The FCA launched 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 regulator’s first tranche of rules introduce the IFPR, and focus on reporting, Pillar 1 capital requirements, own funds, prudential consolidation and the group capital test. It also proposes a range of transitional provisions for firms facing the largest capital increases. 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 FCA will publish a Policy Statement (PS) and near-final rules after each consultation. The UK final rules will enter into force on 1 January 2022, subject to the FS Bill passing through Parliament.

The regime represents a wholesale change to the prudential framework for UK-authorised investment firms, covering a considerable breadth of areas including capital, liquidity, remuneration, reporting and the underlying supervisory approach. While the first consultation provides greater clarity on certain aspects of the UK regime, this is a complex piece of regulation which requires careful consideration by firms.

**Context and timescales**

The EU Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) will enter into effect on 26 June 2021. The FCA intends for the domestic IFPR regime to achieve the same overall outcomes, but acknowledges that certain amendments are appropriate to account for the specifics of the UK market, from 1 January 2022.

The FCA will stagger the topics on which it consults, with the first consultation covering topics that the regulator believes firms will require the most time to prepare for. The FCA’s provisional consultation timeline is set out in the table on the right-hand side.

The regulator states that near-final rules establishing the key aspects of the regime will be in place by the time the second PS has been published. The third consultation and PS will address final points of the regime, consequential amendments to the Handbook, and any gaps or issues identified through the consultation process.

**First consultation (December 2020)**

- MIFIDPRU1: Application (aspects of)
- MIFIDPRU2: Prudential consolidation and the group capital test
- MIFIDPRU3: Own funds resources
- MIFIDPRU4: Own funds requirements (aspects of)
- MIFIDPRU5: Concentration risk
- MIFIDPRU9: Regulatory reporting (aspects of)

**Second consultation (expected early Q2 2021)**

- MIFIDPRU1: Application (remainder)
- MIFIDPRU4: Own funds requirements (remainder)
- MIFIDPRU6: Liquidity
- MIFIDPRU7: Risk Mngt & Governance, ICARA and SREP
- MIFIDPRU9: Regulatory reporting (remainder)
- Other: Remuneration requirements
- Other: Interaction between MIFIDPRU and other prudential sourcebooks
- Other: Permissions and application forms

**Third consultation (expected Q3 2021)**

- MIFIDPRU8: Disclosure & ESG
- Other: Consequential amendments to Handbook and CRR technical standards
- Other: Approach to existing BRRD and FICOD provisions
- Other: Final overall application provisions
Categorisation of firms

Small and non-interconnected FCA investment firms (SNIs)

The FCA is maintaining its proposal to replace the current definitions of FCA investment firms (e.g. BIPRU, IFPRU) with just two broad categories: firms will either be a 'small and non-interconnected' (SNI) investment firm, or they will not.

The categorisation is intended to introduce additional proportionality within the regime, which will span not just the calculation of prudential requirements, but also apply to other areas of the IFPR such as disclosure and remuneration.

To qualify as an SNI, an investment firm:

- must not carry out activities that have the greatest potential to cause harm to its customers or to the markets in which it operates (i.e. firms with permissions to deal on their own account), and
- must not carry out any activities on such a scale that would cause significant harm to customers or to the markets in which it operates.

The FCA has proposed quantitative thresholds for assessing the scale of activities carried out by an FCA investment firm. The below table sets out the thresholds an FCA investment must be below to be considered an SNI. If regulatory consolidation exists, the thresholds should be assessed on a group basis.

<table>
<thead>
<tr>
<th>Measure*</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets under management</td>
<td>£1.2 billion</td>
</tr>
<tr>
<td>Client orders handled - cash trades</td>
<td>£100 million per day</td>
</tr>
<tr>
<td>Client orders handled - derivative trades</td>
<td>£1 billion per day</td>
</tr>
<tr>
<td>Assets safeguarded and administered</td>
<td>zero</td>
</tr>
<tr>
<td>Client money held</td>
<td>zero</td>
</tr>
<tr>
<td>On- and off-balance sheet total</td>
<td>£100 million</td>
</tr>
<tr>
<td>Total annual gross revenue from investment services and activities</td>
<td>£30 million</td>
</tr>
</tbody>
</table>

* These thresholds, with the exception of the on- and off-balance sheet total, only relate to the MiFID activities the firm undertakes.

