Alder Capital's Response to CP 49

Introduction
Alder Capital welcomes the opportunity to comment on CP 49 and congratulates the Central Bank of Ireland ("Central Bank") on its openness and transparency in holding a consultation on this important issue. For ease of reading, Alder Capital has set out a high level summary of its comments at the beginning of this submission. The detail behind each high level summary point has been set out later in the document.

Summary of Comments

1. The principle for levying fees ought to be: *Fees charged should be directly related to supervisory resource consumed* rather than the principle set out in CP 49 namely that the impact score determines the level of fees charged to a regulated entity.
2. Impact metrics for MiFID firms ought to ensure that lower impact scores are given to those MiFID firms that do not deal with retail clients, do not hold client money and fall within categories of investment firms in Article 20(2) and (3) of Directive 2006/49/EC. To achieve that aim, certain impact metrics ought to have multiple divisors rather than a single divisor in order to arrive at a better assessment of impact.
3. The Central Bank ought to benchmark the distribution of its impact scores to ensure that they are not inconsistent with other regulatory risk measures.
4. The firm believes that the Central Bank should make its impact scores publicly available on its website.
5. If the Central Bank uses impact scores to determine the regulatory fees that firms will be charged then it ought to have regard to Article 157 of the Treaty of Rome, as amended, regarding the need to ensure that its actions do not discourage an environment favourable to initiative and the development of undertakings ***particularly small and medium-sized undertakings***.

1. Principle for Calculating the Industry Levy

In paragraph 5.3 of CP 49, the Central Bank states:

> *Central Bank is minded to move towards using impact scores as the basis for the setting of the levies it charges regulated firms each year. Under this approach the impact score … would be used as the principle determinant of the levy a firm paid.*

Alder Capital submits that this is the wrong approach to setting the basis of the levy that a firm pays. The levy that a firm pays should be directly related to the amount of supervisory resource it consumes. The proposal in paragraph 5.3 may be directly in conflict with the important principle set down by the Central Bank in paragraph 5.5 namely,

> *…it has been an important principle of the funding process that cross subsidisation between industry categories should be avoided to the extent reasonably possible.*

In Alder Capital's view, there is an assumption that a firm's impact score will be directly related to the amount of supervisory resources that the firm consumes. Until the Central Bank has communicated to regulated firms how impact scores are calculated and has operated impact scores for a number of years and considered how impact scores are related to supervisory resources consumed it is difficult for firms to have any confidence that they are being charged for the supervisory resources they consume.

If impact scores were to be a 'major determinant' of the levy that firms pay and if cross subsidisation between industry categories is to be avoided to the extent reasonably possible then the use of a linear function to link the impact score to the levy payable would in Alder Capital's view be wholly contrary to the Central Bank's stated 'no cross subsidy' principal

To illustrate the problem that a linear mapping would give rise to, consider the following example. Take a Low Impact Firm with an impact score of 20 and a High Impact firm with an impact score of 100. According to the Consultation Document, the High Impact firm will have a dedicated supervisory team. By contrast, for the Low Impact firm, the Central Bank's

> *data processing capabilities, likely to be accompanied by electronic submission of returns by all firms, will increasingly allow for automated return checking*;

Desk-based reviews and thematic inspections will also form part of the supervisory engagement model for Low Impact firms.

Using a linear model to map impact scores to levy payments would lead to a breach of the principle that levy cost should be driven by the consumption of supervisory resources as the impact score of the High Impact firm is just 5x (20 versus 100) that of the Low Impact firm's score but the cost of supervising the High Impact firm is likely to be 125x[1] that of supervising the Low Impact firm.

In the example quoted, the mapping formula to move from impact score to levy would need to be a cubic function so that the ratio of the levy for a High Impact firm to that for a Low Impact firm would be 125:1. Otherwise the stated principle of no cross subsidy between firms is breached.

2. Impact Metrics for MiFID Firms

Impact metrics for MiFID firms ought to ensure that lower impact scores are given to those MiFID firms that do not deal with retail clients, do not hold client money and

[1] Assuming the Central Bank spends 10 person days a year supervising a Low Impact firm and 1,250 person days a year supervising a High Impact firm.

fall within the categories of investment firms in Article 20(2) and (3) of Directive 2006/49/EC.

Taking into account the Central Banks statements regarding the need for the level of supervisory engagement to be related to the inherent risk of the firm (page 3), the fact that smaller firms are unlikely to create systemic problems in the event of failure (page 7) and noting the Central Bank's concern in relation to any firm to which retail clients have exposure, it seems to Alder Capital that impact scores ought to rise to the extent a firm deals with retail customers and to the extent it holds client money.

