New Prudential Requirements for Investment Firms

PILLAR 4 CONSULTANTS

Introduction

1. The Investment Firm Directive and Regulations (IFD/IFR)

PILLAR 4
CONSULTANTS

Most investment firms currently engaged in dealing, portfolio management, or operating trading platforms (MTF/OTF) are in scope of the EU wide prudential rules set out in CRDIV/CRR (EU Directive 2013/36/EU and the EU Regulation 575/2013).

Firms that don't hold client money or client assets nor engage in placing with or without a firm commitment can be exempt from CRDIV/CRR and remain under the previous iteration of the prudential rules know as CRD III (Capital Requirements Directive III).

Firms that remained under CRD III are known as 'BIPRU' firms for prudential purposes in the UK and typically include investment management firms and brokers/dealers that do not hold client money or client assets themselves or engage in placing. Brokers/Dealers that hold client money or safeguard client assets themselves or engage in placing are known as 'IFPRU' firms. Firms that operate trading venues such as a Multilateral Trading Facilities (MTFs) and Organised Trading Facilities (OTFs) also come under the IFPRU classification.

Whilst the implementation of CDIV/CRR in January 2014 helped bring about several important changes such as a simplification of capital structure into two tiers (previously three), an introduction of the concept of leverage, and a focus on liquidity; investment firms were still required to comply with a set of rules drafted predominantly with Banking risks in mind. This often led to complications for investment firms in interpreting and implementing the rules.

The IFD/IFR was drafted in an effort by the EBA and ESMA to create a prudential regime tailored to investment firms. Whilst the new prudential regime strives to be reflective of risks faced by investment firms, it is far from being over simplistic. On top of having to adopt to the new rules, it could be expected that firms may witness an increase in capital requirements following implementation of the IFD/IFR, currently on track to become applicable on 26 June 2021.

Firm Classification

2. Firm Classification under IFD/IFR

Investment firms will be classified into three categories as summarised below.

- Class 1: Systemically Relevant Firms: Investment firms with total assets over EUR30bn will fall into this category and will be treated like Banks for prudential purposes. These firms will remain in scope of CRDIV/CRR and likewise out of scope of the IFD/IFR. Class 1 firms will see a significant increase in base capital requirements from the present EUR730K to EUR5m in line with Credit Institutions.
- Class 2: Non-Systemically Relevant Firms: Investment firms that are not classed as Class 3 (Small and Non-Interconnected) and do not have total assets that exceed EUR30bn will be classed as Non-Systemically Relevant Firms or Class 2 firms.
- Class 3: Small and Non-Interconnected: Investment firms that have both total assets less than EUR100m and revenue less than EUR30m can fall under Class 3 subject to meeting several stringent K-factor thresholds linked to AUM/AUA and client orders handled.

Class 1 firms will be treated as Banks for prudential purposes and will be in scope of the revised CRDV/CRR2 which will start to apply from mid-2021. Class 2 and Class 3 firms previously subject to CRDIV/CRR/CRDIII could now be out of scope of these regulations and in scope of the IFD/IFR. It is important for Investment firms to establish which category they fall into. The three step approach in the decision tree below can help firms make this determination.

3. Decision Tree for SME Investment Firm Classification

PILLAR 4 CONSULTANTS

Step 1- Do you deal on own account or place/underwrite financial instruments with total balance sheet assets exceeding EUR5bn?

Yes

No

Class 1 (Systemically Relevant Firm) classification likely

If total assets >=EUR30bn, authorisation will be required as a credit institution

If total assets >=EUR15bn, authorised under MiFID but prudentially supervised under CRD/CRR

If total assets >=EUR5bn but less than EUR15bn, authorised under MiFID but prudentially supervised under CRD/CRR subject to FCA discretion depending on risk of the firm

Step 2- Does the investment firm meet all of the following conditions

- Does not deal on own account or incur risk from trading financial instruments
- Does not hold client assets or money
- Has assets under both discretionary portfolio management and non-discretionary (advisory) arrangements of less than EUR 1.2bn
- Handles less than EUR100 million per day of client orders in cash trades or less than EUR1bn per day of client orders in derivatives
- Has a balance sheet smaller than EUR100m including off balance sheet items
- Total gross annual revenues from investment services of less than EUR30m

Yes

Class 3

(Small and Non-Interconnected)

No

Class 2

(Non-Systemically Relevant Firms)

Please note that this article does not purport to give regulatory, legal, or financial advice and the intended use of this article is deemed to be for general information purposes only.

