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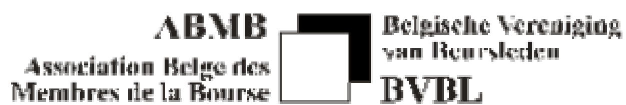

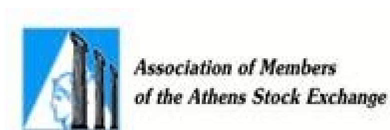

Norges Fondsmeglerforbund

The Association of Norwegian Stockbroking Companies

SWEDISH
SECURITIES DEALERS
ASSOCIATION

March 18, 2005

MEMORANDUM

APPLICATION OF CAPITAL REQUIREMENTS DIRECTIVE TO INVESTMENT FIRMS

The memorandum below is sent by the following European associations of investment firms.

- **Association Belge des Membres de la Bourse** : **ABMB-BVBL** : Belgium
- **Association Françaises des Entreprises d'Investissement** : **AFEI** : France
- **Association of Members of the Athens Stock Exchange:** Greece
- **Associação Portuguesa de Sociedades Corretoras e Financeiras de Corretagem : APC** :Portugal
- **The Association of Private Client Investment Managers and Stockbrokers : APCIMS :** UK
- **Associazione Italiana Intermediari Mobiliari : Assosim :** Italy
- **Bundesverband der Wertpapierfirmen an den deutschen Börsen e.**V. **BWF** : Germany
- **The Association of Norwegian Stockbroking Companies : NFMF :** Norway
- **Raad van de Effectenbranche : REB :** Nederlands
- **Verband unabhängiger Vermögensverwalter Deutschland : VUV :** Germany
- **Swedish Securities Dealers Association: SSDA** : Sweden

This memorandum summarises the shared concerns of the investment firms' community across much of the EU in relation to the expected detrimental impact of the Capital Requirements Directive, and puts forward proposals for minimising that impact. Attached to the memorandum are appendices that (1) give a background to the anticipated impact on small- and medium- sized enterprises and (2) set out our proposals in more detail.

Overview

The application of the Basel II banking framework to investment firms within the EU, through the implementation of the re-cast Capital Adequacy Directive (now the Capital Requirements Directive, or CRD), is of great concern to the community we represent. For more than two years the trade associations representing investment firms within ten European countries have been sharing their views on this development, in order to establish a common position. Although recognising that the models and markets under which our member firms operate are different, we consider that the new regime will impact on our industry in fundamentally similar ways, giving rise to similar issues. The purpose of this memorandum is to set out our common position and explain the issues that underlie it.

We have noted the response of the European Commission to concerns expressed about the application of Basel II to investment firms, which enables certain types of investment firms to adopt a different treatment in regard to the new operational risk capital charges. However, we do not feel that the scope of the relevant derogations goes far enough to ensure that all investment firms are treated in the most appropriate way. Recognising that it is unlikely that reconsideration will be given to the application of the CRD to investment firms, we are proposing that the capital charge for operational risk, where it applies, should at least be subject to a threshold to prevent disproportionate increases in levels of regulatory capital.

Fair treatment for investment firms

1. We consider that many of the issues arising from the application of the Basel II framework to investment firms stem from the fact that the framework was developed for the banking industry in order to better align the capital requirements within banks to the particular risk structure that they carry. The potential impact of the new Accord was tested before finalisation in three Quantitative Impact Studies, taking the effective composition of operational risk, credit risk and market risk for banks into account. Since investment firms carry a significantly different risk structure, a purely formalistic application of the complex new framework is likely to have clearly distorting effects.

2. Our concern regarding the Basel II framework centres on the changes to capital requirements provisions (generally referred to as Pillar 1) and not to the enhanced standards for managing business risks, as set out in Pillar 2. The embedding of robust, yet proportionate, systems and controls for the management of risk is relevant to all businesses, and is as equally appropriate to the investment sector as the banking sector.

Disproportionate increase in regulatory capital

3. We support equal treatment for businesses which have similar business risks. For investment firms we agree that this treatment should meet the Basel objective in terms of maintenance of the overall level of capital, but limited to this particular market sector. There appears to be no basis on which an increase in the overall level of capital for investment firms could be justified.

