Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

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State of play of the EBA advice on the design of a new prudential framework for MiFID investment firms

AMAFI contribution

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

AMAFI has closely followed progress at EBA level on the design of a new prudential framework for MiFID investment firms since the EBA report published in December 2015. In this respect, it provided comments on the EBA Discussion paper[1] released in November 2016[2]. Moreover, AMAFI encouraged its members to take part in the QIS exercises in July 2016 and July 2017.

During the public hearing held on July 3rd, 2017, the EBA disclosed the state of play of its advice to the European Commission regarding the design of a prudential framework for MiFID investment firms. The state-of-play document includes 58 draft recommendations addressed to the European Commission (EC) that summarise key features of the proposed new prudential regime for investment firms. EBA representatives invited participants to comment on these before the EBA communicates its final advice to the European Commission. AMAFI attended the meeting as well as the July 17th meeting at the EC in Brussels. We therefore wish to communicate our opinion on the EBA's proposal.

Before providing our feedback for each broad area of the proposed new regime, AMAFI would like to point out the following general comments.

[1] EBA/DP/2016/02, *Discussion paper on designing a new prudential regime for investment firms*.
[2] AMAFI 17 / 09

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I. – GENERAL COMMENTS

We welcome very much the fact that the EBA and the EC allow institutions to comment on the current state of play of its proposal and we see this as evidence of the willingness to seek the broadest possible consensus on the future regime.

In addition, we are satisfied with a number of amendments to the initial version displayed in the Nov 4th, 2016 Discussion paper. In our views, the latest proposal reaches a good compromise between, on the one hand, tailoring a prudential regime better suited to the specifics of EU Investment Firms and, on the other hand, preserving the relevant *acquis* of CRR, in particular for counterparty credit risk and market risk RWA quantification. We thank the EBA for having kept a number of suggestions coming from the industry, and specifically from AMAFI's previous contribution.

Moving forward towards completion of the new framework, we insist on major stakes that we hope the EBA and the EC will fully take into account. These are the following:

1/ It is crucial that the new regime applies to all MiFID investment firms in the European Union, in order to ensure a level-playing field regardless of the firm's activity or the jurisdiction where it operates. Indeed, we are concerned about the current situation where different regimes seem to apply, especially for firms specialised in trading on own account, some of which are classified as 'local firms' and/or are subject to other rules set at national level, whereas French investment firms are currently subject, for the most part, to CRD4/CRR rules.

We are happy that recommendation 1 confirms the intention to submit all MiFID investment firms to the new regime. In this respect, we would prefer future prudential rules to be defined in a European Regulation rather than in a Directive, as a Regulation better ensures maximum harmonisation throughout the EU. The possibility for national competent authorities to apply national discretions should be removed or reduced to the strict minimum.

2/ In order to ensure a level-playing field with credit institutions exercising similar activities, it is also very important that the definition of class 1 firms be limited to systemic institutions in the sense of G-SII and O-SII criteria. The supervisor should not seek to include a defined number of institutions in class 1 in any case, regardless of whether they meet G-SII or O-SII criteria. For example, national competent authorities should not have the discretion to include the biggest national investment firms in class 1 if they do not meet systemic firms' criteria.

3/ We are happy that the proposal considers the issue of consolidated supervision and the possibility for investment firms that are part of a banking group to apply for a waiver from individual supervision based on a provision similar to article 7 CRR. However, we do not understand why such a waiver would only be applicable to class 3 firms. We believe that it is important to keep the current exemption for all investment firms, just as it is currently open to all institutions subject to CRR. The conditions required by article 7 CRR ensure that the exemption is limited to institutions with an adequate operational setup in place. We do not see the rationale behind the fact that smaller firms (class 3 firms) could be exempted from solo-based supervision while other, non-systemic (class 2) firms could not. **This question is crucial** considering the French banking system. Indeed, among 79 investment firms authorised by the *"Autorité de ontrôle prudentiel et de résolution"* (ACPR), about 20 are subsidiaries of French banks and supervised on a consolidated basis. Those investments firms, according to their activities, would mainly be classified in class 2.

