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Client Alert
Commentary

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FCA Consults on Post-Brexit Prudential Regime for Investment Firms

Important changes lie ahead for investment firms as the FCA's Discussion Paper (DP20/2) indicates that the UK may depart from EU capital rules.

Key Points:

- The FCA is consulting on a UK capital regime that in some respects breaks ranks with the EU.
- Many firms will face changes to capital requirements and risk processes.
- Remuneration rules will change for some, with a loss of flexibility and potentially lower exemption thresholds.

At the end of the Brexit transition period (currently scheduled to end in December 2020), the UK will be free to follow, or depart from, future EU legislation. One important legislative proposal, the Investment Firm Directive and the Investment Firm Regulation (IFD/R), has been completed at an EU level, but will not come into force until 26 June 2021 *(i.e.*, after the end of the transition period). Therefore, although (as the FCA's Discussion Paper notes) the UK was "heavily involved in policy discussions" on the European regime, the UK needs to decide how much of the regime to implement into law. In some important regards, highlighted in this *Client Alert*, the UK is consulting on departing significantly from the proposed European regime.

Types of investment firms

There will be four types of investment firms:

- Systemically important firms, primarily credit institutions, which will remain subject to the Capital Requirements Directive/Regulation (CRD/R)

- Certain large firms (total value of consolidated assets of the firm is more than €15 billion, or in certain circumstances €5 billion), which will also primarily be subject to prudential requirements in the CRD/R

- All investment firms that are not Small Non-Interconnected firms (SNIs), which will be subject to the IFD/R in full

- SNIs, which will be subject to a reduced IFD/R regime

Only the very largest investment banks will therefore be subject to the CRD/R. For most investment banks, the critical threshold will therefore be to understand whether they are an SNI or not. The key thresholds (which may apply on a firm or combined group basis) are:

- Assets under management (AUM) less than €1.2 billion
- Client orders handled in cash trades less than €100 million a day
- Client orders handled in derivatives less than €1 billion a day
- Not holding client monies or assets
- On and off balance sheet total assets less than €100 million
- Total annual gross revenue from investment services and activities less than €30 million

Firms that exceed a threshold criteria are not SNIs. This *Client Alert* highlights certain issues relating to the calculation of those thresholds, and the benefits of being an SNI.

Capital and own funds

Regulatory capital will still be composed of three classes:

- Common Equity Tier 1 (CET1) capital
- Additional Tier 1 (AT1) capital
- Tier 2 (T2) capital

This follows closely the existing regime. However, there are a small number of important alterations. Significantly, the deduction for holdings of capital instruments on a trading book will not apply to non-significant market making holdings. This alteration is intended to promote market making activity, but firms will need to be clear that these holdings are indeed part of their normal market making activity and are non-significant.

Firms' capital requirements will be calculated based on three elements:

- An Initial Capital Requirement (ICR): These levels will be €750,000, €150,000, or €75,000 depending upon the activity being undertaken. In summary, firms that deal on their own account and/or underwrite, and certain OTFs, will be €750,000 firms. Most other firms will be €150,000 firms; however, they will be €75,000 firms if they do not have permission to hold client money or securities, and only receive and transmit orders, execute orders on behalf clients, undertake portfolio management, provide investment advice, and conduct placings without a firm commitment.
- A Fixed Overhead Requirement (FOR): This requirement is calculated as three months' overheads. In an important change from the existing regime, this will apply to all investment firms, and may be one of the key causes of increased capital requirements if implemented as proposed.
- A new K-Factor Requirement (KFR): The KFR is new, but does not apply to SNIs (although the FCA says that the KFR approach should be "considered by" SNIs in any event).

The new KFR regime

The KFR is a significant departure from the current regime. The FCA notes that "firms must recognise that the new approach is very different to what they are used".

