18 February 2022

FIA EPTA response to the European Banking Authority (EBA) Consultation Paper on the Draft Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under IFD

Introduction:
The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the EBA Consultation Paper on the Draft Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under IFD. 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 members believe that the overarching principle of proportionality, which stems from the Level 1 legislation, should be applied across all topics covered in the Draft Guidelines and the elaboration of that principle in the regulation should be guaranteed. More specifically, in relation to Section 4 on the Business Model Analysis, proportionality should be applied across all elements and levels of assessments to be performed by the national competent authority. In addition, the overall aim of IFR/D was to increase proportionality and risk sensitivity compared to the CRR/D framework. Using the SREP-methodology from the banking sector for the investment firms sector seems to run counter to that goal. The banking prudential regulation might be appropriate and balanced and accepts certain market practices that are appropriate for banks. This is not the case for the regulatory framework applicable to investments firms and in particular proprietary trading firms. Investment firms dealing on own account typically have a low-risk profile: businesses are non-complex but at the same time operate in highly competitive markets, portfolios are fully hedged, and risk windows are short. The risk of a single proprietary trading firm to the market, therefore, is limited and lower in respect to the market risk of the financial sector overall. Consequently, we propose to include acceptance of the principle of proportionality and its application in specific sections of the Draft Guidelines in relation to the proprietary trading firms business models. FIA EPTA would welcome the opportunity to provide further background to the EBA on the issues raised in our response.

Title 2 The common SREP

Question	FIA EPTA response
Question 1. Do you agree with the proposed categorisation and the proportionate approach to the application of the SREP to different categories of investment firms?	FIA EPTA members welcome the proposal to clearly define the categorisation of investment firms; however, we have some concerns on how these categorisations will be applied. The largest and most complex investment firms are now Class 1 investment firms that are subject to the provisions of Directive 2013/36/EU and Regulation (EU) No 575/2013 and the associated SREP Guidelines for the assessment of credit institutions and are outside the scope of these guidelines. We note that an investment firm that performs activities referred to in point (3) or (6) of Section A of Annex I to Directive 2014/65/EU and has total assets of over EUR 250 million would be categorised as a Category 1 investment firm.

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	As stated in recital 5 of Regulation (EU) No 2019/2033 "Investment firms do not have large portfolios of retail and corporate loans and do not take deposits. The likelihood that their failure can have a detrimental impact on overall financial stability is lower than in the case of credit institutions." We would therefore expect a proportionate methodology to be applied when conducting the Supervisory Review and Evaluation Process (SREP) for investment firms. The draft guidelines propose that competent authorities should update the assessment of all individual SREP elements at least once every 2 years for Category 1 investment firms. We believe that updating the assessment of all individual SREP elements at least once every 3 years rather than 2 years would achieve the aim of harmonising the SREP framework in a more proportionate manner.

Title 4 Business model analysis

Question	**FIA EPTA response**
Question 2. Do you agree with our proposal regarding business model analysis? Are there any other drivers of business model/strategy that you believe competent authorities should consider when conducting the investment firms' business model analysis?	*This answer has been coordinated with APT.* In this context, we would like to respond to paragraph 389 of 10.5 on the Basis for Use of Other Supervisory Measures. Art 39(2)(e) IFD creates two ways in which a CA can exercise its intervention powers; "to restrict or limit the business, operations or network of investment firms or to request the divestment of activities that pose excessive risks to the financial soundness of an investment firm" The key ground for the exercise of these powers is that there is an activity that is posing an excessive risk to the financial soundness of the firm. In Section 10.5 of the Draft Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under IFD, Application of Other Supervisory Measures, Para 389 sets out guidance for a competent authority exercising its powers under Art 39(2)(e). "In accordance with Article 39(2), point (e) of Directive (EU) 2019/2034, competent authorities may require the investment firm to make changes to the business model or strategy where: a. they are not supported by appropriate organisational, governance or risk control and management arrangements; b. they are not supported by capital and operational plans, including allocation of appropriate financial, human and technological (IT) resources; and/or c. there are significant concerns about the sustainability of the business model."

