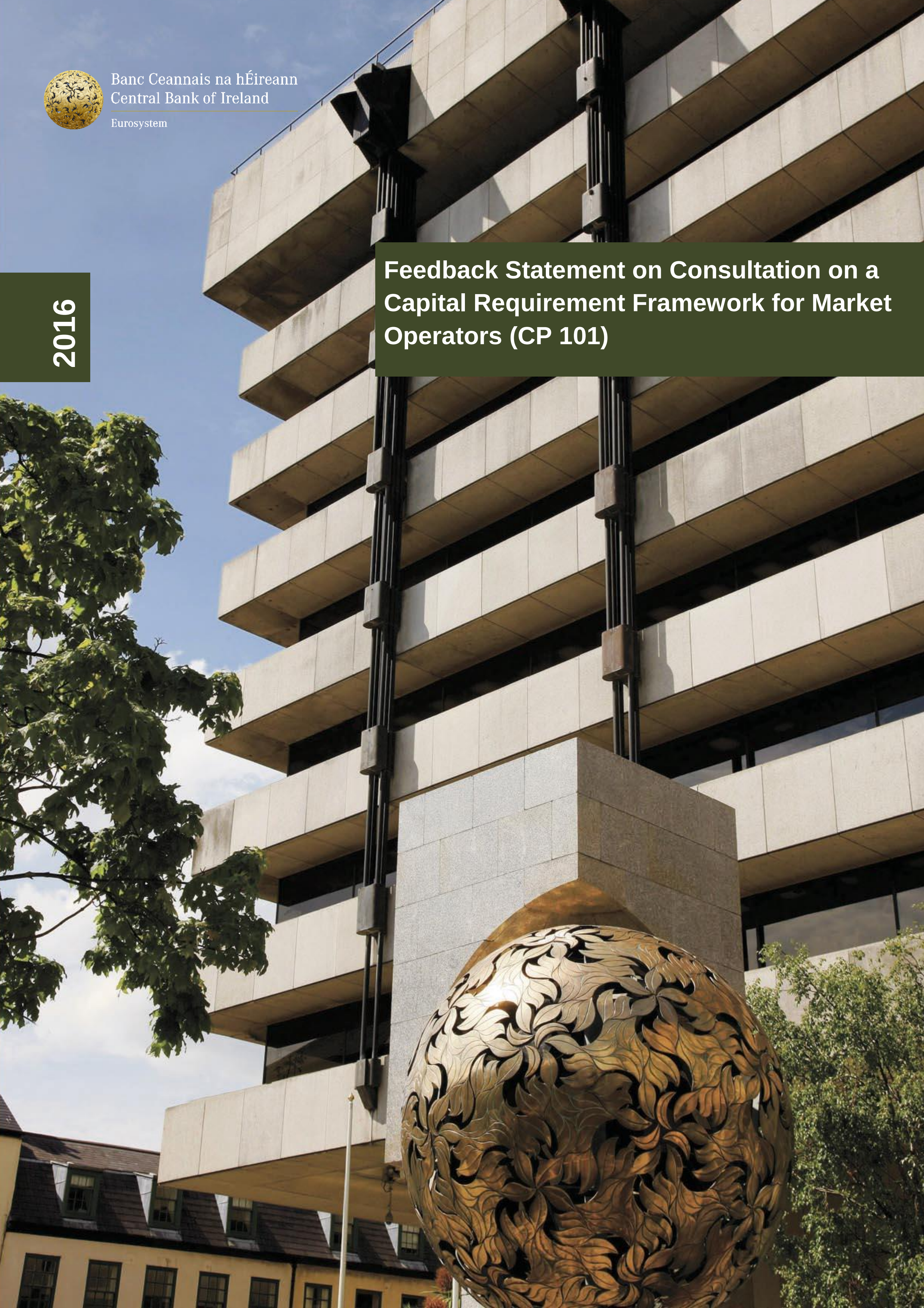
Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2016

Feedback Statement on Consultation on a Capital Requirement Framework for Market Operators (CP 101)



Contents

Introduction

1. On 12 February 2016 the Central Bank of Ireland (the "Central Bank") published Consultation Paper CP 101 on a Capital Requirement Framework for Market Operators ("CP 101"). The Central Bank invited all stakeholders to provide observations and comments on the proposed Capital Requirement Framework (the "CRF"). The closing date for comments was 6 May 2016 and 1 response was received.

