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Financial Services Risk and Regulation

EU's investment firms prudential regime: all change please

HOT TOPIC
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Highlight

The EU prudential regime for investment firms has been agreed and will be published this year in the Official Journal. The package will introduce strategic, operational and regulatory challenges for investment firms.

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Summary
The European Commission (EC) adopted a legislative proposal in December 2017 to amend the current EU prudential rules for investment firms. The package of measures, comprising of the Investment Firm Regulation and Investment Firm Directive, replace the Capital Requirements Directive/Capital Requirements Regulation (CRD/CRR) framework for investment firms. Following discussions between the European Council, Commission and Parliament, the final compromise texts on the regulation and the directive were announced on 19 March 2019. The regime has to be transposed by national competent authorities (NCAs) within 18 months after publication in the Official Journal. Publication is expected in October 2019, so the regime will come into force in April 2021 at the latest. A transition period of five years for capital requirements, during which capital requirements will be limited to twice the firm's current capital requirements under CRR (or twice their fixed overheads in the case of firms which were not subject to capital requirements under CRR) will apply. Also, CRR market risk rules will continue to apply for five years or until the application of CRR2 market risk rules, whichever is later. In the UK, it remains to be seen what impact Brexit has on the new rules. But, given the FCA's significant contribution to the proposals, we expect that the UK's implementation will align with the EU approach.

New regime coverage

The new regime revises capital requirements, capital composition, group consolidation, liquidity requirements, reporting, disclosure, governance, remuneration and supervision of investment firms as set out in CRD IV and CRR, and in the Markets in Financial Instruments Directive 2 and Regulation (MiFID2 and MiFIR).

Introducing a more proportionate and fit-for-purpose regime for investment firms, the new framework presents a significant revision to the existing prudential framework for investment firms.

The regime is relevant for firms undertaking MiFID activities including IFPRU and BIPRU firms, collective portfolio management investment firms as well as CRR investment firms supervised by the PRA.

Compared to the proposed framework, which we discussed in a previous Hot Topic, the final text includes notable changes in a number of areas with respect to:

- firm classification
- consolidated capital supervision and group capital testing
- capital floors
- K-factors
- concentration risk and reporting
- liquidity risk
- governance and remuneration
- Pillar 2 capital and supervisory focus
- third-country equivalence
- reporting and disclosure.

In this Hot Topic we discuss the key aspects of the final texts, analyse the potential impact on firms and set out the steps you should take.

Firm classification system

While the EC's initial proposal consisted of three classes for different types of investment firms, the final text has a more granular categorisation system. The final text keeps 'bank-like' (Class 1) firms subject to CRD/CRR with direct supervision (where applicable) by the European Central Bank (ECB) under the Single Supervisory Mechanism (SSM).

This captures firms with consolidated asset size above €30bn. In the UK, these are likely to be a similar group of firms to the current list of PRA-designated investment firms.

The final compromise text introduces two additional subclasses for Class 1 firms:

The first sub-class captures MiFID licensed firms providing underwriting and dealing on own account services with an asset size above €15bn. It subjects these firms to CRD/CRR but not to the direct supervision of the ECB under SSM.

The second sub-class captures MiFID firms providing underwriting and dealing on own account services with assets between €5bn and €15bn, for which national competent authorities (NCAs) can impose the CRD/CRR rules, depending whether the firm's activities pose a systemic risk or not.

Investment firms which deal on own account, underwrite financial instruments or place financial instruments on a firm commitment basis on a significant scale, or which are clearing members in central counterparties, may have business models and risk profiles that are similar to those of credit institutions. So competent authorities also have the option of continuing to subject these firms to CRR and CRD.

In line with the initial proposal, the final text set out a new and tailored prudential framework for the 'non-systemic' (Class 2) firms. Likewise, it also subjects 'non-interconnected' (Class 3) firms to much lighter prudential rules. Those are described in more detail below.

The categorisation between class 2 and class 3 firms is based on quantitative thresholds such as gross revenues, client money held etc. prescribed in the framework as initially proposed.

Consolidated capital supervision and group capital testing

The final framework requires consolidated supervision but introduces the group capital test as an alternative for groups that consists of only investment firms. This means that parent undertakings are required to comply with prudential requirements on a consolidated basis. But for simple groups (to be defined by the NCAs), NCAs can consider the regulatory capital position of the solo entity or entities, provided the parent undertakings in these groups have sufficient capital to cover the book value of their holdings in the subsidiaries and their contingent liabilities in favour of investment firms, financial institutions, ancillary services undertakings and tied agents in the group.

Capital floors

The new regime includes a capital floor i.e. minimum capital requirements (MCR). The MCR for Class 2 firms is the higher of the initial capital requirements (ICR), the fixed overhead requirement (FOR), and K-factor requirements. The FOR is equal to the 25% of the fixed overheads of the previous year.

Given their comparatively simpler business models, the capital requirements for Class 3 firms will be the higher of ICR and FOR. This new regime also revises the ICR to be either €750k, €150k or €75k based on the type of activities carried out by investment firms.

