Bundesverband der Wertpapierfirmen e.V.
Friedrichstraße 52, 60323 Frankfurt/Main

European Banking Authority (EBA)

Floor 46
1 Canada Square
London E14 5AA
United Kingdom

your reference

your message of

city_date
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EBA Discussion Paper - Designing a new prudential regime for investment firms

(EBA/DP/2016/02)

Dear Sir, dear Madam,

The Bundesverband der Wertpapierfirmen e.V. (bwf)[1] is a trade association representing securities trading firms and brokers at the exchanges and other securities markets throughout Germany[2]. The bwf therefore expressly welcomes the opportunity to participate in the European Banking Authority's public consultation on designing a new prudential regime for investment firms.

In the light of the highly heterogeneous investment firm universe across member states, it might be deemed helpful to start with a brief description of our membership structure: bwf members are usually small and medium sized enterprises. However, despite of their size they are – with very few exemptions – usually completely "wholesale" firms. While they might play a significant role for the functioning of retail markets, in particular in their role as on exchange market-makers, authorized by the particular exchange, their direct market counterparts and clients are German and international banks, UCITS companies, insurance companies and other investment firms alike. While some of the members are still focused solely on their function as on exchange market-makers, others offer the full range of trading, order routing and order execution services on German and European trading venues across a wide range of instruments. Some member firms are also active in the IPO, corporate finance- and portfolio-management-business.

[1] The Bundesverband der Wertpapierfirmen e.V. is registered in the list of interest representatives with the European Commission under Registration No. 1880407752-10. The association does not have the status of a recognised European partner organisation nor is it a representative of a European (sectoral) social dialogue committee.

[2] With two of our members being active in the wholesale energy-market as well.

Bundesverband der Wertpapierfirmen e.V.

Federal Association of Securities Trading Firms – a registered association

Registered Seat
Fasanenstraße 3
D-10623 Berlin

Postal Address & Office
Friedrichstraße 52
D-60323 Frankfurt/Main

Tel.: +49 (0) 69 92 10 16 91
Fax: +49 (0) 69 92 10 16 92
mail@bwf-verband.de
www.bwf-verband.de

Secretary General
Michael H. Sterzenbach
m.sterzenbach@bwf-verband.de

Legal Adviser
Dr. Hans Mewes
Am Sandtorkai 44, D-20457 Hamburg
Tel.: +49 (0) 40 36 80 5 - 132
Fax: +49 (0) 40 36 80 5 - 333
h.mewes@bwf-verband.de

Banking-Account
Deutsche Bank PGK Frankfurt
IBAN DE08500700240018321000
BIC DEUTDEDBFRA

According to the EU legal framework, most bwf members are categorized as CRR-investment firms, while only a small minority of them have the status of CRR-credit institutions. Equally important, the vast majority of our members are – regardless of their limited size – classified as "trading book" institutes since the early days of "Basel I". Therefore, they are subject to a highly complex set of prudential requirements, originally designed and equally important, calibrated with a regulatory focus on large, internationally active banks.

With the German classification and terminology for financial institutions being slightly different from the EU-systematic, it might be also worthwhile to be noticed that most bwf members, while (CRR) investment firms according to EU-classification, are assigned the status of credit institutions under German law in their capacity as "securities trading banks" ("Wertpapierhandelsbanken"). However, this national specific terminology should not distract from the fact that these firms are clearly categorized as investment firms and not as credit institutions according to European law.

Introductory Remarks

Within the context of the EU Commission's endeavor to create a Capital Markets Union and after more than a decade experience of the application of prudential rules designed – and calibrated – for (large and internationally active) banks, the bwf expressly welcomes the project of evaluating the feasibility of a distinct new prudential regime which is intended to address the specific characteristics, business models and resulting risk structures of investment firms in a more appropriate and proportionate way.

However, with the new regime proposed in EBA's discussion paper – at the current stage – being rather a broad technological concept than an elaborated, comprehensive set of verifiable applicable rules, any assessment regarding possible advantages and disadvantages compared to the current regime under CRR must be necessarily preliminary and limited.[3]

In particular, in the absence of any tangible and sufficiently precise definition for the technical measurement of the assessment base and weighting factors for anticipated risk factors, a quantitative comparison regarding current and possible future capital requirements under a new regime is simply not possible. Therefore, despite our principle sympathy expressed above, we do not want to conceal that bwf member firms have also expressed their concern that a well-intended but possibly imperfectly designed new regime in the end might be worse than the existing one with all its flaws and deficiencies.

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[3] Aside from the impossibility to anticipate any capital requirements under a new regime in a quantitative way, the associated administrative burden as well as any technical switching to change to a new regime remain completely unclear at present.

