



### Frequently asked questions: Revised Framework for Investment Firms

Brussels, 20 December 2017

#### 1. Investment firms

##### What are investment firms?

Investment firms play an important role in facilitating savings and investment flows across the EU, forming a vital cog in a well-functioning Capital Markets Union. Alongside credit institutions (banks), they provide a range of services which give investors access to securities and derivatives markets. Such services include investment advice, portfolio management, executing orders for clients, trading in financial instruments and helping companies raise funds on capital markets.

Unlike credit institutions, investment firms do not accept deposits, nor do they provide loans on a significant scale. This means that they are a lot less exposed to the risk of depositors withdrawing their money at short notice and of borrowers failing to pay them back. They do however compete with credit institutions in providing investment services, which credit institutions can offer to their customers under their banking licence.

According to the European Banking Authority (EBA), there are roughly 6,000 investment firms in the European Economic Area (EEA). Most of these are relatively small. However, a small number of investment firms hold a significant proportion of all assets.

Most investment firms only provide a limited range of investment services (e.g. investment advice). Conversely, larger firms tend to provide a broader range of services. Around a quarter of all EU investment firms trade in financial instruments, either for the firm itself or for its clients, and help companies raise funds on capital markets. These are the services currently subject to the most stringent prudential requirements.

##### How are investment firms currently regulated?

Credit institutions and investment firms have very different primary business models, but they overlap in the services they can provide. Up to now, all investment firms have been subject to the same EU prudential rules as credit institutions: The [Capital Requirements Regulation and Directive \(CRR/CRDIV\)](#) lays down the amount of capital, liquidity and other risk management requirements which credit institutions and investment firms have to comply with.

Typically, prudential requirements on financial institutions are designed to (i) ensure that they have sufficient resources to remain financially viable and to carry on providing their services through economic cycles; or (ii) enable an orderly wind-down without causing undue economic harm to their customers or to the stability of the markets they operate in. As a result, they should aim to guard against the risks that different financial institutions face and pose and broadly strike a balance between ensuring the safety and soundness of different financial institutions, while avoiding excessive costs which could hinder them from carrying out their business in a viable way.

The prudential framework for investment firms in the CRR/CRD IV works in conjunction with MiFID. The [Markets in Financial Instruments Directive \(MiFID\)](#) (MiFID II/MiFIR as of January 2018) sets out the conditions for the authorisation of investment firms. It also determines how they should behave on financial markets when providing their services (e.g. in terms of conduct of business). Credit institutions are also subject to some MiFID provisions when providing investment services.

##### What is the Commission proposing to change and why?

The current prudential rules in the CRR/CRDIV were developed for banks. They are based on international standards developed by the Basel Committee on Banking Supervision (BCBS) for large banks. Over time, the rules have become more complex, and do not fully take into account the different business profiles and risks of investment firms. Investment firms are subject to a number of specific exemptions from these rules which Member States do not always apply consistently. It has therefore become more costly for investment firms to comply with these rules.

This proposal aims to ensure that investment firms are subject to key prudential requirements and corresponding supervisory arrangements that are adapted to their risk profile and business model, without compromising financial stability.

In particular, today's proposal aims to differentiate the prudential regime according to the size, nature and complexity of investment firms:

- **The largest firms would remain under the prudential regime of CRR/CRDIV.** This also means that these firms would be **supervised as significant credit institutions.** This would be achieved by treating these investment firms as credit institutions. This is in line with developments in other jurisdictions across the world.
- **Smaller firms would enjoy a new bespoke regime with dedicated prudential requirements.** These would, in most cases, be different from those applicable to banks. In areas such as own account trading where risks of credit institutions and investment firms are similar, the proposal introduces a simplified version of some of the current prudential requirements into the new regime.

### What are the benefits?

Today's proposal:

- Ensures that only the largest and most systemic investment firms are under CRR/CRDIV, which were designed to capture the risks of banks;
- Establishes investment firms' prudential requirements based on the specific risks they pose for customers and markets;
- Better addresses risks in investment firms' business models;
- Preserves a level playing field between banks and investment firms;
- Makes prudential requirements more risk-sensitive;
- Simplifies the way capital requirements are set, both for firms and supervisors;
- Ensures that legislation is simple, proportionate and up-to-date.

### Why are you making these changes now?

Articles 493(2), 498(2), 508(2), 508(3) of the CRR require this review. The EBA has worked on calibrating a new regime for several years ([EBA opinion on the design of a new prudential framework for investment firms](#)). The outcome of the 2016 [Call for Evidence on EU Financial Services](#) also confirmed the need to design a more proportionate prudential regime for investment firms.

