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BVI[1] preliminary position paper on EBA's and ESMA's discussion paper: Call for advice on the investment firms prudential framework

We take this opportunity to summarise our most important preliminary views on EBA's and ESMA's discussion paper 'Call for advice on the investment firms prudential framework'. We will provide a detailed response to the individual questions raised in the consultation in due course. We also reserve the right to make further detailed comments on the proposals made in the discussion paper that are not the subject of the questions. We would also be grateful if we could discuss our comments further.

I. Market impact: Germany is the largest market in terms of the total number of investment firms affected by the investment firm prudential framework (Regulation (EU) 2019/2033 (IFR) and Directive (EU) 2019/2034 (IFD)), accounting for more than 700 (around 32 per cent) of all investment firms in the EU. Of these, over 600 investment firms alone are qualified as small and non-interconnected ('class 3'). This accounts for around half of all class 3 firms in the EU.

II. IFD/IFR is currently a very complex framework: In principle, we agree with EBA and ESMA that the introduction of the prudential framework for investment firms has led to the simplification of individual obligations (especially for class 3 investment firms) and thus to a reduction in the burden. Nevertheless, the IFD represents a very complex legal framework which sets out new prudential requirements and more regulatory measures such as IFR and further Level 2 and 3 requirements in addition to the obligations already stipulated under MiFID. This was a significant change compared to the previous rules for investment firms providing MiFID services such as portfolio management or investment advice under the CRD/CRR framework. We therefore see a need for further improvements to simplify the regulations in order to achieve the initial objective of the IFD/IFR framework to establish appropriate and proportionate prudential arrangements for investment firms (cf. see our proposals under section VII).

Due to its complexity, the initial implementation of the IFD/IFR framework required a great deal of effort. This applies in particular to investment firms with a limited licence to provide certain MiFID services such as portfolio management and investment advice without the authorisation to deal on own account and to hold clients' assets and which now qualify as class 3 or class 2 investment firms. Until the IFD/IFR came into force, these companies were not considered investment firms within the meaning of the CRD/CRR, meaning that most of the provisions of the CRD/CRR did not apply to them (see Art. 4 (1) no. 2 letter c CRR II). For those companies with a limited licence (such as portfolio managers and investment advisors) that are now classified as class 2 investment firms, this also meant the implementation of additional obligations and more reporting effort than before. For the latter in particular, it is therefore not possible to speak of a simplification of the investment firm prudential framework.

III. Further increase in complexity due to new proposals to further adapt the IFD/IFR to banking regulations: We are very concerned that many of the new proposals from EBA and ESMA will lead to a further tightening of the requirements and further complexity of the regulations. In particular, the consideration of transferring further requirements from the last banking package (CRR 3 /

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 115 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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CRD 6) and other provisions of the current CRD/CRR in the context of own capital requirements and risk management processes to investment firms represents another step backwards in banking regulation. In particular, the fundamental review of the trading book required under CRD6 and CRR3 and the new boundary analysis between banking and trading book is too complex (and thus neither appropriate nor proportionate) for a prudential framework such as IFR/IFD, in particular for class 2 and 3 investment firms. The current definition of trading book in Article 4(1)(54) IFR, that focuses on trading intent, is sufficient and fit for purpose. Such an extension of the rules would also mean that limited licence firms (see Art. 4 (1) no. 2 letter c CRR II) in particular, which were exempt from many rules under the old CRD/CRR, would have to fulfil new requirements via the IFD/IFR and would then also have to implement additional processes from banking regulation in the future. The original aim of the EU legislator to create a risk-oriented and simplified framework for investment firms that is independent from the banking framework and better adapted to their business models is thus being thwarted. We also see this as very questionable because originally these CRD/CRR rules were not discussed, tested and introduced with a view to whether they are also suitable for investment firms. Further, any future changes to the banking framework that do not account for the specificities of investment firms would still have a direct impact on them because these rules would be directly applicable to investment firms through the references from IFD/IFR to CRD/CRR.

IV. Important aspects are not the subject of the consultation questions: The consultation questions raised by EBA and ESMA do not relate to all topics raised in the discussion paper. For example, there are no questions on the proposed expansion of the trading book activities to non-trading book activities with implications on the K-factors and on the adoption of the Banking Package (CRR 3 / CRD 6), prudential consolidation, and ESG risks. The response template on the EBA website only allows for answers to the questions raised without any option to provide further remarks or upload additional documents. This cuts off our ability to comment at all on the relevant points raised in the consultation paper, limits the call for advice on the mandated review to aspects pre-selected by EBA and ESMA and thus prevents the collection of a holistic view of the industry.