A non-SNI investment firm can become an SNI firm if it:

- meets all the requirements for being an SNI FCA investment firm, and
- continues to meet all the requirements for a continuous six-month period, and
- has notified the regulator that it has met all the conditions for being an SNI FCA investment firm for a continuous six-month period.

A firm will no longer be a SNI FCA investment firm three months after the date on which the relevant threshold was first exceeded if it no longer meets any of these thresholds:

- assets under management
- either or both of the client orders handled
- the on- and off-balance sheet, or
- the total annual gross revenue.

Prudential consolidation and the group capital test

Scope of application

Prudential consolidation will apply to all FCA investment firm groups, except if the FCA has granted permission to a group to use the alternative of the group capital test (GCT). The regulator is proposing to introduce a GCT test (see below) for FCA investment firms that do not wish to be subject to prudential consolidation, provided they meet certain specified conditions.

The FCA’s approach to prudential consolidation under the IFPR is broadly similar to the CRD/CRR, for those firms familiar with that approach. The obligation for ensuring compliance with regulatory consolidation is now the responsibility of the parent entity, rather than the regulated entity. An FCA investment firm group will comprise a UK parent undertaking and its relevant subsidiaries, where at least one entity is an FCA investment firm.

The definition also includes connected undertakings that are not subsidiaries. If any one of the subsidiaries or connected undertakings is a UK credit institution then the group will not be an FCA investment firm group. A relevant subsidiary and a connected undertaking is any of the following:

- an investment firm
- a financial institution
- an ancillary services undertaking
- a tied agent.

In theory, an FCA investment firm group may be subject to consolidation under both the UK CRR and the IFPR if the group contains a PRA-designated investment firm and an FCA investment firm, or a subset of firms could form an IFPR sub-group within a banking group. These different prudential consolidations have different consolidated requirements, as each focuses on different types of risk or harm. The group would have to satisfy both sets of consolidated requirements.

Obligations for prudential consolidation

UK parents to which consolidation applies must comply, on the basis of its consolidated situation, with obligations in these areas:

Composition of own funds

Own funds should be made up solely of common equity tier 1 (CET1) capital, additional tier 1 capital and tier 2 capital.

Own funds requirements

The FCA is proposing that the total consolidated own funds requirement of an FCA investment firm group must be met with consolidated own funds. The requirements will be the highest of:

- the consolidated fixed overheads requirement (consolidated FOR)
- the consolidated permanent minimum capital requirement (consolidated PMR), or
- if the UK parent entity is treated as a non-SNI FCA investment firm, the consolidated K-factor requirement (consolidated KFR).

However, the overall capital requirement for many firms will be greater due to the additional capital requirements created through the Individual Capital and Risk Assessment (ICARA) process.
**Concentration risk**
Firms face new monitoring requirements for general concentration risk, which will apply to all investment firms (including entities with which FCA investment firms place client assets and their own cash). Firms that trade in their own name will need to calculate an additional K-factor, K-CON, for assessing concentration risk that could lead to an increased own funds requirement.

**Liquidity**
As a baseline, prior to the ICARA process, a consolidation group must hold an amount of liquid assets equal to or greater than one third of the amount of the consolidated FOR, plus 1.6% of the guarantees provided to clients by entities in the consolidation group.

**Reporting**
UK parents for which prudential consolidation applies must comply with reporting requirements for the consolidated group.

**Additional requirements**
The application of the ICARA process on a consolidated basis will be consulted on in the next consultation. Consolidated requirements for disclosure and governance and remuneration will follow in subsequent consultations.

