ALLEN & OVERY

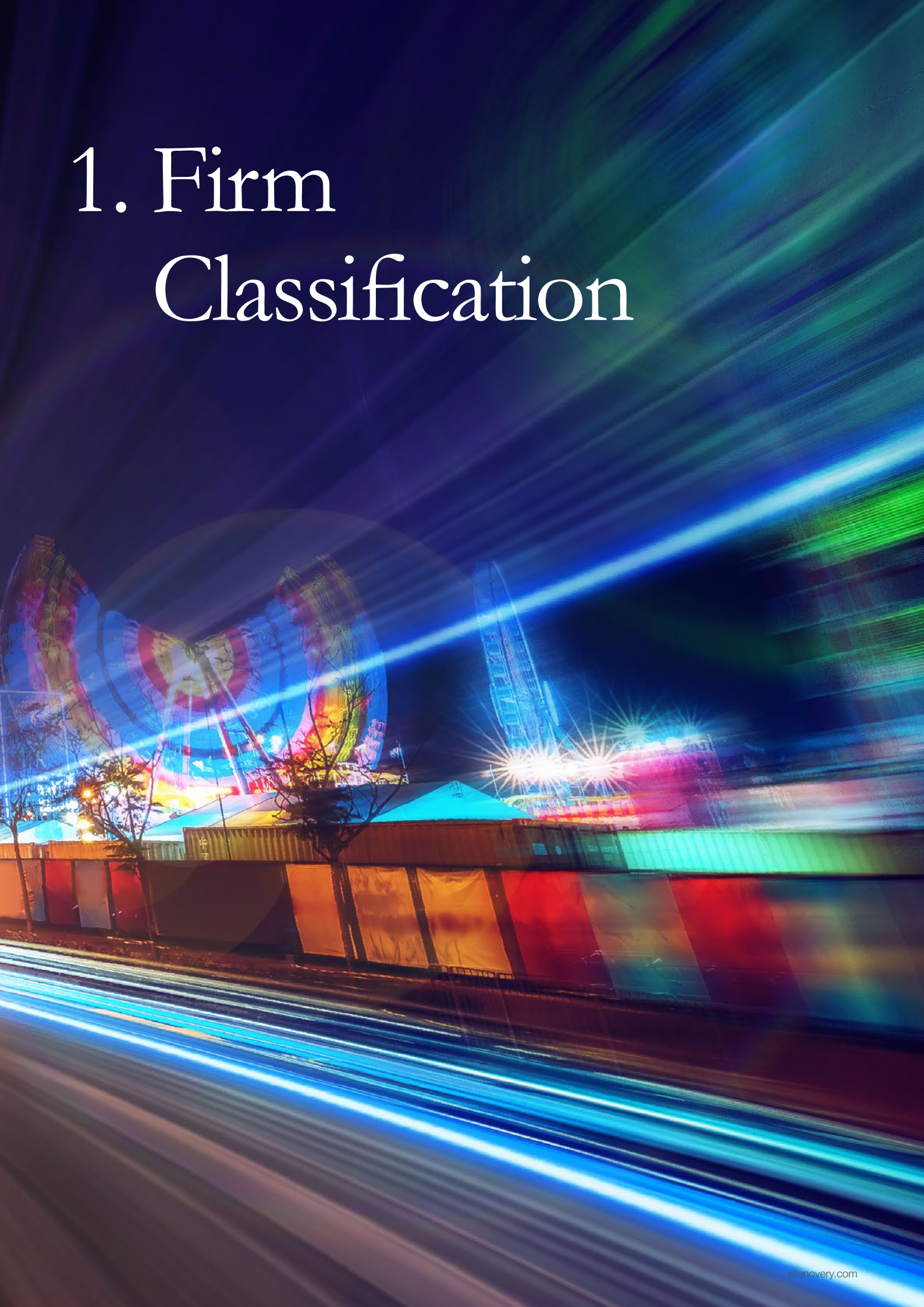
New Prudential Regime for Investment Firms

September 2020

allenovery.com

Contents

1. Firm Classification



Overview

One of the key changes introduced by the Investment Firm Regulation (**IFR**) and the Investment Firm Directive (**IFD**) will be to create new prudential categorisation of investment firms. The IFR/IFD creates four new categories of firms.

(i) Systemically important investment firms – often referred to as 'Class 1A firms' – this category covers those investment firms that are considered to be sufficiently important to the orderly functioning of financial markets that they should be reclassified as credit institutions and be subject to the prudential requirements contained in the Capital Requirements Regulation (**CRR**) and the Capital Requirements Directive (**CRD**).

(ii) (Large) investment firms – often referred to a 'Class 1B firms' – these are large investment firms that deal on own account and/or carry out underwriting/placing on a firm commitment basis (MiFID activities (3) and/or (6)) but which are not of the same systemic importance as the Class 1A firms. This category of firms will remain subject to the prudential requirements contained in the CRR and CRD.

(iii) Investment firms – often referred to as 'Class 2 firms' – these are non-systemic investment firms that do not carry out dealing on own account or underwriting activities. This category of firms are subject to the full scope of the prudential regime is set out in the IFR and IFD.

(iv) Small and non-interconnected investment firms – often referred to as 'Class 3 firms' these are very small investment firms with 'non-interconnected' services. This class of firms is subject to a more 'light touch' regime under the IFR/IFD which is proportionate to the risks that the firms pose to the public and the financial markets.

Of these categories, Class 2 firms will be most heavily impacted by the new prudential regime set out in the IFR/IFD. For the other firms, there will be fewer new obligations to comply with, although all in-scope investment firms will be required to measure and report against the new thresholds for each category of investment firm.

This bulletin sets out the tests for each class of firm, together with the areas of the new regime that are relevant to the different classes.

Source materials

(i) IFR Articles 1, 12, 55, 58 and 62

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

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

(iv) HM Treasury (**HMT**) policy statement "Prudential standards in the Financial Services Bill: June update"

Thresholds

(a) Class 1A firms

IFR amends the CRR definition of credit institution to include an investment firm that:

(i) carries out MiFID activities (3) and/or (6); and

(ii) has consolidated assets equal to or greater than EUR30 billion; or

(iii) has consolidated assets with a value that is less than EUR30bn, but the firm is part of a group in which the total value of the consolidated assets of all undertakings in that group that individually have total assets of less than EUR30bn and which carry out MiFID activities (3) and/or (6) is equal to or exceeds EUR30bn; or

(iv) have assets whose total value is less than EUR30bn, but where the firm is part of a group in which the total value of the consolidated assets of all undertakings in the group that carry out MiFID activities (3) and/or (6) is equal to or exceeds EUR30bn, where the consolidating supervisor, in consultation with the supervisory college, so decides in order to address potential risks of circumvention and potential risks for the financial stability of the Union.

Class 1A firms must apply for authorisation under CRD as a credit institution and will be directly supervised by the European Central Bank (**ECB**) if they are established in the Eurozone.

Where a firm falls below the relevant thresholds for a period of five years, competent authorities can change the categorisation of systemically important investment firms back from credit institutions to investment firms (ie from Class 1A to Class 1B).

It is important to note that in the UK, HMT has decided that it will not be adopting the Class 1A categorisation, but will instead be maintaining the pre-existing designation regime for regulating systemically important investment firms.

(b) Class 1B firms

IFR Article 1(2) defines Class 1B firms as those investment firms that:

(i) carry out MiFID activities (3) and/or (6);

(ii) are part of a group where the combined total value of the assets of all undertakings in the group that carry out any of the activities of dealing on own account or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (or both) and have total assets below EUR15bn exceeds EUR15bn; and

(iii) have been determined by the relevant competent authority, in accordance with IFD Article 5, as satisfying the two criteria above and are sufficiently systematically important to be considered to be Class 1B firms.

Class 1B firms will fall into Class 2 if they no longer meet the thresholds calculated over a period of 12 consecutive months or their competent authority decides that they should be reclassified.

Class 2 firms will be elevated to Class 1B where they cross the relevant thresholds on an average over 12 months or where the relevant competent authority decides. Should a firm cross a relevant threshold then they must notify their competent authority (though no approval is required). Class 2 firms that are part of a consolidated banking group under CRR may also apply to their national competent authorities to be classified as Class 1B firms (subject to meeting requirements under IFR Article 1(5)).

