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EBA's Discussion Paper – Designing a new prudential regime for investment firms

Introduction

Ruffer LLP offers only one service to clients which is discretionary investment management and at present has £20.6 billion assets under management. We are authorised and regulated by the Financial Conduct Authority. Ruffer LLP is a limited liability partnership (LLP) owned by current and former members of staff. This structure aligns our interests with those of our clients by emphasising investment returns and client relationships that are sustainable over the long term.

A consequence of the global financial crisis was the Basel Committee on Banking Supervision (BCBS) and competent authorities were given a mandate to revise Basel II make banks safer and to reduce significantly the likelihood of their failure. We support the work of the EBA and the UK PRA and FCA to achieve its objectives.

A strong, resilient and well-capitalised banking sector is a benefit not only to the overall financial services sector, but also to investment firms such as ours. It means that our clients have access to range of competitive banking services and thus opportunities to deposit funds that are guaranteed (up to £85000 in the UK). It also enables us to more clearly show to our clients a comparison of the risks and rewards for the services we offer with those offered by banks.

The need for separate CRRs for credit institutions and investment firms

We can understand that at the time the CRD/CRR was drafted it may have seemed appropriate for the EU to include investment firms within the scope of the prudential regime.

But with the advent of the many changes that have been introduced since then that are focussed on credit institutions and those still in motion, we think that the CRR is no longer is fit for purpose as the basis to set out the prudential regime for investment firms.

We therefore welcome the publication of the EBA discussion paper that adds to the EBA recommendations for sound prudential regime for investment firms in response to the Commission's call for advice of December 2014 [1] published in December 2015.

We recommend that the existing CRR should be retained and restricted for the prudential supervision only of a credit institution and that a new Investment Firm CRR (IFCRR) should be drafted applicable to all investment firms.

[1] ***https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-20+Report+on+investment+firms.pdf***

EBA recommended approach to the new prudential regime for investment firms

In its December 2015 report it set out in section 3.2 an analysis of investment firms' risks and risk-specific regulatory framework covering Market risk, Credit risk, Operational risk, Liquidity and funding risk, Large exposures and concentration risk; and Leverage risk.

We note that the EBA states in paragraph 29 of that report – and we agree – that *"perhaps the greatest source of potential risk for investment firms overall was 'operational risk', in the sense of when something goes wrong with the business operations or investment services and activities of the firm*".

It is therefore disappointing to see that the EBA has chosen to ignore that classification of risks, and to also ignore any attempt to quantify and include a measurement of operational risk and credit risk in the proposed regime.

Instead the EBA proposes to create a completely new and different taxonomy of risks in which it has concluded that for an investment firm risk can be primarily grouped into two broad risks; RtC - Risk to Customers and RtM - Risk to Market access. In addition the proposals are to scale up these risks – possibly in a non-linear manner – to reflect the implied leverage, systemic risk and scale of the firm. In addition it proposes to retain the calculation of the fixed overhead requirement (FOR) as a floor to the revised capital requirement.

We do not support this approach. Our view is that the classification of risks and the measurement of those risks using the proposed metrics do not represent the risks to investment firms and would not lead to a comparable regime or assessment of risk and capital adequacy across investment firms. We think that the FOR is an outdated measure that is not risk sensitive and should not form part of the future regime in its current format.

We therefore do not support a segregation of investment firms into the three categories as proposed in the DP and do not support the proposal for some investment firms - just because they are systemic and carry out certain 'bank-like' activities - to be subjected to the CRR. Instead we favour a proportionate approach to prudential supervision of all investment firms within a single regime.

Our proposals for the scope of an IFCRR

We are pleased to read that the EBA still seems to be open to the idea to considering a simplified CRR that would be applicable to investment firms. We agree with the analysis set out in paragraphs 179, 180 and 181. In conclusion our view is as follows:

We think that a new prudential regime for investment firms should in conceptual terms mirror the approach for the measurement of risk in credit institutions with the same categories, Credit including Counterparty Credit Risk and Residual Risk, Market, Operational Risk, Securitisation and Concentration Risk. We would expect the most significant risk to be Operational Risk followed by Market Risk for those firms that engage in proprietary trading activity. We think that there is significant merit in retaining the same taxonomy of risks across the financial sector that would in turn simplify the consolidation of risk within groups that include both types of institutions. We think that the best approach would be establish an investment firm CRR tailored to meet the needs of all investment firms.

