FAQs: The Investment Firm Prudential Regime

6 January 2021

The UK Investment Firm Prudential Regime or "IFPR" is a new streamlined and simplified regime for the prudential regulation of investment firms in the UK. The IFPR is being introduced by the Financial Conduct Authority (FCA) in accordance with the new Financial Services Bill and new Part 9C of the Financial Services and Markets Act 2000.

In this FAQ guide, we explain what the IFPR is, when the changes will come into effect and how different firms will be impacted by the regulation.

What is IFPR and why is it relevant to me?

The UK Investment Firm Prudential Regime or "IFPR" is a new streamlined and simplified regime for the prudential regulation of investment firms in the UK. The IFPR is being introduced by the Financial Conduct Authority (FCA) in accordance with the new Financial Services Bill and new Part 9C of the Financial Services and Markets Act 2000.

It is intended to come into force on 1 January 2022 following a package of FCA consultation papers. The first of these, CP20/24 (CP), was released by the FCA in December 2020 and followed an earlier FCA Discussion Paper, DP20/2 (DP).

In broad terms, the new prudential regime will be aligned with changes proposed in the European Union under the Investment Firm Directive (IFD) and the Investment Firm Regulation (IFR). This is legislation which came into force on 26 December 2020 and will take effect in the EU on 26 June 2021. Although Brexit means that the IFD and IFR will not apply in the UK, the FCA was a key advocate of, and heavily involved in policy discussion on, the new EU regime before the UK's exit from the EU. Unsurprisingly, therefore, the IFPR is heavily influenced by these EU changes.

In its first CP, the FCA makes clear that the intention of the new IFPR regime is to refocus prudential requirements away from the risks firms face, to take adequate account of the potential for harm to consumers and markets. The new proposals will also strip away much of the complexity in the existing prudential framework and this is to be welcomed.

However, the new rules will also make significant changes to the way UK investment firms will be regulated for prudential purposes and the remuneration rules to which those firms are subject and consequently, we expect that significant resource and planning will need to be devoted by firms in 2021 in order to be ready for the early 2022 implementation date.

I think my firm is an investment firm and so will be impacted. How do I check?

The following firms will be caught by the new regime:

- investment firms subject to BIPRU and GENPRU;
- full scope, limited activity and limited licence firms subject to IFPRU and the CRR;
- "local" investment firms;
- matched principal traders;
- exempt CAD firms;
- investment firms which previously were exempt under Article 3 of MIFID but opted in; and
- various specialist commodities derivatives investment firms.

You can check if you are performing investment services, and therefore amount to an investment firm, by comparing your permissions profile against the services which are MiFID services, described further in the following guidance in the FCA Handbook: PERG 13.3. There is a useful table tracking UK regulated activities to the following MiFID services using the following link.

We're not an investment firm, do we need to worry about whether these new rules will be applied to us?

Generally speaking, we expect the answer to this to be "no". However, it appears that one type of firm which may be impacted by the proposals are collective portfolio management investment firms (CPMI firms). These are firms with permissions to manage an alternative investment fund (AIF) and/or permission to manage a UK UCITS fund which also have what are known as "MiFID top up" permissions. These firms are not investment firms as such but they do have permissions to conduct certain activities which are "investment services".

If you are a CPMI firm, you will have a restriction on your permissions profile (a CPMI restriction) on the FS register which makes this clear. Please refer to the Restrictions heading in your entry on the FS register.

CPMI firms are likely to be brought into scope of the new proposed regime although it is not yet clear if this will be for the whole of the firm's business or just its additional "MiFID business". At the current time, it appears the detail of the new prudential rules may only catch the "top up" business but the requirements for remuneration remain unclear. The FCA stated in the CP that it would explain how its draft rules would apply to CPMI firms in a subsequent consultation in the course of 2021.

For UCITS and AIF managers which do not have MiFID top ups, IFPR is not generally expected to apply. However, there is one further change in IFD which impacts all UCITS managers and AIFMs regardless of MiFID top ups. This is the cross reference in IFD to the UCITS Directive and to AIFMD, such that own funds must be held by these firms which is no less than the FOR (fixed overheads requirement) calculated under Article 13 of the IFR. It may be that a corresponding change will be made in IFPR in line with the above, in IFD. However, this will be addressed, it is expected, in a later FCA consultation paper.

When will the new rules apply?