Permanent Minimum Capital Requirement

4. Permanent Minimum Capital Requirement ("PMC")

Currently, initial capital requirements under CRDIV/CRDIII are established based on the type of MiFID activity undertaken by Investment firms. In the UK, Investment firms are currently classed as BIPRU50K, IFPRU125K, or IFPRU730K with the numbers denoting the base capital requirement. A similar approach to classification has been adopted in the IFD, however most firms will now see an increase in initial capital requirements known as 'Permanent Minimum Capital Requirements' under the IFD.

MiFID activity	Current	IFD	Firms Likely to be Captured
▪ A3- dealing on own account (including matched principal) ▪ A6- underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis)	EUR730K	EUR750K	Market Makers, Principal Dealers (Proprietary), Matched Principal Brokers, Local Firms, OTFs dealing on own account in non-liquid sovereign debt
Firms not permitted to hold/control client money or securities but which are authorised to provide either of: ▪ A1 reception and transmission of orders ▪ A2 execution of orders on behalf of clients ▪ A4 portfolio management ▪ A5 investment advice ▪ A7 placing of financial instruments without a firm commitment basis	EUR50K	EUR75K	Agency Brokers not holding client money or assets, Portfolio Managers, Wealth Managers, Discretionary Investment Management, Advisory Firms, Corporate Finance Firms
▪ All other MiFID investment firms including A8 operating an MTF and A9 operating an OTF (where the OTF doesn't deal on own account in non-liquid sovereign debt)	EUR125K	ERU150K	Investment firms holding client money or client assets as part of investment activity, MTFs, OTFs

Variable Capital Requirements

5. “Fixed Overhead Requirement”

Most Investment firms should be already familiar with the Fixed Overhead Requirement (FOR), which is a form of variable capital requirement. The fundamental calculation remains largely unchanged from the CRR with a requirement for firms to hold capital against at least one quarter of the fixed overheads of the preceding year. The items for deduction from overheads have somewhat changed with minor derogation from the CRR. The EBA in consultation with ESMA is to develop draft regulatory technical standards by 26 December 2020 on items that can be deducted which will include at least the following:

- *Staff bonuses and other remuneration, to the extent that they depend on the net profit of the investment firm in the respective year*
- *Employees’, directors’ and partners’ shares in profits*
- *Other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary*
- *Shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue, and where the payment of the commission and fees payable is contingent on the actual receipt of the commission and fees receivable*
- *Fees to tied agents*
- *Non-recurring expenses from non-ordinary activities*

6. “K-Factor Requirement”

K factors are a novelty and a key inclusion and change for investment firms subject to CRDIV/CRR/CRDIII. These are a form of variable capital requirement created to capture investment firm risks dependent on investment activity undertaken.

The K factors are only applicable to Class 2 firms. Class 3 firms whilst not in scope of all of the K factors will still have to monitor K-AUM and K-COH along with the size of their Balance Sheet and P/L to determine whether they meet thresholds necessitating a shift to Class 2 and for reporting purposes to the FCA.

K factors are categorised into three groups of risks RTC (Risk to Customers), RTM (Risk to Market), and RTF (Risk to Firm). Each of these groups have several K factors within them that will be used to quantify variable regulatory capital. Firms will have to monitor K-factors and associated capital requirements on an on-going basis and this is expected to necessitate changes to regulatory capital monitoring systems.

The table below summarises K factor requirements.

