FIA EPTA response to the EBA Consultation Paper on Draft Guidelines on the application of the group capital test for investment firm groups (EBA/CP/202/16)

25 October 2023

Introductory comments

FIA EPTA welcomes the objective of the EBA to ensure a harmonized interpretation and implementation of the Group Capital Test ("**GCT**") by setting objective criteria to assess whether the structure of an investment firm group is: a) sufficiently simple, and b) poses significant risks to clients or to market. We agree that it is indeed important to ensure a level playing field in the application of the regime across the EU and important to provide guidelines to NCAs for them to supervise investments firms in an efficient manner.

The European Principal Traders Association (FIA EPTA) represents Europe's leading Principal Trading Firms. Our members are independent market makers and providers of liquidity and risk transfer for markets and end-investors across Europe, providing liquidity in all centrally cleared asset classes including shares, bonds, listed derivatives, and ETFs. FIA EPTA works constructively with policymakers, regulators, and other market stakeholders to ensure efficient, resilient, and trusted financial markets in Europe. More information about FIA EPTA and independent market makers is available on: www.fia.org/epta and www.wearemarketmakers.com.

While we support the EBA's objectives with these draft guidelines, we feel that the Consultation Paper fails to recognize the critical importance of the GCT for the application of the governance and remunerations requirements on a consolidated level. Indeed, such requirements are made, for activities carried on in non-EU countries, more proportionate when the Group Capital Test is applied. This is evidenced by the cost benefit analysis that shows that the application of the GCT results on average in substantially higher capital requirements (on average 465% higher for firms applying for the GCT under Article 8(3) IFR), suggesting that the driver for such application is not a reduction of capital.

We also note from the EBA cost benefit analysis that very few firms applied for the GCT. Although there are indeed relatively few EU headquartered firms with significant operations in non-EU countries (due to the amount of capital and time needed to develop international activities), they still represent a material part of the liquidity provided to the EU capital market and contribute to the diversity of market participants, supporting the EU's objective of open strategic autonomy. The EBA should therefore be mindful to support the international growth of more EU headquartered investment firms and, at the very least, not to disincentivise the small number of existing EU headquartered firms that already have an international presence. These EU headquartered firms indeed contribute to the stature of the EU as an global financial centre, which should also remain as a realistic location for non-EU firms.

We would therefore be very concerned about the significant impact that more stringent requirements, or any potential reduction or removal of the availability of the Group Capital Test, would have on the competitiveness of EU headquartered firms compared to non-EU headquartered firms that are not, for example, subject to comparable remuneration and governance requirements. Furthermore, these international operations which are carried out in countries with well-established and mature prudential and risk management rules, are very important for EU headquartered firms for the following reasons:

- They reduce risk by providing diversification benefits
- They provide additional liquidity and financial resources by way of repatriation of profits to EU group holdings.
- They support innovation by allowing access to new technologies not yet developed in the EU.

Based on the above we would caution the EBA to not make the availability of the GCT more stringent as it would not make the system more resilient. By contrast, we would suggest the EBA to consider if the main concern of these guidelines is to set a minimum amount of capital, to disassociate the capital component from the governance and remuneration requirements (i.e., by allowing firms to apply Article 7 for capital but Article 8(3) or 8(4) for any other purposes). This has been presented as an option within paragraph 20 of section 3.2, whereby a competent authority may require the application of Article 7 of IFR only for the purposes of the calculation of capital requirements, without performing prudential consolidation of other aspects (i.e., Governance and Remuneration).

FIA EPTA would like to emphasize that **the primary benefit of obtaining the Group Capital Test in its current form relates to the proportionate application of remuneration and governance requirements on a consolidated basis** whereby the application of remuneration requirements for example would significantly impair the competitiveness of the firm to recruit and retain personnel on a global basis.

