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New prudential regime for investment firms | Little detail yet

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On November 4th 2016 the EBA released a discussion paper (DP) setting out possible options for a new prudential regime for investment firms, particularly those that are not deemed “systemic and bank-like”. Published in response to the European Commission’s call for advice back in June, the paper was expected to shed some light on the direction of travel that the EBA is going to take in developing a more appropriate regime for investment firms given the distinctive nature of risks that they pose to investors and other market participants. The guiding principle behind the proposed regime is that firms that pose more risk to customers and markets, or which have more own risk, should attract higher capital requirements. However, the paper does not include any specific calibrations and, therefore, offers relatively little detail on the likely impact on firms’ individual capital requirements.

Changes to the current framework and categorisation of firms

Last month, the EBA issued an opinion suggesting that only investment firms currently identified as O-SIIs (at the moment, fewer than ten firms in the EU) should remain subject to the full CRD/CRR regime. It also recommended that any specific changes related to this category of investment firms should be postponed until the CRR review was at a more advanced stage. This was the EBA’s answer to the question on which firms should be deemed both systemic and bank-like (or Class 1 firms).

The paper published on Friday outlines features of a new regime for all other investment firms (i.e. not systemic and bank-like, or Class 2 and 3 firms). While there are no specific thresholds for categorising this group of firms, it is fairly clear that the Class 3 group will comprise the smallest non-interconnected firms, for which the new framework has to deliver a simple regime providing for orderly wind-down. The Class 2 group includes firms that are systemic (but not bank-like) as well as bank-like firms that are not significant in size. These firms are likely to see the biggest change in their prudential requirements.

No more CRD/CRR for most investment firms?

The DP sets out a broad range of questions and options on the design of the new tailored regime for Class 2 and 3 firms. The EBA is attempting to draft a basis for harmonised rules for investment firms. It has proposed setting fixed overheads requirements (FOR) and initial capital acting as de minimis requirements with capital calculations to reflect different business models.

The key innovation suggested by the EBA is the so-called K-factor approach to calculating capital requirements. This involves attributing capital factors to two broad types of risks, namely:

- Risks to customers (RtC) factors such as assets under management, assets under advice, assets safeguarded and administered, client money held, liabilities to customers and customers' orders handled; and
- Risks to market integrity and liquidity (RtM) factors such as proprietary trading activity.

A set of scalars or percentages will be applied to reflect size, turning each individual factor into an amount of capital required. The sum of these factors is then multiplied by a measure of the risk to which a firm itself is exposed from its on- and off-balance sheet exposures.

For small, non-interconnected investment firms (Class 3 firms), an alternative approach could be based mainly on FOR and initial capital.

While the EBA's preferred approach is to develop the aforementioned standalone prudential framework for investment firms, it also noted that applying the CRR in a more proportionate and targeted manner remained an option, at least for some investment firms.

The devil (will be) in the detail

Without knowing how the proposed framework will be calibrated, it is too early to conclude whether it will lead to an increase in capital requirements, particularly for any Class 2 firms. However, the EBA's proposals seem to be moving in that direction. For smallest firms, FOR and initial capital would seem to offer the simpler capital framework promised by the EBA.

Other important points to highlight include:

- The DP discusses the possibility of introducing a minimum liquidity standard (as a quantitative threshold and an alternative to LCR/NSFR).
- As regards the remuneration rules, it is fairly clear that firms that are not deemed systemic and bank-like will not be subject to the same requirements as firms that are in the scope of full CRD/CRR requirements.
- The DP does not make reference to any potential changes to the Pillar II capital regime. However, the EBA mentions that it may develop the detail of a supervisory review process for investment firms.

Next steps

- The deadline for comments is 2 February 2017. There will also be a public hearing on 1 December 2016.
- It will be a long time before all the details are fleshed out. Following the feedback from industry and stakeholders and analysis of data collected during the EBA's data collection exercise (that ran from July to October 2016), the EBA will submit the opinion supported by a report to the European Commission by 30 June 2017.

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