(c) Class 2 firms

Class 2 firms are all those investment firms that:

(i) do not meet the special criteria for any of the other classes of firm; and

(ii) have not received approval to be treated as a Class 1B firm in accordance with IFR Article 1(5).

A Class 2 firm may become a Class 3 firm if it ceases to meet the Class 2 firm criteria for a continued period of at least six months. It is necessary for firms changing their categorisation to notify their competent authority, although no formal approval is required.

(d) Class 3 firms

IFR Article 12(1) sets out that Class 3 firms are those investment firms for whom a set of risk measures are below certain thresholds – with the result that those investment firms should be relatively low risk and therefore should be subject to less onerous prudential regulation. For an investment firm to be a Class 3 firm, it is necessary for it to satisfy each of the following requirements:

(i) K-AUM – Assets under management of less than EUR1.2bn or more on a combined basis across all investment firms within the group (calculated at end-of-day);

(ii) K-COH – Client orders handled of less than EUR100 million/day for cash trades or EUR1bn/day for derivatives on a combined basis across all investment firms within the group (calculated at end-of-day);

(iii) K-ASA – Client assets safeguarded and administered is zero on a solo entity basis (end-of-day);

(iv) K-CMH – Client money held is zero on a solo entity basis (intra-day);

(v) K-DTF – Daily trading flow and net position risk is zero on a solo entity basis (end-of-day);

(vi) K-NPR – Net position risk is zero on a solo entity basis (end-of-day);

(vii) K-CMG – Clearing margin given is zero on a solo entity basis (intra-day);

(viii) K-TCD – Trading counterparty default is zero on a solo entity basis (end-of-day);

(ix) On and off balance sheet total of less than EUR100m (based on previous financial year data) on a combined basis across all investment firms within the group; and

(x) Total gross revenues from investment services and activities of less than EUR30m (based on previous financial year data) on a combined basis across all investment firms within the group.

Where a Class 3 firm breaches any one of the following criteria it will immediately be classified as a Class 2 firm:

(i) K-ASA – Client assets safeguarded;

(ii) C-CMH – Client money held;

(iii) K-NPR – Net position risk;

(iv) K-CMG – Clearing margin given; or

(v) K-TCD – Trading counterparty default.

A Class 3 firm must breach one of the following criteria for a sustained period of three months for it to be reclassified as a Class 2 firm:

(i) K-AUM – Assets under management;

(ii) K-COH – Client orders handled;

(iii) On and off balance sheet total; or

(iv) Total gross revenues.

Which aspects of the IFR/IFD are relevant to each class of firm?

(a) Class 1A firms

Outside of the UK, large investment firms that may be categorised as systemically important will need to engage with their supervisor in advance of submitting an application for reauthorisation as a credit institution by 27 December 2020. Any firms that are re-authorised as credit institutions will also be subject to direct supervision by the ECB and subject to the single supervisory mechanism going forward (including consolidated supervision as relevant) to the extent they are established in the Eurozone.

(b) Class 1B firms

Class 1B firms will remain subject to the CRR/CRD. The key new IFR/IFD obligation for these firms is the threshold-reporting regime set out in Article 55 of the IFR. This requires Class 1B firms to report to their competent authority against the threshold criteria set out in section 3 above.

(c) Class 2 firms

Class 2 firms are the category of firms most impacted by the new regime set out in IFR/IFD. They will be subject to the new IFR/IFD regime in the following key areas:

(i) regulatory capital and liquidity requirements, including using the new K-factors for calculating capital requirements;

(ii) governance;

(iii) remuneration;

(iv) regulatory reporting; and

(v) public disclosure.

(d) Class 3 firms

Class 3 firms are not subject to a number of the IFR/IFD modules that impact Class 2 firms. Where Class 3 firms are subject to specific requirements set out in the IFR/IFD, they are often subject to a less onerous version of the module. The key areas that will impact Class 3 firms are:

(i) regulatory capital and liquidity requirements (although competent authorities can exempt Class 3 firms from liquidity requirements);

(ii) regulatory reporting; and

(iii) public disclosure (for firms that issue AT1 capital instruments).

Practical next steps for firms

A firm's classification under the IFR/IFD is the key factor for determining how the new regime will impact that firm going forward. Therefore the most important immediate step for firms is to carry out their internal assessments against the criteria to determine what category of firm they will be under the new regime. To be able to do this, firms may need to build new monitoring systems to capture the necessary data. These systems will also be able to be used for ongoing monitoring purposes as required under the new regime. Firms should note that because some of the thresholds are based on group-wide metrics, the corresponding data will need to be monitored and assessed on a group-wide basis.

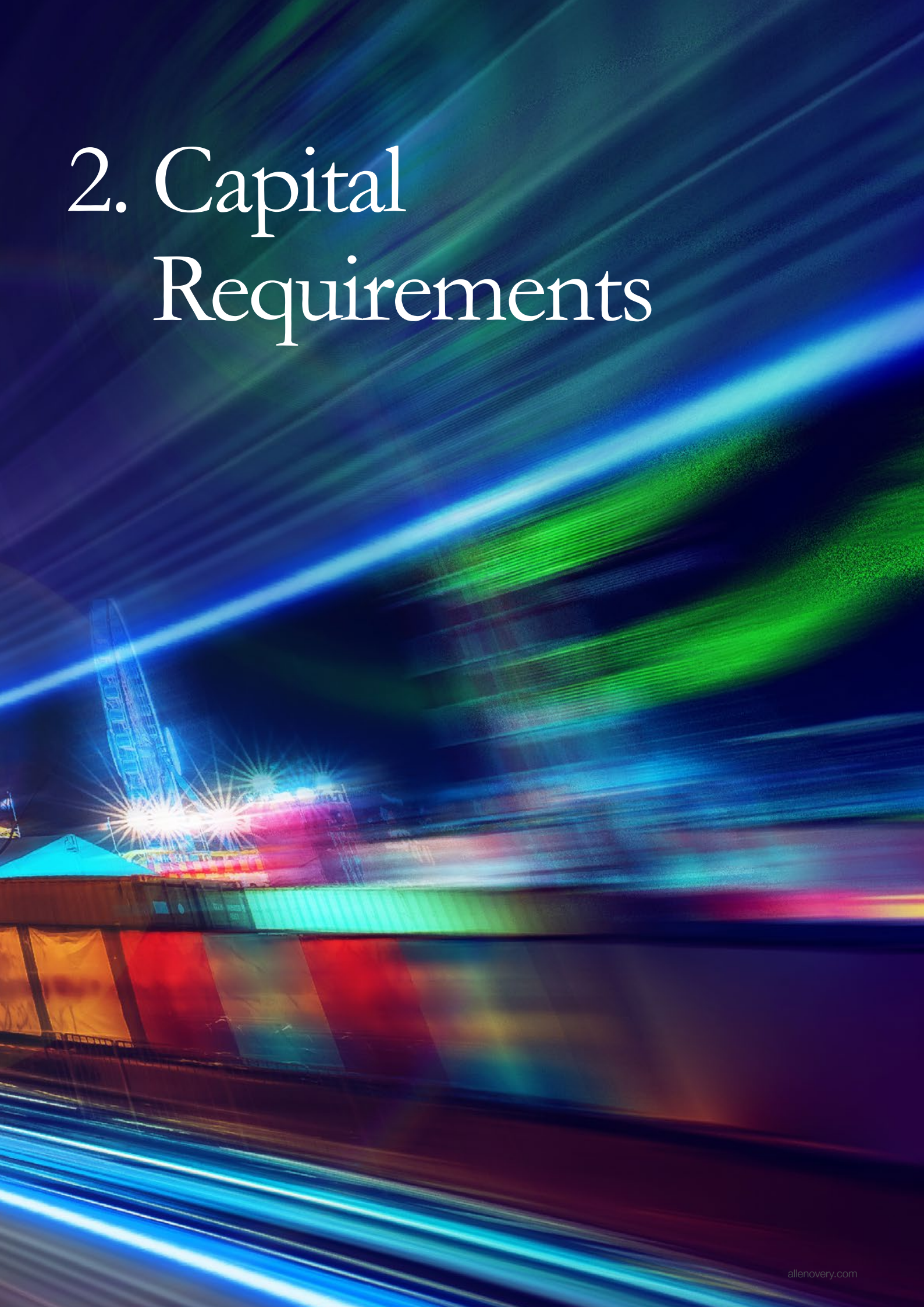
When determining their future classification, firms may wish to take a more nuanced view than simply looking at the different criteria and then measuring against the relevant data. Firms that would (based on the quantitative criteria) be a Class 2 firm may wish to consider the benefits and disadvantages of opting up to a Class 1B firm if they are already within a group subject to consolidation under CRR. Equally, firms may wish to consider the impacts that different group restructurings or new business lines could have on their future classification.

