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# REVIEW OF THE PRUDENTIAL REGIME FOR INVESTMENT FIRMS

## AMAFI feedback

*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.

Given the importance of the subject for its members, AMAFI has closely followed the progression of this dossier at European Banking Authority (EBA) level during the last two years. In this respect, we attended various meetings organised by the EBA and the European Commission (EC) as well as by the French supervisor (ACPR), and provided our input via papers addressed to the EBA and to the EC during the consultation process[1]. Moreover, AMAFI encouraged its members to take part in the Quantitative Impact Studies (QIS) exercises in July 2016 and July 2017.

AMAFI would like to thank the EBA and the EC for the transparency and the quality of the consultation process.

On December 20th 2017, the EC released a proposal on new prudential requirements for investment firms (Investment Firms Regime, IFR), which consists of a proposal for a Directive and a proposal for a Regulation (the Proposal).

In the context of the new "give your feedback" policy of the EC, AMAFI would like to make the following comments. They reflect the core business of its members, that is to say trading activities on own account or on behalf of clients carried out by independent investment firms (IFs) or subsidiaries of a larger banking group.

[1] 17-09 - EBA Discussion paper on a new prudential regime for Ifs, AMAFI contribution (2 February 2017)
17-54 - EBA Investment Firms Regime, AMAFI contribution (27 July 2017)

AMAFI ■ 13, rue Auber ■ 75009 Paris ■ France
Phone : +33 1 53 83 00 70 ■ Fax : +33 1 53 83 00 83 ■ http://www.amafi.fr ■ E-mail : info@amafi.fr

## I. – GENERAL COMMENTS

AMAFI generally supports the global framework proposed by the EC as it intends to meet regulatory principles AMAFI fully agrees with:

- Set up an actual EU proportional regime taking into account the size, the activities, the complexities of business models of IFs within the EU.
- Set up an actual level playing field between EU IFs which is not the case today given the numerous national discretions allowed by the current CRD/CRR regime.
- Set up an actual level playing field between EU and non EU systemic entities.

That being said, AMAFI strongly disagrees with one point of the Proposal which is of the utmost importance when considering the goal to put in place a simpler prudential regime for IFs. The point is the level of application of requirements, and especially the possibility for National Competent Authorities (NCAs) to exempt IFs from the application of various requirements on a solo basis (article 6 of the draft regulation).

According to the current draft, an NCA could only grant exemptions for small and non-interconnected IFs (class 3) and for systemic investments firms (class 1) but not when the IF is eligible to the k-factors requirements (class 2).

AMAFI does not understand the rationale behind this. Moreover, compared to the current regime (*art. 7 CRR*), this is a serious step backwards which would bring more complexity especially for IF groups which comprise only class 2 firms. AMAFI encourages the EC and the co-legislators to deeply assess and review this point.

Besides those general comments AMAFI would like to add more specific issues, namely:

- The classification of Investment Firms and, more precisely, the definition of Class 1 firms,
- Consolidated vs. individual supervision,
- Suggestions on specific k-factors,
- Remuneration policies.
- Third countries regime.

## II. INVESTMENT FIRMS CLASSIFICATION

### Investment firms classification

We support the general classification into 3 distinct categories of investment firms:

| Category | Definition | Proposed prudential regime |
|---|---|---|
| Class 1 firms<br>deemed « systemic » | Regulation Proposal, art. 60 | CRR/CRD |
| Class 2 firms | Neither in class 1 nor in class 3 | New regime based on k-factors |
| Class 3 firms<br>deemed « small, non-interconnected » | Regulation Proposal, art. 12 | Simplified new regime |

We also support the definition of class 3 investment firms as stated in article 12 of the proposed Regulation, and do not have any comment on it.

## Class 1 firm identification (*art. 60.2 of the draft regulation*)

Article 60.2 of the draft Regulation aims at (i) defining class 1 firms and (ii) qualifying those firms as credit institutions.

(i) Class 1 definition.

