ALLEN & OVERY

New Prudential Regime for Investment Firms

September 2020

2. Capital requirements

Overview

The new EU prudential regime for investment firms introduces a new framework for calculating capital requirements for investment firms. It involves firms having to assess and monitor their activities against a set of so-called "K-factors" in order to, first, determine a firm's classification for prudential purposes and, second, to determine the regulatory capital requirement that applies to the firm or its consolidation group.

This is a significant change to how capital requirements currently apply to investment firms – the evolution of the regime is intended to take into account the differences in risk measurement applicable to investment firms compared with banks. The new regime will require firms to:

(a) build internal systems and controls that will allow the assessment of relevant activities against the applicable K-factors; and

(b) monitor the activity levels to ensure that the firm:

(i) maintains adequate regulatory capital resources (at solo and consolidated level); and

(ii) appropriately reflects its classification for prudential purposes (including keeping the regulators apprised of the firm's classification and any changes thereto).

A Class 3 firm's capital requirement will be the higher of the permanent minimum capital requirement (**MCR**) (slightly modified compared with the current rules) or the fixed overheads requirements (**FOR**). Class 2 firms will need to hold the higher of the MCR, FOR or the K-factor requirement.

Once firms determine their capital requirements, they will need to meet them using CET1, AT1 and Tier 2 instruments familiar from the existing regime under the EU Capital Requirements Regulation (**CRR**), subject to modifications in how some deductions and adjustments apply to capital instruments under IFR.

Source materials

(a) Investment Firm Regulation (**IFR**) Articles 5-6 and 11-42

(b) Investment Firm Directive (**IFD**) Articles 9-11

(c) European Banking Authority Consultation Paper EBA/CP/2020/06 setting out Draft Technical Standards dated 4 June 2020

(d) Financial Conduct Authority Discussion Paper DP 20/2 dated June 2020 (**DP 20/2**)

Description of obligations

(a) Firm classification

Each investment firm will need to determine its prudential classification under IFR. With the exception of firms that will continue to be subject to CRR, firms will need to determine (by reference to thresholds calculated on the basis of K-factors, on- and off-balance sheet items and gross revenue from investment services and activities) if they qualify as small and non-interconnected firms under IFR (referred to as Class 3 investment firms) subject to a light-touch regime. If not, firms will be subject to a full set of requirements under the new regime (as so-called Class 2 investment firms). For more details, see our **IFR bulletin no 1** on firm classification.

(b) K-factors

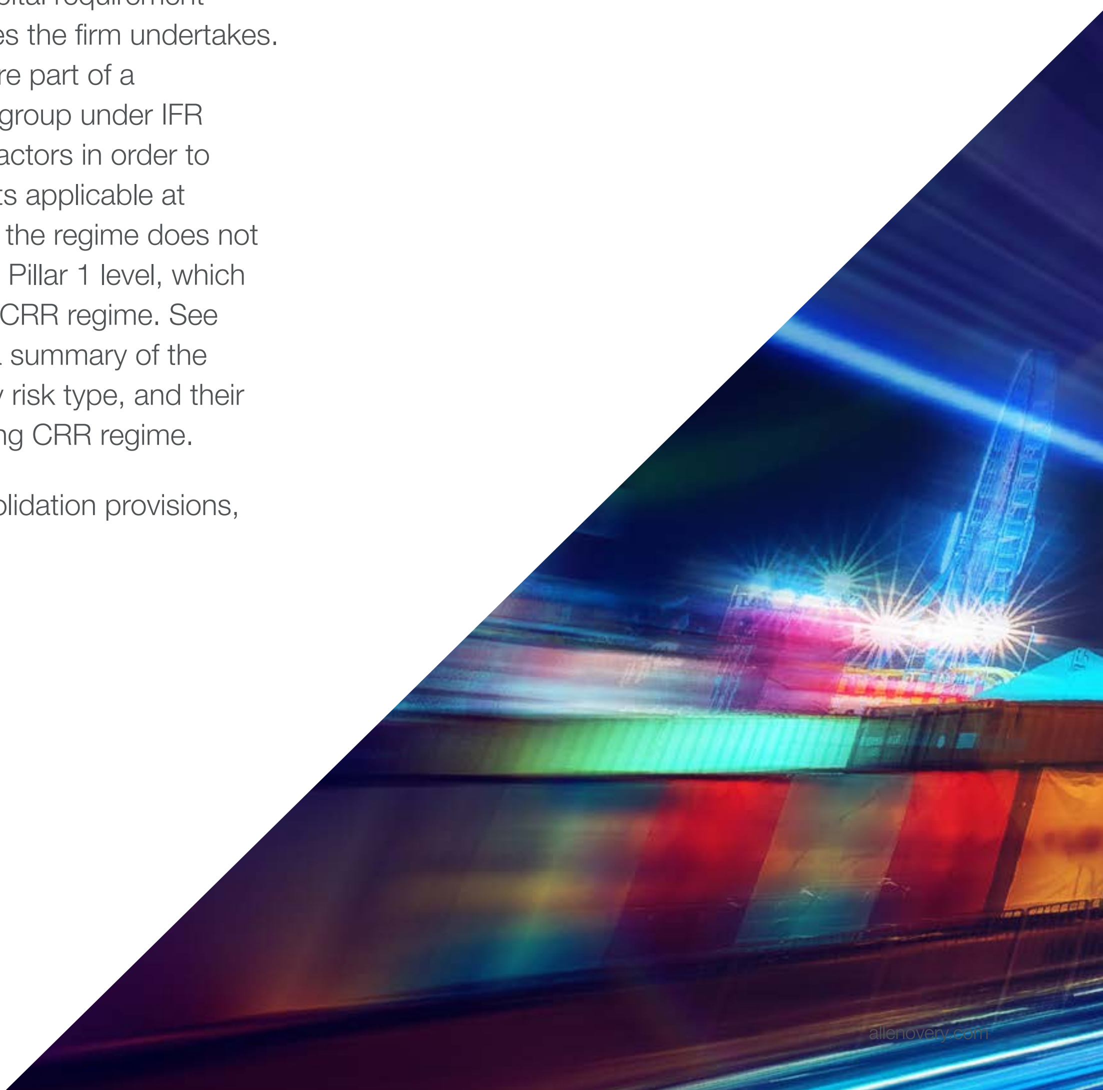
Apart from being used for firm classification purposes, K-factors are used under IFR to determine a Class 2 firm's capital requirement based on the types of activities the firm undertakes. Note that Class 3 firms that are part of a consolidated investment firm group under IFR will also need to calculate K-factors in order to determine capital requirements applicable at a consolidated level. Notably, the regime does not explicitly capture credit risk at Pillar 1 level, which is an important feature of the CRR regime. See the Annex to this bulletin for a summary of the various K-factors, grouped by risk type, and their comparables under the existing CRR regime.