	We believe that the current draft of Para 389 of the Draft Guidelines requires clarification to align it with the grounds established in the Level 1 text. The Directive text refers explicitly to excessive risks to the financial soundness of the Firm, but the connection of Para 389(a) to (c) to that basis is not articulated and unclear. The Guidelines suggest that a CA can require changes where the business model or strategy are not supported by the elements (a) to (c). However, this is not the basis of the power in the Level 1 text, which requires the presence of excessive risk to the financial soundness of the firm for the exercise of the power. We note also that terms such as "operational plans" and "allocation" are undefined in this context, meaning that without clarifying that their assessment is connected to the evaluation of excessive risk to the financial soundness of a firm, the Guidelines might accidentally create alternative grounds for the 39(2)(e) power that are not contained in the Level 1 text. Alternative proposal: we would therefore propose that the guidance emphasize that the exercise of the power is on the basis of excessive risk to the financial soundness of the firm, and clarify that areas (a) to (c) listed in Para 389 are elements of a firm's operations that a CA may evaluate in its determination of whether the risk in a part of a firm is excessive, such as to warrant the exercise of the Art 39(2)(e) power. Additionally, in Para 84 under c, the assessment of the investments firm's risk appetite seems to be based upon the average risk appetite levels of a peer group. This setup comes with three concerns: (i) This relative measurement of this criteria is contrary to the measurements of the criteria in Para 84 under a and b where an investment firm is being assessed on its own merits and not on those of its competitors. Based upon game theory, it would be possible that the best performing investment firm could become under severe scrutiny because its competitors, based upon their aberrant risk appetite, underperform. Putting the better performing investment firm on the spot creates a business incentive. This would be an unintended consequence of the setup of the measurement. (ii) it jeopardizes the required EU supervisory convergence because CA's have the competence to consider per jurisdiction whether the investment firm's risk appetite is high or transcend the average. (iii) investment firms dealing on own account have an incomparable business model to other investment firms serving clients or customers. Based upon the trading and hedging strategies, the risk related to dealing on own account, is limited, only lies on the firm and not on any other market participant. In addition, the risk-to-market is small because if a dealer on own account might leave the market, competitors will instantly take this (released) position. Based upon the above and taking into account the essential link to the other criteria and the characteristics of the individual investment firm, we suggest rephrasing the criteria under Para 84 under c as follows: "risk

	appetite: competent authorities may consider whether the investment firm's business model or strategy relies on a risk appetite that is considered not appropriate related to the assessment of the return on equity and cash-flow structure of the investment firm." Terminology: we also note that in contrast with the directive text, which refers to "business, operations or network of a firm", the guidance refers to "business model or strategy". We would also propose that the guidance be amended to reflect the Directive text, replacing the terms "business model or strategy" with "business, operations or network".

Title 5 Assessing internal governance and investment firm-wide controls

Question	**FIA EPTA response**
Question 3. Do you agree with the proposed criteria for the assessment of internal governance and firm-wide controls?	*This answer has been coordinated with APT.* Each supervisory process should be proportionate to the nature, size, complexity and inherent risk of the relevant investment firm. Investment firms come in different shapes and sizes, but typical liquidity providers dealing on own account have a low-risk profile: businesses are non-complex, portfolios are fully hedged and risk windows are very short (matter of days if not seconds). Regulators should be in the position to apply proportionate reviews given the nature, size, complexity and risk profile of the firm. Most liquidity providers are relatively small, low-risk firms, regardless of balance sheet size. In practice, these firms have simple governance models as they are founder/employee-owned, which is fit for purpose given the nature of their firms. Therefore, we believe the governance and control rules, that appear to be inspired by those for large banking groups, deserve a proportionate application.
Question 4. What are the appropriate methods for the investment firms to analyse the potential impact of cyclical economic fluctuations on their activities and risks? Are	*This answer has been coordinated with APT.* Liquidity providers (*market makers*) have very short risk cycles and their positions are typically hedged. Because they appropriate the spread between bid and ask prices as a business model and *not* by investing for the longer term, the