The KFR is calculated as the sum of each of the (up to) three K-Factors that apply. The K-Factors are:

- Risk-to-Client (RtC)
- Risk-to-Market (RtM)
- Risk-to-Firm (RtF) (which only applies to firms with dealing and underwriting permissions)

K-AUM

For asset management firms, an important RtC factor relates to assets under management, which is seen as a proxy for the potential harm a firm might cause by incorrectly managing client portfolios. As well as capturing discretionary managed portfolios, non-discretionary arrangements where advice is provided are also within scope. Exactly what is caught by this requirement is described in some detail, but is not entirely clear. It is not intended to capture one-off advice, but will cover advice of an ongoing nature covering an entire portfolio that is similar to a discretionary managed portfolio other than for the fact that the client wants to retain final decision making power. It will also cover periodic reviews, where the investment firm charges based on a percentage of the assets of the portfolio.

A further complexity arises when considering delegated asset management arrangements. If a firm delegates, it must still include those assets within its K-AUM calculation, but the firm to whom it delegates need not include those assets to avoid double counting. However, if the firm delegating is based in a third country that does not have a comparable AUM-based capital requirement, then the firm receiving the delegation needs to include the value of the assets when measuring its total AUM. It is not clear how firms are expected to understand whether a third county has a comparable AUM-based capital requirement.

K-CMH

This risk factor is derived from the amount of client money held by a firm. It only applies to money that is held, not controlled. Firms will be required to undertake a monthly calculation based upon a six-month rolling daily average. The period in question is a six-month period, covering the most distanced six months in a nine-month period (*i.e.*, excluding the most recent three months). This approach — which occurs in a number of areas of the proposed new regime — is referred to in this *Client Alert* as the "six months in the last nine months approach".

K-ASAs

This risk factor relates to safeguarding and administering client assets, irrespective of whether they are held on balance sheet or in third-party accounts. In this regard (and unlike in relation to K-AUM), it includes amounts that have been delegated to a firm to safeguard and administer, so some double counting may occur. A daily average is to be calculated based upon a six months in the last nine months approach.

K-COH

This risk factor takes into account risks from the execution of orders in the name of the client, and the reception and transmission of client orders. There are two elements to this regime. The first amounts to cash trades, where the requirement is 0.1% of the amount paid or received. The second relates to derivatives based upon the notional amount of the contract (guidance is given in this regard), where the amount is 0.01%. This factor does not capture situations where investors are brought together to facilitate a transaction (*e.g.*, in a corporate finance context).

K-DTF

This risk factor captures operational risks relating to the value of trading activity (the daily trading flow) conducted on own account, or in its name to execute client orders. It measures the daily trading flow excluding any flow captured within the K-COH calculation. Firms need to determine a rolling average (separately for cash and derivatives trades) using the six months in the previous nine months approach. Detailed guidance is given on calculations; for instance, interest rate derivatives are to be calculated on the basis of the time to maturity of a swap of 10 years' duration.

K-NPR/CMG

Where firms deal on own account, or execute for clients in the name of the firm, they need to take one of two approaches to provide for potential market risks. K-CMG requires the FCA's permission, and is based upon a calculation of margin. This looks to the third-highest day margin requirement in the previous three months, and applies a multiplying factor of 1.3 to that number. Other firms will use a Net Position Risk approach to their trading booking activity. The FCA's permission can be sought to use an internal model to calculate K-NPR, but firms are warned that early engagement with the FCA will be required if they wish to seek such approval.

K-TCD

This factor looks at the risk of the default of a trading counterparty. It applies to firms that are dealing on own account or executing orders for clients in the firm's name. The Discussion Paper sets out a number of detailed and complex elements of the calculation.

Prudential consolidation

Group consolidation applies in a way that will be familiar to firms already caught by the CRD. One change is that the IFD/R puts the obligations both on the regulated firm and directly upon the (potentially unregulated) HoldCo. There is, in addition, a further attempt to close down any capital benefit from the use of service companies, as they would fall within the definition of "ancillary service undertakings" that would therefore be within the consolidation group.

