Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2016

Consultation on a Capital Requirement Framework for Market Operators

Consultation Paper CP 101

Contents

Introduction	2
Proposal	2
Questions for Consideration	3
Consultation Process	3
Annex I – Proposed Capital Requirement Framework	5
Schedule 1 – Liquid Financial Assets - Securities	9
Schedule 2 – Liquid Financial Assets - Deposits and Accrued Interest	10

Introduction

Market Operators of a regulated market are authorised under Regulation 47(1)(a) of the European Communities (Markets in Financial Instruments) Regulations 2007 (as amended) ['the MiFID Regulations'].

Market Operators are not subject to the Capital Requirements Regulation[1] or Capital Requirements Directive IV[2] [collectively 'CRD IV']. However under the MiFID Regulations:

- Regulation 48(c) states "*that the proposed market operator has the mimimum level of capital which shall be specified by the Bank*"; and

- Regulation 63 states "*The market operator of a regulated market shall – …(f) have available, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed.*"

This consultation paper signals the Central Bank of Ireland's (hereafter 'Central Bank') proposed Capital Requirement Framework for Market Operators.

Proposal

The Central Bank proposes introducing a risk based capital requirement to apply to Market Operators in Ireland. It is intended that the proposed Capital Requirement Framework would be imposed on Market Operators either as a condition on authorisation in accordance with Regulation 48(c) of the MiFID Regulations and pursuant to Regulation 145[3] of the MiFID Regulations or in the form of Central Bank regulations under the Central Bank (Supervision and Enforcement) Act 2013.

The proposed Capital Requirement Framework sets the Basic Capital Requirement for Market Operators as the higher of six months operating expenses and the exposure assessed through a Market Operator Risk and Capital Adequacy Assessment Process ('MORCAAP')[4]. In addition to this figure, it is proposed that there is a separate Strategic Capital Add-on which will be set by the Central Bank on a case-by-case basis and will be within the range of 10% to 30% of the Basic Capital Requirement. This Strategic Capital Add-on is proposed in order to reflect the strategic importance of the individual Market Operator and the reliance placed on Market Operators by other financial market participants.

The proposed Capital Requirement Framework also incorporates a capital add-on for new entrants. This capital add-on applies to any newly authorised Market Operators in Ireland for a period of three years post-authorisation. The proposed capital add-on ensures that any new entrant is well-resourced and can prove their capacity over time to run a Market Operator structure. This is particularly important given the reliance of other financial market participants

---

[1] Regulation (EU) No 575/2013
[2] Directive 2013/36/EU transposed in Ireland by S.I. No. 158 of 2014
[3] Regulation 145 states that *"(1) The Bank, in respect of … the market operator of a regulated market may do all or any of the following: …(b) at any time impose conditions or requirements and amend or revoke any condition or requirement imposed under this paragraph;…(2) Any condition or requirement referred to in paragraph (1) may be imposed in relation to any or all of the following: (a) an investment firm, the market operator of a regulated market or a regulated market;…"*
[4] The MORCAAP is detailed in Annex 1.

on such structures. The capital add-on for new entrants is incorporated within the Basic Capital Requirement calculation.

The proposed Capital Requirement Framework requires that both the Basic Capital Requirement and the Strategic Capital Add-on are met by both high quality capital and by Liquid Assets. In this regard certain definitions within the proposed framework have been broadly aligned to those set out in CRD IV.

Full details of the proposed Capital Requirement Framework are set out in Annex 1. While it is intended that this framework will be applied to Market Operators in Ireland, it should also be noted that the Central Bank will maintain a significant degree of supervisory discretion in considering any new applications. This is due to the varied nature of Market Operator structures and business models and the impact that they can have on other financial market participants. Depending on an individual business model, the Central Bank may wish to impose some additional or different conditions on authorisation with respect to capital or liquidity requirements.

Questions for Consideration

We are consulting on all of the proposed Capital Requirement Framework set out in Annex 1 and we welcome stakeholders' views on any aspect of the proposals. In particular we welcome stakeholders' input on the following questions:

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

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?

