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Draft CMCE response to EBA Discussion Paper:
A new prudential regime for investment firms

[Draft v~~1~~2 – 31~~26~~ January 2017]

1. Are the criteria used to identify G-SIIs/O-SIIs appropriate for the identification of systemic and bank-like investment firms? 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?

CMCE members have no objections with regards to the proposed criteria. We agree that only a small sub-set of investment firms would meet the criteria of G-SIIs / O-SIIs and they should remain within the CRD IV / CRR framework. It is noted that the current estimate of the EBA team is that only 8 of circa 7000 Investment Firms will be in scope of these definitions. Whilst this makes practical sense as it limits the number of firms that likely will remain in scope of CRD and CRR it has the unintended consequence of placing unnecessary pressure on classes 2 and 3 to accommodate a large number of firms with a diverse range of business models and risk profiles.

The consequences of this issue will be considered further in subsequent questions.

2. Views on the principles for the proposed prudential regime for investment firms?

CMCE agrees that the objectives of a potential new prudential regime should not be the same as those applicable to systemic and bank-like firms. Should commodities firms fall within the scope of any such regime by virtue of their current / future authorisation as investment firms, the regime should only be focused on ensuring orderly winding down of a failing firm.

As stated in the December 2015 opinion of the EBA the aim is to make recommendations that "will lead to a more proportionate and risk-based prudential regime for investment firms."

There is a risk that the current proposals whilst different from those under CRD/R share one of the issues raised in the EBA report of December 2015:

"Furthermore, the current categorisation does not contain an (inherent) analysis of the risks posed by investment firms and their various business models when imposing prudential requirements."

This is especially true for commodity dealers whom have only recently (December 2016) been engaged in the data collection exercise that was initiated in July 2016 for a number of other types of investment firms.

There is a clear need for the EBA to hold a further workshop with commodity dealers once the responses to the Discussion Paper and data collection have been received and analysed. Without this additional work there is a risk that proposals will be made to the Commission that reduce the capital available for investment in EU markets without any justification on the basis of risks posed to customers or markets.

CMCE does not agree with the EBA's suggestion that the purpose of the regime should be to ensure continuation of services. In respect of commodities firms, we believe that orderly winding down should be the guiding principle for the future regime as commodities firms do not provide 'services' to clients. We refrain from comments on the potential objectives for other types of investment firms – such as asset managers, brokers, etc – as they may be quite different.

If adopted, a new regime should complement, not override, existing markets and conduct regulation, to which CMCE members are already subject. From the competitiveness point of view, we agree that the regime should be harmonised across EU Member States in order to ensure level playing fields for all firms. We would therefore advocate little or no discretion for National Competent Authorities (NCAs) in the implementation of a new regime.

We agree that firms that pose more risk should hold more capital, provided that the new regime is based on an adequate and evidence-based risk assessment. Unfortunately, this is not the case now as the data gathering exercise for commodity trading firms and Commodities Dealers were launched post-publication of the EBA Discussion Paper. We therefore believe that the EBA may have to re-assess some of its analysis following consideration of the data received in the course of the exercise that is due for submission in February.

As noted above the drawing of a narrow scope for Class 1 is problematic most notably as it means that a number of "systemic" (but not bank-like) Investment Firms will be captured in class 2 but under the current proposals will be subject to the same requirements as non-systemic firms categorised in class 2 even if the resulting capital requirements are different in scale.

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?

CMCE is generally supportive of the the three tier classification of investment firms and agrees that small and non-interconnected firms should be classified as Class 3 firms. The majority of CMCE members are non-complex firms that should fall within Class 3. However it should be recognised that size is not a reliable indicator of risk and as a result the term "very small" should not be an important factor in assessing the firms that are categorised in class 3 and regulated on a "gone concern" basis.

CMCE agrees that Class 3 firms should be subject to minimum own funds requirements based on fixed overhead requirements (FOR) only. The current proposal of 25% annual fixed overheads appears reasonable and would be appropriate given the low risk profiles of such firms. The latter should not be solely based on the size of a firm's balance sheet but on other factors and arrangements that play an active risk-reducing role in the firm's day-to-day management including physical assets held and hedging positions not recognised by balance sheet or off-balance sheet exposures.
CMCE disagrees with the EBA's suggestion of merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality. Class 3 should be a clearly defined category within a new, bespoke regime. We do not believe that the CRR framework provides sufficient flexibility that would allow any meaningful 'proportional' amendments and we fear that any such attempt to do so would result in an even more complex regime.

The EBA's proposal would be made more proportionate as apparently intended in their December 2015 paper if Class 2 was focussed upon Investment Firms whom are risk assessed as "systemic" and regulated on a "going concern" basis.

