EBA/CP/2021/41

10 December 2021

Consultation Paper

Draft Regulatory Technical Standards on the specific liquidity measurement for investment firms under Article 42(6) of Directive (EU) 2019/2034

Contents

1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 10 March 2022. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

According to Article 42(1) of Directive (EU) 2019/2034 (IFD) competent authorities shall impose specific liquidity requirements for an investment firm on the basis of an assessment of supervisory review and evaluation process (SREP) of an investment firm.

Article 42(6) of IFD mandates the EBA to develop draft regulatory technical standards to specify in a manner that is appropriate to the size, the structure and the internal organisation of investment firms and the nature, scope and complexity of their activities how the liquidity risk and elements of liquidity risk referred to in paragraph 2 of Article 42 of IFD are to be measured.

The EBA has therefore developed these regulatory technical standards (RTS) aiming at establishing a harmonised approach that defines the relevant elements of liquidity risk to consider for the purposes of point (a) of paragraph 1 of Article 42 of Directive (EU) 2019/2034.

The draft RTS provide all-encompassing elements, which may raise major concerns for investment firms' liquidity risk, that the competent authorities shall take into account when measuring material liquidity risk. The assessment aim at ensuring that an investment firm maintains adequate levels of liquid resources, including in respect of addressing material sources of risk to markets, to clients and to the investment firm itself, acknowledging that these elements may either be independent or arise due to the interconnectedness of the liquidity risk of that firm with its market, credit or operational risk. Such elements cover liquidity risk stemming from trading activities or from loss in income from portfolio management, funding, external events affecting liquidity, operational risk on liquidity, reputational risk on liquidity, inadequate management and controls of liquidity risk and group structure. In general, competent authorities are required to consider those elements under both normal and severe, but plausible conditions.

The assessment of the elements of liquidity risk is risk-based in order to ensure proportionality. Therefore, competent authorities should assess only a smaller set of elements for small and non-interconnected investment firms that meet the criteria under Article 12(1) of Regulation (EU) 201/2033.

Next steps

This consultation paper is issued for a consultation period of three months. The final draft RTS will be subsequently submitted to the Commission for endorsement before being published in the Official Journal of the European Union.

3. Background and rationale

3.1 Background

1. Liquidity requirements are set out in and Regulation (EU) 2019/2033[1] ('IFR') and supervised in accordance with Directive (EU) 2019/2034[2] ('IFD') on a risk-based approach ensuring that more stringent requirements apply to firms exposed to higher liquidity risks because of their size or the nature of their activities.

2. In particular, Article 42(1) of IFD states that competent authorities may impose specific liquidity requirements on investment firms that are exposed to liquidity risk or elements of liquidity risk that are material and are not covered, or not sufficiently covered, by the liquidity requirements set out in IFR. Furthermore, competent authorities may impose specific liquidity requirements on investment firms that do not meet the liquid assets and governance requirements set out in Articles 24 and 26 of IFD, respectively, where other administrative measures are unlikely to sufficiently improve the arrangements, processes, mechanisms and strategies within an appropriate timeframe.

13.2 Regulatory approach within the RTS

3. The purpose of these draft RTS is to specify how the liquidity risk and elements of liquidity risk referred to in Article 42(2) of IFD are to be measured.

4. Liquidity risk may be influenced by an investment firm's exposure to other risks, such as market, operational or reputational risks. For example, losses of assets' value due to price fluctuations are most relevant for liquidity risk when an investment firms holds assets on own account for itself or its clients. Operational risk may affect investment firm's liquidity when an investment firm is unable to trade, to issue commercial papers or to access credit lines, but also because it exposes the assets to legal risk, including fraud, that may lead to liquidity risk. Reputational risk affect liquidity, when, for example, market counterparties reduce their exposure to the investment firm in over-the-counter (OTC) operations that brought liquidity to the investment firm through cash or collateral. Since all these risks are strongly interconnected, competent authorities shall assess the investment firm's exposure to those risks as well when setting specific liquidity requirements.

