IFPR Newsletter

IFPR Implementation Observations – concluding report

This month we published the observations from our multi-firm review into firms' progress in implementing the internal capital adequacy and risk assessment (ICARA) process and reporting requirements under the Investment Firms Prudential Regime (IFPR).

During our review most firms engaged well and showed that they were able to make the transition to the new regulations. However, there are still areas for improvement. This publication should be considered together with our February 2023 publication. Firms must act now to consider our findings and assure themselves that they are meeting our rules. We are also holding briefings in our offices and through trade associations on the contents of our publications. Please get in touch with your supervisors or trade associations for further information.

Investment Firm Groups

Under the IFPR, prudential consolidation applies where there is an investment firm group (except where the FCA has granted permission to that group to use the alternative of the group capital test). An FCA investment firm group will comprise a UK parent undertaking and its relevant subsidiaries (and connected undertakings), where at least one entity is an FCA investment firm. The FCA investment firm may be the parent or a subsidiary entity. An investment holding company, or a mixed financial holding company may also be the UK parent.

We have noticed that some firms may not have been including all relevant financial undertakings within the scope of their investment firm group. We would therefore remind all firms and UK parent entities subject to MIFIDPRU of the relevant rules in MIFIDPRU 2.4 which set out how to determine the existence and content of an investment firm group.

Further, we have noticed attempts by some controllers of MIFIDPRU firms to either avoid the existence of an investment firm group, or to reduce the scope of application of prudential consolidation under MIFIDPRU 2.5 to their group. In such cases we would remind firms of section 143J of the Financial Services and Markets Act (FSMA), which deals with a requirement to have a UK parent undertaking. This section provides that where two or more FCA investment firms are subsidiary undertakings of the same parent undertaking then the FCA may exercise its power under section 55L(3) of FSMA to impose a requirement on the FCA investment firms to secure that a parent undertaking with its head office in the United Kingdom is established.

Where we see multiple MIFIDPRU firms owned by third country parent entities, we are prepared to exercise our power (as above) if necessary. For example, where the non-UK parent entities are highly leveraged and could potentially pose a risk to the on-going financial soundness of the MIFIDPRU firms. The establishment of a UK parent entity would create the existence of an investment firm group (where there is none already) and the correct application of prudential consolidation to it should help mitigate the potential for harm.

Compliance with requirements for issuing CET1 capital instruments

Where a firm is seeking to include a new issuance of a capital instrument as part of its common equity tier 1 capital (CET1), if not previously granted permission for that capital instrument, an application for permission under MIFIDPRU 3.3.3R (1) must be made using the form in MIFIDPRU 3 Annex 2R. This must be approved prior to the capital instrument qualifying as regulatory capital. Where we have previously granted permission for a capital instrument, subsequent issuances of that instrument do not require prior permission, but a notification must be made under MIFIDPRU 3.3.3R (2) and using the form in MIFIDPRU 3 Annex 3R. These obligations extend to a UK parent entity where there is an investment firm group and capital instruments are sought to count as consolidated CET1.

Firms may have gained deemed permission for capital instruments that were in issuance pre-IFPR to qualify as CET1 by utilising the transitional provision in MIFIDPRU TP 7 and submitting a TP 7.4R notification (prior to the deadline of 29th June 2022). We have noticed in some instances that where firms made these notifications, the capital instruments referred to within them may not actually satisfy all the conditions under the relevant provisions of the UK CRR (as applied by MIFIDPRU 3.3) to count as CET1. These are the conditions in article 28 of the UK CRR (in the form in which it stood as at 1 January 2022). It is therefore important that firms ensure that where they have relied upon MIFIDPRU TP 7, the capital instruments which have been 'deemed to be approved' meet those conditions of the UK CRR. If a firm discovers that it has been misreporting to us the true value of its eligible regulatory capital, it should consider if it has a need to notify us of this under Principle 11 of our Principles for Business.

Where a firm is reliant upon other reserves (e.g. capital contribution reserves) to qualify as CET1, we would remind them that the items may be recognised as such only where they are available to the institution for unrestricted and immediate use to cover risks or losses as soon as these occur. If a firm is wishing to include substantial amounts of other reserves, it may decide it is appropriate to submit a Principle 11 notification prior to their classification as CET1. This would ensure that we are sighted on the reason behind a potential subsequent increase in CET1 figures reported to us.