On the general economy of the proposed regime, we tried to summarise our understanding in the table displayed at the end of this document (cf. appendix). We are glad that it appears close to the table which we displayed in the "general comments" part of our response of the November 4th, 2016 Discussion Paper.

On the detail of the EBA state-of-play proposals, please refer to our comments below.

II. – COMMENTS ON EBA DETAILED RECOMMENDATIONS

We attended the session held in London on July 3rd, 2017 and analysed the related presentation document[3] with great attention. We summarised below our main comments on detailed recommendations for each major area of the proposed prudential framework (for greater clarity, we mentioned relevant recommendation references).

Investment firms classification: recommendations 1 to 7

We fully agree with the statement that the framework should apply to all MiFID investment firms (recommendation 1).

We approve of the proposed criteria to identify class 3 firms (recommendation 5), except on the 'zero' threshold for NPR / DTF / TCD. In practise, this threshold would lead to capture in class 2 not only investment firms that perform trading on own account but also investment firms that trade on behalf of clients and may be obliged to keep, even marginally and for a limited period of time, positions in their balance sheet for technical reasons (e.g. late settlement-delivery). In this respect, we stress the fact that, for similar reasons, firms are required to seek a license for trading on own account even if their activity is strictly limited to trading on behalf of clients. Therefore, we believe that a threshold higher than zero is appropriate and we suggest to set the threshold at EUR 1.5m, i.e. 1.5% of the EUR 100m balance sheet size threshold. This threshold would be coherent with the current rate of settlement failure and with EBA proposed coefficient for K-COE.

Regarding recommendation 3, we agree with the proposed approach to defined class 1 firms as 'systemic' investment firms, and we insist that any level 2 regulation aimed to develop classification criteria for investment firms remains as close as possible to G-SII and O-SII criteria set out for defining systemic banks. "Taking the specificities of investment firms into account" should not lead to define systemic investment firms in a materially different way from systemic banks. As stated in our previous contribution, it is important that institutions providing similar investment services under the status of bank or under the status of investment firm are considered 'systemic' or 'non-systemic' based of the same criteria. Regulation should also ensure that all systemic institutions would be subject to the same prudential rules.

We are supportive of all other provisions in recommendations 1 to 7.

Consolidated supervision: recommendations 8 to 10

We appreciate that the EBA considers the issue of supervision on a consolidated basis through the ability to apply for a waiver from solo-based supervision. We approve the fact that a waiver similar to the current one under article 7 CRR would be included in the new prudential framework for investment firms that are part of a group containing a credit institution.

However, we do not understand why such a waiver should be limited to class 3 firms. We really believe that class 2 firms should also benefit from this possibility, insofar as investment firms that carry out market activities within a banking group could be obliged to comply, at the same time, with CRR on a consolidated basis and with the new regime on a solo basis. This would be burdensome, not straightforward and, in our opinion, it would not bring additional security in terms of financial stability. This situation potentially exists in the French market where some of the biggest investment firms in the country belong to systemic banking groups; in theory, they could fall both into the scope of group-wide supervision by the ECB and solo-based supervision by the French regulator, ACPR. We do not consider that this would be appropriate.

[3] *State of play of the EBA Advice on the design of a new prudential framework for MiFID investment firms*, London, 3 July 2017.

Regarding the consolidated supervision of investment firm-only groups, we do not have any comment.

Composition of capital: recommendations 11 to 16

We welcome the EBA's willingness to simplify capital composition rules and specifically the possibility to include additional Tier 1 capital up to one-third of core Tier 1 capital, as well as Tier 2 capital up to one-third of Tier 1 capital (recommendation 12).

Regarding prudential filters:

- We are happy that the EBA does not refer to the application of a prudential filter similar to that of article 34 CRR (which refers to prudent valuation rules); indeed, as stated in our previous contribution, we favour a removal of prudent valuation rules from the new framework and consider this would be a substantial simplification. We understand implicitly that this is the option retained by the EBA's state-of-play proposal and we support this.

