# INVESTMENT FIRM PRUDENTIAL REGIME

## 1. What are the main features of the regime?

A regulator explained the new prudential regime of investment firms has now been agreed. The legal text has been finalised and it will soon be published. The discussion will address the issue of what the key elements of the agreement are, the challenges of implementation, and the key outstanding issues going forward.

The EBA had been asked by the Commission to prepare a report in advance of the legislative proposal. Most of the recommendations, if not all, have been taken on board and are reflected in the system. There will be about 30 mandates coming from the legislation, so the implementation will be a significant challenge. Focus is needed on the agreement and what participants think the key achievements of the legislative process are, and what added value new legislation will bring to the investment-firm space in Europe.

A policy-maker believed it is fitting that a regulator should chair the session because the Commission's proposal took inspiration from the EBA documents. There are around 6,000 investment firms in the EU. The vast majority of them are small and tailored to some services. A minority are very large and provide a broad range of services. They are systemically important, because those firms manage 80% of the assets. When the Commission launched the call for evidence in 2014 the overwhelming reply from market participants was wariness about compliance costs and proportionality. As a result of the EBA's advice a Commission proposal has been made that has generated a fruitful discussion in the European Council and European Parliament and arrived at three results which simplify the mechanism substantially and reduce the costs of compliance without reducing its effectiveness.

The first result is that now there is a much more appropriate and proportionate regime for the non-systemic investment firms. This is centred on a set of risk metrics called K-factors, which determine capital requirements.

The second result is that the largest, class 1 firms whose size and activities make them systemic remain subject to the bank prudential supervision.

The third result is that clearer and stronger rules have been introduced for the provision of investment services to EU clients from third countries. This has been done by improving the MiFID equivalence regime.

### 1.1. Key issues and challenges

An official stated that the final compromise is a balanced one. There are two broad areas of concern which deserve further monitoring in the implementation of the text that has been agreed. The first concern regards a level playing field in financial stability issues. Small investment firms deserve some proportionality because the banking framework is not formally suited to those firms, but the initial proposal created a very large class of investment firms that could be treated in a way that is not fully consistent with what is thought to be the right objective in terms of financial stability.

Progress made in the discussion is the creation of the 'class 1 minus' class, which enlarges the set of investment firms that will be subject to prudential requirements comparable to those faced by banks. This addresses the level playing field issue and is also necessary from a financial stability viewpoint, as the class 1 category was initially empty as it was defined.

Regarding the prudential side of the text, the two things that need to be monitored are the possible side effects of the decision to introduce a new definition of 'credit institution' by making very large investment firms credit institutions. This could have a number of side effects, such as access to euro-system financing, access to the Single Resolution Fund, and consistency with the provisions of the Financial Conglomerates Directive. All of these concerns have been discussed and could be addressed at a technical level, but close monitoring is needed.

The aspect of concern that the official's organisation has in terms of implementation is the prudential regime itself, particularly the treatment of market risk. Since capital requirements are set according to the volume of certain services and businesses (K factors) rather than risks, the definition of a prudential requirement are in the hands of market participants; that could create bad incentives, so very close monitoring is needed.

Regarding the other aspect of the text, enhancing the equivalence regime of the MIFIR Regulation is a necessity due to the current context. Good progress has been made in this respect, as the equivalence decision will be taken based on a more granular assessment. The concern the official's organisation could have with the equivalence regime is that it is an equivalence that is decided at the level of the country, so EU authorities do not have any power to enforce the rules. This is part of the very idea of equivalence, but if there are third-country firms that are based in a country that the Commission has deemed equivalent and that behave well on the EU market, then inadequate tools are available to actually enforce rules that provide sufficient protection for EU consumers.

Article 49 provides ESMA with additional powers, which is very useful, but it is an area that needs to be closely monitored, as it is believed the Commission will not decide to question equivalence based on the misbehaviour of a few players if it has rightfully decided that the third-country's legal framework is correct. Close monitoring is needed as a result of this.

An industry representative stated that the industry has welcomed the European Commission's proposal, based on the EBA report, to design an appropriate prudential regime for investment firms. The overarching principle that should apply is that the same activities entailing the same risks should be subject to the same regulatory framework. It is positive that the equivalence assessment for third-country investment firms that seek to provide investment services in the EU has been strengthened in the legislative process.

Yet, the industry does not know how the equivalence assessments will be carried out as no third-country investment firms have benefitted from them to this date (the MiFID II/MiFIR regime only entered into force on 3 January 2018), and also because the context has changed due to the UK's decision to leave the EU.