**Group Capital Test (GCT)**
The FCA is proposing a GCT for firms that do not wish to be subject to prudential consolidation, provided they meet certain conditions. In order to use the GCT, the investment firm group must satisfy the regulator that:
- the group has a sufficiently simple structure to justify applying the group capital test, and
- there is no significant risk of harm to others that means that the investment firm group should be supervised on a consolidated basis.

In addition, the UK parent (or other intermediate holding companies) must hold enough own funds to cover at least the sum of the full book value of their holdings, subordinated claims and instruments in subsidiaries, and the total amount of their contingent liabilities in the investment firm group.

Each UK parent firm in an FCA investment firm group must report individually on how it is meeting the GCT.

If an investment firm group contains a parent entity that is established outside the UK, the FCA’s expectation is that its parent in the UK, known as a responsible UK parent, must ensure compliance with the GCT. The responsible UK parent must either:
- ensure that the non-UK parent entity holds sufficient own funds to meet its own GCT, or
- itself hold an additional amount of own funds in respect of (i) above as part of its own GCT.

The UK responsible parent must also report on behalf of any third-country parent to show that it meets the above criteria.

An investment firm group can opt to apply the requirements of the GCT, rather than those of prudential consolidation, on a temporary basis before the FCA grants permission if the following conditions are met:
- the parent of, or an investment firm within, the investment firm group has applied to the FCA for permission to use the group capital test within a month of the date on which the new IFPR rules first apply, and
- the management body thinks there is a reasonable basis to conclude the investment firm group would satisfy the criteria to be granted permission to use the GCT.

**Own funds - definition and composition of capital**
Own funds will need to be made up solely of CET1 capital, additional tier 1 capital and tier 2 capital. The paper sets outs proposals for the provisions in the UK CRR and MiFIDPRU that relate to each tier of regulatory capital.

Under IFPR, firms must deduct certain items from their own funds. For some firms this will be entirely new; for those familiar with the UK CRR regime, a number of items which have the potential for partial deduction from the different tiers of own funds under UK CRR will now need to be deducted in full:
- defined benefit pension fund assets on the balance sheet of the institution
- deferred tax assets that rely on future profitability
- non-significant investments in financial sector entities, as far as they relate to holdings of capital instruments that are not held in the trading book
- significant investments in the CET1 instruments of financial sector entities.

Unlike the EU, the FCA proposes to require software assets to be deducted in full under IFPR.

An FCA investment firm with qualifying holdings in entities outside the financial sector will be required (subject to a specific exceptions) to deduct any amount of such holdings from its CET1 capital, where this exceeds the following limits:
- an individual qualifying holding in a non-financial sector entity exceeds 15% of the FCA investment firm’s own funds
- the total of all the qualifying holdings in non-financial sector entities exceeds 60% of the FCA investment firm’s own funds.

The FCA proposes that firms maintain own funds above these percentages of their own funds requirements:

1. Common Equity Tier 1 capital ≥ 56%
2. Common Equity Tier 1 capital + Additional Tier 1 Capital ≥ 75%
3. Common Equity Tier 1 capital + Additional Tier 1 Capital + Tier 2 capital ≥ 100%

**Trigger events for Additional Tier 1 (AT1) Capital**
The FCA proposes that to avoid a firm breaching its CET1 requirement, it must set a trigger level at which it converts its AT1 capital. This trigger, which can be augmented by additional triggers, must be set at no less than a firm’s CET1 capital falling to 64% of its total own funds requirement. This mirrors existing requirements under CRR, but is expressed in a different way to reflect the structure of capital under the IFPR.

**Own funds requirements**

**Ongoing permanent minimum capital requirement (PMR)**
The FCA proposes a new permanent minimum requirement for own funds, based on the activities that an FCA investment firm undertakes. The table overleaf sets out the amount of the PMR that the regulator proposes will apply to an FCA investment firm based on the investment services and activities it carries out.
K-factor requirements

This FCA consultation paper focuses on some specific K-factors, which will apply to firms that have permission to deal as principal, including where they do so on behalf of clients. All the remaining K-factors that may apply to any FCA investment firm will be covered in the next consultation.

