ALLEN & OVERY

New Prudential Regime for Investment Firms

September 2020

5. Liquidity and concentration

Overview

The new EU prudential regime for investment firms contains obligations for the first time to hold liquid assets against specific liquid resource requirements and to limit their exposures to groups of connected counterparties in order to reduce the impact of concentration risk.

The liquidity regime has been designed on the basis of the liquidity coverage ratio (**LCR**) provisions of the Capital Requirements Regulation (**CRR**) with appropriate modifications to take account of the ability and need for investment firms to access liquid assets. The CRR did not apply specific liquidity requirements to all investment firms. The liquidity regime under the Investment Firm Regulation (**IFR**) allows investment firms to use a broader range of liquid assets than those permitted under the CRR (including unencumbered short-term bank deposits and a limited amount of receivables).

The concentration risk regime applies to all investment firms with exposure limits applicable to all investment firms that deal as principal, even where this is for clients. It is closely based on the CRR's large exposures regime, with derogations for non-trading book exposures and an exemption for commodity dealers' intra-group exposures. The concentration limit is also cast more generously than the limit under CRR, being set at 25% of all own funds, rather than just Tier 1. However, unlike under the CRR, all investment firms will be subject to the IFR's concentration risk regime.

The largest and most significant firms (**Class 1 firms**) will be subject to the CRR's liquidity and large exposures requirements. Small and non inter-connected firms (**Class 3 firms**) and all other investment firms (**Class 2 firms**) must apply high-level concentration risk and liquidity requirements. Class 3 firms can benefit from a discretionary exemption from the more onerous liquidity requirements, whilst the majority of concentration risk rules apply only to Class 2 firms.

Source materials

(a) **Liquidity:** IFR: Recital 28 and Articles 6(3), 7(3) and 43-45; Investment Firm Directive (**IFD**): Recitals 21 and 41 and Articles 24, 29, 39(2)(j) and (k) and 42

(b) **Concentration Risk:** IFR: Recital 27 and Articles 7(1) and 35-42 (Part Four)

(c) Financial Conduct Authority (**FCA**) Discussion Paper DP 20/2 dated June 2020 (**DP20/2**)

Description of obligations: Liquidity

Class 2 and Class 3 firms must monitor and manage their liquidity requirements. They must also hold sufficient levels of specified forms of liquid assets to meet liquidity requirements that are calibrated at one third of their 'Fixed Overheads Requirement' (the **FOR**) (please refer to the **IFR bulletin no 2** on capital requirements for further details on how the FOR is calculated). Where an investment firm has provided guarantees to its clients, it must increase its liquid assets by 1.6% of the total amount of these guarantees.

IFR lists the assets that can be used to meet the liquidity requirements. These include all 'high quality liquid assets' set out under the CRR's LCR Regulation (Delegated Regulation (EU) 2015/61), subject to the same conditions and haircuts, as well as: (i) shares and collective investment units, subject to a limit of €50m and the conditions noted in the CRR's LCR Regulation; (ii) other liquid MiFID financial instruments that are traded on a trading venue, subject to a haircut of 55%; (iii) unencumbered bank deposits; and (iv) for Class 2 firms which do not conduct dealing on own account or underwriting (MiFID Annex I Activities A(3) and A(6)) and Class 3 firms, trade debtor receivables and fees or commissions receivable within 30 days, subject to a cap at one third of the firm's liquidity requirement with a 50% haircut (though receivables, fees and commissions cannot be used to meet any 'Pillar 2' obligations – see below). Client money and client assets cannot be used to meet liquidity requirements, even where these are held in the name of the investment firm.

Class 2 firms and, at the discretion of competent authorities, Class 3 firms must have adequate and proportionate systems and controls to ensure that they have adequate amounts, types and distribution of internal liquid assets. These assets must cover the nature and level of risks to which a firm is or might be exposed and which it may pose to others. These systems and controls must be subjected to regular internal review.

Class 2 firms and Class 3 firms must have robust adequate and proportionate governance, systems and controls to identify, measure, manage and monitor their liquidity risk over an appropriate set of time horizons, including intra-day, to ensure that adequate levels of liquid assets are maintained. This should include an assessment of risks to clients, the market and the firm itself.

The IFR's liquidity requirements also apply to investment firm groups on a consolidated basis. Please refer to our **IFR bulletin no 3** for more details on consolidated requirements under IFR.

Competent authorities can impose more stringent 'Pillar 2' requirements where needed under powers enacted to implement IFD Articles 39 and 42. This includes both liquidity requirements and additional reporting requirements. Pillar 2 liquidity requirements can be imposed to address liquidity risks that are not covered, or not sufficiently covered, by the 'Pillar 1' requirements set out in the IFR, a well as failings in a firm's internal liquidity controls and governance.

The EBA, in consultation with ESMA, is to develop draft regulatory technical standards to specify how the liquidity risk and elements of liquidity risk are to be measured for the purposes of applying these additional Pillar 2 liquidity requirements. These are due to be submitted to the Commission by 26 June 2021.

