Key takeaways for Class 2 Firms (non-systemically relevant)

General

- Brokers/Dealers that deal on own account (MIFID activity A3) including on a matched principal basis or hold client money or client assets will generally be classed under Class 2 (non-systemically relevant). Investment and Portfolio Managers (MIFID activity A4) who either hold client money or asset are also likely to fall into this category. See our decision tree to establish which Class you fall into.
- Note that, IFPRU125K (limited license) and IFPU730K (full scope) firms are likely to be classed as Class 2 as they typically either hold client funds or assets or will typically deal on own account on proprietary or matched principal basis exposing them to some level of risk on financial instruments traded.
- Class 2 firms will be in scope of K-factor requirements and liquidity requirements and need to give due consideration to these requirements in regulatory capital models and capital monitoring systems.
- The K-factors introduce several new capital quantification concepts for Class 2 firms previously not covered under the CRR, such as allocating capital against client money held both on a segregated and non-segregated basis, against assets safeguarded, and client orders or trading flow handled.
- Calculating rolling average daily figures for several K-factors such as K-AUM, K-COH, K-CMH, K-ASA, and K-DTF will require some administrative attention or automation for continuous monitoring purposes.
- Investment firms currently subject to a EUR125K and EUR 730K base capital requirement will see an increase in Permanent Minimum Capital requirement (PMC) to EUR150K and EUR750K respectively under the IFD.
- Under the IFD, all firms dealing on own account, including firms making use of a matched principal exemption (also known as limited license firms) and local firms, will be subject to a PMC of EUR750K. Transitional provisions are available for these firms to build up the required capital over a five year period.

Credit risk

- Firms subject to the CRR were required to assess all assets not deducted from own funds against credit risk and hold capital against items like bank balance, receivable, tangible assets, etc. The concept of credit risk has been omitted under the IFR and depending on Balance Sheet exposures some investments firms may benefit from this lack of detailed capital quantification for credit risk.

Market risk

- Market risk quantification under K-NPR or K-CMG will apply to firms who deal on own account including on a matched principal basis exposing them to risk on financial instruments traded.
- Market risk calculations for K-NPR will be still performed under the CRR (so the CRR still applies). There aren't any separate or new rules on market risk stipulated through the IFR for investment firms unlike counterparty credit risk where a new calculation regime has been introduced.

- What this means is that firms exposed to market risk are still required to use the CRR for quantification of such exposures.

Counterparty Credit risk

- A simplified counterparty credit risk regime has been introduced under the IFR for quantification of K-TCD that also takes into consideration a simplified CVA calculation. The calculation is driven off an overarching formula to calculate K-TCD 'K-TCD = α X EV X RF X CVA' and formula to calculate exposure value 'EV = Max (0; RC + PFE – C).' Replacement cost (RC) for derivative contracts is the CMV (Current Market Value) and PFE is calculated as the product of an Effective Notional (EN) time a Supervisory Factor (SF). Whilst, overall, the counterparty credit risk calculations are somewhat simpler than before, firms may see an increase in potential future exposure (PFE) due to the revised Supervisory Factors (SFs) introduced under article 29 of the IFR.
- Firms are still awarded the option of using the existing CRR methods (mark to market method, standardised method, original exposure, etc) for calculating exposure to counterparty credit risk subject to receiving permission from the Regulator to do so.
- Derivative contracts directly or indirectly cleared through a central counterparty (CCP) where several strict conditions are met, exchange-traded derivative contracts, and derivative contracts held for hedging purposes of an investment firm resulting from non-trading book activity, are exempt from TCD requirements.

Concentration risk

- With regards to concentration risk (Part six of IFR), firms should be able to monitor trading book exposure by client (or group of connected clients) and ensure that they are within limits. Where limits are exceeded, K-CON has to be quantified and capital has to be allocated.

- Matched Principal Brokers that use a single LP are likely to exceed concentration limits on their lopsided trading exposure to a single LP and will be required to quantify capital under K-CON.
- Due to likely significant single name LP exposures, Class 2 firms such as matched principal brokers, may see a rise in capital requirements due to mandatory quantification of K-CON under the IFR.

Simplified own funds calculations

- Firms subject to CRR might be familiar with the concept of TREA (Total Risk Exposure Amount) which was essentially the firms Pillar 1 variable capital requirement multiplied by 12.5 to arrive at TREA. The requirement for firms under the CRR was to hold CET1, Tier 1 (CET 1+ AT1), and Total Capital (CET1+AT1+Tier2) of at least 4.5%, 6.0%, and 8.0%, respectively of TREA. It was not uncommon for firms to find the concept of TREA puzzling. The concept of TREA has been removed from the IFR where a more straightforward 'Own Funds' calculation has been introduced where Capital Resources (CET1+AT1+Tier 2) have to be equal to or greater than the overarching capital requirement (higher of PMC, FOR, K-Factor Requirement).

Simplified Liquidity Requirements

- The new IFR rules on liquidity are simple and easy to follow. The overarching liquidity rule is for firms to hold one third of the fixed overhead requirement in liquid assets. The use of liquid assets borrows from delegated regulation (EU) 2015/61 with regard to liquidity coverage requirement for Banks. Class 2 firms will need a pay closer attention to their liquid asset requirements under the IFR.