Therefore, it is paramount that at least one – and if need be, more than one – comprehensive quantitative impact studies are conducted as an empirical basis for calibration of the proposed new regime. Furthermore it should acknowledged that for "systemic and bank-like" ("class 1") investment firms, which are representing the highest level of risk, the full CRD/CRR requirements should remain in place under the new regime. It can be inherently concluded from this EBA recommendation that capital requirements for "class 2" and "class 3" investment firms must not exceed the comparable amount of capital calculated according to CRD/CRR rules. In other words, in calibrating any new regime, under all circumstances CRD/CRR capital requirements define a "ceiling" which must not be exceeded.[4]

Based on this considerations, we also suggest that the new regime should include an "opt in" possibility for non-systemic and bank-like investment firms to continue their capital requirements, either temporarily or permanently CRD/CRR requirements on a voluntary basis.

This said, we would like to answer the particular questions raised by EBA as follows:

General principles governing the categorisation of investment firms

Question 1. What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of 'systemic and bank-like' investment firms? What are your views on both qualitative and quantitative indicators or thresholds for 'bank-like' activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects in the identification of 'systemic and bank-like' investment firms could be improved?

We fully support EBA's recommendation that "systemic and bank-like investment firms" should form a specific class within the new regime for which the full CRD/CRR requirements should be continued to be applied. However, while we think – as stated in our introductory remarks – that a voluntary application of CRD/CRR rules for non-"class 1" firms should be possible, we are also of the opinion that the definition of "class 1" investment firms neither needs to nor should be extended beyond the limits set by the Commission Delegated Regulation (EU) No 1222/2014 of 8 October 2014 for the identification of globally systemically important institutions and EBA's (revised) technical standards on G-SIIs and the EBA guidelines on O-SIIs. Even more, since paragraph 12 of the EBA guidelines on OIIs

[4] In this context we would like to express our deep astonishment regarding EBA's view expressed at the Commission's stakeholder meeting on 27 January 2017 that the current CRD/CRR requirements are not considered to be "fit for purpose" to address the specific risks of investment firms. Such a view, which we definitely have to reject, would not only be evidently inconsistent with EBA's own recommendation that the most risky "class 1" systematically important and bank-like investment firms should stay under the CRD/CRR regime but also raise inevitably the question of the appropriateness of current and future capital requirements for banks which do and will continue to offer the whole range of investment services to their clients on a balance sheet which is largely funded by deposits..

gives relevant competent authorities sufficient flexibility in determining factors for the identification of systemically important investment firms. Accordingly, we also agree with EBA's conclusion that consequently only a very small sub-set of investment firms in the EU would remain subject to full CRD/CRR requirements.

However, we clearly disagree with EBA's view that underwriting/placing of financial instruments on a firm commitment basis with a significant exposure to market and/or counterparty credit risk and proprietary trading at a large scale should be considered to constitute "bank-type activities". The mentioned activities are investment services, no matter by whom and at which scale they are carried out.

The observation that universal banks are important – and sometimes systemically important – players in the securities markets should not deviate from the widely accepted and legally specified definition that the characteristic activity of banks/credit institutions lies in the acceptance of deposits on the one hand and the granting of credit on the other[5]. Accordingly, the typical "banking risk" results typically from a maturity mismatch between repayable on demand/short-term liabilities resulting from deposits and (comparably illiquid) assets in form of granted credits with a longer maturity. These risks are addressed by an active asset/liability-management which is the indispensable core control mechanisms for banks.

Nevertheless, to the extent that universal banks are also active in the securities markets e.g. by proprietary trading, underwriting or other investment services, they are exposed to risks typical for investment firms. Furthermore, regulatory concern for banks engaging in financial market activities might be even higher compared to investment firms since the latter do not fund their balance sheet by unconditionally repayable deposits.

Question 2. What are your views on the principles for the proposed prudential regime for investment firms?

The general intention of creating a less complex prudential regime which is guided by the principle of proportionality which acknowledges in particular that non systemic and bank-like investment firms do not require the same level of assurance as G-SIIs and O-SIIs is certainly the right approach. However, a sense of scepticism with respect to a possible misinterpretation what might constitute "bank-like" activities remains.

Furthermore, the conclusion that the potential negative impact which the failure of investment firms might have on customers and markets is not to be criticised as such. However, in its generality the same principles provide the rationale for banking regulation and therefore – without further elaboration and clarification –

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[5] Cf: DIRECTIVE 2006/48/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), article 4 (1) (a)

can only provide limited guidance for the judgement of the appropriateness of a specific prudential regime for investment firms.

From our view, in particular the aspect of continuity of service should raise less regulatory concern than in a banking environment where even rumours on an impending closing of business could result in a “bank-run” which also might generate dangerous “knock-on” effects and might even have a severe negative impact on the overall economy. Accordingly, where investment firms are not systemically important and their services provided could be easily and swiftly substituted by other firms, we think that regulators should focus in the first place on the ability to wind down an investment firm in an orderly fashion if needed.

