FINANCIAL
CONDUCT
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A new UK prudential regime for MiFID investment firms

Discussion Paper

DP20/2

June 2020

How to respond

We are asking for comments on this Discussion Paper by **25 September 2020**.

You can send them to us using the form on our website at:
www.fca.org.uk/dp20-02-response-form

Or in writing to:
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Foreword – Christopher Woolard, Interim Chief Executive

Investment firms are critical players in the UK and global economy. They help ensure capital is allocated efficiently and appropriately and help individuals make the most of their savings and investments.

The UK boasts a vibrant number and diversity of such firms. There are currently around 3,000 investment firms operating here, representing by far the largest market in Europe.

With the exception of 8 large investment firms, regulated by the Prudential Regulation Authority, we are responsible for the prudential supervision of these firms in the UK. We have long advocated for a bespoke prudential regime for investment firms. Last year the EU published rules introducing such a regime, the Investment Firm Directive and Regulation (IFD/IFR), to be implemented by 26 June 2021.

We are no longer members of the EU and so, with a transition period ending at the end of this year, we will not be obliged to implement the EU's rules. The precise form of the long-term economic relationship between the UK and the EU will be determined by the ongoing political negotiations.

We supported the overall goals of the EU prudential regime for investment firms (IFD/IFR), and welcome the Chancellor's statement in the budget that the Government intends to legislate for a UK regime. We propose to introduce a UK regime that will achieve similar intended outcomes as the IFD/IFR whilst taking into consideration the specifics of the UK market. This discussion paper in intended to help that analysis.

Given the importance of investment firms to the functioning of the UK and global economy, it is in everyone's interest that they are financially resilient. We do not want these firms to create harm or to fail in a disorderly manner that brings wider disruption to investors or the markets in which they operate. This means it is appropriate that they are held to high prudential standards.

However, it is also important not to create an inappropriate or excessive prudential regime that does not fully align with actual business models, or address the specific risks they pose.

This discussion paper sets out the details of the EU's new prudential regime for investment firms (IFD/IFR), and seeks feedback from stakeholders on the appropriate rules for the UK to apply in this area.

The FCA's view is that proposing new prudential rules for UK firms would help us better deliver against our objectives. A new UK regime would represent a significant improvement in the prudential regulation of investment firms. For the first time, it would deliver a regime that has been designed with investment firms in mind, replacing many rules that were largely designed for deposit-taking credit institutions. The on-going regulatory costs for investment firms should be lower. The new regime would also re-orient the focus of prudential requirements and expectations away from risks the firm faces, to also consider the potential for harm the firm can pose to clients and the market.

While we believe investment firms would benefit, we do not underestimate the scale of the change.

UK investment firms would be subject for the first time to liquidity requirements across the board. The levels of initial capital required for authorisation would be updated. There would be a brand new methodology for calculating capital requirements, the K-factor approach. There would be new remuneration and disclosure requirements. We also have wider expectations for FCA solo-regulated firms, as set out in our recent finalised guidance, 'FG20/1 Our framework: Assessing adequate financial resources'. In line with these, we would expect investment firms to consider not only the threats they face, but also harms they could pose, as part of their internal assessment of financial adequacy and winddown.

Investment firms, investors and other stakeholders should read the contents of this DP. We welcome their responses to the questions that we have asked.

1 Overview

Introduction

1.1 The Financial Conduct Authority (FCA) is the competent authority (CA) under the Financial Services and Markets Act (FSMA) for the prudential regulation of a large number of investment firms authorised under the Markets in Financial Instruments Directive (MiFID).

1.2 This Discussion Paper (DP) sets out the technical details of, and our initial views on, the Investment Firm Directive (IFD) and the Investment Firm Regulation (IFR). The European Union's Official Journal published these on 5 December 2019, and investment firms and competent authorities in EU Member States will be required to comply with them from 26 June 2021.

1.3 As the UK has exited the EU we will not implement the IFD/IFR. Rather, as stated by the Chancellor in his 11 March Budget, the Government intends to legislate to introduce a new prudential regime for UK investment firms (see also the Treasury's policy statement 'Prudential standards in the Financial Services Bill: June update). UK investment firms and other interested stakeholders should read this DP in that light. We are seeking to make stakeholders aware of how we may approach writing the domestic rules to achieve this. This includes, for stakeholders with the capacity, receiving stakeholder views on the EU's regime, and our interpretation of it.

1.4 The approach we have followed in this DP is to set out, coherently and logically, the requirements the IFD/IFR places on EU firms and competent authorities. Where relevant, we have also set out in each chapter our initial views on the intention and implication of the regime and our interpretation of it. This is particularly the case where the regime makes a material change to the status quo, or where the EU's text provides for national discretions, or has ambiguities.

1.5 As an EU Member State authority at the time, we were heavily involved in policy discussions that took place through the EU and European Banking Authority papers and consultations. UK-based stakeholders made significant contributions to these. So, in this DP we are engaging in a more detailed technical discussion on the specifics of the new regime. Correspondingly the questions we ask look to get views on how appropriate our interpretations are, or how we state we would deal with specific issues under a domestic regime. Respondents are of course very welcome to raise wider issues related to the regime, but this isn't the focus of this DP.

1.6 As this DP sets out, the IFD/IFR represents a significant change to how MiFID investment firms will be prudentially regulated. Broadly, we are very supportive of the intention of the regime. It has been designed specifically for investment firms, and we believe introducing UK-specific rules intended to achieve the same overall outcome would be fully consistent with our statutory objectives and mission.

1.7 Despite the scale of the change, we believe the large majority of UK investment firms would welcome such a domestic regime. The following features underline why:

- **Lower regulatory costs** – the potential to result in much more proportionate regulatory reporting and disclosure requirements for investment firms, particularly for smaller, non-interconnected investment firms.
- **Better alignment of requirements to business models** – the new K-factor approach better aligns with the business models used by investment firms than existing regimes. It allows a better alignment between regulatory prudential requirements and business model risk and management strategy.
- **Strengthened supervisory dialogue** – the linking of requirements between business model and risk of harm should allow FCA supervisors and investment firms to focus during the supervisory review process on mitigating the risk of harm in a way that aligns with how the investment firm thinks about its business.
- **Improved competition** – all investment firms carrying out the same investment activity are treated in a simpler and more consistent manner. This allows competition for investment business on a level playing field. This also means the regime will support our competition objective.
- **Better prudential outcomes** – the new regime should improve prudential standards for investment firms overall, for example through the introduction of a proportionate, minimum liquidity requirement for all investment firms. This should improve overall confidence in the financial resilience of investment firms and the industry among customers, counterparties and, where relevant, shareholders.

1.8 While recognising these potential benefits, we are careful at this stage not to provide specific numbers on the expected impact of a new UK regime on investment firm-types, or to state exactly how many investment firms would qualify as small and non-interconnected investment firms (SNIs), should we introduce a similar concept in the UK. This is due to the scope of our rule-making powers not yet being settled (although the Treasury's 'Prudential standards in the Financial Services Bill: June update' provides some more clarity on this). Also, the details of certain requirements in EBA level 2 legislation have not been finalised. These include technical standards and guidelines. While we have left the EU and would no longer bound by such future standards and guidance, we consider it might be appropriate to take them into account when designing our UK regime. This is something that we intend to address through a cost-benefit analysis in a subsequent consultation paper.

1.9 However, the EU's regime has been designed not to radically change the total amount of own funds being held overall, but to better align standards with the business model and source of harm. We expect this would be reflected in the impact of a similar domestic regime on UK investment firms. We would also note that we expect a majority of FCA-regulated investment firms would qualify as the equivalent of SNIs.

1.10 Investment firms should be aware of the scale of the change the IFD/IFR represents. In addition to various less material changes compared to the existing regime, major changes we describe in this DP include:

- an update to the initial capital required for authorisation
- changes to the rules on the definition of capital
- new own funds requirements, including the introduction of the K-factor approach
- new rules on prudential consolidation, group risk and concentration risk
- applying liquidity requirements to all investment firms

- a new approach for investment firm's internal risk and prudential assessments, and the supervision of those requirements
- new requirements on remuneration policies
- changes to reporting and disclosure requirements

1.11 We encourage investment firms and other interested stakeholders to engage with the detailed points in this DP, and provide feedback on them so we can develop our approach before consulting on any necessary rules.

Who does this document affect?

1.12 The information in this DP will be of interest to:

- Solo-regulated investment firms that are currently authorised under MiFID. This includes firms that are currently subject to any part of the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR) including:
  - 'Limited licence' investment firms that are currently subject to BIPRU and GENPRU;
  - 'Full scope', 'limited activity' and 'limited licence' investment firms that are currently subject to IFPRU and CRR;
  - 'local' investment firms;
  - matched principal dealers;
  - specialist commodities derivatives investment firms that benefit from the current exemptions on capital requirements and large exposures;
  - 'exempt-CAD' firms; and
  - investment firms that would be exempt from MiFID under Article 3 but have 'opted-in' to MiFID.
- Collective Portfolio Management Investment Firms (CPMIs).
- Investment firms authorised by the Prudential Regulation Authority (PRA).