Deductions from own funds

Under MIFIDPRU 3.3.6R a MIFIDPRU firm must deduct various items from its common equity tier 1 capital, including intangible assets. These deductions are important – they help preserve the quality and adequacy of a firm's capital, by ensuring that any reduction in the value of these assets (e.g. in stress) can be absorbed by a firm. Where firms have assets that could be characterised as deductibles such as "intangible assets" under accounting standards, but which may also be characterised in other ways, we expect them to take an appropriate and prudent approach. In such cases we would remind firms when assessing the adequacy of their financial resources (including under the ICARA process in MIFIDPRU 7 and Finalised Guidance FG20/1 Our framework: assessing adequate financial resources) to consider the nature of the relevant asset and whether it is prudent to hold sufficient capital to absorb a full deduction.

This issue is equally relevant in the context of the consolidated situation of investment firm groups under MIFIDPRU 2.5. And would also apply to our other prudential regimes for non-MIFIDPRU firms that require similar deductions from their own funds, capital or financial resources.

Matched principal restrictions for firms with permission to deal on own account

In our second policy statement for IFPR (PS 21/9), we set out our intention to no longer apply certain limitations or requirements to a firm's permissions upon authorisation. This was where these typically established which prudential categorisation a firm was previously in but are no longer needed for prudential purposes under the IFPR. However, the relevant existing limitations and requirements are still in force unless a firm has completed a variation of permission to remove such a restriction. This is important as it allows us to judge the level of a risk a firm is taking and its readiness to do so.

One of the existing restrictions includes the matched principal broker (MPB) limitation for firms that have permissions to deal in investments as principal. We have seen examples of firms with the MPB restriction potentially acting outside of their permissions due to a failure to comply with the criteria for what constitutes an MPB. The 'matched principal exemption conditions' are defined in our Handbook Glossary Terms by reference to previous prudential sourcebook rules as they applied on 31 December 2021. These conditions are essentially:

- the firm holds positions for its own account only as a result of a failure to match investors' orders precisely;
- the total market value of the positions is no higher than 15% of the firm's initial capital; and
- the positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

We remind firms that all the conditions must be met for a firm to be compliant with the MPB restriction. Firms that carry this limitation may wish to conduct a holistic assessment to ascertain if their business model/activities meet the relevant conditions.

IFPR reporting

Firms with permission to deal on own account - reporting of K-factors on Form MIF001

As set out in MIFIDPRU 1.2.1R (5) a firm does not meet the conditions to be a small and non-interconnected (SNI) firm when it has the permission to deal on own account. The IFPR introduced a range of K-factor requirements as part of the own funds requirements for non-SNI MIFIDPRU firms, several of which only apply to a firm that deals on own account (see MIFIDPRU 4.11, specifically MIFIDPRU 4.11.4R, 4.11.5R and 4.11.6G). Further, our reporting requirements in MIFIDPRU 9 set out that non-SNI firms should complete the K-factor requirements in Form MIF001 (as well as all MIFIDPRU firms being required to complete the monitoring metrics in Form MIF003).

We have noticed that some non-SNI firms have not been reporting values in the K-factor fields in Form MIF001, and specifically where they have permission to deal on own account (and nil values for daily trading flow (DTF) in Form MIF003). We remind firms that they should be reporting accurately to reflect the activity that is taking place.

We acknowledge that there may be situations in which it is possible that a firm with dealing permission will report zeros for some of the K-factors relevant to firms dealing on own account. For example, K-NPR might be zero where a firm is perfectly matched or hedged and genuinely has zero position risk, foreign exchange risk and commodity risk (although it could still have values for K-TCD in respect of trading counterparty default and/or K-DTF for its daily trading flow). However, where this results from a firm continually not using a relevant permission (such as dealing on own account), it should consider whether it may need to apply to remove it, to reflect accurately the nature of its business activity.

Items to be entered into cell 6A in RegData on Form MIF002

We note there is a mismatch between the text for cell 6A on Form MIF002 in the Handbook version compared to the RegData version. Cell 6A refers to trade receivables that are used to meet the Basic Liquid Asset Requirement (BLAR).

In the Handbook version of the Form MIF002 and its guidance notes cell 6A should be reported as the total value of trade receivables from trade debtors that are receivable within 30 days, even if they are not used to meet the BLAR. Whereas in RegData the text for cell 6A says 'Trade receivables used to meet core liquid asset requirement' (which is incorrect).

Firms should be completing cell 6A on Form MIF002 as directed by the Handbook version and its guidance notes, which is the full value of trade receivables, before adjustments, irrespective of whether or not any are actually used to meet the BLAR.

General reporting guidance for Form MIF006

Form MIF006 concerns reporting for firms with permission to use the group capital test (GCT). Cell 6 on that form includes the need to enter amounts for the book value of various investments in subsidiaries. Given that the return is to be completed in units of £1,000, where a firm has a book value of an investment in a subsidiary and this value is greater than zero but less than £1,000, the firm should enter a value of '1' to show there is some investment applicable to that cell.