The K-factors that apply to FCA investment firms dealing as principal are:

- net position risk (K-NPR) – a requirement based on the FCA investment firm’s market risk
- clearing margin given (K-CMG) – an alternative to K-NPR to provide for market risk based on the margins given by the FCA investment firm to a clearing member
- daily trading flow (K-DTF) – a requirement based on the value of the FCA investment firm’s daily trading flow
- trading counterparty default (K-TCD) – a requirement based on the risk of a trading counterparty failing to meet their obligations to the FCA investment firm.

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.

Other K-factors, which potentially apply to all firms, may also apply to FCA investment firms that deal as principal, depending on the investment services or activities carried out. These are K-factors for:

- individual portfolio management and ongoing advice (K-AUM)
- holding client money or client assets, (K-CMH and K-ASA)
- handling client orders (K-COH).

Initial capital requirement (ICR)

The FCA has set the initial capital required for authorisation at the same level and quality as the PMR.

Application to firms authorised to conduct MiFID business

The IFPR will not affect the ICR of FCA investment firms that are authorised ahead of the IFPR taking effect. Their ICR will no longer be relevant for the purposes of their capital requirements, or any other requirements, under the IFPR. These FCA investment firms should instead consider what their PMR will be under the IFPR and how they will transition to that new requirement. The PMR will form one of the ‘floors’ to their capital requirements.

Capital requirements for SNI and non-SNI investment firms

The own funds requirements for non-SNI groups will be the higher of the PMR, FOR and their KFR, while for SNI groups it will only be the higher of the PMR and FOR. The FCA will address how a firm should calculate the FOR in a subsequent consultation.

<table>
<thead>
<tr>
<th>PMR</th>
<th>FCA investment firm service/activity</th>
</tr>
</thead>
</table>
| £750,000 | MiFID activities undertaken include one or more of:  
• dealing on own account  
• underwriting and/or placing on a firm commitment basis  
• operating an Organised Trading Facility (OTF) without a limitation that prevents both matched principal trading and dealing on own account. |
| £150,000 | All other FCA investment firms, including, but not limited to, firms with permission to:  
• operate a Multilateral Trading Facility (MTF)  
• operate an OTF, only with a limitation that prevents it from carrying out either of the following:  
• matched principal trading  
• dealing on own account. |
| £75,000  | Unless, MiFID activities undertaken only from among the following:  
• reception and transmission of orders  
• execution of orders on behalf of clients  
• portfolio management  
• investment advice  
• placing without a firm commitment basis.  
And, the firm does not have permission to hold client money or securities during the course of MiFID activities. |

Own funds requirements – transitional provisions

The transitional provisions give investment firms up to five years to comply with specific elements of IFPR implementation, particularly to ease the change for firms with an increase in own funds requirements under the new regime. But these are by exception, and the majority of the regime comes into force in January 2022. The transitional provisions will also apply to the calculation of capital on a consolidated basis.

The provisions allow some firms to limit their own funds requirements derived from their FOR or KFR to twice their own funds requirements calculated under their old regime. Firms able to apply these transitional provisions are required to re-calculate their own funds requirements under both the existing regime and the IFPR on at least a quarterly basis throughout the periods that they intend to rely on the transitional provisions.

We still await detail about transitional provisions under Pillar 2 requirements, which will drive the capital requirements of many firms.
Concentration risk monitoring and K-CON

The FCA imposes new monitoring requirements for general concentration risk that will apply to all investment firms (including entities with which FCA investment firms place client assets and their own cash). The regulator expects all FCA investment firms to monitor and control all sources of concentration risk, including:

- exposures in a trading book
- assets (for example, trade debts) not recorded in a trading book
- off-balance sheet items
- the location of client money
- the location of client assets
- the location of its own cash deposits
- the sources of its earnings.