they currently used by investment firms in their risk management processes?	direction of the market and economic cycles are largely irrelevant. Firms manage their risks well during turbulent markets in order to fulfil their market making obligations. Position risk (which should be almost flat, as these are typically fully hedged with related instruments) and liquidity risk is closely managed during such events in the ordinary course of business. Because the result of a trade is (almost) immediately cleared and settled, profits or losses are not subject to long term exposures. The result of a trade (P&L) is immediately known and will not change over time. Therefore, cyclical risk and economic fluctuations are largely irrelevant to the risk profile of the firm.

Title 6 Assessing risks to capital

Question	**FIA EPTA response**
Question 5. Do you agree with the proposed criteria for the assessment of risks-to-capital? Does the breakdown of risk categories and subcategories provide appropriate coverage and scope for the supervisory review, having in mind various business models of investment firms?	*This answer has been coordinated with APT.* We appreciate that the criteria for the assessment of the risks-to-capital and the breakdown of risk categories and subcategories are aligned with the capital requirements of Regulation (EU) 2019/2033. As a market making firms operating on own account, our members acknowledge that some pillars of the risk to capital (Risk-to-Client, and some categories of the Risk-to-Market) are less pertinent for the business model of market making firms and consequently that the future SREP framework will take into account this specificity. FIA EPTA is also 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 expressed 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 at all times 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 the a new SREP assessment has taken place.

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Here, the 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 relatively 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.

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.

	We do not support the approach that the risks listed in paragraph 257 are "operational risks not covered by Pillar 1". The purpose of P2R is to ensure supervised entities adequately capture the risks that are in Pillar 1, and to account for additional risks. As set out in Recital (26) to IFR, K-DTF covers all operational risks pertaining to trading. This is further stated in paragraph 225 of the RTS "Competent authorities should form a view on the degree of operational risk related to trading on own account". Because market makers have no other activities, K-DTF sufficiently covers operational risk. Also, paragraph 226 correctly includes risks pertaining to algorithmic trading in the section Daily Trading flow. The definition of DTF as introduced in level 1 is not limited to only some types of operational risks. Indeed DTF is referenced in recital 26 as covering operational risks to an investment firm with a trading activity with no explicit limitation of the type of operational risks. It is the industry understanding that DTF covers all operational risks arising in market makers and firms dealing on own account from their trading activity (which is the only activity that these firms have). If this were not the case, the legislation in level 1 would have made a specific reference to the type of operational risks covered by DTF or to the type of operational risks excluded by DTF for firms with trading activity. The wording of the level 1 text evidences the policy option taken by the co-legislators, which these RTS should be in line with. Paragraph 263 provides further evidence that this part of the RTS contradicts the level 1 text in this regard by including risks not covered by Pillar 1 risk relating to models, e.g. valuation, pricing models, models for algorithmic trading. The pricing model is a clear example of an internal system used for trading, a failure of which could result in a large volume of trades being concluded. If these model risks are not covered by DTF, it puts into question what DTF does cover. We note further that the current approach, besides being in contradiction with level 1, would also create uncertainty for firms and create an unlevel playing field where some NCAs may treat some operational risks as covered by Pillar 1 and some not covered by Pillar 1. Should our reading or our understanding not be correct, we would kindly ask if the EBA can provide details on how the calibration for DTF was done at level 1. In summary, the EBA methodology seems to presuppose that the risks in paragraph 257 are not covered by K-DTF. 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. As such, we recommend that paragraphs 256 to 264 inclusive should be moved from the existing section 'Operational risks not covered by Pillar 1', and instead inserted within the 'Daily Trading Flow' section (paragraphs 225 to 226). In addition, paragraph 256 should be removed as K-DTF covers all Operational risks as substantiated above.