5. Investment firm's nature regarding funding is different from credit institutions since the later have a different source of funding through clients' deposits. Investment firm's funding comes

[1] Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 (OJ L 314, 5.12.2019, p. 1).

[2] Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU (OJ L 314, 5.12.2019, p. 64).

from external or internal sources, which may be less stable or of a variable nature in terms of access, security, price and credit sensitivities of funding sources and maturity. Therefore, liquidity risk which comes from an investment firm's liabilities should be assessed as an indicator of liquidity risk. Furthermore, competent authorities should consider not only normal market conditions where funding is stable, but also severe, but plausible market conditions for the whole market or specific for an investment firm, when these may lead to lost access of the funding.

6. Severe, but plausible conditions may not only affect investment firms' access to stable funding, but also have an impact for liquidity which comes from asset depreciation. Therefore, a competent authority should assess macroeconomic, including geopolitical, and microeconomic risks where an investment firm provides services, or have exposures, on own account on its own or clients' name.

7. An investment firm belonging to a group may carry out significant activity or may have concluded arrangements with its parent or other entities within the group which may affect investment firm's liquidity, such as profit and loss transfer agreements. These exposures should be reflected in the assessment of the investment firm's specific liquidity requirement.

8. In accordance with Article 24 of the IFD, an investment firm should have, proportionally to the complexity of its activities, a liquidity management framework that includes sound processes, systems and arrangements, such as documented procedures, clearly defined reporting lines and internal control mechanisms in order to enable monitor, control and assess its liquidity at all times.

4. Draft regulatory technical standards on the specific liquidity measurement for investment firms under Article 42(6) of Directive (EU) 2019/2034

In between the text of the draft RTS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards on the specific liquidity measurement for investment firms under Article 42(6) of Directive (EU) 2019/2034

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU [3], and in particular Article 42(6) thereof,

Whereas:

(1) To ensure that competent authorities apply for the purposes of Article 42(1), point (a) of Directive (EU) 2019/2034 a common approach in addressing all the relevant elements of liquidity risk, this Regulation lays down an all-encompassing list of the elements, which may affect the liquidity risk of an investment firm acknowledging that these elements may either be independent or arise due to the interconnectedness of the liquidity risk of that firm with its market, credit or operational risk.

(2) To ensure proportionality, the common approach laid down in this Regulation for the assessment of the elements of liquidity risk, should be risk-based. To that end, this Regulation specifies that the assessment of the liquidity risk elements should be performed by the competent authorities on the basis of size, structure and internal organisation of the investment firm and having regard to the nature, scope and complexity of that firm's activities.

(3) To further ensure proportionality, this Regulation requires the assessment of elements that are deemed to be material for investment firms. These firms that meet the conditions for qualifying as small and non-interconnected investment firms set out in Article 12(1) of Regulation (EU) 2019/2033 have a limited material liquidity risk relative to other investment firms. Against this background, this Regulation provides that, for these firms, competent authorities should at a minimum assess the liquidity risk stemming from the loss in income from portfolio management, the funding risk and the group structure relevant to liquidity.

[3] Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU (OJ L 314, 5.12.2019, p. 64)

(4) Liquidity risk from changes in the value of asset prices and subsequent losses connected therewith may affect the balance sheets of investment firms, despite these firms do not holding clients' assets on own account. In particular, firms are providing portfolio management and ongoing advice services may be more sensitive to these market fluctuations that can create or sharpen the cash flow mismatches between inflows from payment of fees typically received on a periodical quarterly or semi-annual basis and outflows for the payment of liabilities as they fall due. Against this backdrop, this Regulation provides that competent authorities should factor in this increased risk for investment firms providing certain investment services or performing activities that are most sensitive to market fluctuations.

(5) Having regard to the different nature of the funding of investment firms compared to the funding of the deposit-taking credit institutions and to the fact that accessing funding by these firms may, in certain circumstances, entail risks for them this Regulation introduces specific elements that competent authorities should take into account when setting specific liquidity requirements.