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

Consultation Process

The Central Bank invites all stakeholders to provide comments on the proposed Capital Requirement Framework set out in Annex 1 and on the questions noted above.

Please make your submissions electronically by email to invfirmspolicy@centralbank.ie or in writing, to:

CP 101 Consultation
Markets Policy Division
Central Bank of Ireland
Block D
Iveagh Court
Harcourt Road
Dublin 2

Responses should be submitted no later than 06 May 2016.

It is the policy of the Central Bank to publish all responses to its consultations. All responses will be made available on our website. Commercially confidential information should not be included in consultation responses. We will send an email acknowledgement to all responses sent by email. If you do not get an acknowledgement of an emailed response please contact us on +353 1 2246000 to verify receipt.

Markets Policy Division
Central Bank of Ireland
12 February 2016

Annex I

Proposed Capital Requirement Framework for Market Operators

The Capital Requirement Framework ('CRF') requires Market Operators to hold capital at least equal to a Basic Capital Requirement plus a Strategic Capital Add-on, whereby:

A. the **Basic Capital Requirement** is the **higher** of:
   six months operating expenses
   or
   a Market Operator Risk & Capital Adequacy Assessment Process ('MORCAAP')
   and
B. the Strategic Capital Add-on is set by the Central Bank as a percentage of the Basic Capital Requirement (to range between 10% and 30%).

A Market Operator should at all times hold capital to meet the Basic Capital Requirement and the Strategic Capital Add-on. Derogation from the requirement to hold sufficient capital to meet the Strategic Capital Add-on may be permitted on a temporary basis only with the prior written approval of the Central Bank.

Operating Expenses

For the purpose of the Basic Capital Requirement calculation, operating expenses are based on the two most recent sets of quarterly financial statements returns submitted to the Central Bank adjusted for:

i. the deduction of material non-recurring expenditure incurred in the previous six months, subject to Central Bank approval, and;

ii. the addition of material exceptional expenses forecast for the next six months.

Market Operator Risk & Capital Adequacy Assessment Process (MORCAAP)

The MORCAAP amount is quantified as **the sum of**:

A. the Market Operator's consolidated internal assessment of the capital required to cover the business risks and associated mitigations in stressed market conditions
   and
B. the amount of capital estimated by the Market Operator as required to support an orderly wind down of the business
   and
C. Capital Add-ons set by the Central Bank.

A. Internal Assessment of Capital Required to Cover the Business Risks and Associated Mitigations in Stressed Market Conditions

A Market Operator shall have in place sound, effective and comprehensive strategies, processes and systems to assess and maintain on an on-going basis the amounts, types and distribution of capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed.

The calculation entails an assessment of the capital required to cover risk of losses in stressed circumstances in order for the Market Operator to be able to absorb losses and continue as a going concern. In this regard, the Market Operator must prepare a recovery plan setting out actions that could be taken to facilitate the continuation, or secure the business or part of the business, of the Market Operator in a situation where the Market Operator is experiencing financial instability. A recovery plan should not assume that financial support will be available from the State. Market Operators shall submit their recovery plan to the Central Bank for assessment and, where the Central Bank so directs, the Market Operators shall demonstrate that the plan can be implemented. The Central Bank may direct the Market Operator to provide any additional information or analysis necessary to assess the recovery plan and to make specified changes to the plan that the Central Bank considers necessary to ensure that the plan can be implemented.

B. Amount of Capital Estimated by the Market Operator as Required to Support an Orderly Wind Down of the Business

The Market Operator is required to estimate the amount of capital required to support an orderly wind down of the business within a defined time period. In this regard the Market Operator shall draw up a plan setting out how the Market Operator would wind down in an orderly fashion in the event of failure. In drawing up the wind down plan, the Market Operator should consider at least one reverse stress test scenario.

The strategies, processes and systems referred to above, as well as the recovery plan and wind-down plan must be approved by the Board of the Market Operator. They shall be subject to regular internal review, at a minimum on a quarterly basis, to ensure that they remain up to date and comprehensive and proportionate to the nature, scale and complexity of the activities of the Market Operator. The Board of the Market Operator must approve the conclusions arising from such internal reviews.