	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.

Title 7 SREP capital assessment

Question	FIA EPTA response
Question 6. Do you agree with the proposed guidance for the setting and communication of additional own funds requirements?	We are concerned that the EBA seems to assume that own funds requirements can only ever increase for an investment firm. This 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 relatively 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. Further, we consider that the SREP Guidelines should include a clear framework for making interim adjustments/improvements of the own fund requirement in the case of early remediation or closure of the actions identified by the CA. We note that such a framework is currently missing from the currently proposed draft Guidelines. Such adjustments should be possible on a continuous basis through the common supervision dialogue. In the absence of such a possibility, firms will not be incentivized to remediate any defects as soon as possible and ahead of an SREP assessment.

	Therefore, we suggest that investments firms might request an updated SREP assessment when they implemented the remediation actions. We consider that doing so will benefit the overall effectiveness of prudential supervision.
Question 7. What are your views regarding the interactions between SREP and internal processes of investment firms (such as recovery planning or ICARAP)?	We agree with the EBA that recovery planning and ICARAP should continue to play a key role in the identification of risks and their assessment. However, we would expect the SREP to take into account adequate mitigation measures already identified by the firm and allow the possibility of self-review in the SREP process. If a CA were to question the reliability of the ICAAP calculations on any of the grounds mentioned in the Consultation, we feel the firm should be allowed the opportunity to amend its calculations prior to the determination of the SREP. As argued above in our response to Q6, the impact of any deficiency should be individually identifiable so that risk-based mitigation can take place, either before or after setting the SREP. Finally, the draft Guidelines do currently not provide clarity on the possibility and frequency of adjustments/bettering in case of an early remediation or closure of the actions identified by the CA. Such adjustments should be possible on an ad-hoc basis through the common supervisiory dialogue. In the absence of such a possibility, firms will not be incentivized to remediate any defects as soon as possible and ahead of an SREP assessment. Therefore, we suggest that investments firms may request an updated SREP assessment when they implemented the remediation actions. We consider this will benefit the overall effectiveness of prudential supervision.
Question 8. Do you agree with the proposed guidance for the setting and communication of P2G? Would you consider it appropriate to express P2G not only as an absolute amount of own funds but also as a percentage of Pillar 1 own funds requirements? Please provide rationale for your views	*FIA EPTA decided not to respond to this question.*

Title 8 Assessing risk to liquidity

Question	FIA EPTA response

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<tr><td>Question 9. Do you agree with the proposed criteria for the assessment of liquidity risk? Should investment firms that deal on own account, in particular market makers, be subject to more comprehensive liquidity risk assessment?</td><td>The points being considered for assessing liquidity risk mentioned in the RTS do not adequately take into account the liquidity risk mitigators coming from clearing via a GCM, which is the most common set-up for Market Makers. While liquidity risk is posed via potential losses and changing clearing requirements (margin calls) from the GCM, the risk of “CCP margin calls”, “matching different maturities of different traded instruments or from the types of contracts” or “managing daily settlements” is significantly diminished by clearing via a GCM. In it’s role as a GCM they are able to identify offsetting liquidity needs across CCPs, settlements and maturities in a relative risk-free nature and are able to utilize deep liquidity resources to shield the Investment Firms from such risk. We, therefore, propose to specifically highlight this liquidity risk mitigation within the RTS to ensure NCAs realize the mitigation. We recommend that the EBA includes such consideration in both the evaluation of risk and resources section of the RTS as follows:

339. For investment firms that deal on own account, competent authorities should assess if the investment firm has a sufficient level of high-quality liquid assets and other liquidity inflows to cover liquidity outflows on a daily basis, including intraday period. Competent authorities should assess investment firms that engage in market making activity more comprehensively, however should take into consideration any liquidity risk mitigation provided by the use of GCMs.

