AFME response to Call for Evidence – EU regulatory framework for financial services

28 January 2016

Executive summary

Viewed in isolation, many recent regulatory reform measures were both necessary and have had their intended effects. The reform programme has substantially strengthened the resilience of the banking sector and improved investor protection and is also significantly reshaping how financial markets operate. Banks are now much less likely to fail; and were they to do so, authorities have the tools to ensure that they can fail with any losses being borne by bank investors rather than taxpayers. With the majority of the regulatory reform programme now adopted, the Commission is right to start examining the interactions between the various reforms and assessing their cumulative impact on the economy, on corporates and investors and on the financial markets. Such assessment is technically challenging for both industry and policymakers but it is essential. The new set of regulations may not be fully consistent and it is important that policymakers avoid negative, unintended consequences.

Formally, the Call for Evidence focuses on rules which have already been adopted by the co-legislators to date. However, a number of important initiatives are still in train at the EU level (e.g. Bank Structural Reform (BSR) and the FTT) and at Basel level (e.g. internal models and sovereign risk). These initiatives are of real significance for Europe's economy and the capital markets – including primary and secondary markets in equities, FICC markets and their related derivatives markets. We therefore urge the Commission to consider such measures in its assessment.

Banks facilitate access to financial markets, matching issuers with investors and providing underwriting services to non-financial companies and governments. If Europe is to develop its capital markets, policymakers need to focus not only on specific measures to benefit markets but also to consider the impact of new regulation on banks' ability to provide capital market services. In particular, it is vital that policies designed to improve the safety of banks do not inadvertently undermine those directed at enhancing the development of capital markets. Preserving market liquidity is crucial both from a financial stability point of view and as a core requirement for the successful development of European capital markets.

Regulatory reform – and in particular additional capital requirements – has already forced bank deleveraging resulting in a reduction in banks' lending capacity and market-making capacity. For instance, European corporate bond trading volumes fell by up to 45% between 2010 and 2015, while dealer inventories have also declined significantly. Several major firms have also recently withdrawn from their primary dealer role in European sovereign bond markets. While some regulatory effects were intended in relation to market-making, there is a risk that some policy measures have gone too far, with their full impact still being masked by exceptionally loose monetary policy.

Our focus in responding to the Call for Evidence is on pro-active suggestions for change that would benefit the economy. The examples provided in this response should be read in conjunction as, when combined, they show the cumulative impact of the individual regulations that are discussed. This paper should be read alongside our supplementary evidence note which provides a broader economic overview of the regulatory reform programme, its impact on financial stability and the current state of market liquidity, credit allocation and long-term investment. Below we highlight nine concrete recommendations for action, drawn from the longer list of issues in this response. In taking forward further regulatory reforms, we would encourage the Commission to follow three overarching principles:

- **Focusing on jobs and growth**. There is a need to reorient the EU's regulatory agenda. The forthcoming reviews of Level 1 legislations must be used to address problems and assess the impact of regulations, focusing on key CMU themes of diversifying funding sources that lead to job creation and support economic growth.
- **Improving coordination between markets and prudential regulators**. Better coordination is needed between market and prudential regulators across different jurisdictions to avoid unintended cumulative impacts on growth and market liquidity. The key measures to consider are MiFID II, EMIR, CRD IV, BSR, Solvency II, UCITS V and AIFMD.
- **Following a better regulation approach**. The legislative institutions should follow an evidence based legislative approach that leads to sufficient flexibility to keep pace with market/sector developments. In this context we note the recently reached agreement between the EU institutions on better regulation. The intentions of Level 1 and Level 2 legislation also need to be better aligned, which could be achieved by keeping Level 1 legislation more high level and introduce fewer fixed thresholds. There must be sufficient time between the finalisation of Level 2 texts and the implementation of new regulation, for both regulators and the industry to make the appropriate resourcing, structural and systems changes. The Commission should consider whether the ESAs require additional tools to vary timing of implementation of certain measures or to respond to industry requests for clarification of unclear Level 1 legislation.

Our main proposals in response to the call for evidence are set out in the table below. The stand-out recommendations for reform concern the need to:

1. avoid further restrictions on market liquidity by *inter alia* amending CSDR and re-evaluating the case for BSR;
2. make targeted changes to prudential rules (e.g. CRR, Solvency II) which may be restricting financing to the economy; and
3. carefully reflect before imposing any new regulatory burdens at Basel level.

Recommendation	**Rationale**
Capital markets regulation	
1. Coherent oversight by EU policymakers of issues affecting wholesale market liquidity	It is acknowledged by officials and the industry that changes to banks' prudential regulations will reduce secondary market liquidity compared to prior levels. Capital markets regulations are likely to add to this effect. For example, MiFID II increases the risk of exposure for market makers and investors and could thereby reduce market liquidity. Also the introduction of a mandatory buy-in regime through CSDR is likely to have a damaging effect on liquidity.

	Due to a variety of factors, including the impact of quantitative easing, it is not yet possible to assess whether these changes pose material risks to financial stability in Europe. In order to achieve a longer range view of possible future risks, and to develop a proactive and transparent early warning process, AFME recommends the establishment of a permanent joint working group of senior central bank and regulatory officials and representatives from investors, corporate and bank trading desks. This European Capital Markets Liquidity Expert Group would assess various market liquidity factors and make recommendations to Commission, Council and Parliament on possible adjustments to regulations that have recently been implemented or are about to come into force.
2. Successful Securitisation Framework	In order to be successful, the new STS securitisation framework must work for the bulk of the market. It would be self-defeating if the new framework were so onerous in terms of its criteria and calibration that only a small part of the market could comply, or little benefit could be achieved by complying. The new framework must also make securitisation attractive for both issuers and investors and the compliance with the new framework must be practical, quick and certain for issuers and investors. The market needs a more level playing field with other fixed income instruments: for example, the liquidity treatment of qualifying securitisation in terms of haircuts, limits, etc., under the LCR should be much closer to that of covered bonds. Prudential treatment of European securitisation should be considered in the context of its strong performance before, throughout and since the crisis. Furthermore, policymakers should not seek to remove all risk from securitisation because risk, sensibly managed and distributed, is an inevitable and healthy feature of all financial markets.
3. Streamlining reporting requirements	A number of regulations that are already in place or are in the process of being implemented introduce new reporting requirements. Although the additional reporting introduced may contribute to financial stability, it may also create duplicative and redundant reporting. It is important that the regulatory authorities focus on streamlining the different reporting obligations and better coordinate the different reports that firms are required to provide. The information requested under the various reporting requirements must be directly relevant to the specific transaction or market and should be requested from the party (or parties) that has access to, or control over, such information.
4. Carefully examine the potential effects of regulations on the post-trade area	The CSD regulation states that transactions should be bought-in or cash compensated following a certain period of time. In addition, a daily penalty fee should be levied against the failing party. Our expectation is that this regulation will have the unintended consequence of reducing liquidity in trading of less liquid stocks, possibly leading to market makers ceasing to make two way prices in securities. The mandatory nature of the buy-in is expected to generate significant numbers of buy-in each day (according to an ECSDA survey) whilst the numbers in the current

	voluntary framework are minimal in normal market circumstances. Furthermore, the buy-in RTS are expected to contain provisions for certain transactions to be bought in at the settlement participant level, rather than the trading level. The consequence is that settlement participants will seek collateral from trading parties to ensure they do not incur significant costs if the trading party does not honour their obligation (either to deliver or to pay the resulting costs). As high quality collateral is required for many other purposes, this will pose a significant additional burden. For example, for government bonds it has been estimated[1] that market makers will increase their spread by 116% to compensate for settlement fines and potential buy-in.
Prudential regulation	
5. A pause at Basel level	While the legislative phase of EU financial reform is largely finalised, significant initiatives are still underway at Basel (BCBS) level with the expectation that the EU will adopt these standards once they are completed. The ongoing BCBS regulatory programme is far reaching and amounts to a fundamental review of the approach to determining and supervising regulatory capital. This programme might well require a further increase in banks' capital requirements, which could reduce both bank and market based financing of the European economy. While the BCBS should continue running impact assessments on how the proposed bank regulation impacts capital numbers and recalibrate the proposals accordingly, the Commission, with its wider economic mandate, should also assess the broader economic impacts on EU markets before the BCBS rules are finalised. If the EU concludes that certain pending BCBS reforms should not be pursued, it should take that conclusion back to the relevant global forum and actively seek to preserve a global level playing field to the greatest extent possible, with respect to both the rules themselves and the timing of their implementation. The importance of global consistency is in fact not only important in the context of prudential regulation, but also market regulation.
6. Targeted changes to CRD IV / CRR and Solvency II	In the context of the impact of regulation on direct bank lending, the Commission should consider the following targeted changes: ➢ *Specialised lending exposures:* the capital treatment of specialised lending needs to be revisited; ➢ *Treatment of derivatives under the leverage ratio calculation:* the leverage ratio increases the cost of providing client clearing business which can lead to banks giving up this business model and we believe that the leverage ratio should be amended to recognise the exposure-reducing effect of segregated margin. This also runs counter to the purpose of the EMIR derivative clearing requirement; ➢ *CRR and Solvency II capital charges and liquidity coverage*

[1] ICMA report (2015) 'Impact Study for CSDR Mandatory Buy-ins'

	requirements for STS securitisation: calibration of capital treatment better to reflect the true economic risk and strong historical performance of STS securitisation for banks (under the proposed CRR Amendment) and for insurers (under Solvency II), as well as adjustments to the Delegated Act on LCR to level the playing field between STS securitisation and covered bonds, are necessary in order to revive the STS securitisation market; and ➢ *SME scaling factor:* continuation of some type of SME scaling factor, and evaluation of a similar type of scaling factor for other key asset classes such as infrastructure finance from both banks and insurers. We also believe that excluding balances held on deposit at central banks from the Exposure Measure of the Leverage Ratio would: (1) provide a more accurate reflection of banks' exposures, (2) prevent disincentives for banks to maintain high levels of liquidity, and (3) reduce the likelihood that the leverage ratio will be unintentionally a binding measure.
7. Careful assessment of banks' funding costs and impact on markets and lending	The BSR proposal is expected to increase the funding and capital costs of banks and thereby the cost of lending to the economy, as well as limiting banks' ability to make markets. We believe that existing Level 1 reforms already address perceived risks in banks' trading and financial markets activities. As highlighted elsewhere in our response, the implementation of the CRR/CRD IV, Bank Recovery and Resolution Directive ("BRRD"), Banking Union, MiFID/R and EMIR, combined with enhanced supervision, has already improved significantly the strength of the banking industry as well as the stability of the financial system. The beneficial impact of the BRRD framework should be examined carefully. Recent analysis conducted by the Bank of England concludes that resolution arrangements "are expected to improve market discipline, and thereby reduce the probability of a future financial crisis by around a third and to reduce the net present value of the economic cost of a crisis from around three-quarters to just under half of pre-crisis GDP"[2]. In addition, the Fundamental Review of the Trading Book, which aims to more accurately calibrate capital requirements for banks' trading books, is now complete. The increased capital requirements and improved transparency coupled with supervisors' ability to address trading risks at a desk level will provide a further direct tool for authorities to address risks where they arise. Moreover, supervisors have and apply broad powers under Pillar 2 to ensure banks capitalise excess risk that is not necessarily captured under Pillar 1 minimum requirements. As the objectives of the BSR proposal have already been met by existing reforms, and considering the economic costs of the proposals, the Commission should re-evaluate the economic rationale for continuing with the BSR Regulation.

[2] Bank of England Supplement to the December 2015 Financial Stability Report: the framework of capital requirements for UK banks

8. Cross-asset class and cross-sectoral review of incentives for funding	SMEs, infrastructure and Simple Transparent Standardised (STS) securitisation are three key asset classes that have very different regulatory treatment across banks, insurers and various types of funds (UCITS, AIFM, ELTIF, IORP etc.). Capital charges for banks and insurers for these three asset classes should be reviewed as a matter of urgency to determine whether they are broadly consistent on an adjusted basis and whether they are calibrated appropriately given the risk profiles of these three sectors and their importance to the EU economy.
9. Careful implementation of the NSFR in Europe required	We have significant reservations in relation to the BCBS NSFR standard, including the treatment of derivatives linked transactions and repos. These treatments could have a substantial dampening effect on the liquidity of securities markets leading to less ability for customers to manage risk, and increased volatility. Implementing the NSFR in Europe should take account of these issues. Some of the NSFR requirements relating to derivatives will have material detrimental effects on the hedging costs of end clients without a clear rationale.

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Rules affecting the ability of the economy to finance itself and grow

Issue 1 – Unnecessary regulatory constraints on financing

"The Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment."

Example 1 for Issue 1

CRD IV / CRR: reduction in corporate lending

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRD IV (Directive 2013/36/EU) / CRR (Regulation (EU) No 575/2013).

- **Please provide us with an executive/succinct summary of your example.**

CRD IV / CRR, one of the cornerstones of the regulatory reform programme, has greatly reduced the likelihood that banks will fail by making them less leveraged and more liquid. Comparing like with like, the CRD IV / CRR will require banks to hold ten times more equity capital than before the crisis[3]. AFME recently responded to the Commission's consultation on CRD IV / CRR[4], but it is worth summarising our views on the impact of this prudential package on the ability of the financial sector to finance the economy. Overall, AFME is very supportive of CRD IV and acknowledges its importance for financial stability. There are however some areas of the legislation where we believe improvements could be made.

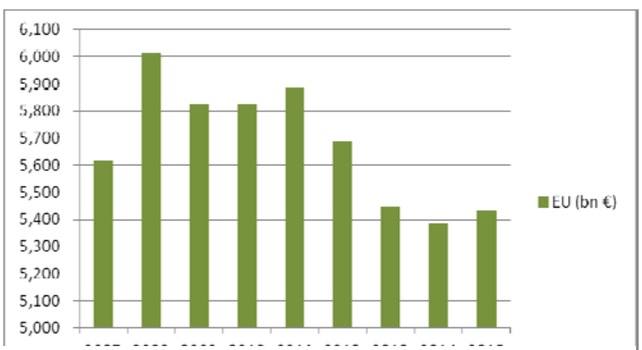


Figure 1: Stock of bank lending to non-financial corporations in EU 28 Member States, source: ECB

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)

Figure 1 shows how the European banking system has become a lot more deleveraged in recent years. Regulation is like to have been, intentionally, one of the major factors causing delivering. Balance sheet strengthening as required by CRD IV has a price. Across 24 banks surveyed by PwC[5], total assets fell by 12% between 2008 and 2013. PwC estimates that market capacity (measured as total assets that can be supported by a given amount of Tier 1 capital) has decreased by 1/5 across all banks in their sample and by 1/3 across investment banks between 2009 and 2013.

The table below shows the multitude of actions banks have taken in response to reform,

[3] Paul Tucker, "Regulatory reform, stability and central banking", Hutchins Centre on Fiscal & monetary Policy at Brookings, January 2014. The annex to the Commission's CRR Review consultation refers in fact to an increase that could be as great as 13 times the pre-crisis requirements.

[4] AFME response to the European Commission's consultation on impact of the CRR and CRD IV on bank financing of the economy

[5] PwC report (2014) 'Impact of bank structural reform in Europe'

both in terms of restructuring their organisations and product offerings. The extent of these changes clearly indicates that we could very well be facing an over-correction, beyond what could be considered as “necessary deleveraging”, with financing, including activities enabling market based financing and services that indirectly support economic agents, being affected.

	Organisational restructuring	RWA, capital & leverage	Proprietary trading	Non-core activities	Investment in risk management	Product / asset exits	Jurisdictional / regional exits	Change in target clients	Cost reduction initiatives
ABN AMRO	✓	✓			+	✓	✓	+	✓
Banque Populaire	+	✓	✓	✓	✓	✓			✓
Barclays	✓	✓	+	✓	+	✓	✓		✓
BBVA	✓	✓	✓	+	✓	✓	✓		+
BNP Paribas	✓	✓	✓	+	+	✓	✓		✓
Citi	✓	✓	✓	✓	✓	✓	✓	✓	✓
Commerzbank	✓	✓	✓	✓	✓	✓	+		✓
Crédit Agricole	✓	✓	✓	+		✓	✓	✓	✓
Credit Suisse	✓	✓	✓	✓	✓	✓	+	✓	✓
Danske Bank	✓	✓		✓	✓	✓	✓		✓
Deutsche Bank	✓	✓	✓	✓	✓	✓	+	+	✓
HSBC	✓	✓	✓	✓	✓	✓	✓		✓
ING	✓	✓	✓	✓	✓	✓	✓	✓	✓
Intesa Sanpaolo	✓	✓		✓	+	✓	✓		✓
Lloyds	✓	✓	✓	✓	✓	+	✓		✓
Morgan Stanley	+	✓	✓	+	✓	✓	✓	+	✓
Nordea	✓	✓		+	✓	+	✓		✓
Rabobank	✓	+		+	+	✓	✓		✓
RBS	✓	✓	✓	✓	+	✓	✓	✓	✓
Santander	+	✓	+	✓	✓	+	+	✓	✓
Société Générale	✓	✓	+	✓	✓	✓	✓	+	✓
Standard Chartered	✓	✓	+	+	✓	+	+		✓

Table 1: *Structural, operational and financial changes within banks,*
Source: PwC study “Impact of bank structural reforms in Europe”

The decrease in lending to corporates, the structural and comparably small share of market-based financing in Europe and the increasing pressure on market liquidity are all signs that choice for banking customers has been reducing and will continue to do so. It is probably possible to argue that other factors such as ultra low interest rates and general growth prospects for certain market segments have also been drivers of market changes. At the same time it needs to be acknowledged that higher capital requirements as well have forced banks to respond by changing their business structure.

The reduction in bank lending has partly been masked by an increase in capital market issuance. Also, the ECB Access to Finance Surveys[6] show relatively weak demand for credit amongst non-financial corporates, and that SMEs are more concerned with finding customers than accessing finance. However, when credit demand does return together with economic growth, banks may very well not be a position to support this growth.

A recent paper by De Nederlandsche Bank (DNB) provides a review of the literature on the effect of bank capital requirements on economic growth[7]. While recognising the challenges in disentangling credit supply and credit demand effects, the paper notes that "most empirical evidence suggests that increase in capital requirements by one percentage point force banks to cut their total lending in the short run by 1.2-4.5% or reduce credit growth by 1.2-4.6 percentage points".

One of the suggestions that we make in the following section would address the issue of banks having to hold capital against central bank deposits and unencumbered high-grade sovereign bonds. Such assets are backed by the full faith and credit of the central government. As a result, these assets do not represent a meaningful exposure against which banks should be required to hold capital. Also the sovereign exposures do not increase banks' risk profiles. In particular, flight to safety becomes more difficult at times of stress if excess cash that investors are willing to deposit with a bank – and a bank would deposit with a central bank – are included in the leverage ratio. Banks may not want to take these often large deposits at short notice due to the associated significant capital requirements, leaving investors exposed to market risk they are trying to avoid.

Additionally, central bank deposits and repo programmes are important elements in supporting monetary policy objectives. If banks' transactions with central banks attract full leverage ratio capital requirements, there are limited incentives for banks to use these facilities and the interest rate transfer mechanism would therefore be ineffective and tighten credit to bank-dependent sectors of the economy. From a monetary policy perspective, outright securities purchases, or Quantitative Easing ("QE"), would become the only monetary tool left in the toolkit as other central bank programmes would inevitably increase banks' capital requirements, becoming a drag on profitability and hence reduce banks' capacity to rent balance sheet. This thereby impacts the banks' capacity to support the economy. The below figure shows the flight to central bank deposits for the ECB and Bank of England. It shows that banks deposit significant amounts of cash with the central bank, in particular during times of market stress.

[6] Survey on the access to finance of SMEs (SAFE), ECB

[7] DNB study (2015) 'Effect of bank capital requirements on economic growth: a survey'

Figure 2: Central bank bank deposits of ECB and Bank of England

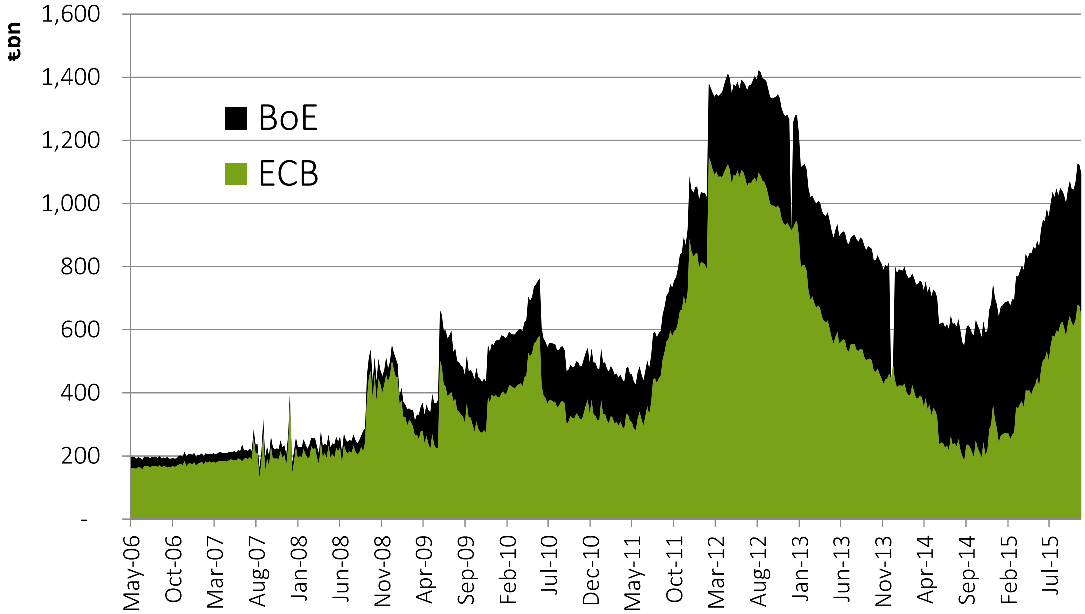


Figure 2: Balances held on deposit at selected European Central Banks – liabilities of selected European central banks to credit institutions, Source: Bank of England and ECB

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We would not support a significant overhaul of CRD IV. We do however have some suggestions for targeted changes (see for more detail pp. 23-26 of our recent consultation response on CRD IV / CRR[8]):

- *Specialised lending exposures:* the capital treatment of specialised lending needs to be revisited. Many specialised lending products, such as project, object and commodity finance, are low risk in nature, supported by identifiable cash flows and are precisely the types of financing tools that can be extremely useful in supporting productive investment and infrastructure financing, particularly in the context of constrained sovereign balance sheets. Today, supervisors in a limited number of jurisdictions impose slotting as the default approach for calculating capital. This results in different capital requirements for different firms active in the same markets. The capital treatment of specialised lending should be implemented consistently throughout the EU and in line with its risk profile;

- *Treatment of securitisation under CRR capital charges and the leverage ratio calculations:* AFME and its members strongly support efforts by the Commission to develop a new EU securitisation framework and to revitalise the securitisation market in Europe. In order to achieve this goal, the sensible calibration of bank capital treatment and the LCR, as well as creating a level playing field with other fixed income products remain crucial. The market needs balanced regulations on capital that recognise the strong performance of European securitisation throughout and since the crisis, as well as the additional strengths of simple transparent and standardised securitisation ("STS"). Therefore, the proposed amendments under CRR should be considered in this context. Furthermore, investors should not be forced to take risk on

[8] AFME response to the European Commission's consultation on impact of the CRR and CRD IV on bank financing of the economy

high cliff-effects between capital requirements for STS and non-STS securitisations. In the context of securitisations, we make further recommendations for necessary review of LCR Delegated Act in order to harmonise the criteria for Level 2b securitisations with those applicable to STS Securitisations. We also believe that the liquidity treatment of qualifying securitisation in terms of haircuts, limits, etc., under the LCR should be much closer to that of covered bonds;

- *SME scaling factor:* we support the continuation of some form of SME scaling factor, as well as the introduction of new scaling factors for certain asset classes such as infrastructure finance – for both banks and insurers;
- *Balanced held on deposit at central bank:* AFME believes that excluding balances held on deposit at central banks as well as unencumbered high grade sovereign bonds from the Exposure Measure of the Leverage Ratio would provide: (1) a more accurate reflection of bank exposures, (2) prevent disincentives for banks to maintain high levels of liquidity, (3) allow for shock absorption and monetary stimulus at times of stress and (4) reduce the likelihood that the leverage ratio becomes a binding constraint and limits banks' ability to take deposits.

These changes to the capital requirements should improve the lending capacity of banks in Europe, not least to infrastructure which is a key objective in the context of the growth and CMU agenda. This increased lending capacity should enable banks to continue playing a pivotal role in the financing of Europe's companies while maintaining financial stability.

Example 2 for Issue 1

CRD IV / CRR and EMIR: costs of derivatives clearing

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRR (Regulation (EU) No. 575/2013) as amended by Delegated Regulation (EU) 2015/62 regarding the Leverage Ratio; and EMIR (Regulation 648/2012).

- **Please provide us with an executive/succinct summary of your example.**

As the Commission notes, CRR and CRD IV are designed to enhance financial stability and to create a robust framework to facilitate the flow of savings and investment to the wider economy. To achieve these aims it is crucial that impediments and roadblocks to the flow of funds from banks to businesses and infrastructure projects be removed or sufficiently mitigated. One of the biggest obstacles to the mobilisation of flows is financial uncertainty.

Bank loans, as with the issuance of debt, carry with them significant interest rate and foreign exchange (if the funds are in a different currency) risks, and banks will be reluctant to direct funds to businesses unless they can be certain those risks can be contained. Moreover, in order to attract funds, companies will likely have to ensure that they maintain balance sheet stability by managing their financing and commercial risks, such as earnings uncertainty on foreign revenues.

This is why derivatives should play a crucial role in the facilitation of the flow of funds. Derivatives are risk-management tools that reduce uncertainty, allowing market participants to effectively recycle risk. Derivatives enable corporates, irrespective of the funding source – banks or capital markets – to efficiently manage risk in their financing activities by allowing companies to tap new investor bases or access cheaper funding, and also allow infrastructure companies to eliminate the mismatch between inflation-linked revenues and fixed rate obligations on borrowings. Derivatives are also central to businesses that need to hedge risks associated with their day-to-day operations, such as eliminating exchange risk on foreign currency earnings, and thus ensuring stability in financial performance paving the way for greater access to funding.

Derivatives are vital to fostering economic growth. They allow banks to manage loan portfolios more efficiently, as well as play an important role in the facilitation of opening up other channels of financing via capital markets while acting as market intermediaries and managing securities inventories more efficiently.

It is therefore critical that the current, and future, bank capital framework in Europe is carefully calibrated and does not impede the effectiveness and efficacy of derivatives markets. Below are our priority issues to consider as part of this review.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The introduced leverage ratio (Delegated Regulation (EU) 2015/62) increases the cost for providing client clearing business which can lead to banks giving up this business model because:

- it does not adequately recognise the risk reducing effect of collateral, particularly Initial Margin in a segregated account for client cleared derivatives;
- nor does it recognise segregated Initial Margin which must be posted by covered

counterparties under new margin requirements[9] for non-centrally cleared derivatives[10];

- it does not recognise securities collateral as Variation Margin - this is inconsistent with the treatment of certain non-cash securities under the LCR where they are considered equivalent to cash and eligible for inclusion in the liquid assets buffer;
- it de-recognises **all** Variation Margin where it does not **fully** extinguish the exposure – the binary nature of the rule, and operational set-up of collateral management, results in significant overstatement of leverage for derivatives portfolios.

Failure to recognise the exposure-reducing effect of such margin acts as a significant disincentive to central clearing, as margin will substantially increase a clearing firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities. This will lead to more clearing firms exiting the business thus concentrating risk among a smaller set of providers. It will also result in a reduction of clearing member capacity to clear for end-users, and increase barriers to entry for smaller market participants.

In addition, CRR Article 305 includes a 'look through' test for assessing the capital requirements of an institution's exposures to CCPs where the institution is not a Clearing Member. We believe this test cannot be met in practice, because firms are unlikely to gain legal certainty that they will be able to look through to the CCP in the event of a default of a Clearing Member. The result is that firms cannot benefit from preferential capital treatment for cleared trades, which again adds to cost of clearing.