(6) To enable competent authorities to determine which potential consequences of reputational and other operational events may have a material impact on the investment firm's liquidity, this Regulation identifies those events as a subset of the list of operational risk events listed in Regulation (EU) No 575/2013 and provides that these events should be assessed by competent authorities when setting the specific liquidity requirements as they are expected to be the more material ones.

(7) For investment firms that are part of a group, that group may provide additional liquidity but also use significant parts of liquid assets belonging to these firms through agreements and other asset-transfer mechanisms between them. In that context, this Regulation lays down that competent authorities should, in their liquidity risk assessment, assess the impact of the group structure and consider the implications that such agreements and other asset-transfer mechanisms may have on the liquidity risk of the investment firms that are part of a group.

(8) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.

(9) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the advice of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[4],

HAS ADOPTED THIS REGULATION:

Article 1

Liquidity risk and elements of liquidity risk justifying specific liquidity requirements

[4] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

1. Competent authorities shall, having regard to the size, structure and the internal organisation of investment firms and the nature, scope and complexity of their activities, measure during their supervisory review and evaluation process carried out in accordance with Article 36 and 37 of Directive 2019/2034, in the manner set out in paragraphs 2 to 4, the liquidity risk or the elements of liquidity risk that are not covered or are insufficiently covered by the liquidity requirements set out in Part Five of Regulation (EU) 2019/2033.

2. The specific liquidity requirement referred to in paragraph 1 shall be measured by determining the need for liquid assets individually for each of the elements in paragraphs 3 and 4 of this Article and adding the amounts of liquid asset for all the elements.

3. Competent authorities shall assess the following:

(a) liquidity risk stemming from trading activities or from loss in income from portfolio management in accordance with Article 2;

(b) funding in accordance with Article 3;

(c) external events affecting liquidity in accordance with Article 4;

(d) operational risk affecting liquidity in accordance with Article 5;

(e) reputational risk affecting liquidity in accordance with Article 6;

(f) inadequate management and controls of liquidity risk in accordance with Article 7; and

(g) the structure of the group as defined in Article 4 (1), point (13), of Directive (EU) 2019/2034 and its impact on liquidity.

For investment firms that meet the conditions for qualifying as small and non-interconnected investment firms set out in Article 12(1) of Regulation (EU) 2019/2033, competent authorities shall, at a minimum, assess points (a), (b) and (g), while the assessment under point (a) may cover solely liquidity risk stemming from loss in income from portfolio management.

4. The assessment referred to in paragraph 3 shall:

(a) take into account all the elements which may have a material adverse effect on investment firm’s liquidity;

(b) take into account the available historical data on liquidity mismatches between liquid assets and liquidity requirements, the historical trends in liquidity and the observed material variations of liquid assets and liquidity requirements for a period of time over which, according to the competent authority, sufficient information is available;

(c) determine whether the investment firm has sound processes, mechanisms and strategies in order to measure, monitor and manage its liquidity risk;

(d) have regard to potential interconnections among the factors referred to in paragraph 3;

(e) be based on reliable and up to date information and ensure the relevant and timely resubmission of amended information in case of material change.

Question for public consultation
Question 1: Where respondents are of the view that the draft RTS should define other elements of liquidity risk, comments are most helpful when they clearly describe the alternative elements of liquidity risk that competent authorities may use to assess whether liquidity risk is adequately covered by Part Five of IFR.

Article 2

Liquidity risk stemming from trading activities or from loss in income from portfolio management

1. For investment firms providing any of the services or performing any of the activities of Annex I, Section A, points (3), (4) and (6) of Directive 2014/65/EU[5] or Article 4(1), point (21) of Regulation (EU) 2019/2033, competent authorities shall assess the liquidity risk to which these firms are exposed by evaluating the general and specific liquidity risk of the assets of these investment firms.

2. For investment firms performing the activity referred to in Annex I, Section A, point (3) of Directive 2014/65/EU, the assessment of liquidity risk shall, in addition to paragraph 1, include the assessment of intraday liquidity risk for their trading book positions.

