Investment firm prudential regime

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The investment firm prudential regime: proportionality, risks and competition

The set of regulatory reforms related to the Basel 3 accord were tailored to credit institutions and driven by micro-financial considerations as well as financial stability concerns. However, the European Union's transposition of the Basel accord applies to all the institutions subject to the CRR and CRD, which includes credit institutions and investment firms authorised under MiFID.

Since these investment firms are not part of that international agreement, it is fair to recognise that their services, activities and business models were not the main drivers of those reforms. This raised the question on whether the prudential requirements of the CRD/CRR would have been still suitable for investment firms in the medium and long-term.

"Prudential regulation for investment firms will be simpler,tailored,easier to implement and maintain."

\- ADAM FARKAS

In order to explore that question further, the European Commission asked the EBA to consider whether the current prudential regime would be disproportionate for investment firms and, if necessary, to propose alternative approaches. The EBA, in close collaboration with central banks, prudential supervisors of investment firms and ESMA, carried out a sequence of detailed analyses in order to identify those areas.

Surprisingly for some stakeholders, the EBA identified only a handful of investment firms for which the CRR would have been appropriate in the future; these investment firms are usually very large subsidiaries of non-EU banking groups that are usually GSIIs. Since they do not hold deposits for their clients or provide lending, these investment firms may operate in the EU under a MiFID license. However, the size and complexity of these investment firms makes them more similar to investment banks, and therefore the banking prudential framework remains well suited. Furthermore, as these large and highly interconnected investment firms are in direct competition with credit institutions, that would ensure a level playing field. >>>

>>> For the large part of other investment firms, however, systemic risk considerations are less predominant and deposit-holders' protection is not at all applicable. Therefore, the EBA recognised the need to completely separate the prudential regime of investment firms from the one for credit institutions. The proposed regime uses key metrics, such as total assets under management or daily trading flows, to identify the risks posed by these firms, which are not well captured in the existing banking framework.

Among the benefits that such separation would have, one is that a dedicated regulation for the prudential requirements of investment firms would be simpler, tailored to that type of business and, overall, easier for the investment firms to implement and maintain over time without, for example, having to monitor technical standards or guidelines not applicable to them.

Nonetheless, a failing investment firms poses risk to customers and to the markets where they operate. Therefore, the EBA recommended that all the investment firms should be subject to going-concern and gone-concern capital requirements, but under a simpler regime.

Similarly, because of the risks to customers and markets, other aspects such as liquidity requirements, concentration limits, risks arising from trading activities, reporting and disclosure requirements were deemed essential for ensuring a healthy environment for investors when relying on these services.

At this juncture, the development of the finalisation of the Level 1 regulation and directive seems to be at its final stage and it is likely that the ball will go back to the EBA who will have to develop technical standards, guidelines or reports in a broad range of areas.

Since this phase will require a few years to be completed, with a staggered publication of the various documents, the EBA commits to ensuring quality, full transparency and timely information to stakeholders. To this end, the EBA plans to disclose its envisaged workplan before the end of the year and accompanying any publication with public consultations. ●

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Review of prudential rules for investment firms

Investment firms are important market intermediaries. They give investors access to capital markets by providing investment services, ranging from investment advice to underwriting and dealing on own account.

There are over 6,000 investment firms in the EU. The sector is diverse, both in terms of the scale and scope of services they provide. The large majority of firms are very small and concentrate on a limited range of services. However, there is also a small number of big firms that provide a broad range of services, resulting in them being systemically important. These make up around 80% of total assets.

Investment firms are subject to EU rules governing their conduct on the markets in which they operate set out in the regulation and directive on markets in >>>

>>> financial instruments (MiFIR, MiFID II). They are also subject to prudential requirements, set out in the regulation and directive on capital requirements (CRR/CRD IV).

The decision to subject investment firms to prudential requirements stems from the early 1990s, when legislators considered that if these firms were to operate on the internal market, then they needed to be prudentially sound. Legislators also wanted to ensure a level playing field in prudential terms with banks, who may provide the same services. They therefore incorporated investment firms into the banking prudential regime.

While this regime was sufficiently general to incorporate these different business models at the time, it has become more problematic since. In particular, in the wake of the financial crisis, the prudential supervision of banks have rightly become significantly strengthened both in terms of "scale" (quantity and quality of capital) and "scope" (also addressing risks in terms of insufficient liquidity buffers and excessive leverage). While appropriate for banks, this would result in a disproportionately strict prudential treatment of investment firms. Unlike credit institutions, investment firms do not accept deposits, nor do they provide loans on a significant scale.