FIA EPTA also believes that the introduction of minimum ratios is not aligned with the intention of the Level 1 requirements, whereby any risk not sufficiently covered should be assessed as part of the ongoing SREP process, and reflected in the additional own funds requirements as set out in Article 40 IFD. We are therefore of the view that **the introduction of any such ratios should be managed via the SREP (Pillar 2) process, and should not be introduced as a criteria for granting the Group Capital Test.**

We further note, with concern, the EBA's implied suggestion that third-country prudential regimes, even those with mature, well established, and well-known prudential regimes such as the US and Australia, may not be subject to a satisfactory level of prudence. This is a material departure to long established international practices that aim at strengthening existing international supervisory cooperation and focus on existing supervisory public information sources on the jurisdiction's prudential standards, such as those published by the Basel Committee on Banking Supervision, including via its Regulatory Consistency Assessment Program. Departing from such practices again risk creating an uncompetitive environment for EU headquartered firms compared to jurisdictions that take a more proportionate approach.

Lastly, we would like to reiterate that prudential regulations have a key impact on the functioning of capital markets and policies should be proportionate and should achieve the right balance between mitigating prudential risk while promoting low barriers to entry to allow for better competition between investment firms and prevent an unlevel playing field between EU and non-EU headquartered investment firms.

These policies should also be assessed holistically with an assessment of the combined effects (as opposed to stand alone cost benefit analysis) of key provisions such as, for example, the availability of the GCT, the application of the governance and remunerations requirements to non-EU entities, and the classification of investment firms as a bank in certain cases. In this respect, we encourage the EBA to closely monitor any negative (combined) impact of these prudential rules on the EU market.

These considerations would be aligned with the EBA's mandate, under Recital 13 of the EBA Regulation, to take due account of the impact of its activities on competition and innovation within the international market, on the Union's competitiveness and on the Union strategy for growth, while at the same time ensuring the well-functioning and prudential safety of the financial system.

Q1. Do you consider the above criteria proportionate and relevant for groups composed exclusively of small and non-interconnected investment firms and ancillary services undertakings? If not, please provide a rationale.

FIA EPTA is not responding to this question.

Q2. Do you consider the above criteria to be relevant for the assessment of the simplicity of the group structure of an investment firm group? If not, please provide a rationale.

FIA EPTA's view is that the number of undertakings is not necessarily representative of the level of risk in a group, however we welcome the discretion of NCAs to take a proportionate approach in some circumstances.

On the transfer of activities and transfer of trading positions, we believe that only transfers in and out of the EU should be relevant. Indeed, transfers within the EU markets should not create additional complexities taking into account that investment firms are still operating within the Single Market in a common and well-known regulatory framework and supervised by Competent Authorities that have cooperation agreements, exchange of information and sometimes discussion forums. We acknowledge, however, that there might be more complexities when transfers are made in a limited number of non-EU jurisdictions, where such cooperation is not well developed.

We would also like to note that investment firms should only make available "contractual agreements" under Article 16(i) and (j) that are *material* and relevant for the assessment of simplicity. Investment firms have many contractual agreements in place (oftentimes numbering in the thousands), and it would be disproportionate and irrelevant to provide all types of contractual agreements.

Q3. Are there other criteria that should be considered for the assessment of the simplicity of the group structure of an investment firm group? If yes, please provide a rationale.

FIA EPTA is not responding to this question.

Q4. Do you consider the above criteria to be relevant for the assessment of the significance of the risk to clients or to market? If not, please provide a rationale.

As detailed in our introductory remarks, FIA EPTA does not agree with the introduction of capital floors when granting the approval of the Group Capital Test, whereby any relief afforded by the granting of the Group Capital Test should be assessed as part of the ongoing SREP process and any related add-on introduced based on any risk that is no longer captured as a result of the Group Capital Test. As mentioned above, investment firms do not apply for the GCT to obtain capital benefits but to ensure a proportionate application of the application of the remuneration and governance requirements to non-EU entities. We note from the EBA cost benefit analysis that this ratio is on average 465%, however this ratio was calculated based on a very limited subset of three firms, so may not be representative of the industry as a whole.

In respect of enforcement proceedings, we believe that it should be contained to *material* enforcement action by EU member states as it would not be proportionate to deny the Group Capital Test for minor enforcement actions.