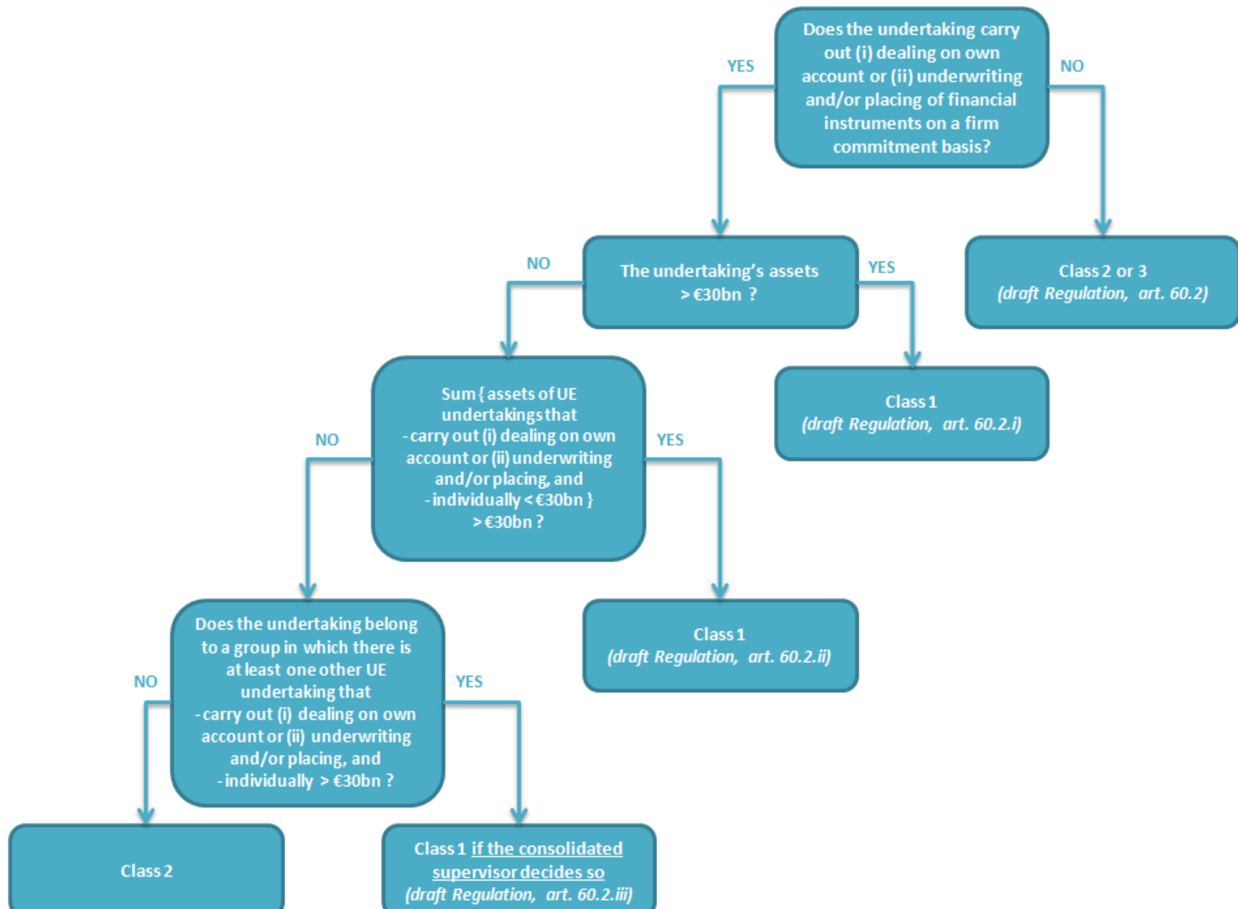
AMAFI welcomes the EC's intention to define clear, straightforward criteria to set the distinction between class 1 and class 2 firms. We believe that the threshold of EUR 30 bn in total assets, defined in article 60.2 (a) (i), is appropriate.

That being said, the drafting of article 60.2 is far from being crystal clear. Our general understanding of this article is summarised by the charts below.

Would this analysis of the drafting be correct, AMAFI welcomes this way of defining class 1 firms. Otherwise, AMAFI considers that article 60.2 should be amended in order to meet these objectives.

Anyway it would be very helpful to have a drafting which is more readable in order to avoid any ambiguity.

Decision tree for the identification of class 1 firms in EU groups



(ii) Integration of class 1 firms into the definition of credit institutions

If AMAFI fully agrees with the fact that class 1 investment firms should be submitted to the CRD/CRR provision and included in the Single Supervisory Mechanism (SSM), it does not mean that including class 1 investment firms in the definition of credit institutions as per article 4.1 CRR is an appropriate manner to do so. Indeed, this could have inappropriate and unexpected outcomes in terms, for example, of credit granting, deposit guarantee schemes. This may generate confusion as to the applicability of other (current or future) EU regulations applicable to credit institutions.