Principles of a new regime

We believe that the principles that underpin the new regime are as follows:

- There should be a review of the eligibility of and definition of capital for non-joint stock companies including LLPs.
- The taxonomy definition of risks should be consistent for credit institutions and investment firms.
- The regime should include an appropriate balance between risk sensitivity, simplicity and comparability with incentives to reward effective controls over operational risk which we regard as the primary risk for an investment firm.
- Operational procedures and control standards and requirements should complement capital requirements, to reflect the full scope of the supervisory toolkit. Operational procedures should be subject to regular review and confirmation by the firms and periodic confirmation by external auditors.
- The measurement of risks for an investment firm should be specific and proportionate to them, and only considered to be same as a credit institution where it is deemed appropriate.
- Investment firms conducting proprietary trading activity should be subjected to an appropriate market risk capital framework.
- There should an initial capital requirement commensurate with the scope of activities that acts as a capital floor.
- There should be an estimate of the buffer of shareholder equity required for the orderly resolution of the investment firm and transfer of client assets to another firm to replace the existing Fixed Overhead Requirement (FOR).
- A leverage ratio is not applicable to an investment firm.
- A net stable funding ratio may be relevant for a few investment firms.
- For some investment firms a measurement of liquidity may be appropriate.

Treatment of non-joint stock investment firms

Ruffer is a limited liability partnership. It therefore has obligations towards its partners that are different to those of a joint-stock company. Consequently it means that there are restrictions placed upon the source of capital resources that are not applicable to joint-stock companies.

There may be benefit in expanding the range of instruments that a partnership or LLP could issue other than Core Equity, such as interest bearing debt on the basis that these funds could be converted into equity in the event of breaches in the equity capital requirements.

We urge the EBA to consult on this matter as well as recognising that a firm in which capital resources are sourced entirely from equity and retained earnings is less risky than a firm that relies upon debt and other instruments.

Process to establish a new regime

It is also unclear from the discussion paper whether the EBA considers that the existing amount of capital held by investment firms to be appropriate.

In addition our concern is that the EBA may think that after it has considered the responses that the Commission could then proceed to draft legislation. We think that such an approach would be premature.

We suggest that the EBA awaits the outcome of the Basel Committee's final deliberations on its revised approaches to Credit, Market and Operational risk and uses these as the basis to assess their suitability for Investment firms.

We think that the next step would be for the EBA to publish a consultation paper setting out the full scope of its proposals – in conjunction with ESMA – that would include the proposals for estimation of risk and calculation of the regulatory capital requirement. We would then like time to comment upon a consultation paper and in parallel for the EBA to conduct a quantitative study of the impacts to firms.

We also encourage the EBA to liaise with the FSB to ensure that any proposals for EU investment firms are consistent with proposals that might emanate from the FSB.

Detailed responses to the EBA DP

We have read the response submitted by the Wealth Management Association. We are agreement with some of their responses.

However, we think that it would be beneficial for the EBA to carefully consider an alternative regime as set out in this letter and in our detailed response to each question that is attached.

We would be very happy to discuss our views with the EBA.

Yours faithfully

Victoria Powell
Regulatory Policy Director
Ruffer LLP

Cc FCA, ESMA and FSB

Principles governing the categorisation of investment firms

4.2.1 ‘Systemic and bank-like’ investment firms

Question 1.

What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of ‘systemic and bank-like’ investment firms?

What are your views on both qualitative and quantitative indicators or thresholds for ‘bank-like’ activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale?

What aspects in the identification of ‘systemic and bank-like’ investment firms could be improved?

4.2.2 Investment firms that are not ‘systemic and bank-like’

Question 2. What are your views on the principles for the proposed prudential regime for investment firms?

We think that investment firms should be subjected to a separate prudential regime.

Therefore we do not think that is a matter of assessing ‘comparable’ or ‘same’ levels of assurance as that required for credit institutions, but instead to implement a regime that establishes an appropriate prudential level of regulation for investment firms.

Our view is that the level of and composition of capital, leverage, liquidity and funding for an investment firm are not directly comparable with a credit institution.

We agree with the principles set out in paragraph 12 b), c), d), e) and f).

With regard to principle 12 a) we have no comment.

4.2.3 Very small, non-interconnected investment firms

Question 3.

What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')?

If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3?

Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

Our preference would be a single prudential regime with 'built-in' proportionality.

We think that this would have the benefit of investment firms being able to determine their business strategy, risk profile and size and growth and to recognise that their capital requirements would be linked to those choices. We are not in favour of retaining the fixed overhead requirement (FOR) as a back-stop or floor to the capital framework in its current form.

