Centrum für Europäische Politik

EU Regulation

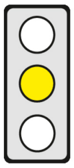
PRUDENTIAL REQUIREMENTS FOR INVESTMENT FIRMS - REGULATION

cep**PolicyBrief** No. 2018-23

KEY ISSUES

Objective of the Regulation: The supervision of investment firms will become more adapted to their respective business models and risks.

Affected parties: Investment firms and their customers, banks



Pro: (1) Dividing investment firms into three classes may counteract the consolidation of the sector brought about by regulation.

(2) The fact that the Commission wants to make class 1 investment firms subject to the same regulation as the banks is justified in the interests of financial stability.

Contra: (1) Graded regulation risks causing distortions of competition.

(2) It is doubtful whether the capital requirements applicable to investment firms constitute the envisaged relief.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2017) 790 of 20 December 2017 for a **Regulation** of the European Parliament and of the Council **on the prudential requirements of investment firms** and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010

Brief Summary

► **Context and objectives**

- Investment firms – e.g. asset managers – provide services – e.g. investment advice, portfolio management – which enable investors to access the capital markets. In this regard, they often provide services typically provided by banks but, unlike banks, they do not take deposits or grant loans. (Explanatory Memorandum, p. 1 and 2)
- About half of EU investment firms are based in the United Kingdom. Eight investment firms, “largely” concentrated in the UK, control around 80% of the assets of all EU investment firms. (Explanatory Memorandum, p. 1)
- Investment firms and banks are currently subject to similar legislative provisions, in particular the Capital Requirements Directive [2013/36/EU, see cep**PolicyBrief**] and the Capital Requirements Regulation [(EU) No. 575/2013, see cep**PolicyBrief**]. According to the Commission, however, the provisions do not take sufficient account of the business models and risks of investment firms. (Explanatory Memorandum, p. 2-4)
- The Commission therefore wants a regulatory framework more calibrated towards investment firms which focuses on their business models and risks and will prevent “harmful regulatory arbitrage” arising from companies relocating their business operations to the EU in the wake of Brexit (Explanatory Memorandum p. 4).
- This regulatory package includes a
  - Regulation with prudential requirements for investment firms (this cep**PolicyBrief**) and
  - Directive with provisions relating to the supervision of investment firms [COM(2017) 591, cep**PolicyBrief** to follow].

► **Division of investment firms into three classes**

- In future, investment firms will be divided into three classes:
  - Class 1 covers all systemically relevant investment firms.
  - Class 2 covers non-systemically relevant investment firms that do not fall into class 3.
  - Class 3 covers (non-systemically relevant) “small and non-interconnected investment firms”.
- Class 1 investment firms are all those which (Art. 60 (2) (a))
  - manage assets of over € 30 billion in value and
  - deal on their own account or issue financial instruments - e.g. shares, loans, money market instruments - on a firm commitment basis, i.e. include financial instruments on their books that have no purchasers.

  This does not include investment firms specialising in commodity derivatives or emissions allowances.

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- Class 2 investment firms are, in particular, all those which – combined for all the companies of a group – (Art. 12 (1) and (2), sub-para. 1)
  - manage assets of over € 1.2 billion in value,
  - process client orders worth over € 100 million/day for cash trades or over € 1 billion/day for derivative contracts,
  - have a balance sheet total of over € 100 million or
  - achieve an annual operating result of over € 30 million.

  Class 2 investment firms are also inter alia those which hold client funds (Art. 12 (1) (d)).
- Class 3 investment firms are all investment firms which fall below all the aforesaid thresholds for class 2 investment firms (Art. 12 (2), sub-para. 2).
- The Commission may adopt delegated acts to adjust the "conditions" for qualifying as a class 2 or class 3 investment firm (Art. 12 (5)).

► **Rules for class 1 investment firms**

In future, class 1 investment firms will qualify as "credit institutions" as is already the case for conventional banks (Art. 60 (2) (a)). They therefore have to fulfil all the rules applicable to credit institutions - in particular the requirements regarding capital, liquidity and concentration risk pursuant to the Capital Requirements Regulation [(EU) No. 575/2013]. In particular (Explanatory Memorandum, p. 3 and 4):

- they must be licensed as a credit institution;
- they are subject to supervision by the ECB where they are established in a eurozone country or in a non-eurozone country participating in the Single Supervisory Mechanism (SSM). Otherwise they are subject to supervision by national banking authorities.