Finally it is also important that other regulations governing derivatives are taken into consideration. For example, the Commission is currently undertaking a review of EMIR, a major part of the European post crisis regulatory framework that transposed the global G20 commitments on reforms including clearing, reporting and margining of non-cleared derivatives into European law. We believe that the Review is an opportunity to propose solutions to those areas of the framework that have worked counter to safer derivatives markets and financial stability. For example:

(1) removing the frontloading requirement and giving ESMA the ability to suspend or terminate the clearing obligation as a matter of urgency; and
(2) the Single EU model for indirect clearing (both OTC and ETC) is not workable in practice, thereby giving rise to various operational and legal complexities resulting from new accounts structure and segregation models (e.g. requirement to offer both gross and net omnibus account structures).

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Treatment of derivatives under the leverage ratio calculation:

The introduced leverage ratio increases the cost for providing client clearing business which can lead to banks giving up this business model and we believe that the leverage ratio should be amended to recognise the exposure-reducing effect of segregated margin. Under the leverage ratio, non-cash variation margin, even if held in segregated accounts,

[9] Draft RTS on risk mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(5) of Regulation (EU) No 648/2012

[10] Since only one party could ever be in-the-money on the derivatives contract and need to use initial margin to cover the default of its counterparty, where two-way margin is required there will always be a surplus of initial margin relative to default risk. Banks cannot use the segregated margin received to leverage themselves further and therefore will result in an overstatement of leverage.

needs to be included in the exposure measure. Cash posted as variation margin does not. This is inconsistent with the treatment of certain non-cash securities under the LCR where they are considered equivalent to cash and eligible for inclusion in the liquid assets buffer.

Treatment of derivatives under the CRR Article 305:
We believe that for the purposes of 'look through' the capital treatment should be linked to the capital treatment of EMIR segregated accounts.

Treatment of derivatives under EMIR:
Frontloading should be removed for all future classes and currencies of derivatives subject to mandatory clearing, because current bilateral legal agreements do not allow for repricing upon conversion to clearing, which is forcing mass terminations.
To ease operational and legal burdens, the following options should be considered for account structures:
Option 1 – require clearing members to offer a minimum standard of gross omnibus segregation
Option 2 – establish gross omnibus accounts as the market standard infrastructure for both ETD and OTC
We also recommend excluding access arrangements where markets are accessed via an affiliate's CCP membership, except where the CCP and the indirect client are both EU entities.

Example 3 for Issue 1

<u>CRR: treatment of liquidity lines to ABCP conduits under the LCR: negative impact on end-users and on funding for the economy</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Article 412 of the CRR which sets out the proposed treatment under the LCR for liquidity lines provided to multi-seller multi-asset ABCP conduits ("ABCP Conduits") and for financing lines provided direct from banks' balance sheets to fund pools of assets isolated within Securitisation Special Purpose Entity (SSPEs), implementing Basel requirements for the LCR.

- **Please provide us with an executive/succinct summary of your example.**

Article 412 fails fully to recognise the strong liquidity performance, even during times of stress, of ABCP Conduits. The effect of Article 412 is to apply calibrations which were designed to penalise discredited structures such as Structured Investment Vehicles ("SIVs") and "arbitrage conduits" (which did experience severe liquidity stress during the financial crisis) to ABCP Conduits.

SIVs and arbitrage conduits were and remain fundamentally different from ABCP Conduits. ABCP Conduits:

- have a 30 year operating history;
- are backed by high quality, liquid assets, subject to a borrowing base and (usually dynamic) credit enhancement which structurally limits unscheduled draws by capping the maximum allowable draw, and incrementally haircutting those draws by defaulted receivables and stressed multiples of other adverse portfolio trends;
- have exhibited strong liquidity performance even during times of stress;
- fund the economy (for example, trade receivables, auto and consumer loans with good performance);
- are supported by sponsor banks; and
- are relied upon by customers as a significant source of working capital.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

We refer to our data submission to the Commission of December 2012 and our letter to the Commission of 11th February 2013 (available upon request). The data submission shows that neither the utilised nor the unutilised portions of total commitments of ABCP Conduits were susceptible to "runs". From January 2005 to June 2012, liquidity funding for the utilised portion of ABCP Conduit funding was never more than 5.45% of the utilised portion of total commitments, whilst the monthly variation between the utilised versus unutilised portions never exceeded 4.34% of total commitments.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

As per our letter of 11th February 2013 we propose the following calibrations for Article 412:

- 10% on the unutilised portion of total commitments for corporates (in line with Article 131b in the Basel LCR Text);

- 40% on the unutilised portion of total commitments for financial institutions (in line with Article 131d and 131e in the Basel LCR Text);
- 30% on the utilised portion of total commitments (supporting commercial paper in issue) for corporates and certain financial companies, see below (in line with Article 131c in the Basel LCR Text);
- 40% on the utilised portion of total commitments (supporting commercial paper in issue) for banks (in line with Article 131d in the Basel LCR Text); and
- 100% on the utilised portion of total commitments (supporting commercial paper in issue) for "other financial institutions" (in line with Article 131f in the Basel LCR Text).

"Certain financial companies" includes among others "captive" financial entities such as bank or other financial subsidiaries of large multi-national corporates. These should, in our view, be treated as "corporates" when applying the above treatments as their business and balance sheets are more reflective of retail lending and their parent company's business profile than that of universal, systemically-important banks.

We very much fear that if the proposed calibrations are not adjusted to take into account the very different nature – and very strong – performance of ABCP Conduits, then this mis-calibration will:

- reduce access to capital markets financing for corporate and other financial customers of banks, when financial conditions call for precisely the opposite policy objective;
- make remaining capital markets financing more expensive by forcing corporate customers to pay twice: both on the market yield demanded by the ABCP investor and on the cost of additional redundant liquidity required by the regulator from sponsor banks to meet the Higher Outflow in the LCR framework; and
- encourage these assets to weigh on bank financing sources, rather than the capital markets, at a time of significant de-leveraging pressure on banks.
- We refer to our data submission and letter of 11th February 2013 for further detailed analysis of the above issues.

Example 4 for Issue 1

Solvency II: negative impact on securitisation

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Solvency II (Directive 2009/138/EC).

- **Please provide us with an executive/succinct summary of your example.**

It is increasingly recognised that aspects of the current EU prudential framework for insurers under Solvency II discourage investment in securitisation. The regulatory review in this area should be placed in the context of how this impacts economic growth and the development of capital markets.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

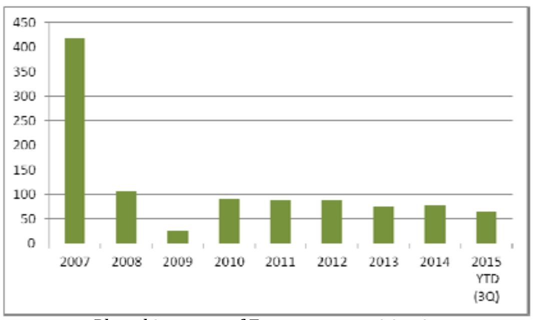


Figure 3: Placed issuance of European securitisations,

Source: AFME

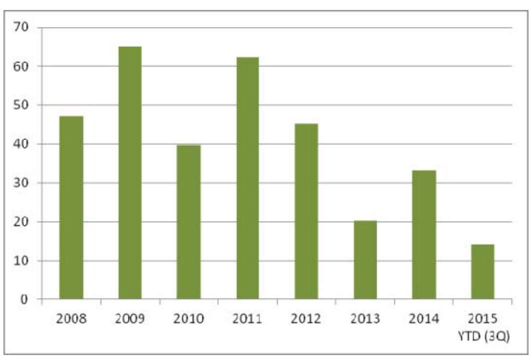


Figure 4: Issuance of European SME securitisations (placed and retained),

The need to revive the STS securitisation market is confirmed in the Commission's CMU Action Plan. Considering the size of the securitisation market in recent years (see figure 3 and 4) and the fact that the investor base is shrinking, revitalisation of securitisation requires urgent measures. If we are able to bring back investors, including insurers, into this market and revive the securitisation, this would create significant potential for increased funding for the European economy. It has been estimated that this could free up an extra €100BN of investment for the economy[11].

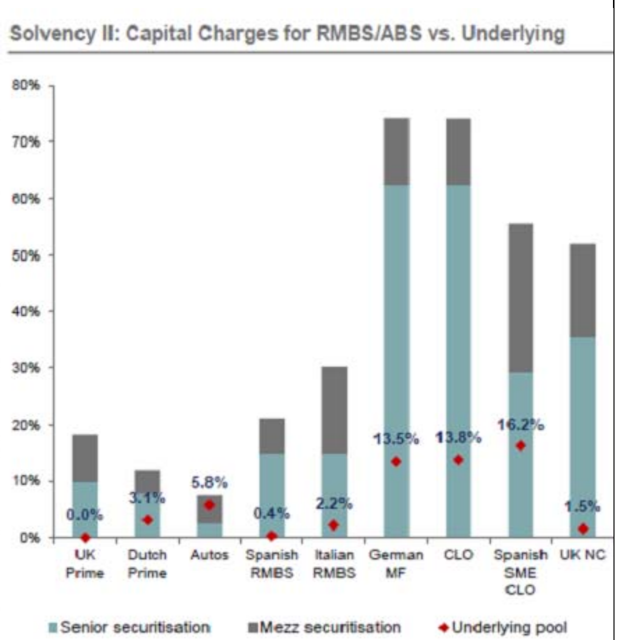
It is possible to point directly to specific provisions in the Solvency II Directive that impact investment decisions of insurance companies in securitisation. Solvency II capital rules have a substantial impact on European insurance companies' allocation of funds to securitisation and capital charges at their current level are driving insurance investors away from securitisation meaning they will stop investment by insurance companies altogether. Key provisions of the Delegated Act mean that insurance companies will remain disincentivised to invest in securitisation for the following reasons:

[11] Speech by Commmissioner Jonathan Hill at the Euromoney Capital Markets Union Forum

- the charges for type 1 securitisations (AAA-rated), despite having been substantially reduced, remain too high: securitisation spreads will not be sufficient to make investments attractive once the capital charges are applied. The proposed calibration charges for the best quality AAA ABS, which dominates the European market and plays a key role in funding activity in many Member States, amounts to a capital charge of 2.3 times that of a AAA corporate bond (charged at 0.9% per year of duration) and three times that of a qualifying AAA covered bond (charged at 0.7% per year of duration). These charges for securitisation are not justified by the empirical evidence and would in effect prevent European insurance companies from investing in this product. Figure 5 shows the Solvency II charges for securitisation and covered and corporate bonds. On the right-hand side the underlying pool is shown for comparison. Also the Commission recognises the need to calibrate Solvency II[12];
- the classification of all non-senior tranches as Type 2 securitisations creates a cliff effect in the capital charge treatment of senior and non-senior securitisations; and
- direct investment in pools of mortgage loans will continue to receive significantly lower capital charge treatment, creating adverse investment incentives. If certain conditions are met, an insurer can invest directly in a pool of mortgage loans without being required to hold any capital against this investment. This contrast with investing in a five year AAA RMBS which has all the usual protections of securitisation in place (e.g. credit enhancement, servicing, swaps to manage basis and currency risk, due diligence, disclosure) but which attracts five times 2.1% nominal of capital. This means that €10,10 for every €100 invested is required in capital.

Solvency II: Capital Charges (per Year of Duration)

Exposure	AAA	AA	A	BBB	BB	<BB	Unrated
ABS - Type 1	2.1%	3.0%	3.0%	3.0%	N/A	N/A	-
ABS - Type 2	12.5%	13.4%	16.6%	19.7%	82%	100%	-
Covered Bonds	0.7%	0.9%	1.4%	2.5%	4.5%	7.5%	3.0%
Corporate Bonds	0.9%	1.1%	1.4%	2.5%	4.5%	7.5%	3.0%
Credit Derivatives (incl. ABS, corp)	1.3%	1.5%	2.6%	4.5%	8.4%	16.2%	5.0%
Unrated loans (non-residential)	-	-	-	-	-	-	3.0%



Source: Nomura, EC, EIOPA, EDW. No adjustment was made for diversification benefits under S-II, since almost all loans fall under the same sub-module and hence relative capital charges would be unaffected by diversification.

11

Figure 5: Capital charges comparison

[12] Speech by Commissioner Jonathan Hill at the Eurofi Financial Forum 2015

The impact of these capital charges becomes particularly clear when considering the risk-adjusted return on capital (RAROC). The larger the RAROC number, the greater the return on capital and the more attractive the investment to the insurer. Insurers are encouraged to invest assets with larger RAROCs, which will depend on the capital charge and yield of the product all else being equal. Therefore, the possibility of insurance company investment in securitisation will be dependent on the extent to which the RAROC of securitisations are comparable to other products. The Solvency II charges disincentivise insurance company investment in securitisation but encourage investment in other forms of credit exposure with similar or greater risk profiles:

- Based on analysis by a member (available upon request), considering spreads and capital charges, the RAROCs of corporate bonds are approximately double securitisations with a similar or better risk profile and whereby the underlying loans are originated by the same corporate. To illustrate, a AAA-rated five year prime UK RMBS would have a RAROC of 4.8%. However, 5-7 year A-rated and BBB-rated corporate bonds would have RAROCs of 8.3% and 8.5%;
- A 3-year AAA-rated auto ABS would have a RAROC of 4.4% compared to a 1-3 year A-rated corporate with a RAROC of 8% (the auto company would typically have a credit rating of A-rated);
- Applying the capital charges for corporate bonds to securitisation, increases the RAROC of the AAA-rated UK prime RMBS to 8.5% - a level more comparable with corporates.

The Solvency II charges strongly encourage investment in underlying loans compared to the securitised form of the same loans, despite whole loan pools generally being riskier and less liquid:

- The RAROC of a pool of residential mortgages at an LTV of 75% would be 12.7%. However, a 5 year AAA-rated prime UK RMBS would have a RAROC of 4.8%, a 3-5 year AAA-rated Dutch RMBS would have a RAROC of 7.2% % and a originally AAA-rated Spanish RMBS (current A-rated) would have a RAROC of 5%;
- The RAROC of a pool of 4-7 year UK commercial loans is 12.7% and the RAROC of a pool of German 4-7 year commercial real estate loans is 5.8%. However, a 5-year AAA-rated CMBS would have a RAROC of 3.3%.

  - **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

In AFME's consultation response on STS securitisation[13] we made further recommendations for necessary review of Solvency II with regard to this asset class: "In addition to the comments below, we would note that the definition of a Type 1 securitisation will need to be amended once the criteria for STS securitisations are finalised so that the two sets of criteria are harmonised. We recommend that Solvency II capital charges be improved by introducing each of the following changes:

- the nominal capital charges for any investment in a securitisation be capped at a level no greater than the aggregate capital charge for the portfolio of underlying loans that back the securitisation;
- the percentage capital charge for senior securitisations be capped at the percentage capital charge that would apply to the underlying loans backing the securitisation, and

[13] AFME response to STS securitisation consultation

- the charges for Type 1 securitisations be reduced to levels closer to the charges of the corporate and covered bonds of comparable credit quality."

AFME continues to engage constructively with the Commission in a dialogue as to what calibrating would more accurately reflect the economic risks. To assist the authorities in reaching a sensible outcome in the recalibration, we aim to prepare, an analytical paper examining how insurer capital charges in Europe should be calibrated. Our study will consider different approaches.

Example 5 for Issue 1

Solvency II: negative impact on debt, infrastructure debt and equity and SME debt and equity financing

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Solvency II (Directive 2009/138/EC).

- **Please provide us with an executive/succinct summary of your example.**

It is increasingly recognised that aspects of the current EU prudential framework for insurers under Solvency II discourage certain types of productive long-term investment in Europe's capital markets. The regulatory review in this area should be placed in the context of how this impacts economic growth and the development of capital markets.

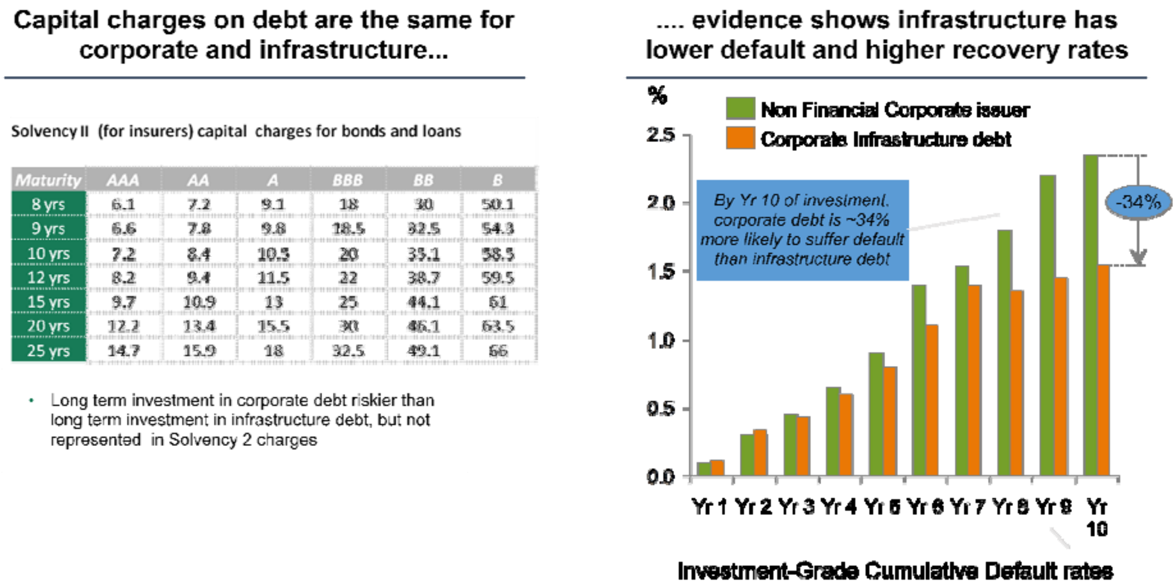
- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Infrastructure finance debt and equity

It is vital that Europe's institutional investors with long-term business models have a framework which will incentivise to invest in long-term assets, including infrastructure debt and equity to provide good investment returns for the final users while playing an important role in underpinning growth and stability in Europe. Solvency II may create unnecessary disincentives for long-term investments such as the Commission's Investment Plan for Europe and increase cost of funding for infrastructure private or public issuers. However, infrastructure investment categories suitably identified, defined and calibrated could remove impediments in infrastructure investments.

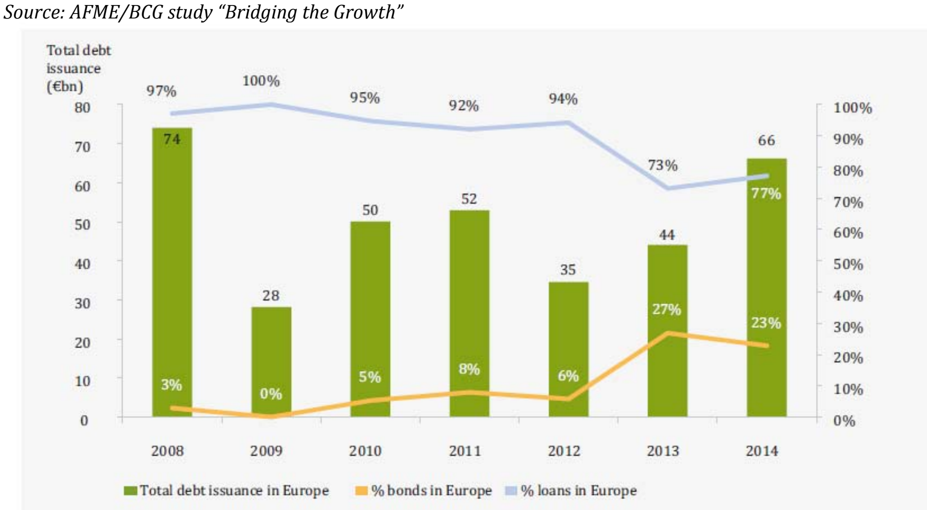
Investors interviewed in 2014 in the BCG/AFME 'Bridging the Growth Gap' report[14] felt that the current Solvency II capital charges fail to distinguish between long-term corporate debt and infrastructure debt, in spite of there being significant differences in default and recovery rates. This observation is borne out in data (see figures below) that indicate cumulative default rates on infrastructure debt are 34% lower than the corresponding rates on corporate debt at a 10-year horizon.

[14] BCG / AFME ' Bridging the Growth Gap' report



Maturity	AAA	AA	A	BBB	BB	B
8 yrs	6.1	7.2	9.1	18	30	50.1
9 yrs	6.6	7.8	9.8	18.5	32.5	54.3
10 yrs	7.2	8.4	10.5	20	35.1	58.5
12 yrs	8.2	9.4	11.5	22	38.7	59.5
15 yrs	9.7	10.9	13	25	44.1	61
20 yrs	12.2	13.4	15.5	30	46.1	63.5
25 yrs	14.7	15.9	18	32.5	49.1	66

Figure 6: European infrastructure bond and loan issuance,
Source: AFME/BCG study "Bridging the Growth"



Source: PFI Thomson Reuters, Financial League Tables
http://www.ifre.com/?&m=0&src=http://www.ifre.com/hybrid.asp?typeCode=68&pubCode=1&navcode=386

Figure 7: Total debt issuance,
Source: AFME-ICMA Guide to infrastructure financing, June 2015

Therefore, we welcomed EIOPA's call for advice in 2015 on definitions for infrastructure debt and equity investment that could be eligible for favourable capital charges, as well as what any preferred capital charges should be (EIOPA CP-15-003 and EIOPA CP-15-004). We also welcome EIOPA's subsequent work (EIOPA CP-15-009) to consider including infrastructure corporate debt investments in the definition of the asset class. In September, EIOPA recommended significantly lower capital charges for eligible non-corporate infrastructure debt, which will have a positive impact on debt investment in this sector.

However, institutional investors, including insurers, are still concerned about the high capital charges for equity investments, which will discourage investment in this asset class by insurers, as is highlighted in the above table.

EIOPA's preferred option on calibration for debt investments in infrastructure project entities (e.g. non-corporate structures) that meet all the relevant requirements is based on a credit risk approach. EIOPA recommends such spread risk charges follow the table below:

		0		1		2		3
Duration	a	b	a	b	a	b	a	b
up to 5	0.00%	0.68%	0.00%	0.84%	0.00%	1.06%	0.00%	1.75%
5 to 10	3.42%	0.38%	4.18%	0.46%	5.32%	0.53%	8.75%	1.05%
10 to 15	5.32%	0.38%	6.46%	0.38%	7.98%	0.38%	14.00%	0.70%
15 to 20	7.22%	0.38%	8.36%	0.38%	9.88%	0.38%	17.50%	0.70%
20 and more	9.12%	0.38%	10.26%	0.38%	11.78%	0.38%	21.00%	0.35%

Table 2: EIOPA's preferred option for calibration of debt investments in infrastructure project entities,
Source: EIOPA's final report on consultation paper no. 15/004

This table highlights that the project finance debt investment will compare favourably to the standard rated corporate bonds below:

	Credit quality step	0		1		2		3		4		5 and 6	
Duration (dur_i)	$stress_i$	a_i	b_i	a_i	b_i	a_i	b_i	a_i	b_i	a_i	b_i	a_i	b_i
up to 5	$b_i \cdot dur_i$	-	0.9%	-	1.1%	-	1.4%	-	2.5%	-	4.5%	-	7.5%
More than 5 and up to 10	$a_i + b_i \cdot (dur_i - 5)$	4.5%	0.5%	5.5%	0.6%	7.0%	0.7%	12.5%	1.5%	22.5%	2.5%	37.5%	4.2%
More than 10 and up to 15	$a_i + b_i \cdot (dur_i - 10)$	7.0%	0.5%	8.4%	0.5%	10.5%	0.5%	20.0%	1.0%	35.0%	1.8%	58.5%	0.5%
More than 15 and up to 20	$a_i + b_i \cdot (dur_i - 15)$	9.5%	0.5%	10.9%	0.5%	13.0%	0.5%	25.0%	1.0%	44.0%	0.5%	61.0%	0.5%
More than 20	$\min[a_i + b_i \cdot (dur_i - 20); 1]$	12.0%	0.5%	13.4%	0.5%	15.5%	0.5%	30.0%	0.5%	46.5%	0.5%	63.5%	0.5%

Table 3: Standard rated corporate bonds,
Source: Commission Delegated Regulation supplementing Directive 2009/138/EC on Solvency II

With regards to equity, EIOPA recommends that the equity risk charge for well-diversified portfolios of infrastructure equity investments in operational projects shall be between 30% and 39% while the correlations with equity Type 1 (listed equity in regulated markets in EEA/OECD countries) and equity of Type 2 (other equities) should be 75% and 100% respectively.

However, EIOPA's advice on infrastructure equity treatment is based on a PFI portfolio of five listed companies which invest mainly in social infrastructure. AFME believes that there should be a clear distinction of capital requirement treatment between listed and unlisted equity infrastructure. AFME recommends that unlisted equity should be included in a new sub-module with a 22% charge.

Also, we believe that prices for listed equities should not be used as a proxy to calibrate the risk charge for unlisted infrastructure projects.

With regards to the definition, we welcome the Commission's further call for evidence on the potential inclusion of infrastructure corporate equity and debt transactions in the definition of the infrastructure asset class in Solvency II.

Moody's report "Infrastructure Default and Recovery Rates, 1983-2014", from March 2015 cites selected findings which show that 10-year credit loss rates for corporate infrastructure debt securities are materially lower than for like-rated non-financial corporates. These findings are reproduced on pages 75-80 of EIOPA's Final Report 15/004[15]. It should be noted that Moody's scope includes investments that many people would consider as utilities.

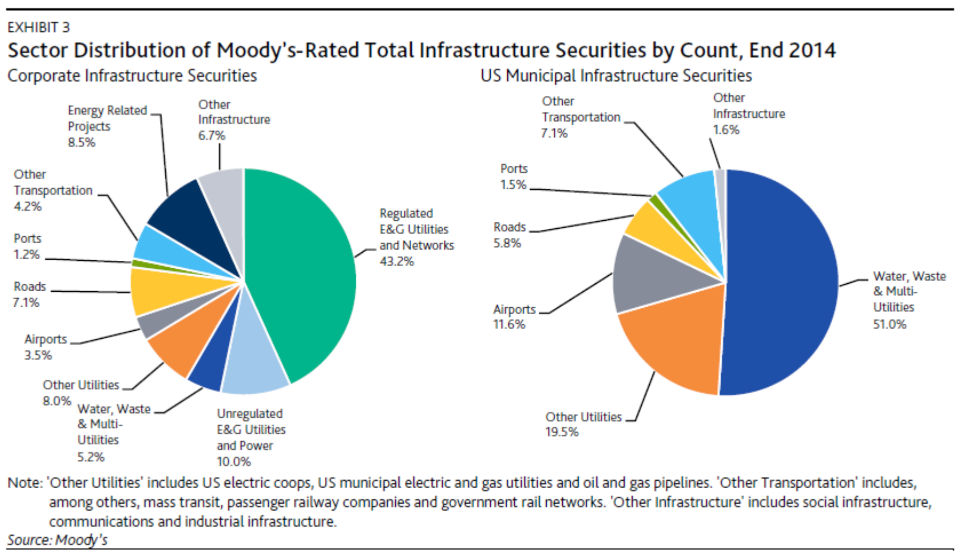


Figure 8: Sector distribution of Moody's-rated total infrastructure securities,
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

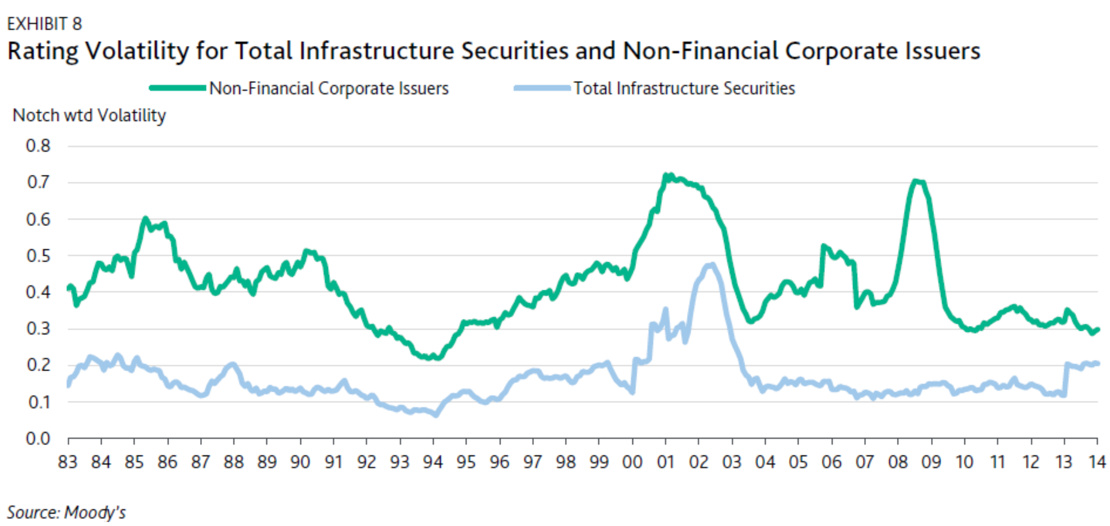


Figure 9: Rating volatility for total infrastructure securities and non-financial corporate issuers,
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

" ... For much of the study period, total infrastructure security ratings have been relatively stable, when compared with NFC issuers. Rating volatility in the US municipal

[15] EIOPA's Final Report 15/004

infrastructure sector has been about one fifth the level exhibited by NFC issuers, while in corporate infrastructure it has been about four fifths the level of NFCs..."