Our view is it is important to ensure that there are the skills, experience and number of employees, and thus employee and other costs that is appropriate for the scale of the business. Therefore an approach that may encourage investment firms to economise and or reduce expenses in order to reduces its estimate of its capital requirement and or the costs of winding up the firm does not seem in our opinion to be a prudent prudential regime for the safety of the customers.

We think that there is merit in replacing FOR with an estimate of the time and costs that could be incurred to transfer customer assets to another firm. There may be merit in firms being required to set aside this amount within their shareholder equity.

We think that the prudential regime should be reflective of the future risks faced by the industry rather than a concept that was established decades ago.

Our preference is a consistent approach that is based upon a minimum capital requirement defined as initial capital requirement (ICR) that acts as a floor.

Question 4.
What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

For the above question, it would be useful to receive detailed comments on each of the following items, which would preclude an investment firm from being in 'Class 3':

- **a) holding client money or securities**
- **b) ancillary service of safekeeping and administration (B1),**
- **c) dealing on own account (A3),**
- **d) underwriting or placing with a firm commitment (A6),**
- **e) the granting of credits or loans to an investor (B2),**
- **f) operating a multilateral trading facility (or MTF) (A8)**
- **g) the MiFID II activity of operating an organised trading facility (or OTF),**
- **h) being member of a wider group,**
- **i) using a MiFID passport, and**
- **j) using tied agents.**

Following on from our answer to Q 3 our view is that to introduce two different approaches by differentiating certain activities set out in MiFiD Annex I and II [2] may lead to artificial choices of a business strategy influenced by the assessment of the regulatory capital implications. We do not think that this is in the interests of promoting a fair market in investment services.

We therefore do not support a differentiation in approach between 'smaller' and 'larger' investment firms.

In paragraph 18 there is a suggestion that whether or not a firm is part of a wider (inter)national banking or investment firm group should be considered interconnected and so precluded from applying a simpler capital treatment. We think that no matter the size of a firm or its degree of connectedness there should be a consistent treatment of the prudential regime for investment firms on a stand-alone firm basis.

So with respect to *i) whether a firm operates in only one or in many EU member states using a MiFiD passport should be not be matter of concern on the basis that the capital requirement is calculated at the legal entity firm level taking into account all branches that fall within scope*. We consider it matter for non-EU competent authorities to decide if they wish to require local 'trapped' capital for a local branch of an EU firm.

We agree there should be a consistent approach for all firms using tied agents within the prudential regime.

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[2] DIRECTIVE 2004/39/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL f 21 April 2004 **on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC** *http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02004L0039-20110104&from=EN*

4.3 Prudential regime for investment firms
4.3.1 Capital requirements

Question 5.
Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

The report on Investment Firms – response to the Commission's call for advice of December 2014 [3] published in December 2015 set out in section 3.2 an analysis of investment firms' risks and risk-specific regulatory framework covering Market risk, Credit risk, Operational risk, Liquidity and funding risk, Large exposures and concentration risk; and Leverage risk.

We note that the EBA states in paragraph 29 – and we agree – that *"perhaps the greatest source of potential risk for investment firms overall was 'operational risk', in the sense of when something goes wrong with the business operations or investment services and activities of the firm*".

It is therefore disappointing to see that the EBA has chosen to ignore that classification of risks, ignore any attempt to quantify and include a measurement of operational risk and credit risk in the proposed regime.

Instead the EBA proposes to create a completely new and different taxonomy of risks in which it has concluded that for an investment firm risk can be primarily grouped into two broad risks; RtC - Risk to Customers and RtM - Risk to Market access.

We do not support the proposals.

Risk to Customers

The proposed approach is to assume that the size of the assets under management (AUM), under advice (AUA), safeguarded and administered (ASA) is representative of a risk to the firm and these asset classes are comparable in terms of risk. We dispute this and find no empirical data or independent research to substantiate this proposition. Our view is that it is nature of different assets under management, for example their risk profile, liquidity, customer type, volume of turnover etc can result in a different risk profile for the firm. Therefore assets under management invested in liquid exchange traded equities equal to 5 times the assets held under management invested in unlisted securities would be seen by the EBA to require 5x as much capital. However, it may be that the opposite is true.

We are unconvinced by an approach that includes the premise that there is a linear relationship between assets under management and a capital requirement. In fact there may be economies of scale that more assets under management may result in a reduction in the marginal contribution to risk for the increased assets under management.

