EBA/CP/2021/34

18 November 2021

Consultation Paper

Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034

Contents

1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the ‘send your comments’ button on the consultation page by 18 February 2021. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA’s rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA’s Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

The EBA has developed these draft regulatory technical standards (RTS) on determination of additional own funds requirements (i.e. Pillar 2 add-ons) for investment firms in consultation with the European Securities and Markets Authority (ESMA), in accordance with the mandate under Article 40(6) of Directive (EU) 2019/2034 (IFD). These draft RTS clarify how competent authorities should measure risks or elements of risks that investment firms face or pose to others, that are not covered or not sufficiently covered by the own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033 (IFR).

These draft RTS are relevant for class 2 and class 3 investment firms, class 3 investment firms gathering all investment firms complying with Article 12(1) of Regulation (EU) 2019/2033, and aim to ensure a consistent and proportionate application of supervisory practices across the Union, providing granular guidance embedding different sizes, business models, and risk profiles of the investment firms, while maintaining risk sensitivity of the calculation of capital requirements under Pillar 2. Given that the application of additional own funds requirements results from a comprehensive supervisory review and evaluation process (SREP), these draft RTS should be read together with the SREP guidelines under Article 45(2) of IFD.

The approach specified in these RTS builds on the structure of own funds requirements set out in Article 11 of IFR, differentiating between class 2 and class 3 investment firms, and reflecting various objectives of the own funds requirements. On the one hand, competent authorities are expected to determine for class 2 and class 3 investment firms, additional own funds requirements to cover the risk of an unorderly wind-down, which could pose threats to their clients, counterparties, and the wider markets in which they operate in case of their failure. On the other hand, for class 2 investment firms only, competent authorities should determine additional own funds requirements to decrease the likelihood of a failure of the investment firm, by covering material risks related to their ongoing activities, including risks to clients, markets and to the investment firms itself. In addition, competent authorities should also consider in the Pillar 2 add-ons any other risks investment firms are facing that are not addressed by any own funds requirements.

These draft RTS propose a number of indicative qualitative metrics to support competent authorities in the identification, assessment and quantification of material risks and elements of risks not covered or not sufficiently covered by own funds requirements set out in Article 11 of IFR. The proposed metrics reflect the size, complexity of activities and business models of the various investment firms across the EU.

Next steps

The draft RTS are published for a three-month consultation period. Consultation responses can be provided by filling in the form on the EBA website. The finalisation of the draft RTS and communication to the European Commission is planned by 30 June 2022.

3. Background and rationale

Introduction

1. Until the adoption of the Regulation (EU) 2019/2033 (Investment Firms Regulation – IFR) and Directive (EU) 2019/2034 (Investment Firms Directive – IFD), the prudential and supervisory requirements regarding own funds and additional own funds were set out in the Directive 2013/36/EU (CRD) and Regulation (EU) No 575/2013 (CRR), with however, some investment firms exempted from full CRD/CRR requirements, depending on which services they provide, and their combination or size.

2. The IFD and the IFR, which were published in the Official Journal of the European Union on 5 December 2019 and entered into force on 26 December 2019, replaced the existing prudential and supervisory framework for investment firms, with the definition of investment firms now aligned with the definition set out in Article 4(1) of Directive 2014/65/EU (MiFID).

3. Investment firms authorised under MiFID vary greatly in terms of size, business model, risk profile, complexity, and interconnectedness, ranging from one-person companies to large internationally active groups, requiring proportionality with regard to the regulatory and supervisory framework. The new regime for investment firms distinguishes between investment firms deemed similar in terms of business models and risk profiles to credit institutions that will remain subject to the prudential and supervisory requirements of the CRR and CRD (Class 1 investment firms), and firms that became subject to the new requirements of the IFR and IFD, according to their systemic importance, and other criteria including size and types of MiFiD activities (Class 2 and Class 3 investment firms, the latter class encompassing only small and non-interconnected investment firms in line with the criteria of Article 12(1) of IFR).

4. The new regime for investment firms under IFR/IFD will be complemented by further harmonisation of the regulatory requirements and supervisory practices through level 2 regulations, in order to foster a European level playing field across investment firms. One of the areas requiring further clarifications to ensure common supervisory practices is the application of Pillar 2 requirements. Given that the application of additional own funds requirements (i.e. Pillar 2 add-ons) results from a comprehensive supervisory review and evaluation process (SREP), a fully integrated approach is required for the development of these proposed draft regulatory technical standards (RTS) on Pillar 2 add-ons and the SREP guidelines under Article 45(2) of the IFD.

5. In this context the EBA, in consultation with ESMA, has developed these draft RTS in accordance with the mandate contained in Article 40(6) of IFD. In developing the proposed draft RTS as well as the SREP guidelines, the EBA's key objective was to provide for a consistent application of methodologies across the Union and sufficient granularity of assessment, while ensuring proportionate approach reflecting different sizes, business models and risk profiles of investment firms. The proposed RTS aim at maintaining risk sensitivity and proportionality in determining own funds requirements under Pillar 2.

6. Competent authorities shall impose additional own funds requirements on various grounds set out in Article 40(1) of IFD. In accordance with the mandate, these draft RTS focus only on one of these situations, detailed in point (a) of that Article, namely where the investment firm is exposed to risks or elements of risks, or poses risks to others that are material and are not covered or not sufficiently covered by minimum own funds requirements. Other aspects of setting additional own funds requirements, in particular based on points (b) to (e) of Article 40(1) of IFD, are further clarified in the SREP guidelines.

Policy proposals

7. The proposed draft RTS elaborate on the methodology for competent authorities to assess, determine and, where necessary, update the amount of additional own funds the investment firms should hold to cover relevant risks. On the one hand, the additional own funds requirements should decrease the likelihood of a failure of investment firms by covering risks related to their ongoing activities, including in particular their risks-to-clients, risks-to-firms and risks-to-markets. On the other hand, competent authorities should also assess the risk of an unorderly wind-down of investment firms' businesses, which could pose threats to their clients, counterparties and the wider markets in which they operate, in case of their failure. This dual objective of additional own funds requirements justifies a dichotomous approach separating the assessment of the risks related to the on-going activities of the investment firm, and the risk of an unorderly wind-down. It is also consistent with the structure of minimum own funds requirements as set out in Article 11 of IFR.

8. In addition, investment firms may be exposed to other risks that cannot reasonably be attributed to any own funds requirements set out in Article 11 of IFR. These include in particular risks such as ICT risk and other operational risks that are not addressed by the minimum own funds requirements. Where those risks are material in nature, competent authorities will need to assess their impact separately and consider such impact within the Pillar 2 add-ons regardless of the type of requirement that is binding for a given investment firm.