" ... Corporate infrastructure debt securities have, on average, higher recovery rates than do NFC issuers. ..."

EXHIBIT 17

Recovery Rates for Defaulted Corporate Infrastructure Debts

Sector	Senior Secured	Senior Unsecured
Utilities	76%	58%
Regulated E&G Utilities and Networks	83%	63%
Unregulated E&G Utilities and Power	80%	55%
Transportation	74%	n/a
Average Corporate Infrastructure Debt Securities	75%	57%
Average Non-Financial Corporate Issuers	53%	37%

Source: Moody's

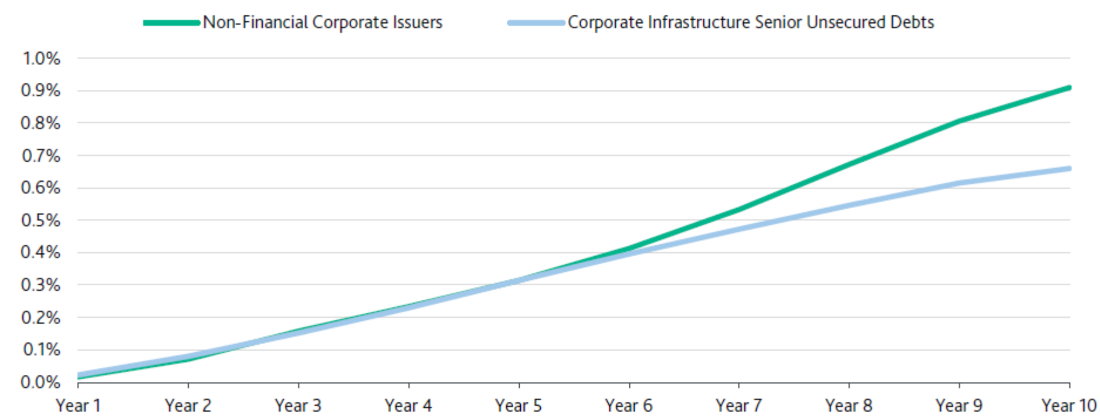
Table 4: Recovery rates for defaulted corporate infrastructure debts,
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

" ... Corporate infrastructure and NFC ratings imply similar credit loss rates for horizons up to about five years. Beyond that, the greater stability of infrastructure credit results in lower loss rates than are observed for like-rated NFC issuers. This, again, is unavoidable: if ratings are set to reflect credit risk over a horizon of about three to five years, and the volatility of two populations is very different, then very long run performances will consequently differ. ..."

Below are loss rates for single-A rated non-financial and corporate infrastructure transactions. Further information is available for other rated categories.

EXHIBIT 18

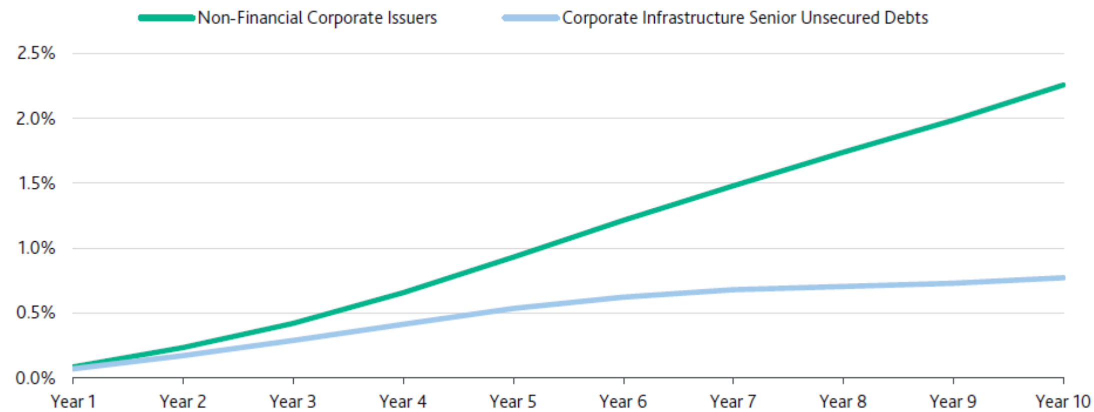
Single-A Credit Loss Rates



Source: Moody's

Figure 10: Single-A credit loss rates,
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

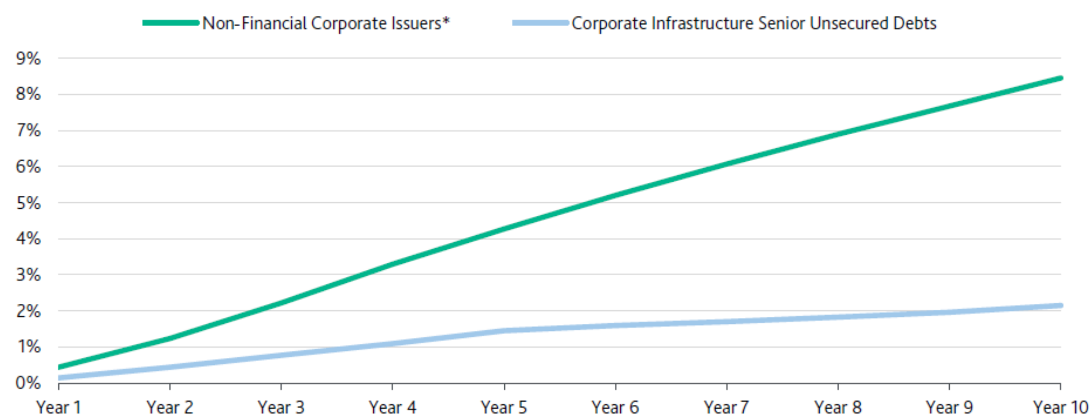
EXHIBIT 19
Baa Credit Loss Rates



Source: Moody's

Figure 11: Baa credit loss rates,
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

EXHIBIT 20
Ba Credit Loss Rates



* Because the rating distributions within the Ba rating class are very different for NFC issuers (44% of all Ba-rated issuers are rated Ba3) and corporate infrastructure senior unsecured debt securities (50% of all Ba-rated debt securities are rated Ba1 and only 24% Ba3), Ba CDRs for NFC have been calculated imposing the alpha-numeric rating distribution of corporate infrastructure senior unsecured debt securities.

Source: Moody's

Figure 12: Ba credit loss rates
Source: Moody's report "Infrastructure Default and Recovery Rates, 1983-2014"

Standard & Poor's, another Credit Rating Agency, provide analyses for Project Finance and another for Corporates ("Global Corporate Default Recovery Study 2014") but does not provide a separate default study for infrastructure corporates. The Global Corporate Default Recovery Study 2014 includes Utilities and Transportation sector corporates. This study states that the utility sector has the lowest default rate with a weighted average of utility default rate at 0.5% between 1981 and 2014. The transportation sector has higher weighted average default rate at 2.1%, however, this figure includes transportation service companies such as airlines which have a higher default rate.

Global Corporate Default Rates By Industry (%)

	2014	2013	Weighted average (1981-2014)	Median	Standard deviation	Minimum	Maximum
Aerospace/automotive/capital goods/metal	0.5	0.6	2.3	1.3	2.1	0.0	9.6
Consumer/service sector	1.1	0.9	2.3	1.6	1.7	0.0	6.3
Energy and natural resources	2.1	1.9	1.8	1.4	2.1	0.0	10.1
Financial institutions	0.2	0.3	0.7	0.3	0.7	0.0	2.7
Forest and building products/homebuilders	0.0	4.2	2.6	1.4	3.0	0.0	14.3
Health care/chemicals	0.7	1.3	1.5	0.8	1.4	0.0	4.8
High technology/computers/office equipment	1.5	0.0	1.2	1.0	1.5	0.0	4.9
Insurance	0.0	0.0	0.4	0.3	1.0	0.0	5.1
Leisure time/media	2.3	4.3	3.7	2.2	3.4	0.0	17.0
Real estate	0.0	1.0	0.8	0.0	2.5	0.0	9.7
Telecommunications	0.5	2.9	2.9	0.7	4.1	0.0	18.9
Transportation	0.8	2.3	2.1	1.9	1.7	0.0	6.1
Utility	0.3	0.2	0.5	0.2	0.8	0.0	4.2

Note: Includes investment-grade and speculative-grade entities. Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

Table 5: Global corporate default rates by industry,
Source: S&P's report "Global corporate default recovery study 2014"

Private Equity investment

With regard to equity investment, we would note that funds for private equity and venture capital investment are sourced from pension funds, insurers and to a lesser extent also from banks. As a result, the prudential capital rules and risk-weights under CRD IV and Solvency II are a key driver (or obstacle) for private equity investment. We understand that there is concern in the private equity industry that the calibration of these prudential rules may be overly conservative as described above. More broadly, the Commission should assess the impact of obstacles to equity investment by various types of funds. Equally, Solvency II should be regularly reviewed to evaluate whether current capital charges create sufficient incentives for equity investment.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

With regard to infrastructure we welcome the Commission's recently announced changes to Solvency II to treat infrastructure as a separate asset class and make sure that capital charges reflect risk/return[16].
We are also supportive of the Commission's recent call for evidence on possible inclusion of corporate infrastructure equity and debt transactions in a special infrastructure asset class.
We would welcome a revision of capital charges for equity infrastructure investments.

Finally, we would support a reduction of the 39% risk weighting for private equity, venture capital and infrastructure funds under Solvency II legislation, which currently overstates the real risk insurers face when investing in the asset classes.

[16] Commission's fact sheet on new rules to promote investments in infrastructure projects

Example 6 for Issue 1

BSR: impact of bank structural reforms on financing of the economy

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Bank Structural Reform (043/2014/EU).

- **Please provide us with an executive/succinct summary of your example.**

Recognising that the Call for Evidence focuses on rules which have already been adopted by the co-legislators to date, we believe that the Commission's proposals for Bank Structural Reform (043/2014/EU) are of such significant importance that they deserve to be mentioned here. With the full effects of existing prudential reforms still to be realised, the proposed BSR proposal is expected to have a significant effect on the banking system in Europe, as also more elaborated on in response to question two. As a report[17] by PwC demonstrates, the structural reforms to the banking system would come at a considerable cost for the economy. As the report explains, the biggest impact of structural reforms for customers is likely to be an increase in the cost of finance for corporate borrowers. This will be concentrated on the smaller users of debt capital markets where liquidity is already weakest and cost is already high.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The study by PwC shows that, based on a typical corporate borrowing spread of 125 basis points, a 30 basis point increase represents a near 25% increase in borrowing spread. PwC estimates that with the Commission's BSR proposal the top 10% of firms most sensitive to changes to the cost of debt will experience a reduction in profits of at least 5%. This translates into an increase in annual borrowing costs to corporates of around €5 billion across the EU, or €2 million on average per issuer.

Pension and fund investors will face higher transaction costs (bid-asks spreads) of trading capital market instruments. PwC estimated that investors of European corporate debt will have to pay an additional 12 bps to trade in corporate debt which will impact long-term returns. When compounded over a corporate bond investment portfolio accumulated over a 40-year working life, this cost amounts to a 5% reduction in the value of the investment. Higher corporate yields also translate into value losses. Investors could face mark-to-market losses of 2% on their corporate bond holdings.

The economic cost of the proposed structural reforms could be significant. As PwC's analysis shows, the total economic costs could amount to €19 billion across the EU (0.15% of 2013 GDP)).

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

AFME remains of the view that existing Level 1 reforms already address perceived risks in banks' trading and financial markets activities. As highlighted elsewhere in our response, the implementation of the CRD IV / CRR, BRRD, Banking Union, MiFID/R and EMIR, combined with enhanced supervision, has already increased significantly the strength of the banking industry, the stability of the financial system.

[17] PwC report (2014) 'Impact of bank structural reforms in Europe'

In addition, the Fundamental Review of the Trading Book (FRTB), the Basel Committee's initiative to more accurately calibrate capital requirements for banks' trading books, is now complete. The improved transparency coupled with supervisors' ability to address trading risks at a desk level will provide a further direct tool for authorities to address risks where they arise. Moreover, supervisors have and apply broad powers under Pillar 2 to ensure banks capitalise excess risk that is not necessarily captured under Pillar 1 minimum requirements.

As the objectives of the BSR proposal have already been met by existing reforms, and the considering the economic costs of the proposals, the Commission should re-evaluate the economic rationale for continuing with the BSR Regulation.

Example 7 for Issue 1

Financial Transaction Tax: negative impact on end-users and the economy

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Financial Transaction Tax (Proposal for a Directive (2013/71/EU) final).

- **Please provide us with an executive/succinct summary of your example.**

It is also important to review the expected negative economic impact of the proposed Financial Transaction Tax which is currently being considered by ten Member States. While end users such as companies and pension funds are not the intended targets of the proposed tax, they are likely to bear heavy costs which have been underestimated thus far in the policy process. The application of an FTT to some derivative transactions would have highly damaging effects for Europe's companies and the economy. Amplified by the so-called cascading effect of the tax, the proposed FTT does not recognise the importance of intermediation and would significantly reduce capital market liquidity, with a consequent increase in costs for end-users. In short, the FTT would act as a brake on economic recovery at a time when Europe is in urgent need of growth, and would cause lasting damage to our capital markets.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Oliver Wyman[18] studied the impact of the proposed FTT (at that time still considered by eleven Member States) on end-users. They argue that two effects have been underestimated:

- cascading taxes paid in the financial system are too large to be absorbed by the financial system and so would in large part be passed on to end users;
- reduced liquidity in the system would increase transaction costs for end-users.
- They estimate an annual cash-flow drag of €30–50 BN resulting from the tax, which would be realised in three different ways:
- securities issued by EU-11 entities would fall in value as expected future cash-flows from the securities decline, imposing losses on holders of those securities;
- EU-11 corporates and governments would find future fund-raising through the capital markets more expensive, as a result of these lower valuations;
- all parties would find it more expensive to manage financial risks, such as interest rate and currency risks on an on-going basis.

[18] Oliver Wyman (2013) 'Impact of the EU11 FTT on end-users' report

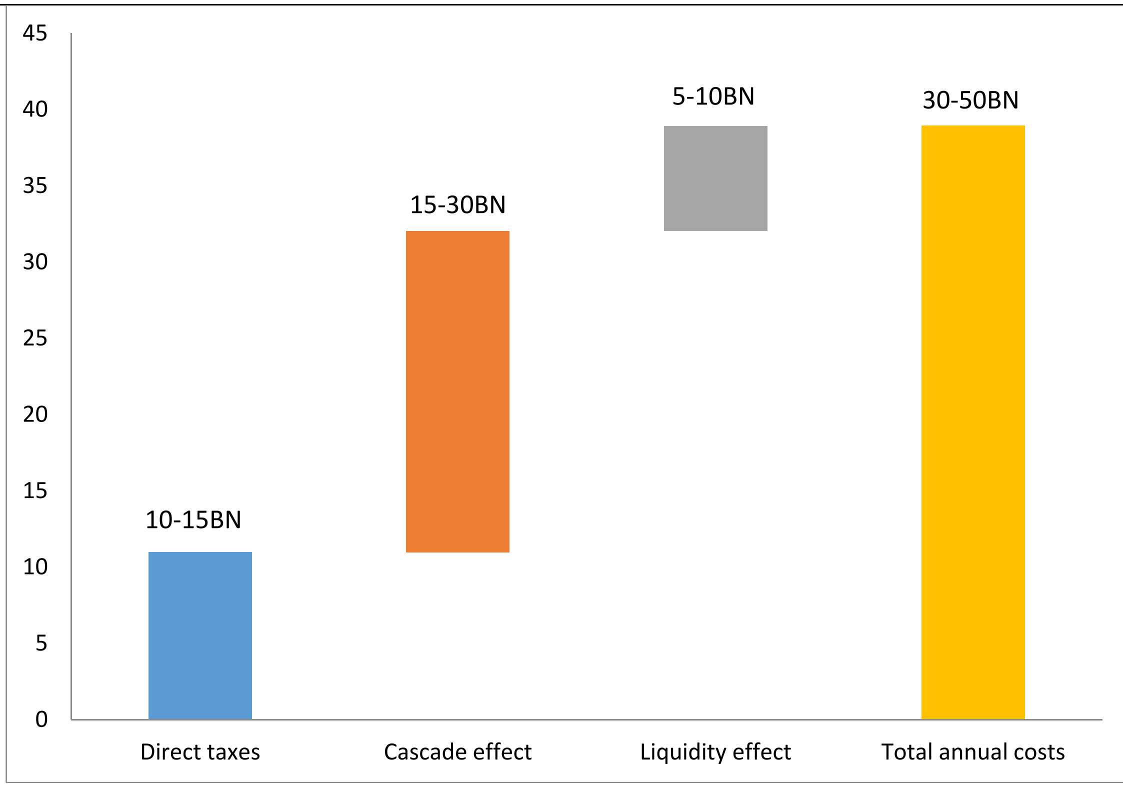


Figure 13: *Annual impact on end-users (€BN),*
Source: Oliver Wyman study "The impact of the EU-11 Financial Transaction Tax on end-users

These effects would have material costs on end-users:

- corporates would face annual costs of €8–10 BN, equivalent to 4–5% of post-tax profits in the impacted economies
- governments would face annual costs of €15–20 BN, equivalent to ~1% of their annual debt issuance
- investors would face a one-off decline in the value of their investments of 4–5% (equivalent to a €260–340 BN decline in asset values). Additionally, they will face annual costs of €5–15 BN in increased risk management costs.

There would also likely be material second-order effects in the bank funding markets, on monetary policy transmission, and on the competitiveness of EU-11 banks in derivative markets and corporate banking which were not quantified by Oliver Wyman.

The potential negative impact of an FTT has been studied by many which has been summarised in a report by PwC[19]. Also, the incompatibility of the FTT and the regulatory reform agenda has been well documented[20].

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Given all of these reasons, it is entirely possible that the economic damage resulting from an FTT would more than outweigh the long-term gains arising from CMU. We would therefore strongly recommend the withdrawal of the proposed EU10 FTT.

[19] PwC report 'Financial transaction tax: the impacts and arguments'
[20] Deloitte report 'Implications of a Financial Transaction Tax for the European Regulatory Reform Agenda'

Issue 2 – Market liquidity

"Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors."

Example 1 for Issue 2

MiFID II: trade transparency and SME growth markets

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

MiFID II (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/2014).

- **Please provide us with an executive/succinct summary of your example.**

Although MiFID II (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/2014) have not entered into force yet, the regime is as currently drafted expected inter alia to have significant impacts on fixed income and equity liquidity and thereby on sovereign and corporate issuers using these markets to raise financing and on investors looking for investment opportunities. The increase in transparency requirements was intended to improve price discovery and increase competition and choice between execution venues, potentially resulting in lower transaction costs. This would result in more favourable terms and conditions for the issue of bonds. However, the transparency rules could if inappropriately calibrated, have unintended consequences for issuers and investors by, for example, increasing market makers' exposure to undue risk. This would curtail their ability to provide liquidity and increase the costs of liquidity that is provided. The detrimental impact on sovereign and corporate issuers access to and cost of capital is likely to be greatest for smaller and thus less liquid issuers looking to tap capital markets for funding of projects that would create jobs and growth.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The non-equity pre-trade transparency requirements may, if inappropriately calibrated, include illiquid instruments, alerting the market to the upcoming positions and hedging needs of liquidity providers, exposing these to undue market risk. We welcome the ESMA decision in its proposed Regulatory Technical Standards (RTS) to use the Instrument By Instrument Approach (IBIA) to calibrate bond liquidity and transparency. Recognising the heterogeneous and dynamic nature of bond liquidity, this decision provides the potential for a much more accurate classification of bond liquidity and for more sensitive transparency requirements. However, a number of concerns remain with the bond transparency regime, including: an inappropriately low liquidity test which considers a bond liquid if it on average trades twice per day; overly high transparency thresholds (SSTI and LIS) which provide insufficient protection for liquidity providers' exposure to undue risk; and the exclusion of sub-100K trades from the threshold calculations which excludes a substantial body of institutional trading and distorts the thresholds.

As far as equity markets are concerned, an example of where MiFID II might lead to unintended consequences is with regard to the caps that have been placed upon pre-trade trade transparency waivers. Investors use these waivers in order to avoid market impact and the use of these waivers is most significant for the least liquid shares. Analysis demonstrates that such liquidity characteristics drive a greater need to avoid market impact and therefore greater use of pre-trade transparency waivers in the indices for stocks with lower market capitalisations. Many shares at this end of the liquidity would disproportionately suffer waiver trading suspensions. It is not necessarily expected that this liquidity will transfer to lit venues. This will reduce overall liquidity in SME shares, reducing also subsequent ability to fund this important part of the market. In contrast MiFID II also contains provisions which are aimed at encouraging the development of SME growth markets, but these provisions contain no added benefit or incentivisation to set up these markets, such that, as currently proposed, SME MTFs enjoy no secondary trading benefits over and above ordinary MTFs.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The impact of MiFID II/MiFIR on the provision of services to investors and the ability for issuers to enter capital markets (and on the cost of capital) should be carefully considered. The following areas should be looked at and recalibrated where necessary:

- the impact of fixed income transparency requirements on the provision of liquidity and the ability of market makers to transact large volumes and hedge their risks.
- the impact of SME equities Growth Markets being exempted from the pre-trade transparency requirement. Healthy secondary trading in SME shares is vital to attract interest in these shares in the primary market, providing SMEs with the necessary access to capital;

Example 2 for Issue 2

CRD IV / CRR: reduction in dealers inventory and market liquidity

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRD IV (Directive 2013/36/EU) / CRR (Regulation (EU) No 575/2013).

- **Please provide us with an executive/succinct summary of your example.**

Given the interconnectedness of the level of liquidity in markets and the ability of capital markets to provide financing to the economy, many comments made in response to question 1 of this Call for Evidence are also applicable in the context of liquidity. In addition to the comments already made, there are the following points that can be made in relation to the impact of regulation on market liquidity.

As noted, the increased capital requirements have improved the stability and resilience of the financial system and banks are now better able to absorb shocks. At the same time, however, and while there are other contributory factors, regulatory reform has been the main driver of increased capital requirements leading to lower returns and reduced appetite from banks to undertake low margin market making activities.

Capital and funding intensive areas such as market making in fixed income, credit, derivatives and commodities have been particularly impacted. There has also been a contraction in the repo markets which serve to fund market making activities. The most problematic regulations are considered to be non-risk based or poorly calibrated standards that inhibit banks from quickly executing low risk but balance sheet intensive trades.

The probability is that market liquidity will considerably worsen going forward. The very loose monetary policies of central banks appear to have provided considerable support for market liquidity while also holding down price volatility. In addition, banks and large dealers are likely to further reduce liquidity provision over the medium term as further regulatory changes that are now only being finalised are introduced.

It is therefore important to better understand how existing rules impact systemic stability, growth and capital markets union to make sure the right balance is struck between financial stability and creating economic growth. Overall, AFME is very supportive of CRD IV and acknowledges its importance for financial stability. There are however some areas of the legislation where we believe improvements could be made.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

When considered alongside the increased cost of bank credit, it becomes clear that if banks can be encouraged to participate in secondary markets, debt capital markets are more likely to become a credible alternative to banks directly providing credit to corporates.

Banks have been traditional providers of market liquidity through trading and market making. There is significant concern that reduced activity by banks could be making some markets more fragile, hindering their ability to provide essential services to companies and investors in a resilient and cost-efficient way[21]. Many banks have

[21] Speech by Dame Clara Furse, External Member of FPC, Bank of England. 11 February 2015.

already exited or reduced market making activities affected by significant increases in capital and liquidity requirements and regulatory reform is therefore a major cause of the reduction in liquidity in the markets that are most affected by capital, leverage and liquidity requirements, such as commodities, securitisation and credit. Banks are also reported to have given up primary dealer roles in European government bond markets which could negatively impact market liquidity and increased regulation is mentioned as a key cause for the exits[22]. Banks' diminished risk appetite and higher costs of capital have reduced the availability of bank credit to the economy and liquidity in financial markets. Observed trends in market liquidity conditions include:

- Diverging liquidity trends: market liquidity in most sovereign bond markets has returned to levels comparable to those before the financial crisis. There are, however, signs of increased liquidity bifurcation and fragility, with market activity concentrating in the most liquid instruments and deteriorating in less liquid assets[23]. For instance, European corporate bond trading volumes have declined by up to 45% between 2010 and 2015. Quantitative easing has in addition led to increased levels of bifurcation and has arguably obscured the pricing of liquidity risk.
- Reduced dealer risk taking capacity: market makers are increasingly focusing on activities requiring less capital and balance sheet capacity. Markets have grown, but the capacity to maintain liquidity – as judged by the market making capacity of the major banks and broker dealers – has declined.[24] Banks in many jurisdictions report allocating less capital to their market making activities and are reducing their inventories by reducing their holdings of, in particular, less liquid assets. In the meantime, there have been measurable reductions in banks' trading capacity: banks' holdings of trading assets have decreased by more than 40% between 2008 and 2015 and dealer inventories of corporate bonds in the US have declined by almost 60% over the same period. Liquidity in sell-side markets is expected to deteriorate further as regulation continues to shrink banks' capacity over the next two years[25].
- Decline in client services: market makers are adopting a more selective approach to offering client services. They are focusing on a smaller range of markets, and market making in many jurisdictions has been observed shifting towards a more order driven or brokerage model[26]. Accordingly, the execution of large trades tends to require more time, with many market makers being more reluctant to absorb large positions.
- Increased volatility: There is evidence that episodes of market correction and volatility are now rising, after falling considerably since the financial crisis. Volatility in bond markets in 2015 was around 40% higher than in 2014. Whereas current market volatility is not as high as the extreme levels during the crisis, volatility is arguably above historical levels during benign economic conditions.

We note that the Bank of England Governor Carney has observed that "the combination of higher capital held against trading books, the new leverage ratio, and the proposed Volcker [and other] restrictions on proprietary trading have already combined to reduce dealer inventories across a range of securities. With dealers less willing to

[22] Reuters' article 'Squeezed bank dealers quit European government bond markets'
[23] CGFS Paper No. 52 'Market-making and proprietary trading: industry trends, drivers and policy implications.' November 2014.
[24] Financial Markets: Identifying risks and appropriate responses, May 2015 (speech by Andrew Bailey, Deputy Governor Prudential Regulation Bank of England and CEO Prudential Regulation Authority).
[25] Morgan Stanley, Oliver Wyman: Wholesale Investment Banking Outlook, March 2015.
[26] 'Shifting tides – market liquidity and market making in fixed income instruments' BIS Quarterly Review, March 2015.

deploy capital against large market moves, volatility has increased and liquidity fallen in the face of shocks...”[27].

When this is considered together with other forthcoming changes such as the NSFR and FRTB, it becomes apparent that regulatory changes are driving fundamental adjustments to banks’ short term securities businesses with potentially serious consequences for market liquidity. Ultimately, the costs of these unintended consequences will be the reduced capacity for banks and capital markets to facilitate investment in the economy and support economic growth.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The aggregate impact on financial market participants and liquidity in financial markets can be far greater than apparent from analysing the individual reforms. This should be carefully considered when reviewing the package of adopted and implemented legislation, including CRD IV / CRR. We would urge the Commission to assess, when reviewing CRD IV / CRR, the following overarching areas:

- bank deleveraging, refocusing and exits from certain lines of business;
- reduction in market-making activities;
- shifts in trading patterns, reducing liquidity for OTC instruments that are not suited to central clearing or trade reporting;
- liquidity contraction in repo markets and its knock-on effect to other capital markets;
- increased demand for and hoarding of liquid assets.