Calculation of exposure value (EV)

Investment firms dealing on their own account must calculate an EV for each client or group of connected clients by adding together:

- the positive excess of long positions over short positions in all the trading book financial instruments issued by the client in question, using the approach for K-NPR to calculate the net position for each instrument, and
- the exposure value of contracts and transactions with the client in question, calculated using the approach for K-TCD.

FCA investment firms that have permission to use K-CMG (the K-factor requirement for clearing margin given) for any of their portfolios will still need to use the rules for K-NPR to calculate their net position for the exposures in those portfolios, for the purpose of calculating any K-CON requirement.

Concentration risk ‘soft limit’

The proposed rules specify a concentration risk soft limit for trading book exposures to a client or group of connected clients. If the EV to a client or group of connected clients exceeds this limit, a further capital requirement, the K-CON, will then apply.

The concentration risk soft limit will generally be 25% of an FCA investment firm’s own funds. However, where the client is, or the group of connected contains, one or more banks or investment firms, the FCA propose that the soft limit should increase to the lower of £150 million or 100% of the FCA investment firm’s own funds.

Exceptions apply in the case of the sum of EVs to connected clients or groups of connected clients. If the EV to a client or group of connected clients exceeds this limit, a further capital requirement, the K-CON, will then apply.

The concentration risk soft limit remains at 25% of the FCA investment firm’s own funds.

Firms that exceeds the concentration risk soft limit for a client or group of connected clients will then be required to calculate the exposure value excess (EVE, which will be used to calculate the K-CON). The EVE is the excess of the EV over the concentration risk soft limit.

Calculation of K-CON

Firms exceeding the concentration risk soft limit for one or more clients or groups of connected clients must calculate K-CON. Firms will need the EV, EVE, the own funds requirement (OFR) relating to that exposure, and the number of days that the excess has persisted in order to make this calculation. The steps for calculating K-CON are set out below:

Step one - own funds requirement for the excess (OFRE):

- OFRE = OFR/EV * EVE

Step two

- The OFRE has a multiplying factor applied to it, determined by the length of time the exposure has exceeded the ‘soft’ limit and by how much (as a percentage of own funds) the EV exceeds the ‘soft’ limit.
- In measuring the length of time the exposure has exceeded the soft limits, the FCA proposes to only include business days.

Concentration risk ‘hard limits’

The FCA is setting hard limits which the level of concentration risk in the trading book should not exceed. These would be set at:

- 500% of the firm’s own funds for an EV to an individual client or group of connected clients that has exceeded the soft limit for 10 business days or less
- 600% of the firm’s own funds for the total of all its exposure value excesses or EVEs that have existed for more than 10 business days.

Notification requirements

If an FCA investment firm exceeds the concentration risk soft limit for a client or group of connected clients, it must notify the FCA of the amount of the EVE, the name of the individual client or the group of connected clients concerned, without delay.

If an FCA investment firm exceeds either of the two hard limits, it will also be required to notify the regulator without delay. This notification would include:

- the amount of the exposure or exposures that have led to the breach
- the name or names of the clients concerned
- any steps the firm has taken or intends to take to deal with the breach and to prevent any future occurrence.

Exclusions and exemptions

Some types of exposures can be excluded from the concentration risk requirements for dealing on own account. These are exposures:

- that have been deducted from own funds
- that are incurred during the ordinary course of settlement of certain transactions (payments, FX, securities)
- that are incurred in the provision of money transmission to, or guaranteed by, institutions with a 0% risk weight in the UK CRR (e.g. central governments, central banks).

