



Deputy John McGuinness,
Chair
Joint Committee on Finance,
Public Expenditure and Reform, and Taoiseach
Leinster House
Dublin 2

24 April 2018

Ref: I 2018/433

Dear Deputy McGuinness,

Re: European Commission Proposals ("the proposals")

- **COM(2017)790: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010 and**
- **COM(2017)791: Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU.**

Further to the letter of Eoin Hartnett of 23 March 2018 concerning the above, Governor Lane has asked me to reply on his behalf. Accordingly, I am pleased to set out the Central Bank of Ireland's ("the Central Bank") initial assessment of the European Commission ("the Commission") proposals to establish a new prudential regime for investment firms within the EU.

Scope of the proposals

The proposals were published by the Commission in December 2017 and apply to all investment firms that are authorised under the Markets in Financial Instruments Directive ("MiFID or MiFID II"¹). This includes firms with a wide variety of business models, conducting investment services and activities such as investment advice, the receipt and transmission of client orders, execution of client orders, portfolio management, proprietary trading, underwriting, operating a multilateral trading facility, and dealing in commodities derivatives.

¹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II") repealed Directive 2004/39/EC ("MiFID") with effect from 03 January 2017.



Existing prudential regime for investment firms

The prudential regime applying to investment firms in the EU has been linked to that applying to banks which, in turn is derived from the Basel framework for internationally active banks². The current iteration of the EU prudential regime for banks and investment firms is set out in the Capital Requirements Regulation³ and Capital Requirements Directive 4⁴ ("CRR/CRD4"). The Basel framework for banks has become increasingly detailed and complex with new requirements introduced in response to the recent financial crisis and to the risks banks pose to financial stability. Many of these new requirements have been developed in the context of bank business models and balance sheets and have been less appropriate for many types of investment firms. This has led to two issues. Firstly, investment firms may have to apply complex capital requirement calculations for risks that may not be material to their business models. Secondly, the CRR/CRD4 regime has developed a complex system of exemptions and derogations for investment firms, which leads to at least 11 categories of investment firms. The categories are driven by a combination of the firms' MiFID activities and services and how they conduct their business, (e.g. whether they hold client money) and each category has different prudential requirements. The result is a complex and, at times, less than optimal overall framework.

EBA Review of the prudential regime applicable to investment firms

At the request of the Commission, from 2015 to 2017, the European Banking Authority ("EBA"), in consultation with the European Securities and Markets Authority ("ESMA") and national competent authorities conducted a review of the prudential regime applying to investment firms. The review concluded with the EBA publishing an Opinion⁵ in September 2017 containing a series of recommendations for a new prudential regime for investment firms. The Central Bank was involved in the EBA review and for the most part was supportive of the recommendations.

Summary of the Commission's proposals

The Commission's proposals, which adopt the vast majority of the recommendations from the EBA, provide for three categories of investment firm:

1. systemic and 'bank-like' investment firms, to which the full CRR/CRD4 regime will apply;
2. other investment firms to which the proposed new regime will apply in full; and
3. small firms that pose less risk and to which a more limited set of requirements under the proposed new regime will apply.

(1) Systemic and 'bank-like' firms

Firms that deal on own account or underwrite on a firm commitment basis and have total assets exceeding €30bn – either on an individual basis or on an aggregate basis (of similar investment firms

² More information is available at: <https://www.bis.org/bcbs/index.htm?m=3%7C14%7C625>

³ Regulation (EU) No. 575/2013

⁴ Directive 2013/36/EU

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<https://www.eba.europa.eu/documents/10180/1976637/EBA+Advice+on+New+Prudential+Framework+o+n+Investment+Firms+%28EBA-Op-2017-11%29.pdf>



within the group) – will fall under the first category above. It is proposed that these firms will no longer be authorised under MiFID but instead will require authorisation as a credit institution under CRD4. The €30bn threshold is in line with the total asset threshold for determining significant banks that fall under the supervision of the European Central Bank (“ECB”) and it is proposed that these investment firms will similarly fall under the supervision of the ECB⁶.

(2) Middle category firms (“other investment firms”)

Firms that are not systemic and ‘bank-like’ and do not meet the criteria to be classified as very small and low risk (see below) fall into the middle category. These firms are subject to the full set of requirements under the proposed new prudential regime. The focus of the new prudential regime is on the potential for harm that an investment firm poses to its customers and to the markets in which it operates and capital requirements are calibrated on this basis.