Is this of interest to consumers?

1.13 The objectives underlying the new EU regime are primarily prudential and about reducing the potential harm that an investment firm may cause to its clients or markets. While there are no direct implications for consumers, we expect that UK investment firms subject to a similar UK regime would find the new prudential framework more appropriate to their business model and less burdensome than the current requirements. This should mean they can devote more effort to efficiently and effectively running their business. Prudential requirements that better align with an investment firm's business model should also help improve stability in the financial sector overall. This should have positive implications for consumer protection and particularly for clients of investment firms.

Rules for investment firms in the UK

1.14 In this DP we describe the EU text of the IFD/IFR with the intention of soliciting views on the approach we could take in the UK under domestic legislation. The IFD/IFR will apply in the EU from 26 June 2021.

1.15 However, considerable amounts of detail remain outstanding. This includes the necessary legislation being in place to ensure that relevant investment firms will be regulated under a new regime similar to the IFR/IFD rather than the on-shored CRR/CRD. This legislation will also provide the relevant regulators with the necessary power to introduce the rules and supervise investment firms under a new prudential regime, such as being able to put requirements on holding companies. We are currently engaged with HMT, the Bank of England (Bank) and the PRA on this subject. Once this has been decided, we will provide further information on how we will introduce the new prudential regime, including consulting on any rules that the FCA may be required to make to fulfil its legal obligations in this area.

1.16 The IFD/IFR also contain mandates to prepare regulatory/implementing technical standards and guidelines. In due course, we might refer to the content of such measures in our rules. This depends on the Government's approach to introduction of the UK regime.

1.17 Our views contained within this DP are included to enable discussion on important aspects of the IFD/IFR. These views do not necessarily reflect our final settled position on the correct interpretation of certain elements of the legislation. They may evolve based on our ongoing analysis, the consultation and conclusion of EU technical standards, feedback from firms and continuing engagement with other key stakeholders.

Equality and diversity considerations

1.18 Potentially, the requirements for investment firms to have a gender neutral remuneration policy could have a positive impact on equality and diversity. Overall, we do not consider that the topics in this Discussion Paper adversely impact any of the groups with protected characteristics i.e. age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment. But we would welcome your comments.

Next steps

What do you need to do next?

1.19 Please send us your comments and/or responses to the questions on our potential implementation proposals by Friday 25 September 2020.

How?

1.20 Use the online response form on our website or write to us at the address on page 2.

What will we do?

1.21 We will consider your feedback and publish a Consultation Paper later in 2020.

2 Key features of the new regime

Introduction

2.1 Below we set out some of the key features of the new EU regime. Please note that IFD/IFR also contain a range of other less significant but still important features and investment firms need to be familiar with all of them. The contents of the IFD/IFR are covered in more detail in subsequent chapters of this DP.

Initial capital required for authorisation (Chapter 5)

2.2 The initial capital required for authorisation has increased for most firms. The new levels are set out in Article 9 of the IFD and are EUR 75k, EUR 150k, and EUR 750k depending on the investment activities the firm carries out.

Definition of capital (Chapter 4)

2.3 The definitions of Common Equity Tier 1 capital (CET1), Additional Tier 1 capital (AT1), and Tier 2 capital (T2) are taken from the CRR. However, there are some differences specified in the IFR. These include a number of deductions that now apply in full, and a concession for not having to make certain deductions when undertaking market-making activity. Also, investment firms that issue AT1 instruments can specify the trigger event in the terms of these instruments.

Own fund requirements (Chapters 5 and 6)

2.4 An investment firm's permanent minimum requirement (PMR) is the same as the initial capital required for authorisation.

2.5 All investment firms are now required to calculate a fixed overhead requirement (FOR).

2.6 Some investment firms will also have to calculate a new activity based, or K-factor, capital requirement (KFR).

2.7 The minimum capital requirement will be the higher of PMR and FOR, or the higher of PMR, FOR and KFR, where the latter applies.

Group risk (Chapters 7 and 8)

2.8 Investment firm groups can be prudentially consolidated in a similar way to the current process under the CRR, but adapted to the requirements of the IFR.

2.9 Alternatively, where the competent authority deems a group structure is sufficiently simple (and provided there are no significant risks to clients or to market), they may allow an investment firm group to instead apply a group capital test.

Concentration risk (Chapter 9)

2.10 All investment firms are required to monitor and control their concentration risk. They will also have to calculate their exposure value for concentrated exposures in a trading book to a client, or a group of connected clients.

2.11 The IFR also introduces the concept of risks arising from concentration in the location of assets safeguarded, earnings from clients, and where the firm's own cash is deposited.

Liquidity (Chapter10)

2.12 All investment firms now have a basic liquidity requirement based on holding liquid assets equivalent to at least one third of their FOR.

2.13 Some investment firms will have additional flexibility in the types of asset they can count towards their liquidity requirement. This includes allowing receivables from trade debtors as well as fees or commissions receivable, both subject to a number of conditions.

Individual investment firm requirements (Chapter 11)

2.14 Following a supervisory review, investment firms can be required to hold additional capital. Other requirements, such as limiting variable remuneration, additional reporting requirements or a specific liquidity requirement can also be imposed.

Regulatory reporting requirements (Chapter 12)

2.15 Investment firms will all have broadly the same regulatory reporting requirements, which will apply on either a quarterly or an annual basis.

2.16 Investment firms that deal in their own name will have to report quarterly the total value of their consolidated assets, when this is greater than or equal to EUR 5 billion.

Remuneration (Chapter 13)

2.17 Investment firms above a certain size must have a clearly documented remuneration policy, set an appropriate ratio between variable and fixed components of total remuneration, and meet requirements around the structure of variable remuneration.

Public disclosure (Chapter 15)

2.18 Investment firms will generally have to publish information on risk management, governance, own funds, remuneration, and investment policy. In due course, they will also have to publish information relating to environmental, social and governance risks (ESG).

3 Application to investment firms

Overview

- The IFR distinguishes between firms that will remain subject to the prudential requirements of the CRR, and those that will become subject to the new requirements of the IFD/IFR. This is based on the systemic importance of the investment firm, determined by criteria including its size.
- For investment firms subject to the new IFD/IFR requirements, the new regime introduces a new type of firm category – small and non-interconnected investment firms (SNIs). It also provides a set of criteria for determining which firms are in this category. The requirements for SNIs under the new regime are more proportionate than for non-SNI investment firms.
- If we were to adopt a similar approach under the new domestic regime we would no longer apply the range of existing prudential categories such as 'full scope IFPRU' and 'BIPRU'. All firms would simply be known as 'Investment firms', of which the (typically) smaller ones will be SNIs.
- We believe such an approach would streamline and simplify the prudential regime for investment firms in the UK.

What this chapter covers

3.1 In this chapter, we:

- identify the current categories of investment firms affected by the IFD/IFR;
- explain where some investment firms will remain on the same prudential requirements as banks;
- describe the new prudential categories of investment firm within the IFD/IFR;
- explain the overall outcome of the IFD/IFR for investment firms; and
- provide a summary of the application to different types of investment firm.

Categories of investment firm affected by the IFD/IFR

3.2 All investment firms that are authorised in accordance with the provisions of the Markets in Financial Instruments Directive (MiFID) will be affected by the IFD/IFR.

3.3 If we adopted UK rules reflecting the IFD/IFR, all existing prudential categories for MiFID investment firms, such as 'full scope IFPRU investment firm', 'IFPRU limited activity firm', 'IFPRU limited licence firm', 'BIPRU firm', 'exempt-CAD firm', 'exempt (BIPRU and IFPRU) commodities firm', 'local firm', etc would cease to exist. Except where stated otherwise, all MiFID investment firms would then be subject to the prudential requirements of the IFD and IFR, regardless of their current prudential categorisation. We refer to these firms throughout this DP as 'investment firms'. The IFR introduces a simpler distinction between different types of investment firm, which we set out in the next section of this chapter.

3.4 There will also no longer be a specific prudential treatment for any investment firm that currently makes use of the 'matched principal' exemption. These investment firms will be treated in the same way as all other firms that deal on their own account, including in their own name but on behalf of clients.

3.5 The MiFID business of collective portfolio management investment firms (CPMIs) will also be affected. Chapter 17 sets out how we expect to treat these firms.

Investment firms that will remain on the CRR

3.6 Generally, the IFD/IFR will apply to all EU investment firms currently authorised and supervised under MiFID. However, the IFR will require a few investment firms to apply for authorisation under the Capital Requirements Directive (CRD) and remain subject to the provisions of the CRD and the Capital Requirements Regulations (CRR). The IFD/IFR also provides for some investment firms to remain authorised under MiFID but to remain subject to the prudential requirements of the CRR and supervised under Titles VII and VIII of the CRD.