C. Capital Add-ons set by the Central Bank

If the quantity of capital allocated is found to be deficient, the Central Bank may impose one or more specific Capital Add-ons. Capital Add-ons will be imposed where the Central Bank deems that there is an omission of an identified risk, an inadequate calculation of the total exposure of a risk or an overestimate of the effect of mitigations in reducing a risk exposure in the MORCAAP. Any such Capital Add-on will then form part of the overall MORCAAP figure to be used in the Basic Capital Requirement calculation until such time as the Central Bank specifies otherwise.

A separate MORCAAP Capital Add-on will be imposed on newly authorised Market Operators for the first three years of operation. This Add-on will be set at twelve months operating expenses and twelve months capital expenditure plus a potential additional amount to address entity specific risks identified by the Central Bank during the authorisation process. The Capital Add-on will form part of the overall MORCAAP figure to be used in the Basic Capital Requirement calculation.

Risk Analysis and the MORCAAP

The MORCAAP should form an integral part of a Market Operator's risk management process, so as to enable the management body (both supervisory and management functions) to assess, on an on-going basis, the risks that are inherent in their activities and that are material to the Market Operator. A MORCAAP is designed to enhance the link between a Market Operator's risk profile, its risk management and risk mitigation systems and its available financial resources – both capital and liquid assets. The Market Operator is required to have an assessment process that encompasses all the key elements of capital and liquidity planning and management and must make other such organisational arrangements for the conduct of the MORCAAP as the Central Bank shall specify by exercising its powers of direction and/or its powers to impose conditions on authorisation.

The MORCAAP should include an assessment of all risks applicable to the Market Operator, including, but not limited to, Capital Risk, Conduct Risk, Credit Risk, Concentration Risk, Environment Risk, Governance Risk, Insurance Risk, Liquidity Risk, Market Risk, Operational Risk and Strategy/Business Model Risk. In addition, Market Operators should include risks arising from planned capital expenditure, risks associated with significant contractual relationships e.g. outsourcing/outsourcer arrangements, risks arising from guarantees or contingent liabilities. An assessment of remuneration polices should also be considered. For each risk identified, the Market Operator should quantify the risk, confirm the risk appetite and consider the appropriate form of risk mitigation, including whether this consists of controls, changes in liquidity management arrangements or additional capital.

The results of the MORCAAP process should be documented and consolidated in a Board approved MORCAAP document.

The Market Operator is responsible for keeping the MORCAAP document up to date at all times. The document must be available for immediate inspection by the Central Bank.

Central Bank Review of the MORCAAP

On an annual basis the Market Operator will submit their MORCAAP document to the Central Bank at a date specified by the Central Bank. The Central Bank will conduct a Supervisory Review and Evaluation Process ('SREP') of the MORCAAP. The SREP will include an evaluation of the methodology employed by the Market Operator in preparing the MORCAAP.

Strategic Capital Add-on

Given the reliance of other financial market participants on Market Operators, a Strategic Capital Add-on will be set by the Central Bank in order to ensure Market Operators are well positioned financially to meet any exceptional circumstance which may arise. The Strategic Capital Add-on will be within the range of 10% to 30% of the Market Operator's Basic Capital Requirement.

Capital

A Market Operator must at all times hold Common Equity Tier 1 capital as defined in Chapter Two of Part Two of the Capital Requirements Regulation[5] at least equal to the sum of the Market Operator's Basic Capital Requirement and the Strategic Capital Add-on.

Liquid Financial Assets

A Market Operator must at all times also hold Liquid Financial Assets at least equal to the sum of the Market Operator's Basic Capital Requirement and the Strategic Capital Add-on.

