



Risk Equalisation Rule¹

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¹ This document relating to the Risk Equalisation Rule is without prejudice to all other ICCL rules, levies, documents, policies and procedures relating to the Investor Compensation Scheme save to the extent expressly stated in this document.



1. Why is the rule needed?

- 1.1. The rule is required to address situations where the quantum of assets covered by the Investor Compensation Scheme ('ICS') and the ICCL Cascade Model is significantly increased following the authorisation of a new investment firm in the jurisdiction and/or the transfer of a book of business to an existing investment firm or any transfer, restructuring, transaction or other arrangement leading to such an increase.
- 1.2. ICCL Cascade Model – The Investor Compensation Company DAC ('ICCL') is charged with implementing and operating the ICS, through the Investor Compensation Act, 1998, ('Act') which transposes the Investor Compensation Schemes Directive ('ICSD') 97/9/EC. Both the ICSD and the Act require that the cost of financing an ICS must be borne by investment firms.

The ICCL operates a cascade model as the framework for funding the ICS in the event of a default or failure of a participating investment firm(s). The cascade represents the funding options available to the ICCL, depending on the extent of the failure, to access funds for the purpose of making compensation payments. This approach is supported by the finding from the EU Commission's study that the availability of several sources of funding, even if never activated, enhances the viability of investor compensation schemes.

The ICCL model consists of the following capital and other funding elements (not necessarily in the order presented below):

- Ex-ante levies;
- Ex-post levies;
- Excess of loss insurance policy;
- Inter-fund borrowing between Funds A and B.

A 2010 EU Commission proposal for recasting of the ICSD contained, among many other matters, a key proposal with regard to the target fund size for investor compensation schemes. While the revised ICSD did not ultimately progress to the final stages, the Board of the ICCL (the '**Board**') has taken guidance from the target fund size proposal which provided that *"at least 0.5% of the value of monies and financial instruments that are held, administered or managed by investment firms...are covered by the protection of the investor compensation scheme."*

During the 2018/19 triennial funding consultation process, a calibration of the target fund size for the ICS was undertaken, utilising this approach. The most recent data available regarding MiFID retail client assets held by investment firms participating in the ICS enabled the Board to determine that, in order to meet the requirements of section 22(3) of the Act, the ICS should have financing capacity of circa €150mn in place by 2024 (equivalent to €30bn of covered funds).



This triennial process established the funding rules and levy rates for firms participating in the ICS, and followed consultation with key stakeholders, resulting in the ICCL's Funding Arrangements publication.

The ICCL legitimately expected, having consulted with industry and the Central Bank of Ireland ('Bank') in November 2018, that no new authorisations or transfers of covered assets from other jurisdictions were likely to occur that would fundamentally challenge the assumptions applied in the Funding Arrangements that were subsequently published by the ICCL in April 2019.

- 1.3. Changing risk profile – The ICCL regularly engages with the Bank, as supervisory authority for the ICCL, and competent authority in Ireland for the ICSD. Through this engagement, an emerging risk was subsequently identified relating to the potential transfer of significant amounts of ICS covered assets into the Irish jurisdiction from other jurisdictions, either through newly authorised entities, or, to existing authorised entities (through an acquisition, restructuring, or other such arrangement) without an equivalent transfer of matching ICS funding.

New start-up investment firms with no or immaterial initial exposures may join the ICS and grow organically within the fund without any consequent material effect on the ratio of actual funding capacity to target funding capacity ('funding ratio'). The ICCL, in developing its triennial Funding Arrangements makes provision for such situations. The ICCL does not make provision in its Funding Arrangements for the transfer of significant amounts of covered assets from other jurisdictions as this has the potential to unnecessarily burden the participant firms with additional levy costs. As a consequence of this, if a large firm with covered assets of a very significant scale, or multiple firms, with covered assets of significant scale were to join the ICS, the funding ratio of the ICCL would be negatively impacted.

This is best illustrated through the example of a firm seeking to join the ICS in 2024, with covered assets of €4bn, when the ICS is expected to be fully funded at €150mn (€50mn reserves and €100mn insurance) based on aggregate covered assets of €30bn. The funding ratio of Fund A of the ICS would be 100% and the effect of an additional €4bn of covered assets being introduced without any matching funds would be to increase the target fund to €170mn² with the effect that the funding ratio for Fund A of the ICS would fall to circa 88% (€150mn divided by the revised target fund of €170mn). That would be the equivalent of setting the funding ratio of the ICS back to that which prevailed at 31 July 2018 or six full years of claims free funding for the entire industry.