The proposed approach also does not take into account the operational risk control environment, including the number and experience of the employees managing the firm.

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[3] ***https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-20+Report+on+investment+firms.pdf***

Our view is that the principal risks that arise from these activities fall within the scope of Operational risk as set out in section 3.2.3 of the original EBA report. In addition there is also reputation risk and business / strategic risk. The risks are not per se a risk to the customer.

We note that the EBA acknowledges the challenge of including in the proposed approach for AUA, one-off advice or specific transactions. This is further reason why we think the proposal does not make sense.

With regard to liabilities to customers (LTC), our view that these represent cover a number of separate risks, credit risk (inability of the client to fulfil its obligations), counterparty credit risk (adverse movement in mark to market of a derivative contract) and liquidity risk that the firm may not be able to settle. There may be proprietary market risk. There will certainly be operational risk. We think that these risks should be identified as such as categorised into the risk categories that are appropriate to those incurred by credit institutions.

With regard to customer orders handled (COH) we do not agree that '*the customer can lose out'*. An investment firm is faithfully required to execute the client's request and errors and omissions are for the firm's account. In the event that an order results in a more favourable outcome for the client, the benefit accrues to the client, not the firm. We do not agree that the number (or similar measure of frequency) of orders handled (COH) represents a measure of risk to the firm.

Risk to Market access.

We think that the EBA is confusing market liquidity with market risk. We recognise that some investment firms will be providers of market liquidity and their sudden absence from the market could disrupt the market. However, a capital buffer serves no purpose in this regard because there is unlikely to be any impact upon the firm. The impact will be on those firms remaining in the market that may no longer have a provider of market liquidity. Our view is that the major providers of market liquidity are the large banks supported by the central banks.

The primary risk of an investment firm is to market risk exposure created by proprietary trading activity (PTA). The rules for determining the capital requirements for this activity are well set out in the current CRR and proposals for the fundamental review of the trading book (FRTB). We are perplexed why the EBA has recommended a new metric for PTA based upon the number or frequency of proprietary trades to be a measure of adverse movements in the mark to market to the firm. We do not agree with proposed measure of risk.

We therefore do not support the proposals and think that a new regime for investment firms should include approaches for the measurement of market risk that are the same for credit institutions (banks) and investment firms and allow the choice in approach to be based upon complexity of the business, regulatory and market expectations.

Scalers

The conceptual framework of the existing CRR is that the scaling of all risk measurement is linear. The additional scaling factors currently only relate to systemically important institutions.

We therefore do not support non-linear scalers.

We are aware the Basel Committee is currently finalising its proposals for the measurement of operational risk that may include the use of scalers and thus we would accept that scalers for that risk might be appropriate to investment firms should the Basel Committee choose to implement them.

Operational procedures and control standards and requirements should complement capital requirements, to reflect the full scope of the supervisory toolkit. Operational procedures should be subject to regular review and confirmation by the firms and periodic confirmation by external auditors.

Question 6.

What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients?

We read that the EBA thinks that *it no longer matters whether the investment firm treats client money and securities as its own liability on the balance sheet, or as completely separate from the accounts of the firm itself, or how asset segregation may work in practice at national or individual firm level, as the K-factor would treat all situations the same*.

We are deeply concerned about this proposal.

Our view is that client money held on the balance sheet entails the client being exposed to the firm even if the funds are deployed in liquid assets. Whereas client money held and segregated with a custodian does not result in the same risk to the firm. The primary risk of the former is liquidity risk for the firm, whilst the latter gives rise primarily to operational risk.

And should there be an RtM for securitisation risk-retentions?

We think that investment firms should be subjected to the same rules that are applicable to credit institutions as set out in the CRR.

Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

No. As noted above, we disagree with the approach to the classification of risk into RtC and RtM.

Question 7.
Is the proposed risk to firm 'up-lift' measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

The essence of the EBA proposals is to assess an inherent risk of the firm separate to the specific risks. The EBA introduces the concept of leverage whilst explaining that this is not the same as leverage as set out in the leverage ratio applicable to credit institutions.

Our opinion is that because the RtF is not envisaged to be a cap on the size of the business, but merely another form of scaler to reflect size, it would be a duplication of the risk already captured in other measures.

The point is that the size of assets under management etc, are not necessarily predictors of risk and thus leverage. Please refer to our response to Q5 that gives some examples for our conclusion.

We do not support the proposals.