The differentiated treatment of systemic and non-systemic entities is a well-established principle of European regulation that should also be applied in this case.

This could be delivered by a broadening of the proposed k-factors to include quantitative and qualitative factors that would differentiate the business models of different types of Investment Firms.

By doing so this would make it easier to identify the systemic firms that should be categorised in class 2.

4. What are your views on the criteria discussed above for identifying 'Class 3' investment firms? For the above question, it would be useful to receive detailed comments on each of the following items, which would preclude investment firm from being in 'Class 3'.

CMCE disagrees with the proposed approach. We believe that classification should not be permission-based, but risk-based. The list of proposed categories of permissions as exclusion factors seems arbitrary and lacking meaningful data-based justification.

We oppose criterion (c) – dealing on own account – the majority of CMCE members are regulated entities that have permission to deal on own account, which reflects a typical business model of commodities sector firms. There appears to be a conflation of the dealing on own account permission with proprietary trading activity. Depending on the business model of the specific commodity dealer use of the "dealing on own account" permission could be used to carry out purely hedging activity that under equivalent European regulation such as EMIR and MiFID II would at least be available for exemptions. There is a need to extend the k-factors to assess the nature of an investment firms activities and market context as well as the proposed k-factors that focus upon balance sheet metrics and the holding of MiFID permissions.

We oppose criterion (h) – being a member of wider group – CMCE members use intragroup guarantees and securities as part of day to day risk management activities. Risk-reducing character of such exposures has been recognised under EMIR and we see no justification to change it. It is clear that a 100% owned Investment Firm that is part of a wider group that is publically listed and well capitalised will be of a far lower risk profile than the same Investment Firm that was an independent legal entity. There is a strong case for this consideration to be added as a K-factor with a downward scaling effect.

We oppose criterion (i) – using MiFID passport - CMCE members disagree with this exclusionary factor. The EBA's analysis of the potential risk posed by passporting in paragraph 19 of the DP fails to acknowledge that the permission to passport is an inherent assurance that the activities will not pose risks in another Member State.

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

CMCE has reservations with regards to the proposed k-factors approach. We see significant limitations of the proposed approach in regards to commodities firms. The proposed approach provides no substantive explanation or justification as to why and how proposed k-factors should be considered by the commodities firms. Therefore we see little applicability of this approach in its current form to commodities firms. Should the EBA and the Commission nevertheless choose to proceed, with a new prudential regime based on the k-factor approach – including for Commodities Dealers – we believe that it would have to be appropriately adjusted. This should include taking into consideration existing market and conduct regulation so as to avoid double regulation.

As previously mentioned there will be a need to review the data submitted during the data collection exercise by commodity dealers and based on the conclusions to broaden the proposed k-factors to include quantitative and qualitative factors that would differentiate the business models of different types of Investment Firms. By doing so this would make it easier to identify the systemic firms that should be categorised in class 2 and regulated on a "going concern" basis.

6. What are your views on the initial K-factors identified? For example, should there be separate K-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?

CMCE is of the opinion that the concept of risk-to-customer (RtC) has little applicability to commodities firms. As Commodities Dealers deal predominantly on own account, do not have permissions allowing holding of client money or securities and transact only with professional counterparties, the RtC factor should be zero.

CMCE believes that the proposed risk-to-market (RtM) factor should be considerably adjusted in order to take account of the business model and risk profile of investment firms trading commodities derivatives. There are a number of risk-reducing factors that such firms undertake in the normal course of their day-to-day operations that should be duly recognized. For example, the great majority of such firms' exposures to financial markets is via exchange-traded derivatives (ETDs), which are regulated financial instruments, cleared and margined, trading in which is subject to stringent market surveillance. The remainder of derivatives exposures that takes place on OTC basis is also subject to stringent risk management requirements, including initial and variation margin and counterparties' risk management procedures.

As currently drafted, RtM is calculated on the basis of a firm's balance sheet. For Commodities Dealers balance sheets do not reflect typical risk management procedures and neither balance sheet nor off-balance sheet exposures consider hedged positions. CMCE suggest that RtM should be based on a net liquidation value (**NLV**) of a firm's portfolio.

Taking both RtC and RtM into account, CMCE does not agree with the proposed risk-to-firm (RtF) factor as it leads to double-counting for all potential risk components that are already accounted for under RtC and RtM factors. If the RtF factor was nevertheless to be adopted, NCAs should have only very limited discretion to apply capital add-on for Class 2 firms and it should be applicable on an individual, firm-level basis.

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?

