EUROPEAN PRINCIPAL TRADERS ASSOCIATION

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New prudential regime for investment firms

FIA EPTA comments

Overview

On the basis of Articles 508(2) and (3) of Regulation (EU) No 575/20131 (**CRR**) the European Commission is drafting a legislative proposal on a prudential regime for investment firms. We welcome the Opinion of the European Banking Authority (**EBA**) in response to the Commission's call for advice on investment firms and consider the recommendations to be broadly on the right track to delivering a more proportionate prudential framework. Nevertheless, FIA EPTA members offer the following comments in respect of the 62 recommendations and encourage the Commission to take these into account when finalising its proposal.

(1) Classification of investment firms

We broadly support the EBA's recommendations proposing a 3-fold classification of investment firms. However, we would challenge the permissions-based classification of non-systemic investment firms. The automatic exclusion from Class 3 of investment firms dealing on own account fails to recognise the distinction between bank and non-bank proprietary trading and disregards the substantial increase of firms holding this permission upon application of Annex I Section A(3) of Recast Directive 2014/65/EU on markets in financial instruments (**MIFID II**) on 03 January 2018. We believe that Class 3 investment firms should be distinguished on the basis of common and objective measures, and would suggest a quantitative threshold based on three months fixed overhead requirements (**FOR**).

(2) Capital requirements

(i) Risk to Market

FIA EPTA members welcome the inclusion of the K-factor on "clearing member guaranteed" (**K_{CMG}**) as a metric for calculating risk to market (**RtM**). We have long championed an assessment of own funds based on the collateral models applied by our clearing firms, which are generally large credit institutions or Class 1 investment firms subject *inter alia* to CRD IV and CRR in full. These models have proven to be very resilient over time, and are easy to implement. However, the EBA's recommendation to use the maximum of the K-factor on "net position risk" (**K_{NPR}**) and K_{CMG} will render the latter obsolete unless clearing members implement overly conservative collateral models.

We are also concerned by the EBA's recommendation on the basis of the calculation of K_{NPR}. We question the application of regulatory capital provisions derived from the Basel Committee on Banking Supervision's revised market risk standard (also known as the "Fundamental Review of the Trading Book" or **FRTB**) to non-systemic investment firms. This standard, which has yet to be adopted in Union law and the efficacy of which has yet to be proven, was developed specifically for systemically-important banks.

While we see merit in some aspects of the revised market risk standard, including more practical provisions on off-setting positions, these merits do not outweigh the prospective costs and substantially higher own funds required of non-systemic investment firms as a result of the application of the fixed shock scenarios prescribed by the standard. We are of the view that shocks should only be introduced into K_{NPR} 3 years after application following a report from the Commission and, if necessary, proposals to better calibrate the shocks for non-systemic investment firms. Additionally, the EUR 300 million threshold proposed by EBA on the basis of Article 325a of the proposed amendments to CRR (**CRR II**) proposal introduces unnecessary granularity to the classification of investment firms and should be removed.

In light of these concerns, FIA EPTA members would advocate for the legislative proposal to permit Class 2 firms to use the following alternative options to calculate RtM:

- K_{NPR} calculated on the basis of the CRR Standardised Approach;
- K_{NPR} calculated on the basis of the FRTB (with application of shock scenarios only after a full impact assessment);
- K_{CMG}; *and*
- Internal models, the approval of which recognises the non-systemic nature of Class 2 firms.

These options should be supplemented by Level 2 measures defining the technical details and practical application. We believe that this approach would introduce greater proportionality to cater for the wide range of investment firms.

(ii) Risk to Firm

The EBA's recommended risk to firm (**RtF**) K-factors are framed as proxies for operational risk. However, we believe that the K-factors on "daily trading flow" ($\mathbf{K_{DTF}}$), "trading counterparty default" ($\mathbf{K_{TCD}}$) and "concentration risk" ($\mathbf{K_{CON}}$) lack sensitivity and sophistication to accurately measure operational risk. In particular, we consider K_{DTF} to be an arbitrary measure which will disproportionality penalise market makers and hinder their ability to do capital planning. We encourage the Commission to consider alternative approaches to operational risk such as defining a maximum for RtF add-ons based on K_{DTF}, or substituting K_{DTF} for an alternative RtF K-factor based on more stable metrics such as Value at Risk (**VaR**) or FOR.

(3) Consistency with CMU objectives

In its Communication on the Mid-Term Review of the Capital Markets Union (**CMU**) Action Plan, the European Commission identified the establishment of a new prudential framework for investment firms as a priority action. The objective of the CMU project is to facilitate alternative sources of market financing to reduce the reliance on bank financing. FIA EPTA members believe that the EBA's Opinion fails to respect the objectives of the CMU Action Plan and, as evidenced by the impact assessment undertaken by FIA EPTA on its members, will generally increase capital requirements for Class 2 investment firms thereby hindering firms' ability to contribute to the liquidity of the market.

Moreover, FIA EPTA members would strongly oppose the EBA's assertion that proprietary trading investment firms operate in competition to banks' proprietary trading. The CMU recognises the financing from proprietary trading investment firms as complementary to that of banks and we believe that this understanding should be reflected in the final legislative proposal for a new prudential regime for investment firms.

About FIA EPTA

*FIA EPTA is comprised of 29 principal trading firms (**PTFs**) which deal on own account in a wide range of financial instruments traded on trading venues across Europe. PTFs play a key role in the modern financial ecosystem, bridging gaps in supply and demand between market participants and facilitating price discovery, especially at times when markets are volatile. Collectively, FIA EPTA members are an important source of liquidity for trading venues and end-investors, allowing those who use the capital markets (whether to invest or to manage their business risks), to buy or sell financial instruments efficiently and at low cost. FIA EPTA's mission is to support transparent, robust and safe markets with a level playing field for all market participants.*