## 2. Categorisation of investment firms

### What new categorisation does this proposal envisage?

Investment firms will be divided into three classes, each of those capturing different risk profiles. This will ensure that prudential requirements are tailored to the size, nature and complexity of the firm.

**Class 1** would include investment firms, with total assets above €30bn and which provide underwriting services (underwriting is a commitment to take up on own books financial instruments when others do not buy them) and dealing on own account (an investment firm deals on own account when it trades in financial instruments against its own proprietary capital). Those services are particularly relevant from a prudential as well as market efficiency and integrity perspective:

- **Prudential:** underwriting and dealing on own account involves credit risk (mainly the risk that the counterparty will not live up to its contractual obligations); and market risk for the positions the firm has taken. Firms providing these services on a significant scale may be important for financial stability.
- **Market efficiency and integrity:** underwriting and dealing on own account are also important for financial markets to function well. Any sudden disruption of service would impact market efficiency, market integrity and investor protection.

**Class 2** firms would be those above any of the following size thresholds:

- assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements higher than €1.2billion (bn);
- client orders handled of at least €100million (m)/day for cash trades and/or at least € 1bn/day for derivatives;
- balance sheet total higher than €100m;
- total gross revenues higher than €30m;
- exposure to risks from trading financial instruments higher than zero;
- client assets safeguarded and administered higher than zero; and

- client money held higher than zero.

**Class 3** firms would be those below all of the above thresholds. They would be subject to the least complex requirements.

### **3. Regime for systemic investment firms (Class 1)**

#### **What is special about systemic investment firms?**

These firms – which the CRDIV identifies as systemic institutions – provide "bank-like" services and underwrite risks on a significant scale across the Single Market. These are the largest and most interconnected investment firms, with risk profiles similar to those of significant credit institutions.

It is appropriate that they remain under the CRR/CRDIV and are treated in all respects as credit institutions.

#### **How do you propose to align their treatment to that of significant credit institutions?**

In spite of being already subject to prudential requirements under CRR/CRDIV, such systemic firms are currently not treated as credit institutions.

The proposal requires that "bank-like" systemic investment firms are subject to the same treatment as large credit institutions. This would ensure a level playing field between credit institutions and large investment firms with similar risk profiles.

Specifically, the proposal amends the definition of a **credit institution** in the CRR by including firms:

- whose business includes dealing on own account in financial instruments, or underwriting or placing financial instruments on a firm commitment basis;
- where the total value of the assets of the undertaking exceeds €30 billion.

Firms meeting these conditions would have to be authorised as credit institutions. They would thereby be subject to CRR/CRDIV requirements and overseen by banking supervisors.

#### **Which institutions would mainly be affected?**

This will depend on further regulatory and market developments. Most systemic investment firms are currently located in the United Kingdom (UK), but many are in the process of relocating parts of their operations to the EU-27. Among other things, such developments would have an impact on which institutions would mainly be affected.

#### **What would be the benefits for regulation and supervision?**

The proposal would level the playing field in terms of authorisation, regulation and supervision of large investment firms and large credit institutions. The proposal is also in line with the [EBA's opinion](#) on issues related to the decision of the United Kingdom to withdraw from the EU. The opinion confirms that systemic investment firms should remain under the CRR/CRDIV.

### **4. Regime for non-systemic firms (class 2 and 3)**

#### **Why do we need prudential requirements for smaller firms?**

Smaller investment firms pose more limited risks than larger firms. Nevertheless they should also be subject to suitable prudential standards. This would ensure that they manage their risks in a sound manner and serve the best interests of their clients. If they fail, prudential standards would ensure that they can be wound down in an orderly manner, limiting the negative impact on their clients and on financial markets.

#### **What capital requirements would apply to Class 2 and Class 3 firms?**

- **Small and non-interconnected firms (Class 3):** their minimum capital would be either the level of initial capital required for their authorisation or a quarter of their fixed costs (overheads) for the previous year, whichever is higher.
- **Other firms (Class 2):** their minimum capital would be set either as for class 3 investment firms, or according to the new K-factor approach for measuring their risks, whichever is higher. The K-factors specifically target the services and business practices that are most likely to generate risks to the firm, to its customers and to counterparties. They set capital requirements according to the volume of each activity.

#### **What are you proposing on corporate governance and remuneration for investment firms?**

Class 1 firms will continue to apply the CRR/CRD IV because they are systemic investment firms.

