Irish Stock Exchange

Irish Stock Exchange plc Response to the Central Bank's Consultation Paper CP 101: Consultation on a Capital Requirement Framework for Market Operators

5th May, 2016

The ISE, as a Market Operator authorised under the MiFID Regulations, welcomes the opportunity to respond to the Central Bank's consultation on a Capital Requirement Framework ("CRF") for Market Operators.

Before addressing the specifics of the consultation paper we feel it is important to consider the overall market and regulatory context and to make some general observations.

While we fully support the overarching regulatory goal of establishing a new CRF for Market Operators, it is essential that this model reflects best practice internationally and is proportionate to the nature, scale and complexity of the business of each such Market Operator. Given the globalised nature of financial markets and the trend towards regulatory convergence we also advocate a CRF for Irish Market Operators which is equivalent to that applying in other European markets, especially the UK. This is critical for competitive positioning reasons and to avoid unnecessary regulatory disparity between these two, and other, jurisdictions.

At a European policy level, we note that the purpose of setting up ESMA, as set out in its published mandate, is to promote stable and orderly financial markets by, inter alia, "completing a single rulebook for EU financial markets, promoting supervisory convergence". Promoting supervisory convergence is further described as "to ensure a level playing field of high quality regulation and supervision without regulatory arbitrage…… between Member States".

Given that the legal authority for the CRF arises from a European Directive, MiFID (Directive 2004/39/EC), which was intended to be applied consistently across the Single Market of the European Union, the ISE's interpretation of the objectives of:

(i) creating a level playing field across the EU Single Market, and

(ii) avoiding regulatory arbitrage by consistent implementation and application of rules across the Single Market

envisages the application of rules governing the CRF for Market Operators to be consistent across that Single Market. We believe that the implementation of aspects of an Irish CRF which would disadvantage Irish based Market Operators vis-à-vis those in other jurisdictions by imposing on them an excessive capital requirement would not be consistent with ESMA policy.

In our view, consideration of the most appropriate model to apply should involve benchmarking against models in other European jurisdictions and we believe that the model adopted for Recognised Investment Exchanges in the UK, which has a similar market structure to the Irish market, is a model which would work well here.

In response to the specific questions posed in CP 101 we have the following observations:

1. **Do you agree with the Central Bank's proposal to establish a risk-based Capital Requirement Framework for Market Operators in Ireland?**

Yes, we agree with the proposal to establish a risk-based CRF for determining the appropriate level of regulatory capital for Market Operators. A rigorous, risk-based model which focuses on actual risk rather than being overly influenced by changes in revenues and growth in balance sheet size, which is a characteristic of the present model, is appropriate.

A risk-based CRF better serves the fundamental rationale for regulatory capital which we believe should comprise the twin elements of:

(i) ensuring that sufficient capital is held against the material risks faced by a Market Operator, and

(ii) enabling an orderly wind down so as to minimise market impact in any termination scenario.

Our view is that the proposed new CRF for Market Operators in Ireland should be based upon two pillars which align with the above rationale, being:

1) a risk-based allocation of capital to the Market Operator's risk profile and to its individually identified and assessed risks utilising a proven, robust internal Risk Management Framework, and

2) adequate capital to facilitate a wind down of the business (i.e. maintenance of six months' trailing operating costs).

We believe that the regulatory capital allocation should be the higher of these two amounts. The use of either the six months' operating costs element or the operating and business/strategic aspects of the risk-based approach as the regulatory capital amount also ensures that sufficient capital is held against risks associated with the growing scale of a Market Operator's business.

2. **The proposed MORCAAP encompasses a risk governance element and a risk based assessment of the capital required in both recovery and wind down scenarios. Do you agree with what is proposed?**

Overall, we agree with the concept of a risk-based assessment but we believe that there needs to be greater cognisance of the nature of an individual Market Operator's business model when assessing relevant risks, especially when compared to investment firms and other financial institutions. In this regard notable differences for the ISE include the complete absence of certain key sources of risk, particularly: client assets, trading and position risk and any contractual relationship with retail clients.

In relation to the detail of the proposed CRF calculation in Annex I of CP 101, we agree:

(i) with the proposal that the Basic Capital Requirement should equal the higher of six months' operating expenses or the MORCAAP, and

(ii) that the calculation of the MORCAAP should include capital allocated to cover the internal assessment of business risks and associated mitigations in stressed market conditions, which directly and prudently allocates capital to the assessment of business risks.

However, we do **not** agree with the overall calculation as, in our view, the regulatory capital allocation should equal the **higher of** the capital allocated from (i) the MORCAAP risk assessment exercise or (ii) 6 months' operating expenses, being the estimated costs of the wind down of a Market Operator's business. Taking the **sum of** MORCAAP plus the amount of capital required to support an orderly wind down of the business is excessive and disproportionate to the level of capital required. As noted above, we believe that the requirement to maintain at least 6 months' operating expenses as regulatory capital under the CRF for Market Operators is sufficient to cover a wind down scenario. This assertion is in line with our earlier comments on the UK's approach.