Once firms have determined their classification, they can begin their scoping exercise to determine which modules will be relevant. This information can then be used as the basis for implementation project planning.

To summarise, firms should:

- Determine the firm's prudential classification under IFD/IFR
- Set-up systems and controls to monitor data against applicable thresholds
- Class 2 firms operating within banking groups should consider whether to opt-up to Class 1B

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:

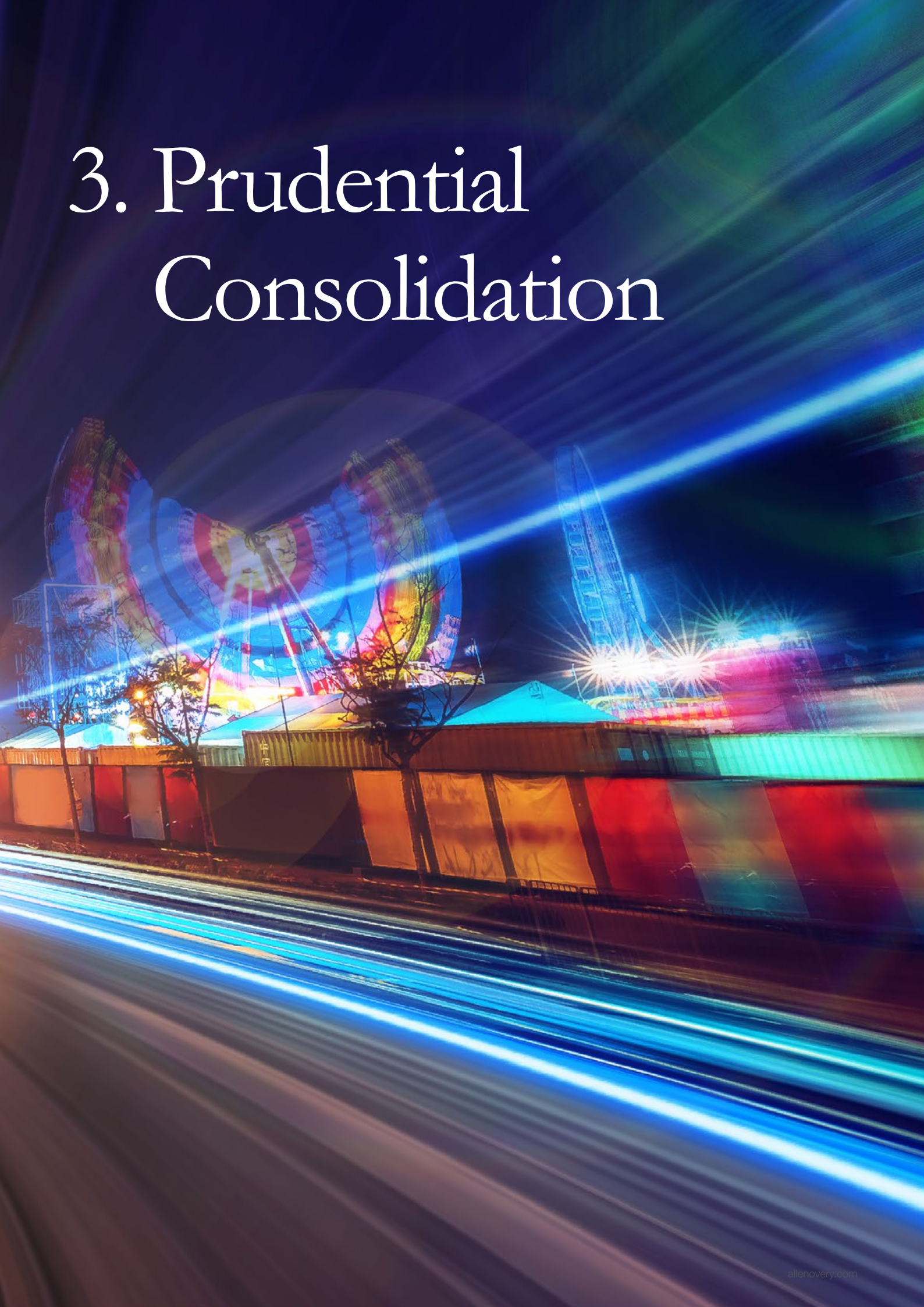
- Determine what capital requirements apply to the firm based on firm's classification and prudential position
- Set up systems and controls to monitor K-factors on a solo and group level
- Model firm's expected Pillar 1 capital requirement
- Assess eligibility of existing capital instruments against 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

3. Prudential Consolidation



Overview

The new EU prudential regime for investment firms contains an obligation to calculate risk, disclose and report on a consolidated basis based on a pre-defined perimeter. The regime has been designed on the basis of the consolidation provisions of the CRR with appropriate modifications to take into account the differences in risk measurement applicable to investment firms. A key feature of the regime is to preclude the possibility of an overlap with a consolidation applicable to a group consisting of at least one European bank.

It is however possible for a diversified banking and investment firm group to be subject to both CRR and IFR/IFD consolidation provisions depending on its precise group structure. Groups have to ascertain the perimeter of their applicable consolidation and perhaps more importantly design structures that identify, extract and aggregate data sets to enable calculation and reporting at the consolidated level. **Moreover, firms must design governance, risk management and remuneration structures to accommodate the new or enhanced standards.**

Source materials

(a) Article 7,8 Investment Firm Regulation

(b) European Banking Authority Consultation Paper EBA/cp/2020/06 setting out Draft Techical Standards dated 4 June 2020

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

Description of obligations

The IFR/IFD framework mandates that in addition to the application of the new prudential framework to EU investments firms, certain parts of the framework apply to investment firm groups on a consolidated basis. The principal obligation is set out in Article 7 IFR.

When does the obligation apply?

The obligation to apply certain prudential requirements on a consolidated basis arises when there is an 'investment firm group' (Article 4(25) IFR) in relation to an 'in-scope' investment firm that is itself captured by IFR/IFD. This scenario will materialise where the group in question consists of a number of 'undertakings' (a terms which includes corporates and partnerships) connected through classic parent/subsidiary relations where at least one undertaking is an investment firm but which does not include an EU credit institution (bank). The rational here is that IFR/IFD is not intended to interfere with consolidation provisions that would apply to a group having one or more European banks and which would continue to be conducted under the CRR/CRD framework. **Investment-firm-only sub-groups within banking groups will have to assess the impact and plan for implementation of consolidated supervision where applicable.**

Are there any derogations?

Yes, Article 8 IFR sets out an effective derogation from Article 7 consolidation requirement in the form of the Group Capital Test (GCT). The derogation is discretionary and rests with the relevant supervising authority. The GCT applies deliberately at the level of each parent undertaking point in an investment firm group and therefore a derogation may need to include more than one entity in its reference with a corresponding application for each parent undertaking (unlike prudential consolidation which applies at a single point at the top point of the investment group in the EU). In order to be eligible for the derogation, the parent undertaking concerned must demonstrate that it holds sufficient own funds relative to the total sum of the full book value of all of its holdings (including subordinated claims) in entities which would be within scope of prudential consolidation (disregarding deductions relating to the same holdings to avoid 'double counting') and the amount of its contingent liabilities to such entities. **The derogation is substantively different than the exemption under the old Capital Adequacy Directive which still applies in the UK under the BIPRU rulebook. The differences being the reference parameters that are required to be aggregated (own funds under CAD, book value under IFR) and which in the case of IFR would exclude any goodwill.**

At which level does consolidation apply?