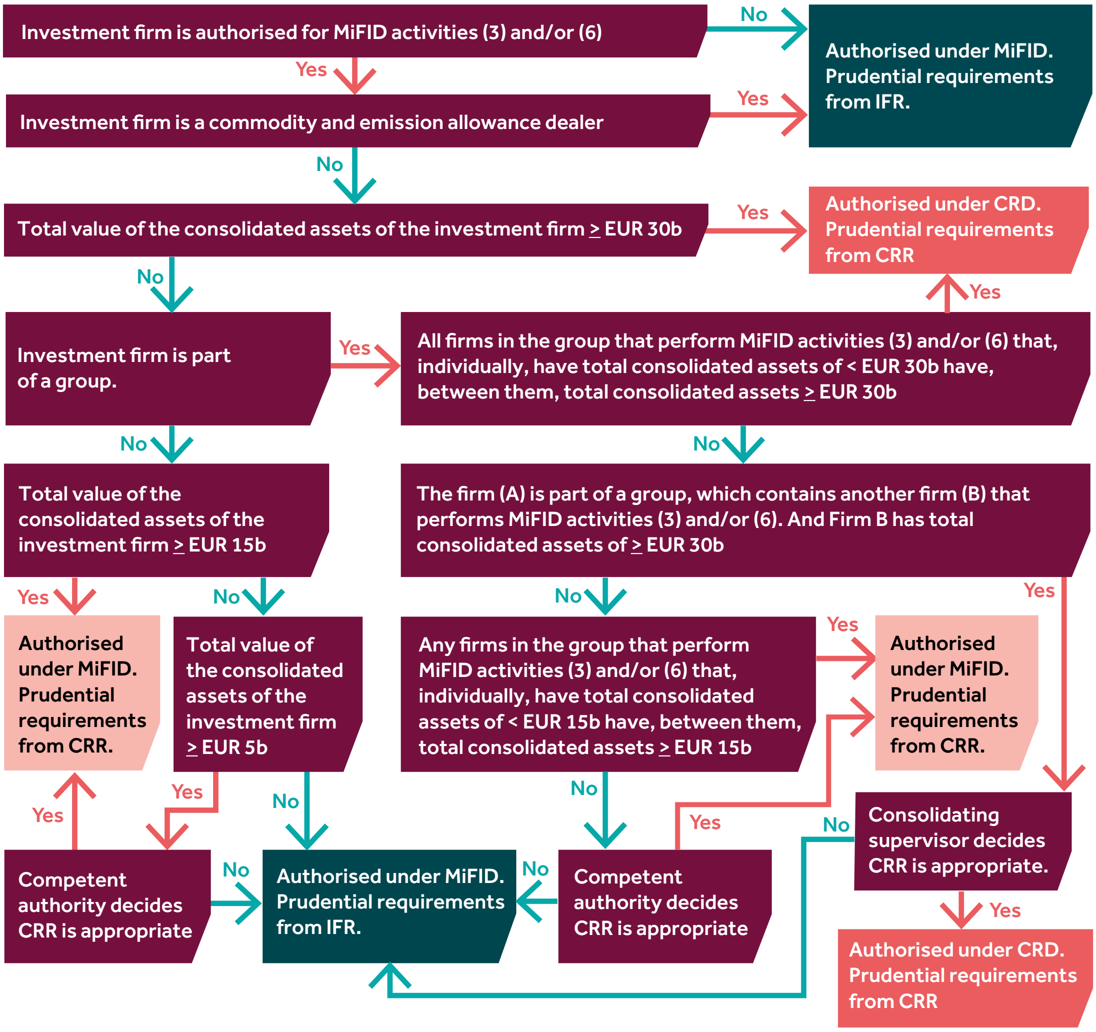
3.7 Under the IFD/IFR, those firms that will need to remain subject to the prudential requirements of the CRD/CRR (but without any of the current specific treatments for investment firms only) are investment firms that are above certain size thresholds, and that carry out either or both of those activities referred to in points (3) and (6) of Section A of Annex I of MiFID. These are:

- point (3) – dealing on own account and
- point (6) – underwriting/placing of financial instruments on a firm commitment basis

3.8 In the rest of this DP, these will be referred to as 'MiFID activities (3) and/or (6)'.

3.9 Figure 3.1 shows how, under the IFD/IFR, firms would either remain subject to CRD/CRR or would move to the IFD/IFR. Where CRD/CRR may apply this chart also shows whether the firm can remain authorised as an investment firm under MiFID or would need to seek authorisation under CRD as a new type of (non-deposit-taking) credit institution.

Figure 3.1 – Authorisation and prudential requirements (MiFID or CRD and IFR or CRR)



Firms that must apply to be authorised under CRD

3.10 The IFR amends the definition of a 'credit institution' used in CRR. The new definition is set out in point (a) of paragraph (3) of Article 62 of IFR. In summary, it now includes an investment firm that is in the business of:

- carrying out any of MiFID activities (3) and/or (6) where one of the following also applies:
  - the total value of the investment firm's consolidated assets is equal to or more than EUR 30 billion;
  - the investment firm is part of a group where at least one other investment firm also carries out MiFID activities (3) and (6), each individual investment firm has a total value of consolidated assets of less than EUR 30 billion, but where the total value of the consolidated assets of these investment firms is equal to or more than EUR 30 billion;
  - the investment firm itself has a total value of assets less than EUR 30 billion, but is part of a group that includes another investment firm that also carries out MiFID activities (3) and (6) with a total value of the consolidated assets of equal to or more than EUR 30 billion, and the consolidating supervisor so decides to require the first investment firm to also become subject to the CRR in order to address potential risks of circumvention and financial stability.

3.11 Investment firms that meet these criteria are considered to be systemically important. The PRA can designate certain investment firms that it considers to be systemically important. So UK investment firms that currently meet these criteria are authorised and regulated by the PRA. Please see the Treasury's policy statement 'Prudential standards in the Financial Services Bill: June update' for its intentions on how these systemically important firms will be treated. All other changes outlined in this DP would not apply to these investment firms. However, they should consider whether the consequential changes to CRR, as set out in Article 62 of the IFR, would affect them if applied similarly in the UK.

3.12 These criteria would not apply to commodity and emission allowance dealers, collective investment undertakings or insurance undertakings.

Firms that will remain authorised under MiFID and be subject to CRR

3.13 Paragraph 2 of Article 1 of the IFR sets out the conditions for where an investment firm must be subject to the prudential requirements of the CRR, and supervised under Titles VII and VIII of the CRD, but remain authorised under MiFID. In that case, a firm would not need to apply for authorisation as a credit institution under CRD. Again, these conditions do not apply to commodity and emission allowance dealers, collective investment undertakings or insurance undertakings.

3.14 In summary, the conditions are that the investment firm is in the business of carrying out any of MiFID activities (3) and/or (6) where any of the following apply:

- the total value of the investment firm's consolidated assets is equal to or more than EUR 15 billion;
- the investment firm is part of a group where at least one other investment firm also carries out MiFID activities (3) and/or (6), each individual investment firm has a total value of consolidated assets of less than EUR 15 billion, but where the total value of the consolidated assets of these investment firms is equal to or more than EUR 15 billion;
- the investment firm's supervisor has decided (under Article 5 of the IFD) that the firm should be subject to the prudential requirements of the CRD/CRR.

3.15 Further, paragraph 1 of Article 5 of the IFD gives competent authorities the discretion to require an investment firm that carries out any of MiFID activities (3) and/or (6) and where the total value of consolidated assets is equal to or exceeds EUR 5 billion (but is less than EUR 15 billion) to apply the requirements of the CRR. One or more criteria must first apply, including where the investment firm's failure or distress could lead to systemic risk. For more information see Chapter 18 on Competent authority discretions.

3.16 In the UK the PRA can currently designate certain investment firms as subject to its prudential supervision, even if the firm is below any published quantitative threshold. If the PRA decided to designate such a firm, we would expect it to apply a CRR-type regime rather than an IFR-type one.

3.17 Finally, paragraph 5 of Article 1 of the IFR contains a derogation where the competent authority has the discretion to allow an investment firms that carries out any of MiFID activities (3) and/or (6) to apply the requirements of the CRR (instead of the IFR) regardless of the value of its consolidated assets. This is subject to the firm meeting certain conditions such as being included within the consolidated supervision of a credit institution under CRR. We give more information on this derogation in Chapter 18 on Competent authority discretions.

3.18 Deciding how the regime will approach the question of which of the two prudential regulators in the UK would be responsible for supervising any UK MiFID investment firms that could be supervised according to a CRD/CRR-type regime (rather than an IFD/IFR-type regime) is a matter for the Treasury. Please see the Treasury's policy statement 'Prudential standards in the Financial Services Bill: June update' for further information.

Investment firms that will be subject to the IFD/IFR

Small and non-interconnected investment firms (SNIs)

3.19 Paragraph 1 of Article 12 of the IFR sets out the criteria that an investment firm must satisfy if it wants to be considered an SNI. These are summarised in Figure 3.2

3.20 Investment firms that meet all of these criteria are considered to be SNIs. This means they will benefit from additional proportionality and so less onerous prudential requirements. This includes their reporting, disclosure and remuneration requirements.