CMCE does not agree with the proposed 'up-lift' measure. We do not see the rationale or evidence that would justify the introduction of an additional measure to address the 'indirect impact of the exposure risk a firm poses to customers and market' as we do not believe that such an indirect risk exists. The risks to be addressed by own funds calculated on this basis of the up-lift factor are already appropriately addressed by the k-factors or risk management arrangements of credit institutions or investment firm counterparties.

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)?

As discussed under Q3 above, CMCE disagrees with the EBA's suggestion regarding the 'built-in' approach. It would be contrary to the EBA's own recommendations included in its December 2015 report. If there is to be a prudential regime applicable to a broader scope of investment firms, it has to be a separate bespoke regime. It appears the EBA is prioritizing the ease of administration of the new regime for investment firms over the risk analysis and resulting differentiated treatment that would be required to deliver clear separation between a systemic class 2 and non-systemic class 3.

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

CMCE agrees that an appropriately calibrated FOR should remain part of the capital regime for investment firms and the basis of thereof for small, non-interconnected Class 3 firms. Any firm in class 3 should be subject to the FOR less the MiFID initial capital that will be required and is expected to be reviewed for the first time since 1993.

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

[no CMCE comments proposed]

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

[no CMCE comments proposed]

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)?

[no CMCE comments proposed]

13. Are the cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

[no CMCE comments proposed]

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?

CMCE would welcome the expansion of the range of items that qualify as regulatory capital for investment firms trading commodities and being part of a non-financial group. This should in principle take account of cash, certain stock and EUAs, subject to appropriate haircuts where applicable.

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?

CMCE notes that the current CRR framework of deductions and prudential filters is highly complex and burdensome to implement, and as such not feasible for smaller and less sophisticated investment firms and hence for commodities dealers.

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

[no CMCE comment proposed]

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?

CMCE agrees that the definition of initial capital should be aligned with the one for regulatory capital, taking into account our comments under Q14.

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?

CMCE disagrees with any automatic increase in initial capital levels. Any such increase should be proportionate, subject to risk-based assessment and should be subject to transitional measures.

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?

[no CMCE comment proposed]

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

CMCE does not believe in merits of adopting a common stress test scenario for liquidity as an obligation for all investment firms. We believe that it would be very difficult if not impossible to devise a scenario that would appropriately account for all the various types of investment firms, including those trading in commodity derivatives.

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 counterexamples 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?

CMCE does not believe that the introduction of additional liquidity requirements or a large exposure regime for investment firms is objectively justifiable. The EBA proposal does not take into account the characteristics of commodities sector firms that already employ diligent liquidity management tools in the course of their day-to-day risk management. These tools are tailored to the specific settlement procedures – including typical lengths of thereof – in commodities sector.

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).

In line with our comments under Q14, CMCE agrees that the definition of liquid assets should be expanded. Certain physical commodities should be included, subject to appropriate haircuts.

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?

[no CMCE comment proposed]

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 line with our comments under Q21 we are of the opinion that liquidity management for Class 3 firms – including commodities firms - is already well covered by the firm's standard risk management function. We see no need for additional operational requirements for liquidity risk management for such firms. Any such tool should only be considered for a sub-section of Class 2 firms that represent an RtC factor above zero.

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?

CMCE believes that the entire CRR concept of large exposures is misapplied in the context of commodities firms, for which the majority of exposures come from intragroup transactions and transactions with external professional counterparties.

We would support limited reporting requirements for identifying potential concentration risk, but only to the extent that it would be applicable to Class 2 investment firms and subject to ongoing NCA supervision powers.

26. What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

[no CMCE comments proposed]

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?

[no CMCE comments proposed]

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?

CMCE would like to reiterate that any new prudential regime for investment firms should take into account the existing scope of market and conduct regulation, and should not seek to replace it.

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

CMCE is of the opinion that investment firms are already subject to stringent and sometimes overlapping reporting requirements under MiFID I (soon to be replaced by a more onerous regime in MiFID II), EMIR and REMIT. We note that the industry concerns about burdensome reporting requirements have been widely shared and have been recently recognised in the European Commission's Communication on Call for Evidence [COM(2016) 855].

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?

CMCE does not believe any additional tools are necessary. In terms of implementation, we would like to suggest restricting NCAs' use of national discretions as experience shows misuse of Pillar 2 discretions undermines the Pillar 1 regime and distorts the level playing field across the EU.

The objective of the prudential regime for Class 2 and Class 3 investment firms should be to ensure they can be wound down in an orderly manner should such a need arise. Therefore, they should be exempt from BRRD and any requirements with a similar purpose.

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

CMCE does not believe that CRD IV governance requirements have any relevance to investment firms. It would be disproportionate to apply those provisions to firms other than full scope CRD IV/CRR firms. As the objective of governance requirements is to ensure that internal processes, procedures and control frameworks are robust, efficient and proportionate to the scale and nature of a business, we recognise that CMCE members already comply with such requirements. Members are already subject to stringent governance requirements under MIFID which will be strengthened upon the application of MIFID II.