We also fully agree that the specific risk associated with holding client money and/or securities should be given special attention. However, it needs to be analysed very carefully, which type of clients a firm is dealing with and to which extent their assets might factually be exposed to risk born by access to these assets by an investment firm. However, to our understanding, the number of investment firms who *actually* have access to assets belonging to their clients is comparably low. And many firms authorized to accept funds and securities from their clients do not make use of this authorisation and therefore do not pose their client’s assets at risk.

Furthermore, where investment firms hold or otherwise have access to securities belonging to their client any regulatory risk assessment lying the basis for capital requirement calculations must duly take into account any provision and arrangements resulting thereof which might prescribe the legally effective segregation of these securities from the investment firm’s own assets. In particular it needs to be evaluated if such provision and arrangements will effectively protect securities belonging to clients and ensure that they remain available to them in the case of insolvency of the investment firm. If so, we think that there is no need to set up any capital charge since the client’s assets are sufficiently protected.

Last but not least, the calibration of regulatory capital requirements should take into account whether money or security belonging to clients could be subject to compensation claims against the relevant investor compensation scheme to which the investment firms belongs in accordance with the investor compensation scheme directive[6]. In this context we regret that the rules governing investor compensation were not further developed as it was suggested by the EU Commission[7].

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[6] Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes

[7] Cf: Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes, Brussels 12.07.2010, COM(2010) 371 final, 2010/0199 (COD)

EBA also concludes as a guiding principle "that firms that pose more risk to customers or markets hold more capital than those that pose less risk". While this seems to be convincing at first glance, care should be taken in the categorisation of risks (and technical risk-factors which represent them). It is important to keep in mind, that even though, capital requirements under the proposed new regime might be calculated by a different, hopefully less complex and more adequate methodology than under CRD/CRR rules, this should not extend the scope of prudential regulation as such. In particular, prudential capital should not be misinterpreted as an internal "Indemnity fund"[8] nor should investment firms be required to hold additional capital for any form for cluster/industry risk[9] which would exceed the concept of requiring capital adequacy on a consolidated group-basis.

Finally, we are highly sceptical whether the last principle proposed which would require "firms with more risky balance sheet or off-balance sheet exposure" should be required to hold additional capital aside from the capital requirements calculated on the basis of the risk to customers and to markets they represent. Here our objections are twofold: To the extent that the proposed principle implicitly assumes a possible "contagion-" or "spill-over-effect" which might increase the probability of a failure of an investment firm's failure, we think that this would – from a methodologic perspective – exceed the CRD/CRR requirements. Secondly, we are concerned that a general assessment of the riskiness of a firm's balance sheet would necessarily reintroduce the complexity of the CRD/CRR regime which the new framework expressly wants to avoid.

Here, it must be stated clearly that in particular for investment firms, balance sheet volume per se is not a reliable indicator for the riskiness of a firm's business model. Multiple business activities/strategies might have a "ballooning"-effect on a firm's balance sheet without a corresponding increase in risk taken. Positions on both sides of the balance sheet resulting from matched-principle-trading, actively hedged positions from securities issuances or more generally various sorts of fully collateralized securities financing transactions are only a few examples of typical activities undertaken by investment firms which have the prescribed effect. Based on this considerations, we think that EBA should refrain from introducing any balance-sheet oriented "surcharges".

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[8] Cf: "Unreliable investment advice" mentioned in paragraph 27 and paragraph 36 focusing generally on situations where investment services are not carried out correctly. Both cases lie outside the scope of prudential capital requirement provisions.

[9] Cf: Therefore, in particular the „too many to fail"-argument presented in paragraph 164 (b) in EBA's discussion paper needs to be rejected because it would – aside from the unanswered question, how such a risk should be quantified in a meaningful way – upload an undue burden to investment firms which has no equivalent within the "Basel"-framework.

Question 3. What are your views on the identification and prudential treatment of very small and non- interconnected investment firms ('Class 3')? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

While there are legally sound and widely accepted criteria to define "class 1" investment firms as already discussed above, EBA would have to develop its own set of indicators and qualitative thresholds in order to define a group of "very small, non-interconnected, investment firms. As we understand, the intention to do so is to minimise the administrative burden for such firms by applying a further simplified set of capital requirements to them which are mainly based on fixed overhead requirements (FOR) and initial capital.