It is expected that firms will need to comply by 1 January 2022. This is, however, subject to appropriate progress and amendments to the Financial Services Bill which was introduced by the UK Government on 20 October 2020. The passage of the Bill through Parliament may result in changes to the new Part 9C of the Financial Services and Markets Act 2000 and it is not impossible this may require subsequent changes to the new IFPR regime before it is introduced.

The FCA has said that it will be monitoring the relevant legislative developments and it will reflect those in subsequent consultations, where required.

I don’t have time to read the full FCA consultation paper, what is this new regulatory initiative about?

The intention behind the new proposal is to create a new prudential regime which is tailored specifically for investment firms and better aligns the standards and rules which apply with the business model of this type of firm (as well as the possible sources of possible harm).

Presently investment firms have to comply with a prudential regime which has been designed primarily for credit institutions and the FCA indicates in its CP that the current regime is not designed to address the potential harm posed by FCA investment firms.

The FCA has also stated that the ongoing regulatory costs for firms should be lower as a result of the changes. However, our view is that this may not always be the case and firms should scrutinise the changes carefully to identify the impact upon them. It does seem clear that the simplification of the regime should free up management time and reduce time spent on complex capital calculations that do little to help firms manage risk. The FCA has indicated its view that the changes should also reduce barriers to entry to the market and allow for better competition.

The key changes will involve:

- new liquidity rules across the board. UK investment firms are not currently subject to liquidity rules;
- changes to the level of initial capital to be held. Initial capital will increase for most firms;
- a brand new approach to calculating capital known as the “K factor” approach; and
- new rules on remuneration and disclosure which allow less scope for firms to determine their approach based upon proportionality principles.

The CP covers in broad terms own fund requirements, prudential consolidation, concentration risk monitoring as well as reporting. The subsequent consultation papers (of which two are expected) will cover remuneration, liquidity, risk management and governance, the ICARA and SREP (as discussed below) disclosures and ESG.

I’m a CPMI firm, how does this impact me?

Please refer to the question above, "**We’re not an investment firm, do we need to worry about whether these new rules will be applied to us?**" which explains the position for CPMIs at the current time of writing.

Will some investment firms remain subject to the UK onshored CRR requirements?

Yes. Investment firms above certain size thresholds and which deal on own account and underwrite/place financial instruments on a firm commitment basis will remain on Capital

Requirements Regulation (CRR) standards. Some firms within this cohort may be obliged to seek authorisation as a new type of non-deposit taking credit institution because they are considered "systemically important".

We would not expect this to apply to many firms. Figure 3.1 of the DP provides a useful flowchart and further details.

I'm an investment firm but only a small one, and our activities are very low risk, will I be excluded from the most onerous parts of the regime?

Certain firms under the regime known as "small and non-interconnected investment firms" or SNIs benefit from additional proportionality and have less onerous prudential obligations, as well as reporting, disclosure and remuneration requirements. Table 2 in paragraph 2.10 in the FCA's CP sets out the threshold tests, based on financial criteria, to be considered an SNI firm and figure 1 in paragraph 2.12 provides a useful flowchart. We suggest checking those charts to determine your likely status.

The SNI test is not a static or one-off test and is not based on activity type; a current exempt CAD firm, for example, will not necessarily be treated as an SNI. A firm which is not an SNI but subsequently becomes one will need to meet the conditions for a period of six months on a continuous basis in order to be treated as an SNI under the regime. This is explained in paragraph 2.13 of the CP.

You can also find a quick summary guide of the difference between being an investment firm under IFD/IFR and an SNI firm in the table in 3.31 of the DP.

IFPR is supposed to be a tailored regime but the initial capital my firm needs to hold in order to be authorised is going up. Please can you explain.

The increase is significant for non-SNI investment firms, including current Exempt CAD firms which currently only require €50,000 initial capital. The FCA justifies the approach on the basis the levels under the previous regime have not been updated since 1993.

Paragraph 5.5 of the CP sets out a summary of the new levels of initial capital. These vary by regulated activities carried on but the categories are:

- £750k;
- £150k; and
- £75k.

A firm which does not have client money and custody permissions but which has "advising", "arranging" (i.e. reception and transmission of orders), "dealing" (executing orders) and/or "managing investments" (portfolio management) permissions only will usually be required to hold initial capital of £75k.

In practice, how much capital will I have to hold?