IFR mandates that consolidation applies at the level of a Union parent investment firm, Union parent investment holding company or Union parent mixed financial holding company. Effectively, this means that consolidation will apply at the 'highest' level of the group within the EU and each group will have to apply its own idiosyncratic structure to the definitional elements to determine the identity of the consolidating entity which may or may not be itself regulated under IFR/IFD.

Importantly, in line with recent amendments to CRR/CRD, the obligations attaching to consolidating entities will apply at two levels: first, to the consolidating entity itself (irrespective of whether or not it is authorised under IFR/IFD) and second, to all investment firms in the group which are subject to IFR/IFD. This is a noticeable change in the scope of focus of regulation of consolidating entities and will require thoughtful consideration for affected groups not least from a governance, systems and controls perspective.

What does prudential consolidation mean?

Where prudential consolidation applies, it requires the consolidating entity to apply the requirements of the applicable parts of IFR/IFD as if all 'in-scope' undertakings falling within the perimeter of the investment firm group are crumpled into a single undertaking/entity.

Which undertakings are within scope of prudential consolidation?

The scope of prudential consolidation under the IFR/IFD includes the entire chain of entities which are owned by the consolidating entity directly or indirectly as a parent (simplistically, majority owned). In addition, it includes undertakings which are not majority owned in the group's chain where the stake constitutes a 'participation' (20% stake) or those with which entities in the group have specified types of relationships resulting in there being significant influence over such entity or common management of the entity together with in-scope entities within the group. These entities are subject to 'full consolidation', in other words their entire activities and risk are taken into account at the consolidating level irrespective of the actual percentage of ownership/control. The Draft Technical Standards set out an optional derogation by a decision of the group supervisor to permit a method other than full consolidation where full consolidation would not be appropriate due to their size or significance. **Insurance intermediaries are excluded from the scope of prudential consolidation.**

With regards to participations in undertakings, these may, with the supervisor's consent, be subject to proportional consolidation in line with the share of the capital held by the group entity. In order for this dispensation to apply certain parameters must be satisfied with regards to the maximum liability the group may incur, the regulated status of the target entity and the solvency of that entity.

In order to fall within the scope of prudential consolidation, group entities must fit within at least one the following types of defined entities: investment firms; financial institutions, ancillary services providers and tied agents. This terminology will capture all entities in the group involved in customer facing regulated activities other than insurance companies and banks. It will also capture operational entities providing services to support the provisions of regulated services across the group and pure holding companies, the latter under the 'financial institution' banner which includes holding companies predominantly owning financial services businesses. This definition, to the extent that it refers to regulated entities, must be applied to both EU entities within the group and to non-EU entities that would have to obtain the relevant regulated status had they been established in the EU. There are no sub-consolidation provisions under IFR with regards to non-EU components.

What aspects of IFR/IFD apply on a consolidated basis?

Article 7 of IFR requires consolidating entities to comply with the following aspects of IFR/IFD: 1. Own funds requirements (type of capital instrument that can meet the consolidated capital requirements); 2. Liquidity requirements; 3. Concentration requirements; 4. Ongoing capital requirements (including minimum initial capital); 5. Disclosure requirements; and 6. Reporting requirements. **Under Article 25 IFD, investment firms subject to prudential consolidation under IFR are also required to comply with the governance, transparency, risk management and remuneration provisions under Chapter 2 of Title 4 IFD.**

The obligation to comply with liquidity requirements on the basis of the group's consolidated position may be waived by the relevant supervising authority considering the nature, scale and complexity of the group in question. Whilst the IFR appears to require the consolidating entity to have liquidity resources at its own disposal, the recent FCA Discussion Paper suggested that reliance may be placed on liquid assets existing elsewhere in the group within the territory of the UK (ie by UK incorporated entities).

The most notable aspect of consolidation is item number 4 which concerns the calculation of applicable capital requirements on an ongoing basis. Like the solo calculation under Article 11 of the IFR, this requires investment firm groups to compute the higher figure produced by any of the following formulae: 1. Fixed Overheads Requirement; 2. Permanent Minimum Requirement; and 3. K-Factor Requirement. This necessitates the processing and computation of data for group entities irrespective of whether or not they are subject to IFR/IFD K-Factor requirements on a solo basis. So small and non inter-connected firms (Class 3 Investment Firm) and non-EU firms' K-Factor data will have to be readily available as if they are Class 2 firms regulated in the EU. This aspect of the regime is onerous and requires early assessment by groups.

Expected impact

Whilst many firms may benefit from the derogation contained in Article 8 of the IFR (depending on the supervising authority appetite to utilise this discretion) those investment firms that will be subject the consolidation provisions in Article 7 would need to take swift steps to determine the perimeter of consolidation and in particular identify the data sets required to be collected and aggregated in order to comply with the provisions of the new regime. Of particular challenge will be the collation of data in respect of firms that are not Class 2 firms because they are classified as Class 3, they are not investment firms (eg UCITS) or because they are not incorporated in the EU.

A different question altogether is whether the combination of the new capital requirement tests embodied in the IFR/IFD structure and the new consolidation provisions of IFR produce enhanced requirements for the top of investment firm group entities and which may necessitate capital injections and/or a restructure to optimise utilisation of capital.

Whilst it is not clear that this is a likely outcome of the assessment, given the complex nature of either of these measures and their implications for the group as a whole, we would advise an early examination of the impact of these provisions.

It is also disconcerting that investment firm groups with IFR regulated firms and at least one CRR regulated firm (due to it being a Class 1 firm) might need to conduct consolidated supervision under both regimes. This appears to be a duplicative outcome and which we would expect to be clarified and corrected during the next few months prior to implementation. It is notable that mixed banking and investment firm groups may be subject to both CRR and IFR consolidation depending on whether the investment firm sub-group is structured so as to give rise to an 'investment firm group' within the meaning of the IFR.

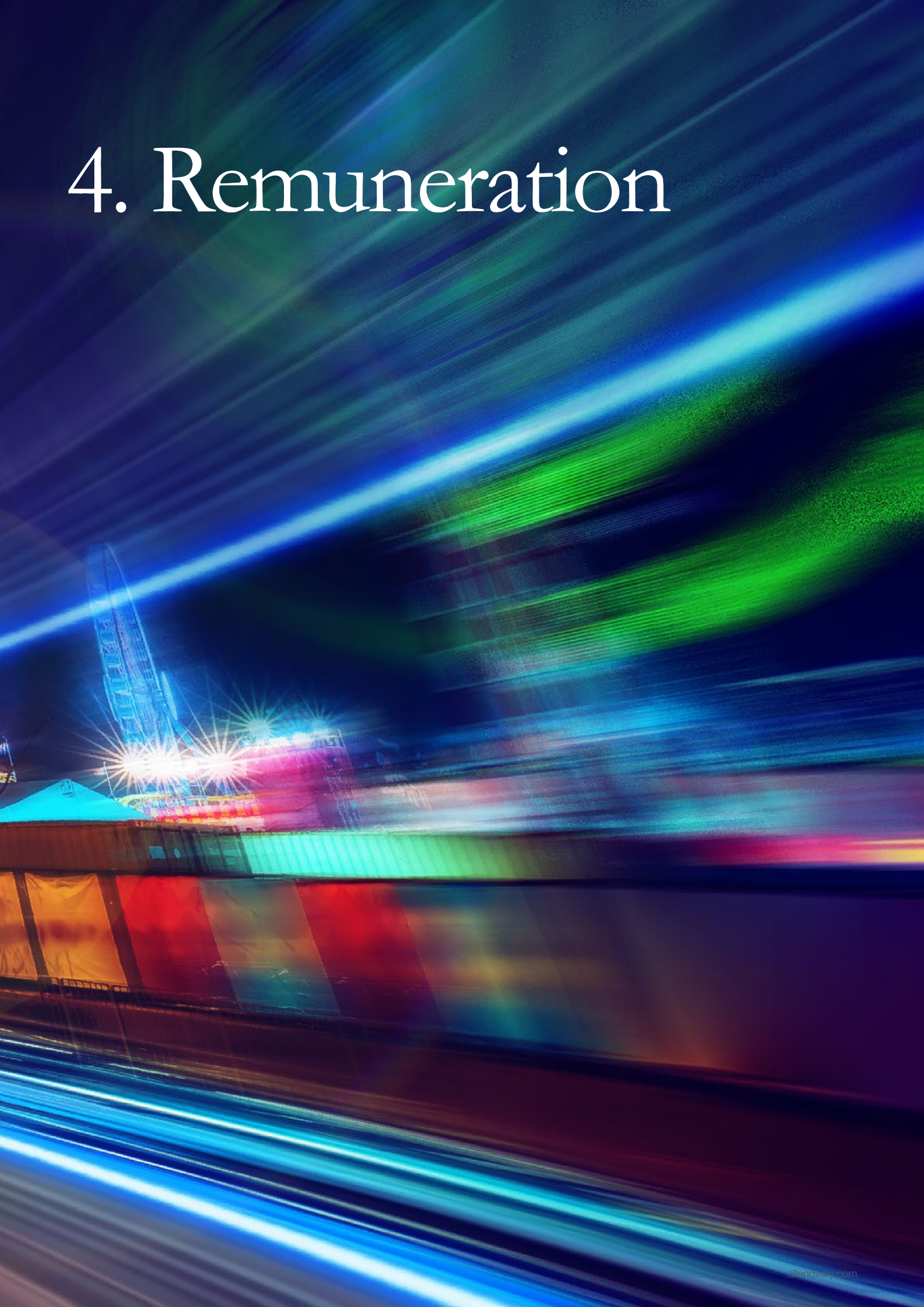
To summarise, the following steps need to be taken:

Assess application of prudential consolidation to your group and if relevant determine its scope

Consider high level impact assessment and any structural solutions

Prepare to implement across capital, liquidity, governance and reporting

4. Remuneration



Overview

The new EU prudential regime for investment firms largely continues the remuneration regime under the Capital Requirements Directive (**CRD IV**). In some respects, such as the replacement of the "bonus cap" with a requirement for firms to set appropriate ratios between fixed and variable pay, the remuneration requirements under the Investment Firm Directive (**IFD**) are less onerous than those in CRD IV. In other respects, such as the new, and significantly more restrictive proportionality framework, the IFD's requirements are more stringent than those in CRD IV. As with developments to the CRD IV remuneration rules under CRD V, IFD requires firms to adopt gender neutral remuneration policies.

The largest and most significant firms (**Class 1 firms**) will be subject to the CRD IV's remuneration requirements. Small and non-interconnected firms (**Class 3 firms**) are not subject to the IFD's remuneration requirements, whilst all other investment firms (**Class 2 firms**) must apply both high-level requirements relating to their remuneration policies, as well as more detailed and onerous requirements for variable remuneration. In certain cases, Class 2 firms can apply the IFD's proportionality framework to disapply some of the IFD's remuneration requirements.

Source materials

(a) IFD Recitals 22 to 26 and 41

(b) IFD Articles 25, 26(1)(d) and 30 to 35

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

(d) HM Treasury, Policy Statement "Prudential Standards in the Financial Services Bill: June update"

Summary of obligations

Class 2 firms must put in place remuneration policies and practices that are consistent with and promote sound and effective risk management. These policies and practices must be gender neutral.

Class 2 firms must identify 'material risk takers' (**MRTs**) – though, in a development from CRD IV, this now includes staff that have an impact on the risk profile of the assets managed by a firm. In DP20/2, the FCA has interpreted this to include all aspects of the MiFID activities carried out by the firm – ie, beyond assets under management, this could include client assets and the firm's own assets. The EBA, in consultation with ESMA, is to develop draft regulatory technical standards to identify MRTs. These must take into account the EBA's existing CRD IV remuneration guidelines, as well as the remuneration provisions of the UCITS Directive, AIFMD and MiFID. These are due to be submitted to the Commission by 26 June 2021.

Class 2 firms must then apply specific requirements to the variable remuneration of their MRTs. EU parent undertakings are required to ensure the identification of MRTs and the application of the remuneration rules on a consolidated basis, including in third countries.

Variable remuneration requirements are, in most respects, the same as those under CRD IV. Firms must assess variable remuneration in the context of the performance of the relevant individual, business unit and the firm, addressing both financial and non-financial criteria over a multi-year period to account for the business cycle of the firm. Variable remuneration should not jeopardise the firm's capital base, must generally not be guaranteed, and must not reward failure or misconduct. The calculation of the bonus pool should take into account both capital and liquidity risks to the firm and the allocation of variable remuneration must account for all current and future risks.

At least 50% of variable remuneration must be paid in instruments, rather than cash, though the IFD enables a more flexible approach to be taken to the choice of instruments than is available under CRD IV. The EBA, in consultation with ESMA, is to develop draft regulatory technical standards to specify the eligibility of certain types of instruments for the purposes of paying variable remuneration. These are due to be submitted to the Commission by 26 June 2021.

The pay-out of variable remuneration is subject to a deferral requirement of three-to-five years, paid out pro-rata across the deferral period (unlike changes made to CRD IV by CRD V, the minimum deferral period has not been increased to four years). Instruments paid out must then be retained by the recipient, though, unlike CRD IV, a minimum retention period of one year is not specified.

Whilst CRD IV's "bonus cap" is abandoned, firms must set an "appropriate" ratio between fixed and variable remuneration. This is expected to vary between different types of staff. Malus and clawback provisions covering all variable remuneration remain applicable, though these now focus on failures in individuals' conduct.

Discretionary pension benefits must be set in line with the business strategy, objectives, values and long-term interests of the firm. Upon retirement, these must be paid out in instruments and made subject to a five-year retention period. Where an employee leaves the firm before retirement, these must be held by the firm, in the form of instruments, for five years.

Remuneration committees must be established and must be gender balanced, which firms operating with fewer staff may find difficult to achieve in practice. The remuneration committee may be established at group, rather than firm, level – this is not expressly tied to the consolidation group, and so should be capable of implementation at an entity in a third country (eg a group parent). Whilst the FCA has adopted this view, the approach to be taken by EU Member States and the EBA remains to be seen.

When does the obligation apply?

These obligations will apply from 26 June 2021 (or, in the UK, when implemented in UK law by way of the upcoming Financial Services Bill and regulatory rules, the timing of which is expected to broadly mirror that of the EU, but is yet to be confirmed). In practice, these requirements will take effect based on the timing of the start of each firm's remuneration year.

Are there any derogations?

IFD Recital 22 indicates that the requirements under MiFID II Articles 9(3)(c) and 24(1), which focus on the prevention of conflicts of interest, as well as requirements relating to corporate governance, are sufficient for Class 3 firms. IFD Article 25 accordingly exempts Class 3 firms from the IFD's remuneration requirements.

Class 2 firms can apply two forms of proportionality assessments in order to disapply requirements on deferral, retention and pay-out in instruments (the **pay-out process rules**), as it is considered that these are not appropriate for small and non-complex investment firms or for staff with low levels of variable remuneration. The FCA currently permits malus and clawback to be disapplied on proportionality grounds but this discretion is not available under the IFD.

The first of these proportionality assessments relates to individual staff. The pay-out process rules can be disapplied for individuals with low variable pay of up to EUR50,000, representing up to 25% of the individual's remuneration. Competent authorities are permitted only to reduce this threshold.

The second proportionality assessment enables firms to disapply the pay-out process rules at the firm and, if applicable, the consolidated level. This requires that the value of the investment firm's on and off-balance sheet assets is, on average over the preceding four-year period, equal to or less than EUR100m. Competent authorities may reduce this threshold. Competent authorities may also increase this threshold up to EUR300m where appropriate, taking into account a particular investment firm and the characteristics of its group, if the investment firm:

(a) is not one of the three largest investment firms in its Member State by value of total assets;

(b) is not subject to recovery and resolution planning obligations under the BRRD, or is only subject to simplified recovery and resolution planning obligations under BRRD Article 4;

(c) has on- and off-balance sheet trading-book business equal to or less than EUR150m; and

(d) has on- and off-balance sheet derivative business equal to or less than EUR100m.

The EBA is also due to develop guidelines on the application of these proportionality requirements.