Number of Customers
MiFID firms are required by legislation to classify all their customers and indeed to have in place a procedure for doing so. It should not therefore be difficult for the Central Bank to obtain from MiFID firms the split of their customers into two categories: (i) retail; and (ii) professional clients and eligible counterparties ('Institutional Customers').

Further, Institutional Customers tend to perform their own due diligence on regulated firms before doing business with them and monitor the performance of regulated firms once they have commenced business with them. These practices impose certain risk disciplines on firms that deal predominantly with Institutional Customers.

Alder Capital believes that the impact metric *number of customers* should be split into number of retail customers and number of Institutional Customers with a significantly higher divisor being applied to the number of Institutional Customers and a lower divisor being applied to the number of retail customers in calculating an impact score. Alder Capital believes that this is preferable to a crude divisor that ignores the split of a firm's customers between retail and Institutional Customers. This splitting of customers into retail and Institutional Customers and the use of two different divisors for the two categories of customer identified would allow the level of supervisory engagement to be calibrated with greater precision to the inherent risk profile of firms.

Turnover
Similarly, turnover is a very crude measure of risk for any firm. The composition and diversification of turnover by line of business are important in assessing risk. In the financial services industry, at one end of the scale, turnover arises from transaction fees whereas at the other end of the scale turnover may arise from underwriting on a firm commitment basis. Turnover needs to be split into its different sources with different divisors for each source for a serious calibration of the inherent risk of firms.

Amount of Client Money
Alder Capital suggests that the amount of client money would be a much better metric than turnover in terms of the kinds of risk that the Central Bank is focusing on as seen on page 7 (paragraph 2.3.2) of CP 49.

Number of Staff
Regulated entities that take their regulatory, data protection, companies acts, health and safety and other legal responsibilities very seriously and who run their firms with staffing levels appropriate to sound risk management and operational policies are penalised by this crude impact metric compared with regulated entities that operate

with lower levels of compliance staff for comparable businesses. Number of retail sales staff is a more appropriate metric in terms of the Central Bank's desire to arrive at proxies for a firm's potential to cause losses for a large number of customers as described in paragraph 2.3.3.

Alder Capital submits that the firms assigned the lowest impact scores might reasonably be those firms that satisfy all of the following five criteria:

1. Do not hold client money;
2. Do not deal with retail clients;
3. Fall within categories of investment firms in Article 20(2) and (3) of Directive 2006/49/EC;
4. Have 'own funds' considerably in excess of either the Pillar I or Pillar II requirements; and
5. Regulated in the United States of America by the SEC or the CFTC/NFA in the provision of the same or broadly similar investment services.

3. Benchmarking Impact Scores

The Central Bank might like to consider benchmarking the distribution of its Impact Scores against the distribution of Pillar I or perhaps even Pillar II capital requirements of firms and consider how it might explain any inconsistencies to itself, the firms it regulates, the European Systemic Risk Board, the IMF and the ECB.

4. Transparency

The firm believes that the Central Bank should make its impact scores publicly available on its website so that external parties may judge the quality of its supervision, the extent to which the levy imposed on different firms creates competitive distortions in the market and so that firms operating in the financial services industry may use the publicly disclosed ratings in conducting due diligence on financial service providers and counterparties.

5. Competition

According to Article 157 of the Consolidated Treaty of Rome[2],

> *The Community and the Member States shall ensure that the conditions necessary for the competitiveness of the Community's industry exist. For that purpose, in accordance with a system of open and competitive markets, their action shall be aimed at: …*
> *— encouraging an environment favourable to initiative and to the development of undertakings throughout the Community,* ***particularly small and medium-sized undertakings,*** [Emphasis added]

[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:321E:0001:0331:EN:PDF

In the light of Article 157, Alder Capital believes that it would be important for the Central Bank to consider carefully the effect of any formula for converting impact scores into levy payments on small and medium-sized undertakings as Article 157 requires that *Member States* ***shall*** *ensure that the conditions necessary for the competitiveness of the Community's industry exist. For that purpose, in accordance with a system of open and competitive markets, their action shall be aimed at: …*
— encouraging an environment favourable to initiative and to the development of undertakings throughout the Community, ***particularly small and medium-sized undertakings,***

The key words in the Article are 'shall ensure' and 'particularly small and medium-sized undertakings'.

Conclusion
Alder Capital thanks the Central Bank for the opportunity to comment on its proposals in CP 49 and trusts that the ultimate implementation of impact scores will be publicly transparent, not lead to competitive distortions, accord with existing risk measures for firms such as Pillar I capital requirements and follow the principle that a firm's levy should be directly related to the supervisory resource it consumes.