9. The RTS specify a number of indicative metrics to support competent authorities in identification, assessment and quantification of material risks and elements of risks not covered or not sufficiently covered by own funds requirements set out in Article 11 of IFR. The proposed metrics reflect the size, complexity of activities and business model of the various investment firms within the EU.

10. The frequency of the supervisory review and evluation processes varies depending on the size and risk profiles of the investment firm. In order to ensure the adequacy of additional own funds over time, the RTS specify situations where such requirements should be reviewed and updated.

Examples

11. The calculation of additional own funds requirements would typically follow the following steps:

    1) An investment firm with a known permanent minimum capital requirements (PMCR) calculates its fixed overheads requirements (FOR) and, if belonging to Class 2, its K-factor

requirements (K-FR). In line with Article 11 of IFR it determines the minimum own funds requirements as the highest of PCMR, FOR and KFR.

2) The competent authority then calculates the capital considered adequate to cover this risk of an unorderly wind-down of the investment firm's business, and if the investment firm belongs to Class 2, also the capital considered adequate to cover the risks-to-clients, risks-to-firm and risks-to-markets from its on-going activities.

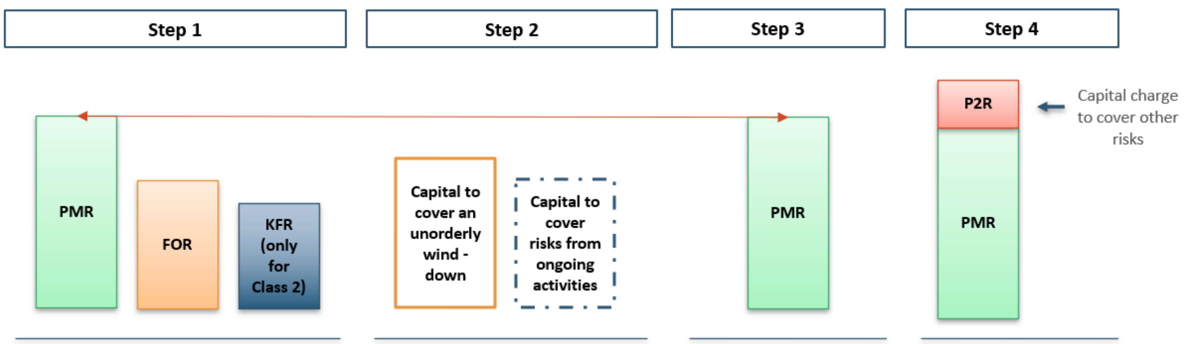
3) In line with the provision of Article 40(3) of IFD, the competent authority shall determine the level of the additional own funds as the difference between the highest computed capital considered adequate to cover aspects set out in point 2 and the minimum own funds requirements set out in point 1. The result of this deduction is floored at the level of minimum own funds requirements.

4) The competent authority also calculates capital considered adequate to cover any other risks that are not covered by any own funds requirements. Since such capital cannot be considered as covered by any own funds requirements, it shall be considered, if not nil, as the minium Pillar 2 add-on.

5) The competent authority determines the Pillar 2 add-on in accordance with point (a) of Article 40(1) of IFD by adding the capital considered adequate to cover other risks as calculated in step 4 to the difference computed in step 3. This Pillar 2 add-on may be further adjusted by determining additional own funds requirements to address points (b) to (e) of Article 40(1) of IFD, as further explained in the SREP Guidelines.

12. Several illustrative examples are presented below for the practical application of the proposed framework. Please note that all these examples present only the part of the process of setting own funds requirements that is addressed in these RTS. They therefore assume that there are no further adjustments to the Pillar 2 add-on which could be performed in step 5 as explained in the previous paragraph. Moreover, the scale used in these examples is not meaningful and therefore the relations between the levels of minimum and additional own funds requirements should not be read from these examples.

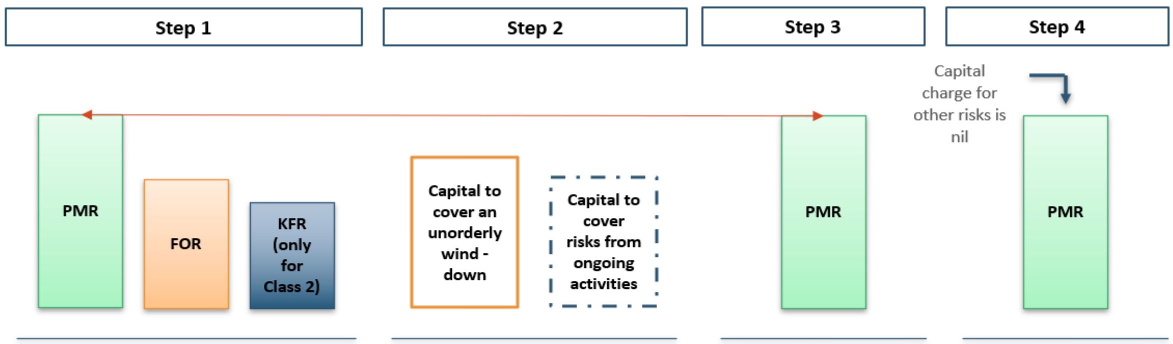
Figure 1: Example 1 of P2R determination



13. Figure 1 presents an example where FOR and KFR are lower than PMCR, which is higher than the the capital considered adequate to cover the risk of an unorderly wind down or to cover risks from

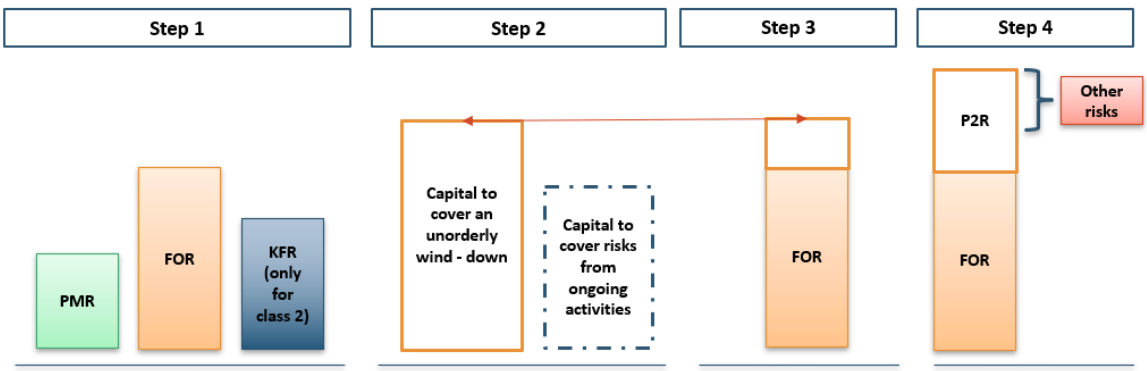
ongoing activities. In this case the Pillar 2 add-on reflects only the capital necessary to cover other risks, addressed neither by FOR nor KFR.