While we have certain sympathy for the approach as such, it should be clear that wherever EBA would "draw a line" to further devide the very heterogenous univers of investment firms, it would inevitably create some hardship resulting from "cliff-effects". The problem seems even more difficult to solve since there are no easily observable and generally agreed creteria to undertake such a classification. In particular, we think that the discussed differentiation based on the general, "real economy" focused EU SME definition would not provide a suitable and appropriate way forward. This results not only from the fact that balance sheet volumes of investment firms can be very volatile but also from sometimes very small profit margins which cannot be observed in other industries and which might – even for otherwise small firms – result in comparably high turnover figures.

Therefore, at the end of the day, it would require a "political" decision to define such a group. Not only would such a classification need to be based on industry specific thresholds, EBA might even have to consider to apply different thresholds with respect to general business figures such as balance sheet, turnover or profit on different types of investment firms (e.g. asset managers vs. brokerage and trading firms).

Based on this appraisal, we think that defining a distinct group of "class 3" firms would only be the second best solution. It would be clearly preferable if the proposed new regime would be indeed so simple and proportionate (e.g. an excel calculation based on easily available business figures) that it would be applicable without undue administrative burden and without resulting in disproportionate capital requirements even for very small firms.

Such a general approach with "build in" proportionality would also avoid any discussion whether trading venues (MTFs/OTFs), passporting firms under MiFID or firms making use of tied agents would require any specific consideration.

Question 4 What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

If EBA should decide to opt for a three class regime, despite of our reservations expressed above, we are of the opinion that under regulatory cautiousness considerations, only firms holding client money or securities[10] should preclude a "class 3" categorisation.

Prudential regime for investment firms

Question 5. Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

The rationale that regulatory intervention, e.g. in the form of capital requirement, can be justified in the light of risk to a firms customers or clients (micro-level "RtC") or by the risk a firm might pose to the market as a whole (systemic/macro-level "RtM") is common ground and widely accepted in principal.

As already mentioned above, we are less convinced of the idea to supplement "RtC" and "RtM" by an additional risk to firm ("RtF") component. From our understanding, "RtF" can cause "RtC" and/or "RtM" to materialize in particular in the case of the failure of a financial institution (bank or investment firm alike). Therefore, under the CRD/CRR framework, a firm's risk weighted assets are taken as an indicator for the risk posed to others.

Whereby the circumstance that a firm holds risky assets on its balance sheet alone is not restricted to the financial industry and would not give raise to any regulatory concern, as long as these risks could not have a severe negative impact on clients (in particular depositors in the case of banks), market participants and others. Therefore, we think it would be a misunderstanding to assume that CRD/CRR requirements do not take the risks associated with investment services (as well as the risk of depositors) appropriately into account. One could rather argue, that CRD/CRR constitute an indirect risk management approach, while the new regime proposed by EBA shall address the risk posed to customers and markets in a more direct way. Aside from the complexity the CRD/CRR framework has grown into over the years and numerous amendments and workover, neither of the two approaches seems to be superior per se. – However, the intention to steer "RtC" and "RtM" directly with a preferably simplistic and non-complex set of rules definitely poses a challenge which might not be underestimated.

[10] Excepting those cases where an investment firm can convincingly demonstrate that all assets belonging to client are fully and effectively shielded or ring-fenced in the case of insolvency of the firm.

Question 6.What are your views on the initial K-factors identified? For example, should there be separate factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

Measuring risk by using factor based models which break up an overall risk in multiple components which can be assessed by various risk factors is common ground in risk management for many years. The approach is well accepted and practical as long as one is aware of it limitations.

A prerequisite for the application of a factor based approach is that the technical parameters measuring the different risk components will deliver results with a comparable degree of reliability and that the quantification of the different factors can be aggregated in a meaningful way. Where factor based models calculate the overall risk by simple addition of various factor based components. – in other words the overall risk equals the sum of the partial risks it is statistically assumed that the risk factors are fully positively correlated and therefore all partial risks would materialise at once. From EBA's perspective, a (simple) factor based approach might be appealing because it is comparably easy to calculate[11] and the estimation of the overall risk is highly "conservative" at the same time.

Therefore, a factor based approach looks like a rational and principally feasible way forward. Aside from very general and rather abstract statements, it remains very difficult to make any practical judgement on the quality and appropriateness of the proposed model which unfortunately has not reached the level of technical concretion yet, which would allow for any kind of comparable calculation against the background of the current regime. Or as it was aptly pointed out in a metaphorical way in the course of the EU Commission stakeholder meeting on 27 January 2017, commenting on EBA's discussion paper resembles the task of comparing "a devil you know" to "a potential new devil which you do not know". However, a few more general and rather qualitative remarks seem to be expedient:

First of all, it is eye-catching that a multible of factors are proposed to calculate the assumed risk to customers "RtC" (AUM, AUA, ASA, CMH, LTC and COH[12]) while a single factor, namely PTA[13] is suggested as a proxy for "RtM". Furthermore, it needs to be noted that some of the metrics are based on "stocks"[14] while other metrics would be based on "flows"[15] and the metrics for ASA potentially could be

[11] Unfortunately this does not automatically means that the results are accurate and meaningful.