Class 2 firms would continue to apply some provisions based on the CRR/CRDIV, including specific governance arrangements and rules on remuneration which are made to be better suited to the business models of investment firms. As previously proposed for smaller credit institutions (see also the [Banking Reform Package of November 2016](#)), the rules will allow further proportionality: these

firms will be free to choose between the types of instruments used to pay out part of the variable remuneration. The requirements which are considered as the most burdensome for these smaller investment firms (deferral and pay-out instruments) do not apply to firms below €100 million of total assets and for staff with low levels of variable pay. Competent authorities can still decide that investment firms below the threshold are not subject to the derogation.

For Class 3 firms, the rules on governance and remuneration should focus on investor and consumer protection, as such firms do not pose significant risk to the financial stability. MiFID, which applies to all investment firms, ensures that remuneration structures of sales staff do not incentivise staff to recommend products which do not reflect clients' needs. MiFID also offers guarantees concerning robust governance arrangements, such as suitability requirements for board members. Therefore, remuneration and governance rules provided under MiFID are considered to be sufficient for Class 3 firms.

## **5. Economic impact**

### **What impact would the proposal have?**

The proposal will provide certainty, facilitate the business activities of investment firms, boost competition, and support the objectives of the Capital Markets Union.

The proposal should lower compliance costs for investment firms. This is because prudential rules would be simpler and better linked to the business models of firms. According to the EBA's preparatory work for its advice on the review, aggregate capital requirements for all EU investment firms are not expected to change significantly. The new capital requirements are expected to be 16% lower than today's total level of harmonised requirements and capital add-ons imposed by supervisors. This more than offsets the 10% increase in the harmonised requirements applicable to all EU firms. Capital requirements may increase more for some investment firms whose risks would be captured for the first time.

The simplified application of the existing CRR/CRDIV rules takes into account the lower systemic importance of investment firms. The proposal gives investment firms a transitional period of five years before they must apply the new requirements in full. In the meantime, the Commission - together with the EBA - would carry out a review of the calculations underpinning the new requirements. This is to ensure they are set appropriately.

## **6. NON-EU COUNTRIES**

### **Do non-EU countries have similar requirements?**

Most non-EU countries have prudential requirements which apply differently to different types of investment firms (portfolio managers, investment advisers, broker-dealers etc.) At the same time, parts of the proposed rules are based on international principles agreed by the Basel Committee on Banking Supervision. These include the capital requirements for market risks of firms that trade financial instruments.

A number of non EU-countries treat systemic investment firms as banks.

### **5. What about third country equivalence for investment services?**

MiFiDII/MIFIR provides a framework under which the Commission may take a decision to recognise a third country's prudential and market conduct framework as equivalent to EU rules for certain types of activities directed at professional clients. As long as such a decision has not been taken, national rules apply for third country firms. This means that every Member State is free to determine itself the conditions according to which firms based in third countries may access their market.

As the proposals change the EU prudential rules for investment firms, the equivalence test must also be adjusted to include these new rules. In addition, also following the Commission staff working document on equivalence of February 2017, it is proposed to set out in greater detail some of the requirements for equivalence. The proposal also clarifies that with regard to third countries for which firms likely to use the equivalence decisions may be of systemic importance to the EU, any equivalence assessment will have to be very detailed and granular and also assess supervisory convergence with the EU. The Commission is never obliged to consider a third country's rules and standards as equivalent.

## **7. PROCESS**

### **What role has the EBA played in the review?**

As part of the review the Commission consulted the EBA and the European Securities and Markets Authority (ESMA).

- The Commission launched a first call for advice in December 2014.

- EBA and ESMA published a [report](#) in December 2015. The report evaluated the current regime. It recommended that only systemic firms remain in the CRR/CRDIV and that a revised prudential framework be designed for all non-systemic investment firms.
- The Commission launched a second call for advice on the content of a revised prudential regime in June 2016.
- EBA published for consultation a [discussion paper](#) on a revised prudential regime in November 2016.
- EBA published its [final advice](#) for a new prudential regime for non-systemic investment firms in September 2017.

### **Why is there no impact assessment?**

According to the [Better Regulation toolbox](#) (tool #9), no Commission impact assessment is necessary whenever an EU agency has been mandated to carry out policy-design work and related analysis. This is only to the extent that the Commission proposal does not substantially deviate from the agency's recommendations. In addition, the Commission should consider the agency's assessment to be of sufficient quality, including in terms of stakeholder consultation ([EBA's work on the design of a new prudential framework for investment firms](#)).

The Staff Working Document accompanying the proposal explains the European Supervisory Authorities' (ESA) advice. It explains results of the ESAs' analysis and consultation, and gives the Commission services' views on those results.

### **What are the next steps?**

The proposal will now be discussed by the European Parliament and the Council. Once adopted, an implementation period of 18 months is envisaged before the new regime starts to apply.

### **For More Information**

[Prudential rules on investment firms](#)

[MEMO](#)

[Factsheet](#)

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