4. The calibration of the new capital framework in order to achieve the objective of maintaining the overall level of capital has been based on the banking risk model. This calibration basically relies on the compensating effect of reductions in credit risk related to the banking book, to offset the new operational risk charge of approximately 12% of the overall regulatory capital requirements. However, when the new capital framework is applied to the investment firm risk model, this can result in a disproportionate increase in capital, due to the addition of operational risk charges without the compensating risk requirement reductions.

5. Even allowing for an increase of 12% for the additional operational risk charge which, as discussed above, **cannot be offset**, it is anticipated that the capital requirements for some investment firms would rise substantially following implementation of the CRD. A study carried out by Price Waterhouse Coopers[1] (PWC) showed that the CRD could raise the capital requirements by an average of 37% for some investment firms. Furthermore, an analysis of certain types of investment firms, not exposed to a significant amount of market risk or credit risk, showed that the impact of the operational risk charge could be closer to 120%[2].

Competitive disadvantages

6. The US does not intend adopting the Basel framework for its investment firms and neither will the framework apply in other countries outside Europe. We believe this could lead to a significant weakening of the international competitiveness of European investment firms and may force some firms to relocate their businesses to less-restrictive areas.

7. Given that the EU approach to the regulation of banks and investment firms is that they operate within the same markets, and sometimes face the same risks, then it is important to take into account that they are competitors within this market, not only in regard to the provision of products and services, but also in regard to raising capital. It has been suggested above that there would be a need to for investment firms to increase regulatory capital in order to comply with the CRD and that the required level of capital would be disproportionately high; this would therefore put investment firms at a further disadvantage to banks.

8. The PWC report states that the Commission has already identified the operational risk charge as a potential cause of competitive distortions for investment firms.

Responses to the issues

9. Having expressed our concerns to the European Commission and our respective Member States in regard to the issues set out above, we are satisfied that some improvements have been achieved within the current amended proposals.

[1] Price Waterhouse Coopers, Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms in the EU (MARKT/2003/02/F) dated 8 April 2004.
[2] European Commission, Review of the Capital Requirements for EU Investment Firms – 2004 Quantitative Impact Study Main Conclusions, dated 20 July 2004.

Treatment of limited licence firms (50K and 125K firms)

10. We welcome the proposal to exclude the limited licence firms (generally those with an initial capital requirement of EUR 50K and EUR 125K) from the requirement of an explicit capital charge for operational risk, as set out in Art. 20(2) of recast Directive [93/6/EEC]. These firms will continue with a capital requirement based on the higher of (i) the expenditure based requirement (EBR), and (ii) the sum of credit risk, market risk and foreign exchange risk. On the basis of the risk model for these firms, this will tend to result in a charge equating to the EBR and will mean little change in capital for these firms.

11. However, we also take the view that the exclusion under Art. 20(2) should be applied to all investment firms since there has been no indication that a continuation of the current capital requirements regime would lead to a future shortfall in the level of capital held within this sector.

Splitting of 730K category firms

12. A review of the impact of the new requirements on firms with an initial capital requirement of EUR 730K has led to the splitting of this category to enable a further exclusion from the explicit operational risk charge to be applied to firms trading in principal, but only in order to fulfil client orders. The risk model for such firms is similar to that for limited licence firms, but with some exposure to market and credit risk. For firms conducting limited trading activity the response has been to adopt a new treatment, as set out in Art. 20(3) of recast Directive [93/6/EEC], based on the EBR, but extended to reflect these additional risk exposures.

13. As with the treatment under Art. 20(2), the EBR approach under Art. 20(3) provides an alternative basis for providing capital against operational risk, rather than an exemption from it. Moreover, it is acknowledged that the level of capital charge that this gives rise to compared to the CRD requirements, will be dependent on the particular accounting model of the firm and will not necessarily result in a lower capital requirement.

Further proposed solutions

Higher risk 730K firms

14. An attempt has been made to justify the application of the CRD to those 730K firms trading on their own account, on the basis that such firms put their balance sheet at risk and therefore run the risk of customers losing money or assets. "However this is not necessarily the case since investment firms are not allowed to take deposits and generally do not hold client assets. Moreover, when they receive client assets in form of funds or financial instruments it must be held in accounts **segregated from those of the firm**. Furthermore, investment firms are not allowed to employ client's funds (contrary to bank deposits) for their own account business. Furthermore, banks were assured broad capital neutrality under the new regime even though it is generally agreed that putting the balance sheet at risk is at the core of the banking business.

