RegCORE Client Alert

ECB-SSM updates its supervisory expectations for prime brokerage services

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QuickTake

The adage that prime brokers cannot fail has long been disproven - notably by the failures of Lehman, MF Global and many others that have since led to a flurry of legislative, regulatory and institutional reforms being put in place following the 2008 Global Financial Crisis (the **GFC**). Equally, the assumption that family offices are immune from solvency issues was also negated by the very rapid public downfall of Archegos Capital Management (**Archegos**).

What started with Archegos' widespread margin call defaults during March 2021 rapidly led to a loss of USD 20 billion in two days followed by arrests of Archegos' founders along with key individuals in the United States on charges of racketeering, conspiracy, securities fraud and wire fraud. For global banks (mostly non-Banking Union headquartered banks) exposed to this family office, this culminated in losses well in excess of USD 10 billion. Once again, despite global GFC reforms, opacity, increasingly complex interactions between prime brokers in the US, the EU and indeed further afield and the non-bank financial institutions (**NBFI**) sector catapulted risk management efforts to the fore during the firefighting that followed. It also prompted some global policymakers to revisit the post-GFC rulebook to prevent something similar from happening again.

With that in mind, now that Archegos' fate has joined many a tale in a risk management (as well as financial regulatory law) textbook, the European Central Bank (**ECB**), acting in its role as the head of the Banking Union's Single Supervisory Mechanism (**SSM**), decided to take up the issue in a deep dive article titled "Supervisory expectations for prime brokerage services", published 17 August 2022 in its Supervision Newsletter. As the title suggests, the article recaps the ECB-SSM's own take on the issue and the performance of a targeted "desk review analysis of the risk governance and risk management frameworks associated with prime brokerage services" (the **DRA**), focusing on a subsample of Banking Union supervised institutions (**BUSI**s) for which it is the lead supervisor.

The article however serves as a preliminary forum for setting out the ECB-SSM's supervisory expectations on prime brokerage services offered by BUSIs ahead of potentially more formal supervisory guidance published on the subject matter. This is important as, due to a number of EU legislative reforms, the ECB-SSM is also now the lead supervisor for a number of NBFIs in addition to those credit institutions providing prime brokerage services. This Client Alert assesses the key takeaways from this ECB-SSM article.

The ECB-SSM's prime brokerage DRA and its supervisory expectations

As part of its 2022-2024 SSM Supervisory Priorities publication[1], the ECB-SSM announced that it would first finalise the DRA and secondly clarify its supervisory expectations on prime brokerage and BUSI's management of NBFI exposures. These supervisory expectations, which the ECB-SSM has chosen to update[2] and now communicate via the article states that the supervisory expectations:

> "…have an overarching objective to ensure that BUSIs have sound risk management, strong governance and a proper risk culture applied to BUSIs' prime brokerage business offering."

The article summarises the importance of that overarching objective by reminding readers that:

> "These are after all the main safeguards to help financial institutions manage risks stemming from a business characterised by high competition, which can lead to excessive risk-taking, and a lack of transparency about clients' investment strategy and counterparties' portfolio composition."

The ECB-SSM's choice of words is interesting as while the statement indicates the valuable nature of prime brokerage business models and their service to market participants more generally, there is a concern on conduct of business weaknesses leading to risks drivers that could become a prudential regulatory concern (and thus fall within the ECB-SSM's mandate) and thus what this means for BUSIs' risk management efforts and thus financial stability more generally.

Consequently, the ECB-SSM's DRA findings have helped shape these updated supervisory expectations, which BUSIs[3] should, as a minimum, look to strengthen:

	Theme	ECB-SSM supervisory expectations of BUSIs when offering prime brokerage services	Comments from PwC Legal
1	**Client onboarding (including know your counterpart/ client/ customer (KYC)**	• Maintain an adequate, comprehensive and well-documented credit assessment process in place covering all financial and non-financial aspects of the client relationship • An effective KYC process should be part of the credit assessment and performed on an ongoing basis making use of all available (public and non-public information to minimise risks of dealing with high-risk parties • A party's failure to provide KYC information should result in a more conservative approach to collateral, margining and limits or, in justifiable cases, trigger offboarding of that party • Outcomes of the credit assessment process should be a key element in the onboarding decision and underpin contractual provisions including determining limits, margining caveats, collateral arrangements, credit tiering or reporting requirements	• The ECB-SSM's wording does not cross-refer to applicable KYC standards stipulated in EU as well as national legislative instruments • The ECB-SSM's standards focus on the outputs from KYC assessments as they apply to (and are considered by) BUSIs in the credit risk assessment components given that this latter part is in the ECB-SSM's mandate • There is no discussion on onboarding assessments to consider overall exposures to a group or closely connected entities and/or concentration risk elements
2	**Risk Appetite Framework (RAF) & managing of risk(s)**	• Maintain a sound and robust risk governance framework in which executive management should be adequately involved in decision-making and be able to rely on a comprehensive overview of all associated risks • Document and maintain a clear risk strategy, which defines the RAF in addition to ensuring an adequate and effective credit risk management process tailored to the prime brokerage services offered to respective client types is in place including setting clear limits	• On the governance aspects the ECB-SSM's wording is comparably more lenient than other Guidelines and requirements set by EU authorities (EBA, ESMA etc.) as well as those at national law (which may also differ slightly