2. CP 101 relates to the introduction of a risk based capital requirement to apply to Market Operators in Ireland. CP 101 raised 3 specific questions for respondents to address. This paper briefly summarises the responses received to each question along with the Central Bank's comments and decisions. It is, therefore, intended that this paper be read in conjunction with CP 101, which can be found on the Central Bank's website[1].

3. The Central Bank intends to impose the CRF in the form of Central Bank regulations (the "Regulations"). This is pursuant to the provisions of the Central Bank (Supervision and Enforcement) Act 2013 (which permit the Central Bank to make regulations for the proper and effective regulation of regulated financial service providers). The process of converting the CRF into Regulations may involve changes in legal drafting appropriate to a statutory instrument but will not involve a change in the policy position outlined herein. In the interim period, before Regulations are issued, the Central Bank may impose the CRF via conditions of authorisation.

4. Nothing in this feedback statement should be read with, seen as a clarification of or a supplement to the Regulations. This feedback statement is published to promote understanding of the policy formation process within the Central Bank and is not relevant to assessing compliance with regulatory requirements.

5. The Central Bank would like to thank parties who contributed to the policy development process through CP 101.

Markets Policy Division

Central Bank of Ireland

4 July 2016

[1] http://www.centralbank.ie/regulation/poldocs/consultation-papers/Documents/CP101%20Consultation%20on%20a%20Capital%20Requirement%20Framework%20for%20Market%20Operators/CP101%20Consultation%20on%20a%20Capital%20Requirement%20Framework%20for%20Market%20Operators.pdf .

Feedback on issues raised in CP 101

General Comments

6. The respondent was supportive of the proposal to implement a risk-based CRF for Market Operators in Ireland. The respondent further commented that it is important that the model reflects best practice internationally and is proportionate. The respondent advocated for a model equivalent to that applying in other European Markets, in particular in the UK, as the UK has a similar market structure to Ireland. The respondent commented on ESMA's objectives of promoting supervisory convergence and ensuring a level playing field of high quality regulation and supervision between Member States and noted a concern that the implementation of aspects of an Irish CRF which could disadvantage Irish Market Operators by imposing on them an excessive capital requirement would not be consistent with ESMA policy.

Central Bank: In developing the proposed CRF for Market Operators, the Central Bank considered its risk based approach to financial regulation, the European regulatory environment and international practice establishing capital requirements for Market Operators. The Central Bank has a legislative mandate under MiFID to both specify a minimum level of capital to be held by a Market Operator[2] and to ensure that a Market Operator has available, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of transactions concluded on the market and the range and degree of risks to which it is exposed[3]. To date, there has not been any European Level 2 measures/technical standards or Level 3 guidance specifying the minimum level of capital that should be held by Market Operators or detailing the level of financial resources that Market Operators must hold on an ongoing basis. Thus, the Central Bank must exercise its judgement in this regard and as such, proposing a transparent and defined Irish CRF for Market Operators is within the Central Bank's mandate and in accordance with the European legislative framework.

The risk-based aspect of the CRF is designed so as to take into account the individual characteristics of a particular Market Operator and to hence ensure that the framework is implemented in a proportionate manner, resulting in a proportionate level of capital that must be held by Irish Market Operators.

Question 1: Do you agree with the Central Bank's proposal to establish a risk-based Capital Requirement Framework for Market Operators in Ireland?