This means that they are less exposed to the risk of depositors withdrawing their money at short notice and of borrowers failing to pay them back. To address this, legislators have over time put in place a number of dedicated regimes within the banking prudential framework. However, this has resulted in a complex framework that is unevenly applied across the internal market. It has therefore become more costly for investment firms to comply with these rules.

The Commission proposals adopted in December 2017 acknowledge that the broad diversity of investment firms in terms of scale and scope of services provided merit a differentiated prudential regime. Building on EBA advice, the Commission therefore proposed to divide the investment firm population into three different classes and to tailor the prudential regime applying to each.

The largest firms with assets above EUR30bn (class 1) have business models and risk profiles that are similar to those of significant banks. Given their size and systemic importance, they present a risk to financial stability. The regulatory framework for banks is the best equipped to deal with these risks. These firms should hence be regulated and supervised as large banks.

The remaining investment firms would be lifted out of the bank prudential framework and instead become subject to a dedicated prudential regime. The larger of these (class 2) would become subject to a new prudential regime structured around so-called "k-factors". These aim to ensure that class 2 firms are able to absorb losses by setting capital aside to cover the main risks they face as a result of the services they provide to customers and by virtue of operating on capital markets. By contrast, the smallest investment firms (class 3) would only have to set aside sufficient capital to ensure that they could be wound down in an orderly manner in case of trouble.

The Commission proposals also revise the conditions governing third country firms' provision of services in the EU. MiFiDII/MIFIR provides a framework under which the Commission may take a decision to recognise a third country's prudential and market conduct framework as equivalent to EU rules for certain types of activities directed at professional clients. As the proposals change the EU prudential rules for investment firms, the equivalence test had to be adjusted to include these new rules. In addition, the Commission proposed other changes, including a more detailed and granular assessment of countries from which service provision is likely to be of systemic importance.

The European Parliament adopted its negotiation mandate in September 2018 and the Council followed suit in January this year. The co-legislators reached a provisional political agreement on 26 February. ●

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A regulation whose effects will have to be monitored closely

The definition of an appropriate prudential regime for investment firms is key to ensure the financial stability of the Union. From the start, France has been supportive of the objective of the Commission's proposal to tailor and streamline the prudential regime applied by some of these firms which contribute positively to the financing of the European economies, having in mind the Capital Market Union (CMU). However, it is unfortunate that the envisaged new rules are, in some respect, less prudent and risk sensitive than existing CRR rules for similar business lines. In our view, this could create competitive distortions and level playing field issues, as a credit institution and a class 2 investment firm carrying out the exact same activities on the exact same scale might face different own fund requirements. Besides, as of now, class 1, designed for systemic and bank-like investment firms above 30bn€ in balance sheet, is empty in the EU27. The introduction by colegislators of a "class 1 minus" (above 15bn€) will ensure that large investment firms, that take risks directly on their balance sheet, will apply sound and robust standards.

Moreover, changing the definition of credit institutions to include class 1 investment firms, instead of amending the Single Supervisory Mechanism's Regulation, may have unexpected side effects (access to Eurosystem operations, access to Single Resolution Fund, disruption of the application of the "conglomerates" Directive). A thorough follow-up of those possible side effects will be necessary as they could also introduce competitive distortions. For example, class 1 firms turned into credit institutions would gain direct access to the Single Resolution Fund (SRF), while having contributed very little or even nothing at all, creating moral hazard.

As regards the third country regime, we need to make sure its implementation preserves the stability and integrity of European markets and the need for a level-playing field between market players.

The initial MIFID/R third country regime was in no way satisfying on that point, since it would have merely allowed third country firms to act under an equivalence decision on the EU financial markets without complying with rules equivalent to those of EU law. This would have resulted in a loss of sight for European regulators, leading to the defeat of core MIFID/R principles, such as pre and post transparency or trading obligation.

The initial proposal of the Commission addressed the risk of legal divergence by making sure the equivalence assessment would be more granular and could be reviewed periodically. To facilitate this decision by the Commission, the final compromise allows equivalence decisions not to cover all financial activities and services. Even though the final agreement calls for a dedicated reporting for systemic activities, one can argue that equivalence is still unfitted for bank-like actors, which may pose a systemic risk for the EU markets. When drafting the equivalence decision and designing the specific operational conditions, the Commission and the supervisors will need to be vigilant on systemic risk. The specific operational conditions will also play a crucial role in avoiding competitive distortion between EU firms and third country firms.

Only practice will tell us whether our efforts to shed light on supervisory blind-spots will prove enough. ●