3.21 Many of the measures in Figure 3.2 refer to the 'K-factors' concepts that we explain in Chapter 6, and so must be read together with that chapter.

3.22 Some of these criteria apply on the basis of the individual investment firm, while others are measured on a combined basis for all investment firms that are part of a group. The latter avoids the potential for arbitrage where an investment firm might otherwise split a growing business into more than one entity so that each is individually below the relevant thresholds, but not when the values are combined.

Figure 3.2 Threshold criteria to be an SNI

	Measure	Threshold	Application on a individual firm or combined basis
a	AUM or assets under management (IFR Article 17)	< EUR 1.2 billion	Combined
b(i)	COH or client orders handled – Cash trades (IFR Article 20)	< EUR 100 million/day	Combined
b(ii)	COH or client orders handled – derivatives (IFR Article 20)	< EUR 1 billion/day	Combined
c	ASA or assets safeguarded and administered (IFR Article 19)	Zero	Individual
d	CMH or client money held (IFR Article 18)	Zero	Individual
e	DTF or daily trading flow (IFR Article 33)	Zero	Individual
f	NPR or net position risk (IFR Article 22) or CMG or clearing margin given (IFR Article 23)	Zero	Individual
g	TCD or trading counterparty default (IFR Article 26)	Zero	Individual
h	On- and off-balance sheet total	< EUR 100 million	Combined
i	Total annual gross revenue from investment services and activities	< EUR 30 million	Combined

Notes:

The items in rows (a), (b)(i) and (ii), (c), (e), (f) insofar as it relates to NPR, and (g) would be measured using end-of-day values.

Alternatively, the items in rows (a) and (b) could be measured using the methods specified for the relevant K-factor own funds requirements. In this case, the measurement would be done over the most recent 12 months (and without exclusion of the 3 most recent monthly values).

The item in row (f) insofar as it relates to CMG would be measured using intra-day values.

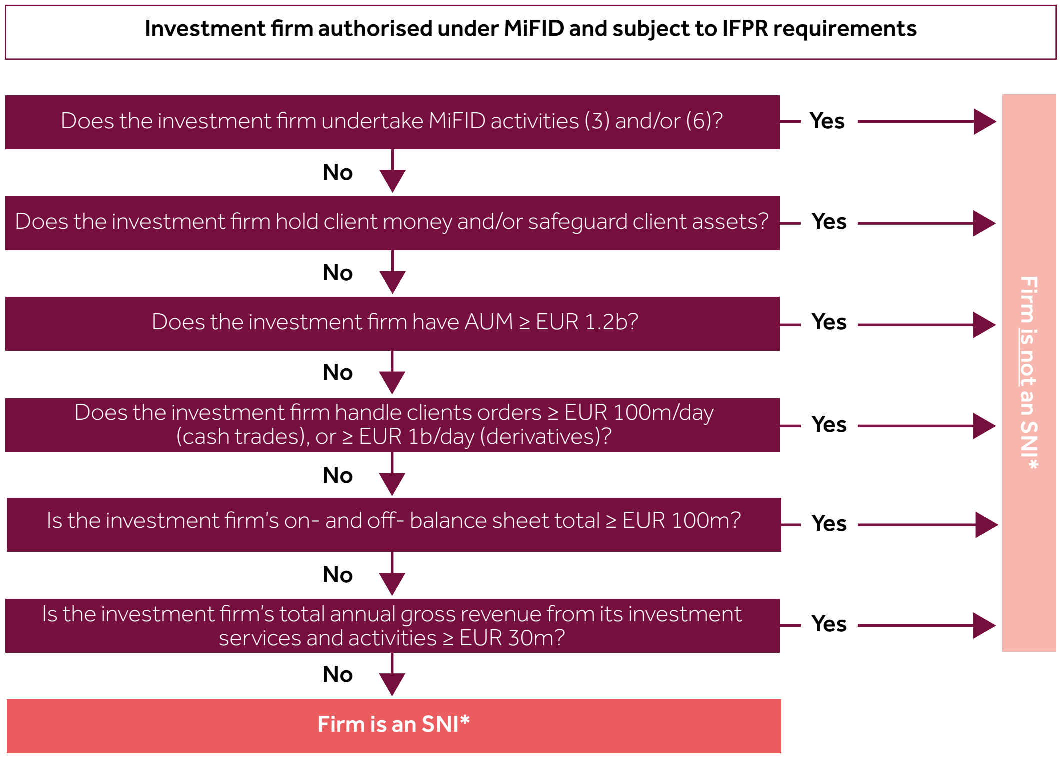
The item in row (d) would be measured using intra-day values, except where there has been an error in the record keeping by the investment firm and which is resolved before the end of the business day so that the threshold is not breached.

The items in rows (h) and (i) would be the levels at the end of the last financial year for which accounts have been finalised and approved by the management body. If these are not available after 6 months from the end of the last financial year, an investment firm would use provisional accounts.

For the purposes of measuring the total annual gross revenue in row (i), those investment firms that are part of a group may exclude any double counting that arise in respect of the combined amount of gross revenues generated within the group.

3.23 Figure 3.3 aims to help an investment firm assess the criteria of paragraph 1 of Article 12 of the IFR (and as set out above) to determine more easily if it would be classified as an SNI firm or not.

Figure 3.3 Flow chart to assess classification as an SNI



* Small and non-interconnected investment firm as defined in Article 12(1) IFR.

All other investment firms

3.24 All other investment firms (those that are not subject to the CRD/CRR or are not SNIs under the IFD/IFR) will be subject to the full prudential requirements set out in the IFD and IFR.

3.25 However, there is an element of proportionality in how investment firms with average balance sheet total of EUR 100m or less over the previous 4 year period can apply the remuneration requirements. We give more information on remuneration requirements and their applicability in Chapter 13.

3.26 There is also an exemption from concentration risk requirements for investment firms that are commodity and emission allowance dealers, subject to certain conditions – see Chapter 9 on Concentration risk.

3.27 Generally, where an investment firm no longer meets the criteria for being an SNI it would cease to be an SNI with immediate effect and will need to let the competent authority know without delay.

3.28 However, by way of derogation from the above, where the investment firm no longer meets any of the conditions set out in points a, b, h, and i, (in Figure 3.2) but continues to meet the other conditions in (c) to (g), it would only cease to be considered as an SNI after a period of 3 months. This is calculated from the date on which the firm exceeded the relevant threshold. Under a UK regime we would expect an investment firm which is an SNI to notify us as soon as possible of any breach of a threshold that would mean it can no longer be an SNI.

3.29 Where an investment firm that was not an SNI subsequently meets all of the conditions to become one, it would only be considered to be an SNI once it has continuously met those conditions for a period of 6 months. Under a UK regime we would expect an investment firm to let us know as soon as possible when it first meets all of the conditions for becoming an SNI.

Summary of the investment firm types

3.30 The following table (Figure 3.4) broadly summarises the types of investment firms that will result from the introduction of the new EU prudential regime, showing how they are authorised and which prudential requirements apply:

Figure 3.4 – Summary of investment firm types

Type of firm	Authorisation	Prudential requirements
Systemically important firms	Credit institution – CRD	CRR and CRD
Certain large firms that deal on own account and/or underwrite on a firm commitment basis	Investment firm – MiFID	CRR and parts of CRD
SNIs	Investment firm – MiFID	Reduced IFR and IFD
All other investment firms	Investment firm – MiFID	Full IFR and IFD

High level comparison of differences in requirements between SNI and non-SNI investment firms

3.31 The following table (Figure 3.5), summarises the main prudential requirements for investment firms and shows where SNI's may have more proportionality.

Figure 3.5 summarising the main prudential requirements for investment firms and where greater proportionality may be available for SNIs.

Requirement (DP Chapter)	Investment firm	SNI investment firm
Definition of capital (Chapter 4)	Uses the same CRR definition, with a few simplifications for deductions.	
Capital requirements (Chapter 5 and Chapter 6)	The higher of: • Fixed overheads requirement • Permanent minimum requirement • K-factor requirement	The higher of: • Fixed overhead requirement • Permanent minimum requirement
Group risk (Chapter 7 and Chapter 8)	Either prudential consolidation, or the option to use a group capital test.	
Concentration risk (Chapter 9)	Broader definition of 'concentration' risk, including location of client money, and source of income. Additional capital requirement for 'exposure values' greater than 25% of own funds in a trading book.	Basic requirement to monitor and control 'concentration risk'

Requirement (DP Chapter)	Investment firm	SNI investment firm
Liquidity (Chapter 10)	Minimum liquid asset requirement. Definition of liquid assets is expanded compared with that in the CRR, with no limit as to their composition. Both SNIs and non-SNIs that do not deal in their own name (including for clients) or underwrite, may also use additional items to make up a proportion of their liquid assets.	
Risk management, governance & review process (Chapter 11)	Similar governance requirements to current CRD (taking account of what is in MiFID II). Firms to consider their own risks. Supervisory review at frequency and intensity determined by the competent authority. (Article 39 of the IFD).	No additional governance requirements to those in MiFID II. Firms to consider their own risks but no individual review mandated. Can be requested by the competent authority.
Reporting (Chapter 12)	Same as SNI, plus risk and remuneration reporting. Large own account dealers may also be required (by Article 55 of the IFR) to report against the thresholds in Article (1)2 of the IFR for monitoring where the CRR is to be applied (instead of the IFR).	Limited reporting on own funds, capital, balance sheet and revenue. Reporting to confirm they meet conditions in Article 12(1) of the IFR.
Remuneration (Chapter 13)	No bonus cap but similar core remuneration principles and approach to variable remuneration as current CRD. Malus and clawback to be applied by all non-SNIs.	No additional requirements to those in MiFID II.
Public disclosure (Chapter 15)	Limited disclosure including risk management, governance, and remuneration policy.	Only for firms that have issued AT1 instruments.