Question for public consultation
Question 2: Are the requirements for liquidity from trading activities or from loss in income from portfolio management or investment advice of an ongoing nature sufficient? Should market risk on liquidity be relevant only for investment firms providing or performing investment services and activities referred to in paragraph 1 of this Article?

Article 3

Liquidity risk stemming from funding

1. Competent authorities shall consider the following:

(a) access to funding sources;

(b) secured and unsecured funding sources;

(c) different maturities of funding sources;

[5] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

(d) the risk of disruption to the investment firm's daily cash flows caused by an interruption in the investment firm's credit facilities; and

(e) the investment firm's off-balance sheet liabilities and funding sources.

2. For investment firms which do not meet the conditions for qualifying as small and non-interconnected investment firms set out in Article 12(1) of Regulation (EU) 2019/2033, competent authorities shall assess whether the investment firm's internal procedures for monitoring and managing liquidity requirements include a requirement to maintain adequate level of funding under normal and severe, but plausible conditions. Severe, but plausible conditions shall be deemed as covering market stress and stress inherent to an investment firm where funding may not be accessible on a timely or cost-effective basis.

3. Where competent authorities conclude that the investment firm's internal procedures referred to in paragraph 2 do not sufficiently cover funding risk and that funding risk is material for the investment firm, they shall assess liquid asset needs for the investment firm's funding risk under severe, but plausible conditions.

Article 4

External events affecting liquidity

1. Competent authorities shall assess whether the investment firm's liquidity level would allow it to continue to comply with its liquidity requirement in adverse macroeconomic, microeconomic, and geopolitical conditions.

Article 5

Operational risk affecting liquidity

1. Competent authorities shall assess the consequences of the following operational events on the investment firm's liquidity:

(a) unavailability of the investment firm's systems used to access the market or funding sources;

(b) external or internal frauds; and

(c) order execution errors.

Question for public consultation

Question 3: This article identifies the items in Table 3 of Article 324 of Regulation (EU) No 575/2013 that are more relevant for liquidity risk of an investment firm. Are there any other operational risk events materially relevant to the liquidity risk of an investment firm?

Article 6

Reputational risk affecting liquidity

1. Competent authorities shall assess how any of the following events related to a loss of reputation can affect the investment firm's liquidity risk:

(a) the investment firm's market access is reduced;

(b) the investment firm's funding sources are reduced by counterparties;

(c) market counterparties reduce their exposures to the investment firm in OTC operations.

Question for public consultation

Question 4: Are there any other element of reputational risk that would significantly affect an investment firm's liquidity risk?

Article 7

Inadequate management and controls of liquidity risk

1. Competent authorities shall assess the risks arising from inadequate management and controls of the liquidity risk management framework having regard to at least the following:

(a) the systems for measuring, managing and reporting liquidity risk and its governance framework, including the adequacy of the risk management function;

(b) any mitigating actions, including the reduction of activities requiring large cash outflows, the setup of credit lines, the capital increase in cash and the use of assets as collateral in repo transactions;

(c) the robustness of the investment firm's recovery plan, where the obligation to draw up and maintain a recovery plan in accordance with Article 5(1) of Directive 2014/59/EU[6] applies.

Article 8

Group structure relevant to liquidity risk

1. Where an investment firm is part of a group as defined in Article 3(1), point (13) of Directive (EU) 2019/2034, competent authorities shall assess the risk posed by an excessive concentration of liquidity sources among the entities of the group.

2. Competent authorities shall assess whether there are mechanisms in place that request the investment firm to transfer part or all of its liquidity resources to the parent entity or to other entities of the group.

[6] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

3. Competent authorities shall assess the mechanisms used within the group to provide the investment firm with access to liquidity or to mitigate the investment firm's liquidity risk, and in particular, their effectiveness based on whether or not these are formal pre-arranged agreements.

4. Competent authorities shall assess the criticality of the investment firm to the group's revenue, client base and activities.