[12] Assets under management, assets under advice, assets safeguarded and administered, client money held, liabilities to customers and finally customer orders handled.

[13] Proprietary trading activity.

[14] AUM, AUA, CMH, LTC.

[15] COH, PTA.

even a mixture of both[16]. Therefore, more information is needed regarding the demarcation of the different factors and how they should be weighted in a way which would allow a consistent and meaningful aggregation.

Moreover, we are concerned that that the definition of "RtC" would exceed what can be subsumed and a generally accepted concept of "prudential capital requirements". Even though, we are discussing a new regime based on a different methodology compared to CRD/CRR it is still essential to assure that both regimes are based on a common understanding regarding the scope and purpose of prudential capital requirements. To the extent that EBA's explanation gives reason to belief that prudential regulation, aside from continuity and stability and concerns, should also cover risks associated with any kind of "misperformance" such as unreliable investment advice, poorly managed investments or poor execution, we have to emphatically reject such a conception. As mentioned before, prudential capital buffers are not to be regarded as an internal indemnity or investor compensation fund, otherwise, small and medium sized investment firms would be subject to additional regulatory capital requirements which would not apply to systemically important "class1" firms and credit institutions under CRD/CRR.

Within the set of "RtC" risk factors we think that the definition and scope of the "customer orders handled" category requires some further clarifications as it remains unclear to us which kind of risk should be addressed. While we first thought that "COH" should cover some form of operational risk, the formulation "there is a risk that the customer can lose out" is so vage that EBA's intention must remain unclear and therefore requires clarification.

Moreover, a clear and practicable distinction between "customer" or "client"[17] and "(market) counterparts" is needed, even more as EBA focusses on firms handling customer orders as part of a "chain". In particular, it needs to be clarified that any such "chain" ends with an order entering a trading venue, irrespectively which market model the trading venue employs. Consequently neither the investors whose order is matched with the "customer order handled" by a fully electronic matching engine or is executed by a market maker becomes part of the described "chain".

Therefore, we also consider the formulation "this K-factor may also apply for orders conducted via multilateral and organised trading facilities (MTFs/OTFs)" to be highly mistakable. In particular while an investment firm can be operating an MTF or OTF[18], it is not "handling customer orders" but providing market infrastructure. Requiring investment firms to hold prudential capital when operating an MTF or OTF would also raise severe level-playing-field concerns. Aside from the fact that such venues compete directly with regulated markets but regulated

[16] Unfortunately the proposed metrics are not further exemplified but simply repeat the name of the proposed K-factor.

[17] We assume that EBA uses the terms "customer" and "client" in an interchangeable way.

[18] And this activity is considered to be an investment service under MiFID II.

markets themselves are allowed under MiFID/MiFID II to operate MTFs and OTFs without being authorized as investment firms and therefore would not have to comply with capital requirements stipulated by the proposed regime.

While we agree that "customer" in principle could include banks and other institutions, a clear distinction is between "customer" and "counterpart" is needed. E.g. when the bank (or any other customer) is requesting a quote for a transaction in a specific security and of a specific size, the investment firm becomes a (potential) counterpart and is not receiving or handling a client order. However, since there is a huge diversity of transaction patterns to be anticipated we suggest that the "COH" category should be restricted to constellations where an investment firm is acting as an agent. Since any transactions where the investment firm acts as principal would be captured as "proprietary trading activity" we do not see any reason of regulatory arbitrage.

However, the "proprietary trading activity" measurement and more general the definition of "RtM" k-factor(s) itself also requires further discussion. The difficulty which we have in understanding the concept at this point results from the simple question how can non-systematically important firms pose a risk to the markets at all? EBA gives only a rather superficial explanation when it talks about "an impact on others, including via disruption to market access or liquidity etc."

While we are willing to concede that their might be a definition of "disruption" below the level of a systemic crisis which by definition would endanger the orderly function and stability of the market as a whole, it is still difficult to concede how such a situation could be triggered by the investment firms in question. Even more so, since it can be reasonably assumed that the overwhelming majority of firms are "non-clearing members" with their transactions being cleared (and the fulfilment of the transactions being granted) by a bank acting as clearing- or general-clearing-member. Therefore, applying capital requirements for a potential risk to market to non-"class 1" investment firms sounds a little bit like "solution is looking for a problem".