The EBA has made the case that the general requirements of CRD and CRR are not proportionate to the potential risks posed by the vast majority of investment firms. The same principle applies to the specific Governance and Remuneration requirements as stated in paragraph 176 of the EBA Discussion Paper. We support the proposal of the EBA.

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?

CMCE has no comments with regards to the application of the current CRD IV remuneration and governance framework to 'systemic and bank-like' firms. For all other firms, any approach including remuneration requirements should be subject to the proportionality principle and an evidence-based risk assessment, taking into account the range of regulatory and legislative requirements that are already applicable. However, we question the need for such regime for commodities firms (see our response to Q33).

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?

CMCE does not believe that any separate prudential remuneration framework for investment firms other than 'systemic and bank-like' investment firms is needed or justified. As the principle objective of the CRD IV remuneration framework was to address excessive risk taking by some large credit institutions and investment firms, the same objective seems misapplied in the context of commodities firms. Those commodities firms that are MiFID authorised have to comply with MiFID rules on governance and remuneration for investment firms and there is no evidence that this system is malfunctioning or leading to any abuse. Commodities firms do not deal with retail counterparties and do not hold client money or securities, therefore there is no need to develop an additional framework for such firms that would aim to 'protect customers'. Equally, commodities firms are already subject to regulation governing conduct so no action is required in this area.

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?

CMCE does not believe that any investment firm – other than those that are systemic and bank-like – should be within the scope of the CRR regime. Any amendments would only make this regime more complex and therefore ill-suited to smaller and less sophisticated firms, including commodities firms.

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

CRD IV / CRR regime has been designed for credit institutions and systemic, bank-like investment firms. As such, this regime is not appropriate for any other institution. ~~Recent~~The European Commission's recent proposals to amend certain elements of the regime in order to make it more appropriate for smaller banks and to ease what has been perceived as disproportionate regulatory burden~~. This development~~ only highlights ~~the fact that~~how the current regime is not appropriate to investment firms other than G-SIIs and O-SIIs.

CMCE notes a number of CRR provisions that are particularly inapplicable to commodities sector. This includes requirements to hold own funds that does not take into account the risk profiles of commodities firms. In addition, all provisions relating to risk capital requirements – and in particular reliance on the standardised approach for risk calculation – leave~~s~~ smaller and less sophisticated market participants at a~~in~~ considerable disadvantage to large financial institutions that can develop their own tailor-made, internal models. Liquidity and large exposure requirements are not adapted to commodities firms' business models and relevant risk management tools that such firms already have in place to monitor and mitigate potential risks. In addition, the large exposure regime seems to be particularly punitive for commodities firms, ~~whose~~ the majority of whose exposures stem~~s~~ from intragroup transactions ~~and intragroup transactions~~which are not exempt from large exposure regime.

~~CMCE members either already have affiliates authorised as investment firms under MiFID, or will have to become authorised when MiFID II becomes applicable. As such, certain CMCE members are already covered by the definition of Commodities Dealers under Articles 493 and 498 CRR, or will soon be so. As such, to date CMCE members have not been within scope of CRR and so cannot comment on its application. However, we are of the opinion that the current CRR framework has been adopted to address a completely different set of business models and risk factors than those presented by commodities firms. As such, commodities firms should remain out of scope of the CRR~~

~~and if any prudential regime is to be developed for investment firms and Commodities Dealers, it has to be appropriately tailored to the characteristics of commodities sector firms.~~

~~Specific provisions which would be inappropriate include, but are not limited to:~~

1. ~~Countercyclical buffers in respect of own fund requirements~~
2. ~~Capital requirements for intragroup transactions~~
3. ~~The 100% risk weight where there is no external rating~~
4. ~~Limitations on netting sets~~
5. ~~The large exposure regime for non-systemic investment firms, in particular the inclusion of a intragroup transactions and exposures to clearing members and regulated markets (see also Q.25)~~
6. ~~Provisions allowing margin call cash collateral to be used to mitigate PFR (capped exposure)~~
7. ~~CVA capital requirements and clearing capital requirements~~
8. ~~The application of the Fundamental Review of the Trading Book requirements (FRTB) or SA – CCR~~
9. ~~The Liquidity Coverage Ratio, and NSFR (in general the whole application of Part 6 CRR liquidity requirements)~~
10. ~~Remuneration requirements~~
11. ~~The regular updates to CRR requirements to take into account changes in international standards and market developments. The compliance costs of these changes would be disproportionate for Commodities Dealers~~

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