We would not support a significant overhaul of CRD IV. We do however have some suggestions for targeted changes which are explained in example 2 of issue 1.

Also, we consider that better coordination is needed between prudential and market regulators and policy makers to avoid unintended cumulative impacts of different regulatory initiatives on growth and market liquidity. We recommend establishing a permanent joint working group of senior central bank and regulatory officials and representatives from investors, corporate and bank trading desks to assess various market liquidity factors and make recommendations on possible adjustments to calibration of regulations on a much timelier basis than otherwise would happen.

[27] The UK at the heart of a renewed globalisation, October 2013 (speech by Mark Carney, Governor of the Bank of England).

Example 3 for Issue 2

FRTB: impact on trading activities and market liquidity

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Basel Committee on Banking Supervision (BCBS) revised market risk framework proposed in the Fundamental Review of the Trading Book.

- **Please provide us with an executive/succinct summary of your example.**

One of the regulatory drivers of changes to market liquidity include the Fundamental Review of the Trading Book by the Basel Committee. Under this framework, capital will be calculated for trading activities at a desk level and will be based on stressed calibrations. The framework will also include liquidity horizons for trading risks, requiring more capital for less liquid products.
In our initial analysis of the final rules which were published on 14 January, we welcome the significant changes that have been made in several areas of the framework. We also commend the BCBS for its commitment to review the rules over a monitoring period, incorporating outputs from other important regulatory initiatives, such as treatment of sovereigns and simple, transparent and comparable securitisations as well as from the monitoring QIS exercises.
However, we are increasingly concerned that despite BCBS's reiteration not to significantly increase overall capital requirements, the trading book capital under the new rules is over 1.5 times its current proportion of total risk based capital. Based on the BCBS's impact assessment, we worry that the rules will have a disproportionate effect on dealer banks and result in further reduction in bank capital markets intermediation and reduction in market liquidity.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Standardised floors, combined with limited availability to use proxies in both the standardised and internal models in the new trading book may further exacerbate the problem of limited risk sensitivity and higher capital requirements, while the interplay with the changes in RWA framework and the TLAC requirements is yet to be fully assessed. Furthermore, the EU bank structural reform may increase the cost of capital markets financing already targeted by the FRTB, resulting in yet another overhead for banks and industries that raise funding from the markets.

On its own, the FRTB is likely to have a significant impact on certain areas of the wider EU markets, for example:

- EU's work on growth and its objective to unlock funding for SME/securitised assets can be undone by the penal capital treatment of banks' market making exposures of such assets in the FRTB;
- FRTB's reliance on credit ratings, historical data availability and volumes in determining appropriate capital levels will have an outsized negative impact particularly on the small cap and emerging EU markets;
- small cap/periphery EU investments are often linked to onshore/offshore products to make them appealing to offshore investors. FRTB makes the economics for banks to provide these products less appealing due to increased capital requirements for

structured products and their hedges in these markets;

- cross currency swaps are the main instrument for funding local currency assets in most emerging EU capital markets. Penal treatment of non G7 currencies in the rules may reduce dealers' ability to maintain inventory in these markets.

  - **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

- It is recommended that the RRA is dropped from the FRTB framework because it is not risk sensitive and acts more as a tax on volume and threatens the key objective of a credible fallback to internal models. Failing this it should be substantially recalibrated to ensure that it meets its objective;
- On NMRFs it is suggested that zero correlation assumption should be allowed in the aggregation of NMRF capital charges;
- Securitisation capital charges should be adjusted by significantly recalibrating the credit spread risk component and aligning capital more closely with the banking book;
- The overall calibration of the SBA should be such as to reduce cliff effects in capital requirements relative to IMA and this should be tested in an EU context not just at BCBS.

Example 4 for Issue 2

BSR: reduction in market making capacity

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Recognising that the Call for Evidence focuses on rules which have been adopted by the co-legislators to date, we believe that the Commission's proposals for Bank Structural Reform (043/2014/EU) are of such significant importance that they deserve to be mentioned here.

- **Please provide us with an executive/succinct summary of your example.**

Existing prudential reforms address perceived risks in banks' trading and financial markets activities. With their full effects still to be realised, the imposition of undue requirements on bank structures and other measures seems unnecessary. It is also likely to distract from ongoing implementation efforts and cut across adjustments to business models that are already taking place in response to the regulatory changes. It is essential that any new requirements are considered in conjunction with the broad economic and regulatory contexts, including consideration of the cumulative impact of existing reforms. If wrongly conceived, additional measures under BSR could have a significant impact on the viability of banks' market-making activities and increase transaction costs for capital markets participants.

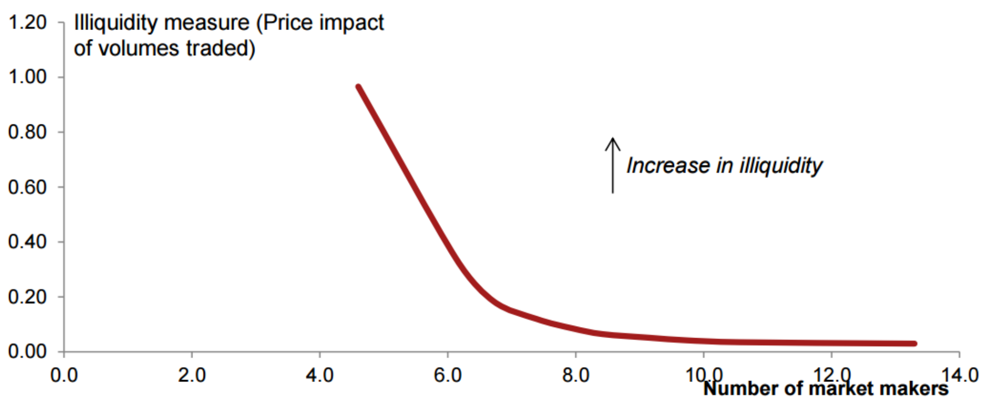


Figure 14: Relationship between the number of market makers and liquidity, Source: PwC study "Impact of bank structural reforms in Europe"

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

PwC has analysed the expected impact of the bank structural reforms on market liquidity[28]. They analyse the impact of structural reform by using an econometric approach to analyse the relationship between the number of market makers, market liquidity and the liquidity risk premia. The econometric results show that market makers play an important role in providing liquidity in European corporate bond markets. They find a statistically significant relationship between the number of market makers and the liquidity risk premia. Figure 14 shows the relationship between the number of market makers and liquidity for their sample of bonds.

[28] PwC report (2014) 'Impact of bank structural reforms in Europe'

As PwC explains, market makers are catalysts in corporate bond markets. They absorb order imbalances by holding inventory, which results in an increase of speed and probability of buyers and/or sellers meeting a match i.e. liquidity. The analysis of the impact of structural reforms suggests that around half of the banks in the analysis are likely to exit the credit business. These are likely to be banks that experience unsustainable levels of returns following structural reform and lower market share in the credit business. An exit of nine market makers would result in an increase in corporate bond spreads around 30 basis points, according to PwC.

If separation of market making is required above certain thresholds, the most likely outcome is that second and third tier wholesale banks will shrink their financial markets operations to levels below the limits. Such withdrawal of capacity will impact pricing of liquidity as well as bid/offer spreads. The need for ex-ante separation as proposed has also been questioned by policy makers including President of the Supervisory Council at the ECB Danièle Nouy[29].

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

AFME remains of the view that existing Level 1 reforms already address perceived risks in banks' trading and financial markets activities. As highlighted elsewhere in our response, the implementation of the CRR / CRD IV, BRRD, Banking Union, MiFID/R and EMIR, combined with enhanced supervision, has already increased significantly the strength of the banking industry, the stability of the financial system.

In addition, the Fundamental Review of the Trading Book (FRTB), the Basel Committee's initiative to more accurately calibrate capital requirements for banks' trading books, is now complete. The improved transparency coupled with supervisors' ability to address trading risks at a desk level will provide a further direct tool for authorities to address risks where they arise. Moreover, supervisors have and apply broad powers under Pillar 2 to ensure banks capitalise excess risk that is not necessarily captured under Pillar 1 minimum requirements.

As the objectives of the BSR proposal have already been met by existing reforms, and considering the economic costs of the proposals, the Commission should re-evaluate the economic rationale for continuing with the BSR Regulation.

[29] Handelsblatt interview with Danièle Nouy, Chair of the Supervisory Board of the ECB (April 2015)

Example 5 for Issue 2

<u>CSDR: impact of mandatory buy-in on market liquidity</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Central Securities Depository Regulation (Regulation 909/2014) Article 7 Settlement Discipline.

- **Please provide us with an executive/succinct summary of your example.**

The Central Securities Depository Regulation (Regulation 909/2014) is expected to have an adverse impact on market liquidity. This results from:

➢ Additional costs to end investors and very significant impact on market liquidity, which does not seem to be in proportion with the intended objective to improve settlement efficiency;

➢ Significant costs in terms of the collateral that will need to be mobilised to mitigate risk for CSD participants under ESMA's proposed buy-in Options 2 and 3.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

We are particularly concerned by the mandatory nature of the Level 1 text. We believe that the consequences of introducing the mandatory buy-in regime as envisaged under the Level 1 text will damage market liquidity and should be reviewed with policymakers.

An ICMA study titled ICMA "Impact study for CSDR Mandatory Buy-ins" published in February 2015[30] states that "when mandatory buy-in regulation is implemented, liquidity across secondary European bond and financing markets will reduce significantly, while bid-offer spreads will widen dramatically. The results suggest that even the most liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. The survey further suggests that for many less liquid bonds, including sovereign and public issues, market-makers will retrench from providing liquidity altogether. The €5.5 trillion European repo market will also be radically re-shaped, driving more reliance on very short-dated repo funding ('exempt' repo), while the more stable, fixed-term repo markets will see dramatic widening of spreads for more liquid securities, and a total withdrawal of liquidity for less liquid securities, including some sovereign and public bonds, and most corporate bonds."

[30] ICMA report 'Impact Study for CSDR Mandatory Buy-ins'

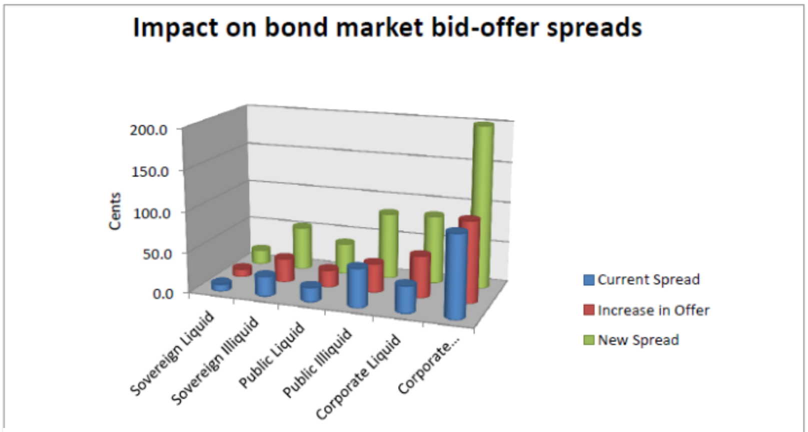


Figure 15: Impact of buy-in regulation on bond market bid-offer spreads,

Source: ICMA study "Impact study for CSDR mandatory buy-ins"

The results of the study appear to be the opposite of what policymakers intended when introducing a settlement discipline regime. In November 2014, ICMA published a report[31] which outlined the inability to continue market making as one significant concern resulting from the proposed measures. For government bonds the study indicates that the seventeen respondents polled for liquid securities would increase their spread by 116% to compensate for settlement fines and potential buy-in. This can be attributed to the relative size of the transactions and the concern that an entity that facilitates a transaction on behalf of another will need to source the bonds. If the deliverer fails, the intermediary would have to choose how best to make good its delivery to the ultimate purchaser.

A similar increase in spread would be seen for sovereign illiquid bonds although the difference is that 25% of respondents would cease to make markets in these bonds. One fifth of respondents also reported that they would no longer show offers in liquid corporate bonds they did not already hold, whilst the number of market makers no longer showing offers in illiquid corporate bond bonds not held in inventory are expected to double to 40%.

ESMA has three proposals as to how a buy-in could be executed:

1) Trading level executing the buy-in;

2) Trading level executing the buy-in with fall back option;

3) CSD participant level executing the buy-in.

Option 3 is the most concerning. It proposes that the settlement participant should bear the responsibility of the buy-in process (or cash compensation). The settlement participant is not usually the same entity as the trading party and will be unaware of the trading party's business intentions. It will therefore need to call collateral from the trading party to insure itself against being left with the cost of the buy-in. This will add to the scarcity of high grade collateral.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We strongly consider that the introduction of a mandatory buy-in regime is likely to have damaging effects on liquidity in all European securities and that the Level 1 text of CSDR should be amended to reflect a voluntary buy-in process. In a study in February 2019, the Trade Association for Central Securities Depositories (CSDs), ECSDA, estimated that there would be 7,500 mandatory buy-ins per day, based on current volumes. We question the value of this number of buy-ins every day and the potential

[31] ICMA report 'Impact Study for CSDR Mandatory Buy-ins'

disruption to markets. End investors purchase securities for their portfolios and calculate their Net Asset Values (NAV) at end of day. If mandatory buy-in is enforced the end investor may receive a cash compensation in lieu of the securities. At best, this will place the investor at the same point as the original purchase, although they will have to buy securities again in this instance, potentially disrupting their NAV calculations.

We support the continued voluntary nature of buy-ins and are prepared to work with policymakers to ensure that a realistic agreement can be reached that does not involve thousands of buy-ins or cash compensations on a daily basis.

Example 6 for Issue 2

NSFR: negative impact on derivatives and market liquidity

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRR (Regulation (EU) No 575/2013) Article 510(3) stipulating that the Commission shall, if appropriate, submit a legislative proposal to the European Parliament and Council on how to ensure that institutions use stable sources of funding.

- **Please provide us with an executive/succinct summary of your example.**

We have a number of very significant reservations in relation to the BCBS NSFR standard, including the treatment of derivatives and linked transactions and the asymmetrical treatment of repos. These treatments could have a substantial dampening effect on the liquidity of securities markets leading to less ability for customers to manage risk, increased volatility and higher operating costs and reduced returns for investors.

In particular, the impact of the NSFR requirements in relation to derivatives would result in increased costs which would constrain investors' access to markets and discourage the use of derivatives as hedging tools thereby increasing systemic risk. There would also be a negative impact on the liquidity of the underlying cash markets.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Recent Joint Trade Associations' quantitative work on derivatives indicates that the current treatments under the NSFR would lead to a total estimated additional funding requirement of around €750bn for the banking industry leading to an annual cost of between €12-15bn that would need to be passed to end-users. The drivers of the additional requirement are as follows:

➢ <u>Treatment of variation margin:</u> Around half of this additional requirement is owing to the application of the leverage ratio netting criteria to variation margin whereby collateral must totally match the exposure before it may be considered. Collateral must also be in the form of cash only, which is inconsistent with the definition of liquid assets under the LCR and implies that they have no funding value;

➢ <u>20% RSF factor for all derivative liabilities</u>: This accounts for a further 40% of the increased costs. The rationale and empirical background to the requirement is, however, unclear;

➢ <u>85% RSF factor for initial margin</u>: The remaining additional funding requirement arises from the application of a 85% RSF factor to derivatives initial margin posted by banks and the inability to assign value to initial margin received.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We continue to advocate that a holistic review of the treatment of derivatives under the NSFR should be undertaken.

In the meantime, there is the need to avoid some of the NSFR's potential unintended or disproportionate impacts on banks' ability to provide market services which facilitate client financing, investing and hedging, in particular through the exempting of interdependent assets and liabilities through the application of the provisions of Paragraph 45 of the new standard. There still appears scope for interpretation in relation to the definition of interdependent transactions and we suggest that derivatives market risk hedges, client clearing transactions, client short facilitation and some other types of qualifying transaction should, subject to appropriate operational requirements to ensure they involve no significant funding risk, qualify for exemption from the NSFR as linked transactions.

Finally, further consideration should be given to the ASF and RSF factors assigned to repo transactions under the proposed framework.

Example 7 for Issue 2

AIFMD: impact of asset segregation on market liquidity

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

➢ AIFMD Article 21, paragraph 11 (d) (iii) (as well as Article 99 of the AIFMD Delegated Regulation of 19 December 2012).

➢ UCITS V Article 22(a), paragraph 3 (c).

- **Please provide us with an executive/succinct summary of your example.**

One of the main areas of the focus for AFME with regard to the AIFMD and UCITS V are the rules on asset segregation. Full segregation does not provide a higher level of protection to investors or their assets than current asset segregation upon insolvency of a sub custodian to whom custody has been entrusted. Full segregation does not have a positive impact on speed and efficiency with respect to the return of assets upon such insolvency. Full segregation applied in all contexts would have negative and damaging operational impacts and result in higher operational risk with respect to depositaries, as well as with respect to the prime brokerage, collateral agency and securities lending industries and full segregation would likely reduce market liquidity in securities with negative impact on investors.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The AIFMD and UCITS V Level 1 legislation is unclear with respect to asset segregation requirements up the chain of custody. This results in the risk that the AIFMD and UCITS V rules will lead to an unnecessary segregation of securities positions which could have a negative impact on investment funds' ability to participate in activities such as (triparty) collateral management and securities lending. Participating in these activities lead to more liquidity in financial markets and also serve as risk-management tool, increasing returns for investors.

The AIFMD and UCITS V Level 1 legislation do not distinguish between "delegation" of the custody function as such, and "delegation" in the event that a custodian uses a sub-custodian. Therefore the Level 1 rules would seem to apply in both cases.

We believe that the legislation does not require such segregation and that current asset segregation practices (which are not restricted to full segregation) are both permitted by the legislation and considered more beneficial to the market generally. Prime brokers maintain a custody account for each separate client on their books and records. At a sub-custody level prime brokers maintain an omnibus client account (or individual client accounts in certain markets) separate from their proprietary account. Incorrectly interpreting the Level 1 requirements could prohibit the use of omnibus accounts up the chain of custody while the use of omnibus accounts enhances liquidity as securities are allowed to be lent or used as collateral more freely.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

For the review of the AIFMD and UCITS V, we would suggest amending the Level 1 text to clarify that full segregation is not a necessary requirement of the Directive.

Issue 3 – Investor and consumer protection

"Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence."

Issue 4 – Proportionality / preserving diversity in the EU financial sector

"Are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how"?

Example 1 for Issue 4

MiFID II: impact on provision of research

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

MiFID II (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/2014).

- **Please provide us with an executive/succinct summary of your example.**

AFME supports certain aspects of ESMA's framework when applied to cash-equity research. However, we believe that the current Level 2 drafts will harm European retail consumers by limiting competition among portfolio managers, reducing returns to investors and disincentivising issuance. Level 2 includes a requirement for broker-dealers that provide execution and other services to price these services separately through a separate charge. It also stipulates that the supply of these services must not be influenced by the levels of payments received for execution.

Some services may be provided by broker-dealers on promotional grounds for little or no cost to the investing firm. Similarly, a service may be priced differently depending on the relationship that a broker-dealer has with the investing firm, or the prospect of such a commercial relationship. MiFID II already acknowledges this principle in the inducements regime applicable to all investment firms under Article 24(9) (the "quality enhancement" test).

For equities research, we are concerned that ESMA's framework will be jeopardised in practice by the proposed highly restrictive operational conditions, including: the proposed requirement for investment managers to obtain written agreement to amend the research budget; and the possible misinterpretation of the ESMA's Advice to effectively prohibit the simultaneous collection of separately determined research funds and execution payments.

With regards to FICC research, we are concerned by the potential application of the inducement regime. It is unclear how the Advice could be applied in practice since it is fundamentally inconsistent with the structure of the FICC markets where investment managers and their clients generally do not pay for research and where trades are executed on a principal basis via request-for-quote (RFQ) so that research does not influence execution.

Finally, although we agree that portfolio managers should understand the value they ascribe to execution and other services, we believe that an attempt to regulate the supply of services and their pricing goes beyond the scope of the ESMA mandate and may violate fundamental principles of the common market. This is because ESMA's mandate is limited to prescribing a regime for benefits falling within the inducements regime for portfolio managers and independent advisers.

Whatever the outcome of this issue, in order for there to be a workable regime, it is important that there is EU-wide consistency in the application of the Delegated Acts.

Further, it is critical that the regime works in the global context – for example, asset managers should be able to access non-European research.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Equity research:

AFME welcomes the recognition that investment managers may use the resources of their clients to pay for research. However, the proposed requirement for the manager to seek written agreement from each client to increase the research budget introduces significant operational challenges which, if left unaddressed, will likely result in a de-facto ban on European investment managers' use of client resources to purchase research. This will have a material detrimental impact on end-investor choice and returns, on issuers' access to and cost of capital, on small and medium-sized enterprises (SMEs) in Europe and on the EU growth agenda.

Another concern is that such complexity will lead European investment managers to absorb research costs in their own fee; this solution will likely prove challenging for smaller investment managers with fewer assets off of which to generate a fee, leaving them at a competitive disadvantage to their larger peers.

When considering the options for payment for research, one of the options is the collection of research funds via execution payments. For this option, we are concerned by the potential requirement that the research charge to the client must not be linked to the volume and/or value of transactions executed. The inclusion of the term "linked" may be misinterpreted, potentially prohibiting the simultaneous collection of separately determined research funds and execution payments, which is not, we think, the intention.

A prohibition on the simultaneous collection of funds for research and payment for execution services would have a detrimental impact on choice and returns for European investors compared to investors in other jurisdictions. This is particularly true in the US, where major US broker-dealers today generally do not accept cash payments for research, and are highly unlikely to change this practice due to significant administrative challenges, restrictions and legal uncertainty.

We note that a prohibition on the simultaneous collection of funds for research and payments for execution may also have VAT implications as in a number of European countries, dealing commissions are exempt from VAT which might no longer be the case.

FICC Research:

It is critical to understand the key differences between equity and non-equity markets when determining the potential application of MiFID II to FICC research.

FICC trading is primarily principal-based (as opposed to agency-based) and on a request for quotation (RFQ) basis. RFQ is a standard trading protocol in the FICC markets and typically requires the investment manager to approach at least three broker-dealers for a quote. When involved in the RFQ process, the provision of research by a broker-dealer does not influence where final execution takes place in FICC markets and is neither a factor in the price offered by the broker dealer, nor is it priced into the bid-ask spread. The bid-ask spread does not change when research is *not* offered by the broker-dealer to the client.

One the reasons broker-dealers provide these is to be considered a preferred provider of services to the investment manager, and therefore be selected by the investment manager to participate in the RFQs process. One of these many services is investment research. However, as seen in practice, none of these services guarantee that the broker-dealer will be included in the RFQ process; but the broker-dealer may offer investment research, along with other services, in order to increase its chances of being asked to participate in the RFQ process. Under the proposed new regime, investors will need to pay for research separately which is expected to lead to less demand. The proposed new regime for FICC research payments would therefore result in reduced FICC research coverage.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

With regard to client consent we propose instead a more pragmatic approach that would require investment managers to provide active notification of budget changes to their clients, thereby allowing those clients who do not support such expenditures to take their business elsewhere, rather than prohibiting the expenditures without full consent in the first place. We believe such a 'terms and conditions' approach to be practical and consistent with the regulatory objective of protecting investors.

With regard to payment options for equity research we believe that enhanced Commission Sharing Agreements (CSAs) (i.e. CSAs with ex-ante research budgets) allow for the simultaneous and therefore efficient collection of separately determined research and execution charges. We also recommend that the wording requiring research charges not be *linked* to the volume and/or value of transactions executed be changed to permit the simultaneous collection of separately determined research and execution charges.

With regard to FICC research we note that the nature of the FICC market structure means that the risk that the provision of research would distort execution to the detriment of investors is low in the case of FICC research. As such, any benefits achieved by the proposed requirements are outweighed by the adverse unintended consequences when applied to FICC research. We recommend that policy-makers undertake a comprehensive regulatory impact analysis in advance of any application of MiFID/R to FICC research.

Unnecessary regulatory burdens

Issue 5 – Excessive compliance costs and complexity

"In response to some of the practices seen in the run-up to the crisis, EU rules have necessarily become more prescriptive. This will help to ensure that firms are held to account, but it can also increase costs and complexity, and weaken a sense of individual responsibility. Please identify and justify such burdens that, in your view, do not meet the objectives set out above efficiently and effectively. Please provide quantitative estimates to support your assessment and distinguish between direct and indirect impacts, and between one-off and recurring costs. Please identify areas where they could be simplified, to achieve more efficiently the intended regulatory objective."

Example 1 for Issue 5

CRD IV / CRR: cost and compliance burden of remuneration guidelines

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRD IV (Directive 2013/36/EU) / CRR (Regulation (EU) No 575/2013) / EBA Remuneration Guidelines.

- **Please provide us with an executive/succinct summary of your example.**

Some areas of the EBA's Remuneration Guidelines and the CRD IV remuneration provisions create unnecessary, excessive compliance costs and complexity. Unless proportionate application of the CRD IV remuneration provisions is retained (as recommended by the EBA to the Commission), there will be a significant extension to the scope of provisions whereby group-wide policies and the requirements related to material risk-takers would have to apply to subsidiaries that are not subject to CRD IV. We are concerned that these rules will impact competition, creating an un-level playing field between in-scope and out-of-scope firms, such as investment management businesses, operating in the same markets, both within the EU as well as in relation to third countries:

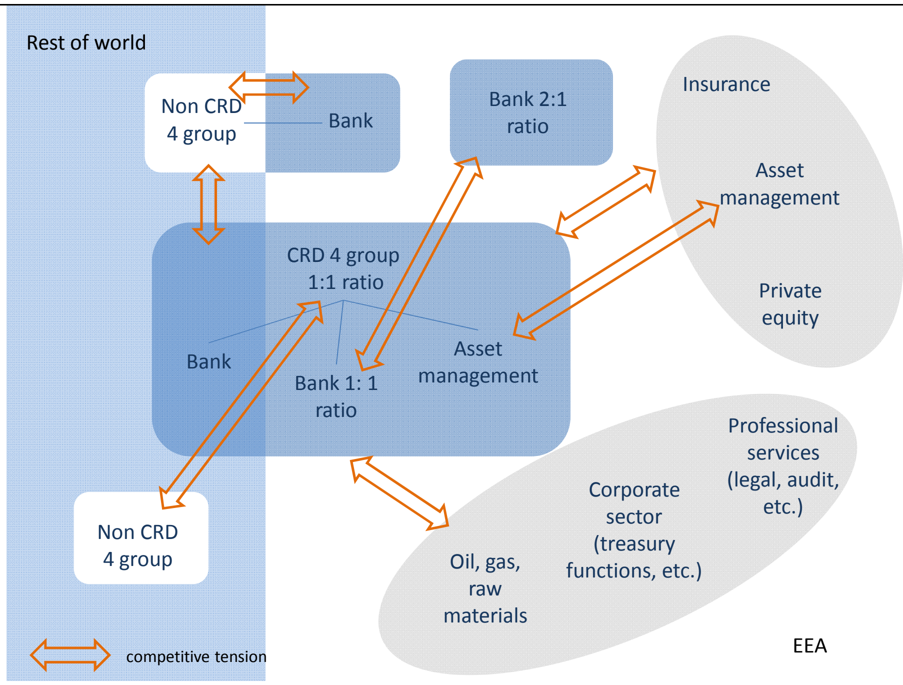


Figure 16: Impact of remuneration guidelines,

Source: AFME

In addition, if the application of the principle of proportionality is removed, a significant number of additional individuals will be subject to the remuneration requirements of CRD, regardless of whether it is appropriate to apply such strict deferral periods and payout structures to individuals who may only have very low levels of variable remuneration. In our opinion, the cost/benefit case for making such a significant change is far from being proven.

On the basis of a sample of our member firms, the removal of the proportionality principle would result in a 12 fold increase in the number of legal entities being affected, while the number of individuals that would be subject to remuneration requirements would more than triple compared to the current situation. Apart from the obvious additional administrative burden this will create for firms operating in Europe, it is entirely unclear that the new approach will contribute in any way to an increase in financial stability.

