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# New Prudential Regime for Investment Firms

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7. Internal capital and risk assessment process

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# Overview

The new prudential regime for investment firms set out in the EU Investment Firms Directive and Regulation (**IFD** and **IFR**) respectively introduces a new capital adequacy and risk assessment and supervisory review and evaluation process (**ICARA**).

# Source materials

(a) IFD Articles 24, 29, and 36

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

# What would the ICARA process involve?

The ICARA process is a new requirement for investment firms, which is set out in the IFD.

Investment firms that are in scope of the requirement must assess and maintain internal capital and liquid assets sufficient to cover the nature and level of risks which they may pose to others and to which the investment firms themselves are or might be exposed. The ICARA requirements include an obligation on the firm to maintain documentation setting out appropriate strategies and processes to ensure that it is able to meet the requirements.

The FCA confirmed in its discussion paper that it would expect to apply the ICARA process in the UK. The FCA considers that the ICARA process will help investment firms demonstrate how they are meeting the FCA Threshold Condition to have appropriate financial and non-financial resources. To date, the FCA is the only regulator to provide further colour on the process. As such, their discussion paper provides useful colour on the requirements, albeit only specifically applicable in the UK.

The FCA set out that under a UK ICARA process, they would expect the assessment to:

(a) reflect the risks to which the firm is exposed and the amount of risk it poses to clients and to markets;

(b) apply a forward-looking approach to consider how these risks could evolve throughout the economic cycle;

(c) determine the appropriate level of financial resources required to cover these risks beyond what is covered under 'Pillar 1';

(d) consider business model viability and the strategy's sustainability, including through reverse stress testing, to determine vulnerabilities in the business model; and

(e) consider necessary financial resources and planning to allow for a credible wind-down of the firm if it closes.

## Which firms does ICARA apply to?

The IFD mandated that ICARA applies to investment firms that do not meet the conditions for qualifying as small and non-interconnected investment firms (Class 3 firms, and those not meeting the requirements Class 2 firms)(see our **IFR bulletin no 1** on firm classification). However, there is scope for the competent authority to apply the requirements to Class 3 firms if they consider that appropriate.

The FCA would expect the ICARA requirements to apply to both Class 2 and Class 3 firms, although noting that, particularly for Class 3 firms, the ICARA requirements should apply on a proportionate basis.

The FCA's view is that the IFD requirements do not require that an ICARA is applied on a consolidated basis, but they also consider that the IFD does not preclude them from asking firms for an ICARA to be performed with respect to a consolidation group. They will not generally require firms to apply the ICARA requirements at the consolidated level, but they would wish to retain the discretion to do so. Irrespective of the likelihood that a consolidated ICARA will not be required, investment firms should take account of any risks associated with their membership of a group as a part of their individual ICARA process. For more details on IFR consolidation requirements, see our **IFR bulletin no 3**.

Firms are expected to review their documented ICARA on an annual basis.

## Comparison to ICAAP requirements under CRD

Whilst there are a number of similarities between the current ICAAP requirements in the UK and the ICARA requirements, there are also material differences in approach. The FCA provides the following comparison between the ICARA requirements and the UK ICAAP requirements:

| Current ICAAP | ICARA process |
|---|---|
| A specified list of risk categories sets out how investment firms are expected to identify, manage and assess their risks. This can mean that risks are put into categories that are not necessarily appropriate. | The focus should be on the investment firm's business model and its activities. From there it will identify, assess and estimate the potential harm to clients, to markets, and to the firm itself. |
| Investment firms assess their different exposure risks according to the detailed capital requirements set out in the Capital Requirements Directive (**CRD**). | Investment firms assess their different exposure risks according to the detailed capital requirements set out in the Capital Requirements Directive (CRD). Investment firms will focus on risks to their financial adequacy from potential changes in the book value of assets, changes in the value of trading book positions, and losses from the potential failure of counterparties.<br>Investment firms should consider the risks to themselves in light of the knock-on effect they may have upon their clients and the markets they operate in. |
| Wind-down plan not required as part of the ICAAP. | Investment firms will have to consider wind-down as part of the ICARA process. |

Fundamental to the ICARA process is identifying risks and potential harms and considering what could go wrong to the point of failure of the firm. Investment firms need to consider 'what-if' scenarios for the activities they undertake, the harm that can be caused and the events leading to that harm. The assessment will need to factor in the likelihood of the events materialising, and that different events might occur at the same time.

Investment firms will also need to consider and account for other risks that can reduce the level of their own funds. This may require a more conceptual approach to assessing the risk than that which those familiar with the current ICAAP may be used to. For example, investment firms will need to consider as appropriate and explain the impact (including on their ability to service clients or markets) of:

– losses from changes in the book value of assets, including claims on tied agents;
– losses from the failure of clients or counterparties to transactions in financial instruments;
– changes in the value of positions in financial instruments, foreign currencies and commodities; and/or
– obligations to defined benefit pension schemes.

Firms are required to consider if they need liquidity above the minimum level prescribed under the formal rules (see our **IFR bulletin no 3** on liquidity and concentration).

The FCA is intending to implement the requirement for Class 2 firms to take into account the viability and sustainability of their business models and strategies. They must consider what is both necessary and realistic, in terms of timescale and maintenance of own funds and liquid resources, throughout the process of exiting the market. For Class 2 firms, they would also be likely to consider whether to issue individual guidance on further own funds to cover wind-down in stressed economic conditions.

## Supervisory review and evaluation process – SREP

IFD sets out the requirement for the supervisory reporting and evaluation process (SREP). It is likely that this process will be similar to the current SREP for CRR investment firms. Consistent with the change of focus of the ICARA, there will be greater consideration of the potential for wider harm. Reviews of investment firms' own assessments of adequate financial resources and wind-down planning should be carried out in a consistent and proportionate manner.

Class 3 firms will not be subject to regular, cycle-driven supervisory reviews. The FCA would still expect Class 3 firms to consider the risks which they may pose to others and to which they may be exposed themselves, although would not expect any documentation of this to be lengthy and unnecessarily detailed. Class 3 firms may be subject to individual SREP on an ad hoc basis or as part of a thematic review.

As a part of the SREP process the FCA anticipates setting two types of Pillar 2 capital guidance: (i) Pillar 2R, which will be legally binding; and (ii) Pillar 2G, which will be a buffer requirement with the formal status of 'guidance'. This is a material shift from the current individual capital guidance provided to firms, which is not directly legally binding, albeit the FCA can take steps to enforce it. The FCA expects the total capital requirements, which include Pillar 1 and Pillar 2R, to be met with the same quality of capital as Pillar 1, while Pillar 2G should be met by CET1 capital only (as is already the case for other capital buffers under CRR).

The FCA will provide further detail on Pillar 2 for liquidity in future publications.

## Next steps

Investment firms will need to review their current documentation to assess how it will meet the requirements of the new ICARA process. UK investment firms should also consider if the new legal status of Pillar 2R puts them in breach of any agreements, which may require a review of relevant documentation, including finance documentation.