Liquid Financial Assets must meet the following criteria:

i. Liquid Financial Assets shall be free from any encumbrance. An asset shall be deemed to be unencumbered when the Market Operator is not subject to any legal, contractual, regulatory or other restriction preventing it from liquidating, transferring, selling, assigning or, generally, disposing of such asset within a 30 day period. This 30 day period may be extended only in relation to deposits with credit institutions where a duration risk haircut is applied.

ii. Liquid Financial Assets shall not be held or issued by the Market Operator itself, its parent undertaking, its subsidiary or another subsidiary of its parent undertaking or by a special purpose entity with which the Market Operator has close links.

iii. Liquid Financial Assets may only comprise cash and cash equivalents, securities as set out in Schedule 1 subject to the haircuts set out therein or such higher haircuts as the Central Bank may specify from time to time and deposits and accrued interest as set out in Schedule 2 subject to such haircuts as the Central Bank may specify from time to time.

Capital Requirement Framework Report

A Market Operator is required to submit a completed Capital Requirement Framework Report via the Central Bank's Online Reporting System on such template or templates as specified by the Central Bank from time to time:

- as at 31 March, 30 June, 30 September and 31 December each year within 20 business days of the reporting date.
- within 5 business days of a material change arising in the MORCAAP. A material change is identified as a 10% movement in the overall MORCAAP figure, a 20% change in the capital attributed to an individual risk or the introduction of a new risk which accounts for greater than 5% of the overall MORCAAP figure.

[5] Regulation (EU) No 575/2013

Schedule 1

Liquid Financial Assets - Securities

Securities may be defined as relating to any interest the Market Operator has in corporate stock or stock rights or in a note, bond, debenture or other form of indebtedness issued by a government or a corporation.

The following securities may be included in Liquid Financial Assets subject to the haircuts noted:

a) assets representing claims on or guaranteed by the central government of an EU Member State subject to a 0% haircut.

b) assets representing claims on or guaranteed by the central government of a third country that meet the criteria set out in Article 10(1)(c)(ii) of Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 (‘the LCR’) subject to a 0% haircut.

c) extremely high quality covered bonds that meet the criteria set out in Article 10(1)(f) of the LCR subject to a 7% haircut.

d) high quality covered bonds that meet the criteria set out in Article 11(1)(c) of the LCR subject to a 15% haircut.

e) covered bonds that meet the criteria set out in Article 11(1)(d) of the LCR subject to a 20% haircut.

f) high quality covered bonds that meet the criteria set out in Article 12(1)(e) of the LCR subject to a 30% haircut.

g) corporate debt securities that meet the criteria set out in Article 11(1)(e) of the LCR subject to a 20% haircut.

h) corporate debt securities that meet the criteria set out in Article 12(1)(b) of the LCR subject to a 50% haircut.

i) shares that meet the criteria of Article 12(1)(c) of the LCR subject to a 50% haircut.

j) shares or units in collective investment undertakings that fall within the categories set out in Article 15(2) of the LCR and subject to the haircuts set out therein.

k) asset backed securities that meet the requirements of Article 13 of the LCR subject to the haircuts set out therein.

Schedule 2

Liquid Financial Assets - Deposits and Accrued Interest

Deposits held with credit institutions (together with the relevant accrued interest) are permissible as Liquid Financial Assets subject to consideration of three risk categories, namely Concentration, Institution and Duration.

Concentration Risk: The maximum amount which may be held with any one credit institution is 20% of deposits and accrued interest. This applies at both group and entity level.

Institution Risk: The Central Bank will from time to time set out for individual Market Operators haircuts which will be applied to deposits held with credit institutions to reflect credit risk.

Duration Risk: This is based on the maturity dates of deposits held at the relevant reporting period end where a higher haircut attaches to deposits with longer maturities than for those with shorter maturities.

Deposits that are guaranteed by a central government of an EU Member State or the central government of a third country with a long term credit rating of AAA or equivalent[6] are not subject to any concentration, institution or duration risk haircut.

[6] Ratings refer to the credit ratings used by Standard & Poors, Fitch and Moodys.

T +353 1 2246000 **F** +353 1 1 6716561 www.centralbank.ie invfirmspolicy@centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Bosca PO 559, Sráid an Dáma, Baile Átha Cliath 2, Éire
PO. Box No 559, Dame Street, Dublin 2, Ireland