- 1.4. Adjustment of the existing funding rules to manage new and evolving risks – the transfer of a significant amount of ICS covered assets into the Irish jurisdiction from other jurisdictions, either to a newly authorised entity, or, to an existing authorised entity (through an acquisition, restructuring, or other such arrangement) without an

² Revised target of €170mn calculated as €34bn * 0.5% resulting in a funding shortfall of €20mn.



equivalent transfer of matching ICS funding - would require an adjustment to the ICCL cascade target. The Funding Arrangements of the ICS set out the ICCL's accepted cascade mix, that being the ratio of reserves to excess of loss insurance required to meet the overall cascade target for the ICS ('**Cascade Ratio**'). The Cascade Ratio was set at 1:2 in the Funding Arrangements and the Board has determined that this will be maintained, subject to the availability of additional insurance, when addressing additional cascade target requirements arising from such covered asset increases. A worked example is provided under part 7 of the rule (below).

- 1.5. New funding rule necessary to manage the new and evolving risks – The new and evolving risks identified subsequent to the publication of the Funding Arrangements, were not anticipated in the setting of the levy rates for the period August 2019 to July 2022. While the Board's initial preferred approach would be to apply the existing Fund A basis of assessment, it was clear on review that the ICCL could not achieve its statutory funding objective on such a basis.

The Board has considered the matter in detail, and having consulted with the Bank in accordance with section 22(2) of the Act, has determined that the most appropriate approach is to introduce a new funding rule that would seek to ensure that the funding and cascade ratios of the ICS are not impacted to such a degree as would prevent the ICCL from demonstrating that it is achieving its statutory objectives, with a relevant firm being required to contribute to the maintenance of the existing ratios through a "risk equalisation" levy.



2. Who will the rule apply to?

2.1. The rule will apply to:

- 2.1.1. Any newly authorised investment firm³ that causes the aggregate level of assets covered by the ICS to increase by €250 million or more upon authorisation by the Bank or at any point in the three-year period following authorisation by the Bank; and/or
- 2.1.2. Any existing authorised investment firm that acquires a book of business or enters into any transaction, restructuring, or other arrangement that causes the aggregate level of assets covered by the ICS to increase by €250 million or more upon the completion of a transfer, restructuring, transaction or other arrangement or at any point in the three-year period following the completion of the transfer, restructuring, transaction or other arrangement.

3. How will the risk equalisation levy be collected?

3.1. The risk equalisation levy will be initially calculated by the ICCL on notification by the Bank of:

- 3.1.1. a new firm applying to become an authorised investment firm, or,
- 3.1.2. an application for approval of a proposed transfer, restructuring, transaction or other arrangement by an authorised investment firm

where the projected or known value of covered assets that will come within the scope of the ICS upon the issuance of the authorisation by the Bank or upon completion of the transfer, restructuring, transaction or other arrangement or at any point in the three-year period following the issuance of the authorisation by the Bank or completion of the transfer, restructuring, transaction or other arrangement amounts to €250 million or more.

3.2. The initial calculations of the risk equalisation levy (the "**Initial Risk Equalisation Levy**") will be based on the estimated, projected or known amounts of additional covered assets as advised by the relevant firm to the Bank that will come within the scope of the ICS upon issuance of the authorisation by the Bank, the completion of a transfer, restructuring, transaction or other arrangement or at any point in the three year period following the issuance of the authorisation by the Bank or the completion of the transfer, restructuring, transaction or other arrangement.

³ Authorised investment firm has the same meaning as given in the Investor Compensation Act, 1998.



- 3.3. Once the Initial Risk Equalisation Levy has been calculated for the relevant firm, the ICCL will advise the Bank of the outcome so that the applicant and/or firm can incorporate the impact of the levy into its projections for the Bank's authorisation process and/or acquiring transaction approval process and/or other applicable approval process.
- 3.4. The Initial Risk Equalisation Levy may be re-calculated by the ICCL (the "**Revised Initial Risk Equalisation Levy**") at any point up to five business days before the issuance of an authorisation by the Bank or five business days before the completion of the transfer, restructuring, transaction or other arrangement on the basis of updated estimates, projections or known amounts of additional covered assets as advised by the relevant firm to the Bank that will come within the scope of the ICS upon the issuance of the authorisation by the Bank or upon completion of a transfer, restructuring, transaction or other arrangement or at any point in the three year period following the issuance of the authorisation by the Bank or the completion of the transfer, restructuring, transaction or other arrangement.
- 3.5. The relevant firm must discharge the Initial Risk Equalisation Levy (or the Revised Initial Risk Equalisation Levy if applicable) by no later than thirty calendar days after:
 - 3.5.1. the Bank has issued an authorisation to the firm; and/or
 - 3.5.2. all or any part of the relevant transfer, restructuring, transaction or other arrangement has been completed.