15. The basis for application of the Basel II to banks should not be used to justify the application of the requirements to investment firms and the resulting additional burden on firms. Both the PWC report and the 2004 Quantitative Impact Study refer to the significant increases in level of capital for these firms, which may be disproportionate to the risks they are running. This appears to be in part due to the impact of new requirements for risk arising in the trading book, in addition to the impact of the operational risk charge. Although these considerations have already led to a reduction of the beta from 18% to 15% in regard to the trading and sales business line, we feel that this does not go far enough to ensure that there is a proper and proportionate alignment of capital to risk, and that reconsideration should be given to the application of the CRD requirements to all investment firms.

16. As an alternative way forward, we strongly suggest that for any investment firms to which the CRD is applied, the level of the explicit operational risk charge is made subject to a threshold. This threshold should be calculated in order to achieve an operational risk charge of no more than 12% of the overall capital requirements, in line with the Basel objectives.

Groups

17. The situation described above is further compounded for groups of investment firms. Where any firm within such a group does not come within the derogations set out in Art. 20(2) or 20(3) of recast Directive [93/6/EEC], even where such a firm is incidental to the group, then the whole group will be subject to the full CRD requirements in respect of operational risk. We consider this to be an inequitable situation, given that the risk profile for each individual part of the group has not changed and therefore the appropriate capital requirements applied at the individual level should still lead to the calculation of capital charges sufficient to cover risk. We would therefore propose that where any firm not covered by the derogations noted above contributes a minimal amount to the total revenues of the group, the remaining firms within the group should continue to base their capital charges on the requirements that would apply if they were solo entities.

APPENDIX 1

IMPACT OF THE CRD ON SMALL- AND MEDIUM-SIZED FINANCIAL SERVICES FIRMS

In seeking regulatory relief, small- and mid-sizes firms (SMEs) usually have recourse to various familiar arguments, relating to "level playing fields", and their roles in job-creation and commercial innovation, the inherent value of entrepreneurialism and the perils of excessive concentration in their areas of business. Such arguments are at least as applicable to the financial services sector as they are elsewhere, but since they are familiar, we will not revisit them here. Rather, our discussion concentrates on reasons why we believe that the situation in the financial services sector makes the needs of SMEs unusual and their relief uniquely appropriate.

Proportionality and perverse consequences

The primary goal of capital adequacy regulation is systemic integrity. SMEs in the financial services sector by definition pose few risks to systemic integrity, and consequently regulation of their capital structures should be "light touch". Any competitive advantage they might derive from such treatment will be more than offset by the economies of scale and scope that they (also be definition) forego. Systemic risk is most effectively reduced by diversifying it across numerous firms: actions that tend to concentrate it by reducing the number of firms that are able to take on small portions of it have the opposite effect. The result of CRD treatment that is too onerous on financial services SMEs will be to increase systemic risk.

Systemically important niches

While many SMES in the financial sector are simply small versions of their larger competitors, many are not. Finance offers numerous niche opportunities, many of which are best served by firms that are independent of the sector's giants. Some of these are activities that must be insulated from the conflicts of interest that their inclusion in a diversified firm would entail (e.g. market making services, specialist merger advice to the financial sector), while others are services to the sector's giants that they would be unwilling to purchase from their more direct competitors (e.g. inter-dealer brokerage). Finance has made structural accommodation for these needs in various ways, through the establishment of single capacity, limited licences or "boutiques". When imposing increased fixed costs on the financial services sector, it is extremely important that regulators recognise the importance of many of these niches and the historical origins of the exceptional treatment that some firms occupying them have enjoyed.

The increased burden of regulation on the financial sector, arising not only from the CRD but from several other Directives as well, is likely to result in the multiplication of such niches: while increases in fixed operating costs would generally be expected to foster an increased appetite for economies of scale, the consolidated treatment of operational risk and heightened concern over conflicts of interest are likely to devalue economies of scope. Some niche activities simply cannot support the increased overheads that will be imposed on large diversified firms.

