Friday, 6 October 2017

EBA proposals for higher capital requirements, and changes to pay regulation and other prudential rules, for MiFID firms

On 29 September 2017, the European Banking Authority made recommendations to the European Commission for a new European law addressing the prudential regulation of MiFID investment firms. The next step is likely to be the European Commission making a formal legislative proposal to the European Council and Parliament. The current indications are that the European Commission is likely to follow the EBA's recommendations fairly closely.

Whilst the timetable is not clear (including the interaction of this process with the passage of the proposed CRD V and CRR II legislation which is currently being negotiated), the process might be expected to result in new legislation taking effect at some point around 2020. Certain transitional reliefs may cushion the impact on capital requirements for a period of between two and five years – these are more generous for smaller firms.

SUMMARY

- The proposals will affect all MiFID investment firms
- The proposed new regime will not apply to other firms such as AIFMs or UCITS managers (but may influence future developments for such firms)
- The regime is likely to apply from around 2020 onwards
- Exempt-CAD firms are likely to see significant increases in regulatory capital requirements (subject to transitional arrangements)
- Group requirements will apply to exempt-CAD firms for the first time
- Transitional arrangements will apply to cap the increase in capital requirements during the first 3 years
- Firms could potentially become subject to more onerous remuneration rules
- New liquidity requirements will apply

Although by that date it is possible that the UK will no longer be a member of the European Union (although it may be subject to negotiated transitional arrangements), it is likely that the new law would impact UK firms in one way or another, not least because many of the policy proposals have been inspired by UK policymakers.

The EBA's high level opinion can be found here and its more detailed proposals here.

COMMENTARY ON THE EBA PROPOSALS

Travers Smith has been heavily engaged with a number of trade associations in attempting to influence the EBA's recommendations. Although there have been some successes, we believe that the framework as a whole is likely to be unwelcome to firms because:

- it is likely to increase the total amount of capital in the system;
- it will increase the capital requirements for a small number of firms dramatically (potentially, in some cases, in the order of hundreds of times), although some transitional arrangements will apply;
- there will remain significant complexity in the rule book – for example the definitions of what counts as "capital" will be unchanged;
- some firms will become subject to more onerous pay regulation; and
- there are relatively few proposed instances of de-regulation.

Firms should engage with their trade associations soon with a view to seeking to influence the legislative process. Although many firms will be concentrating on MiFID II planning in the near future, industry associations will welcome engagement before long. Next year, firms should factor these proposed changes into their business planning, for example in relation to Brexit, and start to consider the impact of the capital and liquidity requirements on their financing arrangements.

WHAT ARE PRUDENTIAL RULES?

By "prudential regulation", we mean rules requiring firms to hold and report on capital and liquid assets on their balance sheets, to monitor and report on their exposures to third parties, to operate certain internal governance processes and to regulate the way in which they pay their staff.

WHICH FIRMS WILL BE AFFECTED?

The report covers all MiFID investment firms (such as investment banks, brokers, corporate finance firms, asset managers and wholesale and retail investment advisors). Many, but not all, of these firms are currently subject to prudential rules set out in the EU Capital Requirements Regulation (**CRR**) and Capital Requirements Directive (**CRD**). Under the new proposals, the vast majority of these firms would be carved out of CRD/CRR (which is designed principally for banks) and made subject to a new, somewhat more tailored, regime.

The relevance of the EBA's recommendations to AIFMs with "top-up" MiFID permissions under Article 6 AIFMD is currently unclear (and may depend upon differing EEA Member State interpretations). Subject to that, the proposals would not directly affect other AIFMs or UCITS management companies, although they are likely to be a source of inspiration for future prudential rules directed at those types of firms.

WHAT ABOUT GROUPS OF UNDERTAKINGS?

The proposals would apply on a consolidated basis — i.e. to groups of firms headed by an EEA parent undertaking. It appears likely that there could be closer scrutiny of corporate cross-border structures in future from a prudential perspective, at least to prevent arbitrage by dividing business between several smaller operations.

Where investment firms are part of banking groups, broadly the existing CRD/CRR rules will apply on a consolidated basis and the new regime will apply on a solo basis.

NEW CATEGORISATION OF FIRMS

The EBA has proposed a new system of classifying investment firms, so that not all firms will be treated in an identical way under the new prudential regime.

The very largest firms (known as "**Class 1 firms**") (which potentially could number as few as eight firms) would continue to be subject to CRD/CRR (including, in due course, CRD V and CRR II). The precise criteria for being a Class 1 firm are to be left to delegated legislation, although the EBA suggests that in principle, these should be either systemic firms or firms that are exposed to the same types of risks as deposit-taking banks.

The smallest firms ("**Class 3 firms**") would be subject to somewhat lighter touch rules. For example, they would not be subject to pay regulation beyond that included in MiFID II, the K-factor derived capital requirements (see *Key areas of change* below) would not apply to them, and they could include some short-term receivables in their liquid asset calculations. They would eventually become subject to the fixed overheads requirement, but they would be allowed a period of five years to build up sufficient capital, during which the capital requirement would increase at a fixed rate.

The majority of firms ("**Class 2 firms**") will be subject to all of the key changes set out under the "*Key areas of change*" heading below. A firm would fall into Class 2 if:

- its level of AUM or assets under advice is higher than **EUR 1.2 billion**; or
- it handles client orders valued higher than **EUR 100 million** per day for cash trades and/or higher than **EUR 1 billion** per day for derivatives; or
- it has a balance sheet total higher than **EUR 100 million**; or
- it has gross revenues higher than **EUR 30 million**; or

  (The tests above must be applied on a combined basis for all investment firms which belong to the same group. The EBA's opinion is unclear on whether this refers to a regulatory consolidation group or a general corporate group)
- it holds any client assets in custody; or
- it holds any client money; or
- it operates a trading book.

