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Prudential Rules for Investment Firms:

How to tailor a targeted prudential framework?

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MEETING REPORT

All investment firms are currently subject to the prudential requirements primarily designed for banks[1]. The European Commission's proposal for a prudential framework devoted exclusively to investment firms will alter this regime. The overarching objectives of the new prudential framework is to ensure that the firms have sufficient funds to remain financially viable and avoid contagion to customers and the wider economy.

The main obstacles and challenges of the proposed prudential framework for investment firms were discussed by policy-makers, industry representatives and other experts at the CEPS-ECMI Conference on Prudential Rules for Investment Firms, hosted by ABN AMRO Clearing in Amsterdam.

Welcome remarks

Speaker: **Lieve Vanbockrijck**, ABN AMRO Clearing

The legislative overhaul in the aftermath of the global financial and economic crises have broadened and deepened the regulatory and supervisory scrutiny. For example, the Markets in Financial Instruments Directives (MiFID I & II) have forced unregulated financial service providers to become investment firms.

Consequently, investment firms now include many different types of institutions that pose different risks to the financial system. There are investment firms that are quite similar to banks in their activities and risks like investment banks, whereas there are also investment firms that are very distinct and do not even deal with client money like proprietary traders. The new prudential framework for investment firms needs to address these differences in activities and risks in between investment firms. Moreover, appropriate supervision is required for effective enforcement.

Sesssion I – What prudential rules for investment firms?

Speakers: **Mattias Levin**, European Commission; **Diederik Dorst**, Flow Traders; **Emmanuel de Fournoux**, AMAFI; and **Paul Rich**, Financial Conduct Authority.
Moderator: **Karel Lannoo**, CEPS/ECMI

There are approximately 6,000 investment firms in the EU. Most of these investment firms are established in the United Kingdom (55%), Germany, France and the Netherlands. The number of investment firms in continental Europe is expected to grow in the upcoming years, with UK based investment firms creating subsidiaries on the continent in the contect of Brexit as well as the commitment from EU legislators to reduce the bank dependence for financial intermediation (e.g. Capital Markets Union).

[1] Directive 2013/36/EU and Regulation (EU) No 575/2013 on capital requirements for banks and investment firms (CRD IV/CRR)

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The are large differences among investment firms, looking at their size and activities. Currently, these firms are subject to prudential rules that are primarily designed for banks, which makes them more cumbersome and complex than necessary to address the specific risks of investment firms. The European Commission proposal creates a distinct regime for investment firms. The regime divides the investment firms in three classes, which is a substantial simplification compared to the eleven regimes in the current framework.

Class I covers **systemic investment firms** (more than EUR 30 billion in total assets) that will, according to the Commission proposal, be required to obtain a credit institution license. They will thus remain subject to the same capital requirements as banks. Based on the current threshold for this first class, eight investment firms - all based in the UK - would be required to obtain a credit institution license. This is similar to the existing prudential regimes in the UK and United States.

Class II covers **larger and riskier non-systemic firms** (based on risk metrics) that will be subject to a simplified version of the existing rules. These investment firms will be subject to the higher levels of permanent minimum/initial capital, fixed overheads requirement or K-factor capital requirement. The K-factor capital requirement introduces a new way to ensure that the capital requirements of the investment firm are responding to their risk profile, including customer- (assets under management, client money, etc.), market- (net trading position) and firm-related risks (counterparty default, concentration risk, etc.).

Class III covers **small and non-interconnected firms** that will be subject to simpler capital requirements with the higher levels of the permanent minimum/initial capital or fixed overhead requirement.

Besides the capital requirements there are some other prudential requirements for all investment firms, including concentration risk, liquidity, disclosure/reporting requirements and remuneration and governance provisions. Moreover, the equivalence regime to allow investment firms from third countries to be active in the EU and vice versa has also been revised.

Discussions regarding the Commission proposal focus on whether it strikes the right balance between new and bank-like requirements, is sufficiently proportionate for smaller firms, addresses the specific risks and is sufficiently simple and clear.

The European Council and European Parliament are now forming their opinion on the proposal before starting the trialogues to find a political agreement on the final legislative text. Indeed, there the first exchanges in the Council appear largely supportive of the proposal, but there is some discussion, primarily about whether the thresholds determining the distribution between classes are not too high and there seems to be opposition to the less stringent reporting requirements for smaller firms. In parallel, EP-rapporteur Markus Ferber has issued a report with his first thoughts and the Commission is conducting a public consultation.

The investment firms and conduct-of-business supervisors are primarily concerned that investment firms are treated like banks, whereas their business is in most cases inherently different. Although a large number of the investment firms are part of banking groups, many are also stand-alone. For example, proprietary traders (including market makers) do not take client money, their services are substitutable, they have a largely matched and correlated portfolio and their exposures are more liquid than banks. They therefore argue that less stringent capital requirements would be more appropriate.

Although there seems to be broad support for the Commission proposal among investment firms and supervisors, some would like the regime to be entirely distinct from bank capital requirements. The proposed capital requirements and liquidity requirements do not always reflect the risks of investment firms. The high watermark in market risk, for instance, will require investment firms to hold more capital for a period of three months whereas the composition of the portfolio of some types of investment firms is changing every couple of days. Moreover, the proportionality in the proposal primarily addresses the frequency in the reporting, whereas it is especially the amount of reporting that determines the required resources.

There are also some concerns about proportionality. For example, smaller investment firms are put at a disadvantage with the application of standard risk-weights that are by definition higher than those of larger firms that use internal models. Moreover, the prudential requirements are also applied to activities outside the EU consolidated in the group, which might put EU investment firms at a competitive disadvantage compared to investment firms in third countries, some argued.