7. The respondent agreed with the proposal to establish a risk based CRF for Market Operators. The respondent commented that the regulatory capital requirement should be based on the higher of two pillars – (1) a risk-based allocation of capital based on individually identified and assessed risks and (2) adequate capital to facilitate a wind down which the respondent equated with six months operating costs.

[2] Regulation 48(c) of S.I. No. 60 of 2007.
[3] Regulation 63(f) of S.I. No. 60 of 2007.

Central Bank: The Central Bank agrees that ensuring adequate capital based on individually identified and assessed risks and ensuring adequate capital to facilitate an orderly wind down are two key components of an appropriate capital regime for Market Operators. The Central Bank considers that six months operating costs is an appropriate quantitative minimum for the level of capital required. These views are reflected in the proposed CRF as the Basic Capital Requirement is defined as the higher of six months operating expenses or the Market Operator Risk and Capital Adequacy Assessment Process (the "MORCAAP") figure, with the MORCAAP figure representing the sum of the capital required for individually identified and assessed risks in stressed market conditions and the capital required for an orderly wind down. The assessment of the capital required for an orderly wind down under the MORCAAP is a bespoke assessment that should take into account the individual characteristics of a Market Operator's business model and may result in a figure that is higher or lower than six months operating costs. The assessment should be based on robust assumptions and in this regard, will be subject to challenge by the Central Bank as part of the annual SREP.

Question 2: The proposed MORCAAP encompasses a risk governance element and a risk based assessment of the capital required in both recovery and wind down scenarios. Do you agree with what is proposed?

8. The respondent again agreed with the concept of a risk-based assessment of capital requirements but noted that there should be greater cognisance of the nature of an individual Market Operator's business model when assessing the relevant risks. The respondent agreed that the Basic Capital Requirement should be defined as the higher of six months expenses or the MORCAAP figure and also agreed that the MORCAAP should include capital required to cover the consolidated internal assessment of business risks and associated mitigations in stressed market conditions.

9. The respondent disagreed with the proposal that the MORCAAP be defined as the sum of the consolidated internal assessment of capital required to cover risks in stressed market conditions and the amount of capital estimated as required to support an orderly wind down of the business. The respondent noted that requiring these two amounts to be added together leads to an excessive and disproportionate regulatory capital requirement, effectively double counting what is required in actuality. The respondent reiterated prior comments that six months operating expenses is sufficient to cover a wind down scenario and noted that this is already taken into account in the Basic Capital Requirement calculation. They further noted that there is a strategic impact and commercial cost to retaining excessive levels of capital which could impede business development spend or capital expenditure and may also disadvantage an Irish Market Operator compared to a competitor in another jurisdiction.

10. Also related to the above comments, the respondent disagreed with the application of Capital Add-ons under the MORCAAP and the Strategic Capital Add-on, noting that the risk-based allocation of capital under the MORCAAP should rely on a robust risk management framework and should be agreed with the Central Bank before finalisation. The respondent noted that they considered these capital add-ons penal and aired a concern that they will result in a capital requirement that exceeds that required in other EU jurisdictions. The respondent was also concerned that there is no clear basis upon which these Capital Add-ons will be set.

11. With respect to recovery and resolution plans, including the consideration of reverse stress test scenarios, the respondent noted that elements of these requirements are more appropriate to the

banking sector. The respondent considers that the approach taken should be individual to the Market Operator and that where a Market Operator has not issued any convertible or debt instruments and does not take deposits and thus there is no potential to bail-in debt-holders or customer balances, a recovery and resolution plan approach is not relevant. The respondent noted that the only avenues in a resolution scenario for their business would be an equity cash call to existing or new investors or a sale of the business, thus the implications of a wind down are therefore, more severe and demanding than a recovery/resolution scenario. The respondent considers that maintaining six months operating expenses as regulatory capital allows sufficient time for a scheme of resolution to emerge.