In addition, from a legal perspective, including class 1 investment firms in the definition of credit institutions would create an issue as regards the 2013 French Banking Law (*Loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires*), which imposes to host proprietary trading activities in a dedicated entity having the status of investment firm.

Therefore AMAFI recommends another legislative way in order to fulfil the same regulatory objective without the potential drawbacks. It would mainly consist in:

- Including, within article 4.1 CRR, a definition of systemic investment firms which would refer to article 60.2 (a) of the proposed Regulation and would ensure that CRR applies (i) to credit institutions and (ii) to systemic investment firms;
- Amending Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies related to the prudential supervision of credit institutions in order to include class 1 investment firms.

## II. – INDIVIDUAL / CONSOLIDATED SUPERVISION

Three cases should be considered here:

- Systemic (class 1) investment firms that are part of a banking group subject to CRD-CRR on a consolidated basis;
- Non-systemic (class 2 & 3) investment firms belonging to a banking group; and
- Groups of non-systemic investment firms.

### Class 1 investment firms belonging to a banking group

We understand that these firms would be subject to the CRD-CRR rules, both on an individual basis and on a consolidated basis.

Under such circumstances, the exemption mentioned in article 7 of CRR, which allows the consolidated supervisor to exempt an undertaking from individual supervision if all conditions stated in article 7 are met, will still be possible. AMAFI strongly supports this possibility.

### Non-systemic investment firms belonging to a banking group subject to CRD-CRR on a consolidated basis.

Article 5 of the draft Regulation provides that all investment firms should comply with the requirements laid down in parts 2 to 7 on an individual basis.

Such firms would therefore be subject:

- To the future investment firms' regime on an individual basis; ***and***
- To the CRD-CRR regime on a consolidated basis.

Article 6.1.d.i allows an exemption to this principle for investment firms that are included in a group the parent company of which is a credit institution, but only when the investment firm considered is a class 3 firm.

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 non-systemic investment firms, just as it is currently open to all institutions subject to CRR.

This provision would deprive the consolidating supervisor from the possibility to grant an exemption to a class 2 firm, whereas it could do so to class 1 firm (please see above) and to a class 3 firm. In our views such a distortion would not be acceptable because unfounded.

The conditions required by article 7 of CRR ensure that the exemption is limited to institutions with an adequate operational setup in place, i.e. own funds are distributed adequately between the parent entity and the investment firm, and there is no obstacle to the prompt transfer of capital by the parent entity. These conditions are, in our opinion, an appropriate safeguard against abusive exemptions.

As similar provisions are stated in article 6 of the future investment firms regime, 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.

Consequently, class 2 investment firms that carry out market activities within a banking group could be forced 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 benefit in terms of financial stability. Finally, it would unduly penalise class 2 firms compared to class 1 and class 3 firms.

**This question is crucial** considering the French banking system. Indeed, among 75 investment firms authorised by the *Autorité de Contrôle 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.

## Groups of non-systemic investment firms (investment firm-only groups)

Investment firms that are part of an investment firm-only group cannot benefit from the exemption stated in article 6.1.a of the draft Regulation. Article 8 (k factor consolidation) of the proposed Regulation seems to allow a consolidation of the k-factor requirements in certain circumstances but it is far from being sufficient.

First of all, we do not see the rationale behind the difference between groups of institutions subject to the CRD-CRR regime, where article 7.1 allows consolidated supervision if all appropriate conditions are met and upon agreement by the supervisor, and investment firms where no equivalent provision would exist. This does not favour a level-playing field on the exercise of supervision by competent authorities.

Second, this situation would also create a distortion between, on the one hand, the situation of systemic (class 1) groups of investment firms which could apply for the application of article 7.1 CRR and, on the other hand, non-systemic groups of investment firms which would be deprived of this possibility.

Third, this situation would lead to several undesirable practical consequences:

- Individual firms would have to capitalise intercompany transactions, including when they are purely technical or designed to perform transfer of scarce resources (capital, liquidity) within the group; in addition, such transactions would be double-counted, as an exposure between entity A and its subsidiary B would be capitalised both within A and B. In our views this would lead to a very substantial increase in capital requirements which would not reflect an increase in the level of risk borne by the firms considered. K-KON (concentration risk) capital requirement is of specific concern in this context.