A harmonised supervisory framework of investment firms across for investment firms across the continent is key

according to the industry representative, to prevent any sort of regulatory arbitrage and ensure that the level playing field is guaranteed with EU-based firms. The strengthened role of ESMA in this regard is also welcomed, to ensure that sound and robust standards are applied in a consistent way amongst investment firms.

A policy-maker felt there are two points worth highlighting. The European Commission did not propose the class 1 minus, but debate at the European Council and European Parliament showed that there was a majority around that idea and the Commission did not oppose it.

Regarding equivalence, it is clear that it requires some monitoring when it is given to countries that are close, whose size is significant and that have many activities and interactions with the European Commission. The Commission was used to an equivalence regime in the past for small islands in the Atlantic and now things may change. It is clear that the Commission, which is responsible for equivalence, will have to play its role until the end.

### 1.2. Implementation of standards

A regulator explained that the EBA is going to gather approximately 30 mandates and is planning to publish a road map of them. Clarity on the implementation issues will be given as soon as possible. The question of how equivalence will actually be assessed is something to be seen once the legislation enters into force and is applied, as it can only be assessed once put it into practice. The lead on that will be the technical assessment by ESMA in consultation with the EBA, and the European Commission will have the final say.

### 1.3. By promoting proportionality, fair competition and financial stability the IFR is expected to contribute to the CMU project

The panel received a question from the audience on whether the EBA advice and the legislators are bank-biased in setting prudential requirements for investment firms, and how they view that, especially in light of the wider CMU objectives.

A policy-maker explained that the starting point is that there is an excessive bank bias. The notion of a level playing field had been put into question by the overwhelming reaction to the call for evidence. The regime that existed since the CRD was introduced has reached its limits. The CMU effort comprises a component of proportionality, a component of simplicity, and a component of making it easier for investors to access the market. Due to that the previous regulatory regime was very imprecise because it included a number of entities that were not completely similar.

The discussion on class 1 minus has been an attempt to more accurately calibrate what remains in the old regime and what goes under the new, simplified, regime. The trade-off is between financial stability issues which apply to systemic firms, and a competitiveness and growth issue that makes access to the market easier. As with all legislative pieces there will be a review in three or four years, but it is a good starting equilibrium. The markets will state whether something needs to be changed, but what is interesting is that this had been a true CMU reform as it is very different from what it had been.

A regulator noted that industry representatives on the panel are exposed to different types of regulations and may be able to compare which activities fall under which types of regulations, and how this helps to properly address the risks in different businesses.

An industry representative agreed with a policy-maker. It is important to contextualise the IFR within the broader EU regulatory framework for financial services. The Capital Market Union and Banking Union need to be finalised and the EU needs to be coherent with its political ambition as the competitiveness of its economy is at stake. Market fragmentation should be avoided at all costs, and vigilance should prevail when implementing the new regime, as it is the only way to ensure a sound level playing field between market participants, ensure financial stability, and enhance the competitiveness of the EU.

The assessment conducted by EBA (which fuelled the Commission's proposals) that started in 2014 did not anticipate Brexit. The figures that are mentioned do not take into account the large investment firms in the UK that are at the moment under the CRR, because it is thought that they would remain under this regime and under the supervision of the UK's PRA. As this has changed everyone needs to be very careful about the consequences and risks in terms of level playing field and fragmentation. A thorough impact assessment of the post-Brexit situation is therefore needed when implementing the 30 mandates stemming from the final agreement, in order to mitigate any unintended consequences that result from it.

A regulator asked an official whether European investors have fewer opportunities and higher costs in using third-country service providers in the EU, because of strict equivalence rules, and whether a cost-benefit analysis has been carried out on the issue of tightening equivalence rules.

An official stated that a balance is needed between costs to EU consumers and the rules to which investment service providers are subjected. That has been done internally within their organisation. MiFID II rules might create costs for some customers, but they are meant to protect market integrity. If these rules impose a cost on consumers then third-country service providers that could escape these rules could have a competitive advantage over EU players and offer services at a lower cost, which is the problem.

The aim of the equivalence regime is to ensure that the rules established in the EU in the interest of market integrity and EU consumer protections are implemented. Parties could agree that EU rules do not necessarily need to be enforced; acceptance could be made that foreign rules produce equivalent results. This is the whole idea of the equivalence regime, but the cost that EU rules impose on EU customers are costs that their organisation has accepted to be legitimate in view of general-interest objectives that the EU is pursuing.