Commodity and emission allowance dealers

3.32 The IFD/IFR apply to commodity and emission allowance dealers in the same way as to other MiFID investment firms. However, they do have some additional derogations.

3.33 Part Four – Concentration risk, does not apply where:

- The other party is a non-financial counterparty;
- Both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;
- The transaction can be assessed as reducing risks involving the commercial activity or treasury financing activity of the non-financial counterparty or of that group.

3.34 Liquidity and most disclosure requirements do not apply until June 2026. Disclosure of investment policy and environmental, social and governance risks (ESG) apply at the same time as they apply to all other investment firms.

3.35 Commodity and emission allowance dealers cannot become subject to CRD/CRR.

4 Capital and own funds

Overview

- The IFR follows broadly the same approach as the CRR on the relevant features for assessing the quality of capital. Differences are largely due to investment firms' business models and how capital requirements apply under the IFD/IFR.
- Investment firms will be required to hold Common Equity Tier 1, Additional Tier 1, and Tier 2 capital to the same proportions as set out in the CRR. This is on the basis that, as with credit institutions, the quality of capital determines its utility in allowing investment firms to remain financially resilient in the event of unexpected losses. The quality is determined by
  - permanence (capital that is not meant to be paid back), and
  - level of subordination and its ability to absorb losses, including without interrupting normal business operations on an ongoing basis
- Currently some MiFID investment firms may apply different definitions of capital than those of the CRR or the IFR. These include 'BIPRU Firms' and 'Exempt-CAD' firms. The IFR will apply to all MiFID investment firms. This will mean that previous definitions of capital, such as the concept of 'Tier 3' capital (for example, short term subordinated debt), that these firms could use would no longer apply. Investment firms may only use those set out in the IFR, as explained in this chapter.
- We believe this would result in greater resilience for investment firms and improved capacity to absorb losses. This will increase their safety and soundness and reduce their capacity to cause harm.

What this chapter covers

4.1 In this chapter we:

- set out the definition and types of capital that are eligible as own funds
- explain the composition permitted to meet an investment firm's own funds requirements
- identify changes to the items that need to be deducted and other differences compared to own funds under the CRR when establishing the amount of own funds held under the IFR, and
- note how qualifying holdings outside the financial sector are to be treated

Definition and composition of own funds

Capital class definitions

4.2 Regulatory capital for the purposes of own funds under the IFR (and currently the CRR) is made up of 3 classes of capital:

- Common Equity Tier 1 (or CET1) capital;

- Additional Tier 1 (or AT1) capital; and
- Tier 2 (or T2) capital.

4.3 CET1 is the highest quality of capital for the purposes of own funds. It has the highest degree of permanence, subordination and ability to absorb losses immediately they occur.

4.4 AT1 also absorbs losses, but AT1 items are less subordinate to those classified as CET1 capital. AT1 instruments issued must also be capable of either being written down or converted to CET1 instruments. CET1 conversions happen when a trigger event occurs, when the CET1 of the investment firm would otherwise be deemed to be at too low a level.

4.5 T2 capital is generally shorter-term, so it is not permanent (eg subordinated debt with an initial maturity of at least 5 years). T2 capital only absorbs losses if the investment firm becomes insolvent, rather than on a 'going concern' basis.

4.6 Each of these classes must meet a set of criteria for capital instruments issued or other capital items held before they can be included under the relevant class. Articles 30, 55 and 65 of the CRR make clear that where this is not the case then such instruments cease to qualify with immediate effect. Investment firms apply regulatory adjustments, in the form of relevant prudential filters and deductions to the list of qualifying instruments or items under each category. This process then arrives at the amount of capital that qualifies as own funds for regulatory purposes in each respective capital class.

4.7 According to paragraph 1 of Article 9 of the IFR, the definitions of, and specific criteria for, CET1, AT1 and T2 capital are the same as those in the CRR. So investment firms need to refer to the relevant articles from Part Two of the CRR to determine what can contribute to own funds and the necessary adjustments from prudential filters and deductions that each class of capital requires.

Minimum conditions for the amounts of each class of capital that may be used to meet own funds requirements

4.8 Investment firms are required to hold own funds consisting of the sum of their CET1 capital, AT1 capital and Tier 2 capital. They should meet all the following conditions at all times:

a. $$\frac{\text{Common Equity Tier 1 capital}}{D} \geq 56\%$$

b. $$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 Capital}}{D} \geq 75\%$$

c. $$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 Capital + Tier 2 capital}}{D} \geq 100\%$$

where D is defined at the highest own funds requirements according to Article 11 of the IFR.

4.9 The intention of these conditions is to ensure that there is sufficient quality of capital by providing for a minimum amount of CET1 capital, while also enabling an investment firm some use of lower classes of less permanent capital where it wants to do so. As there is no obligation to hold any AT1 or Tier 2 capital, an investment firm could comply by choosing to meet 100% of its requirements with CET1 capital.

Changes in deductions from own funds (to be deducted in full)

4.10 The various deductions and adjustments firms need to make to own funds have been largely carried over from the CRR. However, Article 9 of the IFR contains several key differences for the way investment firms treat certain deductions.

4.11 For example, the CRR uses a complex set of calculations to provide relief if firms are only making partial deductions for certain balance-sheet items. These items include, deferred tax assets and holdings of capital instruments in other financial sector entities. The IFR simplifies the treatment for certain deductions (from the relevant classes of capital), but does this by requiring them to be deducted in full. These are as follows:

- The deductions for defined benefit pension fund assets on the balance sheet of the institution referred to in point (e) of paragraph 1 of Article 36 of the CRR apply in full, without the application of Article 41 of the CRR.
- The deductions for deferred tax assets that rely upon future profitability referred to in point (c) of paragraph 1 of Article 36 of the CRR apply in full, without the application of Articles 39 and 48 of the CRR.
- The deductions referred to in point (h) of paragraph 1 of Article 36, point (c) of Article 56, and point (c) of Article 66 of the CRR for non-significant investments in financial sector entities, as far as they relate to holdings of capital instruments that are not held in the trading book, apply in full, without the application of the mechanisms provided for in Articles 46, 60 and 70 of the CRR.
- The deductions referred to in point (i) of paragraph 1 of Article 36 of the CRR for significant investments in the CET instruments of financial sector entities apply in full, without the application of Article 48 of the CRR.

Provisions on own funds in the CRR that do not apply or are to be applied differently by investment firms when determining own funds under the IFR

4.12 The IFR also specifies that some provisions on determining own funds of investment firms in the CRR should not apply to, or operate differently for, investment firms as follows:

- Article 49 of the CRR, which gives a set of requirements for deducting investments in holdings of financial instruments in financial sector entities where consolidation, supplementary supervision or institutional protection schemes are applied, does not apply.
- The deductions given to in point (h) of paragraph 1 of Article 36, point (c) of Article 56, and point (c) of Article 66 of the CRR and the related provisions in Articles 46, 60 and 70 of that Regulation, as far as those deductions involve holdings of capital instruments held in the trading book, shall not apply. The purpose of not applying these requirements is to avoid discouraging investment firms from making markets in capital instruments of financial sector entities, provided that these holdings are non-significant.
- The trigger event referred to in point (a) of paragraph 1 of Article 54 of the CRR does not apply. This refers to the point at which AT1 instruments issued would have to be written down or converted to CET1 capital, which is when the CET1 capital ratio of the CRR institution falls below either 5.125% or a higher level where specified. This specific provision of the CRR cannot be carried across because it applies to a banking-style capital ratio that the IFR does not use. Instead the investment firm shall specify the trigger event in the terms of the AT1 instrument.

- The aggregate amount in point (a) of paragraph 4 of Article 54 of the CRR does not apply. This is the aggregate amount of AT1 instruments issued the firm wants to write down or convert to restore the CET1 ratio back to no less than 5.125%. Instead the amount to be written down or converted should be the full principal amount of the AT1 instrument.