4. Will the risk equalisation levy be subject to a look-back review?

- 4.1. The risk equalisation levy is being introduced to ensure that the ICS can meet its funding obligations arising from additional covered assets without materially impacting the ICCL's ability to fulfil its statutory mandate of discharging potential compensation liabilities following the authorisation of a new investment firm or the completion of any transfer, restructuring, transaction or other arrangement involving an existing authorised investment firm that leads to a substantial increase in the amount of covered assets.
- 4.2. Consequently, the ICCL shall re-calculate the risk equalisation levy for the relevant firm, on the first, second and third anniversary of the application of the Initial Risk Equalisation Levy (or the Revised Initial Risk Equalisation Levy if applicable) based on the amount of covered assets of the firm as at 31 December of the preceding year.
- 4.3. Should any re-calculation result in a higher risk equalisation levy applying to the firm at any point, the firm shall pay the balancing amount to the ICCL within thirty calendar days of notification by the ICCL.
- 4.4. Should the re-calculation result in a lower risk equalisation levy, a risk equalisation levy refund situation will only arise in circumstances where the actual value of covered assets transferred has not exceeded the value used to calculate the Initial Risk Equalisation Levy / Revised Risk Equalisation Levy at any time from the date at 3.5.1 / 3.5.2 through to the reporting date for anniversary 3.

5. Would the annual funding levy rules also apply to the firm?

- 5.1. Where the risk equalisation levy applies to an investment firm upon its authorisation the funding rules applicable to Fund A firms or Fund B firms to pay an annual levy will only be applied to that newly authorised investment firm after the first anniversary of the application of the Initial Risk Equalisation Levy (or the Revised Initial Risk Equalisation Levy if applicable)).
- 5.2. Where the risk equalisation levy applies to an existing investment firm it will remain subject to the funding rules applicable to Fund A firms or Fund B firms to pay an annual levy without interruption or deduction.
- 5.3. In both cases, the obligation to discharge annual contribution levies will be in addition to the liability for any additional risk equalisation levy balancing payments due following the re-calculation on the first, second and third anniversary of the application of the Initial Risk Equalisation Levy (or the Revised Initial Risk Equalisation Levy if applicable)).



6. Would the ex-post funding rules also apply to the firm?

6.1. Yes, in the event that the ICS experienced compensation claims of such scale that the Board has determined a requirement to apply ex-post levies to firms, those rules would also apply to the relevant firm (in addition to its obligations to discharge the risk equalisation levy and annual levy).

7. How will the risk equalisation levy be calculated?

7.1. The formula to calculate the risk equalisation levy is as follows⁴:

Risk Equalisation levy	=	“REL”
Reserves percentage of cascade model as at 1 August 2019 (33.3%)	=	“RM”
Projected or Known Additional Covered Assets	=	“CA”

Covered Assets is calculated by adding the value of:

- Client assets held for MiFID retail clients⁵ (client funds and financial instruments) as returned to the Bank in accordance with the Monthly Client Assets Report, and,
- Client assets held for Other clients for whom the firm provides regulated services other than MiFID⁶ (client funds and financial instruments) as returned to the Bank in accordance with the Monthly Client Assets Report, and,
- Assets under management as returned to the Bank in accordance with the Monthly Metrics Report, but excluding assets under management for MiFID professional clients.

$$[CA * 0.5\%] * RM = REL$$

⁴ The ICCL may apply some rounding to the calculations

⁵ In circumstances where a firm has entered into a tripartite arrangement, for ICCL purposes, the relevant firm is required to return to the ICCL the value of client assets held by the custodian.

⁶ In circumstances where a firm has entered into a tripartite arrangement, for ICCL purposes, the relevant firm is required to return to the ICCL the value of client assets held by the custodian.



7.2. Example of Initial Risk Equalisation Levy:

7.2.1. If a relevant firm was proposing to introduce into the ICS, additional covered assets estimated, projected or known to be in the amount of €600 million, the Initial Risk Equalisation Levy (or the Revised Risk Equalisation Levy) would be calculated as:

$$\begin{aligned} & [CA * 0.5\%] * RM = REL \\ & [€600mn * 0.5\%] * 33.3\% = €1.00mn \end{aligned}$$

7.3. Example of Look-Back Review

7.3.1. A relevant firm is assessed with an Initial Risk Equalisation Levy (or the Revised Risk Equalisation Levy) of €1 million on 13 September 2020, based on estimated covered assets to be transferred of €600 million.

7.3.2. **Anniversary 1** – On 13 September 2021, the firm is reassessed on the basis of actual covered assets as at 31 December 2020 of €595 million – no additional liability or repayment arises as a Risk Equalisation Levy refund situation can only arise at the third anniversary reassessment.

7.3.3. **Anniversary 2** – On 13 September 2022, the firm is reassessed on the basis of actual covered assets as at 31 December 2021 of €625 million. An additional liability of €41.6k arises and is levied.

$$\begin{aligned} & [CA * 0.5\%] * RM = REL \\ & [€625mn * 0.5\%] * 33.3\% = €1.0416mn \\ & [€1.0416mn - €1.0000mn] = €0.0416mn \end{aligned}$$

7.3.4. **Anniversary 3** – On 13 September 2023, the firm is reassessed on the basis of actual covered assets as at 31 December 2022 of €610 million. No additional liability arises as the actual amount of covered assets in year 3 is less than the actual amount of covered assets reassessed in year 2. No risk equalisation levy refund arises due to the application of rule 4.4.