To date, the proportionate application of the CRD IV requirements has helped mitigate this effect for those material risk takers whose functions within the firm (e.g. compliance/risk,/HR, etc.) and/or total compensation levels do not justify treatment beyond the CRD minimum requirements of 40%/3 year deferrals. Going forward, if the proportionate application is removed, it is precisely these types of important functions that will be at risk of leaving the regulated industry to join other firms not subject to these requirements.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Beyond the key issue of proportionate application of the CRD IV remuneration rules, and while we welcome the EBA's efforts to ensure consistent application of the remuneration requirements throughout the EU, we are concerned that the EBA's Remuneration Guidelines will introduce unnecessary operational complexity. For example:

- By requiring the creation of remuneration committees at the level of each significant entity, the Guidelines fail to recognise the diversity of group structures and resulting governance practices, we think this requirement is contrary to the objective of achieving effective group-wide remuneration policies. Remuneration is typically the responsibility of a global remuneration committee that sets the firm's policies and approach to remuneration across the firm on a global business line/divisional basis but not by individual legal entity. Requiring multiple remuneration committees raises governance issues as to how the subsidiary committees should interact with consolidated parent remuneration committees under group-wide remuneration governance hierarchy, with the risk subsidiary remuneration committees ending up asserting their autonomy over remuneration policy and jeopardising the CRD IV requirement to implement a group-wide remuneration policy. Requiring individual structures risks creating a fragmented approach to remuneration policies within a firm and will make remuneration governance extremely complicated and unnecessarily costly. The types of costs involved include finding and appointing suitably experienced individuals who would be willing to sit on the board of the subsidiary and its remuneration committee. Unnecessary shareholder approval for the extension of the maximum ratio in the case of fully owned subsidiaries. To require the approval of intermediate shareholder levels in such cases creates unnecessary administrative burdens in groups with complex organisational structures with no additional benefit. It should therefore be clarified that shareholder decisions can be taken at the group level and cascaded down in these cases.
- The non payment of dividends during vesting periods. This compromises the economic position of employees compared to other shareholders and reduce the value of awards granted. It is normal market practice across all sectors and is an institutional investor requirement in most markets to have dividends accrue on deferred and long-term incentive awards.
- Listed firms should be able to use share-linked instruments as recommended by the EBA to the Commission. While the payment of a portion of variable pay in instruments is generally a useful tool to align the incentives of an individual with that of the firm (and the firm's shareholders), there is no economic justification or behavioural incentive for disallowing the use of share-linked instruments for listed firms as is current the case in the CRD IV. We provide more information on the complexity of this requirement below.

The efficiency of the CRD IV remuneration requirements, and in particular those related to deferral requirements, needs to be evaluated in the context of the imposition of a cap on variable pay combined with the extent to which the requirements are applied

proportionately.
According to a 2015 report[32] by McLagan on remuneration trends in the banking industry, the portion of variable pay has reduced significantly over past years, as have amounts of variable pay. EMEA bonus pools in the banking and capital markets industry are estimated to have decreased by 54% between 2009 and 2014. We have provided updated figures to the Commission in the context of our response to the recent consultation on the CRD IV remuneration requirements.

Bonus deferral
While some level of deferral (which is expressed as a combination of a percentage of the total variable amount and a number of years over which this amount is deferred and vests) is useful in incentivising behaviour, there is a tipping point beyond which individuals begin to discount the value of their variable pay. This tipping point is exacerbated in the context of increasingly limited variable pay. In other words, when variable pay levels become too low and deferral percentages and periods too high, variable pay no longer creates the intended incentives. The decrease in perceived value of variable pay is evidenced in a piece of research, "The Psychology of Incentives", carried out by PwC in conjunction with the London School of Economics and Political Science[33].

Use of physical shares

The use of physical shares is not possible in all countries, implying the differentiated treatment of employees depending on their location. Indeed, in some big countries, there are legal/regulatory impediments to use such instruments issued by a parent company:

- in Russia, if the parent company is not listed in the country, the employees cannot receive shares at all.
- in the US, a maximum 5 M$ can be awarded in shares to employees in the US where the parent company is not listed on a US stock exchange. This cap, which includes all types of remuneration in shares (profit-sharing; company savings plan; employee share ownership; free shares; variable remuneration), can be quickly exceeded.

A payment in shares cannot be put in place on a uniform basis in all countries, given the different legal, regulatory, accounting and tax constraints and formalities.

In addition, from an operational standpoint (governance; accounting and tax; external and internal communication; IT; HR), the distribution of shares is very complicated and costly:

- obtaining shareholder approval;
- re-invoicing the expense to the relevant entities and tax deductibility;
- various formalities to manage vis-à-vis market authorities and the public;
- internal communication towards identified staff;
- service contract to put in place with the securities intermediary in charge of the management of the distribution of shares;
- management of the withholding of social charges and income taxes on the employee's bank accounts for the parts of variable remuneration paid in

[32] McLagan (2015) report on remuneration trends
[33] PwC study 'Making executive pay work: the psychology of incentives'

instruments;
- dedicated IT tools to put in place;
- more HR staff increase to manage the whole process.

The points underlined above would be even more problematic if the payment in shares would apply to an even larger and diversified population, i.e. should proportionally no longer apply to the remuneration rules.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

- We recommend that the proportionate application of the CRD IV remuneration rules be maintained. We refer the Commission to our response[34] to the recent consultation on the CRD IV remuneration rules for more information;
- In our view, instead of forcing the establishment of remuneration committees at every level of a group (when an entity is deemed to qualify as significant), it would be more efficient to allow the group remuneration committee to carry out that function on behalf of the subsidiary;
- Where a fully-owned subsidiary of an EU parent institution exists and is not itself listed on the open-market, authorisations received from shareholders of the EU parent institution should apply;
- Dividends should accrue to employees during vesting periods;
- Regarding the attribution of variable compensation in instruments, listed firms should be allowed to use share-linked instruments such as cash indexed to the instruments' price. This tool is easier and less costly to put in place and can be implemented on a uniform basis at worldwide level, while it contributes in exactly the same way as a payment in instruments to the alignment of the employees with the performance and risks of a group.

Further, to ease the burden on fixed pay levels:

- The maximum ratio could be applied to cash only or alternatively, payments of deferred equity could be incentivized by introducing more appropriate valuation mechanisms or a more meaningful discount factor that applies to all deferred equity;
- Firms could be given the flexibility to adjust downwards or forfeit fixed remuneration i.e. for capital preservation / when various prudential metrics are triggered

Additionally:

- Only those individuals whose activities really have a "material" impact on the risk profile of the firm should be captured by the remuneration provisions;
- The unnecessary year-on-year changes in the number of employees captured as a result of exchange rates fluctuations (because quantitative thresholds for identifying Material Risk Takers are set in euros) should be addressed.

[34] AFME response to Commission's consultation on CRD IV remuneration rules

Example 2 for Issue 5

<u>CSDR: collection of buy-in information by CSDs</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CSD Regulation, Article 7
CSD Regulation Level 2: Draft RTS on CSD Requirements: Article 54, paragraph 2 (x)
CSD Regulation Level 2: Draft ITS on CSD Requirements: Annex 4, Table 1, Row 24 (pages 163 and 164)

- **Please provide us with an executive/succinct summary of your example.**

The draft text of the CSDR Level 2 requires that CSDs collect and store extensive buy-in information in case of settlement fails (covering the final results of the buy-in, the amount of cash compensation, and the cancellation of the original instruction). CSDR Article 7 however does not require that buy-in information be transmitted to the settlement level and stored by CSDs. There is also no evidence to suggest that the collection of buy-in information by CSDs will give them useful additional information.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

According to the ESMA Final Report (page 28)[35], the purpose of this requirement is to give CSDs the ability "to assess the impact of the buy-in process on settlement efficiency, and to adequately tailor the measures that a CSD may take to improve settlement efficiency".

The information requirements are very broad, cover all types of transactions (exchange-traded, CCP-cleared and OTC transactions), and apply to all CSDs involved in the settlement of a transaction (i.e. the CSD of the delivering party, the CSD of the receiving party, and any other CSDs involved in the realignment of positions).

Buy-in information is trading-related information. There is currently no mechanism in place for such information to be transferred to the settlement level (i.e. to the CSD). Building such a mechanism for OTC transactions will require a major investment by all parties in the custody chain (centrally cleared trades are catered for by Central Counterparties).

We estimate that the cost for all CSDs and settlement banks to build the relevant infrastructure to collect this information will be significant. ECSDA estimated that the cost for its members for reporting of buy-in and settlement fines to amount to nearly EUR 24 million, or EUR 1.25 million per CSD on average. The high costs are partly due to the need for the ICSDs to implement the functionalities and reporting not just in relation to EU "domestic" transactions, but also to their international business. Once implemented, the system for preventing and monitoring fails will have to be operated. This is expected to cause further yearly operating costs of nearly EUR 5 million or over EUR 250,000 per CSD[36]. We would anticipate similar costs to ICSDs (i.e. above the

[35] ESMA Final report on CSDR
[36] ECSDA Comments on the upcoming CSDR technical standards and technical advice on settlement discipline

average) for large international banks participating in multiple European markets. This, at a time when the same CSDs and banks are focused on and, investing in the T2S pan-Euro area settlement platform.

In addition to the expected cost, the quality of the data is questionable. As already stated, the settlement discipline provisions within CSDR are built on the premise that the settlement participant (i.e. the member of the CSD) is the offending party. However, the settlement participant only acts on instructions from its client, which may be the trading party, but in other instances, may be once (or more) removed from the trading party.

It is not clear how useful the collection of this information will be if it only describes the settlement level parties. They are reliant on their customers, the trading parties, to have executed transactions that will enable successful delivery.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The requirement for CSDs to collect and store extensive buy-in information should be dropped from Article 54 (x) of the CSDR RTS on CSD Requirements and Annex IV – Format of CSD Records - field 24 of CSDR Draft ITS. We recommend the use of electronic trade confirmation and affirmation tools to ensure that transactions are agreed by both trading parties as soon as possible in the trade lifecycle. We fully support the use of settlement fines as described in CSDR as a measure to encourage timely settlement. We would recommend assessing the impact of these measures before undertaking extensive investment in a system that may prove of little value.

Example 3 for Issue 5

Transparency Directive: differing disclosure requirements among national regulators

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Transparency Directive (2004/109/EC, and subsequently amended).

- **Please provide us with an executive/succinct summary of your example.**

Article 3 of the Transparency Directive allows home Member States to make an issuer subject to requirements which are more stringent than those laid down in the Directive (with certain exceptions and conditions applying). This has lead to differing interpretation of disclosure requirements between 28 national regulators leading to divergent approaches by firms, with potential market moving implications.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.**

The following examples of differing interpretations of disclosure requirements have been brought to our attention:

- Germany's disclosure obligation calculation date is trade date, instead of settlement date;
- There are different interpretations between national regulators of the collateral taker exemption;
- There are differing deadlines for reporting. For example, in the UK the reporting deadline is T+2 whereas in the Netherlands it is T+1;
- Different regulators use different forms that need to be filled in to disclose the information.

In addition, the current requirement to publicly disclosure positions on a gross basis also presents inconsistent and potentially confusing information to the market. An example would be if a client wanting to take a long position in a CFD for 100 shares. The dealer would be short 100 CFD (as a result of writing the CFD to the client) and to hedge itself would go long physical shares by 100. This makes the dealer's net exposure (between the CFD and the physical share positions) zero. However, under the rules to disclose positions on a gross basis, the dealer ends up disclosing only the long position of 100 physical shares.

This all leads to less optimal reporting results, increased legal translation and compliance costs. The requirement to disclose positions on a gross basis can be potentially confusing to the market.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Our proposed solution would be to amend the legislative instrument to a Regulation to ensure a uniform approach across the EU28 countries. Also, we would suggest amending the measure to require disclosures on a net basis.

Issue 6 – Reporting and disclosure obligations

"The EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.

Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals.

Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value."

Example 1 for Issue 6

SFTR, EMIR, REMIT, MiFID and MiFIR: lack of consistency in reporting requirements

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

SFTR (COM/2014/040), EMIR (Regulation 648/2012), REMIT (1227/2011/EU), MiFID (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/ 2014).

- **Please provide us with an executive/succinct summary of your example.**

The regulatory reform programme introduced different reporting requirements for market participants. In some cases different requirements have introduced conflicting reporting requirements, centred on the following issues:

- The requirements apply to different entities/persons. Also, in some cases both parties to a trade are required to report, which has lead to data quality issues and double counting;
- The requirements apply to different financial instruments, and in some cases there are differing interpretations by NCAs as to which financial instruments are in scope;
- Where multiple reports under different regulations are required for the same trade, the timing, format and content of those reporting obligations differ, meaning that one report cannot satisfy all obligations;
- There is a lack of explicit guidance as to exactly how financial instruments should be reported and how reporting fields should be formatted. In some cases where there is guidance, it contradicts industry conventions, which requires additional processes for reporting parties and trade repositories;
- Many of the above challenges are also exacerbated when cross-border trades are considered, as they are often subject to conflicting or duplicative international reporting requirements.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Requirements applying to different entities

In general, SFTR, EMIR and REMIT apply to any person who trades relevant products, whereas MiFID and MiFIR reporting regimes generally only apply to EU regulated investment firms and banks. This means that firms need to consider for each trade, under each regulation, whether and how to report.

Further, under EMIR for instance (and in some circumstances under SFTR), both counterparties to a trade are required to report. In many cases a non-financial counterparty will not be equipped to carry this out, leading to widespread non-compliance, flawed data and necessary remedial steps such as delegated reporting. With respect to two-sided reporting under SFTR, reporting requirements for certain counterparties come into effect sooner than such requirements for other counterparties, leading to uncertainty as to whether the in-scope counterparty must report for the out-of-scope counterparty, and if so, how such reporting should be made.

Of serious concern is the fact that a lack of consistency in reporting requirements, as outlined below, means that the two reports submitted by the parties to a trade may not be identical in format, resulting in mismatched data, requiring correction by one or both parties, which can be a significant undertaking when the number of trades is taken into account.

Double counting

Furthermore, double-counting occurs when both parties involved in a transaction provide data to their respective national authorities. In the case of securities financing transactions, the same transaction may be reported twice, by both lender and borrower (if both are required to report), leading to an overestimation of the size of the overall securities financing market. Therefore it is necessary to make adjustments for double-counting, in order to derive meaningful aggregate measures.

The Financial Stability Board (FSB) in their most recent publication on *Standards and Processes for Global Securities Financing Data Collection and Aggregation* have used the following example to illustrate the effect of double-counting on a national and international level. The example illustrates the situation of double-counting in case where market participants will be required by the national/regional authority to report. The problems as well as the possible solutions could also apply under the circumstances where SFT data are reported to a trade repository.

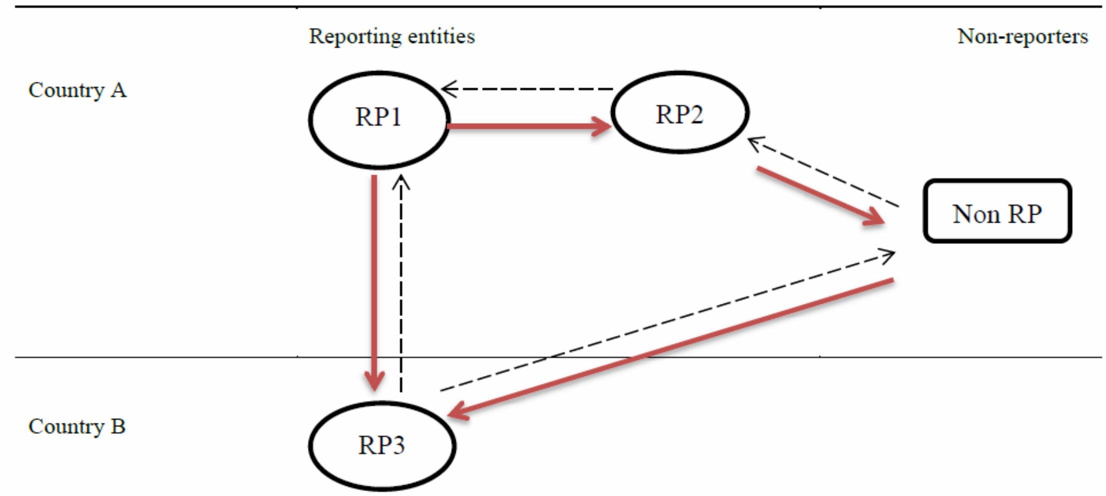


Figure 17: Double-counting of reporting,
Source: FSB report "Standards and Processes for Global Securities Financing Data Collection and Aggregation"

In the example, there are three reporting and one non-reporting entities (e.g. a non-financial corporations or a government). Transactions between reporting entities will be double counted, while transactions between a reporting and non-reporting party will not contribute to double-counting.

The reporting entities RP1 and RP2 as well as the non-reporting participant NonRP are all residents of the same jurisdiction A, while reporting party RP3 resides in jurisdiction B. Solid arrows are cash legs of individual repo contracts whose security legs are shown as dotted arrows. The baseline scenario is for all reporting entities to report all transactions whether or not the reporting party is the cash provider or the cash taker and without regard to issues arising from double-counting.

Under the baseline scenario, the jurisdiction A report will include:

i. RP1 report of RP1 to RP2 transaction
ii. RP2 report of RP1 to RP2 transaction
iii. RP2 report of RP2 to NonRP transaction
iv. RP1 report of RP1 to RP3 transaction

Jurisdiction A report will thus turn out to include double-counting of the transaction between RP1 and RP2.

Jurisdiction B report will meanwhile include:

v. RP3 report of RP1 to RP3
vi. RP3 report of NonRP to RP3

Based on the reports from jurisdictions A and B, the global aggregate will count twice not only the RP1 to RP2 transaction reported by jurisdiction A but also the RP1 to RP3 transaction reported by jurisdictions A and B. In addition, the jurisdiction A report will not include the NonRP to RP3 transaction.

<u>Requirements applying to different products</u>

In terms of the overlapping reporting requirements, trades will often fall within more than one reporting regime. Certain transactions may need to be reported under

MiFID/MiFIR, SFTR, EMIR or REMIT. While some effort has been made to harmonise these reporting requirements, particularly with respect to Article 9 of EMIR, Article 2 of MIFIR and Article 4 of SFTR., more could be done to streamline and harmonise reporting obligations under various regulations.

Multiple conflicting reports

The reports mandated under different regimes are required according to different deadlines. For example, MiFIR post trade transparency reports are expected to be filed as close to real-time as technically possible (MiFIR Article 10), and are followed by both MiFIR transaction reporting (MiFIR Article 26) and EMIR trade reporting (EMIR Article 9) by the close of the next working day. Under SFTR, in-scope entities should report details of SFTs they have concluded as well as any modification or termination to a trade repository no later than the working day following the conclusion, modification or termination of the transaction.

Besides these timing differences, the same report cannot be used for multiple reporting obligations, as the information required and format prescribed under each differs. This requires the trade repositories to create processes to transform the data they receive from firms into the required fields and formats for each reporting obligation, even though in essence the same data being reported in each case.

A lack of specific and accurate guidance on products, fields and formats

The above point on multiple conflicting reports is compounded by the lack of explicit prescription on the part of national and European authorities of exactly how data should be reported. This has led to firms reporting products and populating fields in different ways, and different trade repositories also using their own data standards when accepting these reports. A couple of examples are:

- There has been divergence as to whether FX swaps should be reported as one or two contracts (i.e. a near and a far leg). If the two counterparties to an FX swap reported it differently, it would remain permanently unmatched. On this point, we welcome ESMA's decision in its Final Report on the Technical Standards for EMIR Article 9 (page 25 Recital 3) that derivative contracts composed of a combination of contracts should be reported in their individual components. However, this guidance extends beyond FX Swaps to other complex derivatives, and it is not yet clear how these are defined, or how the counterparties to a trade should agree how to break these complex derivatives into component parts.
- Fields such as 'notional amount' were identified as the cause of frequent mismatches for FX trades involving currencies such as Yen. This was due to counterparties rounding the amount differently according to their individual systems. The Global FX Division of the GFMA recently led an initiative to identify common mismatches such as this, and worked with market participants and DTCC to create industry standards, and, where appropriate, change tolerances. However, field format discrepancies between counterparties are common, and will remain so until full and specific guidance is issued by ESMA.

Conversely, some ESMA rules on how to report products, while specific, are unhelpful.

Notably, the taxonomies that ESMA uses are not always consistent with those recognised by the industry[37]. With a project underway to define a Unique Product Identifier, and proposals for greater ISIN use under MiFID, AFME is concerned that the industry may not be sufficiently consulted in this process and that the results may not reflect the market as it exists to those who trade in it.

Cross border conflicts

Finally, duplicative obligations can also result from diverging requirements between the EU and non-EU jurisdictions. This is typically the case for reporting to trade repositories when one counterparty is located in the EU and the other one outside the EU. The EU counterparty may be required to report twice (to one trade repository in the EU and to one trade repository outside the EU), for example when one counterparty is located in the US.

In the same manner as reporting requirements within Europe often differ, there is also a lack of global consistency. This exacerbates the problem of reporting the same information in multiple formats, and, as noted by the FSB in their recent Thematic Review of Trade Reporting[38], makes the data very challenging for regulators to aggregate across jurisdictions for a global picture of exposures and risk.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

There are a number of solutions which we would advocate for reducing the duplicative and conflicting reporting obligations in Europe.

Firstly, together with a number of other industry associations, some of our members advocate moving to a single-sided reporting regime under EMIR. This would remove the need for a matching process, which is particularly unnecessary when many smaller counterparties already delegate the reporting of their side of the trade. We support the International Swaps and Derivatives Association's (ISDA) response to the Commission's EMIR Review[39], which outlines in full out reasons for advocating that single sided reporting should be used in Europe.

Secondly, we encourage the Commission and ESMA to engage in international efforts to harmonise reporting requirements. For example, CPMI and IOSCO have already issued consultations on the Unique Transaction Identifier and other key data elements, with further consultations expected over the coming months. The benefits of global data harmonisation extend not only to firms, for whom it reduces the systems and processes required for multiple reporting obligations, but also for regulators, for whom access to better quality, globally aggregated data would be extremely valuable.

Thirdly, we request that, where necessary, ESMA produces specific guidelines to determine the explicit format and application of particular reporting fields. A lack of clear industry-wide standards results in an inconsistent data set, and in the current dual-sided reporting scheme under EMIR also leads to high levels of mismatches. These guidelines should be developed in conjunction with market participants, and should seek to replicate the way that products are traded and recorded within the industry,

[37] ISDA webpage on UPI and taxonomies
[38] FSB Thematic Review of Trade Reporting
[39] ISDA response to Commission's EMIR Review

rather than imposing artificial concepts and divisions.

Finally, to prevent double counting, AFME believes that reporting requirements at both national and international level should be closely aligned in order to assure accuracy and consistency. The FSB have suggested the following two approaches, which we support, to tackle double-counting with respect to SFT reporting:

- *The aggregate approach* - Reporting entities are required to classify or aggregate transactions based on the characteristics of the counterparty to the transaction. Aggregates could, for example, separate (i) transactions with other reporting entities in the same jurisdiction, (ii) transactions vs. entities in other jurisdictions, and (iii) transaction vs. non-reporting entities. This breakdown enables the identification of transactions reported by both counterparties from cases when only one side provided the data (i.e. transactions between reporting party and non-reporting party such as non-financial corporations, non-reporting financial corporations, or governments). This practice is currently used in the BIS Triennial Central Bank Survey of foreign exchange and derivative market activity and the BIS semi-annual OTC derivatives statistics.
- *The granular approach* - Reporting entities are required to report data by individual transactions that include the counterparty identifiers to the national/regional aggregator. The national/regional aggregator identifies counterparties that are reporting entities and corrects double-counting. To ensure consistency, counterparties should be identified by their global LEI. Double-counting could then be removed looking at the individual security and counterparty pairs.

Example 2 for Issue 6

<u>MiFID II: best execution reporting requirements</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

MiFID II (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/2014).

- **Please provide us with an executive/succinct summary of your example.**

In the context of MiFID II we do have some concerns with regard to the best execution reporting requirements arising from ESMA's proposed Regulatory Technical Standards that were published on 28th September 2015. Initial analysis of the data to be produced according to the proposed requirements, points to the expectation that billions of RTS27 data fields and up to 36,000 RTS28 data fields are to be consumed and analysed by investors.

Referring to their conduct of best execution analysis on their activities on an ongoing basis, asset managers indicate that the nature, volume and complexity of data to be received by their client investors will not assist the clients in getting a better understanding of the quality of an investment firm's execution practices and compliance with its execution policy. As orders are executed, investment firms assess, on a dynamic basis (using the most up-to-date and usually real-time market data available), which venue(s) to which they have access, can best be used to fulfil orders. Then investment firms may ensure that selection decisions are optimised at the time of order routing. Data proposed by the RTS will be stale and lack utility for the consumer for this purpose. Asset managers also maintain that the data as proposed will not provide their clients with a better understanding of how asset managers fulfil their fiduciary duty to them. In being so very voluminous, the picture of best execution is more likely to be obfuscated for the client investor rather than be rendered more clear and proportionality will be lost.

With regard to valid comparisons of best execution, much of the data could be rendered meaningless or misleading. The example that systemic internalisers will provide quotes based on commercial policies (e.g. inventory availability, counterparty risk, settlement risk etc) demonstrates this well. Differing venue policies coupled with varying times of transactions mean that comparison of information across systemic internalisers and compared to other venues will result in a large amount of noise. Comparing this data is unlikely to provide a valid means of identifying whether there might have been a missed opportunity to better execute a trade.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

We do have some concerns with regard to how a number of the best execution requirements could have a negative impact on investor protection. We are, for example, concerned that the inclusion of request-for-quotes (RFQs) in the reporting requirements of Article 6 and 8(b) of RTS27 is not realistic in the context of bilateral transactions concluded through voice trading and is not at all relevant to the assessment by clients of quality of execution. We understand that voice traders would be required to record their own quotes to clients, so that they can fulfil their obligation for publication of quotes under the systemic internalisers regime. However, if they were also required to capture every RFQ from a client, including any amendment or cancelation of an RFQ or also any amendment or cancelation of an order, voice traders would be so significantly impacted in the performance of their function, that the efficient functioning of financial markets would be significantly hampered.

Separately and referring to the proposed requirement for "latancy" data, we consider that "latency" between the time of submission of the request for quote by a client and the time of provision of quote is not at all a question of quality of execution and therefore this data is useless for clients in their assessment of likelihood of execution. A trader may take longer to prepare a quote if the instrument is complex, as there may be additional factors to take into account, but is never incentivised to delay that provision of quote. The client is also not missing out on another opportunity available somewhere else, as these quotes are not readily available by large numbers of dealers, so there can be no feasible assessment of "loss of opportunity". The concept appears to have been inserted in the requirements of Article 6 for the purposes of orders in liquid instruments, where timeliness may indeed impact the ability of client to access a better price in another central limit order book trading continuously the same security.

In addition, the information required to be made public under the RTS 27 could in certain circumstances lead to the disclosure of commercially sensitive information. Changes to the point-in-time transaction references have attempted to ensure regulatory consistency in that where such disclosure has been deemed inappropriate and is not required under the transparency RTS, then disclosure will not be required under this RTS. However, provisions on likelihood of execution under RTS27, Article 6 and Annex 1, Table 6, in particular for less liquid instruments, still require transaction level information providing details of SI positions and trading strategies in a machine-readable format. An unintended consequence of data of this type, particularly where an instrument rarely trades, is dislocation in the market as the data, as proposed, benefits predatory trading strategies rather than to the intended investor client.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The data that would be made public under the RTS would be more beneficial to the intended client investor if it better acknowledged different trading modes and asset classes and is restricted to a more meaningful and usable data set. On this basis and referring firstly to the RFQ issue, we propose the deletion of references to "request for quotes", and unexecuted RFQs in particular, in Articles 6 and 8(b). Referring to our concerns regarding the disclosure of commercially sensitive information, we propose to apply Article 4 (point in time price references) transaction size ranges also to Article 6 on likelihood, such that SI, market makers and other liquidity providers only publish for size range 1 (i.e. up to the Size Specific To the Instrument and/or Standard Market Size) and/or the inclusion of a carve out that if there are less than ten transactions in an instrument per quarter, the report would not be required to include this information. More generally, we recommend that a thorough cost-benefit-analysis of the proposals is conducted to ensure more meaningful and appropriate scoping and data.