7. Summary of K Factor Requirements

K-Factor Group	K-Factor	Description	Summary of Calculation	Coefficient
RTC	K-AUM	Assets under management	K-AUM includes: ▪ Assets managed for clients under discretionary portfolio management (AUM) ▪ Assets managed for clients under non-discretionary arrangements constituting investment advice (AUA) ▪ Includes assets where management has been delegated to another firm ▪ Excludes assets delegated to the firm by another entity	0.02%
	K-CMH	Client money held	▪ Client money held by the firm both on segregated and non-segregated basis	0.4% (on segregated accounts) 0.5% (on non-segregated accounts)
	K-ASA	Assets safeguarded and administered	▪ Value of assets safeguarded and administered for clients on the firm's own balance sheet or on third-party accounts (i.e. arranging safeguarding and administration)	0.04%
	K-COH	Client orders handled	▪ Value of orders handled for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients (excludes principal trades and matched principal trades, these are captured in K-DTF) ▪ Excludes transactions that arise from servicing a client`s investment portfolio already captured in K-AUM	0.1% (cash trades) 0.01% (Derivatives)

7. Summary of K Factor Requirements Continued

PILLAR 4 CONSULTANTS

K-Factor Group	K-Factor	Description	Summary of Calculation	Coefficient
RTM	K-CMG	Clearing members guarantee	▪ Total margin required by a clearing member or qualifying central counterparty, where the execution and settlement of transactions of a firm dealing on own account take place under the responsibility of a clearing member or qualifying central counterparty	K-CMG shall be the third highest amount of total margin required on a daily basis by the clearing member from the investment firm over the preceding three months, multiplied by a factor of 1.3
	K-NPR	Net position risk	▪ Trading book transaction value for dealing on own account including matched principal transactions	Calculated in line with approaches laid out in the CRR
RTF	K-CON	Concentration risk	▪ Trading book exposures to a client or group of connected clients which exceeds limits established in the IFR	Calculated in line with article 39 of the IFR and Part Four on concentration risk generally

7. Summary of K Factor Requirements Continued

K-Factor Group	K-Factor	Description	Summary of Calculation	Coefficient
RTF	K-DTF	Daily trading flow	▪ Rolling average of value of total daily trading flow (absolute value of buys and the absolute value of sells for both cash and derivative trades) measured throughout each business day over the previous nine months, excluding the three most recent months. K-DTF will be the arithmetic mean of the daily values from the remaining six months calculated on the first business day of each month. ▪ K-DTF includes transactions executed in a firm's own name for itself (dealing on own account) or on behalf clients (matched principal basis)	▪ 0.1% (cash trades) ▪ 0.01% (derivatives)
	K-TCD	County party default	▪ Trading book exposures in instruments and transactions giving rise to risk of trading counterparty default.	Calculated in line with articles 25 to 32 in the IFR

Own Funds and Requirements

8. Own Funds Composition and Requirement

Own Funds are the sum of Common Equity Tier 1 (CET 1), Additional Tier 1 (AT1), and Tier 2 (T2) which are classified according to the CRR. However, the IFR offers derogation on deductions from CET 1 as outlined in article 9 of the IFR.

The capital composition on investment firms must meet the following conditions at all times as set out in article 9 of the IFR.

(a) $$\frac{\text{Common Equity Tier 1 capital}}{D} \geq 56\,\%,$$

(b) $$\frac{\text{Common Equity Tier 1 capital} + \text{Additional Tier 1 capital}}{D} \geq 75\,\%,$$

(c) $$\frac{\text{Common Equity Tier 1 capital} + \text{Additional Tier 1 capital} + \text{Tier 2 capital}}{D} \geq 100\,\%,$$

Note that the denominator ('D') represents the variable capital requirement calculated as the higher of the following:

- *Fixed Overhead Requirement*
- *K factor requirement (RtC + RtM + RtF)*
- *Permanent Minimum Capital requirement*

Liquidity Requirements

9. Liquidity Requirements

The Liquidity requirement for investments firms is set out in article 43. The requirement is to hold an amount of liquid assets equivalent to at least one third of the fixed overhead requirement. The types of liquid assets that can be used to meet the liquidity requirement are laid out in article 43 (a) through (d).