Against this background, the only appropriate and justifiable calculation of prudential requirements for "RtM" we could imagine, should be closely aligned to the margin which investment firms have to place with their clearer(s) who guarantee(s) the clearing and settlement of the firm's transactions[19]. Not only is the concept of margining tested and accepted for a long time and not to be forgotten, vested by regulators, it also has the convincing advantage that it is was developed and is calculated not from the abstract perspective of a regulatory "ivory tower"

[19] However, since the clearing bank is subject to CRD/CRR capital requirements for their business, one could argue that any "RtM" requirement for investment firms relating to cleared transactions inevitably leads to a duplication of regulatory capital hold for the transaction.

but by market participants who have a “skin in the game” and want to effectively cover the risks they are exposed to[20].

Finally a word on operational risk as discussed by EBA in paragraph 29 of the discussion paper: While it might be true that many investment firms currently do not have to calculate a “Pillar 1” operational risk requirement, this assumption does not hold true for bwf member firms. In fact, the inadequate calibration of operational risk charges for investment firms is still one of the most obvious examples of the weaknesses of the current regime.

While the Basel Committee originally suggested that banks should reserve 15% of their regulatory capital for operational risk on average, the European implementation of Basel II resulted in much higher oprerational risk charges for investment firms affected. It is not uncommen that these firms have to reserve 50% of their regulatory capital for regulatory risk. In other words, capital requirements did double as a result of Basel II.

While nobody denies that investment firms are confronted with operational risk, it is generally accepted that the exposure to operational risk is positively correlated with the size and complexity of an institution. Therefore it is simply crotesque that small and medium sized investment firms shall be required to hold – in relative terms – three times more capital for operational risk than intended by the Basel Committee for large and complex, globally active “Basel banks”. – The simple reason for this clear disaccord simply lies in the fact that investment firms were not considered in the multiple quantitative impact studies conducted before finally calibrating the rules.

Therefore, in our view, the possible correction of excessive capital requirements for those investment firms, which currently have to calculate operational risk charges under “Pillar 1”, is one important aspect which makes the idea of an alternative prudential regime for investment firms generally appealing.

Question 7. Is the proposed risk to firm ‘up-lift’ measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

As already mentioned above, we clearly object the application of any kind of “amplifiers” based on a “risk to firm” calculation which in our view would reintroduce the CRD/CRR approach “through the backdoor”. Under the assumption that the k-factor model appropriately und comprehensively captures the risks investment firms pose to others, either on a micro (“FtC”) or systemic/macro (“FtM”) level we

[20] Furthermore, we assume that for the vast majority of investment firms, the potential problem of non-cleared trades should be negligible. However, if there are any non-cleared transactions, we suggest that EBA could set up rules for a notional margin calculation which are based on margining parameters obtainable in the market.

do not see any need to "leverage" these requirements. Furthermore, this would add a level of measuring "indirect" risk factors which from a methodological point of view goes beyond the CRD/CRR framework. Furthermore, to calculate any "RtF" in a sufficiently risk sensitive way, you would bring back a level of complexity comparable to the CRD/CRR regime.

Question 8. What are your views on the 'built-in' approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?

Please refer to our answer given to question 3.

Question 9. Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

As mentioned above, we think that for the vast majority of investment firms, which either have no access to money or securities of their clients[21], or where these assets are effectively shielded or ring-fenced against the risk of the firms insolvency and which do not represent any systemic risk in the original sense that they pose a danger to the orderly functioning of the markets they are active in, the possibility to orderly wind down an investment firm in the case of market exit/failure should be the main regulatory concern.

Here the fixed overhead requirement (FOR) offers a long established, firm specific and sufficiently precise proxy. The 25% FOR which goes back to the days of Basel I are based on the assumption that it would take about three month to wind down a regulated entity. However, it should be anticipated that this is a very generalized assumption which might not hold true for every business model. One could even argue that for securities trading firms or for asset managers who are not directly involved in the safeguarding of securities belonging to their clients, the three month assumption is overly conservative and consequently the calculated level of required capital too high. E.g. for most types of securities trading firms whose transactions are cleared and guaranteed by a clearing bank, it can be reasonably assumed that the "winding down" of any risk the firm might pose to others, from a regulatory point of view, should not take longer than one or two settlement circles[22]. Everything else would be simply a commercial insolvency procedure which does not require particular regulatory attention.

Nevertheless, we would say that "25% FOR" is a well-established and sufficiently simple metrix which for most firms would provide a very comfortable "buffer" from a regulatory point of view.

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[21] Given that they have clients at all and do not deal solely with market counterparts.

[22] With settlement circles in most markets usually lasting two („T+2") or three ("T+3") days.

However, the usefulness and feasibility of the concept is essentially based on the prerequisite that the calculation of "fixed overhead costs" is done in an appropriate and comprehensible way. In particular, the principles which were developed and which are currently applied to some firms according to CRR requirements[23] would have to undergo a comprehensive reassessment and recast where necessary when the scope of firms to which FOR requirements apply should widened.