Q5. Should groups constituted of undertakings holding only Common equity tier 1 and additional tier 1 capital be allowed a reduction of the ratio referred to in paragraph 17(a) to 85%? If yes, please provide a rationale.

FIA EPTA has no strong views on this matter. Reducing the ratio should be irrelevant for most firms as the average ratio of firms applying for 8(3) is 465%. However, should the quality of own funds be a relevant consideration, it would seem sensible to reduce the ratio as well as extend this reduction to the 95% and 100% ratio referred to in Article 17(e) IFR (as the same rationale should apply).

Q6. Are there other criteria that should be considered for the assessment of the significance of the risk to clients or to market? If yes, please provide a rationale.

FIA EPTA is not responding to this question.

Q7. Do you consider the above criteria to be relevant for granting the derogation pursuant to Art. 8(4) IFR? If not, please provide a rationale.

FIA EPTA would stress that this ratio is not substantiated although the cost benefit analysis (p.34) implies that this 25% uplift is to cater for the updated book value that some investments may have to do under national laws. For this reason, we believe that this ratio should be 100% for firms that do not have to update their book value.

With regards to the thresholds set out in Article 24 IFR, FIA EPTA, does not agree that this is an appropriate metric to use as a result of the prescribed methodologies within this consultation paper and the RTS on the scope and methods of the prudential consolidation of an investment firm group.

Due to the differences in the calculation methodologies, there are scenarios in which the sum of IFR on an individual basis will be lower than under the full consolidation (Article 7). This is not a signal of an increase in risk to the market or to clients. The below provides an example of such a scenario where the calculation would yield an incorrect result for an investment firm, and highlights the limitations with introducing such a minimum ratio.

Example:

The below sets out an example of where the application of Article 7 could result in a higher capital requirement than that calculated under Article 8(4) due to the methodological differences within the calculations.

- *In accordance with the RTS on prudential consolidation, Article 7(5), K-NPR is applied on a consolidated basis. However, as set out in the general provisions for the calculation of own fund requirements for Market Risk (CRR article 325b(2)); positions across entities can only be netted if there is a guarantee of mutual support within the Group.*
  - *In the case of a 'simple' structure, as required for the application of Article. 8 IFR, it is unlikely that such guarantees are in place.*
  - *As a result of the above, the K-NPR under Art.7 is the sum of individual K-NPR, applying a base currency of EUR.*
- *In accordance with the methodology for the calculation of own fund requirements under Art.8(4), as set out in paragraph 22 of the consultation paper. Whereby the K-NPR on a consolidated basis is the sum of the individual K-NPR, applying local currency (e.g., USD).*

This difference in base currency can lead to the total K-NPR under Article 8(4) being lower than that calculated under Article 7.

A simple example is an Investment Firm Group with a US subsidiary. The subsidiary is funded in USD, and has a reporting (base) currency of USD. In EUR terms the total value (equity value) of the firm is EUR 100M. For simplicity, one can assume the entity has zero trading positions and only maintains 100M in USD cash deposits, and as such the only K-NPR requirement relates to 'open' FX exposure.

- *In the case of the application of Article 8(4), the [K-NPR = zero], as there is no FX exposure vs. the base currency (USD).*
- *By contrast, under Article 7 the [K-NPR =EUR 4M]. Whereby the 4% requirement for closely correlated currency exposure applies (USD vs. EUR).*

As a result the requirement under Article 7 is structurally higher then under Article8(4).

Q8. Are there other criteria that should be considered for the purposes of granting the derogation pursuant to Art. 8(4) IFR? If yes, please provide a rationale.

FIA EPTA would urge the EBA to publish, for the benefit of NCAs, a non-exhaustive list of factors to consider when determining whether a non-EU prudential regime has a satisfactory level of prudence or at the very least, publish a list of countries that would, based on existing knowledge, work done by the Basel Committee and cooperation agreement, meet the level of prudence. For reference see the comments made in Question 9.

Q9. Do you agree with the provided elaborations on the definitions of "notional own funds" and "satisfactory level of prudence"? If not, please provide a rationale.

