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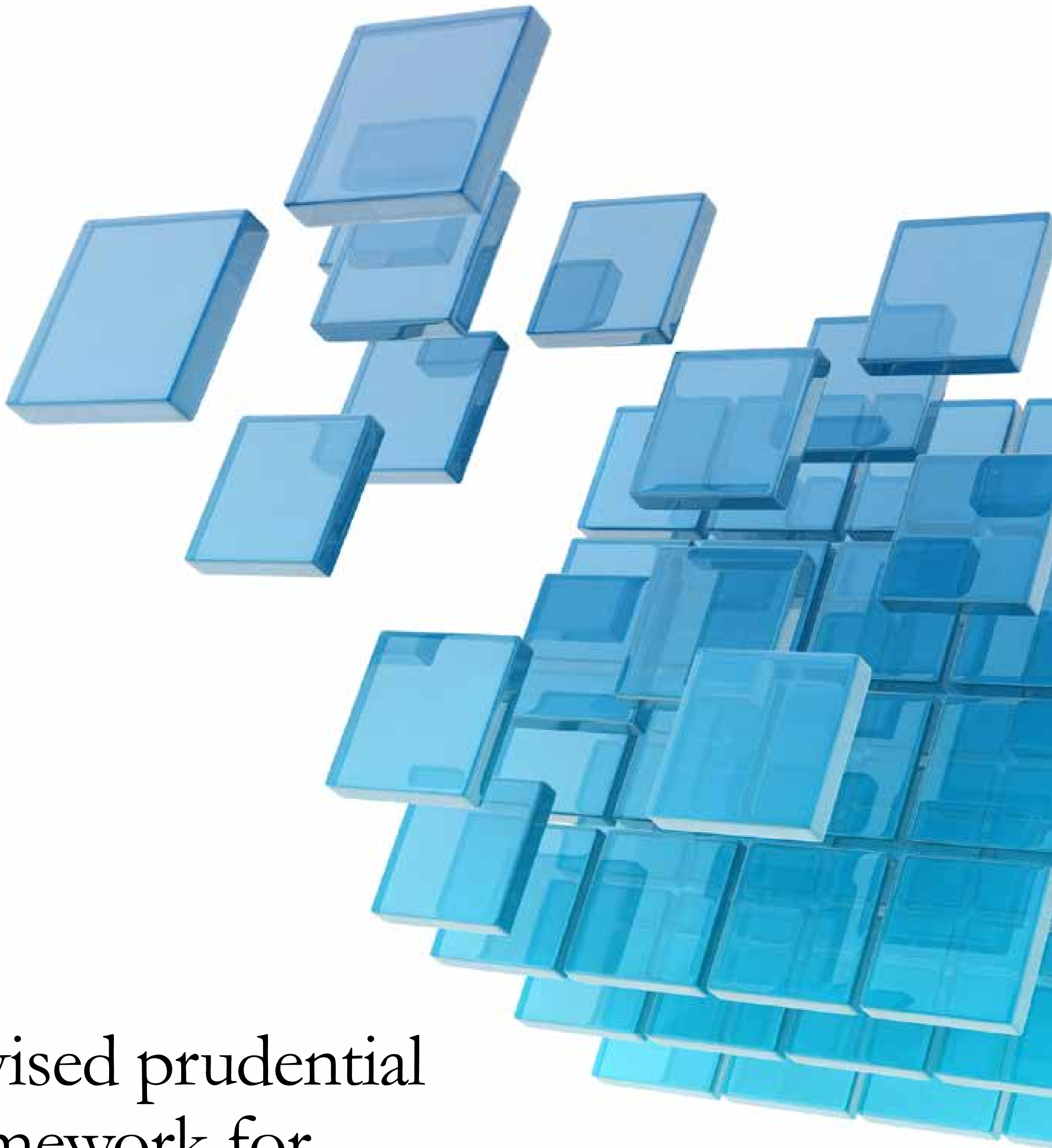

Revised prudential framework for investment firms

February 2018

Overview

On 20 December 2017, the European Commission published proposals to revise the framework for the prudential regulation of investment firms. The proposals were anticipated and are an attempt to "ensure that investment firms are subject to key prudential requirements and corresponding supervisory arrangements that are adapted to their risk profile and business model, without compromising financial stability".

The proposals are comprised of a Regulation on the prudential requirements of investment firms and a Directive on the prudential supervision of investment firms. The Directive sets out requirements for the appointment of prudential supervisory authorities, addresses cooperation between home and host authorities, supervisory powers, tools and administrative penalties and revises the rules on corporate governance and remuneration and the level of initial capital required of investment firms. However, this note will focus on the proposals set out in the draft Regulation which deal with own funds, levels of minimum capital, concentration risk, liquidity and reporting and public disclosure for all investment firms that are not designated as "systemic".