Figure 2: Example 2 of P2R determination



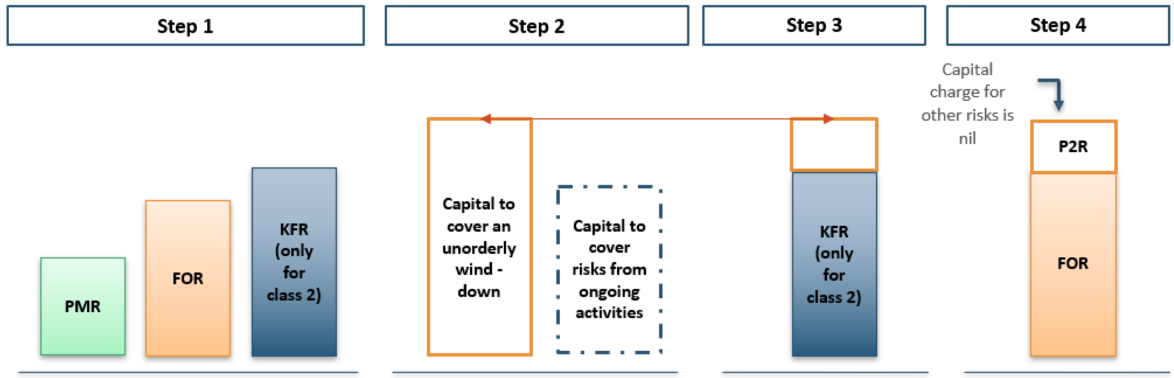
14. Figure 2 presents an example where FOR and KFR are lower than PMCR, which is higher than the capital considered adequate to cover the risk of an unorderly wind down or to cover risks from ongoing activities. In this case the Pillar 2 add-on is nil since there is no capital charge for other risks.

Figure 3: Example 3 of P2R determination



15. Figure 3 presents an example where FOR is lower than the capital considered adequate to cover the risk of an unorderly wind-down. In this case, the Pillar 2 add-ons reflects the capital necessary to cover the risk of an unorderly wind-down and to cover other risks, addressed neither by FOR nor KFR.

Figure 4: Example 4 of P2R determination



16. Figure 4 presents an example where KFR is lower than the capital considered adequate to cover the risk of an unorderly wind-down. In this case, the Pillar 2 add-ons reflects only the capital necessary to cover the risk of an unorderly wind-down since there is no capital charge for other risks.

EBA/GL-REC/20XX/XX

DD Month YYYY

EBA draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Regulation (EU) 2019/2034 (Investment Firms Directive)

COMMISSION DELEGATED REGULATION (EU) …/…

of XXX

supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying the calculation of additional own funds requirements to cover risks or elements of risks not covered or not sufficiently covered by own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2034

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,
Having regard to Directive (EU) 2019/2034 of the Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2014/59/EU and 2014/65/EU[1], and in particular the sixth paragraph of Article 40 thereof,
Whereas:

(1) To ensure harmonised application of additional own funds requirements across the Union, a uniform approach on the measurement of those requirements should be set out in this Regulation by determining the level of capital adequate to address all material risks to which the investment firms may be exposed.

(2) A detailed and comprehensive methodology, proportionate to the nature, scope and complexity of activities of the investment is necessary for competent authorities to appropriately monitor the risk profile of investment firms, and to identify, assess and quantify material risks, using all relevant sources of information. Based on this methodology, competent autorities will be able to ensure that investment firms hold adequate additional own funds to cover each risk category (risk-to-client, risk-to-firm, risk-to-market) as well as any other material risks.

(3) The level of additional own funds requirements should be seen as adequate, when it both reduces the likelihood of a failure of the investment firm and limits the risk of its unorderly wind-down that would pose threats to the firm's clients and to the wider market, including other financial institutions, market infrastructure, or the market as a whole. Due to this dual objective of additional own funds requirements, and consistently with the structure of minimum own funds requirements as set out in Part Three or Four of Regulation (EU) 2019/2033, it is appropriate that competent autorities consider separately the risks related to on-going activities of the investement firm, and the risk of unorderly wind-down of the investment firm's business.

[1] OJ L [number], [dd.mm.yyyy], [p.].

(4) To ensure that an orderly wind down of an investment firm's business is attainable, that investement firm should hold sufficient own funds to withstand additional operational expenses occuring and risks arising upon winding down period. In particular, business continuity, investor protection and market integrity should not be jeopardised during the winding down period and, to that end, the firm should be capable, also during this period, to absorb costs and losses not matched by a sufficient volume of profits. Considering that the length of the winding down period may significantly differ depending on specific circumstances, it is appropriate that competent authorities take it into account when setting additional own funds requirements. Moreover, considering the potentially diverse legal forms that investment firms can have, had to be taken into account the applicable national insolvency, corporate and trade laws, which may affect the length of wind down processes, as well as associated costs and risks.

(5) To ensure proportionality in determining additional own funds requirements, this Regulation should set out that risks and elements of risk not covered or not sufficiently covered by the K-factor requirement as specified in Article 15 of Regulation (EU) 2019/2033 should be measured only for those investment firms that are subject to the K-factor requirement in accordance with that Article 15 and not for the small and non-interconnected firms that meet the criteria specified in Article 12 and are not subject to K-factor requirement in accordance with Article 11 (2) of Regulation (EU) 2019/2033.

(6) In addition to the risks not fully or sufficiently covered by the own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033 that should be taken into account by competent authorities when determining the additional own funds requirements in accordance with this Regulation, other risks not covered at all by the own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033 including risks explicitly excluded therefrom exist for investment firms. To ensure appropriateness and proportionality, this Regulation should, therefore, specify that risks not covered at all by the own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033 including risks explicitly excluded therefrom should be assessed and measured by competent authorities on the basis of the size and business model of the invetsment firm as well as on the basis of the scope, nature and complexity of its activities.

(7) To ensure the correct measurement of risks, the risks referred to in Part Three or Four of Regulation (EU) 2019/2033 but not fully or adequately covered therefrom should, in principle, be measured separately for each risk category (risk to clients, risk to markets, risk to firm). For the same reason, the risks not covered in Part Three or Four of that Regulation included those explicitly excluded therefrom, should, in principle, be measured on a risk-by-risk basis. Nevertheless, when the measurement per risk category or on a risk-by-risk basis is not feasible or overly burdensome, this Regulation lays down, taking into account the principle of propotionality, that the measurement of risks should in those cases be performed on an aggregate level.

(8) To strike the right balance between prudential considerations and proportional application, this Regulation lays down that the measurement of risks on an aggregate level should not be applied for investment firms subject to the initial capital requirement laid down in Article 9(1) of Directive (EU) 2019/2034: these firms

subject to higher initial capital requirements should be assessed in terms of risks with a measurement per risk category and on a risk by risk basis.