Example 3 for issue 6

CRD IV: countercyclical buffer disclosure requirements

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRD IV (Directive 2013/36/EU) and the disclosure of information in compliance with requirements for a countercyclical buffer (Commission Delegated Regulation 2015/1555/EU).

- **Please provide us with an executive/succinct summary of your example.**

We welcome efforts to improve the transparency and quality of financial information and we also agree with the recognition that "requiring disclosure of information imposes a cost on banks, as on any firm, and this cost must be offset by resulting benefits for it to be justified"[40]. These efforts have recently been manifested in various fora, most notably through the work performed by the Enhanced Disclosure Task Force (EDTF) and the new Pillar 3 requirements introduced by the Basel Committee.

We recognise that the supervisory mandate of regulators includes, among its principles, transparency and disclosure of information. Given the need to minimise adverse effects on competition and efficiency and proportionality[41], a balanced approach to banking disclosures is needed in which both costs and benefits are taken into account. This means that the reader of any disclosure report needs to disentangle overlaying disclosures, while the banks themselves are required to produce information to meet different regulatory requirements in different formats. The result of the proliferation of disclosure requirements, particularly when they relate to mandated disclosures, is that they pose the danger of diluting the ability to identify real risks affecting financial institutions. Numerous disclosures which cover a range of possible risks can lead to real warning signs being hidden among the multitude of data.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Financial institutions are, for example, required to disclose their Balance Sheet reconciliation to market risk (under Template L12 column (e) of the revised Pillar 3 disclosure requirements). The template is aimed at providing information on the main reasons for differences between the carrying amounts in financial statements and the exposure amounts used for regulatory purposes. Although the format of the template is intended to be flexible it does seem, at least in respect of the information required in column (e) ('market risk framework') to require a comparison between two different sets of figures which do not directly relate to each other (Balance Sheet figures and the output from value-at-risk information). As such, it does not appear that the disclosure would bring significant benefits, with the information produced unnecessarily burdensome for the value it provides to the user.

[40] Schaffer, 1995, p.26 (from paper by Baumann and Nier)
[41] PRA approach to bank supervision (Article 30)

Another specific example of where disclosures are bringing little value to the understanding of financial institutions risk framework is found in some of the countercyclical capital buffer (CCyB) reporting requirements. This includes information relating to the "geographical distribution of credit exposures relevant for the calculation of the countercyclical capital buffer"[42]. The legislation would seem to require the table to be produced in all cases, listing any country where the institution has credit exposures representing more than 2% of its RWA exposure. This would be applicable even in the case of financial institutions setting the CCyB at 0% (as was the case for the 2014 Pillar 3 Reports of a number of banks). In such cases, the table would seem to add little value to the understanding of the institution's compliance with Pillar 3 requirements while creating both added administrative costs and an array of lengthy explanations and detailed information.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Besides addressing the above mentioned points, we believe that if banks publish details on RWA and exposure measures in their statutory disclosures and Pillar 3 reports, these should be (in combination) comparable across institutions. The Basel Committee, in its January 2015 paper, set out five guiding principles for Pillar 3 Disclosures. In turn, each illustrates the importance of transparency, but also the way in which disclosures need to be tailored for specific circumstances to avoid information overload and the risk of not achieving the objectives of regulators. AFME strongly supports these principles, and it is against these that we have built our approach to considering what an optimal disclosure framework should look like:

- disclosures should be clear;
- disclosures should be comprehensive;
- disclosures should be meaningful to users;
- disclosures should be consistent over time;
- disclosures should be comparable across banks.

In addition to the above, we would urge regulators to identify the readership of new disclosure requirements which will offer a measure of whether the disclosures serve a real market demand.

[42] EBA Final Draft Regulatory Technical Standards on disclosure of information in relation to the compliance of institutions with the requirement for a countercyclical capital buffer under Article 440 of Regulation (EU) No 575/2013

Example 4 for Issue 6

SFTR: impracticalities of margin funding reporting

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Securities Financing Transactions Regulation (COM/2014/040).

- **Please provide us with an executive/succinct summary of your example.**

There are some issues with the reporting requirements as developed in the Securities Financing Transactions Regulation (COM/2014/040). The main issue with regard to the list of minimum elements in the Level 1 legislative text is that this has been developed from the perspective of repo trades only, and thus most minimum elements do not fit comfortably in the margin lending space (or will at the very least have a different meaning/interpretation). This will lead to data being reported that is not relevant, e.g. maturity date, first callable date, market segment**.**

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

A Securities Financing Transaction or SFT means:

- a repurchase transaction;
- securities or commodities lending and securities or commodities borrowing;
- a buy-sell back transaction or sell-buy back transaction;
- a margin lending transaction.
- Margin lending refers to short term collateralised loans provided by a financial firm (usually a bank or a broker) to its clients with the purpose of taking leveraged trading positions. The securities provided as collateral are held in margin accounts and are usually re-hypothecated to provide competitive funding conditions to its client known as "prime brokerage agreement".
- While margin loans are very similar to repo and securities lending transactions, they also exhibit certain differences. The main similarities with repo and securities lending are:
- like repo and securities lending, margin loans involve the temporary exchange of assets, namely the short-term provision of cash secured against collateral;
- margin loans also allow banks or brokers to create "collateralised" short-term liabilities provided they can access underlying collateral securities;
- the economic effects (and related financial stability risks) seem thus equivalent to those of repo and cash-collateralised securities lending in that they create leverage and facilitate maturity and liquidity transformation.
- The main differences between margin lending and repo and securities lending are:
- unlike repo and securities lending margin loans are usually subject to portfolio margining;
- a great share of repo and securities lending activities usually take place under

industry-standard master agreements, while prime brokerage agreements generally differ across brokers and jurisdictions;

- repo and securities lending could involve temporary transfer of title of the collateral, while margin lending only provides the broker with the right to re-hypothecate the collateral. However, full transfer of title occurs once the collateral has been re-hypothecated by the broker. Then, the broker has the same obligation as under a repo or securities lending transaction to return "equivalent securities" to the client.

  - **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Given these differences, some of the reporting requirements as set out in the SFTR are not applicable to the margin lending space. We list the following fields which are either not available in their current form or not relevant in the margin lending space:

- assets used as collateral and their type, quality, and value; - this will only be available if allowed to be reported on a position and portfolio basis;
- whether collateral is available for reuse; - this depends at what level the details are required. This could ultimately be taken from the legal documentation. Currently this will not necessarily be in all Prime Brokerage systems so may be required to be built as a separate functionality if required to be provided in reporting;
- in cases where it can be distinguished from other assets, whether it has been reused; - the total value of re-hypothecated assets is preferred rather than on an asset by asset basis;
- any substitution of the collateral; - this is not relevant;
- the repurchase rate, lending fee or margin lending rate; haircut; value date; - this will be available but will be made up of variable rate components so will not necessarily be available as a single combined rate;
- maturity date; - this is not relevant;
- first callable date; and – this is not relevant;
- market segment: - clarity is required.

We argue that in connection with the FSB's development of a global data template for information to be provided under SFTR, the GFMA (an umbrella group consisting of AFME, its US counterpart SIFMA and its Asian counterpart ASIFMA) has had meetings and discussions with the FSB regarding the differences between securities lending and margin lending and, particularly, the reporting information that would be relevant to margin lending. This has been reflected in the FSB data templates and therefore any other reporting template used should be aligned with FSB global data template work as closely as possible.

Example 5 for Issue 6

<u>MiFID II: requirement to report positions held by clients of clients</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

MiFID II (Directive 2014/65/EU), Article 58(2).

- **Please provide us with an executive/succinct summary of your example.**

Article 58(2) of MIFID II requires investment firms to provide the competent authority of the relevant trading venue on a daily basis with a complete breakdown of their positions taken in commodity derivatives or emission allowances or derivatives thereof traded on a trading venue and economically equivalent OTC contracts, as well as "those of their clients and the client of those clients until the end client is reached".

This obligation would require investment firms to report information not only on positions they have with their direct clients, but also on any underlying clients of those clients, all the way down the chain until the "end client" is reached. However, investment firms are not in a position to control access to information about positions of clients other than the specific trades they directly enter into with their own clients.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The current Level 1 text of MiFID II raises a number of concerns, including:

- **Who is the "client" at each stage**? While an EU investment firm should be able to identify who are its "clients" (as we understand that these should be entities to which the EU investment firm owes obligations under MiFID II), this will become more difficult where a non-EU client or unauthorised EU client deals with a counterparty and is required to assess whether or not that counterparty is a "client". As discussed further below, an EU investment firm will not necessarily have any relationship with the clients of its clients nor any visibility as to the positions of their clients' clients. The EU investment firm will be entirely reliant on its clients to procure and provide this information. The EU investment firm will have no way of monitoring whether the information provided is accurate or complete.
- **Who is the "end client"**? The reporting obligation under Article 58(2) MiFID II requires an investment firm to report the position of its clients in the relevant instruments, as well as the positions of any clients of those clients "until the end client is reached". It is not clear who the "end client" would be. Would the investment firm be required to obtain information on and report the positions of every relevant entity until it reaches entities that have no clients of their own? If this is the case, the EU investment firm will have no way of assuring itself that it has identified the "end client" and will have to rely on the information provided by their clients (i.e. the ultimate "end client" has been correctly identified). Again, the EU investment firm will have no way of monitoring whether the information provided is accurate or complete

- **How should the investment firm obtain the necessary information**? An EU investment firm will not necessarily have any relationship with the clients of its clients, or the clients of those clients. Even if an investment firm imposes a contractual obligation on each of its clients to disclose the positions in relevant instruments held by each of their clients and to impose a similar contractual obligation on those clients, the clients of an EU investment firm may not accept that obligation or may not provide that information despite such contractual obligation. In addition, the EU investment firm will have no way of checking or confirming the information provided by their client nor determining whether or not it may be inaccurate or incomplete.
- **How should the investment firm deal with any restrictions on disclosure**? Each EU investment firm will need to take steps to ensure that its disclosure of client positions (ie. its clients and the client of its clients) does not give rise to any commercial sensitivity, privacy or data protection concerns or to other restrictions on disclosure. This raises its own difficulties, but these are amplified by the fact that each EU investment firm will need to be comfortable that the disclosure of positions of underlying clients of clients does not breach any restrictions on disclosure or incur liability for the EU investment firm.

MiFID II does not contain any wording equivalent to that in Article 9(4) EMIR or Articles 4(7) and (8) SFTR, which would clarify at least for EU entities that reporting positions under MiFID II will not be considered to breach any restriction on disclosure of information imposed by the relevant contract or by any legislative, regulatory or administrative provision, and that no liability resulting from the disclosure shall lie with the reporting entity or its directors or employees.

For the reasons set out above, the reporting obligation in Article 58(2) is unlikely to meet sufficiently the objectives of increasing transparency and providing more information to regulators, investors and the public in general. Streamlining and clarifying the reporting obligations would improve quality, effectiveness and coherence.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We would propose:

- deleting the obligation in Article 58(2) MiFID II for investment firms to report information on positions taken by "their clients and the clients of those clients until the end client is reached";
- requiring each party to a transaction that gives rise to a position subject to the position limits regime to report its own positions (so that an investment firm would report only its own positions; its clients and their clients or counterparties would report their positions either directly or by providing the details to the investment firms that can report on their behalf). This approach is consistent with the approach taken for position limits, where each person has the obligation to monitor the size of the position that it can hold, and in line with the EMIR and REMIT reporting regimes, where each market counterparty or participant is required to make their own report;
- including a provision in MiFID II and MiFIR equivalent to the provision in Article

9(4) EMIR and Articles 4(7) and (8) SFTR.

Alternatively:

- Article 58(2) could be amended by removing the end client reporting requirement for investment firms and replacing it with an own account client reporting requirement of those positions that a firm holds directly with its client. Clients (and their clients) could be allowed either to report directly or to provide the details of their positions to the investment firms that can report on their behalf;
- including a provision in MiFID II and MiFIR equivalent to the provision in Article 9(4) EMIR and Articles 4(7) and (8) SFTR.

However, such an alternative approach will not provide any relief in the case of clients which are non-EU entities because the reporting positions under MiFID II may still be considered to breach restrictions on disclosure of information imposed by the relevant contract or by relevant legislative, regulatory or administrative provisions, and the investment firm may have liability resulting from such disclosure.

Issue 7 - Contractual documentation

"Standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/ investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening."

Example 1 for Issue 7

BRRD: alignment of contractual recognition requirements with FSB principles

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

BRRD (Directive 2014/59/EU), Article 55.

- **Please provide us with an executive/succinct summary of your example.**

Overall, we are very supportive of the BRRD and believe that is has been fundamental in enhancing the financial stability of the European banking system. The beneficial impact of the bank recovery and resolution framework established through the BRRD has been recognised. Recent analysis conducted by the Bank of England concludes that resolution arrangements "are expected to improve market discipline, and thereby reduce the probability of a future financial crisis by around a third" and to reduce the net present value of the economic cost of a crisis from around three-quarters to just under half of pre-crisis GDP"[43]. Separately, in its recent consultation paper on its approach to setting MREL, the Bank of England estimates "that systemically-important banks could become around one third less likely to fail" and that "MREL reduces the probability of a crisis by between 26% and 41%"[44].

However, one element of the BRRD that has a particular impact on banks and their ability to provide services to clients, is Article 55 of the BRRD. Article 55 requires European firms to include provisions in agreements which create liabilities governed by the law of a jurisdiction outside the EU to give contractual recognition to the application of the bail-in tool. The scope of Article 55 is significantly broader than that agreed by the Financial Stability Board[45] and includes liabilities that are highly unlikely to be bailed-in, do not contribute to loss absorbing capacity of the bank and where there will be very significant challenges to including contractual recognition provisions, in particular in relation to trade finance and contracts with financial markets infrastructure. To date there has been no substantive impact analysis in relation to

[43] Bank of England, Supplement to the December 2015 Financial Stability Report: The framework of capital requirements for UK banks and Brooke et al (s015) "Measuring the macroeconomic costs and benefits of higher UK bank capital requirements", Bank of England Financial Stability Paper no. 35, December

[44] See Bank of England, The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL): Consultation on a proposed Statement of Policy, December 2015

[45] See FSB Principles for Cross-Border Effectiveness of Resolution Actions

Article 55.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Article 55 requires European banks to include contractual recognition provisions in a broad scope of contracts, including those relating to:

- operational liabilities such as supplier agreements of minimal value;
- contingent liabilities e.g. letters of credit, guarantees and indemnities; and
- membership of clearing and settlement systems outside the EU.

In addition to including clauses in new contracts, Article 55 requires changes to existing contracts where liabilities could be created after 1 January 2016. This involves a very significant renegotiation program, potentially involving many thousands of counterparties. Amending existing contracts to include contractual recognition clauses is not something that can be done unilaterally and where it is possible, will take time to implement. In some cases it is likely to be impossible for banks to do so. Counterparties often lack the ability to amend contracts or their standard terms of business, for example due to fiduciary duties not to accept such amendments. These difficulties were seen in the challenges with obtaining buy-side adherence to the ISDA Resolution Stay Protocol. However, they are even more challenging in relation to Article 55 where European requirements depart from the international standard and a globally consistent approach is required.

AFME's members have undertaken a thorough analysis of the contracts which are within the scope of Article 55 and identified the following categories as presenting particular challenges:

- contracts where there is no realistic possibility of inserting the relevant provisions – and in some cases, it is not clear what these would achieve. Examples include trade finance which, since 1933, has been governed not by national laws but by protocols developed by the International Chamber of Commerce and contracts with central clearing counterparties which would be very difficult to amend and where the bail-in could in any event be counterproductive;
- contracts where there is clear resistance from the local regulatory authorities to any change in the terms, for example uninsured corporate deposits of a non-EU branch of a bank, which are governed by local law; and
- contracts where it may be possible to insert the relevant provisions but not within the timeframe specified by the BRRD, even though our members have been working on this for some time.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We consider that the scope of Article 55 BRRD should be reviewed. We suggest that the focus of contractual recognition requirements should be to ensure the credibility and feasibility of the resolution plan. Liabilities governed by non-EU law which are likely to bear losses should be considered in the context of the resolvability assessment rather than a blanket requirement applicable to every liability that could theoretically be bailed in. We propose that this could be achieved by aligning the requirement under Article 55 with the FSB's agreed scope, namely debt instruments.

This proposal would mean that the scope would include (save where the resolution authority is satisfied that recognition can be achieved under the law of the third country or a binding agreement):

- all liabilities that are eligible for MREL (or TLAC once implemented) which are governed by non-EU law;
- all debt instruments which are governed by non-EU law; and
- any additional liabilities identified by the resolution authority where the absence of contractual recognition requirements creates an impediment to resolvability.

This approach would enable resolution authorities to be satisfied that all firms are resolvable without imposing an undue burden on them and bring the EU in line with global standards[46].

Issue 8 - Rules outdated due to technological change

Please specify where the effectiveness of rules could be enhanced to respond to increasingly online-based services and the development of financial technology solutions for the financial services sector.

Issue 9 - Barriers to entry

Please document barriers to market entry arising from regulation that the EU should help address. Have the new rules given rise to any new barriers to entry for new market players to challenge incumbents or address hitherto unmet customer needs?

[46] See AFME paper on this issue

Interactions of individual rules, inconsistencies and gaps

Issue 10 - Links between individual rules and overall cumulative impact

Given the interconnections within the financial sector, it is important to understand whether the rules on banking, insurance, asset management and other areas are interacting as intended. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-sectoral rules (for example with regard to financial conglomerates). Please explain in what way and provide concrete examples.

Example 1 for Issue 10

CRR and MiFID II: aligning treatment of equities as eligible collateral

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

CRR (Regulation (EU) No 575/2013) and MiFID II (Directive 2014/65/EU).

- **Please provide us with an executive/succinct summary of your example.**

An unintended consequence seems to have arisen from a reference to MiFID II that is being made in the CRR. The CRR allows equities traded on a Recognised Exchange as eligible collateral (albeit subject to a higher volatility haircut than those on a main index). The definition of "Regulated Exchange" in Article 4(92) of CRR references the definition in point (14) of Article 4 of MiFID (Directive 2004/39/EC). ESMA has given further interpretation to the Level 1 MiFID definition of a Regulated Exchange. Due to the Level 1 definition of Recognised Exchange it was not possible for ESMA to include non-EEA exchanges on its proposed list of Recognised Exchanges.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

We understand that the limited nature of the list will significantly reduce the volume of eligible collateral that market participants currently use, particularly for securities from non-EEA markets. The unintended result will be a material increase in Risk Weighted Assets and Large exposures as EEA banks will no longer be able to recognise certain widely-used securities as eligible collateral for the purposes of credit risk mitigation. As a result, the framework will place material constraints on the ability of EEA firms to compete with non-EEA institutions, particularly in offering clients access to non-EEA markets.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

Allowing non-EEA exchanges to join this list would help alleviating the restrictions to collateral eligibility, and so we strongly urge the Commission to consider revisions to the Level 1 text. If no changes are made, the inability of non-EEA exchanges to be recognised exacerbates the impact of the narrower range of indices allowed in those markets (as securities outside the "main" index cannot "qualify" instead via exchange listing) – further reinforcing the need for a wider range of indices to be allowed if a level of eligibility comparable to that allowed for non-EEA firms is to be achieved. MiFID and CRR have different objectives, and we believe that this should be considered in the approach to specify recognised exchanges.

Issue 11 – Definitions

"Different pieces of financial services legislation contain similar definitions, but the definitions sometimes vary (for example, the definition of SMEs). Please indicate specific areas of financial services legislation where further clarification and/or consistency of definitions would be beneficial".

Example 1 for Issue 11

Market Abuse Regulation: clarifications of requirements

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Market Abuse Regulation (MAR – 596/2014/EU).

- **Please provide us with an executive/succinct summary of your example.**

In relation to the Market Abuse Regulation (MAR) draft technical standards (DTS), we have a number of fundamental issues with regard to:

- Investment recommendations;
- Suspicious transactions and order reports;
- Insider lists;
- Buy backs.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Investment Recommendations

MAR seeks to ensure transparency, requiring persons producing or disseminating investment recommendations to ensure information is objectively presented, and to disclose any conflicts of interest. To this end MAR DTS Article 6.1 (a) requires the producer of a recommendation to state whether it holds more than 0.5% of the issued share capital of the issuer to which the recommendation directly or indirectly relates. This seems appropriate.

The scope of MAR is broader than MAD, and therefore more recommendations are expected to be subject to the disclosure requirements applied to investment recommendations under the DTS. Applying the same set of DTS disclosure standards to all MAR investment recommendations would create major additional process and cost, particularly in the case of in-scope marketing communications, which might lead businesses to conclude that some types of recommendation should no longer be made available to clients. That would impact the amount of market information received by industry participants, trading volumes, liquidity and ultimately growth.

Furthermore, the DTS includes a number of additional disclosures, such as those set out in Article 4. These disclosures appear to be designed to provide recipients of an investment recommendation with additional information to enable them to make a better-informed investment decision. We note that these disclosures have been crafted with traditional, substantive independent research in mind which is based on models and employs a rating system (e.g. a system that provides a recommendation, based on a framework, for issuers or securities using terms such as buy/hold/sell). They are not appropriate for marketing communications falling within the scope of the MAR investment recommendation definition ("in-scope marketing communications"), which are fundamentally different, in that they are sent to existing clients, are not necessarily based on models or valuations and do not include the long, reasoned, in-depth analyses that the DTS seems to presuppose. It would therefore be disproportionate to treat in-scope marketing communications in the same way as traditional, substantive independent research by applying the full set of disclosures set out in the DTS to the former.

Suspicious transactions and order reports

This part of MAR requires market operators and investment firms that operate a trading venue to establish and maintain effective arrangements, systems and procedures for preventing and detecting market abuse and attempted market abuse. An entity will be compliant with the obligation in paragraphs 1 and 2 of Article 16 of the DTS if the level of monitoring is effective and appropriate for the size and nature of the business the entity conducts. We welcome the confirmation within a recital of the DTS that surveillance and monitoring systems do not always have to be automated.

However, we are concerned about the suggestion that firms may still be required to have systems that produce automated analysis and alerts of every transaction and order. The requirement for the system to produce alerts, in our opinion, indirectly imposes an obligation on the systems to be automated, directly contradicting the statement in the recital of the DTS. In addition, ESMA has defined 'orders' in the DTS in a very broad way, including every type of order and each and every quote (including modifications, updates, cancellations etc.). As a result, this would cover quotes on every trading system, including voice trading. This one-size fits all model for trading activities may not be the most efficient surveillance approach. We think that automated surveillance systems have a big role to play, but the DTS requirements should reflect the different types of trading systems and allow firms to adopt a risk-based approach without imposing automated systems in all instances by default.

Insider Lists

The obligation to maintain sensitive personal data (full names, addresses, phone numbers, national ID numbers) of an individual not employed within the group of an investment firm or credit institution, i.e. employed by third parties such as lawyers, accountants, printers and the like, should rest on that individual's employers and not on the relevant firm/institution, provided that when the regulator requests the information it can be provided quickly to the firm/institution and on to the regulator and without tipping off. We anticipate significant data protection issues otherwise. Investment firms and credit institutions must be entitled to rely on this external data on a best effort basis.

There is, finally, the question of individuals' personal data being transmitted electronically across national borders (both within the EEA and to and from third countries). Regulators will have to become involved in making legally enforceable demands for such data, in the situation where local data protection or employment law would otherwise conflict with the proposed insider list requirements.

Buy backs

Trading in own shares as part of an equity buyback programme is not considered to be market abuse under MAR Article 5 (1) (safe harbour) if certain conditions are met. The DTS suggests that in order to benefit from this safe harbour, transactions have to take place on a trading venue (therefore excluding OTC transactions from the safe harbour). This will cause a problem in the (not unusual) scenario in which the broker-client leg of the transaction is traded OTC (i.e. the broker buys shares on a trading venue and then sells to the client bilaterally i.e. OTC). This appears to be at odds with the objectives of the Capital Markets Union (to remove barriers to capital markets access), and the recent non-binding resolution of the EU Parliament, which encourages a wider range of investment choices and risk mitigation tools.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We believe that Articles 3 and 5 of the DTS constitute an appropriate set of disclosure standards for in-scope marketing communications, with the addition of the 0.5% disclosure in Article 6.1.a of the DTS, mentioned above.

With regard to investor recommendations, the MAR Level 2 disclosure requirements should take into consideration the different types of investment recommendations under MAR (including in-scope marketing communications and other investment recommendations which do not employ a rating system as against traditional substantive independent research using a rating system). We therefore suggest that the DTS exempt in-scope marketing communications and other non-rating based types of investment recommendation from certain disclosure requirements, as set out above.

With regard to suspicious transactions and order reports we believe that DTS should not require firms to put in place systems that create alerts for the full range of trading activities. We would suggest that the DTS be amended in order to allow firms to adopt a risk-based approach for certain types of trading systems. We do agree that surveillance and monitoring must be capable of analysing every transaction. The word “capable” appears in the ESMA report (at para 6.4.2.149) but not in the DTS text – we suggest that “capable” is also used in the context of suspicious transactions and order reports in the DTS.

With regard to insider lists, we would suggest that banks, national competent authorities and professional organisations work together to arrive at the most effective means of implementing the new regime for insider lists with a view to achieving the common aim of making it easier to identify potential market abuse.

With regard to buy backs, we suggest, therefore, that it is recognised (in the RTS or ESMA Q&A) that if an issuer purchases shares from a broker on a riskless principal basis and the corresponding market purchase by the broker was on a trading venue, that will be considered to satisfy the requirement under the RTS on buy backs (Article 3.1. a), i.e. that the shares shall be purchased by the issuer in a trading venue where the shares are admitted to trading or traded, provided that all the conditions referred to in Regulation (EU) No 596/2014 and the other conditions of the RTS on buy backs are met.

Example 2 for Issue 11

<u>Short Selling Regulation: definition of market making</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Short Selling Regulation (SSR - Regulation 236/2012).

- **Please provide us with an executive/succinct summary of your example.**

The SSR would benefit from updating some of the definitions in the regulation**.** A few changes should be made to the Short Selling Regulation (SSR - Regulation 236/2012), in order to improve liquidity in European financial instruments caught by the scope of the SSR provisions (e.g. by ensuring that the scope of the market making exemption is appropriately defined so as to permit market makers to engage in legitimate market making business) and reduce SSR compliance costs to investors which inhibit end users from engaging in the European capital markets (e.g. by harmonising the short position disclosure regime).

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

<u>Example 1: large block positions require market makers to manage inventory</u>

Larger dealers are often the only sources of liquidity for block positions, which UCITS funds and pension funds buy or sell to meet redemptions and payment obligations or to rebalance their portfolios in response to changing market conditions. Market makers may have relationships with both buyers and sellers in the relevant positions as well as the expertise and incentive to provide supply and demand to both sides without disrupting the market. Market makers today build and manage inventories on an ongoing basis before customers commit to a block trade. If they are only able to do this in response to a customer trade, customers will suffer from increased execution time, along with worse pricing and higher price volatility.

Executing a block trade also requires market makers to prudently manage their inventory to reflect prevailing market liquidity, avoid disrupting the market and protect the customer's trading strategies. If market makers are uncertain about the permissibility of accumulating and disposing of these blocks in a gradual manner, they will provide less favourable size and pricing terms to customers or may even decline to execute certain trades at all. If investors cannot sell block positions to market makers, they will need to unwind the positions on their own. This means that they will either hold the positions for longer than they would like, or alternatively that they will dispose of the positions quickly, resulting in lower prices and a lesser amount of proceeds. Either directly or indirectly, this will drive investment costs higher and returns lower, eroding investment.

<u>Example 2: market makers in sovereign debt may need to buy CDS protection ahead of trading large bond positions with clients</u>

Market makers may be asked by a client (or may anticipate a client's request) to purchase a significant bond position it holds. The market maker may only be able to agree to the risk of such a trade if it can purchase CDS protection over the relevant sovereign beforehand – this is especially likely to be the case where the relevant bond market itself is illiquid (and so the market maker will need to unwind its physical position over time) but the CDS market for the sovereign in question is sufficiently liquid.

The likely impact on limiting market makers' ability to manage their risk in this way is a loss of liquidity in the bond markets (particularly in the debt of economically weaker Member States), causing widening spreads and therefore an increase in the cost of investing in EU sovereign debt. Compounded by concerns large investors may develop with respect to building significant bond holdings (because of difficulties in selling such a position to a market maker easily), limiting the scope of the exemption may impede certain Member States' capital raising efforts.

