18 February 2022

FIA EPTA Response to the European Banking Authority (EBA) Consultation Paper on the Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034

Introduction:
The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the EBA Consultation Paper on the Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034. FIA EPTA represents 26 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands, and the UK. Our members are independent market makers and providers of liquidity and risk transfer on trading venues and end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike. FIA EPTA would welcome the opportunity to provide further background to the EBA on the issues raised in our response.

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

EBA draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Regulation (EU) 2019/2034 (Investment Firms Directive)

Question	FIA EPTA response
Question 1. Do you have any comments on the structure and elements included in this Consultation Paper for the computation of Pillar 2 add-ons?	*This answer has been coordinated with APT.* **1. Creating an effective Pillar 2 floor may lead to disproportionate capital requirements** FIA EPTA is concerned about the fact that art. 4(2) of the draft Delegated Regulation effectively creates a floor with respect to the additional Pillar 2 requirements. This is the result of the fact that the additional own funds requirements as calculated in art. 4(1) are to express both (1) as an absolute amount, as well as (2) as the ratio of that amount to own funds requirements. The second paragraph of art. 4(2) subsequently states that where the level of the own funds requirements varies, the level of additional own fund requirements shall always be the highest of the absolute amount and the amount necessary to satisfy the ratio. Justification for the introduction of this floor seems to be given in recital 10, where it stated, *"To ensure that additional own funds requirements remain adequate over time, it is necessary to adjust them proportionally to any significant increase of own funds requirements […]"*. This 'floor' is then to remain in place at least until a new SREP assessment has taken place. Here, EBA seems to assume that own funds requirements can only ever increase for an investment firm. That is not necessarily the case for investment firms, and in particular for principal trading firms. In particular trading firms with market making obligations may see their own fund requirements both increase and decrease in relative short periods of time, depending on market circumstances – in particular trading volumes and volatility. By way of example – during the 2020 Covid induced market volatility many market makers remained in the market to provide liquidity. The increase in trading activities of these firms led to a significant increase in own fund requirements from k-factors such as K-DTF, K-NPR and K-CMG. If a floor for additional pillar two requirements would have been in place in the Spring of 2020 these market making firms would have been faced with much higher capital requirements, until long after the markets calmed and own fund requirements from these K-factors would have come down again.

	As an alternative we propose the NCA may either decide to apply a fixed amount *or* a fixed ratio to the additional own fund requirements of a firm. Another alternative that may be considered is that of setting the additional own funds requirement to be a percentage of the average of the own funds requirement. By way of an example, an investment firm's additional own funds requirement could be set as a percentage of the firms average own funds requirement where the average is calculated over a year. In general, the risks that are covered by the additional own funds requirement are not directly linked to the current level of the own funds requirement. However, as the size and/or business model of an investment firm changes over time it makes sense for the additional own funds requirement to react to that change. We believe that linking the additional own funds requirement to the average level of the own funds requirement over a set period achieves this aim. This alternative approach would result in a sufficiently conservative but stable additional own funds requirement that would allow investment firms to perform forward capital planning and ensure that investment firms that act as market makers are in a position to continue to provide liquidity to financial markets, particularly during periods of volatility. **2. Pillar 2 add-on requirements may lead to holding capital beyond what is needed for continued operation or orderly wind-down** Secondly, we are also concerned about the determination of additional own funds requirements to cover risks or elements of risks not covered by Pillar 1 requirements proposed in the EBA consultation paper. Paragraph 8 of the Consultation Paper states that: *"investment firms may be exposed to other risks that cannot reasonably be attributed to any own funds requirements set out in Article 11 of IFR. These include in particular risks such as ICT risk and other operational risks that are not addressed by the minimum own funds requirements. Where those risks are material in nature, competent authorities will need to assess their impact separately and consider such impact within the Pillar 2 add-ons regardless of the type of requirement that is binding for a given investment firm."* While we agree that investment firms should indeed consider all operational risks and the amount of capital that is required for those risks, the consultation paper goes on to say that the requirement for these extra risks (the minimum Pillar 2 add-on) should then be added to the higher of an investment firm's wind-down costs and the capital needed for K-Factors. Where wind-down costs are greater than the K-factor requirement this means that an additional capital requirement will be

	added to the wind-down cost. However, the calculation for the minimum Pillar 2 add-on will be for when a firm is operating in a business-as-usual mode and not when it is winding down. Therefore, asking firms to add the minimum Pillar 2 add-on to their wind-down costs could lead to a disproportionate level of capital requirement and will not reflect the actual cost of wind-down. It is also unclear which operational risks can be compared to K-DTF. As currently drafted, the RTS will have the effect of requiring investment firms to hold additional capital over and above that required to continue operating or wind down in an orderly fashion and therefore, compared to other jurisdictions, make investment firms in the European Union less competitive. Therefore, we suggest that: • The sum of all K-factor and Pillar 2 add-ons should then be compared to the wind-down cost and the capital requirement should be the higher of the two. **3. Material risks or elements of risks not captured by the own funds requirements** We do not support the inclusion (in article 3 of the Draft RTS) of ICT risks in risk that are not sufficiently covered in any own funds requirements set out in Article 11. As explained in our comments to question 5 on The EBA guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under IFD, DTF was intended in the level 1 text to cover operational risks resulting from a trading activity (recital 26) with no distinction of the type of operational risks and no specific exclusion. However, in line with the framework as envisaged by Level 1, investment firms will include these risks when making their assessment and compare it with DTF. Only in cases where Pillar 1 does not adequately cover these risks would additional P2R measures be warranted. In summary, we cannot support the EBA methodology that presupposes that risk arising from ICT are not covered by the own funds requirements. Additional P2R measures would be warranted only in cases where Pillar 1 does not adequately cover operational risks, including ICT risk, resulting from trading on own account. We would therefore suggest moving the reference to ICT risk from article 3(2)(a) to article 2 paragraph 3.

	The risks identified in the discussion paper as candidates for a Pillar 2 addition are already covered by K-NPR, K-CMG and K-DTF. NCAs and firms should only have to identify Pillar 2 requirements in case risks are not, or inadequately, covered by Pillar 1.
Question 2. Do you agree with the proposed indicative qualitative metrics? Are there any other aspects or situations not sufficiently taken into account in this proposed approach?	*FIA EPTA decided not to respond to this question.*