This depends on whether you are an SNI firm or non-SNI. The difference is explained in the answer to the "**I'm an investment firm but only a small one, and our activities are very low risk, will I be excluded from the most onerous parts of the regime?**" question above.

If you are non-SNI, your initial capital requirement will be the higher of the fixed overhead requirement (FOR), the permanent minimum requirement (PMR) and the K factor requirement (KFR). If you are SNI, then your capital requirements will be the higher of the FOR and the PMR.

- The PMR is basically the initial capital as described above.
- The FOR is expected to be one quarter of the fixed overheads for the previous financial year, although the details for calculation are not covered in the CP and the FCA will address this in its subsequent consultation papers.
- The KFR is entirely new and is a new way of calculating the potential for harm in a firm (including its risk to clients and the market). Please refer to the "**People are talking about the “K factors”. What are these?**" question below.

Although theoretically the KFRs don’t apply to SNI firms. In reality, SNIs will need to assess their firm against these metrics to ensure that they remain an SNI. This is because the K factor tests are in practice relevant to the thresholds for remaining an SNI.

The above explains the calculation for what is known as “Pillar 1” capital. Firms which are not SNI firms will also have to perform an additional Pillar 2 assessment and this may require them to hold additional capital. Please refer to the "**My firm has to prepare an ICAAP (Internal Capital Adequacy Assessment Process). Is that being scrapped now?**" question below.

People are talking about the “K factors”. What are these?

This is a completely new approach to determining the minimum own funds requirement. The K-factor capital requirements are essentially a mixture of activity and exposure-based requirements. It is intended to reflect harm and is very different from the historic calculations under the old regime. For many firms, some of the K factors will not be relevant and the calculation methods are designed to be straightforward.

The KFR is the sum of each of the K factors that apply to the business of the investment firm.

Figure 6.1 of the DP sets out the K factors and chapter 6 explains how to calculate them.

In brief, the K factors are divided into three categories:

- risks to client (RtC);
- risks to market (RtM); and
- risks to firm (RtF).

Not all K factors will have to be considered by each firm, however. For instance, if a firm does not hold client money or assets then two RtC K factors for client money held (K-CMH) and assets safeguarded and administered (K-ASA) can be ignored.

For the time being, the CP only addresses the K-factors relevant to firms which deal on own account and the remaining K factors are to be explained in a further consultation. However, the detail of the other K factors are also considered in the DP and in the group consolidation context under chapter 3 of the CP.

Will there be changes to the type of capital I will have to hold?

Yes, possibly, depending on your current status.

The IFPR follows a similar approach to the CRR on assessing capital quality. Investment firms will have to hold Common Equity Tier 1, Additional Tier 1 and Tier 2 capital in the same proportions as set out in the CRR.

This will however be a change for firms that do not currently work on CRR concepts such as BIPRU firms and exempt CAD firms. These firms will not have some of the current categories available to them such as Tier 3 short term subordinated debt. Consequently, there may be changes to the type of capital held for this profile of firm.

There are also some changes against the CRR regime in order to simplify the calculation of certain deductions and to remove reference to concepts that do not exist in the IFPR. Further detail is set out in chapter 4 of the CP.

I've been told the IFD/IFR impose new liquidity obligations. What are they?

All firms, even SNIs, under the regime must comply with minimum quantitative liquidity requirements. The intention is to create a resilience in each firm to a sudden liquidity shock. However, please note that the detail of the new liquidity rules has yet to be set out in the CP and so the summary below reflects the position described in the DP and the IFD/IFR regime.

In short, the objective is to be able to fund overheads for a period (at least one month) even if there is no continuing income. The requirement is to hold an amount of certain types of liquid assets equivalent to at least one third of the amount of the FOR (fixed overhead requirement). It is intended as a baseline requirement and firms are entitled to hold more. Figure 10.1 of the DP explains eligible liquid assets and the discounts (haircuts) which need to be applied to them.

My firm has to prepare an ICAAP (Internal Capital Adequacy Assessment Process). Is that being scrapped now?

The ICAAP will be scrapped and replaced with a new ICARA process which is short for "internal capital and risk assessment". SNI firms won't usually need to perform an ICARA although the FCA will have discretion to require this.

There will also still be a SREP process (short for Supervisory Review and Evaluation Process). This is the process by which the FCA determines if the firm has a sound understanding, management and coverage of its risks and may impose a capital add on where it has concerns.