345. Competent authorities should assess the adequacy of the liquidity resources of investment firms that are market makers necessary to meet their liquidity needs over different time horizons, including intraday. This assessment should take into account all of the following criteria:
a. the liquid assets available in a timely manner for the investment firm’s viability under normal and severe but plausible conditions;
b. the overall liquid assets available to the investment firm over the full period of the relevant severe, but plausible conditions;
c. the characteristics of different severe, but plausible conditions, such as severity and duration, and periods considered in the evaluation of the investment firm’s liquidity needs;
d. the amount of assets that would need to be liquidated over the relevant time horizons;
e. whether the actual liquid resources, including the quality of liquid assets, are in line with the investment firm’s liquidity risk;
f. the availability and magnitude of liquidity resources provided by GCMs</td></tr>
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Title 9. Determination of the outcome of liquidity assessment

Question	FIA EPTA response
Question 10. Do you agree with the proposed guidance for the setting and communication of specific liquidity requirements?	In line with our response to Question 6, we would expect the CA to (1) provide the clear qualitative and quantitative criteria that will be taken into account in the setting of the liquidity requirement. We would expect further (2) precision on the frequency of the review of the liquidity requirements, as improving the liquidity risk management and reporting may not be reflected until the next supervisory assessment. Therefore, we suggest that investments firms may request an updated SREP assessment when they implemented the remediation actions.

Title 11 Application of SREP to investment firms groups

Question	FIA EPTA response
Question 11: Do you have any views or suggestions with regard to appropriate incorporation of ESG risks within SREP, including any proposed methods or criteria for the assessment of ESG risks within SREP?	FIA EPTA members welcome and support the assessment and future integration of material ESG risks into the SREP process. We also welcome the distinction made by the EBA between ESG risks between credit institutions and investment firms in the report on management and supervision of ESG risks for both types of firms. That said, the investment firm category – albeit making references to investment firms dealing on own account – in FIA EPTA's view does not take the full spectrum of firms in this category into account. ESG risk thus far seems to be assessed through the prism of the transmission chain based on the assumption of deliberate investment/portfolio construction decisions by investment firms. Whilst this may be appropriate for firms that operate client businesses and make directional investment decisions, we would emphasise that this is not the case for all types of investment firms, including those such as FIA EPTA's members which deal on own account as market makers/liquidity providers. In this respect, FIA EPTA would suggest following the SFDR regulation in which the different characteristics of investment firms is acknowledged. Incorporating investment firms that provide portfolio management or provide investment advice, in accordance with Article 24 (4) of Directive 2014/65/EU.

	The SREP Consultation fits in the legislative trend to add an ESG component to new regulation. FIA EPTA members would like to emphasise that we support this trend, incorporating ESG risks are extremely important to transition towards sustainable capital markets. We observe, however, that the ESG component in the SREP Consultation is not clearly defined, guidelines are not conclusive and the details are indistinct. This makes it almost impossible for investment firms, to comply with the new regulation. This leads to legal uncertainties and therefore any new criteria's or requirements should be clarified in detail. Therefore, the EBA should take this into account when incorporating additional ESG risk criteria or requirements in the SREP assessment. When integrating ESG risks into the various aspects of the SREP it would therefore be important to take appropriate account of the exact nature and business model of the investment firm that is being supervised, rather than using a one size fits all approach. FIA EPTA members are proprietary trading firms (PTFs) that deal on own account as market makers and liquidity providers who are aware of the need to take into account the potential impact on ESG factors in business operations. PTFs use their own capital to act as market makers and liquidity providers. They buy and sell financial instruments for their own risk and do not manage funds for third parties. They utilise rigorous risk management frameworks based on risk-based controls that will gradually evolve to take appropriate account of ESG risks that are deemed material to the firm. FIA EPTA members are already or soon will need to start reporting on ESG related topics in their annual reports, for example, on efforts on diversity and inclusion as well as contributions to zero-emission and net positive impact. FIA EPTA members, therefore, support a principle-based approach that would require ESG factors to be reflected in the overall risk framework but without setting prescriptive requirements.