The proposed regime would categorise investment firms into three buckets:

1. firms which are considered "bank-like" systemic investment firms. The proposals would subject them to the same authorisation, supervision, capital, liquidity and corporate governance requirements as banks;
2. investment firms which cross particular size or risk thresholds. Such firms are subject to adapted supervisory and prudential requirements; and
3. the smallest and "non-interconnected firms" which are subject to the least complex requirements.

The EBA's final advice and discussion paper published in November 2016 referred to these categories as class 1, class 2 and class 3 respectively. Although the Regulation does not use this terminology, for ease of reference we have adopted such class references in this note.

The requirements apply on an individual basis, although subject to certain requirements, a derogation is provided for class 3 firms within banking groups subject to consolidated application and supervision. A derogation is also contemplated from the liquidity provisions where the investment firm is included in group supervision on a consolidated basis and the group has centralised liquidity management functions. A specific group requirement also applies to investment firm only groups (of class 2 and 3 firms).

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Investment firm categorisation

When seeking to apply the proposed new regime to a firm, the first thing to do is to identify which category the firm falls into.

The first category is investment firms with total assets above EUR30bn and which provide underwriting services and/or dealing on own account. Such services are seen as important for financial market efficiency, integrity and investor protection. They also subject the investment firm to credit and market risk. The proposals subject such 'bank like' systemic institutions to continued regulation under the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRDIV). They are required to be authorised and supervised as credit institutions. The definition of 'credit institution' in the CRR will be amended to include such investment firms.

The second category is investment firms which cross any of the following thresholds:

– Assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements of EUR1.2 billion or more, assessed by applying end of day levels on a combined basis for all investment firms that are part of the group;

– Client orders handled of at least EUR100 million/day for cash trades and/or EUR1bn/day for derivatives, assessed by applying end of day levels on a combined basis for all investment firms that are part of the group;

– A balance sheet total of at least EUR100m, assessed by applying end of last financial year figures on a combined basis for all investment firms that are part of the group;

– Total gross revenues of EUR30m or more, assessed by applying end of last financial year figures on a combined basis for all investment firms that are part of the group;

– Have any exposure to risks from trading certain financial instruments, assessed by applying end of day levels on an individual basis;

– Safeguard and administer any client assets, assessed by applying end of day levels on an individual basis; and

– Hold any client money, assessed intra-day on an individual basis.

Such investment firms will have minimum capital requirements of the higher of: the initial capital requirement for their authorisation; a quarter of their fixed costs for the previous year (or, where there are no such historic figures, projected costs); and the sum of K-factors specially designed to reflect risks posed by the firm. They will also be subject to corporate governance and remuneration rules.

Class 3 investment firms are those below all of the thresholds applied to identify a class 2 firm. Such firms are subject to the least complex requirements. They simply apply the corporate governance/remuneration rules of MiFID II and have minimum capital requirements of the higher of: the initial capital requirement for their authorisation; and a quarter of their fixed costs for the previous year (or, where there are no such historic figures, projected costs).

Capital requirements and K-factors?

Class 2 investment firms need to assess the value of their regulatory capital requirements by reference to K-factors. K-factors are intended to target the services and business practices that are most likely to generate risks to the firm, to its customers and counterparties. They set capital requirements according to the volume of each activity. A class 2 firm's regulatory capital requirements will be the higher of: its initial capital requirements; a quarter of its fixed overheads for the previous year; and the sum of K-factors applicable to it.

K-factors are split into three broad categories: risk to customers (RtC) and for firms that deal on own account and execute client orders in their own name, risk to market (RtM) and risk to firm (RtF).

RtC K-factors are Assets under Management (K-AUM), assets safeguarded and administered (K-ASA), client money held (K-CMH) and customer orders handled (K-COH).

K-AUM considers the value of assets that an investment firm manages for its clients both under discretionary management and non-discretionary arrangements constituting advice. It includes assets which the firm has delegated to another undertaking and excludes assets that another undertaking has delegated to it.

K-COH brings into capital requirement assessments the value of orders that an investment firm handles for clients, through the reception and transmission of orders and through the execution of orders on behalf of clients. It excludes transactions executed by the investment firm in its own name either for itself or on behalf of a client.