(9) To ensure consistency in the measurement of material risks investment firms may pose to others or face themselves, competent authorities should rely on certain qualitative metrics. Considering that risks are evolving throughout the business cycle of a firm, it is necessary that competent authorities, not only take into account static assessment but also perform a historical trend analysis of such metrics. To appropriately capture all the relevant risks, different metrics should be used for investment firms with different business models and activities. Furthermore given that these metrics are of an indicative nature, under certain conditions, and having taken into account the business and operating models, legal form, and availability of reliable data, competent authorities may not apply or adjust the application of these metrics.

(10) To ensure that additional own funds requirements remain adequate over time, it is necessary to adjust them proportionally to any significant increase of own funds requirements as set out in accordance with Part Three or Four of Regulation (EU) 2019/2033, such own funds requirements being an indication of the scale and riskiness of the activities of an investment firm.

(11) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.

(12) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the advice of the […] Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 109x/2010 of the European Parliament and of the Council[2].

[2] Regulation (EU) No 109x/2010 of the European Parliament and of the Council ...[+*full title*] (OJ L [number], [date dd.mm.yyyy], [p.].).

HAS ADOPTED THIS REGULATION:

Article 1

Risk of unorderly wind-down

1. Competent authorities shall, having regard to the legal form, business model, the business and risk strategy and the scale and complexity of the activities of an investment firm, measure during their supervisory review and evaluation process carried out in accordance with Article 36 of Directive 2019/2034 the risk of unorderly wind-down of the investment firm's business, by determining the amount of capital that would be considered adequate for that firm to be orderly wound-down under plausible scenarios.

2. The measurement referred to in paragraph 1 shall be proportionate to the complexity, risk profile, and scope of operation of the investment firms and to the potential impact of its wind-down on clients and markets and shall include:

(a) an estimation of the realistic timeframe to wind-down the investment firms;

(b) an assessment of operational and legal tasks the investment firm will have to undertake during the wind-down process over a realistic timeframe;

(c) the identification and assessment of material fixed and variable costs;

(d) the identification and assessment of material risks or elements of risks that could materialize during the wind-down process; and

(e) any other aspect relevant for the winding-down process.

3.. Where information on recovery actions and governance arrangements is available in the investment firm's recovery plan and has been considered by competent authorities as sufficiently credible and reliable, these authorities shall take that information into account for the purpose of paragraph 2, points (b) and (c).

4. For investment firms subject to the initial capital requirement laid down in Article 9(1) of Directive (EU) 2019/2034, competent authorities shall include in their measurement:

(a) the closure costs including litigation costs for the purpose of paragraph 2, point (c); and

(b) the loss in revenues and the loss in net realizable value of assets expected to be incurred due to the wind-down process for the purpose of paragraph 2, point (d).

5. Competent authorities shall identify and quantify material costs, risks or elements of risks and determine the capital considered adequate to absorb them as set out in paragraphs 1 and 2. To assess the materiality and perform the measurement, competent authorities shall use the relevant indicative metrics referred to in Article 6(1) and combine them with static and historical trend analysis exerting thereupon expert judgment, as appropriate.

6. The capital considered adequate to cover the risk of unorderly wind-down of an investment firm's business measured in accordance with this Article shall be at least equal to the fixed overheads requirement of that firm calculated in accordance with Article 13 of Regulation (EU) 2019/2033.

Article 2

Material risks or elements of risks not captured or not fully captured by K-Factor requirements

1. Where the investment firm does not meet the conditions for qualifying as small and non-interconnected investment firm set out in Article 12(1) of Regulation (EU) 2019/2033, competent authorities shall, having regard to the business model, legal form and business and risk strategy and the scale and complexity of the activities of an investment firm, measure during their supervisory review and evaluation process carried out in accordance with Article 36 and 37 of Directive 2019/2034 any risk or element of risk deriving from the firm's on-going activities, which that firm poses to itself, to its clients and to the market and which it is not captured or not fully captured by the K-factor requirement, by determining the capital that would be considered adequate to cover the relevant risks related to K-factor requirement.

2. The measurement referred to in paragraph 1 shall be made separately for each risk category set out in Article 15 of Regulation (EU) 2019/2033 (risk-to-clients, risk-to-firm, risk-to-markets).

For investment firms subject to an initial capital requirement lower than the requirement laid down in Article 9(1) of Directive (EU) 2019/2034, where more granular quantification is deemed by competent authorities as not feasible or as overly burdensome, the measurement need not be performed at the level of each risk category but on an aggregate level.

3. The measurement referred to in paragraph 2 shall aim at identifying and quantifying material risks or elements of risks for each risk category, including risks from the use of internal models as referred to in Article 22 of Regulation (EU) 2019/2033, based on the indicative metrics set out in Article 6(2) to (4) and on expert judgment to be exerted by competent authorities.

4. Competent authorities shall ensure that the capital considered adequate to cover material risks related to K-factor requirements is not lower than the total K-factor requirements.

Article 3

Material risks or elements of risks not captured by the own funds requirements set out in Part Three and in Part Four of Regulation (EU) 2019/2033

1. Competent authorities shall, having regard to the business model, the legal form and the business and risk strategy and the scale and complexity of the activities of an investment firm, measure during their supervisory review and evaluation process set out in Article 36 of Directive 2019/2034 any risk or element of risk deriving from any of the firm's on-going activities other than those assessed under Article 2 and not already covered by the own funds requirements of that firm set out in Parts Three and Four of Regulation (EU) 2019/2033 ("D"), by determining on a risk-by-risk basis the additional capital considered adequate to cover material risks or elements of risks.

2. The measurement referred to in paragraph 1 shall include the identification, assessment and, where appropriate, the quantification of the following risk areas:

(a) the risks posed to the security of the investment firm's network and information systems to ensure confidentiality, integrity and availability of their processes, data, and assets; and

(b) the interest rate risk and credit risk arising from non-trading book activities.

For investment firms subject to an initial capital requirement lower than the requirement laid down in Article 9(1) of Directive (EU) 2019/2034, where more granular quantification is deemed by competent authorities as not feasible or as overly burdensome, the measurement need not be performed on a risk-by-risk basis but on an aggregate level.

3. To perform the measurement referred to in paragraphs 1 and 2, competent authorities shall use the relevant indicative metrics referred to in Article 6(5) and combine them with static and historical trend analysis exerting thereupon expert judgment, as appropriate.

4. The additional own funds to the requirements set out in Article 11 of Regulation (EU) 2019/2033 shall at least be equal to the capital considered adequate pursuant to paragraph 1, where such capital is not nil.