KEY AREAS OF CHANGE

The headline changes are as follows:

- ***Pay regulation:*** Many firms will be subject to new pay regulation. The proposals indicate that Class 3 firms should be subject only to the remuneration rules under MiFID II. However, the EBA recommends that the remuneration rules applicable to Class 2 firms ought broadly to follow the format of the CRD pay regulation designed for banks, including mandatory deferral of a significant proportion of variable remuneration, payment in instruments as opposed to cash (albeit not necessarily the shares of their employer) and risk adjustment (malus and clawback). In addition, the EBA thinks that the European Commission should "consider carefully" the pros and cons of imposing the bonus cap on these firms. There is some indication in the proposals that the EBA's main concerns in this context relate to firms dealing on own account and/or holding client money or client assets. However, the specific recommendations do not expressly limit the proposed application of CRD-like remuneration rules only to Class 2 firms undertaking such activities. This may be clarified in due course. The EBA refers to the possibility that some smaller firms, or some staff receiving only low levels of pay, may be eligible for "waivers". Class 2 firms will continue to be subject to some disclosure requirements in relation to remuneration.

- ***Minimum fixed overheads requirement:*** All firms, including those currently exempt from CRD/CRR, will eventually have a minimum capital requirement which is at least equal to 25% of their annual fixed overheads (such as salaries and rent) — i.e. essentially, three months' worth of normal operating expenses. For some firms this will be a very significant increase. For example, certain firms whose current permissions are limited to advising on and arranging transactions are currently subject to a fixed capital requirement of EUR 50,000, and if those firms have significant operations, the new fixed overheads requirement could be hundreds of times higher than the current requirement. However, the EBA has also recommended that transitional arrangements should apply (see below), which would cap the increase in capital requirements during the first three years of the new regime.

- ***Activities-based capital requirement:*** For Class 2 firms (which may include some firms whose capital requirements are currently driven by the fixed overheads requirement), the fixed overheads requirement will in future operate as a floor. There will also be capital requirements calculated by reference to the firm's particular activities (known as "**K-factors**"). For example, for asset managers and investment advisors, there will be capital requirements of 0.02% of assets under management or assets under advice. For any firm holding client money, capital equal to 0.45% of client money balances must be maintained. These capital requirements are cumulative, so that where a firm undertakes multiple activities which contribute to different K-factors, the overall capital requirement will increase.

- ***Transitional arrangements for capital requirements:*** The EBA has recommended that the capital requirement for exempt-CAD firms should be capped at twice the amount of their existing fixed capital requirement for a three-year period. Other firms would also have their capital requirements capped at twice the level of their current capital requirements under the existing regime during that three-year period. After two years, the EBA has suggested that it should provide a report to the European Commission on the calibration of the new capital regime, which could recommend further changes.

- ***Removal of professional indemnity insurance (PII) option:*** The EBA has recommended that the option for certain firms (such as exempt-CAD firms in the UK) to use PII to meet part of their initial capital requirement should be removed.

- ***Group capital requirements:*** For groups that contain only one or more Class 2 and/or Class 3 firms, but do not contain Class 1 firms or a deposit-taking bank, the EBA is proposing to apply a new group capital test (but not full consolidation). This will mean that some groups containing exempt-CAD firms will become subject to group capital requirements for the first time, which may result in a major impact for such firms and their parent entities. The EBA is also recommending that national regulators should have the power to impose full consolidated capital requirements on such groups on a case-by-case basis.

- ***Pillar 2 (ICAAP) requirement:*** In addition, the EBA has indicated that there should still be an internal capital adequacy process, similar to the current ICAAP, although possibly simplified or applied in a more proportionate manner. This will mean that capital requirements under the new regime may still be adjusted by national regulators. The EBA is also calling for greater standardisation of the Pillar 2 process as applied by regulators.

- ***Pillar 3 disclosures:*** The EBA is recommending that "Pillar 3" public disclosures should be abolished for Class 3 firms and significantly simplified for Class 2 firms, so that the latter need only publicly report on their capital levels and capital requirements.

- ***Liquid assets requirement:*** All firms will be required to maintain the equivalent of at least one month's fixed overheads in liquid assets – i.e. broadly, cash or near cash. For Class 2 firms, short-term receivables are unlikely to count for these purposes, although the EBA has indicated that they may be used by Class 3 firms to satisfy up to one third of the liquid assets requirement, subject to a 50% haircut being applied to the value of the relevant receivables.

- ***Concentration risk (large exposures):*** Class 2 firms will be required to report on their concentration risk to regulators, although the EBA has indicated that Class 3 firms could be exempted from this requirement. In practice, this will mean that asset managers are likely to have to report concentration risk on (i.e. large exposures to) affiliates and their own funds (for example, in relation to accrued management fees). Although certain Class 2 firms may be subject to hard concentration limits, this will only be the case if they deal on own account or trade in their own name when executing client orders. For asset managers that operate on an agency basis, this is likely to mean that they will escape the application of such limits.

- ***Simplified prudential reporting:*** Class 2 and Class 3 firms will be subject to a new, simplified prudential reporting regime which is designed to focus on capital and risk metrics that are more relevant to those firms. This may be a welcome development for those firms that are currently subject to complex COREP reporting requirements under the existing CRR regime.

- ***Consequential effects:*** There will be consequential effects on other EU laws. For example, the eligibility of firms to be a "sponsor" of securitisations, such as CLOs, for the purposes of proposed new EU risk retention legislation may turn on their status as a CRD/CRR firm. In due course, when the proposed new prudential legislation is published, firms will need to consider these potential impacts carefully.

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