For more details on IFR consolidation provisions, see our **IFR bulletin no 3**.

(c) Own funds requirement

Firms are required to hold a minimum amount of regulatory capital (at a solo and, if applicable, consolidated basis) that is the higher of the MCR, the FOR or (for Class 2 firms) the K-factor requirement.

To determine the K-factor requirement, firms will need to calculate the amount for each K-factor, multiply it by the relevant coefficient (if applicable for the relevant K-factor) and add all resulting individual K-factor amounts together to obtain the overall K-factor requirement. Once the own funds requirement is calculated, firms need to ensure that they have sufficient capital with which the requirement can be met. Note that some legacy capital instruments (particularly those used under the pre-CRR prudential regime – the Capital Adequacy Directive or CAD) may not meet the eligibility criteria for capital instruments under IFR.



To whom do the obligations apply?

The own funds requirement will apply to all in-scope investment firms on an individual and (depending on the group structure) consolidated level. In the UK, the FCA has indicated that the own funds requirement will also apply to investment managers with MiFID permissions who undertake discretionary client-by-client portfolio management services (ie CPMI firms for the purposes of the FCA Handbook) with respect to such firms' MiFID business. Consequently, all investment firms and CPMI firms will need to monitor their activities against the K-factors to monitor firm classification (Class 2/Class 3) and to calculate applicable capital requirements.

Are there any derogations?

Yes. Solo consolidation waivers may be granted by national competent authorities to firms that form part of a banking, insurance or investment firm consolidation group (subject to other requirements being met).

The K-factor requirement will not apply to Class 3 firms calculating their own funds requirement on a solo basis. However, Class 3 firms that are members of investment firm groups may nevertheless need to calculate a K-factor requirement to feed into the consolidated own funds requirement at group level.

Otherwise, all Class 2 and 3 firms need to (1) monitor their activities against K-factors and other thresholds for entity classification purposes and (2) maintain own funds requirements at solo and/or consolidated levels using eligible capital instruments.

Are there any transitionals?

Yes. Until 25 June 2026, generally the amount of own funds that firms need to hold under IFR will be capped at twice the amount of own funds that firms would be required to hold under CRR. For any firms established after 26 June 2021, the own funds requirement will be capped at twice the FOR.

Expected impact

The intention behind the new regime is to provide a more risk-sensitive prudential regime that takes into account specific risks posed by investment firms. This is partially achieved through shifting existing Pillar 2 requirements that apply to investment firms to a harmonised Pillar 1 capital requirement. Therefore, whilst it is expected that firms' Pillar 1 requirements will increase, the overall capital requirements should not increase – although this will need to be verified on an entity-by-entity and group-by-group basis.

In order to monitor K-factors and calculate related capital requirements, firms will need to build systems and controls in order to identify, capture and manipulate transaction and asset data which may not be currently captured at all or in the right format. This is likely to involve significant investment, both in terms of time and resources. In addition, the radical nature of the changes to the capital calculations using the K-factors may result in firms (and in particular larger groups) having to consider structural changes to their business models and operational arrangements, including potential group restructurings (particularly when combined with consolidated capital requirements under IFR), to maximise capital efficiency.

Groups consisting of IFR and CRR in-scope firms should also consider the overall impact of CRR2 on their operations.

To summarise, firms should:

- Determine what capital requirements apply to the firm based on firm's classification and prudential position
- Set up systems and controls to monitor K-factors on a solo and group level
- Model firm's expected Pillar 1 capital requirement
- Assess eligibility of existing capital instruments against IFD/IFR requirements
- If necessary, inject additional regulatory capital to meet revised own funds requirements

ANNEX

K-factors summary

Risk type	K-factor	Description	Coefficient	CRR Comparison
Risk to Client (RtC)	**K-AUM**	Assets under management	0.02%	~ Operational Risk
	K-COH	Client orders handled	0.1% for cash trades 0.01% for derivatives	
	K-ASA	Assets safeguarded and administered	0.04%	
	K-CMH	Client money held	0.4% on segregated accounts 0.5% on non-segregated accounts	
Risk to Market (RtM)	**K-NPR** or **K-CMG**	Net position risk (uses CRR Market Risk framework) Clearing margin given	N/A	~ Market Risk
Risk to Firm (RtF)	**K-TCD**	Trading counterparty default risk	N/A	~ Counterparty Credit Risk
	K-DTF	Daily trading flow	0.1% for cash trades 0.01% for derivatives	~ Operational Risk
	K-CON	Concentration risk	N/A	~ Large Exposures