According to article 1 of Commission Delegated Regulation (EU) 2015/488, fixed overhead costs are determined by deducting a catalogue of items from the firm's total expenses. Since the deduction items are defined taking into account only the characteristics of firms to whom article 97 CRR currently applies, the catalogue would be incomplete (and the calculated results therefore inappropriate in many cases) when the rule would be applied to a larger, more diverse universe of firms. For example: From a securities trading firms perspective, the gross expenses from trading activities usually represent a large portion of "overall expenses". However, it would be a clear misconception to include this P&L position[24] in the calculation of "FOR". Not only is the amount of gross expenses from trading activities highly volatile, it would be also completely irrational to include it in a calculation which is aimed to determine the amount of money needed to wind down a firm, because in such a situation, there simply would not be any trading activities anymore.

Question 10. What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

The question refers to the argument presented in paragraph 78 of the discussion paper which is not convincing from our point of view. As long as the identification of parameters (assessment base and scalars) for the applied risk factors will be identified and calibrated in a way which results in capital requirements proportionate to the business volume of the firm, we do not see any justification or need for a deviating treatment of larger firms (even more since the truly systematically important firms will be in "class 1" anyway).

Question 11. Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?

We find it difficult to anticipate the practical relevance of this question. Unless EBA further specifies which kind of firm the question is referring to, we cannot give a meaningful answer.

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[23] Cf. COMMISSION DELEGA TED REGUL ATION (EU) 2015/488 of 4 September 2014 amending Delegated Regulation (EU) No 241/2014 as regards own funds requirements for firms based on fixed overheads

[24] Which is mirrored by „gross profits from trading activities" usually resulting in a very narrow net margin.

Question 12. Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)? Are the cases described above a real concern for the investment firms? How can those aspects

All we can say is that we are not aware that the CRR definition of capital in the would pose specific problems to bwf member firms which are usually incorporated as limited liability companies ("GmbH") or stock companies ("AG") under Germen law.

Question 13.be addressed while properly safeguarding applicable objectives of the permanence principle?

Question 14. What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?

Question 15. In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

Question 16. What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

Please refer to our answer given to question 12.

Question 17. What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

Since bwf members are usually 730k firms, our expertise to estimate whether initial capital requirements for firms with lower requirements (50k/125k) should be increased/harmonised. For 730k firms we do not see any need for an increase. Not only is the distance to the next highest (125k) group from the perspective of a 730k firms very large[25], we also remain critical about the initial classification as such. In our view it is a clear misconception to require a higher initial capital requirement for firms trading on own account, than for those that hold client assets.

With respect to the proposal that initial capital requirements should defined a "floor" we think that the practical relevance of such a rule would be very limited. Nevertheless, we think that the original concept was rather based on the idea to define a "starting point" which might be exceeded as well as undercut in future periods according to the development of a firms business.

[25] And still would remain high if the initial capital requirement for 125k firms would be doubled.

Question 18. What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

We do not have any comments on this question.

Question 19. What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

We do not see a need to establish a separate concept of eligible capital.

Question 20. Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

Taking into account that business models of investment firms may be highly different, we are sceptical about any attempt to define a common stress scenario for liquidity. E.g. the nature, structure and frequency of cash-flows for an asset manager are completely different from those of a broker-dealer (aside from general items as monthly salaries or office space rent).

Question 21. What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for 'non-systemic' investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and 'non-interconnected' investment firms?

In general, the requirement of holding a certain amount of liquid assets as a percentage of FOR could be a practical way forward. However whether it is appropriate or not would depend on which assets are classified as "liquid".

Question 22. What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

Since investment firms usually do not have direct access to central bank funding, it is important and indispensable that cash balances in bank accounts (e.g. with an investment firm's clearing bank) would qualify as liquid assets.

Furthermore, any type of security for which a sufficiently liquid market exists, should also qualify as a "liquid asset". In order to address the risk of changing market prices, a reasonable haircut could be applied for volatile securities.

Question 23. Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply "supplementary" qualitative requirements to individual firms, where justified by the risk of the firm's business?

We do not see the need for minimum liquidity standards for non "class 1" firms aside from a reasonably calibrated simple proxy like the ratio of liquid assets to FOR as discussed in question 21.

Question 24. Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm's business?

In our view, the question is not whether firms have specific operational requirements for liquidity risk management (of course they have, like any other business) but whether there is the need and justification for regulatory intervention.

Once again it should be remembered that the risks of deposit-taking credit institutions and investment firms are structurally different with the "natural" maturity mismatch between assets and liabilities on a bank's balance sheet being one of the main reasons. In other words, where an active asset-liability management is core to manage the risk of an institution, the aspect of an accompanying liquidity management is much more significant from a regulatory perspective than for an investment firm.

