



A new UK prudential regime for MiFID investment firms

**What the FCA proposals mean for
Principal and Matched Principal
Brokers**

September 2020

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1. EXECUTIVE SUMMARY

Across European Union (EU) member states, there is a wide variation in how investment firms are prudentially supervised. In the UK, for example, there are three prudential sourcebooks for investment firms- BIPRU, IFPRU and IPRU(INV). Plus, of course, the prudential regime in the Capital Requirement Regulations and Directive (CRR/CRD IV) imposes methodologies, but these are not very well suited to the business of investment firms and the risks they face.

The European Commission has therefore put in place a revised prudential framework- the Investment Firms Regulation (IFR) and the Investment Firm Directive (IFD) - to address the aforementioned issues. The text of the new regulations is now included in the EU's Official Journal with the rules set to apply from 26 June 2021. To ensure a smooth transition for firms, there are some transitional provisions that will allow a gradual build-up of capital resources to the new required levels.

The UK will be implementing the new regime. In other words, this is unaffected by Brexit. The Financial Conduct Authority (FCA) published a Discussion Paper on 23 June 2020 indicating that their approach to implementing the new regime will be very similar to that of the EU. Final rules are expected to be published in Q1 2021.

This means that a new prudential framework will apply to Principal Brokers (PBs) and Matched Principal Brokers (MPBs) from June 2021. Based on current proposals from the FCA, PBs will see their base capital requirement increase from EURO730k to EURO750k. On the other hand, MPBs, currently EURO50k (for BIPRU firms) or EURO125k (for IFPRU125s), will have their base capital requirement increase to EURO750k. In other words, the base capital requirements of PBs and MPBs will be the same.

Though firms will have a five-year transition period to increase capital to this level, it is still a significant increase for most firms. This paper describes the background to the changes, what they mean for your firm and what changes need to be made in preparation for the coming changes.

If you have any questions regarding the new prudential framework then please contact us and we will be happy to assist. Please also look out for further updates that we will issue once the FCA publishes more information.

2. PROPOSALS EXPLAINED

2.1. Firm Categorisation

Under the current rules, MPBs had a specific prudential treatment which allowed them to be treated separately from other firms which deal on own account, such as PBs. That provision is going away under the new framework. Consequently, MPBs will be treated in the same way as current EURO730k firms for prudential purposes. Under the new framework, PBs and MPBs will be classified as ‘non-Small and Non-Interconnected firms’ or non-SNIs.

The very largest of these firms will fall into either of the following categories and be prudentially assessed under CRR.

Criteria	Prudential Treatment
<ul style="list-style-type: none"> The firm’s consolidated assets \geq EURO30bn; or The firm’s consolidated assets \leq EURO30bn, but it is part of a group that includes at least another firm that deals on own account or underwrites and the total consolidated assets of these firms \geq EURO30bn; or The firm’s consolidated assets \leq EURO30bn but is part of a group with another firm dealing on own account or underwriting, that other firm has consolidated assets \geq EURO30bn, and the consolidating supervisor decides CRR is appropriate. 	<ul style="list-style-type: none"> Systemically Important firms; deemed to be credit institutions. These firms will remain prudentially assessed under CRR and will need to apply to the regulator to be authorised under CRD. IFR will have very limited application to these firms.
<ul style="list-style-type: none"> The firm’s consolidated assets \geq EURO15bn; or The firm’s consolidated assets \leq EURO15bn, but it is part of a group that includes at least another firm that deals on own account or underwrites and the total consolidated assets of these firms \geq EURO15bn; or The firm’s consolidated assets \geq EURO5bn and the competent authority deems it appropriate for the firm to be prudentially assessed under CRR; or The consolidating supervisor decides CRR is appropriate. 	<ul style="list-style-type: none"> Remain authorised under MIFID. Will be prudentially assessed under CRR.

2.2. New Requirements

The requirements in the IFR/IFD will apply to firms differently. A summary of the requirements as currently proposed by the FCA in its June 2020 Discussion Paper is as follows:

	Non-SNIs (Investment Firms)	Comparison with current rules
Definition of Capital	Similar to current rules. Capital comprises: <ul style="list-style-type: none"> Common Equity Tier (CET) 1 capital Additional Tier 1 (AT1) capital and Tier 2 capital 	Nothing significant but there have been some changes to the amount of deductions.
Capital Mix	<ul style="list-style-type: none"> CET1 capital \geq 56% of Own Funds Requirement Total Tier 1 capital (i.e. CET1 + AT1) \geq 75% Total capital \geq 100% 	Not currently applicable for BIPRU firms; for IFPRU firms, similar to capital ratios under the CRR.