We therefore urgently call for further dialogue with the industry in order to holistically evaluate and comment on the proposals introduced by EBA and ESMA or other topics which are not addressed in the discussion paper. We would like to comment briefly on these points as follows:

1. **Expansion of trading book activities to non-trading book activities**: We strongly disagree with the proposal to also consider investments of own funds of investment firms that are not authorised under point (3) or (6) of Annex I, Section A MiFID in the trading book and to set a limit for the concentration risk. This approach would mean that these investment firms would also have to calculate and consider K-factors which currently only apply to trading book activities. Moreover, this would also mean that it would be necessary to define in detail which own capital or liquidity investments belong to the trading book. This would unnecessarily increase the complexity of the framework and would lead to a further increase in expenses and own funds without EBA providing any evidence of relevant risk or need for higher own funds. The proposed limitation of concentration risks would also have an adversary effect: the portfolio manager would be motivated to always keep his own funds below the threshold in order to avoid having to implement the IFR's complex processes for dealing with concentration risks. However, this would prevent the build-up of an adequate capital buffer in excess of the statutory minimum capital and liquidity requirements.

   Moreover, a limitation of concentration risks and considering equity only held in cash, investment firms would be required to invest significant portions of their own capital (such as cash) at least with four different banks to meet the requirement, which creates complexity and is too burdensome. The current supervisory review and evaluation process (SREP) addressed in Pillar 2 better assesses the risk of own capital investments (without a license on dealing on own account) adequately, than setting a concentration risk limit or considering such investments in a (non-existing) trading book.

The assumption that investment firms that offer individual portfolio management might be exposed to increased concentration risks via the non-trading book with their own funds in relation to their balance sheet shows a lack of practical knowledge. We reject the notion of potential regulatory arbitrage in the sense that this would give them a capital advantage over other investment firms which are required to consider additional K-factors based on the trading book. Here, EBA compares practices that are not comparable in the first place. Portfolio managers who are not allowed to deal on own account cannot be compared with the risks of investment firms that do. The manner and composition of a portfolio manager's own funds (and only these are considered in the non-trading book) are specified by law in the IFR. If any risks are identified here, these rules should be amended accordingly rather than setting up complex new procedures that have been developed for banks' trading business models. In any case, it should be legally clarified that the investment of own funds by investment firms that are not authorised under point (3) or (6) of Annex I Section A MiFID does not constitute a service of dealing on own account within the meaning of MiFID.

2. **Prudential consolidation**: The rules on group consolidation should be scrutinised again in depth and their practical implications discussed with the industry. In any case, we strongly disagree with at least the following proposals:

    a) We reject the EBA's call to align the regulatory **scope of consolidation** in accordance with Art. 7 IFR with the regulatory scope of consolidation in accordance with Art. 18 CRR. Rather, the existing approaches and definitions in the IFD/IFR such as ‘investment firm group’ or ‘consolidated situation’ with references to Article 22 of the Directive 2013/34/EU (Accounting Directive) should remain in place. The EU legislator has deliberately opted for a proportional approach based on the Accounting Directive, which deviates from the requirements of the CRD/CRR and thus deliberately only includes certain companies. Rather, the step-in risk considerations mentioned by the EBA are accompanied by a high degree of uncertainty as to which entities must be included in the group consolidation. There is also a lack of any evidence as to whether and which risks have proven to be relevant for investment firm groups in order to expand the scope of application of group consolidation and further increase the implementation requirements for the groups concerned. The EBA also does not provide any evidence as to why the current approach in the IFD/IFR regime should be an undesirable consequence. On the contrary, we are concerned that the extension of the group approach will lead to further excessive reporting obligations for investment firm groups, which, in addition to increasing operating costs, will also lead to excessive capital requirements that are not necessary.

    b) The EBA proposals on readapting the **group capital test** ignore the legislative deliberate intention to deviate from the exhaustive quantitative criteria approach under Article 17 CRR and to set more simplified and appropriate requirements for groups of investment firms than those which apply to groups of banks and which give the national authorities their own scope for assessment due to the different markets and business models without EBA's mandate being to define harmonised rules for this. This principle-based approach established at Level 1 is counteracted by the EBA guidelines that have already been adopted and the corresponding proposals for legislative amendments. In particular, we do not consider the current EBA guidelines on the group capital test to be in line with the requirements of Article 8 IFR and therefore do not agree with the direct transfer of the approaches mentioned therein into the IFR (cf. BVI position paper on the EBA consultation paper on the guidelines). On the contrary, we furthermore encourage the EU legislator to reverse the existing principle of prudential consolidation in such a way that the Group Capital Test in Article 8 IFR would be the rule and prudential consolidation stated in Article 7 IFR as exemption thereto. This would finally provide for an appropriate and proportionate prudential framework reflecting the actual risk and thus necessity to regulate stemming from an investment firm being part of a relevant group.

c) Furthermore, we suggest reducing the excessive regulatory complexity for financial conglomerates subject to Directive 2002/87/EC and limiting the scope of the rules applicable to groups of investment firms within such conglomerates to those areas not adequately covered by the (group) legal framework applicable through the regulatory status of the ultimate holding company.