Therefore, we think the field of regulatory requirements for liquidity management are a good starting point to demonstrate that the new approach is indeed intended to avoid unnecassary and unsuitable regulatory burdens.

Other prudential considerations

Question 25. What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms? What are your views on the proposed approach to addressing group risk within investment Question 26.firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

Historically it can be said that large exposure rules were at least as important for bwf member firms as capital adequacy requirements.

We think that one of the greatest flaws of the current large exposure regime – aside from the fact at it was calibrated for large banks – lies in the fact that the same thresholds apply for (illiquid) credits granted (by banks) and (liquid) securities positions. With a 25% of own funds ceiling for single large exposures, securities trading firms which are dealing with institutional investors, professional clients and eligible counterparts, in practice might have to fulfil their prudential capital requirements many times over simply to have enough "headroom" under the large exposure regime which enables them to trade ticket-sizes required to be accepted within a bank dominated institutional environment.

If EBA wants to address the described problem, it could either consider to introduce different threshold for (illiquid) credits and (liquid) securities and/or different thresholds for investment firms since they have no deposits on their balance sheet.

Question 27. In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

It should be avoided that a firm within a group will have to comply with two different regimes. Where a firm complies with CRD/CRR requirements, there should be no further need to implement the new regime.

However, the requirement to comply with CRD/CRR requirements obviously could put firms which are member of a group in a less advantageous situation than their "stand alone" competitors. We have no solution for this problem at this point but it should be given due attention in further discussions.

Question 28. What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?

We do not have any comments on this question.

A macro-prudential perspective for investment firms

Reporting and any other prudential tools

Question 29. What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

For examples, please refer to our answers to question 6 regarding the operational risk charges and the problems with a large exposure regime which does not adequately takes into ago the differences between (illiquid) credit and (liquid) security positions.

Generally speaking, if the capital requirements for banks which take deposits are correctly calibrated, it must result in inappropriate requirements when the same parameters are applied to investment firms. E.g. regulatory assessment of own account trading should be different, if it takes place on a bank's balance sheet funded to a significant extent by deposits or on the balance sheet of an investment firm which absorbs any risk arising from trading activities by own funds.

Question 30. What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

We do not see a need for additional regulatory "tools". Furthermore, we are highly sceptical whether public disclosure is a reasonable instrument in particular for smaller and medium sized investment firms. In our view, the concept of "market discipline" by disclosure requirements is only meaningful for very large stock companies with a large base of (at least partial) institutional investors.

With respect to the recovery and resolution regime we think that non "class 1" investment firms should be completely excluded. Since they are not considered to be systematically important, they should neither be required to pay into recovery funds (of which they will never profit) nor should they be exposed to any other administrative burden resulting from the recovery regime (e.g. to be required to set up "living wills").

Question 31. What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

CRD governance requirements very obviously were designed for banks and should be applied to banks and possibly "class 1" investment firms only. For all other firms we consider the governance requirements defined by MiFID as more appropriate and sufficient.

Question 32. As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

We do not have any comments on this question.

Question 33. What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

In our view, the current regime is overly restrictive. In particular the restrictions on variable compensation do not appropriately take into account whether they are based on risk taking and uncertain future cash-flows or not. We also think that deferred pay-out schemes are not appropriate for business models based on cash market transactions only.

Question 34. What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

The question cannot be answered in a meaningful, non speculative way, before the qualitative and quantitative parameters of the proposed new model are defined an comparable calculations between the current and new regime can be undertaken.

Question 35. What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.

We fully subscribe to the statement that was made during the Commission stakeholder meeting on 27 January 2017 that "Basel is a banking piece of legislation which ironically was applied to investment firms".

Supplementing the points already raised above we would like to briefly highlight the following points:

Any quantitative parameter of the Basel framework is based on a political compromise on a global level which never took into account the specific situation of investment firms but are based on the assumption that these requirements will be applied to large and internationally active banks which fund their activities to a significant extent by taking deposits.

Where the calibration of capital requirements was based on one or more quantitative impact studies, the specific situation of investment firms was never taken into account because they were simply outside the scope of the Basel regime.

The current Basel framework is based on the concept to set incentives by offering different approaches with an increasing degree of risk sensitivity to calculate the amount of regulatory capital required. However, since the more advanced approaches were necessarily connected with much higher administrative costs, investment firms usually had to pick the "most expensive" basic approaches and were factually excluded from the "incentives based" regime. – However, this is of course not a problem of the original Basel rules but of the European application of the Basel framework to a much wider universe of institutions.

We kindly ask EBA to take our consideration into account in the course of further enhancing the concept of a possible distinct prudential regime for investment firms. We also would be very pleased to discuss with you and further elaborate any of the issues addressed in our response.

Yours sincerely,

Michael H. Sterzenbach
Secretary General