The proposals aim to achieve this above goals by introducing the concept of risk factors, called ‘K-factors’, as ‘proxies’ for the potential harm that a firm can cause to customers and to markets and deriving capital requirements from these K-factors. Not all K-factors will apply to all firms – their application will depend on a firm’s business model and the activities it undertakes. Under the proposals, the K-factors are set out in three categories: Risk-to-Customer, Risk-to-Market and Risk-to-Firm. The capital requirements for individual K-factors are aggregated to give the firm’s overall capital requirement deriving from the K-factors, known as the firm’s “K-factor requirement”.

This K-factor approach is underpinned by the application of both a “fixed overheads requirement”⁷ and a “permanent minimum requirement”. As such an investment firm is required to hold capital which at all times amounts to the higher of the firm’s K-factor requirement, fixed overheads requirement and permanent minimum requirement.

In addition to the above capital requirements, the proposals set out requirements in other areas. Specifically investment firms will be:

- subject to a simple liquidity requirement to hold a minimum amount of liquid assets;
- required to make certain disclosures on an annual basis in the areas of risk management, governance, own funds, capital requirements and remuneration;
- required to report annually to competent authorities in the areas of own funds, capital requirements, concentration risk and liquidity; and
- subject to governance and remuneration requirements that are based on the CRD4 requirements, although simplified. In this regard one key difference here is that the proposals do not set a specific cap on the ratio of variable remuneration to fixed remuneration⁸.

⁶ <https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html>

⁷ The concept of a fixed overheads requirement exists under the current prudential regime for a sub-set of investment firms. There is no proposed change to the actual calculation – it will remain as one quarter of the fixed overheads of the preceding year – however it will now apply to a wider range of firms.

⁸ Under the CRR/CRD4 regime banks and CRD4 investment firms are subject to a restriction on bonus payments to senior management and other key staff, specifically such payments must not exceed 100% of



Finally, these investment firms will remain subject to a Pillar 2 regime where they must comprehensively assess and monitor their risks on an on-going basis and ensure they have adequate capital to cover the nature and level of these risks. Competent authorities will continue to have a range of supervisory powers and tools available to address any deficiencies in this regard, including the ability to impose additional capital in excess of the minimum requirements noted above.

(3) Small, low risk investment firms

A lighter set of requirements apply to the smallest, lowest risk investment firms. To fall into this category a firm must not exceed specified thresholds on a range of metrics. The metrics used are the K-factors and also the balance sheet total and the total annual gross revenue from investment services and activities. For some key metrics the threshold is set at zero, including for client money held and assets safeguarded and administered. Some metrics apply on an individual basis and some on a group basis. In this way it is ensured that only the smallest, lowest risk firms fall under this third category.

Investment firms in this category are subject to a lighter set of requirements in the areas of capital, liquidity, disclosures, reporting and governance.

The Central Bank's initial views on the proposals

The Department of Finance represents Ireland in the discussions on the proposals within the European Council. The Central Bank is providing technical assistance to the Department in this regard. It should be noted that the proposals are at a relatively early stage of discussion within the Council and the Central Bank is considering the proposals, and any issues raised at the Council meetings, on an on-going basis.

The Central Bank is generally supportive of the proposals and considers that having a separate prudential regime for investment firms, distinct from that applying to banks, is desirable. The proposed regime should be simpler and less time intensive for investment firms to apply and is more closely aligned with the range of investment firm business models and applicable risks. Breaking the link with the prudential regime that applies to banks is seen as beneficial as many of the prudential requirements introduced over recent years for banks have (i) had a central focus on banking business models and (ii) been introduced to address financial stability concerns⁹. As such these requirements are not always appropriate for smaller, non-systemically important investment firms. This is reflected in the complex system of derogations and exemptions for investment firms under the current CRR/CRD4 regime. Having a separate prudential regime for investment firms avoids this issue arising in the future as the banking regime continues to develop.

fixed remuneration for the relevant staff. Under the proposals investment firms will no longer be subject to this cap but will be required to set appropriate limits on variable remuneration.

⁹ These requirements include the Liquidity Coverage Ratio, Net Stable Funding Ratio and Leverage Ratio as well as number of capital and systemic buffers.