3. **ESG risks:** We agree with EBA's proposals in the final ESG report developed in accordance with the mandate of Article 34 of the IFR not to change the IFD/IFR framework for class 2 and 3 investment firms. In particular, we support the assumption for class 2 investment firms that any operational errors or poor execution as a risk to be hedged with own funds in portfolio management or investment advice are not related to environmental factors. Therefore, it is not necessary to include environmental risks in the K-factor ‘assets under management’. The composition of the assets under management in terms of their sustainability should also not be used as a basis for differentiating the capital requirements for portfolio managers and investment advisors as this depends on the client's mandate. In addition, sustainability risks must already be taken into account in the internal processes in accordance with Delegated Regulation (EU) 2021/1253 on MiFID II. Should there nevertheless be a loss of income due to a reduction in fees from discretionary portfolio management or advisory services as a result of environmental events, an analysis of such potential weaknesses in the area of company-specific business model analysis as part of the supervisory review and assessment process is already addressed.

V. Interaction of the IFD/IFR with the AIFM and UCITS Directives: We reject EBA's cherry-picking approach of imposing certain IFD/IFR requirements on AIF/UCITS managers who also provide MiFID services. In particular, we are very irritated that the discussion paper contains proposals to adjust the own funds requirements of the AIFM and UCITS Directives or even to limit their MiFID activities. We do not believe that such proposals are in any way covered by the mandate of the IFD/IFR. Article 66 IFD only provides for a mandate to review the level playing field between investment firms and AIFM/UCITS managers with regard to the provisions on remuneration in the IFD/IFR and in the AIFM and UCITS Directives. The EU Commission's call for advice is limited to assessing the interactions between investment firms and other financial activities (and their specific regulatory frameworks, such as UCITS and AIFM) and whether the IFR/IFD need to be amended to better address the risks arising from these interactions. EBA avoids this approach by not proposing changes to IFR/IFD, but by intervening in other sector-specific frameworks. Amending capital requirements of UCITS/AIF managers requires broader consultation under the AIFM/UCITS Directive directly, which were reviewed only recently by the EU legislators as part of the AIFMD review and assessed as appropriate. Based on our data in Germany, we can in any case refute the indirect accusation of management companies engaging in regulatory arbitrage by applying for an AIFM/UCITS licence for predominantly performing MiFID activities in order to avoid the IFD/IFR requirements. We will be happy to provide an analysis of the data for the German market at a later date.

In this debate, we moreover miss an in-depth discussion of whether the IFD/IFR requirements are at all appropriate with regard to the risks of investment firms providing services such as portfolio management and investment advice. Instead, it is proposed that these requirements should be based more strictly on the banking regulations and then transferred to UCITS/AIF managers. We would therefore like to take a step back and review the effectiveness of the current IFD/IFR requirements and then, where appropriate, transfer the requirements of the AIFM/UCITS Directives, which have been practicable and appropriate for many years, to those investment firms that provide portfolio management and investment advice. Otherwise, CRD/CRR would have to be reviewed to determine whether the requirements of IFD/IFR with regard to the K-factor approach for the provision of MIFID activities (here e.g. portfolio management, investment advice) would not then also have to be transferred.

VI. Further improvement is needed in order to simplify the IFD/IFR framework, in particular:

1. **Deletion of all references in IFD and IFR to CRD or CRR**, insofar as these specify content requirements for class 3 or class 2 investment firms.

2. **Reducing complexity of the framework for class 3 investment firms** by including a chapter in the IFD and IFR that conclusively covers all requirements for small and non-interconnected investment firms only. This would make it easier for the investment firms concerned to recognise the rules that apply to them without having to comprehensively legally check whether the requirements that only apply to other investment firms elsewhere do not apply to them due to exceptions.

3. **Removal of the thresholds of Article 12(1)(h) and (i) IFR for 'limited licence firms'** that were previously exempt under the Art. 4(1) no. 2 letter c CRR II (older version). In any case there is a need to require that limited licence firms are placed on an equal footing with small and inter-connected investment firms ('class 3'). As an alternative, this could also call for an approach that the national regulators or national authorities should have the power to decide if some rules of the IFD/IFR should apply to limited licence firms or not, taking into account the specific business models in each Member State.

4. **Deletion of investment advice on an ongoing basis as an eligible K-factor AUM.** In considering the limited inherent risk of investment advice on an ongoing basis to create an event of failure which justifies additional own capital requirements, (operational) risk resulting from investment advisory services versus portfolio management services is different. Recital (24) of the IFR explicitly states that K-AUM in the context of portfolio management services shall capture the risk of harm to clients from an incorrect discretionary management of client portfolios or poor execution and provides reassurance and client benefits in terms of the continuity of service of ongoing portfolio management. Operational risks resulting from poor execution, however, do not occur in the context of investment advice of an ongoing nature.

5. **Adapting the remuneration rules on a consolidated basis in Article 25 IFD to Article 109 CRD V**. It should be possible to apply other remuneration provisions to subsidiaries if they are subject to sector-specific remuneration rules in accordance with other EU legislation (e.g. AIFM/UCITS Directives).