RtM is reflected by a K-factor for net position risk (K-NPR). This is based on the market risk requirements of the CRR, applied to the value of transactions recorded in the trading book. It captures trading book positions of an investment firm dealing on own account, whether for itself or on behalf of a client. For K-NPR, the capital requirement is calculated using either the simplified standardised approach in the CRR (where the firm's trading book business is EUR300m or less), the standardised approach in the CRR as amended by the November 2016 Commission proposals to amend the CRR (CRRII), or the internal model approach in the CRR as amended by CRRII. Where the standardised or internal model approach is used, the K-NPR is then multiplied by a factor of 65%. Alternatively, in certain circumstances and subject to national competent authority approval, the firm can apply a K-factor based on initial margin posted with clearing members for trades guaranteed by the clearing member or otherwise settled on a delivery-versus payment basis (K-CMG).

RtF K-factors address trading counterparty default (K-TCD), concentration risk (K-CON) and daily trading flow (K-DTF).

K-TCD is the capital requirement relative to the exposures in the trading book of the firm in certain derivative instruments, long settled transactions, repurchase transactions, securities or commodities lending or borrowing transactions and margin lending transactions. The Regulation requires firms to apply a risk factor of 1.6% for transactions with credit institution or investment firm counterparties or 8% for transactions with any other counterparty type to the exposure value of the transaction. The exposure value is calculated as the replacement cost plus potential future exposure (for derivatives transactions or long settled transactions) minus the value of collateral (subject to prescribed haircuts). The Regulation further prescribes how to determine the replacement cost and, where relevant, potential future exposure amounts. There are also provisions to recognise the credit risk mitigating effect of netting agreements in the calculation of K-TCD.

K-CON applies to exposures in the trading book which exceed the 25% exposure limit imposed by the Regulation.

K-DTF is the capital requirement relative to the daily value of transactions that the firm enters into through dealing on own account or the execution of orders on behalf of clients in its own name. It excludes transactions executed by an investment firm providing portfolio management services on behalf of investment funds.

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Own funds

Instruments which qualify to meet the capital requirements are the same as those under CRR/CRDIV; Common Equity Tier1, Additional Tier 1 and Tier 2. At least 56% should be CET 1 instruments and only up to 25% can be Tier 2 capital.

Concentration risk

The proposals require all investment firms to monitor and control their concentration risk in the trading book "by means of sound administrative and accounting procedures and robust internal control mechanisms". Furthermore, class 2 firms are required to report on various concentration risks at least annually. For firms that deal on own account or execute client orders in their own name, exposure to a single or connected clients should not exceed a value of more than 25% of their regulatory capital unless it notifies its competent authority without delay and meets a corresponding K-CON capital requirement. There are derogations for firms specialising in commodity derivatives or emission allowances for intra-group exposures provided they service group wide liquidity or risk management purposes. Otherwise, a firm is subject to additional K-CON requirements. There are substantial questions as to the quantum of the K-CON requirement which will have to be clarified in the drafting of the Regulation.

Liquidity

The proposals also impose requirements to mitigate against liquidity risks. All investment firms must monitor and manage their liquidity requirements. The proposals require them to hold at least one-third of their fixed overheads requirements in liquid assets (ie 1/12 of the fixed overheads of the preceding year) and additional liquid asset to cover an amount equal to 1.6% of the total amount of guarantees provided to customers. Assets eligible to meet this requirement are those that qualify as "High Quality Liquid Assets" under the CRR Liquidity requirements together with unencumbered own cash of the firm (not client money). Class 3 firms can also count trade debtors and fees or commissions receivable within 30 days, subject to specific conditions.

Reporting and public disclosure

Firms are required to report annually to their national competent authorities on their compliance with the prudential framework. The details of the requirements will be set out in Level 2 measures but those subject to K-factor requirements will have more detailed requirements than those subject to permanent initial capital or fixed overhead based requirements.

Firms are also required to publicly disclose their levels of capital, capital requirements, its return on assets and risk management objectives and policies for each of the categories of risk addressed by K-factors, concentration risk and liquidity on the same day that they publish their annual accounts. Class 2 firms are also required to publicly disclose their remuneration policies and practices and governance requirements.

Timing?

The proposals are now subject to discussion by the European Parliament and the Council. Once adopted, an implementation period of 18 months is envisaged. It is therefore likely to come in towards the end of 2019, in line with the Commission's desire to complete the Capital Markets Union by the end of 2019.

The proposals also give those investment firms most impacted by the proposals a transitional period of five years before they must apply the new requirements in full.

Impact?

The proposals do not come with an impact assessment. This is because the review was required by the provisions of the CRR. Whether or not the European authorities consider an impact assessment necessary, however, investment firms will undoubtedly be carrying out their own analyses.