	Non-SNIs (Investment Firms)	Comparison with current rules
Own Funds Requirement	<p>The higher of:</p> <ul style="list-style-type: none"> • FOR • Permanent minimum requirement; and • K-factor requirement (KFR) 	<p>BIPRU and IFPRU limited licence firms – Higher of:</p> <ul style="list-style-type: none"> • EURO50k (or EURO125k for IFPRU125 firms); • Sum of credit and market risk; and • FOR <p>IFPRU limited activity and full scope firms – Higher of:</p> <ul style="list-style-type: none"> • EURO730k • Sum of credit, market and either FOR (limited activity firm) or operational risk requirement (full scope firm).
Fixed overhead requirement (FOR)	Quarter of annual fixed overheads for the previous year.	No significant change for IFPRU firms. Some tightening of the allowable deductions for BIPRU firms.
Initial / Permanent minimum requirement	EURO750k	EURO€50k for BIPRU and IFPRU50k firms EURO125k for IFPRU125k firms EURO730k for IFPRU730k firms
K Factor Requirement (KFR)	A new way of accounting for the potential harm that an investment firm can do to its clients, the markets in which it operates and to itself. See Annex I for more details.	Not currently applicable.
Group capital requirements	<p>The relevant own funds requirements will have to be applied on a solo and on a consolidated basis.</p> <p>If a group is sufficiently simple and does not pose a significant threat to clients or the markets, the parent could apply to use a group capital test instead of the consolidated own funds requirements.</p>	The Group Capital Test provision is a new introduction under the IFR/IFD
Liquidity requirement	Firms are required to hold a third of the amount of the fixed overhead requirement in liquid assets.	Only ILAS firms had mandatory minimum liquidity requirements.
Capital Adequacy Assessment (Similar to the old ICAAP, now known as Internal Capital Adequacy and Risk Assessment (ICARA))	<p>Required.</p> <p>Assessments will be reviewed periodically by the FCA. ICARAs must include wind-down plans.</p> <p>The FCA may increase the amount of the Own Funds Requirement by a Pillar 2 Requirement (legally binding) or Pillar 2 Guidance.</p>	<p>ICAAP requirement currently in place. ICARA modifies the approach to assessing risk.</p> <p>The FCA can impose non legally binding individual capital guidance (ICG).</p>
Public disclosures	Firms need to disclose risk management objectives, own funds and own funds requirement, remuneration, and governance arrangements (similar to current Pillar 3 obligations). Larger non-SNIs will also need to disclose ESG risks and investment policy.	Currently no requirement for public disclosure of ESG risks nor all elements of own funds requirement.
Remuneration Rules	<p>Remuneration principles apply in relation to variable remuneration.</p> <p>Provisions on bonus pay outs, deferrals and retention</p>	Main change is in relation to proportionality threshold for bonus restrictions and the requirement to have a risk committee.

	Non-SNIs (Investment Firms)	Comparison with current rules
	periods, and establishing risk committees only apply firms with average 4-year balance sheet size > EURO300m.	
Regulatory reporting	Quarterly. Balance sheet, Income statement, capital adequacy, risk management, liquidity and remuneration.	Semi-annual (BIPRU), quarterly (IFPRU) on balance sheet, income statement and capital adequacy.

3. TRANSITION AND IMPLICATIONS

3.1. Transition Arrangements

A five-year transition period is in place under the IFR rules to allow firms build up the required capital. Firms in existence before 26 June 2021 can, during the transition period (26 June 2021 to 25 June 2026), limit their own funds requirement to twice their current requirement under the CRR (or GENPRU and BIPRU).

Note, however, that firms will be required to prepare periodic updated calculations under the current and new rules throughout the period in which the transition arrangements are used. Firms will be able to continue using the current market risk rules under CRR to calculate the Net Position Risk K-factor in respect of their trading book business for at least five years. Permanent minimum requirements will increase by a minimum of EURO5k each year during the transition period. Special provisions have been proposed for firms that are currently subject to individual capital guidance (ICG).

3.2. Implications

- **Systems and Processes to track K-factors:** It is reasonable to anticipate that the K-factors (Annex I below) will be new for many firms. Some work therefore needs to be done to calibrate IT and Accounting systems and ensure they are able to produce the numbers required for the capital requirement calculations. For some metrics like client orders handled, these would need to be tracked daily.
- **Business model review:** In light of the significant changes being brought about by the new prudential framework, some businesses may find that they are not able to meet the new requirements and may then look to amend their business model to streamline risks and consequently lower their K-Factor Requirement. In other cases, firms may opt to restructure their operations internationally.
- **Capital assessments (ICARA):** The new approach to capital assessments will be new to every firm. In addition, many firms may not have previously carried out a robust wind-down assessment. New skills may therefore need to be brought into the business or outsourced to ensure the assessments are fit for purpose.
- **Capital infusion:** For most investment firms, their minimum capital requirements will increase. New capital may then need to be introduced by the shareholders. Early planning and engagement with shareholders is therefore crucial.
- **Remuneration:** For some firms, there will be new remuneration rules to consider in relation to variable pay. For firms above the EURO300m threshold, how employees receive variable remuneration will be affected. Boards, HR and legal teams may therefore need to restructure compensation structures and plan for employee engagement to minimise disruption and impact on employee morale.
- **Liquidity planning:** We expect this to be of minimal impact, however, the rules now require a minimum of one month's fixed costs to be held in liquid assets, primarily cash. Cashflow forecasts and monitoring systems therefore need to ensure these limits are not breached.