12. With respect to the risk governance aspects of the MORCAAP, the respondent agreed that the Board of a Market Operator must oversee and approve the CRF and that the MORCAAP should be embedded into the risk management framework. The respondent raised a concern on the requirement that the MORCAAP document must be kept up to date at all times, noting that this could pose practical issues.

13. The respondent queried the appropriateness of referring to specific provisions set out in the Capital Requirements Regulation[4] ('CRR') and in Commission Regulation (EU) 2015/61[5] for the definitions of capital and liquid financial assets and commented that any policy decision to bring Market Operators within scope of CRR should be made at European level.

Central Bank: The Central Bank would like to clarify that the consolidated internal assessment of the capital required to cover the business risks and associated mitigations in stressed market conditions that must be carried out as part of the MORCAAP is an assessment that is individual to each Market Operator's business model. It is for the particular Market Operator to determine the specific risks that are relevant to its business, to model appropriate stressed scenarios and to determine the amount of capital that it considers appropriate to hold against those risks. Thus the Central Bank is of the view that there is full cognisance of an individual Market Operator's business model when assessing relevant risks.

In terms of the requirement under the MORCAAP to estimate the amount of capital required to support an orderly wind down, as noted above this is a bespoke assessment taking into account the individual characteristics of the Market Operator's business model and considering specific events which may cause the Market Operator to fail. This bespoke assessment may result in a capital requirement that is higher or lower than six months operating costs. The assessment should be based on robust assumptions and the Market Operator should be able to provide strong justification for the assumptions used. The Central Bank will review and challenge the assessment as part of the SREP which is carried out on an annual basis.

In relation to the requirement under the MORCAAP that the amount of capital required to achieve an orderly wind down is added to the amount of capital required to cover business risks, the Central Bank notes that, while these are independent assessments – one assessment entailing a consideration of the impact of stressed market conditions on a Market Operator's capital position and the other assessment entailing a consideration of the capital required to wind down in an orderly fashion – the Central Bank considers that in reality a wind down scenario is unlikely to occur outside of a stressed scenario that results in the materialisation of other risks and losses. Given the reliance of other market participants on market operators, it is critical that capital required for an orderly wind down still be available after a stressed event has occurred. Therefore, the Central Bank maintains its position that it is appropriate to combine these two amounts and the Central Bank does not view this as a double counting of the capital that is required.

[4] Regulation EU No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012.

[5] Liquidity Coverage Requirement.

With respect to the application of Capital Add-ons under the MORCAAP, the Central Bank agrees with the respondent that the Market Operator's assessments of the capital required to cover business risks and the capital required to support an orderly wind down should rely on a robust risk management framework. As noted in CP 101, the Central Bank intends to review these assessments on an annual basis as part of the SREP. The Central Bank would like to clarify that Capital Add-ons will only be imposed under the MORCAAP where specific deficiencies in the assessments are identified and will be imposed then with reference to those specific deficiencies. Thus any Capital Add-ons imposed under the MORCAAP will have a clear basis and be transparent in terms of the risk and/or deficiency in the process that they are designed to cover. The Central Bank agrees with the respondent that there should be dialogue with the Central Bank on the process and is of the view that through continuous dialogue, the annual SREP and iterative improvements to the MORCAAP, it should be possible to reduce or minimise the necessity for Capital Add-ons under the MORCAAP. The Central Bank is introducing the MORCAAP for Market Operators in order to ensure that Market Operators have a strong, forward-looking, linked risk and capital management framework and have processes in place to consider their risks in stressed circumstances and have adequate capital in order to ensure that the risk of disruption to other financial market participants is minimised. It is not the Central Bank's intention that Market Operators hold an excessive level of capital. The Central Bank would like to note that it has experience in successfully implementing a MORCAAP type requirement across investment firms[6].