Another concern is the lack of a level-playing field. Currently, there is substantial discretion at national level resulting in different requirements and practices across member states. For example, in some member states investment firms are supervised at both individual and consolidated levels, whereas in others only at consolidated level.

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Session II – Which supervisors for investment firms?

Speakers: **Jasper Jorritsma,** Autoriteit Financiële Markten; **Paul van den Berg,** De Nederlandsche Bank; **Bart Joosen**, VU University Amsterdam; and **Martin Koder**, London Stock Exchange Group.
Moderator: **Matthijs Geneste**, ABN AMRO Clearing

Several supervisors currently have duties for investment firms. For example, at EU level the European Securities and Markets Authority (ESMA) has duties under MiFID that regulates their activities and the European Banking Authority (EBA) has duties under CRDIV/CRR that regulate prudential requirements. Although ESMA also had a seat at the table in these discussions, the Commission's proposal is based on an EBA recommendation. Some are somewhat surprised by the limited role of ESMA in the process, given the ambition of the Commission to develop European capital markets. The prominent role of the EBA in the process is reflected in the capital definitions that are largely similar to the complex capital requirements for banks, whereas more simple requirements could, according to some, be as effective and more efficient. In that sense the current proposal is considered a missed opportunity to arrive at tailored requirements for investment firms.

The discussants largely agreed that at both EU as well as national levels, the conduct of business supervisors such as ESMA and AFM should have had a more prominent role in the drafting process. Indeed, conduct–of-business supervisors have in general a much deeper understanding of the specific risks of investment firms. In daily supervision there can be a distinction between prudential and conduct supervisors focusing on financial stability and conduct-of-business respectively. However, in the legislative process a holistic approach would be more effective in striking the right balance.

There are diverging views on how the supervision of investment firms should be organised. Some argue that the prudential supervision (excluding approval of market risk models) should be moved to the conduct-of-business supervisors, since they are already responsible for checking compliance with MIFID, which has strict requirements on how to deal with client money, risk management, etc. Others argue that ESMA and other conduct supervisors do not currently have the organisational capacity to execute prudential supervision. Along these lines there should also be a more prominent role for ESMA in the formulation of the rules including implementing standards as well as supervisory guidance and convergence, but prudential supervisors should remain responsible. Otherwise, at European level, EBA and ESMA could in the foreseeable future merge into a single institution with the relocation of EBA to Paris, where ESMA is already located. Although this would consolidate conduct and prudential supervision at EU level in a single institution, some fear that this might lead to a more bureaucratic organisation. In the meantime, one should ensure that at least the relevant competent authorities should be involved in the preparation of the proposal, with clear division in tasks and responsibilities.

Supervisory convergence is also essential for investment firms. Although the rules are clearly defined, they still leave quite some room for national interpretation,in particular for clarifying definitions such as client money.

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Closing remarks

Speakers: **Karel Lannoo**, CEPS/ECMI and **Jan Bart de Boer**, ABN AMRO Clearing

Capital markets are an important (potential) contributor to sustainable economic growth in the EU. This requires the development of prudent, but also sufficient institutions to provide liquidity in the markets, including in continental Europe. The introduction of MiFID II has shown – with the exit of around fourteen players from the market – that it is not self-evident that there are sufficient liquidity providers. In fact, apart from the Netherlands with more than 10 liquidity providers, in most EU-27 countries there are between 0 and 2 non-bank domestic liquidity providers left. The build-up of excessive pools of capital across different types of financial institutions in order to abide by stringent capital requirements could lead to further erosion of the market for non-bank liquidity providers.

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Agenda

09:30 – 10:00	Registration and coffee
10:00 – 10:15	Welcome remarks **Lieve Vanbockrijck**, Chief Financial Officer, ABN AMRO Clearing
10:15 – 11:15	Sesssion I – What prudential rules for investment firms? In proposing a prudential framework exclusively for investment firms, the European Commission aims to make prudential requirements more proportionate and risk-sensitive for these companies. In particular, the smaller investment firms can benefit under the new regime from less-demanding requirements. The question remains, however, whether the Commission can succeed in creating a risk-sensitive system with less demanding requirements for less-risky firms. Is there a need to further tailor the proposed framework? Could the framework be made more proportionate and risk-sensitive? Does the framework address the inherent risks of investment firms? **Mattias Levin**, European Commission **Paul Rich**, Financial Conduct Authority **Diederik Dorst**, Flow Traders **Emmanuel de Fournoux**, AMAFI Moderator: **Karel Lannoo**, CEPS/ECMI
11:15 – 11:45	Coffee break
11:45 – 12:45	Session II – Which supervisors for investment firms? Several supervisors have currently duties for investment firms. For example, at EU level the European Securities and Markets Authority (ESMA) has duties under MiFID that regulates the activities and the European Banking Authority (EBA) has duties under CRDIV/CRR that regulate the prudential requirements. Does such dispersion of responsibility contribute to effective and efficient supervision? Should the regulation of investment firms at EU level be consolidated in one supervisory authority? And which institution would be best placed to perform the direct supervision of investment firms at national level? **Jasper Jorritsma,** Autoriteit Financiële Markten **Paul van den Berg,** De Nederlandsche Bank **Bart Joosen**, VU University Amsterdam **Martin Koder**, London Stock Exchange Group Moderator: **Matthijs Geneste**, ABN AMRO Clearing
12:45 – 13:00	Closing remarks **Karel Lannoo**, Chief Executive Officer, CEPS/ECMI **Jan Bart de Boer**, Chief Commercial Officer, ABN AMRO Clearing
13:00 – 14:00	Sandwich lunch