In the event of the resolution of an investment firm, the primary risk is the availability of shareholder equity to allow the firm to be resolved and clients and their assets transferred to another firm. We recommend that an important focus of a separate regime for investment firms should be to estimate that amount.

Question 8.
What are your views on the 'built-in' approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?

We support a common approach with built in proportionality.

Such an approach will minimise the disruption from firms if the scale of their activities change. From a supervisory perspective a common approach may also assist when aggregating data to review sector issues or when comparing firms.

Question 9.
Should a fixed overhead requirement (FOR) remain part of the capital regime?
If so, how could it be improved?

The EBA sets out a number of different historical rationales for the FOR implying that "*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".*

We agree with the former assessment. In the event of a wind-down the principal risk is that there may not be sufficient equity to continue to pay the expenses during a wind-down period. The EBA points this out and notes that there have been occasions when this equity has been exhausted before completing a wind-down.

But, we do not agree that FOR is a proxy for operational risk. We do not see any meaningful relationship between expenses of which employee costs are the most significant and the operational risk of a firm.

The CRR is quite clear that the current calculation of the capital requirement is the higher of the calculation of FOR and the other risks (excluding operational risk).

Our opinion is that within the CRR the FOR is merely an alternative simple calculation of the other risks (excluding operational risk) in which if FOR is higher then this results in a higher minimum regulatory capital requirement. FOR is a method to calculate a floor.

We think that the minimum capital requirement for an investment firm should be calculated with reference to the risks of the firm and that a new approach should be considered to calculate a floor if it is considered that the estimation of the aggregate of all risks is insufficiently conservative.

Our opinion is that if a new regime was to be implemented with a measure of operational risk playing the central role – based upon the rules that we expect the Basel Committee soon to finalise – then there might be no need for a floor.

However, in addition, operational risks are potentially larger and more diverse that other risks and focusing such an array on a single solution, capital, will inevitably lead to a capital number that may be unrealistically high. For this reason we think that a new regime should introduce the principle that institutions should not only need to meet capital standards/requirements but also operational procedures and control standards and requirements and that these should be subject to regular review and confirmation by the firms and periodic confirmation by external auditors. Our view is that a suitable sanctions program would also be needed as tool for the CA to apply to institutions trying to game this requirement.

In summary we do not support the proposals as set out.

Question 10.
What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

Our view is that these risks to investment firms are the same as those incurred by credit institutions.

We do not support the proposals set out in paragraphs 79 and 80.

We recommend investment firms should be required to choose from and follow the same approaches as credit institutions taking into account their size and complexity.

Question 11.
Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?

No comment.

4.3.2 Definition and quality of capital for investment firms

In its report published on 14th December 2015 on page 59 the EBA set out its findings on 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.

Question 12.
Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?

No. It is unclear how the current rules are meant to apply to non joint stock companies and such firms have to try and interpret rules that essentially do not recognise their legal form.

The EBA proposals are silent on this matter.

We would encourage publication of a consultation paper on the subject.

Question 13.
Are the cases described above a real concern for the investment firms?
How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

The issue is a real concern to investment firms that are not non joint stock companies. There is no recognition in the rules of their corporate structure and European and national regulators are also unclear as to how such firms should be treated. Such investment firms have no certainty as to the approach that should be adopted and the reporting requirements have to be done on a 'best fit' basis. The development of a separate regime for investment firms allows consideration of the various corporate structures under which investment firms operate.

In terms of the permanence of capital we believe the key consideration is whether the investment firms has access on a continuing basis to sufficient cash or relatively liquid assets to ensure the funding of orderly wind down. We do not think the 'permanence' of capital is a key consideration.

Question 14.
What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?

For joint-stock investment firms we think that the same full suite of instruments that are permitted for credit institutions should be available.

There may be benefit in expanding the range of instruments that a partnership or LLP could issue other than Core Equity, such as interest bearing debt on the basis that these funds could be converted into equity in the event of breaches in the equity capital requirements.

Question 15.
In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

The concerns - for example - that the EBA sets out in paragraph 93 are equally applicable to credit institutions and investment firms.

We think that the best approach is to determine the deductions and prudential filters appropriate for investment firms when setting out the new regime. We would then be in a position to comment upon them.

Question 16. What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

We think that the trend to harmonise the definition of capital with accounting values and principles should be continued taking into account the specific factors that affect investment firms and differentiate them from credit institutions.

