Specific **prudential framework for** investment firms

Introduction

On 5 December 2019, the legislative texts that will introduce a prudential regime specific for (MiFID) investment firms were published in the EU Official Journal. This regime is relevant for all non-bank firms undertaking investment services and activities. The current prudential regime has its origin in 1993, when banks and investment firms became subject to uniform prudential requirements. Because of this investment firms have been subject to the same EU prudential rules as banks which however do not always do justice to the specific business model of investment firms. Therefore the European Commission has undertaken a fundamental review of the overall prudential framework for investment firms in consultation with the European Banking Authority (EBA). The European Parliament and Council agreed on an amended proposal consisting of a Regulation on the prudential requirements of investment firms and a Directive on the prudential supervision of investment firms. It is important to note that although the regime is meant to ease the burden for investment firms, some investment firms will face increased capital requirements.

Is this regime relevant for you?

The regime is relevant for:

Type of business	Which relevant MiFID services do they undertake?
Proprietary traders	Dealing on own account
Wealth managers	Portfolio management and investment advice
Commodity traders with a MiFID license	Dealing on own account
MTFs and OTFs	Operation of multilateral trading facilities (MTFs) or organised trading facilities (OTFs)
Broker/dealers	Dealing on own account and/or execution of orders
Corporate finance boutiques	Placing of financial instruments
Fund managers	Fund managers often conduct portfolio management next to their fund management activities. Given that their activities are similar to investment firms it is likely that supervisors will continue their current practice of equating fund managers with investment firms for prudential purposes.

The regime introduces three classes of investment firms

Class 1	Class 2	Class 3
Bank-like systemic investment firms with a (consolidated) balance sheet of €30 billion or more. They will need to obtain a banking license. Bank-like systemic investment firms with a (consolidated) balance sheet of € 15 billion or more (or € 5 billion and upon the supervisor's discretion). They will remain under the current prudential framework for banks.	Non-systemic investment firms which cross particular sizes or perform specific activities.	The smallest and non-interconnected firms which are subject to a simplified regime and may only perform a limited set of MiFID services.

	Class 2	Class 3
Size thresholds	Firms in excess of any of the following size thresholds: • Assets under management above €1.2 billion; • Client orders handled of at least €100 million a day for cash transfers or €1 billion a day notional for derivatives; • Balance sheet total above €100 million; or Total gross revenue above €30 million.	Firms below all of the following size thresholds: • €1.2 billion assets under management; • Client orders handled below €100 million a day for cash transfers or €1 billion a day notional for derivatives; • Balance sheet total below €100 million; or • Total gross revenue below €30 million from investment services.
Performed services/ activities	• All investment services and ancillary services; • A firm undertaking another activity then listed on the box to the right	• Reception and transmission of orders in relation to one or more financial instruments; • Execution of orders on behalf of clients; • Portfolio management; • Investment advice; • Placing without firm commitment; and • All ancillary activities except custody of assets; • If undertaking any other investment service or activity a firm is classed 2.

The new rules have impact on capital, reporting, governance, remuneration and liquidity

	Class 2	Class 3

Capital required	The highest of:
	• Fixed overheads requirement (FOR);
	• Permanent minimum requirement (initial capital);
	• K-factors;
	  • Risk to client;
	  • Risk to market;
	  • Risk to firm.
		The highest of:
		• Fixed overheads requirement (FOR);
		• € 75.000 minimum capital (initial capital).

Reporting to authorities	• Quarterly reporting of:
	  • level and composition of own funds;
	  • capital requirements;
	  • capital requirement calculations;
	  • level of activity, including the balance sheet and revenue breakdown by investment service and applicable K-factor;
	  • concentration risks; and
	  • liquidity requirements.
	• Quarterly reporting of total (consolidated) assets if investment firm is dealing on own account or underwriting financial instruments and assets exceed € 5 billion.
		• Annual reporting of:
		  • level and composition of own funds;
		  • capital requirements;
		  • capital requirement calculations;
		  • the level of activity, including the balance sheet and revenue breakdown by investment service and applicable K-factor; and
		  • liquidity requirements.
		• If the investment firm is exempted by its prudential supervisor from the liquidity requirements, it is also exempt from reporting on this requirement.

Governance and Remuneration	• Apply CRD IV like governance rules and remuneration rules, but no bonus cap. Disclose the following information:
	  • Information regarding risk management objectives and policies, internal governance arrangements, own funds, ICAAP, K-factors, remuneration policy, investment policy and ESG related risks; and
	  • CRD IV like country-by-country reporting , including turnover, headcount and taxes paid.
		• Exempt from governance requirements (MiFID II governance requirements apply);
		• Not subject to public disclosure requirements, except where the firm issues Additional Tier 1 instruments.