General requirements

4.13 Paragraph 3 of Article 9 of the IFR requires investment firms to apply the same general requirements as those in Chapter 6 of Title I of Part Two of the CRR. These requirements include provisions on certain forms of distributions on, and conditions for reducing, own funds instruments. They also include technical matters such as short positions and index holdings of capital instruments.

4.14 However, the supervisory permissions required for applying these provisions in accordance with Articles 77 and 78 of the CRR for an investment firm to reduce its own funds should be deemed to be granted if one of the conditions set out in point (a) of paragraph 1, or in paragraph 4, of Article 78 of the CRR (replace with instruments of equal or higher quality, or change in regulatory classification or tax treatment respectively) are fulfilled. This should help simplify administrative burdens in these instances.

4.15 There is a further change compared to the current position under the CRR in paragraph 5 of Article 9 of the IFR. This IFR provision states that any investment firm in an investment firm group, when calculating its own funds on an individual basis, is not required to deduct holdings of own funds instruments of a financial sector entity within that group as long as all of the following conditions are met:

a. there is no current or foreseen material, practical or legal impediment to the prompt transfer of capital or repayment of liabilities by the parent undertaking;
b. the risk evaluation, measurement and control procedures of the parent undertaking include the financial sector entity;
c. the derogation provided for in Article 8 is not used by the competent authorities.

4.16 The condition in point (c) above means that this provision is only available to an investment firm where its investment firm group is subject to consolidated supervision according to Article 7 of the IFR.

4.17 Paragraph 5 of Article 9 of the IFR is meant to apply a similar treatment as currently exists under paragraph 2 of Article 49 of the CRR. However, for a firm which currently forms part of a consolidation group under the CRR and which will now form part of an investment firm group under the IFR, the treatment is effectively stricter. This is because of the above conditions that have been added under the IFR.

Investment firms that are not joint-stock companies

4.18 Under the CRR the EBA maintains a published list of all the forms of capital instruments in each Member State that qualify as CET1 instruments. The UK notified that it treated eligible LLP member capital, eligible partnership capital and eligible sole trader capital as CET1. However, there is currently no specific recognition on the part of the CRR of investment firms that are not legal persons or which are not joint-stock companies. This does not necessarily provide the level of certainty that such types of investment firm may require. This may particularly be the case if any equivalent equity capital instruments or funds unique to legal forms that are not joint-stock companies would otherwise struggle to meet all the detailed conditions in the CRR to qualify as CET1 capital (which may be more directly applicable to, say, a joint-stock company issuing shares).

4.19 Paragraph 4 of Art 9 of the IFR explicitly recognises that under MiFID there may be authorised investment firms that are not legal persons or that are not joint-stock companies – instead they may be established in other forms, such as sole-traders, partnerships or LLPs. The competent authority is therefore provided with the discretion to permit further instruments or funds to qualify as CET1 capital for those investment firms, provided that the relevant instruments or funds also qualify for treatment under Article 22 of Directive 86/635/EEC (on the annual accounts and consolidated accounts of banks and other financial institutions). That provision requires that national law must regard the relevant instruments or funds as equity capital subscribed by the shareholders or other proprietors.

4.20 A list of such conditions (some of which are supplemented by current technical standards) that would apply to a limited company issuing ordinary shares to be counted as CET1 capital can be found in Article 28 of the CRR. A number of these conditions have the combined effect that there should be no ancillary agreements or understandings between the company and the shareholders that the latter would receive preferential treatment in insolvency or would otherwise be repaid or redeemed early.

4.21 Some investment firms that are not legal persons or are not joint-stock companies may already be confident that their existing forms of CET1 capital satisfy all the conditions in Article 28 of the CRR. However, in any cases of doubt, a decision by us to make rules reflecting the provisions in paragraph 4 of Article 9 of the IFR could help to resolve any uncertainty that some investment firms may currently face. But in doing so we would need to consider why specific types of equity capital instruments or funds may find particular conditions problematic, and respect the principle that all forms of allowable CET1 capital should exhibit the same or equivalent forms of loss absorbing characteristics.

4.22 Paragraph 4 of Article 9 of the IFR also gives competent authorities a further discretion to specify different forms of CET1 capital for investment firms which are SNIs, irrespective of the form in which the investment firm is established. However, we do not see any particular reason to weaken the quality of CET1 capital simply based upon the size of business of an investment firm, nor do we immediately see any further specific instruments or funds that would justify inclusion.

Overview of IFR capital tiers

4.23 The following charts seek to provide investment firms with a visual summary of which provisions in the CRR relate to each tier of regulatory capital under the IFR.

4.24 In each case, the chart is intended only to be an overview of the most relevant legislative provisions that may apply, rather than an exhaustive statement of all potentially applicable requirements and conditions. The charts are not intended to be a substitute for detailed analysis of the full legislation and UK investment firms will need to assess their own individual positions against the requirements that are applied to them.

Common Equity Tier 1 (CET1)

4.25 Figure 4.1 summarises the provisions in the CRR relating to CET1 capital, subject to any differences specific to investment firms under the IFR as noted above.

Figure 4.1 – Common Equity Tier 1 (CET1) capital

Common Equity Tier 1 (CET1) Items – Article 26

(a) Capital instruments that meet the conditions of Articles 28 or 29 of CRR
(b) Share premium accounts related to the instruments in (a)
(c) Retained earnings*
(d) Accumulated other comprehensive income*
(e) Other reserves*
* Must be available for unrestricted and immediate use to cover risks or losses as soon as these occur
The conditions set out in Articles 27 to 31 must also be met.

↓

Prudential filters – Items to be excluded/deducted from own funds

(a) **Article 32** – any increase in its equity resulting from securitised assets
(b) **Article 33** – cash flow hedges and changes in the value of own liabilities
(c) **Article 34** – additional value adjustments, by applying the requirements of Article 105 to its assets measured at fair value

Prudential filters – Items not to be excluded

Article 35 – unrealised gains or losses on assets or liabilities measured at fair value, unless referred to in Article 33

↓

Deductions from CET1 Items – Article 36

NB. Items (d) and (k) do not apply
(a) Losses for the current financial year
(b) Intangible assets – including goodwill
(c) Deferred tax assets that rely on future profitability*
(e) Defined benefit pension fund assets on the balance sheet of the investment firm*
(f) Holding of own CET1 instruments (all types)
(g) Holdings of CET1 instruments of financial sector entities (FSE) where there is a reciprocal cross holding
(h) Holdings of non-significant investments in FSEs*
(i) Holdings of significant investments in FSEs*
(j) Deductions to account for holdings of third party AT1 instruments in excess of issuance of own AT1 instruments
(l) Foreseeable tax charges relating to CET1 instruments
(m) Insufficient coverage of non-performing exposures
* Deductions apply in full – see point (2) of Articles 9 of IFR for details
See Articles 37, 38, 42, 43, 44, 45, 47, 47a, 47b and 47c of CRR for further details on deductions

↓

Temporary waiver from deduction from own funds and eligible liabilities – Article 79

May be granted where these are deemed to be held as part of a financial assistance operation.

↓

CET1 capital – Article 50

Additional Tier 1 (AT1)

4.26 Figure 4.2 seeks to provide investment firms with a visual summary of which provisions in the CRR relate to AT1 capital, subject to any differences specific to investment firm under the IFR as noted above.

Figure 4.2 – Additional Tier 1 (AT1) capital

Additional Tier 1 (AT1) Items – Article 51

(a) Capital instruments that meet the conditions of Article 52 of CRR
(b) Share premium accounts related to the instruments in (a)
The conditions set out in Articles 52 to 55 of CRR must also be met.
NB. Point 1 of Article 54 of CRR, related to the trigger event for AT1 instruments, does not apply. The trigger event shall be specified by the investment firm.
See point (iii) of point (e) of paragraph 2 of Article 9 of IFR.

↓

Deductions from AT1 Items – Article 56

(a) Holdings of own AT1 instruments (all types)
(b) Holdings of AT1 instruments of financial sector entities (FSE) where there is a reciprocal cross holding
(c) Holdings of non-significant investments in FSEs*
(d) Holdings of significant investments in FSEs
(e) Deductions to account for holdings of third party T2 instruments in excess of issuance of own T2 instruments
(f) Foreseeable tax charges relating to AT1 instruments
* Deductions apply in full, without the application of the mechanisms provided for in Article 60 of CRR. See point (2) of Article 9 of IFR for details.
See Articles 57, 58, 59 and 60 of CRR for further details on deductions

↓

Temporary waiver from deduction from own funds and eligible liabilities – Article 79

May be granted where these are deemed to be held as part of a financial assistance operation.

↓

AT1 capital – Article 61

Tier 2 (T2)

4.27 Figure 4.3 seeks to provide investment firms with a visual summary of which provisions in the CRR relate to T2 capital, subject to any differences specific to investment firm under the IFR as noted above.