4.3.3 Initial Capital requirements

Question 17.
What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

We agree with the statement in the DP that an on-going obligation is retained and clarified as such, so that the minimum level(s) for authorisation in effect act as a further 'floor' to the minimum level of capital an investment firm must continue to hold in order to keep its authorisation to conduct MiFID investment services.

We support the recommendation that the definition of capital used for the purposes of meeting the minimum level(s) required as a condition for (on-going) authorisation of an investment firm under MiFID should also be aligned with whatever definition of capital (i.e. own funds) is decided to be used for the purposes of meeting the capital adequacy requirements of investment firms.

Question 18.
What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

We believe the current arrangements whereby the initial capital is set by reference to the activities to be undertaken by the investment firm should continue.

4.3.4 Eligible Capital

Question 19.
What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

We would support the concept of eligible capital being aligned, such that there is only one, single, definition of regulatory capital (i.e. own funds) to work with for investment firms, for whatever prudential purpose.

4.3.5 Liquidity requirements for investment firms

We have read with interest paragraph 117.

For the vast majority of investment firms it is important to note that their main out-flows (liabilities) needing some form of liquidity coverage stem from operational expenses, which are not calculated as out-flows in the LCR for banks. Whilst the liquid assets of many investment firms are, in the main, held in the form of bank deposits; in order to avoid contagion risk the LCR does not permit such interbank receivables within the definition of liquid assets, but not doing could have a massive adverse impact for investment firms, who would typically view such deposits as available liquid assets. Holdings of shares may also be important as a source of liquidity for some specialized investment firms.

Such features help confirm that the LCR and NSFR are inappropriate for investment firms.

Question 20.
Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

We believe stress scenarios should be specific to firm's business models.

Question 21.

What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for 'non-systemic' investment firms?

As mentioned earlier, we think that the FOR has been a proxy for the equity required to enable an orderly wind-down of the business in the event that expenses are still required to be incurred during a period when the income has been diminished.

We do not think that FOR is proxy for liquidity.

We do not agree with the EBA conclusions set out in paragraph 117.

Our view is it would be best to develop a specific liquidity methodology for investment firms. This could allow for the inclusion of inflows of fees and commissions and outflows of expenses. It could allow short-term placements with approved credit institutions (for example rated A or better) – subject to concentration risk to be included as liquid assets.

The purpose of the methodology would be estimate the in-flows and outflows over 30 days in order to ensure that the firm can meet its obligations in a business-as-usual basis.

It may be considered appropriate for investment firms that carry out proprietary trading activity to also be required to calculate an IFLCR – Investment Firm Liquidity Coverage Ratio.

More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and 'non-interconnected' investment firms?

As set out above, the FOR focuses only the calculation of the fixed overheads in accordance with the EBA FINAL draft Regulatory Technical Standards on own funds requirements for investment firms based on fixed overheads under Article 97(4) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) published on 29 January 2014[4].

This does not therefore take into account the income received by the firm. It presents a scenario in which there is no further income and only expense.

This is an inappropriate approach to measure liquidity.

We therefore do not support using FOR as the basis for measuring liquidity.

Question 22.
What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

Our view is that the starting point would be allow investment firms to include all the same assets that are eligible for inclusion by a credit institution for the calculation of its liquidity ratio.

If the EBA considers that there are assets that should not be included, we would welcome the EBA setting out its opinion on why that should be the case.

Question 23.
Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply "supplementary" qualitative requirements to individual firms, where justified by the risk of the firm's business?

We would suggest that investment firms that carry out proprietary trading activity be required to conduct an annual ILAAP (Internal Liquidity Adequacy Assessment Process) analogous the approach that is required for credit institutions.

The examples set out in paragraph 136 are examples of matters that would seem prudent to include in an ILAAP and for a CA to consider when assessing the liquidity of a firm.

[4] ***https://www.eba.europa.eu/documents/10180/561374/EBA-RTS-2014-01+%28Own+Funds+-+Fixed+Overheads%29.pdf/da124d04-73ad-4981-9faf-ee6697040dae***

Question 24.
Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm's business?

We would counter against adding layers of complexity in the rules governing liquidity risk management other than as proposed above. Many investment firms have simple business models; they act on an agency basis and do not take principal positions.

Our view is that in-flows and out-flows over the next three to six months can be estimated to reasonable levels of confidence. It is these cash flows that should form the basis of liquidity measurement.

Finally the measurement of liquidity should sit alongside the measurement of risk. It should not be co-mingled.