Article 9

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

9. Article 42(6) of Directive (EU) 2019/2034 (IFD) mandates the EBA to develop draft RTS to specify how to measure the liquidity risk and elements of liquidity risk that are not covered or are insufficiently covered by the liquidity requirements set out in Part Five of Regulation (EU) 2019/2033 (IFR).

10. As per Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation), any RTS developed by the EBA shall be accompanied by an analysis on 'the potential related costs and benefits.

11. This section presents the cost-benefit analysis of the provisions of the draft RTS as described in this Consultation Paper. The analysis provides an overview of problem identified, the proposed options to address this problem and the potential impact of these options. Given the nature and the scope of the draft RTS, the analysis is high-level and qualitative in nature.

A. Problem identification and Baseline scenario

12. Until 25 June 2021, the prudential rules for investment firms were part of the wider EU prudential framework which applies to credit institutions, as set out in Regulation (EU) No 575/2013 and Directive 2013/36/EU, also known as the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD), respectively.

13. The CRR/CRD did not impose harmonised EU level liquidity requirements for all types of investment firms. Pursuant to paragraph 4 and of Article 6 of CRR, only investment firms that are authorised to provide the investment services and activities listed in points (3) and (6) of Section A of Annex I to Directive 2004/39/EC had to comply with the liquidity requirements on an individual basis if competent authority does not exempt such investment firms from liquidity requirements on an individual basis taking into account the nature, scale and complexity of its activities Investment firms with limited authorisations to provide investment services were not subject to liquidity requirements on an individual basis. Moreover, Article 11(3) of CRR extended the exemption to liquidity requirements on a consolidated basis where the group comprises only investment firms. The justification behind these exemptions were due to the fact that the liquidity ratios were originally developed by The Basel Committee on Banking Supervision (BCBS) with a view to applying to credit institutions and not to investment firms and without taking account of the specificities of the activities and services provided by investment firms. Finally, Article 105 of the CRD gave the power to competent authorities, following the supervisory review and

evaluation process, to impose specific liquidity requirements to capture liquidity risks to which an investment firm is or might be exposed.

14. On 26 June 2021, investment firms, authorized under Directive 2014/65/EU, became subject to a new prudential framework, composed of Regulation (EU) 2019/2033 and Directive (EU) 2019/2034, also known as the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD), respectively. With the application of the IFD/IFR, liquidity requirements became mandatory for investment firms unless the competent authority grants an exemption for the small and non-interconnected investment firms.

15. Under Article 43 of the IFR, all investment firms are subject to requirement to hold liquid assets, where an amount of liquid assets equivalent to at least one third of investment firm's fixed overhead requirement.

16. In addition, according to Article 39(1)(k) and 42 of the IFD, competent authorities can impose specific liquidity requirements to investment firms that are exposed to liquidity risk or elements of liquidity risk that are material and are not covered or not sufficiently covered by the liquidity requirement set out in Part Five of IFR or that do not meet the requirements set out in Articles 24 and 26 of IFD and other administrative measures are unlikely to sufficiently improve the arrangements, processes, mechanisms and strategies within an appropriate timeframe. In this way, taking into account the extremely diverse universe of EU investment firms, the IFD acknowledges that some investment firms may be exposed to higher liquidity risk given their size, structure, internal organisation, nature and complexity of their activities. This higher liquidity risk should be covered by specific liquidity requirements in addition to the minimum liquidity requirements.

17. However, IFD does not provide a harmonised approach on how to measure the liquidity risk and elements of liquidity risk. This can create an unlevel playing field across the EU, where competent authorities adopt different methodologies for the purposes of setting specific liquidity requirements. Therefore, more specific clarifications with regard to determination of the specific liquidity requirements are included in these draft RTS.

B. Policy objectives

18. Investment firms throughout the EU are an important element of a well-functioning capital markets, due to their key role in efficient capital allocation. Adequate liquidity requirements are therefore necessary to meet any immediate or additional liquidity needs an investment firm may have (e.g., due to operational expenses, etc.), contributing to sound financial stability.