Cash, short term deposits and financial instruments belonging to clients, even where held in the own name of the investment firm, cannot be treated as liquid assets and cannot be used to meet the liquidity requirement.

The FCA may exempt Class 3 firms from the liquidity requirement altogether (EBA, in consultation with ESMA, to issue guidelines). However if Class 3 firms are deemed to be in scope, they may also include receivables from trade debtors as well as fees or commissions receivable within 30 days in their liquid assets, where those receivables comply with the conditions below. This also applies to investment firms that are not Class 3 but do not deal on own account or underwrite financial instruments and/or place financial instruments on a firm commitment basis.

- *They account for up to a maximum of one third of the minimum liquidity requirements*
- *They are not to be counted towards any additional liquidity requirements required by the competent authority for firm-specific risks*
- *They are subject to a haircut of 50 %*

Public Disclosures

10. Public Disclosures

Class 1 and Class 2 firms are required to publicly disclose the information specified below (covered in detail in part six of the IFR) on the same date as they publish their annual financial statements. Class 3 firms which issue Additional Tier 1 instruments are still required to disclose information on items 1, 3, and 4 below.

Investment firms may determine the appropriate medium and location to comply effectively with the disclosure requirements but all disclosures are expected to be provided in one medium or location, where possible. If the same or similar information is disclosed in two or more media, a reference to the synonymous information in the other media is expected to be included within each medium.

1. *Risk management objectives and policies (detail in article 47 of the IFR)*
2. *Governance (detail in article 48 of the IFR)*
3. *Own funds (detail in article 49 of the IFR)*
4. *Own funds requirements (detail in article 50 of the IFR)*
5. *Remuneration policy and practices (detail in article 51 of the IFR)*
6. *Investment policy (detail in article 52 of the IFR) where applicable**
7. *Environmental, social and governance risks (detail in article 53 of the IFR) - to be disclosed once in the first year and biannually thereafter and applies from 26 December 2022 onwards where applicable***

** Applicable where the value of on and off-balance sheet assets is on average greater than EUR 100 million over the four-year period immediately preceding the given financial year*
***Applicable where the value of on and off-balance sheet assets is on average greater than EUR 100 million over the four-year period immediately preceding the given financial year or if an individual's annual variable remuneration exceeds EUR50,000 or represents more than one fourth of that individual's total annual remuneration*

Reporting to FCA

11. Reporting

Investment firms are required to report the information below on a quarterly basis to the FCA with the exception of Class 3 firms that are required to submit reports on an annual basis.

a) *level and composition of own funds*
b) *own funds requirements*
c) *own funds requirement calculations*
d) *the level of activity in respect of the conditions set out to be a Class 3 firm including the balance sheet and revenue breakdown by investment service and applicable K-factors K-AUM and K-COH*
e) *concentration risk (Class 3 firms can be exempt subject to being exempt from liquidity requirements)*
f) *liquidity requirements (Class 3 firms can be exempt subject to an exemption been granted by the FCA)*

12. Reporting on Concentration Risk

Firm are also required to report on the following granular levels of detail on concertation risk to be reported to the FCA at least on an annual basis:

a) *the level of concentration risk associated with the default of counterparties and with trading book positions, both on an individual counterparty and aggregate basis*
b) *the level of concentration risk with respect to the credit institutions, investment firms and other entities where client money is held*
c) *the level of concentration risk with respect to the credit institutions, investment firms and other entities where client securities are deposited*
d) *the level of concentration risk with respect to the credit institutions where the investment firm's own cash is deposited*
e) *the level of concentration risk from earnings*
f) *(the level of concentration risk as described in points (a) to (e) calculated taking into account assets and off-balance-sheet items not recorded in the trading book in addition to exposures arising from trading book positions*

Class 3 firms are not be required to report on items a to f on concentration risk, insofar as an exemption has been granted from the liquidity requirement by the FCA.