The DP sets out a short table which explains the differences between the ICAAP and the ICARA process at figure 11.3. Again, the detail of this is not set out in the CP and will be covered in the second consultation paper expected at the start of Q2 of 2021.

Is there a transition period to give me time to change?

Yes, there will be certain provisions in the IFPR intended to ease the change to the new regime. It is expected that these will vary depending on the current status and size of the relevant firm and may allow a more lenient calculation of the PMR and the own funds requirement (described above in "**In practice, how much capital will I have to hold?**") for a short term period.

What is changing so far as group consolidation is concerned?

Prudential consolidation is expected to be applied under the IFPR but it only captures investment firm groups (and in some circumstances sub-groups) which exclude credit institutions, unlike the CRR. The effect of consolidation is that the UK parent, along with all of the relevant entities in the consolidation group are treated as if they are a single entity.

In order to identify the consolidation group, the key task is to identify where an investment firm is itself, or is a holding of, a parent undertaking where that parent undertaking is:

- an investment firm;
- an investment holding company; and
- a mixed financial holding company.

The concept of a mixed financial holding company is new and the definition of "financial institution" has changed (as against the CRR concept) to remove credit institutions from scope.

The firms which will then be included in scope of the consolidation are the following:

- investment firms;
- financial institutions (including AIFMs and UCITS management companies as well as intermediate parent companies);
- ancillary service undertakings (including group service companies); and
- tied agents (appointed representatives).

Further details are set out in chapter 3 of the CP but in summary under IFPR a group capital test applies to mitigate the risk of investment firms being exposed to financial strain as a result of their membership of a group. The UK parent to which consolidation applies must comply with obligations relating to:

- composition of own funds;
- own funds requirements;
- concentration risk;
- liquidity;
- disclosure; and
- reporting.

What will change so far as remuneration is concerned?

The detail of this is not set out in the CP and will be covered in the second consultation paper expected at the start of Q2 of 2021.

However, based on the DP and IFD/IFR it seems likely the new regime will involve deletion of the IFPRU and BIPRU Remuneration Codes which will consolidate instead into a single combined Code. The IFD/IFR approach to remuneration is based upon the same core remuneration principles as exist currently but there are some differences particularly on proportionality. It is expected that the position will also change for exempt CAD firms which are not currently subject to any Code and will now be brought within scope for the first time.

However, it is expected that remuneration obligations will not apply to SNI firms. Consequently, exempt CAD firms which qualify as SNI firms under the new regime will continue not to be subject to any Code. In addition, based upon IFD/IFR small non-SNI firms (assets of €100m or less) are entitled to disapply three variable remuneration requirements on pay-out, deferral and retention and these obligations are also disapplied for individuals with annual variable remuneration below €50,000 and which represents 25% or less of total remuneration (i.e. a significant lowering of the current threshold which excludes individuals with total remuneration of no more than £500,000 of which no more than 33% is variable remuneration).

In addition, perhaps the most fundamental change of all is that the broad brush approach of dis-applying the pay out process rules as a BIPRU firm, on grounds of proportionality, is likely to be swept away. This is explained in the DP at 13.44 onwards.

I'm a MiFID firm that does a lot of ESG work, will IFPR impact me?

ESG is expected to be covered in the final consultation paper due to be issued at the start of Q3 2021, according to the FCA's current timeline.

Based upon the DP, there will be new disclosure requirements under the regime, however, for now it appears that these requirements are only relevant for larger non-SNIs (assets of more than €100m). Based upon IFD/IFR equivalent obligations, from 26 December 2022, those firms will have to disclose information on ESG-related risks, physical risks and transition risks every six months, although query if this deadline will be adjusted considering the later implementation date in the UK under IFPR.

Under IFD/IFR, the European Banking Authority (EBA) is also required to consider whether any ESG-specific amendments to the K factors should be made to ensure the appropriate prudential treatment of ESG-exposed assets. The EBA must also produce, if appropriate, guidelines which introduce ESG risk criteria for the SREP.

The FCA has acknowledged the importance of firms integrating consideration of ESG-related risks and opportunities into their business to enable the market to work well. It also encourages all investments firms to consider those risks when calculating their capital and liquidity requirements. Based on the EBA's findings, the FCA may consider introducing its own guidelines for integrating ESG considerations into the supervisory review process. More is expected on this in the consultation paper in Q3 2021.