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5 years IFR and IFD - time for a general overhaul?

7 August 2024

The EU's prudential framework for investment firms, the Investment Firm Regulation (**IFR**) and the Investment Firm Directive (**IFD**), had its fifth anniversary this June 2024. In accordance with the usual procedure, the IFR and IFD mandate the Commission to review several aspects of the framework and submit a report to the Parliament and to the Council by the end of June 2024. However, there is no indication that this mandate will be followed soon. Instead, EBA and ESMA, which were called to advise the Commission on this matter already in 2023, noted that a more systematically collected feedback is required. For that purpose, ESMA and EBA published a Discussion Paper early June 2024, with the prospect of publishing a final report to the Commission at the end of 2024.

While ESMA and EBA generally consider IFD and IFR to achieve their general objectives of creating a robust yet risk-sensitive supervisory framework that is tailored to the size, activities and complexity of investment firms, they see a potential need for certain improvements. By raising 32 questions, the two authorities seek input on considered or proposed changes to the prudential framework for investment firms in 11 sub-sections. The majority of questions concern the application of capital requirements (below (3.) – (6.)), prudential consolidation (below (8.)), and the categorization of investment firms (below (1.) and (2)). In the following, we highlight those of which we think may have the most significant impact on investment firms and other companies providing investment services.

1. Thresholds for the categorizsation of investment firms

First, EBA and ESMA propose to harmonize the scope and calculation of the thresholds for the categorization of investment firms as Class 1 and Class 1-minus, respectively.

- Class 1 investment firms engage in dealing on own account or underwriting issues of securities, have consolidated assets of EUR 30 bn and qualify as CRR credit institutions, subject to CRR and CRD IV.
- Class 1-minus investment firms engage in dealing on own account or underwriting issues of securities, have consolidated assets (i) between EUR 15 bn and EUR 30 bn, or (ii) between EUR 5 bn and 15 bn where the competent supervisor decides to categorize them as Class 1-minus. Class 1-minus firms are authorized as investment firm but subject to the CRR (and Title VII-VIII CRD).

For the calculation of the EUR 30 bn, 15 bn, and 5 bn threshold, the current legislation treats assets of subsidiaries located outside the EU inconsistently: they are to be included for the calculation of the EUR 30 bn threshold, while they are explicitly excluded for calculating the EUR 15 bn threshold. For the EUR 5 bn threshold, IFR is silent as to this aspect of the calculation.

Against that background, EBA and ESMA propose to consistently apply the current approach for calculating the EUR 30 bn threshold, i.e. to also include assets of non-EU subsidiaries and branches in the calculation of consolidated assets of EU undertakings. This would broaden the scope of application of the Class 1-minus category.

In addition, EBA and ESMA would like to assess whether the application of the CRR framework to Class 1-minus investment firms, including by way of order of the competent supervisor, is appropriate in light of their risk profile, nature and complexity. For that purpose, they request an analysis of supervisors' experience with supervising Class 1-minus investment firms and with exercising their discretion to subject investment firms to the requirements of CRR.

Furthermore, EBA and ESMA propose to consider removing the EUR 5 bn threshold which currently applies with respect to the reporting requirement of investment firms of their total value of assets to the competent authority. EBA and ESMA therefore query the operational constraints of potentially removing such threshold, subjecting all investment firms to the reporting requirement, irrespective of their total value consolidated assets.

2. Qualification as a Class 3 firm and transition to Class 2

Whether an investment firm falls within Class 2 or Class 3 (small and non-interconnected investment firms) depends on whether certain criteria set out in Art. 12 IFR are met. While EBA and ESMA have received feedback that these criteria generally work well, EBA and ESMA consider removing the EUR 100 m balance sheet total and the EUR 30 m gross revenue criterion. EBA and ESMA also consider granting a three-month transition period from Class 3 to Class 2 investment firms.

3. Fixed overhead requirement

Under the IFR, investment firms shall calculate, among others, the fixed overheads requirement (***FOR***) (Art. 13 IFR) to determine their own funds requirement. This FOR is based on the assumed own funds required to orderly wind down an investment firm within three months. However, EBA and EBA found that actual wind-down time may differ between business models, and hence suggest considering to adjust the FOR for different types of businesses. They further suggest reconsidering how to take into account expenses for tied agents and for non-MiFID activities.

4. Existing K-factors

ESMA and EBA suggest several technical amendments to existing K-factors, such as, e.g. clarifying the application of K-COH on name give-up and liquidity providing operations. Further targeted amendments are considered for K-AUM, K-DTF, K-CON, K-CMG and K-ASA.

5. Potential adoption of new K-factors

When adopting the new IFR/IFD in 2021, certain risks were not covered by the K-factors capital requirement but left for the supervisory review process. EBA and ESMA suggest that some of these risks should be subject to a new K-factor and therefore transferred from Pillar 2 to the Pillar 1 capital requirements. This includes non-trading book positions in general, and more specifically non-trading book positions in crypto-assets. Furthermore, EBA and ESMA consider revising K-DTF, which captures operational risks based on daily trading flows, but is, according to some national competent authorities (***NCAs***), disproportionally low. EBA and ESMA also suggest considering establishing a specific K-factor for operators of MTF and OTF, and excluding trading venue operators generally from the Class 3 investment firms category. EBA and ESMA also propose to introduce a K-factor capital requirement with new K-factors for the provision of regulated activities that do not qualify as investment services, such as crypto-asset services or crowdfunding services.