Group capital test

The IFD/R introduces a new group capital test (CGT), which focuses on potential strains from membership of a group. It is similar to, but not the same as, a derogation from prudential consolidation under the CRD. Although the FCA has discretion as to whether to permit this approach to be used, the Discussion Paper makes clear the FCA's intention to do so widely and willing. The FCA must first be content that the group structure is simple, and that no significant risks to clients would arise from applying this alternative (to prudential consolidation) basis. In essence, the benefit is that parents simply have to hold enough own funds to cover (i) the sum of the book value of its holdings, subordinated claims, and relevant instruments; and (ii) its total contingent liability to firms in its own group. It is worth noting the impact of the GCT on potential acquisitions, as under prudential consolidation, parents would be required to deduct any goodwill arising at a consolidated level. Under the GCT, acquisitions at a premium would now be similar, as leveraged acquisitions not funded by capital may lead to a deficit in the required amount of CET1 held by the parent.

Concentration risk

All firms (including SNIs) are required to monitor and control concentration risk. Although this may, for many firms, involve primarily their trading book, the Discussion Paper makes clear that other types of risk (such as debtors, client money, etc.) also need to be taken into account in considering concentration risks. The Discussion Paper sets out a number of limits within the trading book, both soft and absolute, where the K-CON is increased if the limits are breached. Certain breaches require reporting.

Liquidity

One of the most important changes in the future regime will be the application, for the first time, of liquidity requirements to all investment firms. Existing liquidity waivers will cease. Firms will be required to ensure that, within a defined list of liquid assets, they hold enough to meet one month's worth of the FOR as a minimum baseline. Haircuts are applied to many asset categories — as an example, financial instruments traded on venues for which there is a liquid market (using the MiFID definition) are subject to a 55% haircut.

Risk, governance, and review processes

The new regime will introduce (to replace the Internal Capital Adequacy Assessment Process, or ICAAP) a new Internal Capital and Risk Assessment (ICARA). This will need to be produced continuously, and reviewed annually. To manage this process, non-SNIs with balance sheets above a certain size (currently €100 million) will need to have a risk committee made up entirely of non-executives. The FCA is considering (indeed, the suggestion is it is likely that the FCA will agree to) raise the limit from €100 million to €300 million (average-on and off-balance sheet assets over the previous four years) before the obligation to have a risk committee arises.

The ICARA approach is more consistent with the regulators' recent approach to Operational Risk than the more metric-driven approach of a typical ICAAP. For the first time, wind-down planning will need to be taken into account. The FCA gives a list of examples of potential harm to clients or markets that will need to be assessed, including:

- Mandate breaches for asset managers
- Trading/dealing errors
- System outages affecting customers
- Corporate finance advice that could result in lawsuits
- The provision of unsuitable advice leading to claims
- Issues with assets under title transfer collateral arrangements (TTCAs)
- A failure to manage transition away from LIBOR

The FCA notes that these changes may impact businesses that currently have Individual Capital Guidance (ICG). Such firms are required to compare the old and new figures, and where the new figure reduces a capital requirement, to apply an equivalent new ICG test to retain existing levels of capital. Firms would need to apply to the FCA for a voluntary requirement (VREQ) to confirm any rebased requirement.

Regulatory reporting

Firms will be required to report to the FCA on their capital position on a quarterly basis, other than SNIs which will do so annually.

Remuneration

SNIs are exempt from the detail of the revised remuneration arrangements, unless they are caught as part of a consolidated group.

Non-UK subsidiaries of consolidated groups, or investment firms, which are not exempted are caught. However, the FCA has acknowledged that this provision is dependent upon it being “not unlawful” for the remuneration code to apply locally. If a firm wishes to take this point, it may be required to notify the FCA in advance.

Non-SNI firms are then split into two categories, with proportionality applying to firms whose on-and-off balance sheet risks are less than €100 million (taking a four-year rolling average). For such firms, the rules relating to (i) payment being in shares rather than cash; (ii) payment being deferred over a period of years; and (iii) holding retention periods for discretionary pension arrangements, are disapplied. The UK will likely choose to raise this level to €300 million, which is permitted under the IFD/R. If it does so, the requirement to have a remuneration committee for firms that exceed a €100 million limit will also be increased to €300 million.