- However, we understand from recommendation 14 that simplification could lead to stricter rules than current CRR rules, i.e. a decrease in total regulatory capital. This would result in particular from full deduction applying instead of deduction based on current CRR thresholds[4]. We disagree with the principle that simplification could lead to more stringent rules than current ones, and would prefer a status quo.

We are supportive of other provisions in recommendations 11 to 16.

Capital requirements: recommendations 17 to 37

Initial capital and permanent minimum capital

We support the minimum capital amounts mentioned in recommendations 18 (for initial capital) and 19 (for permanent minimum capital). In addition, we believe that the principle of a transition period (recommendation 20) is sensible.

Capital requirements for class 3 firms

We support the proposed rules for class 3 firms based on one-quarter of the fixed overhead requirements, in line with our proposal (recommendations 21 and 23).

Capital requirements for class 2 firms

We agree with recommendation 22 and believe it is sensible to retain the highest value between initial capital, Fixed Overhead Requirements and the k-factor approach. We expect the k-factor approach to be the highest value in most cases.

Counterparty Credit risk & Market risk measures

We are supportive of the state-of-play proposal to keep, as part of risk quantification under the k-factor approach, current concepts of market risk (via K-NPR) and counterparty credit risk (via K-TCD). These risk-type-based measures are consistent with risk management processes set up by investment firms in the wake of Basel 2.5 and Basel III.

[4] This currently results in particular from article 48 CRR.

We understand that market risk and counterparty credit risk will be quantified according to the latest approaches currently being revised: FRTB for market risk and a MtM approach (simplified for investment firms) for counterparty credit risk.

Dealing with market risk, FRTB (even under the SBA approach) requires the implementation, testing and monitoring of new regulatory calculation methods, to collect and control an increased volume of data, and to monitor related deployments in I.T. systems. This implies to mobilise substantial resources over a 2 to 3 years' period of time. In this respect, due to a period of uncertainty regarding the future prudential regime, most investment firms have frozen their FRTB projects for the last 12 to 18 months. Therefore, we insist on the need for a sufficient transition period to allow investment firms to adjust to future new requirements regarding market risk and counterparty credit risk computation rules; this transition period should run from the date of publication of the investment firms' prudential framework regulation, or of CRR2 if it was due to be published later.

Regarding counterparty risk, we wonder if the applicable approach will be derived from the current CEM approach, or from SA-CCR or a simplified version of SA-CCR. The EBA document provides no detail on this point. It is worth noticing that CRR2 includes a simplified version of SA-CCR; does the supervisor intend to rely on this simplified SA-CCR approach? We wish that the EC will be more specific in its proposal and that it will consult on the most suitable approach for investment firms.

Other comments on k-factor approach

We approve the removal of the uplift factor, which we thought was not an appropriate way to adequately measure to level of risk borne by the firm.

However, for investment firms which perform asset management activity, we oppose the idea that capital requirements should be proportionate to the AuM K-factor, for the following reasons:

- The AuM K-factor is a direct measure of the size of an asset management firm; however, risk is not necessarily linked to size. Defaults in the asset management industry historically involved smaller firms, not larger ones;

- Investment firms acting as asset managers already face specific risk-mitigating regulations regarding their products (e.g. the UCITS directive) and their organisation as firms (e.g. the AIFM Directive); these regulations already have a strong risk mitigation effect;

- Many investors are credit institutions, funds or other regulated entities which already face their own prudential requirements. Therefore it would appear, in our views, that the AuM K-factor would produce a 'double-counting' effect as regards capital requirements: funds would require capital both at investor level and at the level of the investment firm acting as an asset manager.