Article 4

Total material risk not captured or not fully captured by the own funds requirements set out in Part Three and in Part Four of Regulation (EU) 2019/2033

1. Competent authorities shall measure the total material risk not captured or not fully captured by the own funds requirements set out in Part Three and in Part Four of Regulation (EU) 2019/2033 by determining the level of additional own funds required as the difference between the highest of the amounts calculated in accordance with Article 1 or Article 2 and the own funds requirements D set out in Part Three or Four of Regulation (EU) 2019/2033, plus the amount calculated in accordance with Article 3.

2. For the purpose of this Article, the level of total additional own funds requirements calculated in accordance with paragraph 1 shall be expressed both as an absolute amount and as the ratio of that absolute amount to D.

In cases where the level of D varies and until a new absolute amount is been set by competent authorities as a result of the conclusion of the SREP assessment, the level of additional own funds requirements shall, at all time, be the highest between the absolute amount and the amount of additional own funds necessary for that ratio to be maintained.

Article 5

General qualitative principles for the determination of additional own funds requirements

1. To ensure that the legal form, business model, scale and complexity of activities and appropriateness of internal governance arrangements and controls of an investment firm has been taken into account when the amount of the additional own fund requirements is determined for the purposes of application of Articles 1 to 3, competent authorities shall have regard to the following:

(a) the internal capital adequacy assessment process and internal risk-assessment process by the investment firm set out in Article 24 of Directive (EU) 2019/2034 and the outcomes of their supervisory review and evaluation process assessment of these processes by the competent authority;

(b) data reported in accordance with Part Seven of Regulation 2019/2033;

(c) the outcome of the reviews carried out in accordance with Article 36 and 37 of Directive (EU) 2019/2034;

(d) the results of any other supervisory activities;

(e) other relevant inputs, including supervisory judgement.

2. Competent authorities shall apply the provisions of this Regulation in a consistent manner and shall ensure comparability in the quantification of the additional own funds requirements imposed across all investment firms under their supervisory remit.

Question for public consultation

Question 1. Do you have any comments on the structure and elements included in this Consultation Paper for the computation of Pillar 2 add-ons?

Article 6

Indicative qualitative metrics

1. For the purposes of Article 1, the metrics shall be the following:

(a) the number of tied agents compared to total staff;

(b) the average duration of a wind-down in the jurisdiction considering complexity of the investment firm's business;

(c) the share of non-cancellable contracts and residual duration of these contracts;

(d) identification of markets where the investment firm is the main service provider;

(e) the value and liquidity of fixed assets that the investment firm would have to dispose of during a wind-down;

(f) the average severance payments payable in case of a wind-down considering employment legislation and contracts with employees.

2. For the purposes of Article 2 with regards to the measurement of the risks-to-client the metrics shall be the following:

(a) the amount of client money held over the past five years;

(b) the amount of assets of clients under management over the past five years;

(c) the amount of assets safeguarded and administered for clients over the past five years;

(d) the number of clients complaints and amount of clients' compensations over the past five years;

(e) the number of trading or valuation errors and associated clients' compensations over the past five years;

(f) specifically for investment firms that are portfolio managers or execution brokers:

- the number of breaches of investment mandates and associated losses, including litigation costs, over the past five years;
- the number of major IT disruptions preventing clients to appropriately manage their transactions and related losses over at least the past five years;

(g) specifically for the investment firms that are investment advisors, the number of unsuitable investment advices and associated clients' compensations over five years; and

(h) specifically for investment firms holding clients money, any inability of the investment firm to timely return client money when required and associated financial consequences over the past five years.

3. For the purposes of the application of Article 2 with regard to the measurement of the risks-to-market the metrics shall be the following**:**

(a) the variability of the value of the positions, including due to changing market conditions;

(b) the share of complex and illiquid products in the investment firm's trading book, in terms of volume and net income; and

(c) specifically for investment firms using internal models, the availability of regular back-testing of models used for regulatory purposes.

4. For the purposes of the application of Article 2 with regard to the measurement of the risks-to-firm the metrics shall be the following:

(a) the daily trading flow;

(b) any significant operational events related to daily trading flow and associated financial losses over the past five years, including processing errors;

(c) the variability of the investment firm's income and revenues over the past five years;

(d) the rate of clients or counterparties' default, and associated losses over the past five years;

(e) any losses due to material changes in the book value of assets, including due to changes in market conditions and in creditworthiness of counterparties;

(f) the amounts and variability of payments or contributions under defined benefit pension scheme over the past five years;

(g) any concentration of the investment firm's assets, including clients and counterparties concentration, as well as sectoral and geographical concentration; and

(h) the share of off-balance sheet exposure compared to the investment total assets and related credit risk.

5. For the purposes of application of Article 3 the metrics shall be the following:

(a) any indications of significant financial risks not addressed by own funds requirements set out in Article 11 of Regulation (EU) 2019/2033, in particular:

- the average of total operational risk losses over gross income over the past five years;
- any significant operational events and associated financial losses over the past five years;
- the share of the investment firm's net income coming from businesses or activities that are not listed under Directive 2014/65/EU, such as corporate finance businesses or insurance distribution;

(b) any indication of significant information and communication technology (ICT) risk, in particular:

- the overall complexity of ICT architecture, including share of outsourced ICT services;
- the number of material changes within the ICT environment over the last five years;
- any losses due to disruption due to incidents touching critical ICT services over the last five years; and

- the number of cyberattacks and related losses over the last five years;

(c) any indication of significant interest rate risk arising from non-trading book activities, in particular:

- the volume of transactions based on interest rates or otherwise depending on interest rate, outside of the trading book of the investment firm; and
- the investment firm's hedging policy and potential misalignments between the position and the hedge, outside of the trading book of the investment firm.

6. The metrics referred to in paragraphs 1 to 6 shall not be used or shall be used with adjustments while other metrics shall be used as appropriate by competent authorities, where any of the following conditions apply:

(a) the metric is not appropriate considering the specific legal form, structural changes, business and operating model of the investment firm;

(b) the estimation of the metric is overly burdensome considering the size and complexity of activities of the investment firm;

(c) the estimation of the metric is not feasible due to lack of reliable data, where such data do not fall under Articles 54 and 55 of Regulation 2019/2033 or Article 39 (2), point (j) of Directive 2019/2034;

(d) the estimation of the metric is not feasible due to the lack of reliable historical data rendering the historical analysis periods irrelevant. In such cases, competent authorities shall limit the period of the historical analysis to the time passed since the last supervisory review and process set out in Article 36 of Directive (EU) 2019/2034.

7. Competent authorities could extend the list of indicators pursuant to paragraphs 2 to 6 while ensuring that such additional indicators are proportionate to the investment firm's size, complexity, business, and operating models.

Question for public consultation

Question 2. Do you agree with the proposed indicative qualitative metrics? Are there any other aspects or situations not sufficiently taken into account in this proposed approach?