In relation to the application of the Strategic Capital Add-on, as noted in CP 101, the purpose of this is to ensure that Market Operators are well positioned to meet any exceptional circumstances that may arise. The Central Bank maintains that this is necessary given the reliance of other financial market participants on Market Operators and in this regard, the Central Bank intends to rename the Strategic Capital Add-on and refer to it instead as the Systemic Capital Add-on. The Central Bank views the Systemic Capital Add-On as a buffer type requirement similar, for instance, to the capital conservation buffer that applies to certain investment firms in Ireland[7]. In this regard, it is specifically noted in CP 101 that derogation from the Systemic Capital Add-on may be permitted on a temporary basis with the prior written approval of the Central Bank. The intention behind this is that the Central Bank may allow a Market Operator to dip into the capital set aside to cover the Systemic Capital Add-on if an exceptional circumstance arises, without the Market Operator being in breach of its overall capital requirement. When the capital conservation buffer is fully phased in for investment firms it will mean an additional 31% capital requirement over and above the minimum Pillar 1 capital requirement for these firms. Thus the Central Bank is of the view that the Systemic Capital Add-on range of 10-30% of the Basic Capital Requirement for Market Operators is set at a reasonable level and is not overly penal. It is important that the Central Bank maintains flexibility in terms of the specific Systemic Capital Add-on that applies to individual Market Operators given the potential range of business models that fall under the definition of a Market Operator. The Central Bank hopes to create transparency on the setting of the Systemic Capital Add-on in our bi-lateral engagement with individual Market Operators.

With respect to the comments made on the requirement to prepare recovery and resolution plans, the Central Bank agrees with the respondent that the approach taken should be individual to the Market Operator and would like to clarify that this is the intention set out in CP 101. The plans prepared should be specific to the individual Market Operator, taking into account its capital structure and its business model. The level of detail and complexity required of such plans will depend on the complexity of the Market Operator's business model and on the reliance of other financial market participants on the Market Operator. The Central Bank is of the view that it is important when preparing wind down plans to give consideration as to the events that could potentially cause a Market Operator to fail and this is the purpose

[6] MiFID investment firms are subject to the Internal Capital Adequacy Assessment Process ('ICAAP') which is very similar to the proposed MORCAAP.

[7] Regulation 117 of S.I. 158 of 2014 (CRD IV) imposes this requirement on investment firms that are authorised to provide the investment services listed in points 3 and 6 of Section A of Annex I to Directive 2004/39/EC.

of the reverse stress test scenarios.

The Central Bank acknowledges the comments on the risk governance aspects of the MORCAAP. The Central Bank would like to clarify that the requirement to keep the MORCAAP document up to date at all times should not be an overly onerous task. The purpose of the MORCAAP document is to keep a record of the MORCAAP process and to act as a repository of risks and as such, it should be updated each time the MORCAAP process is reviewed and as soon as is practicable following the identification of new risks and changes in existing risks which are deemed to require a recalculation of the capital required to mitigate such a risk in a stressed environment. It should be clear from the MORCAAP document how the Market Operator will monitor that it at all times holds capital to meet the Basic Capital Requirement and the Systemic Capital Add-on.

The Central Bank acknowledges the comments made with respect to the references to specific provisions set out in the CRR and in Commission Regulation (EU) 2015/61 and confirms that the intention of CP101 is not to bring Market Operators into scope of CRR. In this regard, when these requirements are formulated into regulations, these references will be removed and the specific definitions of capital and liquid financial assets will instead be set out directly in the regulations.

Question 3: Do you consider the proposed capital add-on for newly authorised Market Operators to be appropriate and proportionate?

14. The respondent did not comment in relation to the proposed capital add-on for newly authorised Market Operators.

Central Bank: In the absence of any feedback in relation to this proposal the Central Bank will continue with this element of the proposal as set out in CP 101.

T +353 1 224 6000 **F** +353 1 671 6561 www.centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Bosca PO 559, Sráid an Dáma, Baile Átha Cliath 2, Éire
PO. Box No 559, Dame Street, Dublin 2, Ireland