Therefore, we do not consider the AuM K-factor to be appropriate. If kept in the final regulation, it should at least be deflated from the mandates and subscriptions of prudentially regulated investors. AuM excluding assets coming from regulated entities would be more appropriate, even if less straightforward, as an indicator

On the calibration of k-factor coefficients, we have not precisely assessed the proposed calibration through data based simulations, which is the objective of the current QIS exercise; therefore, we do not have specific comments at this stage.

Liquidity requirements: recommendations 38 to 40

Broadly speaking, we are very favourable to new proposals seeking to simplify the liquidity framework for investment firms and we believe state-of-play proposals will indeed achieve substantial simplification.

Nevertheless, it must be reminded that, even for class 1 firms, the LCR requirement is not pertinent and that a specific regime of liquidity measures should be set up for these firms.

Besides that, e especially welcome:

- the new liquidity buffer requirements, based on an amount equal to one month of Fixed Overheads (recommendation 35): this is a clear, easy-to-compute and straightforward approach,

- the extension of the definition of liquid assets, especially towards unencumbered cash available at bank with a 0% haircut (recommendations 36 and 37),

- the removal of thresholds applicable to L2A and L2B assets (40% and 15% of the buffer respectively).

We also approve of the principle whereby the amount of reporting should be commensurate with the classification of the firm (class 2 firms should be subject to more reporting requirements than class 3 firms). In addition, we expect liquidity reports for class 2 and class 3 firms to be substantially simpler than current liquidity reports applicable to credit institutions under CRR. We are awaiting future proposals in this area.

Concentration risk and K-CON: recommendations 41 to 46

Broadly speaking, we understand that K-CON will reflect similar RWA requirements as the current large exposures regime. To this extent, we understand that the10% limit mentioned at recommendation 44 is erroneous (typo) and that one should read 25%.

We would like to stress that, in our views, it is desirable to keep the provisions of article 395 CRR, including current large exposures limits currently mentioned in section 1. of this article[5].

This K-CON factor will apply to class 2 firms but not to class 3 firms (recommendation 43). This is in accordance with our opinion: in our previous contribution, we indeed advocated for the exemption of class 3 firms from the current large exposures regime. We are grateful to the EBA for converging with us on this issue.

We also approve of recommendation 45 and would like to stress that exposures on CCPs should remain out of scope for K-CON calculation as they currently are in the current large exposures regime.

Pillar 2: recommendations 47 and 48

In these recommendations, the EBA advocates for the existence of a proportionate Pillar 2 process within investment firms in order to assess their own economic capital needs. We agree with this, as we see the Pillar 2 process as an opportunity to carry out a risk self-assessment from an economic perspective and communicate it to the top management and the Board.

The EBA also recommends that competent authorities be able to undertake specific firm-wide assessment and take actions in order to increase capital & liquidity requirements and limit concentration risk. We support this principle. In our views, additional Pillar II requirements at the discretion of competent authorities are an opportunity to foster dialogue between an investment firm and its national regulator.

This being said the persistence of a Pillar 2 and of national discretions shouldn't lead to recreate an "unlevel playing field

[5] 25% of eligible own funds in the general case, and the higher of 25% of eligible own fund or 150 M€ in the case of an exposure on a credit institution.

Reporting and Pillar 3: recommendations 49 to and 51

As mentioned before (please refer to our comments under liquidity requirements), we welcome the principle of a simplified reporting framework for class 2 and class 3 firms, in accordance with the principle of proportionality. We expect COREP and related regulatory reports for class 2 and class 3 firms to be substantially simpler than current reports applicable to credit institutions under CRR. We are awaiting future proposals in this area.

We also support recommendation 51, which sets the principle whereby disclosure requirements (Pillar 3) should be reduced to the strict minimum, and totally removed for class 3 firms.

Commodity derivatives: recommendations 52 to 55

We agree that all commodity derivatives firms in the scope of MiFID II should be in the scope of the new prudential framework. We understand that the prudential regime will be fine-tuned for commodity derivatives firms. Therefore, at this stage we do not have any specific comments and are awaiting detailed proposed rules in order to provide our opinion, if deemed necessary.