It should be noted that the intent of the proposals is not to raise the overall level of capital held by investment firms. In this regard the EBA's impact assessment indicated that capital requirements would increase on aggregate for all non-systemic EU investment firms by 10% *compared to Pillar 1 requirements* today, however would decrease on aggregate by 16% as it is envisaged that there will be less of a requirement for Pillar 2 add-ons. That said, capital requirements may increase for individual investment firms. A key component of the proposed regime is the introduction of capital requirements deriving from a number of customer-centric and market-centric metrics which previously were not used to determine capital requirements for investment firms. For instance, firms that hold large amounts of client money will now be required to hold capital to reflect this fact, recognising that, should such a firm fail, it may have a greater impact on customers than firms that do not hold client money. Some firms may therefore face an increase in capital requirements because of this new approach, however any such increase should be reflective of the risks that they pose to customers and to markets and the Central Bank is supportive of the new approach.

While investment firms with the largest operations will find their minimum capital requirements driven by the new K-factor requirement, for many firms the fixed overheads requirement will still represent their minimum capital requirement. For any firms that face an increase in capital requirements above twice their current level of requirements, the proposals include a transitional period. Therefore the Central Bank considers that any impacted firms should have adequate time to adjust to the new requirements. In this regard the Central Bank will be encouraging firms to conduct impact assessments on the proposals in order that they identify any potential increases in capital requirements at an early a stage as possible. The transition period originally recommended by the EBA was three years, however the proposals set out a five year transition timetable. The Central Bank's preference would be to maintain the EBA's original recommendation of three years in order to ensure a swifter full implementation of the proposals. Member State comments for Ireland submitted by the Department of Finance to the European Council note this preference.

Finally, on capital requirements, there are a number of K-factors set out in the proposals for which the Central Bank has identified areas for improvement but these are largely technical points.

As noted above, the proposals do not solely address capital requirements for investment firms and set out a full prudential regime addressing areas such as liquidity, disclosures, reporting and governance. In the area of liquidity, the proposals address a gap in the current regime by introducing a simple minimum liquidity requirement for all investment firms under which investment firms will be required to hold the equivalent of one month's fixed overheads in high quality liquid assets. The Central Bank's considers that this is an appropriate and proportionate requirement. The current reporting to competent authorities will be replaced by a simpler return, submitted annually, which is focused on the new K-factor metrics. The Central Bank considers that this reporting should be quarterly in order to maintain appropriate oversight over these firms. This comment has been included in Irish Member State comments.



Proportionality

The Central Bank considers that the new prudential regime will be more proportionate than the current regime which, in many instances, required very small firms to follow a very complex regime designed for internationally active banks. The relative simplicity of the proposed new regime should reduce barriers to entry for new investment firms and the ongoing cost of compliance for existing firms. As well as setting out a simpler, more appropriate method for determining capital requirements for investment firms, the proposals also set out more proportionate requirements in the areas of disclosures and reporting when compared to the current regime. Further, the new categorisation of investment firms set out in the proposals ensures the new regime itself has an in-built level of proportionality. The largest, 'bank-like' investment firms will remain subject to the CRR/CRD4 regime, while the very smallest, lowest risk firms will have the lightest set of prudential requirements applying to them.

Proposed application of SSM supervision over systemic, 'bank-like' investment firms

As noted above, it is proposed that investment firms that fall under the systemic, 'bank-like' category will now be required to seek authorisation as a credit institution, be subject to the full CRR/CRD4 regime in the same way as banks and fall under the direct supervision of the ECB. The total asset threshold for determining such firms is €30bn, which is in line with the total asset threshold for determining significant banks which fall under direct ECB supervision. Due to their size and the nature of their activities these investment firms could potentially cause large losses to their bank trading counterparties. Such firms are likely to have a high level of interconnectedness with the financial system and thus present financial stability concerns. Therefore the Central Bank considers there is considerable merit in supervision of them by the ECB in a consistent manner to similar sized banks. It should be noted that there are currently no Irish investment firms that would fall under this category.

There are two aspects to this which the Central Bank is following as the proposals are discussed at the European Council. Firstly, the Central Bank is reflecting on the technical aspects and implications of these investment firms now requiring authorisation as credit institutions. Clarity has been sought on this aspect of the proposals in the Irish Member State comments. Secondly, there has been a suggestion by one Member State in the European Council discussions that the €30bn threshold used to distinguish this category of investment firm should be lowered or dropped altogether. If this suggestion received support in the discussions, the Central Bank would have to consider the appropriateness of any new proposal in this area.



Conclusion

The Central Bank is broadly supportive of the proposed new prudential regime for investment firms and considers overall that is proportionate with appropriate prudential requirements for these firms. As discussions progress at the European Council, the Central Bank will assist the Department of Finance in influencing any technical amendments, particularly in the specific areas that we have highlighted above.

Yours sincerely

Gerry Cross, Director, Policy & Risk