Remuneration committees are required for all firms other than those with an average on and off balance sheet value of less than EUR100m over the preceding four-year period. As this threshold is set by reference to the proportionality threshold discussed above, it is expected that this can also be increased to EUR300m to ensure consistency – whilst the FCA has adopted this view, it remains to be seen whether this will also be adopted by EU Member States and the EBA. Irrespective of the ability to increase the threshold, this is a significant departure from the position under CRD IV, which requires only "significant" firms to establish a remuneration committee and with the meaning of "significant" still subject to the discretion of competent authorities.

Expected impact

The IFD's remuneration requirements are likely to have the greatest impact upon those Class 2 firms that cannot meet the reduced proportionality thresholds, as these firms will no longer be able to disapply the pay-out process rules. The inability for any Class 2 firms to disapply malus and clawback requirements may also require changes to remuneration terms. Additionally, the impact may be significant for CAD-exempt firms (ie adviser-arrangers), as these are not currently subject to any remuneration rules, though this may be avoided where they meet the thresholds either to be classified as Class 3 firms (in which case the IFD's remuneration requirements will not apply at all) or, for Class 2 firms, to disapply the pay-out process rules on the basis of proportionality.

The proportionality thresholds are a significant departure from the existing CRD IV rules, which allow Member States a broad discretion to disapply rules where appropriate. In the UK, under the current FCA rules, proportionality is applied at the individual level to employees whose overall compensation package is less than GBP500k, provided that no more than 33% of this is variable remuneration. The UK also applies asset thresholds only to full scope MiFID firms, and, at GBP15bn and GBP50bn, these thresholds are substantially higher than those under the IFD, which apply to all MiFID firms. Combined with the expanded scope of MRTs, this means that the more onerous provisions of the IFD's remuneration regime are likely to apply to a materially broader set of employees than under the CRD IV regime.

In the UK, aspects of the new remuneration regime that appeared potentially radical will likely be implemented in a less striking way. In particular, IFD requires remuneration policies to be "gender neutral" and remuneration committees "gender balanced". However, the FCA has indicated the former adds little to the position under the Equality Act 2010, whereas it views the latter principle as requiring "firms to promote a culture of inclusion and ensure appropriate representation rather than prescribing equal representation". How EU competent authorities apply these requirements remains to be seen, especially in light of the mandated EBA guidelines on gender neutral remuneration policies.

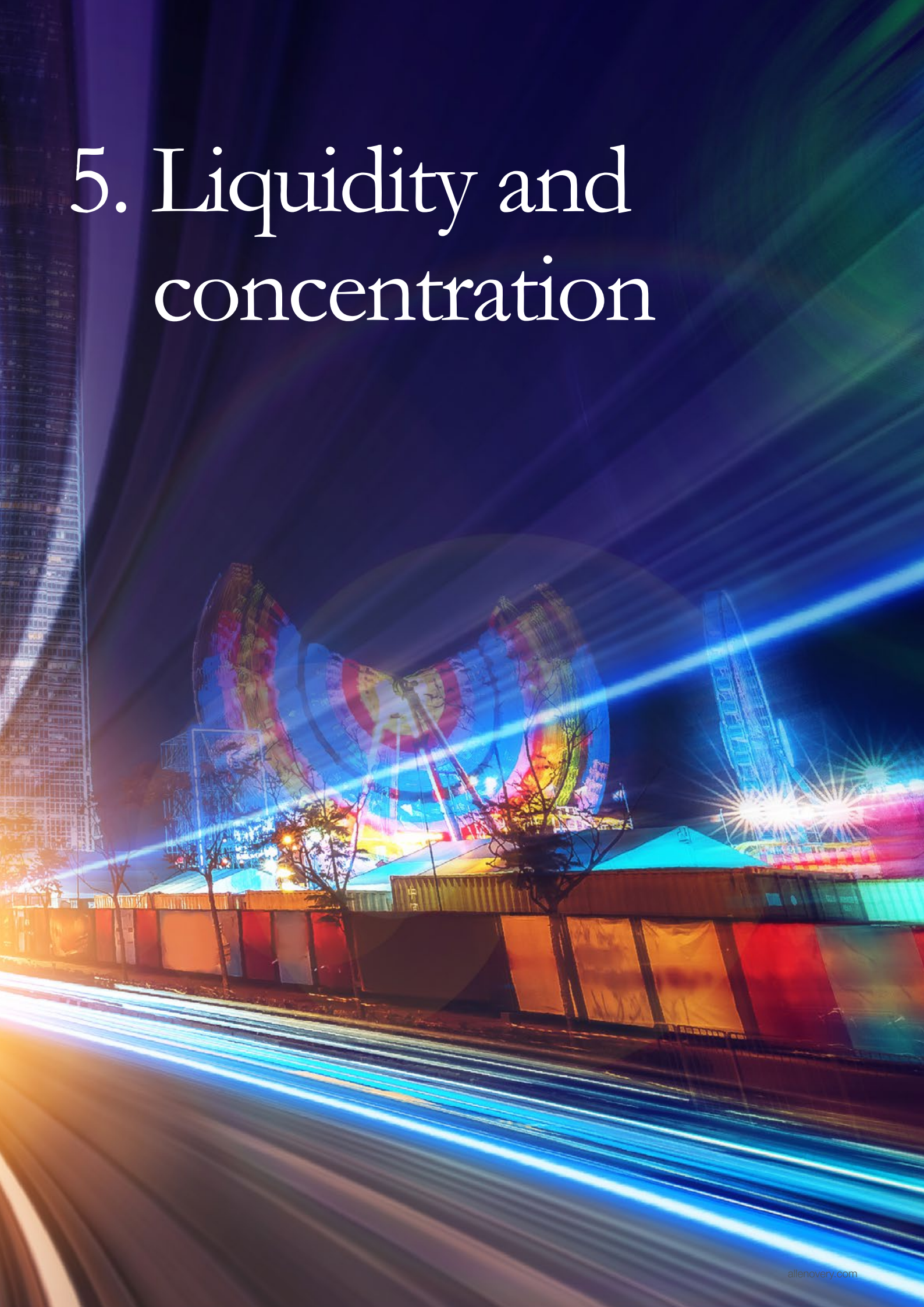
Finally, it is expected that many more Class 2 firms will be required to establish remuneration committees, though the ability to operate these at group level (and potentially outside the consolidation group) may reduce the significance of this impact.

To summarise, firms should:

identify changes to the existing remuneration rules that apply to them

assess the way the changes impact the firm's existing governance and remuneration arrangements

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.