[1] Available here, which should also be read in conjunction with Navigating 2022, published by PwC Legal's EU RegCORE.
[2] In March 2022 the ECB-SSM published a rare "joint letter" together with the Bank of England flagging two areas of specific concern 1) leveraged lending and 2) prime brokerage. Given the global nature of these two business areas the authorities continue to exchange information on supervised firms' practices and act in close alignment with each other. For further details on the ECB-SSM's actions in this area, please see the following Client Alert from March 2022 published by PwC Legal's EU RegCORE.
[3] notably credit institutions and CRR investment firms categorised as "Class 1 investment firms" and thus supervised by the ECB-SSM in the Banking Union.

		• Promptly identify and effectively monitor all material exposures to risks related to the prime brokerage business • Implement and run adequate reporting systems and processes to allow executive management to understand the risks stemming from prime brokerage activity and the potential vulnerabilities of the business model • Avoid use of one-dimensional risk measures in monitoring and limit frameworks and instead use comprehensive suites of stress tests or scenario analysis tools	• The expectation of the having a prime brokerage tailored risk strategy takes existing EU-level and national requirements and applies this more stringently to prime brokerage services
3	**Margining**	• Implement initial margin concepts properly so that these also reflect multiple facets of risks that the prime brokerage business is exposed to • Maintain initial margin models that reflect the composition of margined clients' portfolios, concentration and market liquidity risks to which they are exposed and requisite investment strategies of counterparties and clients • Implement and maintain models that dynamically adjust the level of margin to changes in the risk profiles of transactions	• While these supervisory expectations are indeed sensible, they are very high-level in setting out overall outcomes as opposed to any expectations on operational detail, i.e., such as frequency of updating/reviewing recorded information • Equally, there is no mention of how to reflect collateral asset and custody issues in these vague supervisory expectations
4	**Default management processes**	• Compile and consider all material contractual arrangements and clauses relevant for defaults and close-outs of transactions and reflect these in default management processes and systems • Conduct an ongoing assessment of the efficiency of liquidation strategies and capabilities at hand	

In light of the above, the article reminds readers that the ECB-SSM's Joint Supervisory Teams (**JST**s) "[…] will engage with banks [i.e., credit institutions] showing material deficiencies in these areas to ensure that any shortcomings are adequately and promptly addressed." This might translate through to further actions in the respective supervisory engagement process, resulting in findings that are then addressed to BUSIs for remediation. The article addresses this, in its conclusion, by stressing that:

> "…the abovementioned supervisory expectations are not replacing existing principles on risk governance and risk management. These supervisory expectations have been shared with banks covered by the desk review and other relevant banks. Follow-up work will be done in the context of the targeted review on counterparty credit risk and also as part of upcoming on-site inspections."[4]

Notably the article also goes on to explain how the DRA's findings and the supervisory expectations should be reflected in relevant BUSI's Internal Capital Adequacy Assessment Process (**ICAAP**)[5] and plans. The article clarifies that:

> "Supervisors have also performed a preliminary analysis of minimum capital requirements for prime brokerage services. The ECB expects banks to properly consider the riskiness of this business area in their internal capital adequacy assessment process. The quantification of the own funds for prime brokerage should address all sources of material risk and reflect periods of severe market disruptions."

What the ECB-SSM's current prime brokerage supervisory expectations might be missing

Despite the above, there are areas that are linked to prime brokerage services, which are however not covered in the article nor the ECB-SSM's supervisory expectations – at least as communicated in their current form. This means that, despite a number of standards being set out in existing EU legislative and rulemaking

[4] Readers may wish to consult the following two Client Alerts from PwC Legal's EU RegCORE:
- Revisiting the ECB-SSM Guide on On-site Inspections and Internal Model Investigations (the OSIIMI Guide)
- Revisiting the ECB-SSM Guide to setting administrative pecuniary penalties (the SAPP Guide)

[5] See also ECB-SSM supervisory guidance ICAAPs available here.

instruments applicable to BUSIs and prime brokerage business more broadly, there is no meaningful discussion nor guidance[6] in the article and thus in the present supervisory expectations.

