more limited.



Table 14: Population of investment firms by MiFID investment services by country

	1 Reception Transmission	2 Execution	3 Dealing On Own Account	4 Portfolio Management	5 Investment Advice	6 Placing With Firm Commitment	7 Placing Without Firm Commitment	8 Operating An MTF
Austria	133			48	136			
Belgium	34	16	12	26	32	4	24	1
Bulgaria	52	52	21	21	52	21	21	0
Cyprus	141	127	54	78	61	13	14	0
Czech Republic	20	18	13	12	17	11	13	0
Germany	641	589	35	546	680	8	31	5
Denmark	40	35	8	34	35	1	0	0
Estonia	3	3	2	2	2	1	1	0
Spain	77	43	37	54	215	27	52	0
Finland	55	34	11	37	49	1	16	0
France	84	43	28	25	69	18	31	3
United Kingdom	3 650	2 027	304	1 882	3 603	302	855	38
Greece	59	36	11	37	57	11	34	0
Croatia	7	7	2	8	8	2	5	0
Hungary	17	16	9	14	6	10	11	0
Ireland	75	31	13	62	75	6	19	1
Italy	43	22	16	36	75	5	42	3
Liechtenstein	137	137	17	136	136	17	17	16
Lithuania	6	6	1	16	6	1	6	•
Luxembourg	95	83	8	75	95	1	5	0
Latvia	3	3	0	14	9	0	4	0
Malta	43	26	9	24	37	2	22	0
Netherlands	172	55	12	169	172	2	24	1
Norway	73	38	14	40	84	33	33	1
Poland	37	29	23	23	21	15	36	0
Portugal	18	13	3	48	59	6	1	1
Romania	31	31	19	30	30	19	29	19
Sweden	102	90	22	97	96	6	30	1
Slovenia	5	5	3	5	5	2	5	0
Slovakia	14	14	2	10	12	0	8	0

The geographical breakdown of MiFID investment services by EU country shows, for example, that in all Member States but Germany it is not possible for investment firms to be authorised for the 'execution of order' service without being also authorised for the 'reception and transmission' service. We see also that even though the size of the MiFID investment firms is similar in France and Germany (see Table 12), the investment services for which they are authorised differ; almost all of them have authorisation for the exercise of the 'investment advice service', while only 10% of the MiFID investment firms in France have such authorisation.



5.2 Total number of investment firms per Member State that benefit from a passport under Directive 2004/39/EC

	Number of
	investment firms
Austria	45
Belgium	24
Cyprus	148
Czech Republic	5
Denmark	25
Estonia	2
Spain	52
Finland	17
France	47
United Kingdom	2 079
Greece	18
Croatia	1
Hungary	5
Ireland	62
Italy	5
Liechtenstein	15
Lithuania	1
Luxembourg	79
Latvia	1
Malta	27
Netherlands	N/A
Norway	30
Poland	13
Portugal	2
Romania	12
Sweden	56
Slovakia	10
Slovenia	1

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