European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London
E14 5AA

Dear Sirs,

Discussion paper on a new prudential framework for investment firms

This submission is made by PricewaterhouseCoopers LLP (PwC), the UK member firm of the PwC network. In the UK, we are the auditor of many regulated firms, as well as providing advisory services to a range of investment firms. Our practical experience of investment firms and their business models comes from a range of assignments. We also have a team of dedicated specialists focusing on the impact that new regulatory developments have on the financial services sector.

We welcome the opportunity to comment on the proposals and we are supportive of an approach which creates a new regime for investment firms. We believe that the way that the existing regime is developing under the Basel Committee will become increasingly difficult to reconcile to the business models of the vast majority of the firms that you intend to capture under the discussion paper and so a new regime is timely.

However, we have some reservations on the practical application of some of the proposals which we hope will be clarified when the more detailed proposals become available later in the year. We are also unsure of how the regime will operate in the future: Who will write/update rules? How will the proposals link to the supervisory framework, including ICAAPs and the use of Pillar 2? What will be the future for disclosure requirements? How will consolidation work under the new regime? Without these additional parts of the framework we do not feel able to give our full support, however we believe that the discussion paper provides the first step to a more appropriate regime.

This submission is not intended to represent the views of our clients, but rather to identify and to comment on certain aspects of the discussion paper on a new prudential framework for investment firms which we believe to have particular significance.

We have included our comments on some of the specific areas on which you sought feedback in the Appendix to this letter. We hope that our response will be helpful to you and we would be pleased to discuss our comments further with you.

Yours faithfully

Ben Higgin
PricewaterhouseCoopers LLP

PwC response to EBA discussion paper on new prudential framework for investment firms

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?**

The criteria used to assess whether institutions are O-SIIs or G-SIIs are appropriate for determining the systemic risks posed by an institution, as such it would be appropriate to use these criteria for identifying 'systemic and bank-like' investment firms.

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

PwC welcomes the intent (to design a more appropriate and proportionate prudential regime for investment firms) behind the Discussion Paper (DP). Broadly we support the principles which are set out in the DP, however we think it is important to recognise that non-systemic investment firms represent a broad category of firms ranging from those who take significant balance sheet risk to those whose primary purpose is asset management on an agency basis and face very different (largely operational) risks.

We are also unsure of how the regime will operate in the future: Who will write/update rules? How will the proposals link to the supervisory framework, including ICAAPs and the use of Pillar 2? What will be the future for disclosure requirements? How will consolidation work under the new regime? Without these additional parts of the framework we do not feel able to give our full support, however we believe that the discussion paper provides the first step to a more appropriate regime.

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

This approach seeks to capture both risks *posed to a firm* and risks *posed by a firm* (RtC and RtM*)*. In this respect it is different to the 'classically' micro-prudential approach which largely focuses on mitigating risks posed to firms. As noted in the DP, failure of one or more investment firms can impact on clients, counterparties and the wider market. However, we would suggest that by adequately ensuring the prudential soundness of institutions through addressing the risks posed to them, these risks can be largely mitigated. Ultimately it is the risk to firms which cause them to fail or interrupt the provision of services.

We would also note that broader risks to market functioning may be better addressed through initiatives such as the FSB's work on structural vulnerabilities from asset management activities (although of course this has a narrower scope than the EBA's focus).

The main risks to investment firms are operational and to a lesser degree market and counterparty risk (although the degree to which each risk is relevant will depend on the type of investment firm). We would suggest that the revised capital framework focus on these risks. However these risk categories should not

simply reflect the banking framework and should instead be tailored to reflect the risks to investment firms. For example a number of the K-factors described in the DP could equally be applied to each of these three risks (see below) with further K-factors being developed (see answer to question 4).

Operational risk
- AUM
- Customer orders handled
- Client money and securities held

Market risk
- Proprietary trading activity
- Balance sheet assets and off-balance sheet exposures

Counterparty risk
- Assets and off balance sheet exposures
- Liabilities to customers

4. **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? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?**

If the EBA chooses to follow the approach set out in the DP (i.e. RtC,RtM and RtE) we would suggest amending the K-factors identified. For example,

- **Assets under management** do not per se represent a risk to an investment firm's safety as they do not represent a risk to its solvency. It can be argued at a simplistic level that the larger the amount of AUM the greater the potential operational risk and potential risk of market disruption in the event of failure (due to the difficulty in transferring assets from one manager to another in a stressed scenario). However, it should be clear that the intent of this K-factor is not to 'capitalise' AUM rather to ensure that investment firms with AUM have adequate capital to absorb losses that might be incurred due to the operational risks of managing these assets. The logic of this point is also relevant to **assets under advice**, **assets safeguarded and administered** and **client money (and securities) held**.
- It should also be noted that the proposals will need to include greater details on how AUM are to be calculated, including on clarity on the point of time in which AUM calculations should be based. For example requiring AUM to be reviewed on a daily basis may result in capital fluctuating significantly and create disproportionate burdens for smaller firms.

- **Proprietary trading -** the DP suggests that proprietary trading activity (PTA) would be a relevant K-factor in respect to RtM. As we understand the intent of the RtM factor is to reduce the impact of stress in a firm on market functioning, we would question whether PTA would always be a relevant metric to focus on. In reality the ability of individual investment firms to impact on market functioning will be limited to firms that are very significant and/or operate in less liquid markets. The failure of a firm with significant proprietary positions in a deep and liquid market is unlikely to have

a broader impact on market functioning, although of course proprietary positions have the potential to threaten the underlying solvency of that firm.
If the EBA wishes to address RtM we would suggest focusing on K-factors which better measure the significance of a firm's impact on markets functioning. These could include percentage of trading activity in less liquid, but still economically important markets or market making activities.