Under the IFD/R, requirements relating to remuneration are disapplied for individuals whose variable pay is less than €50,000 and less than 25% of their overall compensation. The current requirement applies proportionality to employees whose overall compensation package is less than €500,000 provided that no more than 33% of this is variable. This means that the IFD/R is likely to catch more employees, and the FCA is consulting on whether this is the correct outcome or whether the UK should take a different approach (for instance, retaining the existing levels).

The FCA makes an important statement relating to the use of proportionality, which appears to agree to the interpretation being taken at an EU-level. The previous regime used the phrase “to the extent” when talking about proportionality. That terminology is removed under the IFD/R. The FCA takes the view that this means that flexibility has been removed, and that proportionality has been hardwired into the IFD/R by, for instance, exempting SNIs, exempting certain types of employees, and exempting firms with balance sheet risks below defined limits (see above). So additional flexibility cannot be justified on a firm-by-firm basis. When implemented, the IFD/R will likely contain the answer, rather than permitting firms to plead their own proportionality cases.

The FCA makes clear that its implementation of the IFD/R will not include the provision of fixed bonus caps.

In other regards, the IFD/R contains familiar approaches (subject to the proportionality points above) to payment being in cash or shares, deferred over a period of time, made subject to malice and clawback etc. In addition, rules relating to limitations on guaranteed bonuses and buy-outs will remain.

ESG

The FCA notes that the IFD/R intends to include a future K-Factor for environmental, social, and governance (ESG) issues. This will be a significant change, as managing ESG risks would then have directly beneficial capital implications for investment firms. The FCA states that all firms (including SNIs) should consider ESG risks. It is likely that investment firm disclosure on the impact of ESG is to be required from late 2022.

Public disclosure

Investment firms will be required to continue to provide disclosure relating to various requirements in the IFD/R (similarly to the CRD/R). However, these requirements will not apply to SNIs unless they have issued AT1 instruments.

Waivers and CRR permissions

Some CRR permissions are carried over into the IFD/R regime (for instance, exemptions for inter-group exposures from the limit to large exposures). But consolidation waivers and firm-specific liquidity permissions will lapse.

Collective portfolio management investment firms

Collective portfolio management investment firms (CPMs) authorised under the AIFMD or UCITS Directive which have MiFID permissions will fall within the new regime. Therefore, if the K-AUM requirement applies, there is no limit on the ultimate amount of the capital requirement, which is a change from the existing regime.

FCA discretions

The regime contains a number of discretions, and the Discussion Paper highlights the FCA’s intentions on a number of them when discussing the relevant rule change. But it also pulls together its view on those discretions in a single section to give an overview of where flexibility is, and is not, likely to be expected.

First, firms will lose any ability to opt into the CRD/R when the IFD/R applies. The FCA does not want to have to supervise firms on two different bases.

SNIs will not be allowed to opt out of the liquidity regime.

On remuneration, it seems likely that the UK will opt for a €300 million balance sheet regime (although the FCA notes that it will need the government’s approval to do so), and the UK is likely to change the IFD/R proposals to permit the use of alternative “shadow” management incentive arrangements where shares are not available.

The FCA notes that it is likely to mandate a single UK HoldCo if a group contains two firms within the scope of the IFD/R.

Transitional provisions

The FCA proposes that transitional arrangements be put in place, as some firms will likely face significant changes. Notably, significant capital changes will likely be required for firms currently operating on a matched principal restriction basis. The FCA proposes that they have five years in which to go "in steps" from either a €50,000 or €125,000 firm to the (now likely) €750,000 requirement.

Conclusion

This Discussion Paper sets out the future direction of travel for capital requirements on investment firms in the UK post-Brexit. It is clear that the UK regulators support the overall approach of saying that the existing CRD/R regime is not fit for purpose for investment firms, and that the new IFD/R regime proposed at a European level is better. In a number of areas, such as remuneration, additional flexibility is likely to be provided. But the regime will be a significant change for firms that may have grown accustomed to the existing ICAAP-led approach. Some firms may be required to make significant improvements to data analysis, data reporting, and capital levels.

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