Article 7

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union.*

It shall apply from 1 January 2023.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]

4. Accompanying documents

4.1. Draft cost-benefit analysis / impact assessment

Article 40(6) of Directive (EU) 2019/34 mandates the EBA to develop draft RTS to specify how to measure the risks and elements of risks that are not covered or are insufficiently covered by the own funds requirements set out in Part Three and Four of Regulation (EU) 2019/2033, including risks that are explicitly excluded from these requirements.

As per Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation), any RTS developed by the EBA shall be accompanied by an analysis on 'the potential related costs and benefits'.

This section presents the cost-benefit analysis of the provisions included in the draft RTS as described in this Consultation Paper. The analysis provides an overview of problem identified, the proposed options to address this problem and the potential impact of these options. Given the nature and the scope of the draft RTS, the analysis is high-level and qualitative in nature.

A. Problem identification and baseline scenario

Until 25 June 2021, the prudential rules for investment firms were part of the wider EU prudential framework which applies to banks, as set out in Regulation (EU) No 575/2013 and Directive 2013/36/EU, also known as the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD), respectively. The minimum own funds requirements of an investment firm were based on its prudential categorisation, which was primarily determined by its MiFID investment services and activities, as well as its ability to hold money and securities belonging to its clients.

Under Article 104(a)(1) of the CRD, competent authorities had the power to require from certain categories of investment firms to hold own funds in excess of the own funds requirements set out in Chapter 4 of Title VII of the CRD and in the CRR relating to risks and elements of risks not covered by Article 1 of that Regulation. The appropriate level of these additional own funds requirements was determined on the basis of the supervisory review and evaluation process (SREP), for which the EBA has issued Guidelines to promote common procedures and methodologies applied in the supervision of all institutions across the EU.[3]

On 26 June 2021, most investment firms became subject to a new prudential framework, composed of Regulation (EU) 2019/2033 and Directive (EU) 2019/2034, also known as the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD), respectively. As a result, the existing Guidelines for common procedures and methodologies for the SREP and supervisory stress testing are not fit for purpose and the EBA has been mandated under Article 45(2) of the IFD to develop

[3] https://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-for-common-procedures-and-methodologies-for-the-supervisory-review-and-evaluation-process-srep-and-supervisory-stress-testing

dedicated GL for investment firms on the common procedures and methodologies for SREP. In addition, under Article 40(6) of Directive (EU) 2019/34 the EBA has been mandated to develop these draft RTS, specifying how to determine additional own funds requirements based on the outcomes of SREP.

The SREP Guidelines help competent authorities to understand if the investment firm is exposed to risks or elements of risks or poses risks to others that are material and are not covered or not sufficiently covered by the minimum own funds requirements. However, they do not provide a harmonized methodology on how to measure these risks and determine the adequate level of additional own funds investment firms need to hold to cover them. This can create an unlevel playing field across the EU, where competent authorities adopt different methodologies for the purposes of setting additional own funds requirements. Therefore, more specific clarifications with regard to determination of own funds requirements are included in these draft RTS.

B. Policy objectives

Investment firms throughout the EU are an important element of a well-functioning economy, thanks to their key role in efficient capital allocation. Adequate supervisory requirements are therefore necessary to reduce the likelihood of failure of an investment firm, or, in the event that it does fail, to limit the risk of unorderly wind-down that could bring disruption to clients, counterparties or to the markets in which it operates.

The specific objective of these draft RTS is to establish a harmonised methodology for the determination of adequate additional own funds requirements investment firms should hold to cover any risks or elements of risks that are not covered or not sufficiently covered by the own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033. Generally, the draft RTS aim to create a level playing field by setting common requirements for the measurement of risks and elements of risks arising from investment firms' various businesses and activities.

The methodology specified in these draft RTS promotes the application of supervisory requirements better aligned with the investment firm's size, complexity and business model that should also help improve the efficiency and stability of financial markets, as well as market confidence in the sector overall. The draft RTS should also have a positive impact on investor protection while strengthening capital requirements against a disorderly failure and therefore against the investment firm's inability to restore client money and assets, placing therefore less reliance on investor compensation schemes.

C. Options considered, Cost-Benefit Analysis, Preferred option

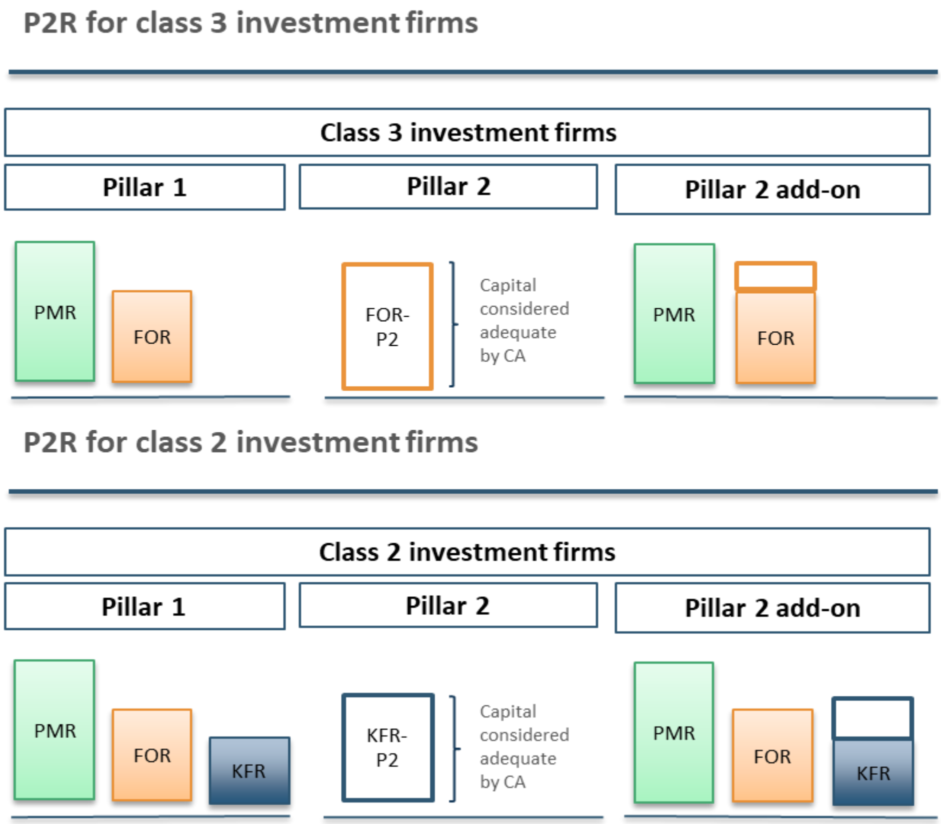
This section presents the main policy options discussed during the development of the CP, the costs and benefits of these options, as well as the preferred options retained in the CP.