Figure 4.3 – Tier 2 (T2) capital

Tier 2 (T2) Items – Article 62

(a) Capital instruments that meet the conditions of Articles 63 of CRR
(b) Share premium accounts related to the instruments in (a)
Article 64 deals with the amortisation of T2 instruments during the final 5 years of maturity.
Article 65 sets out what happens when an instrument no longer meets the T2 requirements

↓

Deductions from T2 Items – Article 66

(a) Holdings of own T2 instruments (all types)
(b) Holdings of T2 instruments of financial sector entities (FSE) where there is a reciprocal cross holding
(c) Holdings of non-significant investments in FSEs*
(d) Holdings of significant investments in FSEs
(e) Deductions to account for holdings of eligible liabilities items in excess of issuance of own eligible liabilities items
* Deductions apply in full, without the application of the mechanisms provided for in Article 70 of CRR. See point (2) of Article 9 of IFR for details.
See Articles 67, 68, 69 and 70 of CRR for further details on deductions

↓

Temporary waiver from deduction from own funds and eligible liabilities – Article 79

May be granted where these are deemed to be held as part of the financial assistance operation.

↓

T2 capital – Article 71

Qualifying holdings outside the financial sector

4.28 A qualifying holding is where an investment firm has a direct or indirect holding in an undertaking representing 10% or more of the capital or of the voting rights, or which make it possible to exercise a significant influence over the management of that undertaking.

4.29 Article 10 of the IFR deals with qualifying holdings outside the financial sector, requiring a deduction from own funds of any qualifying holdings outside the financial sector above the limits specified in that article.

4.30 This is intended to replicate the treatment under Articles 89 to 91 of the current CRR. Under Article 89 of the CRR, institutions are required to apply a 1,250% risk weighting when calculating credit risk capital requirements for qualifying holdings outside the financial sector, above certain limits. Alternatively, under Article 90 of the CRR, to deduct these qualifying holdings from own funds. However, in the IFR, investment firms are not required to calculate capital requirements for credit risk. This means that only the alternative approach of deducting the relevant amounts of qualifying holdings is available, which is why the IFR has its own article rather than simply referring to the CRR.

4.31 Paragraph 2 of Article 10 gives competent authorities the discretion to prohibit an investment firm from having qualifying holdings outside the financial sector that are above the limits specified in the first paragraph of that Article (see Chapter 18 on Competent authority discretions).

Q1: **What are your views on the instruments or funds used by non-joint stock investment firms that should count as CET1 capital? Please give specific examples. (See paragraphs 4.18 to 4.21).**

5 Own funds requirements

Overview

- The IFR updates the initial capital for authorisation for investment firms. While for some investment firms the increase will appear significant, this reflects that the requirement has not been updated since 1993, despite the significant changes in the size of firms and the nature of markets and business models.
- It also introduces a new approach to determining the baseline for own funds requirements, before any further requirements the investment firm identifies as necessary or its supervisor identifies under the risk assessment process. This is the higher of the permanent minimum requirement, the fixed overhead requirement, or the K-factor calculation. As the permanent minimum requirement is set at the same level as the initial capital requirement set out in the IFD it essentially makes this the floor for own funds requirements where the other methods of calculation result in lower amounts.
- As a result of these changes, requirements will likely decrease for some investment firms and increase for others. To help investment firms accommodate the change the IFR introduces a transition period of up to 5 years for investment firms that were subject to the previous regime. We set out more details on this in Chapter 19.

What this chapter covers

5.1 In this chapter, we:

- set out the initial capital required for a firm to be authorised, by MIFID activity, and
- summarise the 3 types of minimum capital or own funds requirements that apply to investment firms once authorised.

Initial capital required for authorisation

5.2 The levels of initial capital required (ICR) for authorisation have increased from those set out in the CRD. They are still based on the investment services and activities an investment firm applies to undertake. They therefore apply not just to a firm seeking initial authorisation but also where an authorised investment firm seeks to change its permitted investment activities.

5.3 The levels of ICR are set out in Article 9 of the IFD. However, Article 11 of the IFR requires that the initial capital of an investment firm shall be constituted in accordance with Article 9 of the IFR – ie be comprised of own funds – which is a change compared to the CRD.

5.4 To deal on their own account and/or underwrite or place financial instruments on a firm commitment basis the ICR is EUR 750,000. This level of ICR would also apply to investment firms under IFR that are currently categorised as:

- 'Local firms'
- either 'BIPRU' or 'IFPRU' and use the 'matched principal exemption'
- 'Exempt IFPRU commodities' firms where they deal in their own name, including on behalf of clients

5.5 Operating an organised trading facility (OTF) when including the additional element of dealing on own account for sovereign debt instruments for which there is not a liquid market (as envisaged under paragraph 3 of Article 20 of MiFID) will also have an ICR of EUR 750,000.

5.6 Providing one of more of the following MiFID investment services and activities, without permission to hold client money or securities, will have an ICR of EUR 75,000:

- receiving and transmitting orders
- execution of orders on behalf of clients
- portfolio management
- investment advice, and
- placing of financial instruments without a firm commitment basis

5.7 The ICR for all other investment firms will be EUR 150,000. This includes:

- operating a multilateral trading facility (MTF), and
- operating an OTF where it does not require the additional permission to deal on their own account as set out above.

5.8 The following Figure 5.1 summarises the new levels of initial capital by activity.

Figure 5.1 – summary of new ICR by activity

Investment firm activity	Initial capital requirement
Deal on own account and/or underwrite or place financial instruments	EUR 750k
Operating an OTF where additional permission to deal on own account for non-liquid sovereign debt instruments is required	EUR 750k
Operating an OTF where additional permission to deal on own account for non-liquid sovereign debt instruments is not required	EUR 150k
Undertaking the following MIFID activities without permission to hold client money or securities: • Reception and transmission of orders; • Execution of orders on behalf of clients; • Portfolio management; • Investment advice; and • Placing of financial instruments without a firm commitment basis.	EUR 75k
Any other MIFID activity (including operating an MTF)	EUR 150k

Overview of own funds requirements

5.9 As outlined in Figure 3.5 in Chapter 3 of this DP, investment firms that meet the requirements to be considered SNIs will have a minimum own funds requirement that is the higher of the PMR and the FOR.

5.10 Investment firms that are not SNIs will have a minimum own funds requirement that is the higher of the PMR, the FOR and the KFR.

5.11 Where the competent authority considers that there has been a material change in the investment firm's business activities, it may require the investment firm to meet a different component of the own funds requirements mentioned above.

Permanent minimum requirement (PMR)

5.12 Article 14 of the IFR sets out that an investment firm's PMR is the same as the initial capital it requires to be authorised with its current permissions.

Fixed overheads requirement (FOR)

5.13 Under the current regime, the FOR only applies to a subset of investment firms. Article 97 of the CRR and the related technical standard set out how to calculate it.

5.14 The IFR now applies the FOR to all investment firms. As currently, it is set as one quarter of the fixed overheads of the previous financial year. The competent authority can adjust this amount if the investment firm materially changes its business during the year. This adjustment could be an increase or a decrease, depending on the business change.

5.15 The EBA is mandated to develop a new technical standard to set out further details for how investment firms should calculate the FOR, under Article 13 of the IFR.

K-factor requirement (KFR)

5.16 The KFR is a new way of accounting for the potential harm that an investment firm can do to its clients, the markets in which it operates and to itself. It is based on the type and scale of the investment firm's activities. A requirement is calculated for each activity and the sum of these is the KFR. In Chapter 6 we explain the various K-factor requirements in detail. The competent authority can adjust the amount of any relevant K-factor if there has been a material change in the investment firm's business activities.

5.17 As noted above, the KFR does not form part of the own funds requirements of SNIs. However, SNIs are still advised to consider the relevant metrics. This is both for monitoring their compliance with the thresholds for remaining an SNI (see Chapter 3) and as part of their internal assessment where the competent authority asks it to apply the requirements of the risk management, governance and review process (see Chapter 11).

Q2: **What level of detail would you find helpful when calculating the fixed overheads requirement (FOR)? (See paragraphs 5.13 to 5.15)**

6 K-factor requirements

Overview

- The 'K-factor' approach is a new approach introduced by the IFR to determine the minimum own funds requirements of an investment firm that is not an SNI.
- The aim of the K-factors is to provide a tailored and more appropriate method for setting a risk-based minimum own funds requirement for all types of investment firm compared to the current regime. Its focus includes the potential to create harm to others.
- Investment firms will only need to apply the K-factors that are relevant to their business model. The information needed to calculate the K-factor requirement has been designed with ordinary business metrics in mind. The formulae to calculate the requirement are intended to be relatively simple, and could, in principle, reduce the need for investment firms to require external support to apply it.
- We believe the K-factor to be one of the most important innovations of the new EU regime. The risk categories it aims to cover better reflect the potential harm that an investment firm can pose to consumers and markets.
- But investment firms must recognise that the new approach is very different to what they are used to. If we adopted rules reflecting those in the IFR we would expect investment firms to consider the K-factor approach when identifying and capturing risks more generally in their risk assessment process, as we set out in Chapter 11 on Risk management, governance and assessment process. Even where the K-factor would not bite, due to the PMR or FOR requirement being higher, non-SNI firms would still be required to calculate it. We consider it ought to form part of the basis for internal and supervisory discussions for sources of harm the investment firm faces and poses.

