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UK IFPR: treatment of credit risk items falling outside of the K-Factors

The UK prudential regime for investment firms (the "**IFPR**"), which comes into force on 1 January 2022, attaches own fund charges by reference to specific categories of K-Factors which are, in broad terms, linked to specific activities, unlike the approach taken in CRR (as amended and "onshored" in the UK) where own fund charges for credit risk depend on the size and nature of individual exposures.

The main K-Factors in the IFPR which are driven by credit risk (such as K-TCD and K-CON) focus primarily on MiFID-type trading carried out by investment firms, which leaves an apparent lacuna with regards to activities involving credit risk which arise under non-trading activities. It is unclear how IFPR firms are meant to address this lacuna.

There is some suggestion that these non-trading activities may have been deliberately omitted from the scope of the IFPR (and therefore, implicitly, that they should not attract an own funds charge); for instance the FCA notes in CP20/24 with respect to the large exposures rules in the IFPR that:

"[o]ur proposals for K-CON, the capital requirements for concentration risk, are based on CRR large exposure (LE) regime for trading book position risk and counterparty risk. Non-trading book requirements have not been carried across as FCA investment firms are not expected to have material positions that are not in the trading book so helping to simplify these requirements."

The FCA's expectation may however not be borne out in practice, with certain items involving credit risk (such as cash deposits with third party credit institutions) likely to remain an inevitable part of an investment firm's activities. The FCA's expectation might also seem inconsistent with the demarcation between CRR and IFPR firms, with the line being drawn (as regards investment firms) based on the size of their balance sheet, rather than by reference to the types of activities they engage in.

Moreover, the omission of non-trading type activities involving credit risk (such as loans extended by investment firms) arguably appears difficult to reconcile with the inclusion of economically similar arrangements within the K-Factors (such as stock loans and repurchase agreements falling within K-TCD).

As an alternative to concluding that credit risk under non-trading type activities do not attract an own funds charge under the IFPR, firms might take the view that they fall within item 28A of the Internal Capital Adequacy and Risk Assessment ("**ICARA**") questionnaire (MiFIDPRU007), which asks firms to set out the additional own funds that they hold with respect to other risks from ongoing activities that are not captured by the K-Factors.

This alternative approach is not without its own challenges, not least since the ICARA questionnaire only requires firms to input the quantitative outcome of its ICARA assessment process and does not provide details as to the process firms should adopt to calculate that outcome. Firms adopting this approach may therefore find it helpful, as part of documenting the rationale for their internal ICARA assessment process, to have regard to the credit risk rules in CRR (for instance, with regards to risk weighting, credit conversion factors and credit risk mitigation) by way of analogy. The level of own funds which firms must hold following their ICARA process is of course ultimately subject to the FCA's discretion, and it may therefore take a different view on item 28A.

We would expect that the issues highlighted above are likely to be of particular relevance to investments firms which were formerly subject to the CRR but find themselves subject to the IFPR from 1 January 2022. It will be important to remain on the lookout for any greater clarity which the FCA may provide going ahead on how it expects firms to treat credit risk items falling outside of the K-Factors.

Key contacts

Benedict James
Partner
benedict.james@linklaters.com

Edward Chan
Partner
edward.chan@linklaters.com

Allegra Miles
Managing Associate (Knowledge)
allegra.miles@linklaters.com

Emeric Monfront
Managing Associate
emeric.monfront@linklaters.com

Elli Karaindrou
Associate
elli.karaindrou@linklaters.com

linklaters.com
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