Determination of additional own funds requirements

The EBA considered two policy options regarding the determination of additional own funds requirements:

Option 1a: Determine the Pillar 2 add-on by calculating the capital considered adequate, i.e. for class 3 investment firms only Pillar 2 add-on to cover the risk of an unorderly wind-down, and for class 2 investment firms only Pillar 2 add-on to cover the risks-to-clients, the risks-to-firm and risks-to-markets from its ongoing activities;

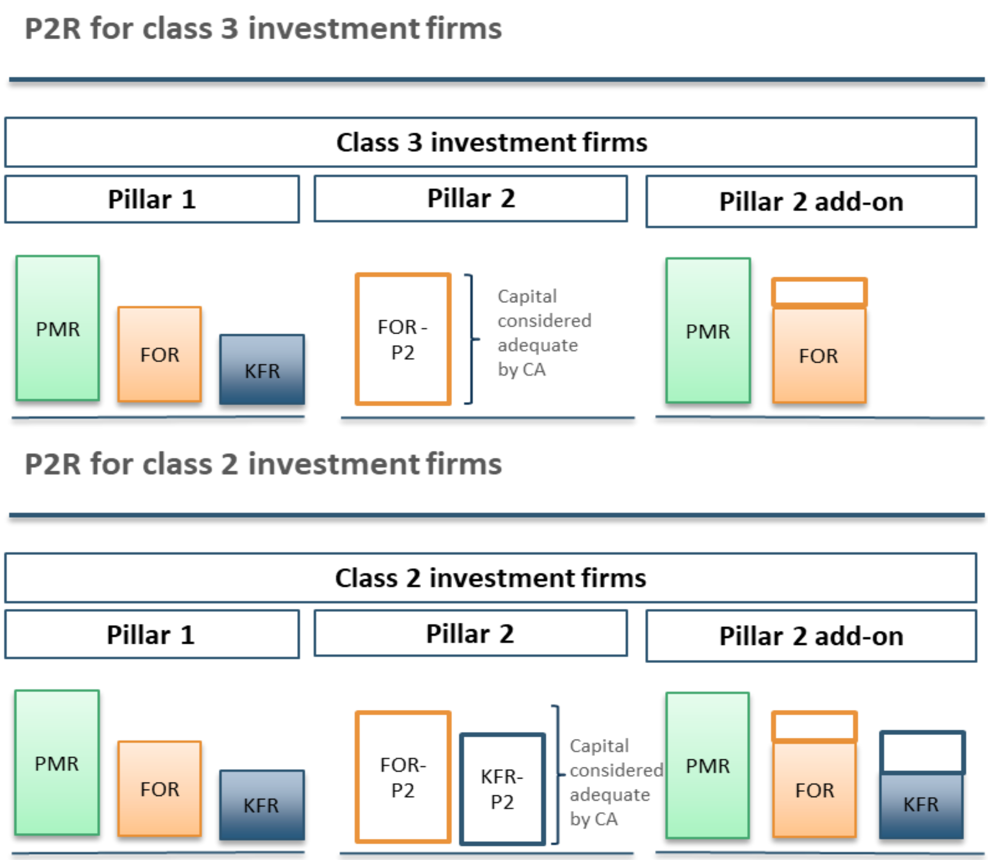
Figure 5: Schematic illustration of Option 1a



Note: The size of the PMR, FOR, KFR and P2R is not meaningful/indicative only.

Option 1b: Determine the Pillar 2 add-on by calculating separately the capital considered adequate (i) to cover all risks and elements of risks arising from the investment firm's ongoing activities and (ii) to cover the risk of unorderly wind-down.

Figure 6: Schematic illustration of Option 1b



Note: The size of the PMR, FOR, KFR and P2R is not meaningful/indicative only.

Option 1a is a simplified approach focused on K-factors requirements for class 2 investment firms, considering that this is the most risk sensitive part of minimum own funds requirements. However, such approach lacks consistency with the structure of Article 11 of Regulation (EU) 2019/2033 and could affect the level playing field and result in the imposition of disproportionate Pillar 2 add-ons, considering that similar share of class 2 investment firms is bound by the fixed overheads requirements or by K-factors requirements (see Table 1). Furthermore, such simplified approach may not be sufficiently prudent by not capturing appropriately the risk of unorderly wind-down.

Table 1: Number of investment firms broken down by constraining requirement, by class

Class	PMCR	FOR	K-factors	Total
Class 2	46	80	69	**195**
Class 3	40	119	-	**159**
Total	**86**	**199**	**69**	**354**

Source: 2020 EBA data collection for investment firms and EBA calculations.[4]

[4] For more information on the 2020 EBA data collection for investment firms see the Final draft RTS on prudential requirements for Investment Firms (EBA/RTS/2020/11)

Option 1b is consistent with Regulation (EU) 2019/2033 by better distinguishing between class 2 and class 3 investment firms, the latter not being subject to K-factors requirements. The structure of minimum own funds requirements as set out in Article 11 of Regulation (EU) 2019/2033 is duplicated under Pillar 2 by distinguishing the capital considered adequate to cover the risks of an unorderly wind-down, and to cover the risks related to the investment firm's ongoing activities, the latter being only computed for class 2 investment firm. Therefore, this option is both more prudent and more proportionate than option 1a.

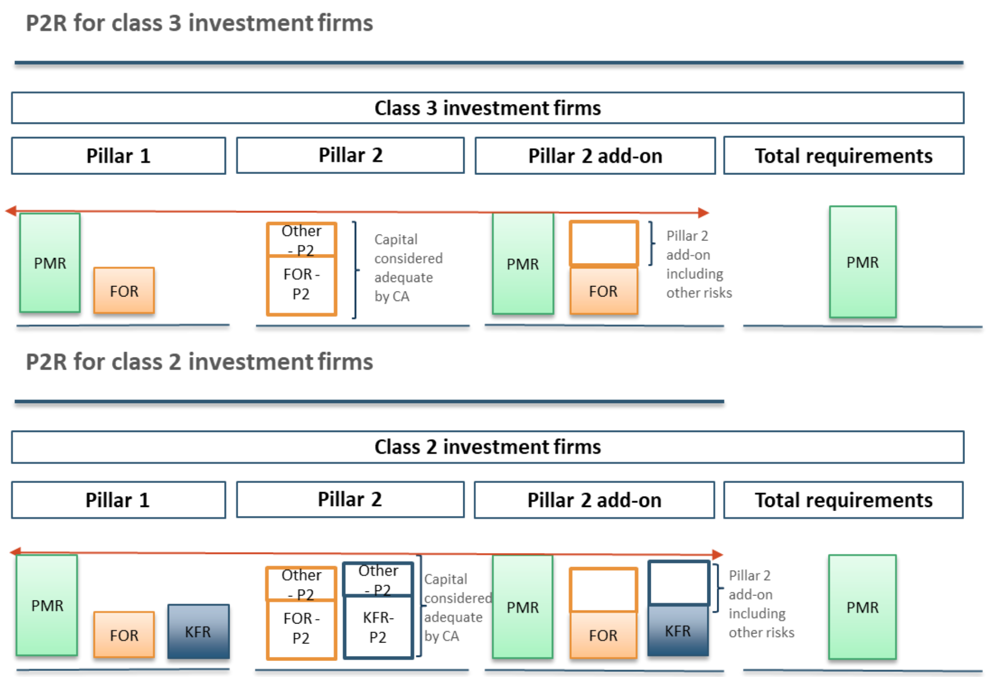
Option 1b is the preferred option.