The EBA, in consultation with ESMA, is to develop draft implementing technical standards by 26 December 2020 to specify formats, reporting dates, definitions and associated instructions to describe how to use the formats.

What Firms Should Do

13. What Firms Should Do Now

We summarise key imminent considerations for investment firms.

- Establish prudential categorisation of your firm- Class 1, Class 2, and Class 3
- Understand how the new requirements apply to your firm based on classification
- Ensure that you have a good understanding of K factors (if applicable) and other requirements set out in the IFD/IFR
- Update existing Internal Capital Adequacy Assessment Process (ICAAP) or similar capital adequacy model with 3-5 year projections
- Update Liquidity Adequacy Assessments in light of new liquidity requirements with 3-5 year projections
- Include stress tests in the capital adequacy and liquidity adequacy forecast process
- Plan action to address any forecasted capital and liquidity shortfalls including under stress
- Don't forget to leave out any firm specific Pillar 2 internal assessments from capital and liquidity adequacy assessments
- Revise or establish on-going 'Capital and Liquidity Adequacy Monitoring Process' including monitoring K factors
- Watch out for key ESMA and EBA updates and technical standards to be published on 26th December 2020
- Watch out for FCA publications, consultations, and final policy to be issued ahead of transposition of IFD/IFR
- Establish detailed reporting requirements following issuance of technical standards by the EBA on 26th December 2020
- Adopt revised ICAAP or similar capital adequacy model ahead of IFR/IFR planned implementation on the 26th of June 2021

How We Can Help

14. How We Can Help

At Pillar 4 we always offer a tailored service to best fit your needs as no two investment firms are alike. The services below in relation to IFD/IFR implementation is indicative and we are more than happy to offer a tailored service upon discussion with you.

- Pro bono initial assessment over phone
- Tailored IFD/IFR Board Briefing and/or training for staff
- Preparing Impact Assessment specific to your business in light of IFD/IFR
- Preparation or update of ICAAP and Liquidity Adequacy Assessment including Stress Tests (Capital Model in Excel and Documentation)
- Preparation or update of Pillar 2 Framework
- Preparation or updates to Risk Management Framework (Risk Appetite Review and updates to Risk Policies, etc)
- Help understanding and implementing changes to regulatory reporting in light of IFD/IFR
- Help developing practical and workable capital monitoring and reporting tools

PILLAR 4
CONSULTANTS

Why US

15. Why US

PILLAR 4
CONSULTANTS

With Pillar 4 you will always be working with a dedicated experienced consultant with several years experience under the belt. Our promise is to deliver to your expectations!

Our Consultants :

- Have a deep understating of CRDIV/CRR and IPRU-INV and the new IFD/IFR regulations
- Have years of experience helping investment firms of all types including Full Scope IFPRU730K firms and MTFs in developing Internal Capital Adequacy Assessment Processes (ICAAPs) and Liquidity Adequacy Assessment Processes
- Have worked with multi sector clients such as CFD Brokers/Dealers, Commodity Brokers, Bond traders, and Trading Venues covering all asset classes including derivatives and cash trades
- Have collaborated with clients to develop practical and workable continuous capital and liquidity monitoring systems to ensure continued day to day monitoring and reporting of prudential requirements
- Posses strong knowledge in risk and have helped firms develop suitable risk management frameworks including Pillar 2 frameworks that integrate with ICAAPs
- Have helped clients navigate SREP reviews and ICG including coordinating with the FCA to revise ICG to be reflective of clients risk profiles
- Have helped all types of investment firms in Gabriel and Corep reporting, including reporting for Full Scope IFPRU730K firms
- Have a strong knowledge in Accounting, Finance, and Risk Management, having worked in those capacities prior to entering the world of regulation and compliance
- Have a dedicated focus on the investment sector and supporting clients on a personal basis on ground-breaking turnaround times

Thank you for your interest and we look forward to working with you!