Governance and remunerations: recommendations 56 and 57

Regarding governance (recommendation 56), the EBA's summary table suggests a proportional application of governance principles depending on which class the firm belongs to[6]. This appears to be in line with the proportionality principle and we agree with the key principles displayed in this table.

Regarding remunerations (recommendation 57), AMAFI would like to make the following comments.

- We agree that class 1 investment firms should remain under the CRD framework. In it indeed in phase with the FSF Principles: FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms". Concretely, it concerns financial institution with of which the value of assets is over EUR 200 billion.

- We agree with the EBA that MiFID rules are appropriate for class 3 firms.

- For class 2 firms when assessing the advantages and disadvantages of a restriction of Article 94 (1) (g) (i) (m) (o) of CRD IV, the European Commission should consider to authorise derogation at an appropriate regime. It means in particular that:

    - The principles set out in points (g), (l), (m) and in the second subparagraph of point (o) of paragraph 1 shall not apply to an institution the value of the assets of which is on average equal to or less than **EUR 10 billion** over the four-year period immediately preceding the current financial year.

    - The principles set out in points (l), (m) and in the second subparagraph of point (o) of paragraph 1 shall not apply to a staff member whose **annual variable remuneration does not exceed EUR 100,000.**

[6] Please refer to pp. 25 to 27 of the presentation material of the July 3rd, 2017 hearing, *State of play of the EBA advice on the design of a new prudential framework for MiFID Investment firms.*

Review clause: recommendation 58

We agree with this recommendation, although the purpose of the review clause should not, in our views, lead to another substantial change in the economy of the prudential framework applicable to investment firms; it should be limited to adjustment or fine-tuning purposes.

APPENDIX. – AMAFI'S UNDERSTANDING OF THE EBA DETAILED STATE-OF-PLAY RECOMMENDATIONS

The table below summarises our understanding of the EBA's state-of-play advice on the new prudential framework for MiFID investment firms.

We are glad to see that the general architecture is close to the contents of our proposal set out in AMAFI's response to the Nov 4th, 2016 Discussion Paper and, specifically, with the table contained in the "General Comments" part of that document.

	CLASS 1 FIRMS	CLASS 2 FIRMS	CLASS 3 FIRMS
DEFINITION	Systemic firms	Other, non-systemic firms	Small, non-interconnected firms
CLASSIFICATION CRITERIA	G-SII or O-SII (same as systemic banks)	Other that class 1 and class 3	Multi-criteria approach based on: - AUM + AUA < EUR 1.2m - COE < 500 orders/day - ASA = 0 - CMH = 0 - NPR, DTF = 0 - TCD = 0 - Balance sheet < EUR 100m - Gross revenue < EUR 30m
OWN FUNDS DEFINITION	No change from current	No AVA / prudent valuation filters	No AVA / prudent valuation filters
CAPITAL REQUIREMENTS	No change from current	k-factor approach including: - Market risk (K-NPR) based on FRTB - CCR (K-TCD) based on simplified SA-CCR	FOR regime (1/4 of fixed overheads)
LIQUIDITY REQUIREMENTS	No change from current (LCR/NSFR)	Approach based on: - 30 days of fixed overheads - liquid assets (larger definition including cash + no cap on L2A and L2B assets	Approach based on: - 30 days of fixed overheads including trade debtors & fees receivable within 30 days - liquid assets (larger definition including cash+ no cap on L2A and L2B assets)
LARGE EXPOSURES REQUIREMENTS	No change from current	Similar to current (K-CON factor)	No capital requirements
REPORTING GRANULARITY	Current or close to current	Proportionality will apply	Proportionality will apply
GOVERNANCE	CRD governance requirements	CRD requirements with proportionality (cf. pp 25-27 of the EBA presentation)	MiFID Rules
REMUNERATION	CRD governance requirements	CRD requirements (tbc by the Commission)	MiFID rules

We look forward to pursuing dialogue on this issue of great importance for the consistency of investment firms' supervision throughout the EU.