6. FRTB and distinction between trading and banking book

EBA and ESMA propose to consider the extent to which amendments under CRR3/CRD6 should also be implemented for IFR/IFD. First, they query whether the fundamental review of the trading book (FRTB), which provides for the alternative standardised approach and the alternative internal model approach, should also apply to Class 2 investment firms which are authorized to deal on own account or underwrite securities issues on a firm commitment basis. The EU authorities would like to discuss three options: (i) mandatory application of the FRTB where a yet-to-be-determined absolute threshold is met, (ii) optional application for the relevant Class 2 investment firms, subject to approval of the NCA, (iii) no application of the FRTB.

Second, EBA proposes to reconsider the definition of trading book in Art. 4(1)(54) and (55) IFR in light of the specific business of investment firms and regulation and the recent change to the definition of the trading book under CRR3. A precise delineation between trading book and non-trading book is in particular relevant for investment firms, because (i) only trading book items are generally subject to the Pillar 1 own funds requirement, and (ii) investment firms may only hold instruments in their trading book if they have a dedicated MiFID authorisation to deal on own account or provide underwriting/placing services on a firm commitment basis. The EBA considers replicating the "boundary" definition under CRR3 and imposing a size limit for investments in financial instruments not held in the trading book for investment firms that are not allowed to deal on own account or provide underwriting/placing services on a firm commitment basis.

7. Liquidity requirements

Investment firms must hold a minimum amount of liquid assets equivalent to at least one third of the FOR (Art. 43 IFR). EBA and ESMA deem this requirement to be "very soft" and propose to increase it, weighing a number of options how to adjust the liquidity requirement (e.g. 100% of the FOR, or a more business-specific number based on the factors of Delegated Regulation (EU) 2023/1651).

8. Framework for prudential consolidation

According to EBA and ESMA, the prudential consolidation framework for investment firms should be amended to limit arbitrage opportunities and to make it more comparable with the prudential consolidation under CRR. For that purpose, the EBA and ESMA suggest amending several definitions relevant to determine the IFR consolidation perimeter. For instance, the definition of investment holding company may be amended to also allow qualifying tied agents or ancillary services undertakings as investment holding company where they are heading an investment firm group. Further, EBA and ESMA are concerned with cases where a parent CRR credit institution holds an investment firm through one or several unregulated entities. Since these would qualify as investment holding companies, IFR consolidation requirements are applicable in addition to the CRR consolidation requirements, which EBA and ESMA deem “unnecessarily complex and burdensome”.

In addition, the authorities propose certain amendments to adequately take into account tied agents, ancillary services undertakings, and crowdfunding service providers under the IFR consolidation requirements. The extension of the scope of the prudential consolidation follows EBA’s view that also financial institutions, the subsidiaries of which are mainly tied agents or ancillary services undertakings, may qualify as investment holding company (Q&A 2023_6779). Furthermore, they suggest extending the scope of prudential consolidation to entities under proportional consolidation or subject to step-in risk, aligning IFR with CRR requirements. Finally, EBA and ESMA suggest limiting the scope of the group capital test to small investment firm groups limited by the number of group undertakings and total assets of the group.

9. Interaction with AIFMD/UCITS Directive and MiCAR

UCITS/AIFM: When reviewing coherence between the prudential framework for investment firms and other legal regimes, EBA and ESMA conclude that UCITS asset management companies and AIFMs providing the same investment services as investment firms are treated differently with respect to the regulatory capital required for that service. They also observe that the top-up services of UCITS management companies and AIFMs are not always “ancillary” compared to the main business of these companies. The EU authorities propose two alternative solutions: (i) impose equivalent capital requirements to UCITS management companies and AIFMs providing ancillary services, or (ii) introduce a limit to the number of ancillary services to be provided by these companies.

MiCAR: When providing crypto-asset services, investment firms are released from certain obligations under MiCAR, including the prudential capital requirements (Art. 67 MiCAR). Instead, the IFR/IFD own funds requirements apply. EBA and ESMA identified certain areas of legal uncertainty as to the application of the different frameworks, in particular with regard to crypto-asset services. For instance, it should be clarified in their view whether ‘client money held’ also includes client money held in relation to crypto-asset services for the calculation of K-CMH and whether ‘client orders’ for the calculation of K-COH also includes orders in crypto-assets.

10. Remuneration under IFD, CRD and AIFMD/UCITS Directive

ESMA and EBA note that investment firms are subject to remuneration requirements under CRD (Class 1 minus), IFD (Class 2) or MiFID II (Class 3), while all UCITS management companies and AIFMs providing ancillary investment services shall apply the requirements under the UCITS Directive and AIFMD. ESMA and EBA wish to explore whether the different standards for regulating staff remuneration, including for derogations from these standards for variable remuneration and under deferral agreements, have an impact on the firms’ abilities to recruit and retain talent as well as on compliance costs, and are, therefore, a concern for the level playing field amongst firms with comparable business activities.

11. Firms active in the commodity markets

With the last question no. 32, EBA and ESMA query whether prudential requirements for firms active in commodity markets, including emission allowance dealers and energy firms, should be established in future.