Description of obligations: Concentration Risk

Class 2 and Class 3 investment firms must monitor and control their concentration risk. The precise scope of this requirement is not specified; however, the IFR's reporting obligations in respect of concentration risk extend beyond trading book exposure to capture any concentration in assets, including debtors, earnings, cash deposits, non-trading book off-balance sheet items, and holding counterparties of client money and custody assets. Although the concentration risk reporting requirements do not apply to Class 3 firms, the FCA is considering adopting this broader scope to the monitoring and control of concentration risk obligations.

Class 2 firms must also apply limits to their trading book exposures to meet concentration risk requirements such that no exposure to an individual client or group of connected clients exceeds 25% of their total own funds. Where a client is, or a client group contains, a credit institution or an investment firm, the limit is the higher of 25% or EUR150m. Where the EUR150m threshold is applied, the sum of exposure to entities that are not credit institutions or investment firms must not exceed 25% of the firm's own funds and the firm's total concentration risk must not exceed 100% of the firm's own funds.

These limits can be exceeded if (i) the firm notifies its competent authorities of the value of the excess and the name of the client(s); and (ii) additional capital requirements ('K-CON' requirements) are met. The concentration risk limits can be exceeded up to a limit of 500% of own funds for up to 10 days, or 600% thereafter. The additional K-CON capital requirement is calculated using the capital requirement applicable to the excess above the limit and applying a multiple to this of 200-900%. K-CON is then added to the other 'Risk to Firm' capital K-factors.

Class 2 firms must calculate their trading book exposure value as the sum of net exposures in financial instruments for: market risk, using K-NPR (firms that would normally use K-CMG for their 'Risk-to-Market' calculations must use CRR II's standardised approach); and counterparty credit risk, using K-CD, in the form that this is applied by the firm. Firms must apply a 'look through' approach by seeking to identify underlying assets in relevant transactions and the counterparty of the underlying exposures. However, certain exposures are excluded from this calculation, including, among others, those which are deducted from own funds; expenses in the ordinary course of payment and settlement; claims against certain government, regional and local authorities and central counterparties, as well as, at the discretion of competent authorities, covered bonds and, subject to specified requirements, intra-group exposures within the IFR consolidation group.

Where an investment firm has material non-trading book exposures, it can be expected that these would be subjected to Pillar 2 capital requirements via the individual capital adequacy assessment process and the supervisory review and evaluation process. Please refer to our **IFR bulletin no 7** for further details on these processes.

The IFR's provisions on concentration risk also apply to investment firm groups on a consolidated basis. The principal obligation is set out in Article 7(1) IFR. Please refer to our **IFR bulletin no 3** for more details on consolidated requirements under IFR.

When does the obligation apply?

These obligations will apply from 26 June 2021 (or, in the UK, when implemented in UK law and regulatory rules, the timing of which is yet to be determined).

Are there any derogations?

Liquidity:

In exceptional circumstances and with the approval of their competent authorities, investment firms can reduce their holdings of liquid assets for a period of up to 30 days. Whilst competent authorities can exempt Class 3 firms from liquidity requirements, EBA guidelines will be drawn up to harmonise the approach taken by different regulators.

Competent authorities can also exempt investment firms from applying the liquidity requirements on a solo basis where the investment firm is part of a CRR or IFR Article 7 consolidation group and their parent undertaking, on a consolidated basis, monitors and has oversight over the liquidity positions of the group's credit institutions and investment firms and ensures sufficient liquidity for these firms. The free-flow of liquidity among the consolidated group must be provided for by a contractual intra-group liquidity arrangement, to which there is no current or foreseen material, practical or legal impediment.

Concentration risk:

An exemption is available for commodity derivatives and emission allowance dealers for hedging or treasury financing exposures to non-financial counterparties, provided both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures.

Expected impact

The application of metric-based Pillar 1 liquidity requirements is a significant new development in the prudential regulation of investment firms, which previously relied only on qualitative liquidity adequacy obligations. However, there remains a recognition that investment firms have different liquidity profiles and requirements to credit institutions as these are set for investment firms in a manner that is more simple to calculate than the CRR's LCR (and, in a development that minimises the burden of the additional compliance work, are based on figures (the FOR) that will be already available to investment firms). It is also recognised in the new rules on eligible liquid assets, which are broader than those which can be used to meet the CRR's LCR, that investment firms have a different ability to raise liquid assets compared to credit institutions. The impact of these new rules may also be mitigated to a degree by the exemption of Class 3 firms, though this is at the discretion of competent authorities.

Similarly, concentration risk requirements will be new for a large number of investment firms (though Class 3 firms will be exempt from the more detailed requirements), with only full-scope investment firms having been previously subject to the CRR's large exposures rules. However, again, there is a recognition that investment firms differ from credit institutions in that the limit is set at 25% of total own funds, rather than the CRR's 25% of only Tier 1 own funds – it is possible that this may encourage some investment firms to increase their holdings of Tier 2 capital (as this is less expensive to raise than Tier 1).

To summarise, firms should:

Assess the impact of new liquidity and concentration requirements on the firm

Ensure the firm has appropriate systems and controls in place to monitor and maintain appropriate liquidity and concentration levels

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