Further K-factors to consider.

As operational risk is the key risk faced by investment firms (and the overwhelming risk for some investment firms) the EBA may wish to consider making operational risk central to the regime. Some examples of K-factors designed to measure operational risk are listed below, these could be developed further to design a regime which would more comprehensively measure operational risk for investment firms;

- Operational reliance on outsourcing providers for critical economic functions
- IT infrastructure cyber resilience

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

Whichever framework the EBA decides on should be risk sensitive and proportionate. This means that the capital requirements resulting from the regime should be commensurate to the risk to the firm from its activities. As such firms that trade on their own account in riskier markets should have higher capital requirements than those that don't. Smaller firms should also have less onerous requirements.

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

Please see answer to question 4**.**

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

The treatment of deductions and filters could be simplified. It is appropriate for some items such as DTAs which rely on future profitability and goodwill to be deducted from capital however some other deductions from capital in CRR may not be relevant to investment firms or are designed to specifically limit contagion in the banking sector (i.e. significant investments in a financial sector entity).

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

Bearing in mind the diversity of investment firms and the extreme variation in the liquidity risk they face, designing a common liquidity stress scenario would not seem appropriate.

Liquidity risk is inherent in the banking model due to maturity transformation. Liquidity risk does exist for some investment firms (those that rely on funding sources which may not always be available to fund their activities). However, certain types of investment firms, such as limited licence assets managers, face limited funding risk to their own balance sheet as the ultimate liquidity risk of the majority of their activities sits with their clients. Asset management activities clearly have the potential to impact on broader market liquidity conditions (for example investors exiting certain asset classes at the same time) however applying liquidity regulation to asset managers would not address this issue.

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 'nonsystemic' investment firms? More specifically, could you provide any evidence or counterexamples 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?

The design of any liquidity measure for investment firms should be proportionate and tailored to the specifics of investment firms' business models. As noted above the liquidity risk investment firms face is very diverse. In light of this the options are i) to design a differentiated liquidity regime for the different investment firm business models or ii) to apply a requirement which acts as a floor for all investment firms. The latter (requiring firms to invest a certain percentage of capital in liquid assets) would not be risk sensitive as it would not take into account the firm's wider liability structure. Instead allowing supervisors to tailor the approach of a firm-by firm basis may be preferable. If the approach of requiring firms to hold liquid assets as a percentage of FOR is pursued this should be calibrated at a level which acts as a backstop measure.

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).

The principles described in annex 4 are sound. However, it is important that the merits of holding a diverse stock of liquid assets is recognised. If all investment firms are relying on the same asset class to provide liquidity in a stress (in addition to CRR firms) then the liquidity of even the most liquid asset may be tested.

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?

When applying any additional prudential requirements, for example under Pillar 2, competent authorities should take into account proportionality and the relevance of additional prudential measure to addressing the perceived risks. For example additional capital requirements are often not the right response to risks that investment firms' face (such as operational risks where enhanced risk monitoring, systems and controls may be more beneficial).

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

We would urge the EBA to consider on a holistic basis whether Investment firms, particularly limited licence asset managers are required to submit data at a level of granularity under the current regime which is commensurate to the level of risk that they pose.

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

A number of the governance requirements in CRD are relevant to all firms. For example members of the management body should be of sufficiently good repute, possess sufficient knowledge, skills and experience not only to perform their duties but also to ensure independence of mind to effectively assess and challenge the decisions of senior management. Board members should also act with honesty, integrity and independence.

However some of the requirements which apply to all CRD firms (such as limits on directorships) may not be proportionate to investment firms that have a more simplified business model. Additional requirements under CRD which apply to significant firms only (such as establishing an independent risk committee) are not proportionate for most investment firms.

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? 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?

The full CRD/CRR requirements includes the so called 'bonus cap' which limits variable remuneration to the level of fixed remuneration (with the ability to increase variable to twice the level of variable subject to shareholder approval). There is evidence that the bonus cap may have contributed to an increase in fixed remuneration as a proportion of total remuneration. To the extent that it has had this effect the bonus cap has reduced the amount of remuneration 'at risk' and may impair the ability of firms to reduce pay-outs in times of stress. These effects should be considered carefully in the context of 'systemic and bank-like' investment firms.

For other investment firms it is important that any remuneration requirements are proportionate. Whilst there may be a role for measures which seek to align risk and reward simply reflecting standards devised with banks in mind would not be the right outcome. The much greater diversity in size and ownership structure of investment firms has the potential to make compliance with specific remuneration requirements significantly more costly for smaller firms (relative to the size and resources of the business). We would also note the challenges of applying remuneration provisions to partnership businesses and would question the merits of applying remuneration requirements to the smallest investment firms at all.

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?

As noted in our response to question 4 we consider operational risk to be the key risk for investment firms and in some cases the overwhelming risk. The capital framework for investment firms should recognise these whilst addressing other risks in a proportionate manner.

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 agree that a separate framework (or indeed frameworks) for investment firms would be preferable to keeping them in scope of CRR. The current regime captures far too broad a spectrum of institutions to be proportionate for investment firms. We would also stress that investment firms themselves represent a very broad category of firms which face very different risks, it is important that this is reflected in the revised framework for investment firms.