The FCA also proposes to exclude exposures to parents or other subsidiaries or connected undertakings of that parent from the calculation, provided the parent or connected entity is supervised in accordance with appropriate standards. In addition, there should be no current or anticipated practical or legal impediments that could trigger capital transfers or repayment of liability, and the risk management frameworks of the parent should cover the relevant group entity.
Commodities exemptions

The FCA also proposes that concentration risk requirements will not apply to commodity and emission allowance dealers, provided they meet certain conditions. These firms will need to notify the FCA in advance that they wish to use this exemption and set out how their activity will meet these conditions.

Reporting requirements

The FCA intends to introduce a single suite of IFPR reporting forms for all FCA investment firms. Currently, these firms complete different sets of regulatory returns depending on which prudential sourcebook they fall under. The single reporting requirement is intended to simplify the current approach and introduce greater consistency and proportionality.

The FCA proposes that all FCA investment firms should report to the regulator on a quarterly basis. The relevant reporting reference dates will be the last business day in March, June, September and December.

Reporting for SNI investment firms

SNI FCA investment firms will generally report consistently with non-SNI firms, but with two exceptions:

- they will not be required to submit reports relating to general concentration risk or the K-CON requirement, although may still need to monitor
- if an SNI firm has been exempted from producing a liquidity report, it’s liquidity reporting obligations.

Fixed overheads and K-factor reporting

Information on the reporting requirements for fixed overheads and the FOR will be included in the next consultation.

At this stage, the FCA is not proposing to routinely collect additional information showing how FCA investment firms have calculated individual K-factors. Nevertheless, the regulator expects that firms will be able to provide this information on request. The regulator may also ask firms with specific business models or those over a particular size to report some additional detail regularly. Additional information required for this, or in support of ICARA requirements, will be included in a later consultation.

Consolidated group reporting

If an FCA investment firm group is subject to prudential consolidation (rather than the GCT), the FCA proposes that the UK parent entity for that group should submit reports on a consolidated basis.

The reports required will depend on whether the UK parent entity is treated as an SNI or a non-SNI firm on a consolidated basis. A UK parent entity that is classified as an SNI firm on a consolidated basis will submit the same reports required from an SNI firm on an individual basis, but those reports will cover the consolidated situation of the group. The same approach will apply to a UK parent entity that is classified as a non-SNI firm on a consolidated basis.

If the GCT applies to an FCA investment firm group, each parent undertaking in the UK that is subject to the GCT must submit a separate return explaining how it complies with the relevant requirements. The reporting requirement for a responsible UK parent will depend on whether that parent undertaking has decided to:

- hold own funds instruments to meet the requirement that would apply to its third-country subsidiary, or
- ensure that the third-country subsidiary holds sufficient own funds instruments to satisfy the GCT at the third-country level.

If the responsible UK parent holds the own funds, it will submit a single GCT return, but will include details of the holdings of the third-country subsidiary, as well as its own holdings.

If not, it will need to submit two returns – one explaining how it complies with the GCT and another explaining how its third-country subsidiary does so.

Investment firm groups may nominate a single FCA investment firm or UK parent entity to submit all reports required from the individual members of that group. But this does not relieve individual firms in that group of their ultimate responsibility for ensuring that they submit any reports relating to their individual position in an accurate and timely way.

What does this mean for firms?

The FCA’s rules confirm both its previous discussion paper, and broadly align with the EU rules. But there is divergence - not only in implementation date - and firms with an EU presence will need to manage the divergence and differing implementation dates.

Firms now have near-final rules for parts of the IFPR, and should consider this to be the starting gun for implementation. Firms should undertake a partial line-by-line analysis of the new rules, and the impact on their businesses. Areas such as modelling capital impacts, considering the impact of the rules on existing group structures, developing responses to reporting requirements and putting in place processes to capture data should be undertaken. Firms’ experiences of completing the recent FCA questionnaire should give a steer as to the effort this could require.

As this is the first of three consultations, it allows firms to break down the work into three chunks. This will help firms to prioritise, but will require effective project management to ensure all component parts of the three consultative areas are aligned.

Finally, 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.

The FCA welcomes responses to its consultation paper until 5 February 2021.