- Pillar 2 rules (e.g. ICAAP / SREP) would have to apply at individual level, even in the case of very small subsidiaries with no consistent risks borne in their balance sheet; it has to be reminded that, considering class 2 investment firms, in most cases even the group would be a relatively limited unit both in terms of size and complexity.

- It would generate additional reporting workload with no value added in terms of capacity to provide an accurate view of risks, as in many cases a consistent view of risks would only be provided by consolidated reports.

- Governance rules, such as, for example, risk and remuneration committees with only independent directors would have to be duplicated for each individual entity comprising the group. This would both add substantial additional burden and impair the ability of the governance structure to assess and monitor the actual risk profile of the institution.

Consequently, the impossibility to apply consolidated prudential supervision would generate undesirable effects:

- Increased complexity regarding the supervision of investment firms-only groups,
- Additional capital requirements not reflecting an increase in the level of risk of the financial system,
- Decreased adequacy of data reported for capturing real risks borne by a group of investment firms.
- Decrease in governance effectiveness.

**For all these reasons, we really believe that a provision equivalent to article 7.1 CRR should exist for non-systemic groups of investment firms in the future regime.** It must be recalled that, in all cases, it would be submitted to approval by the national supervisor, therefore we do not see any risk of consolidated supervision creating situations of inappropriate or “under-calibrated” supervision.

**This is a major point of disapproval of the proposal in its current version**. In our views, it contradicts current practice by competent authorities under the current CRR regime as well as the objective to better capture the level of risk borne by investment firms, in a proportional way and in accordance with the diversity of their business models and operational setups.

## III. – CAPITAL REQUIREMENTS CALCULATION

We welcome the distinction between the regimes that would apply to each of the three categories of investment firms respectively, as it ensures appropriate application of the proportionality principle, especially for small, non-interconnected firms.

We will focus our comments on the k-factor regime that would apply to class 2 firms, hoping that they will help fine-tune the final regime.

From a general perspective, we are fairly satisfied with the proposed k-factor regime, as it ensures that firms are capitalised based on the level of risk generated by the range of activities they exercise and their size.

We are also supportive of keeping, 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.

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 mark-to-market approach (simplified for investment firms) for counterparty credit risk.

That being said, AMAFI considers that the **k-DTF (Daily Trading Flow)** is not well calibrated for derivatives contracts because it will end up with a huge amount of capital requirements which would not be commensurate with the actual risks borne by investment firms.

Indeed this k-factor captures the amount of orders executed by the firm on its own account. AMAFI factually observes that the proposed calibration (0.1% for cash instruments, 0.01% for derivatives contracts) is aligned with the calibration previously defined in the European Financial Transaction Tax (EFTT) project. The detailed technical work performed on the EFTT ended up with the fact that for derivatives contracts, there is a need for a more granular approach.

In this respect, the EC could leverage on previous clarifications agreed upon at EU level concerning the EFTT project. During the examination of this project the industry raised technical issues regarding the appropriate tax base, as the industry agreed that the notional amount was not always appropriate for derivatives.

In practical terms, we would favour a k-DTF calculation base aligned with the principles agreed upon during the December 8th, 2015 EU Council meeting[2] regarding the EFTT project, i.e.:

i) For option-type derivatives: the calculation base should preferably be based on the option premium.
ii) For products others than option-type derivatives and coming with a maturity, a kind of term-adjusted notional amount / market value (where available) might be considered as the appropriate calculation base.
iii) For products other than option-type derivatives and not coming with a maturity, the notional amount / market value (where available) might be considered as the appropriate calculation base.

AMAFI will provide the EC and the co-legislators a more detailed approached in the coming weeks.

[2] http://www.consilium.europa.eu/media/23143/st15068en15_v4.pdf

## IV. – Remuneration policies

In the specific area relating to the remuneration policies, AMAFI would like to make the following remarks:

### 1. Scope of the provisions – A coherent application of the remuneration rules across the EU commands to apply them to subsidiary undertakings, which are part of a group, on an individual basis

Rules on compensation of employees raise important issues of level playing field between market participants. It is therefore essential to try to minimize as much as possible differences in treatment between the various categories of actors, while taking into account the particularities of each of these categories.