FIA EPTA fully understands the concern of the EBA to reduce the burden of NCAs that should otherwise perform an assessment on the prudential regulation of a third country (Recital 29) and its duty to ensure third country subsidiaries do not present a material risk to the EU market. FIA EPTA is of the opinion that the EBA should be equally concerned by the effect that this simplification would have on EU headquartered firms in terms of undue burden, barriers to international growth, international competitiveness and on EU capital markets as a whole.

FIA EPTA is of the opinion that solely assessing a quantitative indicator calibrated for the EU market does not adequately reflect of a "satisfactory level of prudence" of foreign prudential regimes. Moreover, the EBA cites the "change risk of foreign prudential regimes" and "easing of NCA administrative burdens" as underlying the blanket restriction on the use of any other prudential framework other than IFR. However, trading groups operate in a limited number of third-country jurisdictions, most of them being well known and change being slow-moving.

Treating any non-EU prudential regime as failing to achieve a satisfactory level of prudence would be a material departure to long established international practices that aim at strengthening existing international supervisory cooperation and focus on existing public information sources on the jurisdiction's prudential standards, such as those published by the Basel Committee on Banking Supervision. This might set a precedent for jurisdictions to apply local rules to non-local entities resulting in increased regulatory complexity through overlays of multiple capital computation frameworks.

We believe that the EBA would be able to mitigate the risk in a proportionate way by publishing a non-exhaustive list of factors to consider, for use of the NCAs, when determining whether a non-EU prudential regime has a satisfactory level of prudence, such as:

- The type of country;
- The existence of a defined clear and transparent regulatory framework;
- Other qualitative factors that underpin the robustness of any prudential regime;
- Effective coordination and agreement with the non-EU country;
- Existing country's knowledge by the NCA;
- Existence of public information sources on the country's prudential standards (such as those published by the Basel Committee on Banking Supervision, including via its Regulatory Consistency Assessment Program, or those published by the BIS "jurisdictional assessments");
- Information from the ICARA and on-going supervision.

We believe that these factors would enable NCA's to assess, without undue burden, whether the third country has a prudential regime that achieves, focusing on the outcome, a satisfactory level of prudence.

Q10. The purpose of the GCT is to provide for a proportionate approach aiming to prevent capital gearing but also to prevent excessive leverage for simple investment firm groups which do not pose significant risks. In light of this consideration, it may be prudent to prevent the use of the derogation provided in article 8(4) for an investment firm group where the amount of the goodwill included in the value of the participations of the parent undertaking in its subsidiaries is material (e.g., in case where such goodwill, if considered in own funds, would lead to breach the minimum requirements determined under 8(4) IFR). Do you agree with this potential additional criterion? If no, please provide a rationale.

FIA EPTA is not responding to this question.

Additional comments by FIA EPTA:

Granting, amending, and withdrawing the authorization (Article 29)

We note that the CP does not have any questions on this section. However, we would like to make the following comments:

FIA EPTA believes that whether firms obtained two separate exemptions, or one single derogation should not impact on the outcome of any withdrawal. Therefore, the withdrawal of the Article 8(4) derogation under Article 34, when applied as a single derogation with Article 8(1), should not result in an automatic application of Article 7 but rather in the application of Article 8(1). Rather, the withdrawal itself should specify the new approach to be used by the firm.

Cost benefit analysis

As mentioned throughout our response, the EBA's impact assessment only addresses the impact on NCAs on costs in updating their assessment process and procedures. The assessment does not address at all the impact for investment firms either in respect of computing four times a set of capital requirements nor the impact of losing the Group Capital Test for the governance and remuneration requirements. To develop this last point, firms that apply for the Group Capital Test are allowed to apply more proportionate remuneration and governance requirements. In cases where the GCT is lost, those firms will have to set up for each non-EU entity, remuneration and risk committees with non-executive members. They will also have to identify their non-EU material risk takers and apply among other deferrals on remuneration and payment in shares. This would entail substantial changes in corporate structure, employment agreements, valuation work (for the payment in shares), and search for suitable non-executive directors. This is a very lengthy and costly process but most importantly creates a significant competitive disadvantage compared to firms that are not headquartered in the EU.