Liquidity requirements	• To hold at least one-third of their fixed overheads requirements in liquid assets (i.e. 1/12 of the fixed overheads of the preceding year); • Additional liquid asset to cover an amount equal to 1.6% of the total amount of guarantees provided to customers; • Investment firms not dealing on own account or underwriting financial instruments may include receivables from trade debts and fees or commissions receivable within 30 days, but only to satisfy one third of their liquidity requirement and subject to a 50% haircut.	• May be exempt from the requirement to hold at least one-third of their fixed overheads requirements in liquid assets (the EBA is tasked with issuing guidelines specifying the criteria for exempting firms from this requirement); • Additional liquid asset to cover an amount equal to 1.6% of the total amount of guarantees provided to customers; • Able to include receivables from trade debts and fees or commissions receivable within 30 days, but only to satisfy one third of their liquidity requirement and subject to a 50% haircut.

What is meant with Fixed overheads requirement (FOR), Initial capital and K-factors?

Fixed overheads requirement (FOR)

The fixed overheads requirement shall amount to at least one quarter of the fixed overheads (fixed costs) of the preceding year.

Permanent minimum requirement (Initial Capital)

- €750.000 (now: €730.000): for investment firms that deal on own account and underwrite financial instruments (including operators of an OTF that also deals on own account).
- €150.000 (now: €125.000): for investment firms other than the firms referred to above and below. These are firms that do not hold an own balance sheet, but do operate a MTF or OTF or hold client assets.
- €75.000 (now: €50.000): for investment firms that do not deal own account, underwrite financial instruments or operate an MTF or OTF and do not hold client assets.

K-factors

K-factors are the capital requirements set out in the proposed Regulation for risks that an investment firm poses to clients, markets and to itself.

Zoom in on K-factors

Risk to client factors; the four factors below must be added up

K-AUM	The capital requirement relative to the value of assets that an investment firm manages for its clients under both discretionary portfolio management and non-discretionary arrangements constituting investment advice of an on-going nature, including assets delegated to another undertaking and excluding assets that another undertaking has delegated to the investment firm.	0.02% of assets under management
K-CMH	The capital requirement relative to the amount of client money that an investment firm, taking into account the legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm.	0.45% of client money held on segregated accounts and 0,5% of client money held on non-segregated accounts
K-ASA	The capital requirement relative to the value of assets that an investment firm safeguards and administers for clients, including assets delegated to another undertaking and assets that another undertaking has delegated to the investment firm, irrespective of whether assets appear on the investment firm's own balance sheet or are segregated in other accounts.	0.04% of assets under administration
K-COH	The capital requirement relative to the value of orders that an investment firm handles for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients.	0.1% of the value of cash trades 0.01% of the value of derivative trades

Risk to market factors; One of the two must be used:

K-NPR	The capital requirement relative to the value of transactions recorded in the trading book of an investment firm.	This is calculated according to the current market risk calculations set out in the CRR
K-CMG	The capital requirement relative to the amount of total margin required by a clearing member or qualifying CCP, where the execution and settlement of transactions of an investment firm dealing on own account take place under the responsibility of a clearing member or qualifying CCP.	This is the third highest amount of total margin required on a daily basis by the clearing member or qualifying CCP over the preceding 3 months multiplied by a factor of 1.3.

Risk to firm factors; the three factors below must be added up

K-TCD	The capital requirement relative to the exposures in the trading book of an investment firm in instruments and transactions giving rise to the risk of trading counterparty default.	Determined by (i) the exposure value (ii) the counterparty type and (iii) the current market value of the credit risk of the counterparty to the investment firm.
K-CON	The capital requirement relative to the exposures in the trading book of an investment firm to a client or a group of connected clients the value of which exceeds certain preset limits.	For exposures to an individual client or group of connected clients above 25% of the firm's own funds.
K-DTF	The capital requirement relative to the daily value of transactions that an investment firm enters through dealing on own account or the execution of orders on behalf of clients in its own name, excluding the value of orders that an investment firm handles for clients through the reception and transmission of client orders and through the execution of orders on behalf of clients as already reflected in K-COH.	0.1% of the value of cash trades 0.01% of the value of derivative trades

As of when will you need to comply with the new rules?

Dec 2017

Commission proposals for new prudential regime

2018-2019

Proposals subject to discussion by the European Parliament and the Council

Dec 2020

Final legislative texts allow for an implementation period of 18 months

June 2021

The new rules will start to apply from 26 June 2021

The exact transitional rules once the new regime has entered into force will differ on a case-by-case basis, depending on the firm-specific required increase to regulatory capital. For example, firms may limit the capital requirements to twice the relevant capital requirement pursuant to the current prudential framework for a period of five years.

Important: although the legislative texts do not yet apply, regulators may already expect that you take the texts into account in your Internal Capital Adequacy Assessment Process (ICAAP).

How can HVG Law help you?

We can assist you by

1. Determining whether the Investment Firm Regulation (IFR) capital rules actually apply to you.
2. Determining which parts of the IFR are relevant based on your group structure.
3. Analyzing which parts of the IFR are relevant for you based on your activities.
4. Checking whether the required capital is available. This means checking the liability parts of your balance sheet against the minimum capital requirement.
5. In the unfortunate case the current capital is not enough (which of course we do not hope), assisting you in bringing the message to the regulator.
6. Advising you and assist you with implementing the new governance requirements.

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About HVG Law
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