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K-factors

The final framework keeps the proposed 'K-factors' approach to capital requirements for Class 2 firms. This approach comprises a set of observable 'proxies' or factors to represent risks and a set of scalars or percentages to reflect the size of a firm. These capital proxies or factors are attributed to three risks: 'risk to customers' (RtC), 'risk to market' (RtM) and 'risk to firm' (RtF).

The capital requirement from the K-factor formula is the sum of RtC, RtM and RtF. To capture each of these three components, firms are required to use the respective metrics in the table below, multiplied by prescribed K-factors.

K-factors	Metrics
RtC	Assets under management (AUM), client money held (CMH), assets safeguarded and administered (ASA), customer orders handled (COH)
RtM	Net position risk (NPR), clearing member guaranteed (CMG)
RtF	Trading counterparty default (TCD) requirement, Daily Trading Flow (DTF) and concentration risk (CON) requirement

The final regime introduced important changes regarding the definition and scope of some of the controversial K-factors. For instance, it now allows investment firms to exclude from client orders handled (K-COH) those orders which have not been executed, where such non-execution is due to the timely cancellation of the order by the client.

The definition of K-CMH no longer has the word 'controls', reducing the scope by defining it as the amount of client money that an investment firm holds, taking into account the legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm.

The final framework also removed the double counting of K-COH with K-AUM, where the firm already calculates the latter in respect of its clients' investments. While the compromise text requires K-COH to include transactions which arise from investment advice in respect of which an investment firm does not calculate K-AUM, it excludes those transactions where the firm already calculates K-AUM.

Despite requests from the industry, the final text keeps the scope of assets under management (K-AUM) unchanged and includes ongoing advisory services within the definition of assets under management.

The framework allows investment firms to calculate the RtM K-factor by either the K-factor for net position risk (K-NPR) or the one for clearing member guarantees (K-CMG) instead of the higher of these two K-factors, eliminating the need to use both approaches. But it also gives the option to firms to apply K-NPR and K-CMG simultaneously on a portfolio basis.

Finally, for the purposes of calculating the K-NPR, investment firms which deal on own account are now allowed to apply either the simplified or the revised standardised approach under CRR2 or internal models, when FRTB will take effect. Until then, firms must apply the current CRR market risk framework (standardised approach or, if applicable, internal models) for a transition period of 5 years.

Concentration risk

The regime limits firms' maximum concentration risk exposure to 25% of its capital.

It also applies specific alternative thresholds in relation to credit institutions or other investment firms. Where the client is a credit institution or an investment firm (or where a group of connected clients includes one or more credit institutions or investment firms), the limit to concentration will be the higher of 25% of the investment firm's capital or €150m. If the amount of €150m is higher than 25% of the firm's own funds, the limit to concentration should not exceed 100% of the firm's capital. Where a firm exceeds these limits, it will be required to hold additional capital based on the excess over the limit multiplied by a factor between 200% and 900%, depending on the size of the excess.

But the regime will allow firms specialising in commodity derivatives, emission allowances or derivatives to exceed these limits without holding additional capital provided the limit breach is for group-wide liquidity or risk management purposes.

Liquidity risk

All investment firms must have internal procedures to monitor and manage their liquidity requirements and to hold a minimum of 1/3 of their fixed overheads requirement in liquid assets at all times. This is less stringent than the initial proposal, with NCAs now able to use their discretion to exempt Class 3 investment firms from this requirement. When exempting investment firms, NCAs will be required to follow the criteria which will be set by the EBA in consultation with ESMA.

While firms are required to use liquid assets which meet the definition under the LCR Delegated Act (i.e. Level 1, 2A and 2B assets), those Class 3 firms which are not exempted from liquidity requirements will be allowed to use liquid items related to trade debtors and fees or commissions receivable within 30 days as liquid assets, provided these do not exceed 1/3 of the minimum liquidity requirements, do not count towards any additional liquidity requirements imposed by the NCA, and that they are subject to a haircut of 50%.

Governance and remuneration

The final text includes changes to the governance and remuneration rules. While Class 2 firms will be subject to simpler and less granular remuneration disclosure requirements than Class 1 firms, they are required to have remuneration policies in place. For Class 3 firms, the regime does not introduce additional requirements apart from the MiFID requirements on governance and remuneration.

NCAs must monitor the remuneration of high earners but does not introduce a cap on the ratio between fixed and variable pay unless one is required by national law. It does not apply a bonus cap but NCAs will be allowed to apply this separately through national law.

For 'significant firms', the regime introduces a deferral of 40-60% of variable remuneration for Material Risk Takers (MRTs) over 3 to 5 years. It also requires at least 50% of variable remuneration to be given in shares, funds or equivalent. The final text lowers the threshold for exemptions from those rules to € 100m of on-and-off balance sheet assets instead of € 200m of balance sheet assets.

It also lowers the threshold for disapplying the requirements in relation to deferral and payment in instruments on an individual basis where the individual receives annual variable remuneration lower than €50,000 subject to the condition that it does not exceed 1/4 of their total remuneration instead of 1/3.

The regime will also apply malus and clawback to variable pay awarded to MRTs and mandates the EBA to set technical standards for the identification of MRTs in consultation with ESMA.