Example 3: market makers undertaking client order to carry out index rebalancing

In situations where clients of a market maker are attempting to match a specific point-in-time benchmark, such as an index rebalance where the closing price of the day's primary market defines the weighting of shares in a particular index, the market maker may build a position in the shares in question around that benchmark. This serves the purpose of minimising any adverse price movement or liquidity spikes that might occur had the broker been unable to engage in this activity, and the client would be forced to execute all of their order at the benchmark price. The likely impact of restricting the market maker's activity will be a concentration of orders during the time at which the benchmark is being set. With limited subsequent liquidity being provided by other market participants around that benchmark, significant price movements would occur at that time, which bear little reference to the financial fundamentals of the company itself, and more to do with a very short term imbalance of supply and demand for the shares in question.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We would argue for the following amendments to the SSR to be made:

- Amend the definition of "market making activities" under Article 2(k) of the SSR such that:
  - it is clearer that the market making exemption only requires a firm to be a member of a single trading venue, rather than be a member of a trading venue where each instrument in which the firm makes markets is listed; and
  - it is clearer that the exemption is available in relation to market making in any "financial instrument" (per MiFID definition), rather than only in relation to market making in financial instruments positions in which must be taken into account when calculating a net short position in shares or sovereign debt.
- This would in turn allow ESMA to revise its guidelines on the exemption to bring them in line with the interpretation currently adopted by several competent authorities, including the FCA and BaFIN;
- Amend the definition of "market making activities" to permit non-EU market making firms to make use of the exemption automatically, given that the Commission has not made any equivalency determinations in this respect;

- Harmonise the short position disclosure process such that notifications are made to ESMA in accordance with a single disclosure format/process, rather than continue with a regime which requires notifications to be made to relevant Competent Authorities directly in accordance with each such regulator's own disclosure format/process. In addition, ESMA should itself publish relevant non-private short positions disclosed to it, in order to achieve consistent public data in relation to significant short positions held by relevant investors;
- ESMA should maintain a central list of issuer total share capital. There is already a list of 'liquid' issuers used for coverage requirements; although this would be more difficult to keep up to date it must be feasible, and would remove one of the main areas of inconsistency. Frequently, issuer websites, stock exchange information pages, and data providers have different details for the entire issued share capital of a particular issuer, which complicates determining threshold breaches;
- On temporary bans part of the ESMA opinion process should include a check and confirmation of whether existing short positions can be rolled, whether there are any de-minimis exemptions, and whether indices/CISs are excluded. This would minimise the scope of the issues that the industry has to contend with whilst trying to react quickly to new short bans;
- We believe that these changes could support the positive role that the Commission has also recognised short selling can play by contributing to the efficiency of EU markets, notably in terms of increasing market liquidity, more efficient price discovery and helping to mitigate overpricing of securities. At the same time the Commission also argues that short selling presents risks.

Example 3 for Issue 11

<u>Securities Financing Transaction Regulation: clarification of scope and definitions</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Securities Financing Transaction Regulation (COM/2014/040).

- **Please provide us with an executive/succinct summary of your example.**

There are uncertainties about the scope and definitions of the Securities Financing Transaction Regulation.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

<u>Interaction between different Articles</u>

It is unclear for example how the provisions relating to Scope (Article 2), the definition of "counterparty" in Article 3, and Article 4 and Article 15 are intended to work together. Clarity on these points is important otherwise there is scope for confusion and inconsistent interpretation. In particular it is unclear whether the parties set out in Article 2(1)(d) are only in scope for Article 15 or whether the Article 4 reporting requirement also applies (and if so, to which counterparties and in which circumstances).

Also, Article 2 (1) sets out the parties to whom the Regulation shall apply. It would seem that the intention must have been to set out the different circumstances in which the particular operative provisions (Article 4, Article 15 etc) apply. In other words, 2(1)(a) sets out those parties who will be need to comply with the Article 4 requirements, 2(1)(d) the parties who need to comply with Article 15 etc however Article 2 seems to have been drafted in such a way that would suggest that if an entity meets the test for one element, then the whole Regulation applies to that entity, for example, a non-EU entity re-using assets of EU client would be in scope for Article 15 but as a consequence of the uncertainty with regard to Article 2, the whole Regulation would apply to that entity, even Article 4, which would not ordinarily apply on the basis of the Article 4 scope test.

<u>Definition of financial counterparty</u>

Article 2 of the SFTR states that the regulation shall apply to:

- A counterparty to a SFT;
- Management companies of undertakings for collective investment in transferable securities (UCITS) and UCITS investment companies in accordance with Directive 2009/65/EC;
- Managers of AIFMS authorised in accordance with 2011/61/EC;
- A counterparty engaging in re-hypothecation.

Article 3 of the SFTR provides that the definitions of "counterparties" means "financial counterparties" and "non-financial counterparties" as defined in points (8) and (9) of Article 2 of EMIR (Regulation (EU) No 648/2012) as well as "CCPs" as defined in point (1) of Article 2 of Regulation (EU) No 648/2012.

The definition of financial counterparty under EMIR is: “an investment firm authorised in accordance with Directive 2004/39/EC, a credit institution authorised in accordance with Directive 2006/48/EC, an insurance undertaking authorised in accordance with Directive 73/239/EEC, an assurance undertaking authorised in accordance with Directive 2002/83/EC, a reinsurance authorised in accordance with Directive 2005/68/EC, a **UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC**, an institution for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC and **an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EC.”**

The inclusion of UCITs and managers of AIFMs under Article 2 SFTR is not necessary because these are already included within the definition of financial counterparties.

Extraterritoriality

Under Article 2, transactions with counterparties engaging in re-hypothecation that are established as per below are within scope:

1. if the counterparty is in the EU, including all its branches irrespective of where they are located
2. if the counterparty is established in a third country, in either of the following cases (i) the re-hypothecation is effected in the course of the operations of an EU branch or (ii) the re-hypothecation concerns financial instruments provided as collateral by a counterparty established in the EU or an EU branch of a counterparty established in a third country.

Therefore, Article 2 is proposing to bring in scope third country entities (collateral receivers) that transact with EU counterparties. Clarification is needed as to whether there could be any issues arising from this such as extraterritoriality issues.
Contrary to SFTR, in EMIR there is no obligation as a third country. If the intention is to track collateral to a third country then clarity is required whether it applies only to Article 15 or the whole regulation. We estimate that there will be challenges to implementation due to incompatibility with foreign jurisdictions.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

We believe that changes should be made to:

- clarify the interaction of scope and definitions;
- clarify to whom the regulation shall apply;
- clarify the various types of CSDs.

Example 4 for Issue 11

<u>CSDR: Article 7 definition of buy-in related terminology</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Regulation (EU) No 909/2014 on Securities Settlement and on Central Securities Depositories - Article 7 – Settlement Discipline

- **Please provide us with an executive/succinct summary of your example.**

The Level 1 text of the CSD Regulation does not provide for adequate definitions leading to concerns about the entities affected, the instruments covered and the territorial reach of the Regulation. All of the above issues have led to difficulties for ESMA when drafting the Level 2 text. The result is likely to be that settlement participants, who are not direct parties to the transaction, will suffer costs which cannot be passed on to the entities which are actually party to the transaction.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

There should be a clear definition of the term "buy-in" and its objectives.

The lack of clear territorial scope of the buy-in provisions, trading between EU and non-EU parties is likely to be negatively impacted, reducing the attractiveness of investing in Europe for foreign investors.

A clear definition of a settlement transaction is critical and necessary since all obligations under CSDR use this terminology. There should be a precise definition and how that applies to the underlying trade.

There is no clarity on the precise definition of transactions that are within the scope of the buy-in regime e.g. not all settlements represent trades for which a buy-in would be relevant: portfolio transfers, delivery proceeds on the back of corporate actions, margin deliveries or reimbursement all translate into settlement instructions, and a buy-in would be meaningless: there is often no trade/transaction nor two trading parties.

The term participant is used inconsistently in Article 7(10) CSDR. Although 'participant' is defined at Article 2(1) (19) by reference to a CSD, there are circumstances where the term is clearly being used in order to refer to a trading venue member (i.e. a trading participant, rather than CSD participant), for example in Article 7(10) (b) and in addition, a participant of a CCP. It should also be noted that CSDs themselves are participants in other CSDs, which means any CSD acting as an investor CSD would appear to be caught by this measure and will also be accountable for buy-in costs and cash compensation.

We believe that Article 7(6) is based on an erroneous assumption, and will lead to substantial issues, as it only applies to where the buy-in price is lower than the trade price, and not when it is higher. When the buy-in price is higher, there is no requirement for compensation (by the receiving participant to the delivering participant or its client). So in half of the cases there is no price compensation.

There is a concern that non-EU trading parties will not comply with terms in their contracts requiring them to execute buy-ins in accordance with CSDR. We expect that many transactions will be linked, and likely to contain an EU trading party. The EU trading party will not be able to argue that it falls outside the territorial scope of the buy-in regime and will be required under the terms of its contract to invoke the buy-in, which will in turn drive global market practice in relation to EU securities. However, in the case of two non-EU based trading parties trading with each other where neither considers that a European regulation applies to them, the EU based settlement participant will be responsible. Further, these concerns about extraterritoriality are generated by the Level 1 text and we do not think that Level 2 text should be required to solve this difficulty. We believe that most third country jurisdictions have the concept of "right to assets" under civil law, which means that there is a method for the buyer to enforce the delivery of their assets having purchased them.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The lack of clear definitions at Level 1 makes the Level 2 process significantly more complex. We support calls for a precise definition of settlement transactions, i.e. the exact scope of transactions eligible to be bought in, since all obligations under CSDR use this terminology. There is a lack of precision as to the territorial scope of the settlement discipline regime which emanates from the Level 1 text, including the mandatory buy-in regime, and in particular, whether or not the buy-in regime applies to transactions governed by the law of a non-EU jurisdiction and/or traded outside the EU, but settled in an EU CSD. It is crucial to determine the precise territorial application of the settlement fine and buy-in regime instead of trying to solve this issue by holding settlement participants (who are not a direct party to the transaction being bought in) responsible.

Also, Article 7(6) should be amended. Currently, it states that if the buy-in price is lower than the current market price, the failing deliverer should 1) pay the difference in counter values to the receiving party and 2) the failing party is required to pay the same amount again in cash compensation as a penalty. This is counter to market practice and the language is so convoluted that it seems likely that policymakers were not clear about the rationale behind the payments. We believe that the intention of this Article is to ensure that the buyer is not disadvantaged if a buy-in is enacted. This would occur if the buy-in price was higher and securities were delivered to them at this higher price. We could then understand the rationale for recompensing the failing buyer with the difference. This would leave both parties in the same situation before the failed transaction occurred and therefore the requirement for an additional payment (as stated in Article 7(6)) is not considered necessary by us.

Example 5 for issue 11

<u>MiFID II: definition of financial product</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example?**

MiFID II - Directive 2014/65/EU, Article 4 – Definitions.

- **Please provide us with an executive/succinct summary of your example**

The legal language used throughout MiFID II is inconsistent when reference is made to financial products instead of financial instruments. MiFID II provides a definition of financial services and financial instruments, but it does not define the term "product". This causes numerous difficulties in interpretation and application of MiFID II to investment firms' activities. In particular, Article 16(3) of MiFID II uses the term financial instrument and product interchangeably, while the term product implies a broader application scope than financial instrument.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example**

Article 16(3) MiFID uses the term financial instrument and product interchangeably, while the term product implies a broader application scope than financial instrument.

Article 24 and Article 25 MiFID use the term product alongside the term financial instrument and the term financial service, causing interpretational difficulties, for example in assessing the obligations in terms of information to clients and other types of disclosures.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here**

This should be redressed by using the term "financial instrument" throughout the legal text. The term "product" ("financial product", "investment product") should be removed. This would be consistent with the legal definition provided in the Directive and would provide legal certainty as to the scope of firms' obligations.

Issue 12 - Overlaps, duplications and inconsistencies

"Please indicate specific areas of financial services legislation where there are overlapping, duplicative or inconsistent requirements."

Example 1 for Issue 12

Basel work programme: potential inconsistent consequences of capital floors

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Changes to CRD4/CRR that may arise as a result of forthcoming Basel (BCBS) proposals.

- **Please provide us with an executive/succinct summary of your example.**

Significant regulatory initiatives are still underway at BCBS level, with the expectation that the EU will adopt these standards into EU legislation once they are completed. This BCBS regulatory programme is far reaching and amounts to a fundamental review of the approach to determining regulatory capital, via changes to the way the denominator of the capital ratio is calculated. In particular, the role internal models will play in this future framework could be significantly reduced, which will lead to a reduction in risk sensitivity of the framework, negatively impacting capital allocation to the economy. Moreover, despite recent pronouncements of the BCBS, at this point, it is extremely unclear how this programme will not result in further increases to capital requirements.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Since the CRR was initially legislated, the policy objectives of legislators have evolved and the risks to the EU economy have changed. Political, regulatory and central bank initiatives are now underway to develop a framework of market based finance that can help to deliver economic growth in Europe by working alongside the historically bank-centric provision of finance to the EU corporate sector.

We would welcome greater reflection on the future legislative framework as there comes a point when ever increasing measures to protect the system begin to prevent banks from carrying out economically valuable functions, including their market functions. As expressed by Commissioner Hill, "today there is a new threat to financial stability: the lack of jobs and growth"[47]. This tipping point is illustrated in the chart below, taken from BIS Paper No 60 "The long term economic impact of higher capital levels".

[47] Commission Hill speech at Frankfurt Finance Summit

Table 1

Plausible bounds for appropriate capital requirements

	Marginal benefit (% of GDP)			Marginal cost (% of GDP)			Net benefit (% of GDP)		
Effects of an increase in the capital ratio ...	low	mid	high	high	mid	low	low-high	mid	high-low
from 8% to 9%	192	459	726	–3	–2	–0	189	457	726
from 11% to 12%	4	71	137	–3	–2	–0	1	69	137
from 14% to 15%	+0	3	5	–3	–2	–0	–3	1	5

Table 6: Plausible bounds for appropriate capital requirements
Source: BIS Paper No 60 "The long term economic impact of higher capital levels

As the Commission is aware, although EU financial reform is largely finalised, significant regulatory initiatives are still underway at BCBS level, with the expectation that the EU will adopt these standards into EU legislation once they are completed. This BCBS regulatory programme is far reaching and amounts to a fundamental review of the approach to determining regulatory capital. Despite recent pronouncements of BCBS members, at this point, it is extremely unclear how this programme will not result in further increases to capital requirements. Moreover, we recall that in spite of these requirements neither being finalised nor implemented in the EU, they already create market expectations. Firms are not able to give investors a clear view on their mid to long term capital targets and indeed future planning and organisation of their businesses in such an environment is extremely challenging, particular when reform has been ongoing for several years already.

Not only are the incremental benefits in terms of financial stability of further change not clear at this stage, we are concerned that if capital levels increase further, we will be going beyond the tipping point where banks' will be able to maintain lending and market activities. We are also concerned that this BCBS programme will result in capital requirements that do not reflect underlying risk levels which negatively impact capital allocation to the economy as well as market liquidity. This could both weaken bank financing of the economy as well as hamper the development of market based financing in Europe. Thought needs to be given to whether marginal social benefit is sufficient to warrant these further costs; the dividend of "even more resilience" may well be exceeded by the impact on the cost of providing certain services and products to end-users.

In particular, we are referring to the Basel Committee's current work on proposals to introduce a standardised capital floor (or floors), revised standardised approaches for all risk categories, the possible introduction of new risk requirements (IRRBB) and significant changes (reductions) to the use of internal models within the capital framework as well as the recently released FTRB. These changes are being billed the last steps needed to fully complete financial reform; however, they are so fundamental that they may very well produce an entirely new basis for capital requirements, effectively reducing the role of internal models and the risk sensitivity of the capital framework. A risk insensitive framework is likely to create the wrong origination and capital allocation incentives because it encourages investment in high return, high risk assets. It will also disturb the virtuous cycle whereby improvements in risk measurement and management systems are incentivised and integrated into business decisions, which results in improved lending decisions and risk-based pricing. The overall effects of a capital framework that is not sufficiently risk sensitive will be negative for financial stability (less portfolio diversification) and the financing of the broader economy. We view this as being contrary to objectives to move away from crisis-related reform and to focus on growth.

In our view, the case for the introduction of additional capital floors is not at all clear as the leverage ratio already provides a non-risk sensitive backstop to capital requirements and the impacts of leverage ratio, which include incentivising banks to hold higher risk assets on their balance sheets and discouraging the maintenance of low-risk, low yield assets, are likely to be further amplified by capital floors.

In general, the wide range of capital floors planned or being envisaged (such as the leverage ratio, the introduction of regulatory risk parameters, exposure/desk level and standardised floors) on different levels of consolidation makes it difficult for banks to balance regulatory compliance against the allocation of capital to individual business lines. In turn this makes it difficult for them to appropriately allocate capital to the economy. Beyond the possible introduction of floors, we also have significant concerns with the direction of travel at BCBS level which seems to be leading towards a significant reduction the role of internal models in the capital framework. In our view, this will remove or dramatically reduce the risk sensitivity of the capital framework. The negative impacts of reduced risk sensitivity of regulatory capital requirements are expanded on in the May 2015 AFME paper 'Accurately measuring & allocating capital: the need for risk sensitive capital requirements'[48].

Our concerns relate to forthcoming BCBS proposals to reduce internal modelling for IRB banks, either by introducing modelling constraints (such as parameter floors) or disallowing internal models completely in favour of the Standardised Approach. While we recognise that RWA variance has been identified between banks, major work is ongoing at European level to address this variance when it is "undue", that is in cases where there are implementation or supervisory divergences or where the CRR left room for firms to make modelling choices. Indeed, the EBA is undertaking an extensive programme of IRB repair and continues its work to create the Single Rulebook and Supervisory Handbook. We note that the lion's share of RWA variance (75% according to both BCBS and EBA studies) is due to differences in underlying risk levels and is thus both expected and justified. Lastly, while critics of internal modelling are concerned that models can be used to strategically optimise RWAs, we are not aware of any evidence that proves this on a systemic basis. We would be happy to provide the Commission with more information and empirical analysis on this point.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

In order to ensure a regulatory system that measures risk accurately, allocates capital accordingly and provides sound origination incentives that benefit the economy at large, AFME considers that risk sensitivity must remain a decisive feature of the capital

[48] AFME briefing paper (2015) 'Accurately measuring & allocating capital: the need for risk sensitive capital requirements'

framework. Industry stands ready to work together with the Commission to achieve this in a manner that will prove beneficial to financial stability and economic growth. In particular, AFME encourages the Commission to carefully consider the implications of this progressive yet continued removal of risk sensitivity from the international regulatory framework. If there is an intention to remove risk sensitivity from the regulatory framework, this objective needs to be set out explicitly and accompanied by a robust justification for undertaking such a conceptual shift. It would then need to be extensively and publicly debated and tested. Moreover, any further reduction in risk sensitivity also needs to be assessed against the significant progress that has been made to reduce undue variance in capital outcomes. AFME also stress that this needs to be done in a comprehensive manner, taking into account the combined implications of the various work streams mentioned above. Only if there is a proven need to take further action should additional measures such as capital or parameter floors and other model limitations be considered.

Example 2 for Issue 12

Data protection 1: conflicting requirements Data Protection Regulation and MiFID II

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Directive 2014/65/EU and Regulation 600/20146 (collectively known as MiFID II /MiFIR).
Directive 95/46/EC of 24 October 1995 (Data Protection Directive).
Proposal for a Regulation of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data and on the free movement of such data (GDPR).

- **Please provide us with an executive/succinct summary of your example.**

The Directive 2014/65/EU and Regulation 600/20146 both recognise that Member States should ensure the respect of the right to the protection of personal data in accordance with the DPD with regards to the processing of personal data and on the free movement of such data. The implementing Directive also contains reference to the requirements to ensure compliance with national measures implementing DPD where requirements to collect and maintain information relating to clients and services provided to clients involve the collection and processing of personal data. However Articles 16(6)-16(7) creates difficulties in terms of compliance with DPD and GDPR as set out below.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

Article 6(1)(c) of the GDPR permits the processing of data where processing is necessary for compliance with a *legal* obligation. It does not define the term 'legal' though recital 31 refers to the need for clarity, precision and forseeability in this respect. Article 6(1) (c) does not expressly refer to *regulatory obligations*.[49] Regulatory obligations may take the form of guidelines issued for example by ESMA, codes of conduct or regulatory rules issued by National Competent Authorities which may not technically be classified as law. Alternatively legal obligations may be drafted in a way that are high level and entail the application of significant discretion by implementing firms/National Competent Authorities.

In relation to the above, we note that Article 16(6) of MiFID II requires investment firms to keep records of all services, activities and transactions undertaken by them. These must be sufficient to enable a competent authority to fulfil its supervisory tasks and to perform enforcement actions. In addition, ESMA anticipates that the corresponding implementing regulation should be modified to introduce a "non-exhaustive list of records" with the ability for National Competent Authorities to set additional obligations for additional records.

[49] Recital 31a notes that GDPR does 'not necessarily' require a legislative act but a recital cannot in any event contradict the meaning of the text. Recital 24c whilst referring to public authorities still crucially requires a '*legal obligation*', satisfaction of a test of necessity and 'written, reasoned & occasional' requests by public authorities. It is therefore of limited assistance in addressing the above. Moreover the comments above about the status of recitals still apply.

A "non-exhaustive list of records" opens the possibility of non compliance with requirements within the DPD and GDPR. In relation to the GDPR it is entirely unclear whether the lack of precision entailed by this requirement is sufficiently 'precise' or 'foreseeable' in order to be classified as a 'legal obligation'. Moreover if NCAs implement this requirement through the use of *non legal* regulatory rules or guidelines, given that recitals cannot contradict the meaning of the legal text of the GDPR, it is unclear whether this provision would be consistent with the GDPR. Moreover, as the Article 29 Working Party points out[50], it is also unclear as to whether such an approach would lead to outcomes that are consistent with principles of proportionality and necessity.

Additionally, Article 16(7) of MiFID II requires investment firms to record telephone conversations and electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. MiFID II uses broad and open wording such as "at least" and does not define "electronic communications".

The lack of precision entailed by the above definition carries the same risk as per above under the GDPR i.e. the requirement lacks the precision and forseeability that would be necessary for it to be treated as law. Moreover as per above where such requirements are implemented at the national level through the use of non legal regulatory rules or guidelines, it is unclear as to whether this would fulfil the 'legal requirement' issue identified above. As the Article 29 Working Party points out, this may also generate issues from the perspective of proportionality and necessity.

Furthermore, Article 16(7) of MiFID II provides that records shall be provided to the client involved upon request and shall be kept for a period of five years and, where requested by the competent authority, for a period of up to seven years. This extends current data retention periods to a five year period, and added the possibility for NCAs to request a further extension up to seven years but there remains no clarity on the rationale for any extended retention and mixed NCAs application could create application difficulties across investment firms in more than one Member State.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

To remedy both issues the GDPR should clearly define the term 'legal'. It should also set out compliance with requirements by public authorities as a separate ground for processing data or at the very least include compliance with regulatory requirements as a ground for processing data.

In relation to Article 16(6) of MiFID II, the Article 29 Working Party suggests a list of minimum records and inserting specific wording in the implementing legislation and any decision taken to add to the list can only be undertaken after a proper review of proportionality and necessity check.

In relation to Article 16(7) of MiFID II, the Article 29 Working Party suggests specific wording referring to the data protection principles, and the addition of the proportionality and necessity principles directly into the text of MiFID II.

[50] Article 29 Data Protection Working Party letter

Example 3 for Issue 12

Data protection 2: conflicting requirements Data Protection Regulation and MAR

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Regulation 596/2014 of 16 April 2014 on market abuse (MAR).

Directive 95/46/EC of 24 October 1995 (Data Protection Directive).

Proposal for a Regulation of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data and on the free movement of such data (GDPR).

- **Please provide us with an executive/succinct summary of your example.**

The Regulation 596/2014 of 16 April 2014 on market abuse (MAR) contains several provisions concerning data retention periods for personal data, for example, market sounding reports (**Article 11.8**), insider lists (**Article 18.5**) and publication of sanctions decisions (**Article 34.3**), we find identical wording setting out an obligation to keep or publish personal data "*for a period of at least five years*".

The wording setting only a minimum data retention period is inconsistent with the general data protection rule (Article 6 of Directive 95/46/EC) requiring setting a maximum data retention period. To this end, it would place an obligation on investment firms to put in place a monitoring mechanism to guarantee that the data are not kept longer than necessary.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**
- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

To remedy the above issues the GDPR should clearly define the term 'legal'. It should also set out *regulatory* requirements as a separate ground for processing data.

The Article 29 Working Party additionally suggests that the wording of its implementing acts includes additional specific wording in order to set the maximum data retention period (e.g. : "*and for no longer than ...*").

In the longer term however the real solution to both of the above issues lies in greater clarity in relation both to the GDPR and Data Protection Directive about the obligations on the private sector in circumstances where it is asked to process and share data for national security, crime and other public interest purposes, particularly for entities who are regulated by a third country where their parent or affiliates are located.

Example 4 for Issue 12

Extraterritoriality: developing EU measures in a global context

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

A number of measures, which have extraterritorial effects, have given rise to difficulties for international firms' capacity to provide services for their clients. Our concern is, as explained below, a general one as regards the policy making process.

The need to integrate better the development of rules in the EU and other jurisdictions – particularly the US so far (but this is not just an EU/US matter) – has been a major theme in recent years. Issues raised in the past have included the measures to reduce the risk for retail deposits in a banking entity that is also undertaking proprietary trading (i.e. Dodd Frank Title VI and the EU bank structural reforms/ICB follow-up in the UK), rules to mandate exchange trading for liquid derivatives (e.g. the US swap execution facility requirements), the fit of derivatives reporting rules with the confidentiality/data protection requirements in different jurisdictions, measures on the recognition of futures exchanges and the treatment of securitisations. Related to this is the issue of enforcing EU measures outside the EU.

Currently, examples are some important issues as regards securitisations including the framework for introducing simple, transparent and standardised (STS) securitisations and provisions in the Shareholder Rights Directive proposal.

- **Please provide us with an executive/succinct summary of your example.**

In the aftermath of the financial crisis – and in part, of course, prompted by the G20 – jurisdictions adopted a range of measures designed to strengthen the financial system so as to avoid future crises. However, although generally designed to achieve the same objectives, the new rules that were introduced were often adopted in an uncoordinated way, both in respect of implementation timing and content. Insufficient weight was being given to the practical challenges for international financial services firms which would need to comply with the measures being introduced in all the jurisdictions in which they provide services. So, in spite of the G20 emphasis on mutual recognition as being desirable, there were a number of areas where firms were subject to rules – that although designed to achieve similar outcomes – could be inconsistent, duplicative or even contradictory. The potential for mutual recognition of equivalent measures in other jurisdictions which would have helped to avoid these difficulties was not adequately recognised. Comments from our members are that the implementation of G20 commitments differs in each region and often has extraterritorial aspects resulting in significant higher expenditure on market infrastructure building: if there was a more macro level implementation of requirements and cross border coordination huge amounts of cost could be saved and compatibility issues could be solved.

As regards our particular examples referred to above:

➢ There continue to be some important issues as regards the measures dealing with <u>securitisations</u> (most recently as regards introducing "simple, transparent and standardised" (STS) securitisations but this is only one of a number of issues):

As regards *risk retention* requirements: The requirement for originators of securitisations to retain some of (5%) the risk in the assets they securitise ("skin in the game") is a feature of both European and US securitisation frameworks. However, there are major differences between the two sets of rules. In Europe these can be found in Article 404 of the CRR; in the US in 79 FR 77601. For example, the European rules apply to the whole market, while large sectors of the US market are exempt from the requirement. The result is that an issuer in Europe seeking to issue into the US, or vice versa, will have to comply with both sets of rules and possibly retain two different amounts of 5%. AFME and SIFMA have regularly and consistently called for greater co-ordination of these two sets of rules so as to make cross-border flows of capital easier, but with little progress being seen to date.