► **Rules for class 2 and class 3 investment firms**

In future, class 2 and class 3 investment firms will be subject to rules on the composition and level of regulatory capital, on concentration risks, on liquidity and on reporting and disclosure that differ from those applicable to credit institutions (Art. 5). Special rules apply inter alia to investment firms that are part of a banking group head-quartered in the same Member State and subject to consolidated supervision (Recital 11, Art. 6 (1)).

Capital requirements

- In future, class 2 and class 3 investment firms will have to fulfil capital requirements that will be on average 16% lower than currently (Explanatory Memorandum, p. 9).
- In the case of class 2 investment firms capital cannot be lower than (Art. 11 (1))
  - one quarter of the fixed overheads for the previous year ("fixed overheads requirement") (Art. 13 (1)),
  - the "initial capital" required for authorisation - depending on the precise activity of the investment firm - of € 75,000, € 150,000 or € 750,000 ("permanent minimum requirement") (Art. 14), or
  - the value arising from a "K-factor calculation" which takes account of the risks to customers, market and firm (Art. 15).
- For class 3 investment firms, the same requirements apply with the exception of the "K-factor calculation" (Art. 11 (2)).
- In the case of a "material" change in the activities of an investment firm, national supervisory authorities may require that the firm be subject to another of the three capital requirements listed (Art. 11 (3)).
- The requirements relating to the composition of capital are identical to those for credit institutions - and thus also to class 1 investment firms (Art. 9).

Requirements regarding concentration risk

- Class 2 and class 3 investment firms, that deal on their own account – for themselves or on behalf of a client – may not incur an exposure to an individual client, or group of connected clients, which exceeds 25% of their capital or € 150 million, whichever is the higher. Where € 150 million is more than 25% of an investment firm's capital, it may not incur exposure exceeding 100% of its capital. (Art. 36 (1))
- The said upper limits may be exceeded temporarily with the authorisation of the competent national authority provided the investment firm reports the excess "without delay" to the national supervisory authority; the company must then provide security for the concentration risk by way of additional capital. (Art. 36 (1) and (2) in conjunction with Art. 37)

Liquidity requirements

- Class 2 and class 3 investment firms must hold liquid assets of at least one twelfth of the annual fixed overheads. This may be "unencumbered cash" or other highly liquid assets such as government bonds. [Art. 42 (1) in conjunction with Art. 10–13 of the Delegated Regulation (EU) 2015/61]
- Investment firms may fall below the minimum liquidity requirement "in exceptional circumstances" but have to notify the competent authority and restore compliance with liquidity requirements within 30 days (Art. 43).
- With regard to class 3 investment firms, trade receivables as well as fees and commission that can be recovered within 30 days are deemed in certain circumstances to be liquid assets (Art. 42 (2)).

Disclosure and reporting requirements

– Class 2 investment firms must publish information about their risk management, own funds, capital, return on assets, governance and remuneration policy (Art. 45 (1)), on an annual basis.
– Class 3 investment firms which issue "additional Tier 1 instruments" - such as preferential shares - must also publish information about their risk management, their regulatory capital and their return on assets (Art. 45 (2)).
– Class 2 investment firms must submit an annual report to the competent authorities containing inter alia information on their own funds, capital, concentration risks and liquidity. In the case of class 3 investment firms, information about concentration risk and liquidity is not required. (Art. 52)

► **Provisions for investment firms from non-EU countries**

– An investment firm from a third country is only permitted to operate in the EU where (Art. 46, Art. 47 MiFIR)
  - the Commission has adopted an equivalence decision on the prudential and business conduct requirements in the relevant country and
  - the European Securities and Markets Authority (ESMA) authorises it to do so.
– Where, according to the Commission, the services provided by an investment firm in a third country are "systemically relevant", a "detailed assessment" is required for recognition. This will in particular take account of (Art. 61 (2))
  - the "regulatory convergence" between the third country and the EU,
  - whether the third country is willing to cooperate on tax issues.