4.4 Other prudential considerations
4.4.1 Concentration risk

Question 25.
What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

We do not have large exposure other than to their bank. We acknowledge that the activities of investment firms can give rise to large exposures. We support the approach mentioned in the DP whereby the regulator performs supervisory monitoring, through a simple and proportionate reporting regime, which should include Class 3 firms.

4.4.2 Consolidated supervision

Question 26.
What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

We are supportive of the approach illustrated in Figure 6 of the DP.

Question 27.
In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

We are supportive of the approach illustrated in Figure 6 of the DP.

4.4.3 Additional requirements on an individual firm basis

Question 28.

What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?

We think that the proposals set out in paragraphs 159 – 161 are sensible and that guidance by the EBA to CA on the SREP (Supervisory Review and Evaluation Process) would provide a set of common standards and enable investment firms to understand in more detail the expectations of the CA.

4.4.5 Reporting and any other prudential tools

Question 29.
What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

Firms have had to incur costs in acquiring systems to meet COREP requirements and have to pay ongoing maintenance costs. The reporting requirements are exceedingly complex and the reporting requirements focus upon the needs of major banks. In most cases investment firms are only completing a very few number of data fields. The complex nature of the reporting requirements means that many small and medium investment firms have to seek ongoing external advice to ensure they meet their obligations. The data reported is meaningless for most investment firms and does not reflect the typical management information maintained by investment firms. We believe the data is of limited use to NCAs.

We suggest that a new set of COREP and FINREP should be created for investment firms.

Question 30.
What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms?

We note that the EBA has made reference to leverage. Given the fact that the principal business of an investment firm relates to off-balance sheet contingent liabilities and or assets of some form under management we are not supportive of the implementation of a leverage ratio.

We also note that there is mention of a net stable funding ratio (NSFR) but the EBA concludes such a measure may be inappropriate to firms. We would urge caution in reaching this conclusion. If, as we have recommended, a new regime should be applicable to all investment firms, the EBA may conclude that firms with material on-balance sheet exposures might benefit from the calculation of a NSFR designed specifically for investment firms that carry out bank-like activities as mentioned in the discussion paper.

And if required, how could they be made more appropriate?

No comment
In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

We believe that there could be merit in developing a standardised minimum set of Pillar 3 disclosures for investment firms.

4.5 Corporate governance and remuneration

Question 31.
What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

Our view is that it would be beneficial for consistent standards and code of governance embracing all joint-stock institutions covering credit institutions and investment firms.

If it is considered that there should be differences, it would useful to understand why the EBA considers that this should be so.

Question 32.
As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this?

Paragraph 174 notes that most investment firms have pay structures different to credit institutions due to different risk profiles. Yet in paragraph 176 the EBA suggests that investment firms that carry out systemic bank-like activities should be subjected to the same remuneration policies as credit institutions with respect to deferral and the pay out in instruments.

Our view is that if an investment firm is carrying out proprietary trading and business that is typically managed from within the Global Markets and Investment Banking divisions within banks, then it may be appropriate for the employees within the investment firm to be subjected to the same CRD/CRR remuneration requirements.

We do not see why these investment firms should be treated any differently. To do so, we would suggest may encourage the movement of this kind of activity between credit institutions and investment firms to allow different remuneration schemes to be established for the same risks.

For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

Our view is that all investment firms should be subjected to the same set or rules. We think that there may be merit in considering guidance on deferral and pay-out in instruments for joint-stock investment firms for those parts of their business that are engaged in proprietary trading activity. The EBA may wish to consider the development of a maximum distributable amount (MDA) similar to that calculated by credit institutions to ensure that minimum capital requirements are maintained.

Question 33.
What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

We are in favour of a framework that achieves the objectives set out in paragraph 177. In summary for investment firms carrying out business restricted to managing client assets where the profit and loss statement includes realised income and expense, we think that the existing guidance is appropriate.

We would like to see the EBA produce a report setting out any concerns that it may have with the existing MIFID remuneration requirements before we comment.

4.6 Alternative approach to a new regime

Question 34.
What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

We are pleased to read that the EBA still seems to be open to the idea to considering a simplified CRR that would be applicable to investment firms.

We agree with the analysis set out in paragraphs 179, 180 and 181.

In conclusion our view is as follows:

The objective of the EBA's discussion paper is a) to determine the extent to which some or all of the CRD/CRR should be applicable to an investment firm or some firms [5] b to establish whether there should there be a separate new prudential regime and c) the principles for the measurement of risk for an investment firm.