SMEs serving SMEs

One such niche that small- and mid-sized firms in the financial sector have tended to dominate is the provision of financial services to small- and mid-sized firms. With the exception of capital raising, the giants of the industry are generally unwilling to provide such services to SMEs. Many are quite explicit in their refusal: for example, the merger departments of major investment banks state publicly that they will not advise on mergers with a value of less the EUR 50 million. Insofar as the "familiar arguments" in support of the special economic value of SMEs have validity, they underline the special economic value of the financial services provided to that sector. If financial services SMEs curtail their activities as a result of inappropriately heavy-handed regulation, it is SMEs that will suffer disproportionately: larger firms have little incentive to fill any resulting gaps in provision.

Smaller member states and new accession countries

The justification for capital adequacy requirements of any sort is the tacit recognition of the special place of the financial services sector in a modern economy. Regulatory action that would tend to curtail the development of a healthy financial services sector is thus economically self-defeating. Smaller member states, and those with comparatively less-developed economies, will be hampered in their desire to foster financial services support for their economies if the CRD provisions result in a situation where only firms with Europe-wide economies of scale can compete in the financial marketplace. Given a desire to foster balanced economic growth in such member states, it is counterproductive to render firms uncompetitive that are (currently) small because the markets they were created to serve are small or comparatively new.

Mobility of financial services provision

It is salutary to recall that a minor change in the US Federal tax code sufficed to drive what became a major source of high quality employment for Europe – the Eurobond market – out of the US. Capital requirements have a similar effect to taxation on financial services firms, and if those set under the CRD are onerous, they will have a similar effect on aspects of service provision in the financial segment: certain financial activities will remove themselves to other jurisdictions.

Because of the constraints placed on small- and mid-sized financial firms by their size, such firms are unlikely to be able to follow the giants into other jurisdictions. Consequently, they will suffer an insupportable competitive disadvantage with respect to them, and will be forced to withdraw from such services. Relief from onerous CRD requirements would allow them to continue to participate in such activities, thus preventing their complete disappearance from EU jurisdictions, and enabling access to such services to SMEs that are unable to access offshore jurisdictions.

APPENDIX 2

SPECIFIC PROPOSALS TO PREVENT DISPROPORTIONATE INCREASES IN CAPITAL FOR INVESTMENT FIRMS UNDER THE CRD

Proposal 1

Point 10 above refers to the specific treatment adopted within the draft CRD text in respect of those investment firms classified as "limited licence" investment firms (reference Art. 20(2) of recast Directive [93/6/EEC]).

The capital requirement for these firms is based on the higher of:

i. the expenditure based requirement (EBR)
ii. the sum of credit risk, market risk and foreign exchange risk

We consider this to be an appropriate calculation basis to ensure that investment firms hold sufficient capital in respect to their risk model and propose that this treatment is extended to all investment firms.

On the basis that proposal 1 is not acceptable we put forward proposal 2

Proposal 2

For those firms to which the full capital requirements under the CRD would apply, we suggest that the explicit operational risk charge is subject to a threshold to prevent disproportionate increases in capital. This would cover higher risk 730K firms and other investment firms not subject to the provisions of Art. 20(2) and 20(3) of recast Directive [93/6/EEC].

As proposed in point 16 above, the threshold should be applied in order to achieve an operational risk charge of no more that 12% of the overall capital requirements, thus:

The capital requirement would equal the sum of:

i. capital charge for credit risk
ii. capital charge for market risk
iii. capital charge for foreign exchange risk
iv. operational risk charge

but subject to an upper threshold of the sum of:

v. capital charge for credit risk
vi. capital charge for market risk
vii. capital charge for foreign exchange risk

multiplied by 1.136, to allow for an operational risk charge of no more than 12% of the overall capital charges [1 + ((100/(100-12)/100)) x 12)]

Proposal 3

Point 17 above considers the specific situation for groups. If either of the two proposals put forward to prevent disproportionate capital increases for investment firms were accepted, then this would help alleviate the situation for groups containing investment firms covered by the derogations in Art. 20(2) and 20(3) of recast Directive [93/6/EEC] and investment firms that are not covered.

However, we propose a more appropriate treatment for groups where the contribution to total gross income by a firm not covered by one of the derogations in Art. 20(2) and 20(3) of recast Directive [93/6/EEC], does not exceed 10%. In such cases we consider it appropriate that each firm bases its capital requirements on the calculations that would apply to the individual firms.