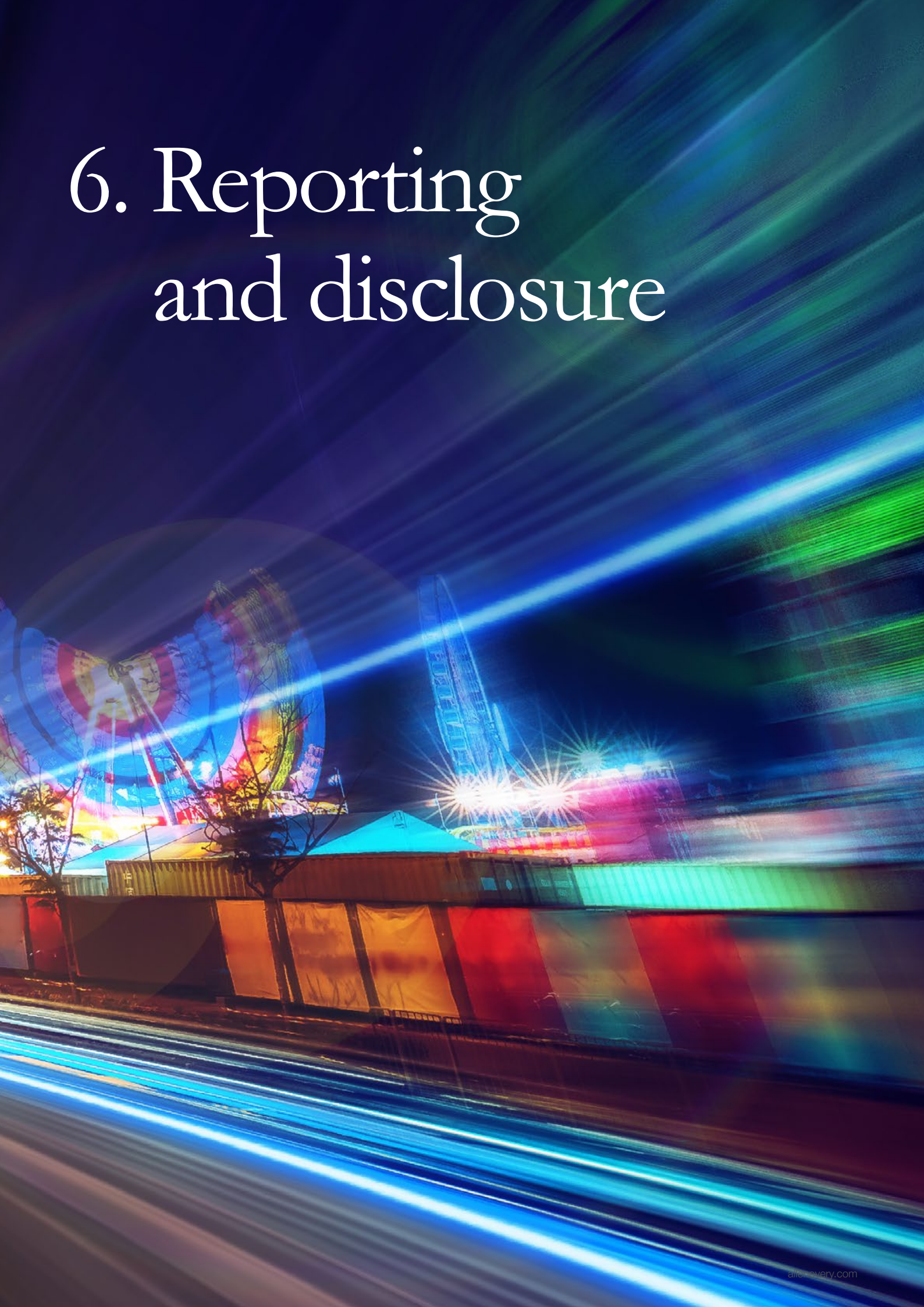
Similarly, concentration risk requirements will be new for a large number of investment firms (though Class 3 firms will be exempt from the more detailed requirements), with only full-scope investment firms having been previously subject to the CRR's large exposures rules. However, again, there is a 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

6. Reporting and disclosure



Overview

The Investment Firm Regulation (**IFR**) and the Investment Firm Directive (**IFD**) introduce a new reporting regime for investment firms. The regime is designed to be more appropriate and proportionate when compared to the existing requirements set out under the Capital Requirements Regulation (**CRR**). Much of the detail on what investment firms will be required to report remains to be prescribed through the technical standards drafted by the European Banking Authority (**EBA**), but the intention is to limit requirements to those data points relevant to the business model of investment firms. However, some of the concepts such as the K-factors and the areas of concentration risk that firms must monitor are new and will require firms to ensure appropriate governance arrangements and develop new systems and processes.

Similarly, the IFR introduces a proportionate public disclosure regime. Class 3 firms are only required to make public disclosures where they have issued Additional Tier 1 (**AT1**) instruments. For most investment firms, however, the regime introduces new disclosure requirements around remuneration and Environmental, Social and Governance (**ESG**), in line with new requirements and expectations for investment firms in these areas. This will drive a requirement for new systems and processes.

Source materials

(a) IFR Article 40(2), Articles 46 – 53

(b) IFR Articles 54 – 55

(c) IFD Articles 27, 34(4), 44

(d) EBA Consultation Paper EBA/cp/2020/06 setting out Draft Technical Standards dated 4 June 2020

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

Reporting obligations

Firms are required to report the level and composition of their own funds, their own funds requirements and the basis of the calculation, their activity profile and size, their liquidity requirements and their adherence to the provisions on concentration risk. See also our **IFR bulletin no 2** on capital requirements and our **IFR bulletin no 5** on liquidity and concentration.

Firms may also be required to report certain remuneration information. See also our **IFR bulletin no 4** on remuneration.

Class 3 firms do not have to report on concentration risk and may be granted an exemption from the liquidity reporting requirements.

Disclosure obligations

The starting point is that firms should publicly disclose certain corporate information, their levels of own funds, own funds requirements, governance arrangements, overall risk profile, risk management objectives and policies, investment policies and remuneration policies and practices in order to provide transparency to their investors and the wider market. Class 3 investment firms are not subject to public disclosure requirements, except where they issue AT1 instruments, in order to provide transparency to the investors in those instruments.

From 26 December 2022, firms will also be expected to disclose information on ESG risks, including physical risks and transition risks, as further defined in the report the EBA is to submit by 26 December 2021.

Each investment firm may determine the appropriate medium and location for their disclosures. However, to the extent possible, all of an investment firm's disclosures should be in the same medium and at the same location. If the information is provided in more than one medium, each medium should include a reference to the others. Competent authorities also have the power to require investment firms other than Class 3 firms which do not issue AT1 instruments, to use specific media and locations for disclosures, in particular the firm's website.

Frequency

The reporting obligations generally arise quarterly, except for Class 3 firms, which are required to report annually. Certain information, such as transfers of exposures exceeding the concentration risk limit or where a firm no longer meets all of the conditions for classification as a Class 3 firm, must be reported immediately or without undue delay. The disclosure obligations are annual and generally tied to the publication of the firm's annual financial statements. The ESG disclosure requirements will apply once in the first year and every six months thereafter.

The IFD also gives competent authorities the power to impose additional or more frequent reporting requirements and disclosures.

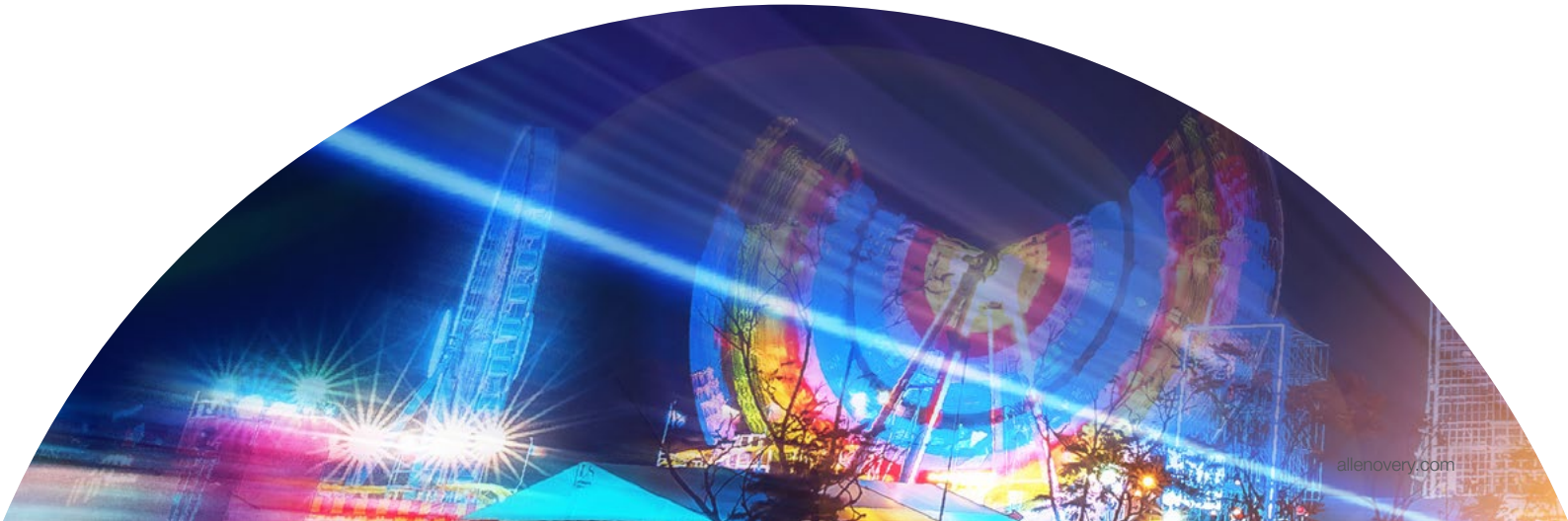
Exemptions?