The proposed MORCAAP, by adding these components together, results in a capital requirement which exceeds the amount necessary to cover the risks attributable to the business and consequently, moves away from being a realistic risk-based approach to effectively double counting the capital required. In a scenario where the Market Operator's capital equals the amount to cover the risks assessed and assuming that this is higher than the capital needed for a wind down, there is already sufficient capital to cover a wind down scenario, should it be required, and the amount additional to this is therefore unnecessary. While, we agree that a prudent approach should be adopted to the level of capital held on a Market Operator's balance sheet, there is a strategic impact and commercial cost to the business from retaining excessive levels of capital which presents its own risk should it impede necessary business development spend or capital expenditure as well as disadvantaging an Irish based market operator vis-à-vis its competitors in other jurisdictions.

On the basis that the risk-based allocations should rely on a robust, proven internal Risk Management Framework, agreed with the CBI before finalisation, we also **disagree** with the proposal to impose both a Capital Add-on to arrive at a MORCAAP figure and then a further Strategic Capital Add-on of 10% to 30% when arriving at the final overall CRF amount. We consider that the Capital Add-on and Strategic Capital Add-on are penal and will result in a capital requirement which far exceeds that required in other EU jurisdictions governed by equivalent MiFID legislation. Furthermore there is no clear basis for either the Capital Add-on or the Strategic Capital Add-on range of 10% - 30% which opens up potential for different amounts being applied with consequent competitive distortion.

The ISE considers that the maintenance of at least 6 months' operating costs as regulatory capital would allow ample time for an orderly wind down so as to minimise market impact in a resolution/termination scenario. We therefore do **not** agree for the ISE's business that additional capital should be allocated to a wind down in addition to the risk-based MORCAAP amount.

With regard to formally defining a recovery/resolution plan for a Market Operator, including the consideration of reverse stress scenarios, we believe that elements of this approach are more appropriate to the banking sector and that it is artificial and potentially misleading to try to apply it to a Market Operator's business model. This approach should be appropriate to the individual circumstances of a Market Operator rather than being a generic one. In particular, this approach is not relevant where a Market Operator does **not**:

(i) have any debt on its balance sheet and there is therefore no potential to bail-in either institutional lending counterparties or corporate bondholders;

(ii) hold any institutional or retail client monies (e.g. deposits) or assets and there is no potential to bail-in customer balances;

(iii) have any preference or redeemable share capital or other forms of convertible capital which could be converted to equity in a resolution scenario.

The only avenues in a resolution scenario for a Market Operator such as the ISE would be an equity cash call to existing or potentially new investors or a sale of the business. The implications of a wind down are therefore more severe and demanding than a recovery/resolution scenario. We consider that the maintenance of at least 6 months' operating expenses as regulatory capital allows sufficient time for a scheme of resolution to emerge, if appropriate.

As noted above, we also consider that a six month window and six months' operating expenses provides sufficient cover for a potential wind down of the ISE's business and therefore additional capital allocated to a wind down should be zero. We do of course recognise that this may need to be tailored to each individual Market Operator's business and risk assessment process.

In relation to the risk governance aspects of MORCAAP, we agree that the Board of a Market Operator must oversee and approve the CRF. This is the case in the ISE. The capital allocation exercise should not be a separate exercise undertaken in isolation and should be viewed as a complementary piece of work which leverages and builds on the rigour of the existing processes, systems and Risk Management Framework of a Market Operator. Market Operators should rely on a rigorous Risk Management Framework to identify and classify material existing and foreseeable risks while also considering business strategy and environmental and market intelligence to provide context in terms of business outlook.

While we accept that documentation of risks is important, the wording of the requirement on page 7 that the MORCAAP document must be kept up to date "at all times" could pose practical issues and documentation should not take precedence over the management, identification and mitigation of risks, albeit that it is clearly important to have comprehensive and timely documentation. There also should be a cost/benefit analysis perspective on the level of resources to be allocated to this process.

In relation to eligible assets, as Market Operators are not covered by the CRR (EU Regulation No 575/213) or Commission Regulation (EU) 2015/61 we query the appropriateness of referring to CRR requirements, in particular in Schedule 1, which refers to credit institutions in the

relevant Regulations. In line with earlier comments on the potential for inconsistent application of regulations across the Single Market, solely impacting Irish market operators, we believe that a policy decision to bring Market Operators within the scope of an EU Regulation, such as the CRR, should be made at European level.

We would appreciate further discussion on the application of the Eligible Assets proposals to ISE held investments.

3. Do you consider the proposed capital add-on for newly authorised Market Operators to be appropriate and proportionate?

We do not wish to comment on newly authorised Market Operators.

Conclusion

We welcome the Consultation Paper and we look forward to the implementation of the new CRF, taking due account of consultation feedback. We would be happy to discuss our response further as well as some of the practical details and timings of how the transition to the new CRF will be handled.