We are supportive of a new regime for investment firms and we believe that the principles that underpin the new regime are as follows:

We believe that the principles that underpin the new regime are as follows:

- There should be a review of the eligibility of and definition of capital for non-joint stock companies including LLPs.
- The taxonomy definition of risks should be consistent for credit institutions and investment firms.

[5] in accordance with Article 4.1. (2) of the regulation (CRR) "means a person as defined in point (1) of Article 4(1) of Directive 2004/39/EC, which is subject to the requirements imposed by that Directive, excluding credit institutions"

- The regime should include an appropriate balance between risk sensitivity, simplicity and comparability with incentives to reward effective controls over operational risk which we regard as the primary risk for an investment firm.
- Operational procedures and control standards and requirements should complement capital requirements, to reflect the full scope of the supervisory toolkit. Operational procedures should be subject to regular review and confirmation by the firms and periodic confirmation by external auditors.
- The measurement of risks for an investment firm should be specific and proportionate to them, and only considered to be same as a credit institution where it is deemed appropriate.
- Investment firms conducting proprietary trading activity should be subjected to an appropriate market risk capital framework.
- There should an initial capital requirement commensurate with the scope of activities that acts as a capital floor.
- There should be an estimate of the buffer of shareholder equity required for the orderly resolution of the investment firm and transfer of client assets to another firm to replace the existing Fixed Overhead Requirement (FOR).
- A leverage ratio is not applicable to an investment firm.
- A net stable funding ratio may be relevant for a few investment firms.
- For some investment firms a measurement of liquidity may be appropriate.

We have set out in this response our opposition to the approach for a RtC and RtM calculation, as well as a scaler approach to take into account size with the FOR as a back-stop.

We think that a new prudential regime for investment firms should in conceptual terms mirror the approach for the measurement of risk in credit institutions with the same categories, Credit including Counterparty Credit Risk and Residual Risk, Market, Operational Risk, Securitisation and Concentration Risk. We would expect the most significant risk to be Operational Risk followed by Market Risk for those firms that engage in proprietary trading activity.

We think that there is significant merit in retaining the same taxonomy of risks across the financial sector that would in turn simplify the consolidation of risk within groups that include both types of institutions.

We think that the best approach would be establish an equivalent investment firm CRR tailored to meet the needs of all investment firms.

Question 35.
What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.

The main problems with the current regime are:-

- The basis of the existing CRR regime is Basle II and III that was designed to address the needs of credit institutions.
- Its focus is therefore on credit risk that forms the majority of the risk of these institutions followed by market risk and to a lesser extent operational risk.
- On the contrary the major risk for an investment firm is operational risk followed by market risk for those firms that carry out proprietary trading activity. Credit risk is a much smaller risk
- The existing regime is therefore exceeding complex for an investment firm and significant portions of the text are irrelevant.
- Thus a very small investment firm needs to have a detailed understanding of what are essentially banking rules often just to determine that the relevant rules do not apply to them.
- Many small and medium sized investment firms have to incur costly ongoing external advice to ensure they meet their obligations.
- The current regime does not reflect the manner in which well-run investment firms monitor their activities from a prudential perspective. The reports such as COREP and FINREP are of little or no value to firms and competent authorities.
- Many of the legal entities that are investment firms are not adequately addressed, for example there is no recognition of limited liability partnerships - LLPs
- Policy formation within the CRD regime is solely directed at banks.
- The EBA has a Banking Stakeholder Group but there is no Investment Firms Stakeholder Group.

For these reasons we recommend that a new CRR specific to investment firms – but following the same conceptual taxonomy of risks is proposed

Process to establish a new regime

It is also unclear from the discussion paper whether the EBA considers that the existing amount of capital held by investment firms to be appropriate.

In addition our concern is that the EBA may think that after it has considered the responses that the Commission could then proceed to draft legislation. We think that such an approach would be premature.

We think that the next step would be for the EBA to publish a consultation paper setting out the full scope of its proposals – in conjunction with ESMA – that would include the proposals for estimation of risk and calculation of the regulatory capital requirement. We would then like time to comment upon a consultation paper and in parallel for the EBA to conduct a quantitative study of the impacts to firms.

We suggest that the EBA awaits the outcome of the Basel Committee's final deliberations on its revised approaches to Credit, Market and Operational risk and uses these as the basis to assess their suitability for Investment firms.

We also encourage the EBA to liaise with the FSB to ensure that any proposals for EU investment firms are consistent with proposals that might emanate from the FSB.

END of Response