Determination of additional own funds requirements to cover risks or elements of risks not covered by Pillar 1 requirements

The EBA considered two policy options regarding the determination of additional own funds requirements for risks not covered by own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033:

Option 2a: Determine the Pillar 2 add-on as the difference between the capital considered adequate, including the capital considered adequate to cover other risks not covered by Pillar 1, and the Pillar 1 requirements;

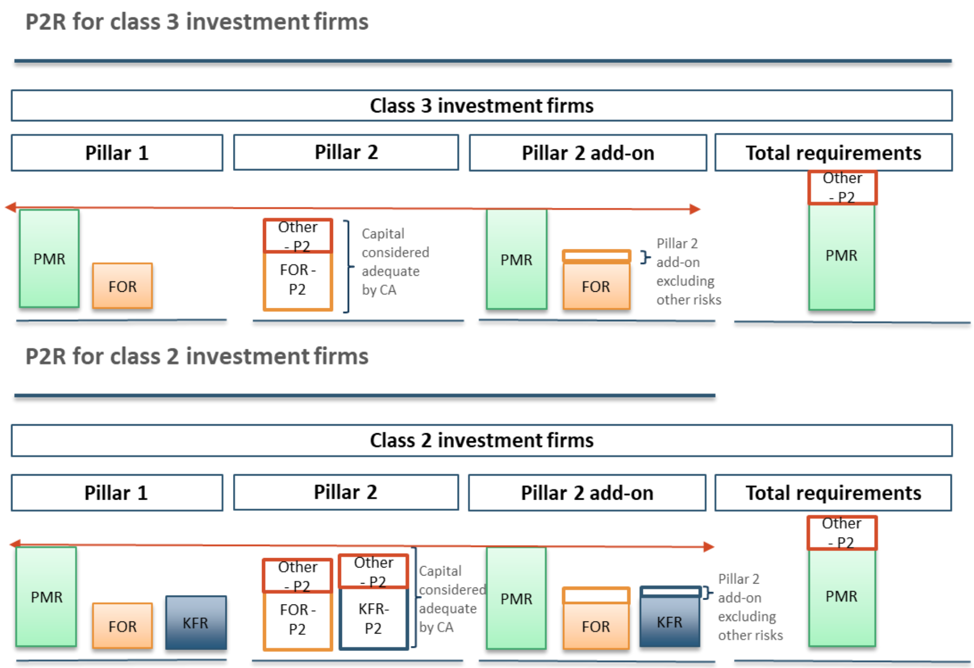
Figure 7: Schematic illustration of Option 2a



Note: The size of the PMR, FOR, KFR and P2R is not meaningful/indicative only.

Option 2b: Isolate the Pillar 2 add-on to cover other risks not covered by Pillar 1 requirements and add it to the difference between the capital considered adequate and the Pillar 1 requirements.

Figure 8: Schematic illustration of Option 2b



Note: The size of the PMR, FOR, KFR and P2R is not meaningful/indicative only.

Under option 2a, the Pillar 2 add-on is the difference between the capital considered adequate to cover the risks and elements of risks not covered or not sufficiently covered by own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033, in line with Article 40(3) of Directive (EU) 2019/2034, in an aggregate manner. Such approach allows to use components of own funds requirements to cover potential material risks that cannot reasonably be attributed to any Pillar 1 requirements.

Under option 2b, the Pillar 2 add-on presents a dual structure. Its first component is computed as the difference between the capital considered adequate to cover the risks and elements of risks not sufficiently covered by own funds requirements set out in Part Three or Four of Regulation (EU) 2019/2033, in line with Article 40(3) of Directive (EU) 2019/2034. Its second component is equal to the capital considered adequate to cover risks that are not covered by own funds requirements. This ensures that any risks the investment firm is facing or poses to others that cannot reasonably be attributed to any own funds requirements are adequately covered by a dedicated Pillar 2 add-on.

Option 2b is the preferred option.

Use of indicative qualitative metrics to support the determination of the Pillar 2 add-on

The EBA considered three policy options regarding the use of indicative qualitative metrics to support the identification and assessment of material risks and determination of the Pillar 2 add-on:

Option 3a: Determine a set of mandatory metrics;

Option 3b: Determine a set of mandatory metrics whose application is conditioned to a set of criteria;

Option 3c: Determine a set of optional metrics.

Under option 3a, the draft RTS specify a set of mandatory metrics to support competent authorities in the identification, assessment and quantification of material risks and elements of risks not covered or not sufficiently covered by Part Three or Four of Regulation (EU) 2019/2033. Nevertheless, this option does not adequately capture the terms of the mandate requiring taking into account the range of different business models and legal forms that investment firms may take, as well as the implementation burden on both investment firms and competent authorities.

Option 3b solves the issue stated in option 3a by providing a set of mandatory metrics to support competent authorities in the identification, assessment and quantification of material while permitting to adjust or disregard some metrics under specific conditions linked to the size, complexity of activities, business models of the investment firms, as well as the considering the availability of data and implementation burden for both the investment firms and the competent authorities. It therefore ensures harmonisation, while allowing sufficient flexibility to competent authorities to take into account the specificities of the investment firm and other circumstances.

Under Option 3c the draft RTS specify a set of optional metrics to support competent authorities in the identification, assessment and quantification of material risks and elements of risks not covered or not sufficiently covered by Part Three or Four of Regulation (EU) 2019/2033. Nevertheless, leaving full discretion to competent authorities to select the metrics relevant for their analysis would not contribute to consistency of supervisory practices and would not fulfil the mandate granted to the EBA for developing these draft RTS.

Option 3b is the preferred option.

4.2 Overview of questions for consultation

Question 1. Do you have any comments on the structure and elements included in this Consultation Paper for the computation of Pillar 2 add-ons?

Question 2. Do you agree with the proposed indicative qualitative metrics? Are there any other aspects or situations not sufficiently taken into account in this proposed approach?