With respect to the impact on capital requirements, the EBA assessed that its September 2017 advice (on which the published proposals are based) would increase Pillar 1 requirements for non-systemic EU investment firms by 10% but decrease them by 16% when compared with total requirements applied as a result of Pillar 2 add-ons.

However, the range of impact will be wide and the proposals themselves anticipate that some firms will face large increases (more than double existing requirements). For some asset managers in particular, the impact will be major.

Whilst the simplification of the regime applicable to investment firms will no doubt be welcomed, at least some in the industry may view the categorisation of firms and the capital proxies as failing to reflect the agency characteristics and business models of many investment firms.

Commission delegated powers

The Commission is granted authority to adopt various delegated acts, in some cases for an "indeterminate" period of time. This includes the power to adopt delegated acts to "clarify" the definitions used in the Regulation to "ensure uniform application" and "to take account of developments on financial markets". Similarly, the Commission is granted the power to change the thresholds for firms to qualify as class 3 firms, to specify the methods for measuring the K-factors and to adjust the coefficients which apply to the K-factors. This would seem to grant the Commission a fair degree of autonomy. That said, either the Council or the Parliament can at any time revoke the power of the Commission to clarify the definitions and/or to adjust the K-factor measures and coefficients. Additionally, an act proposed by the Commission to change the definitions, K-factor measures or coefficients will only come into force if the Council and the Parliament do not object within two months of notification by the Commission.

National competent authority discretion

Another possible concern for the industry is the discretion afforded to competent authorities. Where firms apply the fixed overhead requirement, competent authorities can adjust the amount of capital required where they consider that there have been material changes in the activity of a firm.

The proposed amendments to the definition of credit institution in the CRR also anticipate competent authority discretion to classify an investment firm as a credit institution "to address potential risks of circumvention and potential risks for the financial stability of the Union".

The wider context

The FAQs published by the Commission alongside the proposals state that most systemic investment firms are currently located in the United Kingdom. With Brexit looming, many are in the process of relocating at least part of their operations to the EU-27. As with many European proposals currently on the table, the impact of these proposals needs to be viewed in the context of firms' Brexit contingency plans. It will also be interesting to see whether and if so, how the UK implements equivalent legislation given that this is likely to be adopted in the EU after March 2019.

The proposals must also be considered against the backdrop of ongoing discussions to finalise proposals to amend the CRR and CRDIV, including the proposals to require a group with two or more institutions in the Union (and assets of EUR30bn or more) to have an intermediate EU parent undertaking established in the Union.

For firms which fall within the systemic "bank-like" categorisation and which will be captured by the definition of credit institution in the CRR, careful consideration must be given to any unintended consequences of this classification and revised definition. For one thing, it is clear that the ECB is expanding its interest beyond banks into the investment firm sector.

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Appendix

Appendix

The following table summarises the coefficients or factors and the valuation measure applicable to the various K-factor assessments. Business projections can be used where a firm does not have historical data (ie where they have not been conducting the relevant service for the historical period to be assessed).

Risk type	K-factor	Coefficient/factor	Measure
RtC	K-AUM	0.02%	Rolling average of the value of the total monthly assets under management, measured on the last business day of each of the previous 15 calendar months (excluding the three most recent monthly values). The average or simple arithmetic mean can be used. To be calculated within the first 14 days of each calendar month.
RtC	K-CMH	0.45%	Rolling average of the value of total daily client money held, measured at the end of each business day for the previous three months. The average or simple arithmetic mean can be used. To be calculated by the end of the business day following the measurement period.
RtC	K-ASA	0.04%	Rolling average of the value of total daily assets safeguarded and administered, measured at the end of each business day for the previous six months (excluding the three most recent calendar months). The average or simple arithmetic mean can be used. To be calculated within the first 14 days of each calendar month.
RtC	K-COH cash trades	0.1%	Rolling average of the value of total client orders handled, measured at the end of each business day for the previous six months (excluding the three most recent calendar months). The average or simple arithmetic mean can be used. To be calculated within the first 14 days of each quarter. The value is measured as the sum of absolute value of buys and absolute value of sells for both cash (amount paid or received) and derivative trades (notional amount).
	K-COH derivatives	0.01%	
RtF	K-DTF cash trades	0.1%	The rolling average of the value of total daily trading flow, measured at the end of each business day over the previous six calendar months (excluding the three most recent calendar months). The average or simple arithmetic mean can be used. To be calculated within the first 14 days of each quarter. The value is measures as the sum of the absolute value of buys and absolute value of sells for both cash (amount paid or received) and derivative trades (notional amount).
	K-DTF derivatives	0.01%	
RtF	K-CON	200-900% depending upon the duration of the exposure and the value of the concentration risk relative to the firm's regulatory capital.	Exposure [in excess of the] 25% concentration limit.
RtF	K-TCD	1.6% (where counterparty is a credit institution or investment firm), 8% (for all other counterparty types).	Max(0; RC + PFE – C) Where RC is the replacement cost, PFE is the potential future exposure for derivatives or long settled transactions and C is collateral received or posted.
RtM	K-NPR	65% where standardised or internal model approach is used.	Assessed using either: The simplified standard approach; Standardised approach; or Internal models approach Under CRR (as amended by the CRRII proposals).
RtM	K-CMG	N/A	The highest total amount of initial margin posted to the clearing member over the preceding three months. EBA to draft RTS to specify calculation of initial margin.