Pillar 2 capital and supervisory focus

The regime introduces new rules for Pillar 2 capital add-ons. For risks not covered by the Pillar 1 capital requirements, NCAs will be allowed to impose additional capital requirements. NCAs will also be able to set additional requirements in relation to capital and liquidity as part of their supervisory assessment of firms' internal governance and controls, risk management processes and procedures.

The final text requires firms to meet at least 3/4 of their additional capital requirements with Tier 1 capital. It also requires at least 3/4 of the Tier 1 capital to be composed of CET 1 capital.

Firms should also note that NCAs will have a greater focus on any regulatory arbitrage risks to avoid situations where investment firms would structure their operations according to thresholds set out in this Regulation.

To ensure effective supervision, firms meeting the credit institution definition under CRR must apply for authorisation as a credit institution and NCAs can apply sanctions to those firms that do not comply with this rule.

A firm must submit their authorisation application to become credit institution within one year and one day after the entry into force of the new regime or when they remain over the thresholds for classification as credit institution over 12 months.

Third-country equivalence regime

The final compromise tightens the supervision of the third country firms and the regulatory equivalence conditions. For instance, third country firms operating in the EU through branches will be required to report to NCAs information concerning the scale and scope of services that they provide and activities that they carry out in the EU.

NCAs must share this information with ESMA upon request and notify ESMA on an annual basis of the list of branches of third-country firms active in their territory.

Firms should note that the Commission may introduce conditions to an equivalence decision for third-country firms whose activities are of systemic importance to ensure that ESMA and NCAs are able to monitor their activities and to eliminate any regulatory arbitrage opportunities.

ESMA's supervisory and enforcement role is strengthened, by extending its temporary intervention powers to third country firms so that it can prohibit or restrict a third-country firm from providing investment services or performing investment activities with or without any ancillary services. But ESMA must base its decisions on documented evidence that the activities of the firm are risky.

The final text also introduces amendments to Article 47 of MiFIR to ensure that prudential, organisational and conduct requirements are given due consideration in equivalence decisions in relation to the MiFID II/MiFIR third country equivalence rules.

Reporting and disclosure

Class 2 firms must report all key metrics including their level of capital, K-factors and the firm's categorisation parameters quarterly while Class 3 firms may report annually. The EBA is expected to draft technical standards on the templates for the public disclosures and regulatory reporting requirements.

Class 2 firms must also provide additional granular reporting on capital and liquidity, and concentration risk reporting, as well as pillar 3 disclosures on the level of capital and capital requirements, while class 3 firms are exempt from those.

Small and non-interconnected firms are also exempt from reporting concentration risk, and only have to report liquidity requirements where these apply. But NCAs can impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions, as long as the information to be reported is not duplicative.

The EBA is expected to set proportionate technical standards for Class 3 firms regarding the formats and reporting dates in consultation with ESMA.

Some firms will have to make additional disclosures on environmental, social and governance (ESG) objectives, to assess possible sources and effects of such risk on the firm. Firms with average on-and off-balance sheet assets of over €100m over the previous four year period should consider these risks, although this will require transposition in national law, potentially granting NCAs some implementation discretion. The EBA is expected to introduce further technical guidance on these requirements within two years from the implementation date of the regime.

ESG-related requirements are also expected to be used as part of the supervisory review and evaluation process subject to further consideration by the European Commission 3 years after the implementation of the new prudential regime.

What does this mean for firms?

- The new prudential regime applies to all MiFID 2 firms and therefore captures all investment firms that carry out activities which include transmission of orders in relation to financial instruments, execution of client orders, dealing on own account, managing portfolios, providing investment advice, underwriting financial instruments and operating trading facilities.
- While the EBA indicates that the overall impact in terms of capital for the investment firms' population should be limited (10% increase overall for Class 2 firms), some firms (for instance investment advisers) will experience a substantial increase in requirements. The regulator will expect firms to be proactive in undertaking an impact analysis to assess if the change in rules results in a significant change in the capital adequacy for their firm. This impact analysis should be integrated into the firm's capital planning documents, such as the ICAAP and any other forward looking assessments of capital adequacy.
- Additionally, firms should develop plans to address any gaps highlighted by this analysis, to ensure they can be fully compliant ahead of implementation. Actions such as raising capital or re-engineering business operations to improve capital efficiency can take time, so firms should be aware of these gaps as soon as practically possible.
- Firms will need to ensure they have robust processes in place to capture the data required for calculation of the K-Factors and to report their firm classification thresholds. These will require firms to have implemented these processes well ahead of implementation.
- The proposed changes to the ICR and MCR mean Class 3 firms are likely to need to maintain a higher level of capital on an ongoing basis, which will increase their capital cost. Firms must also develop the capability of on-going capital assessment and planning to ensure capital adequacy.
- While the calculation of liquidity requirements is simplified, both class 2 and class 3 firms must hold their liquid assets in the form of HQLA. This means that firms may need to change their stock of assets to better quality assets, thereby increasing their liquidity cost.
- It is also important for firms to consider the permissions they hold/business they undertake and the implications for remuneration.

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