Financial Services Regulatory Insights

FCA consults on new prudential regime for investment firms

AT A GLANCE

December 2020

What's new?

- The FCA published CP20/24: A new UK prudential regime for MiFID investment firms on 14 December 2020, the first of three consultations to implement the new UK Investment Firm Prudential Regime (IFPR)
- The FCA's first tranche of rules introduce the IFPR, focusing on reporting, Pillar 1 capital requirements, own funds rules, prudential consolidation and the group capital test. It also proposes a range of transitional provisions for firms facing the largest capital increases.
- In addition the FCA has published a proposed template for the new reporting to support the IFPR and the guidance for completing this template.

What does this mean?

- The new regime represents a major change for FCA prudentially-regulated investment firms (FCA investment firms).
- The draft rules will apply to all MiFID investment firms.
- The IFPR simplifies the prudential regime for all FCA investment firms. At present, there are many different regimes which apply depending on size and type of firm; now there will be two categories: those firms that meet the criteria to be 'small and non-interconnected', and all other firms that do not.
- The regime intends to refocus prudential requirements and expectations away from risks the firm faces, to also consider and mitigate the potential for harm the firm can pose to itself, consumers and markets.
- In addition, te regulator believes that the new regime should help to reduce barriers to entry and allow for better competition between investment firms.
- IFPR introduces a number of specific changes to the existing prudential regime for FCA investment firms. These include:
  - **Firm categorisation -** replacing the current definitions of FCA investment firms (e.g. BIPRU, IFPRU) with two broad categories. Firms will either be a 'small and non-interconnected' (SNI) investment firm, or they will not.
  - **Prudential consolidation** - prudential consolidation will apply to investment firm groups, except if the FCA has granted permission to a group to use the alternative of the group capital test. The regulator is proposing to introduce a group capital test for FCA investment firms that do not wish to be subject to prudential consolidation, provided they meet certain specified conditions.
  - **Own funds** - the regulator proposes that own funds should be made up solely of common equity tier 1 capital, additional tier 1 capital and tier 2 capital.

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- **Own funds requirements** - the FCA proposes a new permanent minimum requirement for own funds, based on the activities that an FCA investment firm undertakes. The FCA also intends to increase the initial capital required for authorisation,which will be set at the same level and quality as the ongoing permanent minimum requirement.
- **Calculation of K-factors** - the proposals confirm a new approach for calculating capital requirements – 'K-factors'. The CP provides details on the additional K-factors that will apply to FCA investment firms with permission to deal in investments as principal. The remaining K-factors, could apply to any FCA investment firm will be covered in the next consultation.

  For firms that trade in their own name, the regulator is introducing an additional K-factor (K-CON) to assess concentration risk that could lead to an increased own funds requirement.
- **Concentration risk monitoring** - the FCA is proposing new monitoring requirements for general concentration risk that will apply to all FCA investment firms (including entities with which FCA investment firms place client assets and their own cash).
- **Reporting requirements -** the CP sets out proposed changes in regulatory reporting to account for IFPR.

What do firms need to do?

- The IFPR is a complex piece of regulation, and firms should carefully consider the rules.
- This consultation begins to provide greater clarity on some aspects of the UK regime, including where there is divergence with the EU's approach (the FCA is both more proportionate in some areas, and more robust in others).
- Firms should already by underway with implementation, particularly those with EU entities where the rules take effect in June 2021. With these additional draft UK rules, firms can begin a line-by-line analysis of the UK regme.
- The wider aspects of the regime should not be underestimated. The new ICARA process will require firms to understand and manage risk in an entirely new way, and will take time to drive through the business.
- In particular firms will want to use this paper to consider the impact of the revised regulatory consolidation rules on group structures.
- Firms will also benefit from modeling the K-factors, own funds requirements and deductions to form a more accurate view of the potential impact on their capital position.

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Next steps

The deadline for responding to the consultation is **5 February 2021.**

The FCA intends to publish two further consultations to implement IFPR over the course of **2021**.

The final rules will enter into force on **1 January 2022**, subject to the FS Bill passing through Parliament.