4. NEXT STEPS

The FCA's [Discussion Paper](#) is currently open for comment up to 25 September 2020. Following the Discussion Paper, a Consultation Paper will be issued by the FCA later this year and then a Policy Statement with final rules is expected in Q1 2021.

In the interim, firms are encouraged to acquaint themselves with the FCA's initial proposals on the implementation of the IFR/IFD in the UK and respond accordingly. Firms should determine what IFR category their firm will fall into and begin planning towards meeting the new requirements for that category. The level of effort required to comply should not be underestimated, particularly for non-SNIs.

In summary, the new rules have been designed to ensure firms hold capital better aligned to the risks they face. The changes will however lead to higher requirements and costs to comply. Early planning and review will ensure firms are ready to meet the obligation next year and grow their capital requirements over the transition period.

ANNEX I - K-FACTOR CALCULATIONS

The K-Factor Capital requirement is the sum of K-factors in the following areas:

- Risk-to-Client (RtC);
- Risk-to-Market (RtM); and
- Risk-to-Firm (RtF)

	Criteria	Symbol	Co-efficient	Comments
Risk to Client (RtC)	Assets under management (AUM) - Discretionary and Non-Discretionary (advisory)	K-AUM	0.02%	<p>Calculated as 12-month average of the AUM as of the last business day of each calendar month for the previous 15 months and excluding the three most recent months.</p> <p>Includes AUM delegated to another manager but excludes AUM managed on delegated authority from another Investment entity.</p> <p>Calculated on the first business day of each month.</p>
	Client money held	K-CMH (on segregated accounts)	0.4%	<p>Calculated as six-month daily rolling average of the value of total daily client money held, measured at the end of each business day for the previous nine calendar months, excluding the three most recent calendar months.</p>
		K-CMH (on non-segregated accounts)	0.5%	<p>Calculated on the first business day of each month.</p>
	Assets under safekeeping and administration	K-ASA	0.04%	<p>Calculated as six-month average of the AUM as of the last business day of each calendar month for the previous nine months and excluding the three most recent months.</p>

	Criteria	Symbol	Co-efficient	Comments
				Calculated on the first business day of each month. Includes all assets safeguarded on a delegated basis and those delegated to another investment firm.
	Client orders handled	K-COH	0.1% (cash trades)	Calculated as three-month daily rolling average of the value of total daily client orders handled, measured at the end of each business day for the previous six calendar months, excluding the three most recent calendar months.
		K-COH	0.01% (derivatives)	Calculated on the first business day of each month. COH is the sum of absolute values of buys and sells. Absolute value is amount paid/received for cash trades and notional value for derivative trades. This shall include values executed by firms providing portfolio management on behalf of clients unless already included in K-AUM above. Excludes transactions executed in the firm's name.
Risk to Market (RtM)	Net Position Risk; or	K-NPR	NA (As per CRR approaches)	Applies to all trading book positions. Firms shall also include non-trading book positions where these give rise to foreign exchange risk or commodity risk.
	Net Client Margin	K-CMG	1.3 x third highest amount of total margin required on a daily basis by the clearing member or qualifying central counterparty over the preceding 3 months	Calculated on all positions subject to margin or on a portfolio basis subject to specified criteria.
Risk to Firm (RtF)	Trading Counterparty Default	K-TCD	1.2 x Exposure Value x Risk Factor x Credit Valuation Adjustment	K-TCD and K-CON shall be based on all dealing on own account transactions (for itself or for clients); K-DTF shall be based on all dealing on own account (for itself or for clients) and dealing as agent transactions which it enters into in its own name. Risk Factor is 1.6% for credit institutions and investment firms; and 8% for other firm types.

	Criteria	Symbol	Co-efficient	Comments
				<p>Exposure value is Replacement Cost (RC) + Potential future exposure (PFE) - Collateral (C).</p> <p>RC is Current Market Value (derivative contracts). Other criteria apply for long settlement transactions, margin lending transactions, repo transactions and securities financing transactions.</p> <p>PFE is Effective Notional (EN) x Supervisory Factor (SF) where EN is Notional amount x Duration x Supervisory Delta.</p>
	Daily trading flow	K-DTF	<p>0.1% (cash trades)</p> <p>0.01% (derivatives)</p>	<p>DTF calculated as six-month daily rolling average of the value of the total daily trading flow, measured throughout each business day for the previous nine calendar months, excluding the three most recent calendar months.</p> <p>Calculated on the first business day of each month.</p> <p>DTF is the sum of absolute values of buys and sells. Absolute value is amount paid/received for cash trades and notional value for derivative trades.</p> <p>Includes transactions executed in the firm's name (either for itself or on behalf of clients).</p> <p>Excludes transactions executed as part of providing portfolio management services.</p>
	Concentration risk excess	K-CON	<p>Capital requirement for individual exposures / Total Exposure value x Exposure value excess (EVE)</p>	<p>CON calculates the own funds requirements for exposures to clients or groups of connected clients which are greater than 25% of the firm's own funds or EURO150m.</p> <p>The firm must notify the regulator if those limits are breached.</p>