19. The specific objective of these draft RTS is to establish a harmonised approach for measuring liquidity risk or elements of risk that are not covered or not sufficiently covered by the liquidity requirements set out in Part Five of Regulation (EU) 2019/2033. Generally,

the draft RTS aim to create a level playing field across the EU, as well as promote consistency of market practices and convergence of supervisory practices across competent authorities.

20. These draft RTS take into account the proportionality principle, by setting specific liquidity requirements that are better aligned with investment firm's size, structure and the internal organisation, and the nature, scope, and complexity of its activities. This should help reduce any additional burden for the investment firms and the competent authorities.

C. Options considered, Cost-Benefit Analysis and preferred options

21. This section presents the main policy options discussed during the development of the CP, the costs and benefits of these options, as well as the preferred options retained in the CP.

22. Overall, the draft RTS is not expected to create any direct cost impact for investment firms that are subject to IFD requirements. As for competent authorities, the draft RTS are considered as a necessary intermediate step between the supervisory review and assessment process defined in Articles 36 and 37 of IFD and the imposition of specific liquidity requirements according to point (k) of Article 39(2). Besides, Article 42(2) of IFD requires that the determination of specific liquidity requirements shall be based on the internal liquidity adequacy assessment performed by investment firms in accordance with Article 24(1) of the IFD.

Approach for taking mitigating actions to liquidity risks into account

23. The EBA considered 2 policy options regarding mitigating actions to transform a theoretical intrinsic risk into an actual residual risk.

Option 1a: Using an approach that does not take mitigating actions into account.

Option 1b: Using an approach that takes mitigating actions into account.

24. Option 1a considers the intrinsic liquidity risks that an investment firm is exposed without taking into account any mitigating factors taken by the investment firm to manage and reduce such risks. While this option takes the most prudent approach, it can result in overly conservative requirements. In contrast, Option 1b takes into account mitigating actions taken by the investment firms to manage their liquidity risks. In this way, this option promotes sound processes, mechanisms and strategies to manage liquidity risk. However, under this approach investment firms which do not implement sound liquidity management framework shall be subject to higher specific liquidity requirement.

25. Option 1b has been retained.

Approach for measuring liquidity risk

26. The EBA considered 2 policy options regarding the approach for measuring liquidity risk:

Option 2a: Using a rule-based approach.

Option 2b: Using an approach based on supervisory judgement.

27. Option 2a ensures fully consistent outcomes across the Union by establishing specific rules for measuring liquidity risk. However, taking into account the large diversity of business models and group structures of the investment firms across the EU, a single set of rules would not be capable to coverall liquidity risks aspects. According to the impact assessment of the final draft RTS on prudential requirements for investment firms (EBA/RTS/2020/11), there are around 2500 investment firms in the EU as of December 2019. They vary greatly in terms of size, business model, risk profile, complexity and interconnectedness, ranging from one-person companies to large internationally active groups.

28. On the other hand, Option 2b allows for a certain degree of supervisory expert judgement when measuring liquidity risk. While this level of flexibility provided to competent authorities does not ensure full harmonisation, it is desirable due to the wide variety of investment firms present across the Union.

29. Option 2b has been retained.

5.2 Overview of questions for consultation

Questions for public consultation

Question 1: Where respondents are of the view that the draft RTS should define other elements of liquidity risk, comments are most helpful when they clearly describe the alternative elements of liquidity risk that competent authorities may use to assess whether liquidity risk is adequately covered by Part Five of IFR.

Question 2: Are the requirements for liquidity from trading activities or from loss in income from portfolio management or investment advice of an ongoing nature sufficient? Should market risk on liquidity be relevant only for investment firms providing or performing investment services and activities referred to in paragraph 1 of this Article?

Question 3: This article identifies the items in Table 3 of Article 324 of Regulation (EU) No 575/2013 that are more relevant for liquidity risk of an investment firm. Are there any other operational risk events materially relevant to the liquidity risk of an investment firm?

Question 4: Are there any other elements of reputational risk that would significantly affect an investment firm's liquidity risk?