These missing items include the following points below and it remains to be seen whether the ECB-SSM, possibly together with other EU as well as Banking Union national authorities and/or jointly with the European Securities Markets Authority (**ESMA**), may consider expressing further supervisory expectations in respect to (the following non-exhaustive list of points):

- ***differences between risks connected to credit leverage (i.e. lending) and financial instrument leverage (i.e. in foreign exchange trades, credit derivatives, options, contracts for differences etc.)*** – and the impacts on risks/returns for counterparts and clients of the BUSI's prime brokerage services;
- ***differences in prime brokerage services and transactional arrangements as distinguished between type of transaction, asset class and counterparty/client –*** this applies to both "traditional" i.e., MiFID financial instruments as well as regulated activity and counterparty type categorisations inasmuch as it also extends to cryptoasset markets – even though the latter has been outside the scope of the current DRA;
- ***securities financing transactions (SFTs)*** – whether as applicable to those that are in-scope of and thus regulated by the EU's SFT Regulation or those, such as certain margin lending activity that does not meet the definition of a "SFT" for purposes of the SFT Regulation and thus outside its scope;
- ***distinction between initial margin and variation margin and distinction between centrally cleared and non-centrally transactions –*** as well as general risks related to asset encumbrance (and roles of haircuts), intra-group exposures as well as overall scale and concentration risk drivers and exposures;
- ***risks related to collateral asset quality (for cash, near-cash equivalents, high-quality liquid assets as well as other non-cash eligible collateral assets), enforcement as well as custodian and sub-custodian legal and non-legal risks*** – which may trigger both financial and non-financial risks, including complex legal and regulatory considerations depending on the ownership and custody chains;
- ***collateral upgrade transactions and liquidity swaps*** - and risks involved both in relation to the transactions facilitating the collateral upgrade and/or liquidity swap as well as risks that may arise in relation to mismatches both during stressed and non-stressed trading conditions;[7]
- ***liquidity risk and other financial and non-financial risks*** - that arise in the context of exercising contractual rights of use or rehypothecation rights by the prime broker as well as liquidity disclosures and appropriate liquidity measures for the NBFI sector more broadly;
- ***netting and set-off arrangements (whether contractual or arising as a matter of law) arrangements and their applicability and enforcement*** - notably as FAQs[8] were published and a letter[9] was sent by the ECB-SSM to those BUSIs that are directly supervised by it setting out new requirements, applicable from 31 January 2020 concerning the recognition of contractual netting arrangements that are to be treated as risk reducing for purposes of Art. 295 to 297 CRR. It should be noted that certain national competent authorities, both those participating in the SSM and those that do not, have similar standards for non-ECB-SSM direct supervised BUSIs as well as for other types of regulated firms;
- ***prime custody*** - this is irrespective of the case that prime brokerage and prime custody as well as collateral asset management more broadly, are at a number of BUSIs, inextricably linked business lines and therefore risk drivers but also relevant for risk management measures that are (or should be) linked to prime brokerage;[10]
- ***considerations relevant to risk exposures (other than general supervisory expectations concerning margining and default management practices)*** – that may apply to arrangements between BUSIs' (as well as NBFIs) exposures to financial market infrastructure providers and processes ranging from clearing as well as central counterparties through to payment and settlement systems (including consideration of extent of settlement finality being applied); and
- ***standards of management information as well as regulatory reporting in both centrally cleared and non-centrally cleared markets*** – notably on data gaps and in improving assessments of stress periods on the points discussed both in the ECB-SSM's supervisory expectation as well as the above-mentioned list of considerations that it misses.

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[6] Which does not mean that the ECB-SSM (or indeed other competent authorities) may not consider there are risks that require a BUSI to identify, mitigate and manage these more rigorously so as to meet its supervisory expectations.

[7] It should be noted that supervisory guidance on this point has been issued by some global regulators, including the UK authorities during the period when it was still an EU Member State. That supervisory guidance has also been reflected in conduct of business rules and regulatory reporting requirements.

[8] Available here.

[9] Available here

[10] See considerations discussed by M.Huertas in "Custody, Collateral and Client Money Regulation in the post-crisis world: a comparative study"

Outlook

The findings that have been established as part of the current phase of the DRA have flown into ECB-SSM's updated supervisory expectations on prime brokerage related risks and their management. This may require some BUSIs to update their policies, procedures along with systems and controls and how this is operationalised and compliance evidenced to meet these risk management supervisory expectations. Moreover, BUSIs will also want to benchmark how these requirements compare to as well as go over and beyond what other regulatory authorities and their rules require of them.

That being said, not all of the ECB-SSM's prime brokerage supervisory expectations, fully fall into the ECB-SSM's prudential regulatory mandate under the Banking Union. Some are perhaps more within the technical remit of ESMA notably in its role as technical policymaker and gatekeeper for the EU's Single Rulebook for financial services as it applies to investment activity and securities markets. As a result, the ECB-SSM may consider issuing more formal supervisory guidance on its own or in cooperation with other EU and/or national-level regulatory policymakers.

As stated above the article is clear in communicating that over the short-term the ECB-SSM will carry out follow-up work in the context of its targeted review on counterparty credit risk as well as forthcoming on-site inspections. BUSIs will therefore want to note that such work may prompt similar efforts from other EU level (notably ESMA) and national-level authorities over the next supervisory cycles in respect of non-Banking Union supervised firms and their operations both in the Banking Union and outside of it. It may also, much like the ECB-SSM's joint letter together with the Bank of England (see Footnote 1), prompt coordinated efforts between EU and non-EU authorities. In any event, with the ECB-SSM's continued interest in prime brokerage business along with BUSI's management of risk exposure to NBFIs, identification, mitigation, management and improvement of compliance and risk management practices may need to be improved.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website including for further details of wider Risk and Regulation capabilities from PwC Germany.

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