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New Prudential Regime for Investment Firms

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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

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