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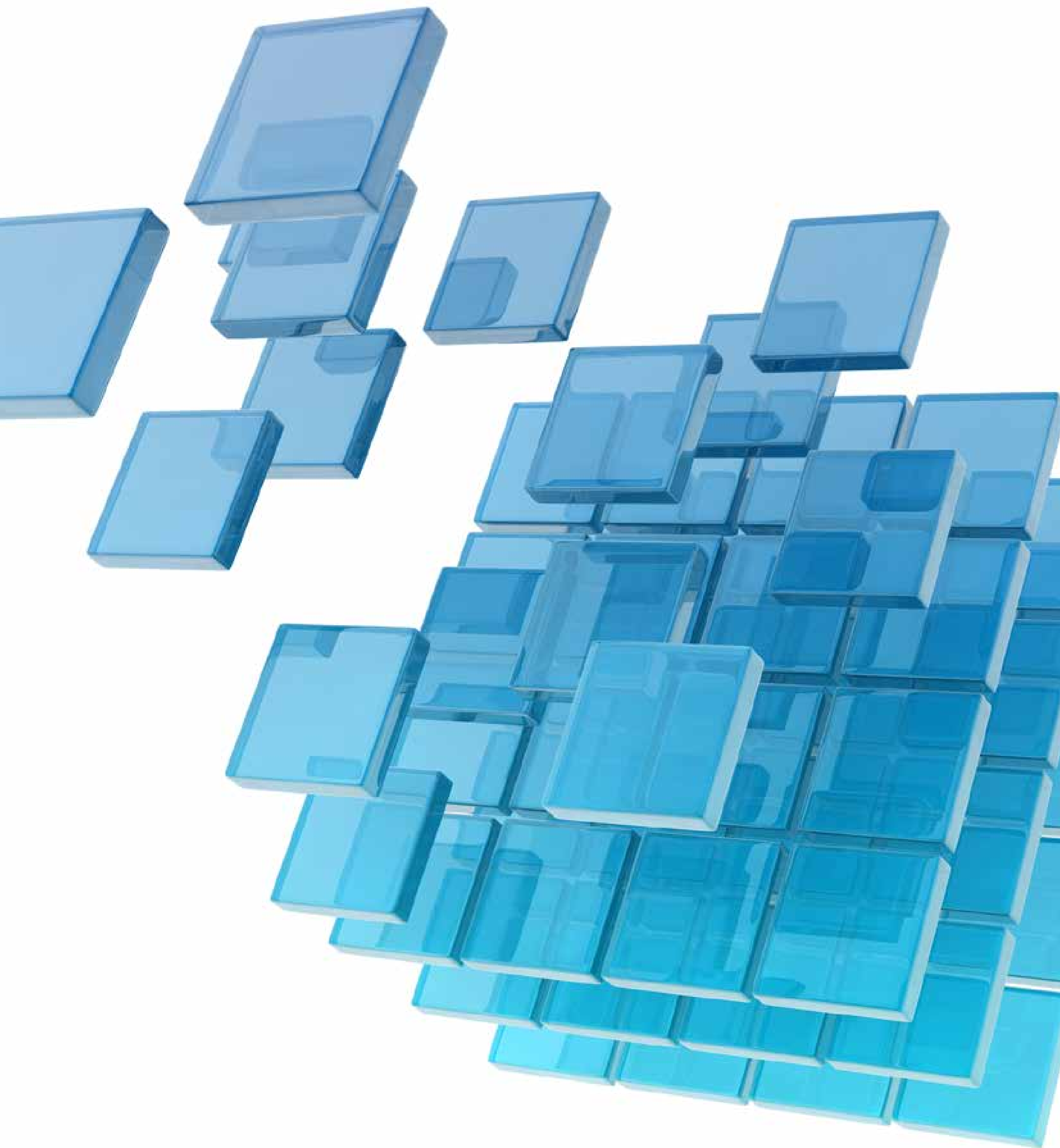

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