The new Directive on prudential supervision of Investment Firms should clarify that when the Investment Firm remuneration rules apply to an Investment Firm on an individual basis (i.e. it is a so called "Class 2" non-systemic Investment Firm that has total assets < EUR 30 billion) then the CRD remuneration rules do not apply to this Investment Firm, even if they apply to the mother company of this Investment Firm. As of today, the CRD remuneration rules apply to banks on a consolidated basis and are therefore applicable to Investment Firms that are subsidiaries of banking groups

As a consequence the remuneration provisions in the proposed legislation for investment firms should always apply to an investment firm;

(i) on a solo basis, and
(ii) even when the investment firm is part of a banking group in which the combined total value of the assets of all undertakings in that group exceeds EUR 30 billion.

It should be clarified that when the Investment Firm remuneration rules apply to an Investment Firm on an individual basis (i.e. the so-called "Class 2" non-systemic Investment Firm that has total assets < EUR 30 billion) then the CRD remuneration rules do not apply to this Investment Firm, even if they apply to its parent company. Today, the CRD remuneration rules apply to banks on a consolidated basis and are therefore applicable to Investment Firms that are subsidiaries of banking groups.

A useful exception to these principles should however concern the Remuneration Committee whose functions, by delegation, could be exercised at group level (*see below*).

### 2. Limitation of the provisions relating to the variable remuneration of the risk-takers (including the management, the compliance staff etc.)

It may be thought that it is only an oversight but the proposal does not limit the scope of the provisions on remuneration to risk-takers only, as is the case in CRD and CRR provisions under review. Thus, article 30-1 provides: "*Member States shall ensure that **any** variable remuneration awarded and paid by an investment firm complies with all of the following requirements (…)".*

Consequently, the scope must be the same as the one of article 28-1: "*Competent authorities shall ensure that investment firms, when establishing and applying their remuneration policies for senior management, risk takers, staff engaged in control functions and for any employee receiving overall remuneration equal to at least the lowest remuneration received by senior management or risk takers, and whose professional activities have a material impact on the risk profile of the investment firm, comply with the following principles (…)".*

## 3. Instruments for the payment of the variable part of the remuneration

AMAFI welcomes the flexibility that is introduced as to the instruments to be used for the payment of 50 % of the variable part of the remuneration. It makes fully sense considering the different legal structures an investment firm may have.

Beyond that, we think that even greater flexibility could be considered for the composition of the variable remuneration as long as the firm can demonstrate that the objective of the alignment with the firm's risk profile is fulfilled. There would be then no need for setting a list of the different instruments that can be used for this purpose.

## 4. Remuneration Committee

An investment firm which is deemed significant and which has the obligation to establish a Remuneration Committee should be authorized to refer to the Remuneration Committee of the group it belongs to in order to avoid burdensome structural arrangements.

## 5. Transitional provisions must be clarified to ensure a smooth chronological application of the legislations

Transitional provision will be necessary to ensure a coherent and smooth transition from the current prudential framework (CRD IV / CRR) currently under review (CRD V / CRR II) until the entering into force of the new framework for investment firms.

Thus, the Commission's proposal for a Regulation COM (2017)790 final and for a Directive COM(2017) 791 final should provide for that pending the review of the prudential framework for investment firms, member states may continue to apply the provisions of the Directive 2013/36 as they stood on [day before the date of entry into force of the amending directive] to investment firms that are not systemic investment firms as defined in point (139) of Article 4(1) of the Regulation (final number to be added – currently standing in COM(2016) 850 final Proposal amending the Regulation (EU) No 575/2013).

## V. – THIRD COUNTRIES REGIME

The present proposal contains several provisions amending the regime for third-country firms under MiFID2/MiFIR. The critical question however is how relevant the MiFIR equivalence regime will prove to be in the context of the UK's withdrawal from the EU. It is of crucial importance to ensure that the level playing field between EU and third-country investment firm is maintained and that distortion of competition between the different firms does not prevail. What is at stake is whether the European Union can accept that the financing of its economy depends significantly on market participants which are not regulated, nor controlled in the EU.

The conditions under which third-country market participants can provide financial services in the European Union are enshrined in different legal frameworks, depending on the nature of the provided services at hand. The issue, aforementioned, should require that a harmonization of the different equivalence regimes be put in place. AMAFI acknowledges however, that this objective is not feasible in such a short time frame given the current political context. We therefore support the choice made to adapt the third-country equivalence regime text by text, provided that this does not prevent, in the longer term, further reflections on the need for deeper reform of the current system in financial services.

AMAFI will closely follow the evolution of the proposal on this fundamental and very sensitive issue.