There are also *disclosure and transparency* issues. Both European and US rules prescribe detailed and prescriptive requirements for disclosure of information in securitisation. These are designed to reflect the local conditions, terms and characteristics of the assets being securitised in their own local markets: for example, Dutch mortgages or US car loans. The US SEC requires specified loan level disclosure for ABS collateralised by residential mortgage loans, commercial mortgage loans, automobile loans or leases, resecuritisations of ABS backed by any of those asset types, and debt securities, and prescribes various other rules related to the offering process and content and timing of information disclosure (see e.g., Regulation AB (2004) 70 FR 1506; Regulation AB II (2014) 79 FR 57183; securities offering reform (2005) 70 FR 44722). However, neither region makes allowance for mutual recognition of each other's rules. Further, the specific local design of disclosure templates to meet the requirements of local regimes allows no flexibility for third country assets to comply. It is simply not possible for, say, a Dutch RMBS deal to comply with the US requirements for MBS disclosure because Dutch mortgages are so different from US mortgages. (Ditto, from the other direction, say, US student loans.)

The recently proposed framework for STS securitisations should provide greater visibility, reduce capital charges for investors, and revive an important market that has sought to re-establish its valuable role since the financial crisis. The treatment of third country issued securitisations is an important elements of the Securitisation Regulation. We strongly support the Commission's open approach to third-country securitisations, both in terms of securitisations being able to receive STSs recognition, and in not requiring that the underlying exposures are located in the EU.

However, we are concerned by the Council's general approach, which would require that the "originator, sponsor and Securitisation Special Purpose Entity ("SSPE") involved in a securitisation considered STS shall be established within the Union". The requirement to issue via an EU branch or subsidiary would limit EU investors' and companies' access to third-country issued securitisations, and reduce activity in the EU by non-EU originators and non-EU securitisations. Excluding non-EU securitisation from STS recognition (and consequent reduced capital requirements) would also result in securitisation exposures with similar levels of credit risk - which could otherwise be STS-compliant - being treated differently for regulatory capital purposes.

- Besides the above example where regulation has an extraterritorial impact on products issued outside the EU, there are also examples of where EU legislation contains extraterritorial requirements that could lead to enforceability issues for firms operating in the EU. The Shareholders Rights Directive, which is currently being debated, is an example of this. In April 2014, The European Commission launched a review of the Shareholder Rights Directive with the aim of improving the corporate governance of companies listed on Europe's stock exchanges. The proposed Directive (2014/0121 (COD)) has provisions relating to the identification of shareholders (Article 3a). Although this is still in the trilogue phase some crucial issues – in the drafting – have begun to emerge which raise important questions as to the plausibility of implementing this article in relation to third country investors (as is referred to in Article 3e).

The originally proposed Article 3e of the Commission reads: '*A third country intermediary who has established a branch in the Union shall be subject to this chapter.'* This version could be interpreted as a limited third country rule that would actually be enforceable as exercised towards an intermediary with a presence in the Union. The Council's general approach, however, reads: *'This Chapter also applies to intermediaries which have their registered office or head office outside the Union in so far as they provide services with respect to shares of companies which have a registered office in a Member State and whose shares are admitted to trading on a regulated market within a Member State'.*Thus the provision would apply whether or not the intermediary has a presence in the EU. However, for intermediaries located outside the EU this provision would not be enforceable.

For example, an institutional investor in California holds Daimler shares that are held in custody with a Californian custodian bank that has no presence in the EU and that has chosen, say, Bank A as its German sub-custodian. In case the Californian investor concludes that it should not be identified as per the terms of the Shareholder Rights Directive (currently in the process of Trilogues), the provisions of the Shareholder Rights Directive cannot be enforced with the Californian investor and its Californian custodian. Bank A should not be held responsible for the non-compliance of the Californian investor as it has no contractual relationship with the investor.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The following consultation responses and discussion papers provide evidence for the issue of extraterritoriality concerns in a number of files:
- Cross Border Regulation Forum Response to IOSCO Task Force on Cross-Border Regulation Feb 2015[51];
- Cross Border Regulation Forum Response to IOSCO Questionnaire – 28May 2014[52]: this includes helpful case studies;
- FMLC – Addressing the Causes of Legal Uncertainty, including the FMLC's February discussion paper on International Financial Regulation Coordination (which, as well as providing a good account of examples of extraterritorial issues, provides a helpful

[51] CBRF response to IOSCO
[52] CBRF response to ISCO Questionnaire

bibliography of contributions to the discussions on this subject) FMLC - Coordination in the Reform of International Financial Regulation – February 2015[53];

- FMLC Interim Feedback Statement Coordination in the Reform of International Financial Regulation – September 2015[54].

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

In respect of the *particular* legislative measures that have prompted us to raise this issue, the outcome has either now been determined or is subject to discussion in the EU regulatory bodies. However, our general concern as regards the policy making process internationally, and within the EU, remains and it is likely that cases of extraterritorial legislation will continue to arise. The legislative process needs to be better designed recognising *as policy is developed and timetables are determined* that there can be important implications for firms providing services to clients in multiple jurisdictions. The Commission should work to ensure that consideration of this impact should be built into the process that culminates in new FSB and G20 policy initiatives and the implementation steps that follow at regional and national level.

With regard to the specific examples discussed above, we believe that, in order to maximise the potential of the STS as intended by the Commission's original proposal, it is essential that the EU legislators maintain an open approach to third-country securitisation. With regard to the Shareholders Rights Directive, the new legislation should adopt the Commission's approach to Article 3e, which focuses on presence in the EU as the trigger for intermediaries' obligations under Article 3.

[53] FMLC – Coordination in the Reform of International Financial Regulation
[54] FMLC Interim feedback statement coordination in the reform of international financial regulation

Example 5 for Issue 12

Inconsistencies of Level 2 and Level 3 measures with Level 1 legislation

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

For this example we only focus on the work of the EBA but equally examples could be provided for work of the other ESAs.

- **Please provide us with an executive/succinct summary of your example.**

While reiterating our support for the EBA and its mission to ensure consistent prudential regulation and supervision across the EU, we do wish to point out that we have encountered certain issues with the Lamfalussy process. Overall, the Level 2 instruments (RTSs, ITSs) and Level 3 instruments (Guidelines, Q&A, etc.) at the EBA's disposal have worked well in developing and promoting the Single Rulebook. Nevertheless, experience of the process has now shown that there are areas where Level 3 instruments are being used to deal with issues that are clearly matters of policy (and not implementation or technical application of the CRR) and/or that may have significant impacts such that they imply substantive policy change. As a result, these would require a thorough cost/benefit assessment.

In practice, Level 3 instruments are extremely impactful because, unless firms receive an indication otherwise from their competent authorities, these instruments have to be complied with, and often with immediate effect. They are therefore far from being "soft" instruments. Examples include the EBA's Shadow Banking Guidelines, where the EBA is effectively taking a stance on an issue that should be dealt with by the co-legislators, and recent Q&A guidance on the application of Potential Future Exposure (PFE) add-ons for written options under the Mark-to-Market Method that is inconsistent with the Level 1 text and represents a significant change in policy.

On the other hand, there are areas where the Level 1 text does not provide the EBA with the ability to run certain key supervisory processes with the flexibility required. For instance, RTSs and ITSs are not efficient instruments for running RWA benchmarking exercises. We elaborate on this below.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

We provide two examples of where we believe that Level 1 policy has been made through Level 2 or Level 3 measures:

- **CRD IV/CRR Q&A 2013_666 on Potential Future Exposure (PFE) add-ons for written options:**

We do not believe that it was the intention of the Level 1 text to require PFE add-on for written options as they are not included in Annex II of the CRR. Moreover, the economics and risks associated with written option contracts, which cannot have a positive value, are not at all similar to those of bought options. This was clear in national competent authorities' rules prior to the CRR entering into force. The effect of this is that a significant amount of capital needs to be sourced or reallocated to cover this "new risk";

- **CRD IV/CRR Q&A 2014_1352 on capital deductions on repurchases of own**

instruments for market making purposes:

We do not believe that the repurchase of own capital instruments for market making purposes, where supervisory permission is given in advance, meets either the condition of "contingent obligation" (CRR Article 76) or of "sufficient certainty" (241/2014 Article 29). Therefore, in our view, an ex-ante capital deduction is not envisaged under the Level 1 text. The consequence of this is the more, and inefficient use of, capital to make markets in their own instruments.

On the other hand, there are areas where the EBA requires more flexibility:

➢ **EBA benchmarking package (mandate given under Article 78 of the CRD4)**

The industry is supportive of the EBA's benchmarking mandate as RWA benchmarking is a means to identify and monitor RWA variance. We are committed to assisting the EBA and competent authorities in making these exercises successful. Indeed, the input to these exercises must be as of high quality as possible to ensure the most meaningful outputs and interpretations.

Pending the adoption of the benchmarking RTS and ITS, the first benchmarking exercise was run on a best efforts basis. Firms have since been waiting for final confirmation and adoption of the package to carry out the necessary IT processes/data requests. However, it has (perhaps somewhat inevitably given the extremely ambitious and technical nature of this reporting exercise) been necessary to make a number of technical corrections to the templates/information requested in the EBA's package. Given the nature of the legal instruments involved, the process for carrying out corrections has lead to significant delays and a continued state of non-adoption of the package, with no visibility for firms on either the content or timing of future exercises. Benchmarking exercises originally foreseen for 2015 have not taken place and there is little information for firms on what to expect going forward.

It is also expected that the EBA will regularly have to make adaptations to the reference portfolios being used in the benchmarking package to reflect market developments. Requiring the same type of cumbersome legal process for adoption each time such a change is made is not efficient.

Lastly, firms have tried to seek clarifications from the EBA on the composition of certain benchmark portfolios. Again, given the legal instruments involved, any questions related to the reporting requirements need to go through the EBA's full Q&A process, which is not conducive to the rapid responses that are required in these types of situations. A more flexible FAQ type approach coordinated through industry trade bodies would be much more appropriate.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

There is a need for greater reflection on the effects of Level 2 and level 3 instruments and, while the EBA's harmonisation work is much needed and welcomed, such instruments should not be used to make financial services policy. Conversely, there are situations such as reporting and benchmarking exercises where more flexible implementation solutions than level 2 instruments are necessary. We recommend that these issues be considered further in the context of reviewing the functioning of the ESAs. This also related to example 1 highlighted under issue 13.

Issue 13 - Gaps

While the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether they are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.

Example 1 for Issue 13

<u>New tools for more flexibility in the legislative process</u>

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**
- **Please provide us with an executive/succinct summary of your example.**

The entry into force date of directives and regulations is enshrined in Level 1 legislation, which provides clarity and certainty to both authorities and market participants. In some instances however, more flexibility with regard to the entry into force date would be welcomed. In some cases more flexibility in the legislative process is needed to provide sufficient clarification to market participants (see also comments on this in the executive summary).

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

A particular recent example is the introductory date of MiFID II which is currently planned for 3 January 2017. Both ESMA and the Commission have said to believe that a delay to the reform of Europe's trading rulebook is necessary for certain aspects. The main reason is that the industry and regulators do not have sufficient time to complete the necessary technology systems.

However, ESMA currently does not have the legal means to allow a delay in the introduction date. ESMA has provided a number of options[55] that could be followed now through:

- a Level 1 measure (either by adopting a new implementation date or changing the Level 1 MiFID II text). Such change would however affect all parts of MiFID and is not targeted enough at the problem areas;
- a Level 2 measure: it risks leaving a legal vacuum and puts at risk the enforceability of some key provisions;
- a Level 3 measure: this would require agreement of all regulators does not give any legal certainty to market participants or regulators. It could also mean an uneven implementation across the EU’s Member States.

The ability of investment firms and venues to comply with a number of the MiFID/R regime’s key requirements (including determining whether they are an SI in an instrument or whether trading in a share has breached the double volume cap) will, irrespective of the regime’s entry-into-application date, be dependent on the prior availability of entirely new sets of data. The delivery of these data sets in a usable format will in turn be dependent on the development of systems for gathering and processing

[55] ESMA note on MiFID/MiFIR implementation

the data as well as the entry-into-application of the obligations for venues and firms to start reporting the unprocessed input data.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

In the US, the CFTC does have such a "No Action power" and is able to delay the enforceability date of regulations. The Commission should explore the possibilities of giving the ESAs the legal tools to enforce legislation later than originally is intended by Level 1 legislation. This could involve the ESAs having the ability to issue a stay of enforcement to a later date, after agreeing this with all national regulators in the EU. The Commission should explore this option in its forthcoming White Paper on the ESAs.

Rules giving rise to possible other unintended consequences

Issue 14 - Risk

"EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged."

Example 1 for Issue 14

AIFMD: asset segregation regime

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

AIFMD (Directive 694/2014).

- **Please provide us with an executive/succinct summary of your example.**

The continued tightening of banks' prudential regulations means that financing of the economy will be increasingly taken up directly by other financial intermediaries who may not necessarily be subject to similar prudential requirements. This could lead to financial stability concerns and competiveness of different parts of the system and should be recognised.

One of the main areas of the focus for AFME with regard to the AIFMD (Directive 694/2014) are the rules on asset segregation and the confusion with respect to the segregation requirements up the chain of custody. The Level 1 text does not distinguish between the "delegation" of the custody function as such, and "delegation" in the event that a custodian uses a sub-custodian. Full segregation does not provide a higher level of protection to investors or their assets than current asset segregation upon insolvency of a sub custodian to whom custody has been entrusted. Full segregation does not have a positive impact on speed and efficiency with respect to the return of assets upon such insolvency. Full segregation applied in all contexts would have negative and damaging operational impacts and result in higher operational risk with respect to depositaries, as well as with respect to the prime brokerage, collateral agency and securities lending industries and full segregation would likely reduce market liquidity in securities with negative impact on investors.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The over-riding theme/requirement of the asset segregation provisions of the Directive is that the property rights of the depositary's clients/investors of the AIF must be protected, such that the assets are not lost upon an insolvency of the third party to whom custody is delegated, or that third party's delegate.

Following the adoption of the AIFMD, ESMA has consulted on the different options for asset segregation under AIFMD. Article 21(11)(d)(iii) of the AIFMD provides that a depositary is required to ensure that a third party delegate undertakes the segregation obligation so that they can at any time be clearly identified as belonging to the clients of a particular depositary. Segregation between AIF and non-AIF assets and segregation between the assets of different depositaries at the sub custodian level and throughout the custody chain (referred to herein as "full segregation") has been rejected by a large number of market participants and organisations, including depositaries, prime brokers and investors. We believe that the legislation does not require such segregation and that current asset segregation practices (which are not restricted to full segregation) are both permitted by the legislation and considered more beneficial to the market generally. Prime brokers maintain a custody account for each separate client on their books and records. At a sub-custody level prime brokers maintain an omnibus client account (or individual client accounts in certain markets) separate from their proprietary account.

The following potential risks have been identified if full segregation is imposed:

- **Settlement Risk:** Unmatched/failed trades increase – Executing brokers would be required to know/ specify multiple SSIs (standard settlement instructions) for each Prime Broker (depending on the relevant client classification type as an AIF or non AIF) across different local markets. Currently all client execution trades/transfers for delivery to a Prime Broker are instructed with a single SSI reflecting the single omnibus client account per market.
  - **Increased Costs for AIF/Investors:** Unmatched and failed trades would likely result in increased costs due to more frequent buy-ins and late settlement fees;
  - **Increased Regulatory Sanctions:** Certain local regulations / markets (e.g. Spain) impose fines for failing trades;
  - **Increased Operational Complexity:** Multiple transfers in and out of client accounts (as opposed to the current regime where there would be only one transfer) will multiply transfer costs and therefore increase costs of short cover (stock lending) and increase asset transfers to support rehypothecation processes, which would likely result in a direct increase in stock loan fees and increased funding costs and/or further transfer fees for the AIF.
- **Concentration Risk:** Depositary/Prime Brokers: The increased operational complexity and associated costs may lead to a decrease in the number of depositary relationships that each prime broker is able to support and/or a decrease in the number of prime brokers that are able to adopt the systems infrastructure to accommodate such segregation requirements;
  - **Market Disruption:** Introduction of multiple new linked accounts into existing prime broker sub-custody operational infrastructure is likely to lead to a period of reduced service levels and reduced efficiency of settlement in early phases of implementation eg introduction/testing/build out by the Prime Broker;
  - **Capacity/Volume/Resource Constraints:** Multiplying the number of custody accounts to be serviced by the local market sub-custodians is likely to result in a need for additional resourcing, which may not be immediately available and which may lead to delays in settlement/reconciliations at the outset. This may also lead to increased sub-custody charges. Some local sub-custodians may not be able to support such a significant increase in industry requirements and there

may be a consequential reduction in local sub-custodian agents (concentration risk);

- **Prime Broker Processes:** Increased operational risk arising from multiple transfers between accounts to support rehypothecation and stock lending on a daily basis;
- **Reconciliation Risks:** Increased reconciliation risks arising from requirement for Prime Broker to reconcile multiple accounts on a daily basis;
- **Decrease in Prime Broker Service Levels for AIFs:**
  - Potential impact on efficiency/processes for tax reclaim arrangements;
  - Potential impact on current service levels for corporate actions in respect of positions across multiple accounts.
- **Recovery and Resolution:** Increased complexity upon any insolvency (of a prime broker or a local sub-custodian) due to multiplicity of accounts and volume of partial settlements between accounts. Potential risks of significant delays in release of client assets following an insolvency event.

Impact on Collateral Management

Full Segregation would have a damaging effect on collateral management.

Collateral management in particular is an environment where beneficial ownership of collateral changes frequently (including intra-day) as part of a dynamic process, whereas custody tends to involve beneficial ownership of securities changing less frequently (i.e., held for longer periods). This market difference is fundamental in understanding the negative impact of requiring segregation throughout the custody chain in the context of collateral management.

Requiring extensive segregation along the chain of custody, would not work effectively in a business model where there are frequent changes of beneficial ownership at the investor level. Such a requirement would force the tri-party collateral market to operate on a bilateral basis, which would increase various risks (e.g., settlement risk, counterparty risk, operational risk), reduce liquidity, and reduce the opportunity for funds to generate additional income in relation to their securities.

A key advantage of the omnibus account structure is the principle of data uniqueness. In any situation where segregated accounts are used, it is necessary for the relevant data to be stored and maintained in multiple locations (i.e., at each intermediary level). In a tri-party collateral management model, in which data at the end investor level is changing frequently, it would be impossible for market infrastructure (with settlement cycles and other obligations) to keep up with frequent changes of collateral at the end investor level if a fully segregated account structure is required. We strongly recommend that (rather than requiring segregated accounts to be used at various levels in the chain of custody) the Commission and ESMA takes a permissive approach, whereby it is possible for such segregated accounts to be used, but without requiring their use.

More broadly, such restriction is inconsistent with overall European policy objectives of encouraging economic growth and instituting a functioning capital markets union. A key aspect of encouraging economic growth is to ensure that markets are liquid, capital is able to move to where it is most needed, and collateral is used to reduce risk in the financial system. As stated by the Commission in connection with its proposed Capital Markets Union "Collateral is a vital part of the financial system as it underpins a large number of transactions in the market and provides a safety net in case there are problems. The fluidity of collateral throughout the EU is currently restricted, preventing markets from operating efficiently". Requiring full segregation throughout the custody chain would go against this stated aim and increase the restrictions that are preventing capital markets from operating efficiently.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

For the review of the AIFMD, we would suggest amending the Level 1 text to clarify that full segregation is not a necessary requirement of the Directive.

Example 2 for Issue 14

EMIR, CSDR, AIFMD and UCITS: constraints in circulation of collateral

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

EMIR (Regulation 648/2012), CSDR (Regulation 909/2014), AIFMD (Directive 694/2014) and UCITS (2009/65/EC).

- **Please provide us with an executive/succinct summary of your example.**

There is an increasing pressure on collateral which is of major concern to firms as both the demand for collateral has increased (e.g. through EMIR, CSDR, AIFMD) while the availability of high quality liquid assets that can be used as collateral has reduced due to different regulations and deterring market conditions. In the context of the use of collateral, future rules and guidelines covering segregation requirements under AIFMD and UCITS V should allow for fluidity in collateral at all levels of the custody chain, and should not unduly restrict the access of AIFs and UCITS to collateral management and securities lending services.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The buy-in measures in the CSD Regulation may have the unintended consequence of reducing trading and stock lending activity in less liquid securities. Additionally, there is potential for additional collateral to be called by settlement agents. This would protect them in the event that ESMA RTS provide for settlement agents to guarantee trades originated by third parties.

We anticipate that ESMA will include rules in their RTS that will require the settlement participant to act as the buy-in counterparty, effectively guaranteeing transactions of its clients. Currently, the buy-in process is on a voluntary basis. The CSDR ensures that this action becomes mandatory. Currently, under the voluntary situation, firms suffer few if any buy-ins as they work with counterparties to settle the transactions. In a recent survey, ECSDA concluded that the total number of buy-ins per year could reach over 1.8 million (7,500 per day), representing a total value of more than EUR 2.5 trillion annually.

In our response to ESMA's Consultation Paper on Buy-ins, AFME estimated that the collateral required by banks from clients, to support those clients' cash trading activities, would be €90bn. This assumes that each trade has to be collateralised by the bank that ultimately has the responsibility for settlement. We recognise that this is an average extra collateral requirement under ESMA option 3 where the settlement participant is required to undertake the buy-in. Under option 1, there are no collateral implications as the trading parties are responsible to each other for the costs of the buy-in.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

The Commission, Member States and regulators should carefully consider the impact of regulation (both already in place and in the process of being adopted) on the use of collateral. In the post–trade area, there are three areas where the impact of regulations on financial risks should be carefully considered:

- Buy-In: The mandatory aspect of buy-in under the CSDR Level 1 has the unintended consequence of deterring banks and brokers from making a two-way price leading to a lack of liquidity in less liquid securities. A trading intermediary faces the prospect of not receiving the securities for onward delivery and will incur settlement fines plus the costs of a buy-in if securities cannot be covered. There are signals that lenders will not favour lending less liquid securities as they may not be able to be recalled in time to cover their own sales. It should be noted that where the failing delivering party is a Central Counterparty (CCP), these costs cannot be passed to them. Also, we would argue that a voluntary buy-in process could address the same issues but retain the flexibility required when each party understands why securities are delayed (e.g. undergoing a corporate action). We favour a buy-in at trading level which is impossible due to the Level 1 text of CSDR. It is not clear if the term "participant" was deliberately intended to capture settlement entities in this context. A new definition, trading party, would assist in changing the regulation to allow a buy-in to occur between the two trading parties that have a legal contract to enforce;
- Collateral management activity: Financial participants should be given the choice to choose their collateral providers from a wide range of collateral counterparties (both tri-party collateral and bilateral services) depending on their own needs and specificities. Regulations should not favor one option in detriment to another one;
- in addition, there should be further clarity in the scope of entities which benefit from the status of "CSD" with a clear distinction between what is an "issuer CSD" and what is an "investor CSD". In this respect the reference to "Securities Settlement Systems" (SSS) should be deleted in a number of legislations to avoid that an investor CSD (which acts actually as a global custodian) is assimilated to an issuer CSD and thus benefit from a privileged status for a number of services. This is notably the case with Article 47.3 in EMIR where it is stipulated that a CCP should held its collateral with an SSS. If this results with CCPs holding their collateral with investor CSDs and not issuer CSDs (as both benefit from the SSS status), the number of CSDs used in this respect will be very limited (probably to the two existing ICSDs). Once again such a development is not consistent with the diversity objective.

  Beyond the lack of clarity this is also a matter of investor and consumer protection as concentration of activities with a very limited number of operators could be very damaging for end users in case of a situation of stress.

Example 3 for Issue 14

EMIR: impact on the use of triparty collateral management services

- **To which Directive(s) and/or Regulation(s) do you refer in your example? (if applicable, mention also the articles referred to in your example)**

Regulation on OTC Derivatives, CCPs and Trade Repositories" (EMIR), Article 47.3.

"Financial instruments posted as margins or as default fund contributions shall, where available, be deposited with operators of securities settlement systems that ensure the full protection of those financial instruments. Alternatively, other highly secure arrangements with authorised financial institutions may be used".

EMIR Delegated Regulation 153/2013, Article 44.

- **Please provide us with an executive/succinct summary of your example.**

EMIR Level 1 sets out the principle that collateral provided to a CCP must be held by the CCP using "highly secure arrangements". This principle is sound. The Level 2 text (Delegated Regulation 153/2013, Article 44) and the ESMA Q&A document are problematic and confusing though, as they only look at the perspective of the CCP, rather than from the perspective of the market participant providing collateral to a CCP.

The outcome of this is unhelpful; regulatory measures to increase the use of CCPs will lead to broader categories of market participant needing to provide collateral to CCPs. Also, the outcome is unnecessary. The requirement under Level 1 for "highly secure arrangements" is legitimate, and can be met by collateral management service providers that are not CSDs.

Separately, it should be noted that EMIR Article 47(3) and Article 44 of 153/2013 also lead to CCPs being prevented from keeping the collateral posted to them at an account held by a custodian bank. They are forced to open an account directly with an SSS (CSD) in own name, to keep the user collateral.

- **Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data etc.)**

The use of a tri-party collateral management provider or a custodian bank is a highly efficient mechanism for a collateral provider to give securities collateral to a collateral taker. For a triparty provider to be used as a mechanism to provide collateral to a CCP, three conditions must be met: (i) the collateral giver must have a securities account at the triparty provider; (ii) the collateral taker (i.e the CCP) must have a securities account at the triparty provider; and (iii) the collateral giver must have securities available on its account with the triparty provider.

The Level 2 text and the ESMA Q&A either prohibit or severely impede a CCP from opening a securities account at a triparty provider that is not a CSD or at any custodian bank. The consequence is that in order to use a triparty provider or a custodian bank the collateral giver has both to open up an account at a CSD, and to transfer securities to that account. Many market participants are not able to open accounts directly at issuer CSDs, and then the only available option would be to open an account with a CSD that is also a triparty collateral management provider. For many categories of market participant, these two requirements may be difficult to meet. Many market participants are not able to open accounts at CSDs, and so it may not be possible to meet condition (i); condition (iii) may also be difficult to achieve, given that many market participants hold, and use, major collateral positions at tri-party providers that are not CSDs.

In short, the Level 2 interpretation of EMIR 47.3 prohibits or severely impedes the use of some categories of collateral management services. This has an impact on market liquidity, and will have an increasing impact on market liquidity as more financial market activity is cleared by CCPs.

With regard to the account that needs to be used to keep the user collateral we believe that there are a number of reasons why the regulation creates unnecessary constraints. First, there is no difference from the point of view of asset protection whether the assets are deposited directly by the CCP in a direct access account or in a segregated account operated at the SSS for the CCP by a custodian bank. In both cases, the assets deposited by the CCP are clearly segregated, protected from any third party claims, and benefit from the protections under the Settlement Finality Directive, primarily the irrevocability of transfers.

Second, the duty for a CCP to use exclusively a direct account at an SSS actually results in additional risks and adds complexities to the process of transfer and management of collateral:

- posting collateral to the CCP still requires the involvement of a transfer agent and a transfer account at the level of that particular SSS that the CCP has selected. This impedes the immediacy of transfer and the efficiency of substitution, and results in higher transaction risks and operational costs for derivatives users; and
- similar to problems faced by users to post collateral, CCPs cannot renounce to the use of global custodians: no single (European or other) SSS can ensure universal access of a CCP to collateral deposited worldwide. In practice, CCP have to use global custodians to manage collateral transfers between multiple CCP direct accounts at various locations. This practical consequence effectively defies the presumed objective that CCP should manage to rely only on own direct custody account. At the same time, the lack of harmonisation in the settlement practices between various SSS makes the use of global custodians essential in order to ensure collateral liquidity.

Finally, an SSS has to be able itself to offer global custody services in order to be able to operate a direct account for a CCP. Only two EU SSS are capable of providing such services, which gives them an undue competitive advantage over others. This would be redressed by ensuring that a CCP may rely on a custodian bank operating an account for it at an SSS. In addition, such concentration of risk within only two entities is unwanted and should be discouraged by providing for more options and a more level playing field among the European CSDs.

- **If you have suggestions to remedy the issue(s) raised in your example, please make them here.**

It should be possible for collateral givers to use “highly secure” collateral management service providers as a mechanism to provide collateral to CCPs. The Level 2 text and the

ESMA Q&A document should be modified accordingly.

With regard to the account that needs to be used to keep the user collateral, we argue that CCPs should have the option to either deposit assets received as collateral and DF contributions within a direct account at a securities settlement system (SSS), or use a highly secured arrangement, such as depositing the said assets at an SSS via a securities account operated in the name of the CCP.

Issue 15 - Procyclicality

"EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how."