The IFR gives competent authorities the ability to exempt a Class 3 firm from the reporting and/or disclosure requirements where such investment firm is a subsidiary and included in the supervision on a consolidated basis of certain entities, provided certain conditions are met. Commodity and emission allowance dealers also benefit from transitional provisions relating to the application of certain of the disclosure requirements.

Investment firms that benefit from a derogation from the remuneration requirements may also be exempt from the requirement to disclose their investment policies and ESG risks.

What if an investment firm fails to report or publicly disclose?

The IFD provides investigatory powers and powers of competent authorities to impose remedies, and the right of Member States to provide for and impose criminal sanctions. Member States are to lay down rules on administrative sanctions and other administrative measures and ensure that their competent authorities have the power to impose such sanctions and measures in respect of breaches of national provisions transposing the IFR and IFD, including in respect of reporting and disclosure failures.



The roadmap to implementation in the EU

In June 2020, the EBA published its roadmap on investment firms which seeks to provide clarity on the EBA's implementation choices in respect of the mandates it is given in developing the new regime. The EBA states that it will integrate Pillar 3 disclosure requirements with supervisory reporting by standardising the formats and definitions, which should facilitate compliance with both requirements. The EBA published a consultation paper on draft ITS on reporting requirements and on disclosure of own funds in June 2020 which it intends to finalise in December. It also anticipates publishing a consultation paper on draft RTS on disclosure of investment policy in November 2020 with a view to a final draft RTS in June 2021. Investment firms will be expected to submit the first supervisory reporting data with a reference date as of September 2021.

The impact of Brexit

In June 2020, the FCA published "A new UK prudential regime for MiFID investment firms" Discussion Paper which sets out the details of the IFD/IFR, and seeks feedback from stakeholders on the appropriate rules for the UK to apply in this area. In the context of reporting and disclosure, the FCA supports the IFR/IFD's more proportionate approach and would look to introduce a similar concept in its regime. It does not expect the reporting forms will be as complex or detailed as the current common reporting (COREP) forms in the CRR. However, given the new concepts such as K-factors and the areas of concentration risk that firms must monitor, new reporting forms will need to be developed.

The FCA note that a prudential consolidation group might expect to report, as a minimum, its consolidated own funds, consolidated own funds requirements, consolidated concentration risk and consolidated liquidity requirements (and potentially to a similar level of detail as at individual investment firm level). The FCA also currently requires investment firms in the UK to report consolidated financial statements (balance sheet and profit and loss) which are not covered by the current CRR (except where FINREP applies) or by the IFR. The FCA state that they do not expect this to change.

The EBA's technical standards in this area have not been finalised. While the UK has left the EU and would no longer be bound by such future standards and guidance, the FCA considers that it might be appropriate to take them into account when designing the UK regime.

And beyond?

By 26 June 2024, the Commission, in close cooperation with EBA and ESMA, must submit a report, together with a legislative proposal if appropriate, to the European Parliament and to the Council, on the appropriateness of the reporting and disclosure requirements in the IFR and IFD.

The report is to take into account the principle of proportionality and the relevance of the application of the disclosure requirements relating to investment policies for other sectors, including those systemic investment firms that remain subject to the capital requirements contained in the CRR and banks.

Expected impact

Whilst the new reporting and disclosure requirements are designed to be more proportionate and relate to more appropriate data points, the new aspects of the regime such as the K-factors, concentration risk and developing ESG requirements will require operational development. Firms must ensure that they have the systems and processes built and in place to capture all relevant data points. Firms should monitor and track the EBA's technical standards, which will provide the necessary outstanding detail in respect of reporting formats, reporting dates and definitions and associated instructions to ensure that their systems will meet the final standards.

The systems must identify trends which may result in an increase in capital requirements for the firm. They must also monitor the numerous thresholds which apply within the new prudential regime. They must be capable of triggering appropriate escalations and disclosures immediately or without undue delay where required (for example where a threshold relevant to the firm's classification is breached).

Firms must ensure that they have established clear lines of reporting internally and that the responsibility for reporting has been clearly designated. Firms which have on average on and off balance sheet assets greater than EUR100mn over the four-year period immediately preceding a financial year are required to set up a risk committee. In contrast to the Capital Requirements Directive, national competent authorities cannot waive this requirement but Member States can increase or decrease the threshold.

Risk and remuneration policies should be reviewed and, in some instances, new policies created. New risk management objectives must be set and strategies and processes developed. The firm's management body will also have to approve concise risk statements.

A firm's auditors must also be engaged in relation to certain of the required disclosures.

To summarise, firms should:

Identify and understand the application of the new reporting and disclosure requirements to your firm and group.

Review and where necessary build systems and processes.

Review and ensure appropriate governance structures are in place.

7. Internal capital and risk assessment process

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. 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.

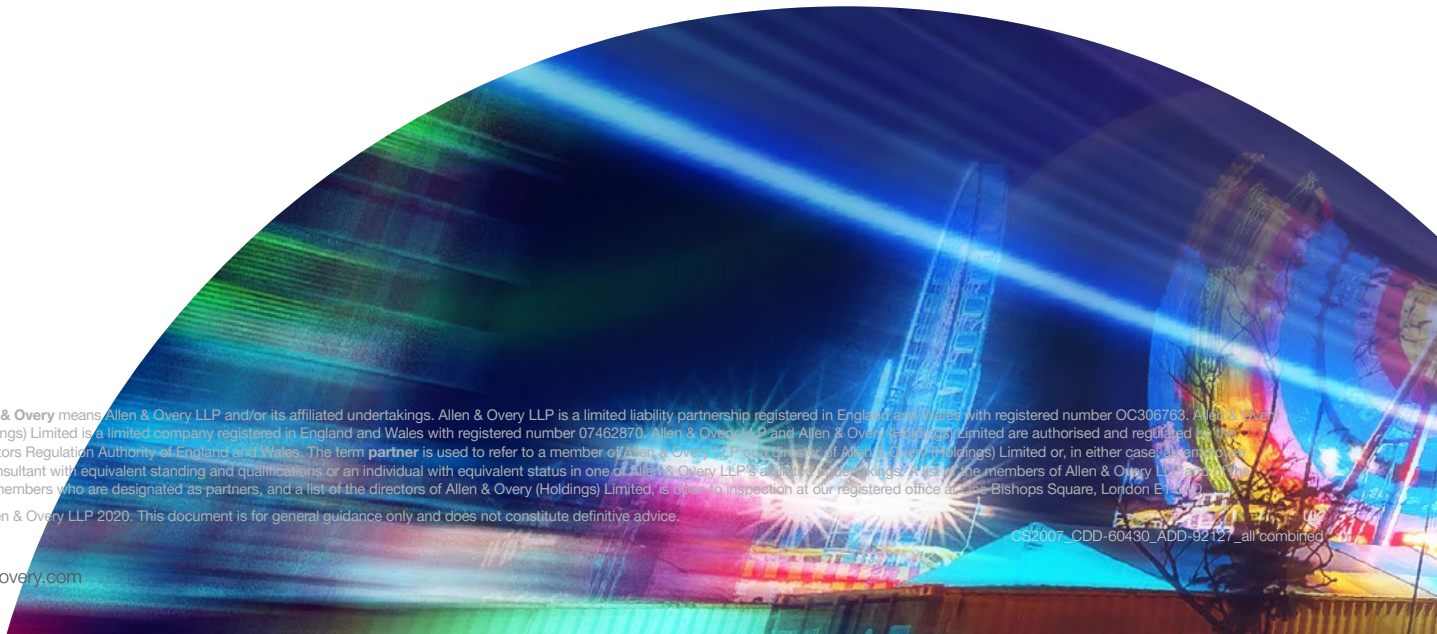
Class 3 firms will not be subject to regular, cycle-driven supervisory reviews. The FCA would still expect Class 3 firms to consider the risks which they may pose to others and to which they may be exposed themselves, although would not expect any documentation of this to be lengthy and unnecessarily 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.



CS2007_CDD-60430_ADD-92127_all combined