► **Transitional provisions**

For five years from the date of application of the Regulation, transitional provisions will apply in particular to the capital requirements (Art. 57).

Statement on Subsidiarity by the Commission

According to the Commission, investment firms "routinely" provide their services across EU borders. Separate rules in the Member States could give rise to discriminatory treatment and thus to competitive distortions thereby leading to a fragmentation of the internal market.

Policy Context

In the 2017 Mid-Term Review of the Capital Markets Union Action Plan, [COM(2017) 292], the Commission announced the creation of a more effective supervisory framework for investment firms. The proposals are the outcome of a review of the provisions of the Capital Requirements Regulation (CRR) applicable to investment firms (Art. 493 (2), Art. 498 (2) and Art. 508 (2) and (3)).

Legislative Procedure

20 December 2017	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament:	Economic Affairs (leading), Rapporteur: Markus Ferber (EVP, D)
Federal Ministries:	Federal Ministry of Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Art. 114 TFEU (Internal Market);
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The division of investment firms into three classes – proposed both for this Regulation and the parallel Directive –, graded according to their systemic relevance, aims to ensure that their regulatory framework is appropriate and proportionate. It has advantages and disadvantages. The grading **may on the one hand counteract a consolidation of the sector brought about by regulation** which threatens smaller investment firms due to the relatively high level of fixed-costs to which regulation gives rise. Such a consolidation would be detrimental to financial stability because investment firms that are "too big to fail" have an incentive to take excessive risks. The division of investment firms into classes can also be justified by the fact that, for reasons of financial stability, non-systemically relevant investment firms require less strict safeguards against insolvency than is the case for systemically relevant investment firms. **On the other hand, graded regulation** always **harbours the risk of distorting competition** and regulatory arbitrage**.** Thus thresholds for the classification of companies cause false incentives because, in case of doubt, business models are not geared to the characteristics of the relevant market but according to the depth and/or cost of regulation.
The fact that the Commission wants to grade major **class 1 investment firms** as "systemically relevant" and **as equal to banks for the purposes of regulation is** appropriate. Strict regulation is particularly **justified in the interests of financial stability.** In addition, distortions of competition will be avoided by ensuring that regulatory treatment is equal to that of banks conducting similar business.
By treating investment firms that are deemed to be systemically relevant in the same way as credit institutions for the purposes of regulation, the Commission rightly wants to prevent Member States from vying with each other to attract the major British investment firms which could give rise to a lowering of supervisory standards. Since, in future, investment firms will be subject, at least in the Member States that are part of the Banking Union, to uniform supervision by the ECB, such a competition will be held effectively in check.
It is doubtful whether the proposed **capital requirements for investment firms** really **will constitute the envisaged relief** in every case. Thus there may be cases in which e.g. class 2 investment firms have to hold more capital than they would if they were treated as class 1 investment firms. In the case of some companies that do not fear the stricter rules on remuneration or the supervision of credit institutions, this could produce the paradoxical incentive to strive for classification as a class 1 company simply for regulatory reasons.
After Brexit takes place, "systemically relevant" British investment firms will only be permitted to offer their services in the EU where the prudential and business conduct rules are equivalent; this will protect consumers and the stability of financial markets in the EU. It is, however, misguided to link authorisation to a willingness to "cooperate for tax purposes": If British prudential and business conduct rules are equivalent to those of the EU, investment firms should also be permitted to offer their services in the EU from a lower-taxation country like the United Kingdom.

Legal Assessment

Legislative Competency

The Regulation is rightly based on Art. 114 TFEU (Internal Market) because differing national financial market rules may obstruct the internal market.

Subsidiarity.

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other respects

Unproblematic.

Impact on German Law

As a result of the Regulation, amendments to the German Banking Act (KWG) and the Investment Trading Act (WpHG), in particular, are necessary.

Conclusion

Dividing investment firms into three classes may, on the one hand, counteract the consolidation of the sector brought about by regulation. On the other hand, graded regulation risks causing distortions of competition. The fact that the Commission wants to make class 1 investment firms subject to the same regulation as the banks is justified for reasons of financial stability. It is doubtful whether the capital requirements applicable to investment firms constitute the envisaged relief.

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