What this chapter covers

6.1 In this chapter, we explain the:

- 3 broad risk categories underpinning the K-factors
- purpose of each K-factor and how it is calculated

Risk categories underpinning the K-factors

6.2 As outlined in Chapter 3, the minimum capital requirements for an investment firm that is not an SNI will be the higher of its:

- fixed overheads requirement (FOR)
- permanent minimum capital requirement (PMC), which is based on the initial capital required for authorisation, or
- K-factor (activity based) requirement (KFR)

6.3 The K-factor requirement is calculated as at least the sum of each of the K-factors that apply to the business of the investment firm. The IFR sets out 3 broad risk categories of K-factors:

- risk-to-client (RtC)
- risk-to-market (RtM), and
- risk-to-firm (RtF)

6.4 RtC covers risks carried by an investment firm during its services, actions or responsibilities, which could negatively impact clients. For many investment firms, failure to carry out its services or operations correctly will be the most important risks they need to manage. The negative impact on clients of this failure could be substantial.

6.5 RtM applies capital requirements against the impact an investment firm could have on the markets in which it operates, and on those counterparties it trades with. For example, if an investment firm exits a trading venue or an over-the-counter market in a disorderly way, the functioning of that market and its participants could be negatively affected. RtM seeks to limit the likelihood and impact of such risk events.

6.6 RtF is intended to capture risks to an investment firm's solvency from its trading activity and market participation. While the primary impact of crystallised risk is on the investment firm itself, its shareholders and its counterparties and creditors, a deterioration in an investment firm's financial standing can lead to increased risks to its clients and/or the wider market. Such risks are particularly acute for investment firms trading in their own name. So RtF only applies to an investment firm authorised to deal on its own account – either for its own purposes or on behalf of a client – and/or underwriting of financial instruments.

The K-factors and how they are calculated

6.7 The range of different K-factors is set out in Figure 6.1 below. Different K-factors may apply according to whether an investment firm undertakes the relevant investment service or activity. Figure 6.1 identifies those K-factors which will apply only to investment firms that deal on own account (in their own name, even if on behalf of clients) and/or underwrite or place on a firm commitment basis. Each K-factor in turn is then explained in detail in this chapter.

Figure 6.1: K-factor own funds requirements

K-factors for RtC that could apply to any investment firm that undertakes relevant business:	
K-AUM	Assets under management
K-CMH	Client money held
K-ASA	Assets safeguarded and administered
K-COH	Client orders handled
K-factors for RtM and RtF that only apply to an investment firm that can deal on own account (in own name, even if on behalf of clients) or underwrite or place on a firm commitment basis:	
K-DTF	Daily trading flow
K-NPR	Net position risk
K-CMG	Clearing margin given
K-TCD	Trading counterparty default
K-CON	Concentration risk

6.8 Investment firms may conduct MiFID investment services or activities using a tied agent (in the UK, this will generally also be an appointed representative). In these cases, the investment firm on whose behalf the tied agent is acting serves as the principal and must take full and unconditional regulatory responsibility for the investment business undertaken through that tied agent. For prudential purposes, it follows that investment firms should include the relevant amount of MiFID investment services or activities conducted through a tied agent within the total amount of business of the principal investment firm. In practice, the two most likely K-factors to apply to MiFID business conducted via a tied agent are likely to be K-AUM and K-COH.

6.9 The amount of AUM (including ongoing nondiscretionary advisory arrangements) should include business undertaken by a tied agent to arrive at the total amount of AUM of the principal investment firm, for the purposes of calculating the K-factor requirement, K-AUM, by that investment firm.

6.10 The value of COH should include the client orders received and transmitted by the tied agent to arrive at the total value of client orders handled by the principal investment firm, for the purposes of the calculating the K-factor requirement, K-COH, by that investment firm. However, to avoid 'double counting', the principal investment firm need not include orders from its tied agent if it is already capturing the same orders/transactions through the value of orders it has received (from its tied agent) and has transmitted on to another party, or where the principal investment firm executes those orders itself.

K-AUM

6.11 K-AUM is the K-factor requirement for the amount of own funds investment firms are required to hold against risks associated with managing assets for clients. It covers both assets managed on a discretionary portfolio management basis and assets under an ongoing non-discretionary advisory arrangement. Article 17 of the IFR describes how K-AUM is calculated.

6.12 As a proxy, K-AUM aims to capture the scale of potential harm an investment firm may cause clients from incorrectly managing client portfolios, including poor execution. It also aims to create a minimum amount of capital that investment firms can use to absorb losses from operational events, including the cost of putting things right for clients, and so helps to provide some continuity of service where an investment firm is under financial stress.

6.13 The IFR defines assets under management (AUM) as '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 ongoing nature'. While not stated in the IFR, we think it would be appropriate for an investment firm to use the market value of an asset when measuring AUM. Where this is unavailable we consider that the correct approach would be for the investment firm to use fair value. This practice would be in line with MiFID reporting obligations. The IFR does not state how the investment firm should treat any negative values or liabilities it manages within a portfolio, for example from derivatives or leverage. Negative values could be either excluded from AUM, added to AUM, or offset with AUM being calculated as the net value of assets the investment firm manages.

6.14 AUM includes both discretionary and ongoing non-discretionary advisory arrangements. Ongoing non-discretionary advisory arrangements are included because the risk of harm to clients relying upon the expertise of the investment firm may be deemed to be sufficiently similar from a prudential perspective. This is irrespective of whether that investment firm is operating on a discretionary or advisory basis for MiFID conduct purposes. An example of where an investment firm might be operating ongoing non-discretionary advisory arrangements is where it has an agreement with the client to undertake periodic review of their investments, particularly where the investment firm may charge based upon a percentage of the assets of the client.

6.15 The IFR sets out when and how an investment firm should measure AUM. The investment firm shall use the value of total assets under management on the last business day of each of the preceding 15 months. The investment firm will exclude the 3 most recent monthly values and calculate the monthly average of the remaining 12 monthly values of that period, to determine the rolling average. The rolling average of that period is then multiplied by the K-AUM coefficient, 0.02%. The result is the minimum capital required to fulfil K-AUM, and the investment firm should update its calculation of this on the first business day of each month.

6.16 By only using the first 12 monthly values (ie those starting 15 months ago), and then averaging them, K-AUM aims to provide an element of both 'smoothing' and 'lagging'. This allows investment firms time to plan for changes in own funds requirements from more recent changes in the level of business activity, and avoid a disproportionate impact from outlying readings. This feature is also used in several other K-factors, covered below.

6.17 The IFR specifies that where an investment firm has delegated the management of assets to another financial entity, the investment firm must include those assets within its K-AUM calculation. But to avoid 'double counting', an investment firm managing the assets of another financial entity on a delegated basis need not include those assets in its K-AUM calculation.

6.18 The IFR does not define the term 'financial entity'. In practice, to be able to manage clients' assets, an entity would normally need to be regulated to carry out the service of portfolio management, either on a discretionary third-party or collective portfolio basis. This includes MiFID investment firms and collective portfolio managers. For both, this aim of avoiding 'double counting' would be satisfied because both these types of entities are subject to an AUM-based capital requirement – CPM and CPMI by way of the Funds Under Management Requirement from UCITS and AIFMD. Similarly, any third country entities that have comparable AUM-based capital requirements would seem to satisfy the aim of avoiding 'double counting'. However, where the delegating entity does not have to meet an AUM-based capital requirement, then there is no 'double counting'. In this case, it would seem that the investment firm receiving the delegation should not exclude the relevant value of assets when measuring the total of its AUM.

6.19 Finally, where an investment firm has not been managing assets for the entirety of the previous 15 months, or has ceased to meet the conditions of an SNI investment firm, it should use available historical data as soon as it becomes available to calculate the average required for AUM. There is also the power for the competent authority to instruct an investment firm to replace missing data points with an amount it determines, based on the business projections the investment firm submitted when it applied for authorisation, as outlined in MiFID.

K-CMH

6.20 K-CMH is the K-factor own funds requirement for the amount of client money an investment firm may hold. Article 18 of the IFR describes how investment firms should calculate K-CMH.

6.21 K-CMH is designed to capture the risk of an investment firm causing potential harm to clients where it holds their money. It takes into account whether the funds are recorded on the investment firm's own balance sheet or in third party accounts, and arrangements provide that client money is safeguarded in the event of bankruptcy, insolvency, or entry into resolution or administration of the investment firm. UK firms hold client money subject to our Client Assets Sourcebook (CASS) and if we adopted rules reflecting those in the IFR these requirements would remain unchanged. As outlined in Chapter 3 of this DP on Application to investment firms, any investment firm that holds client money will not be eligible to be classified as an SNI.

6.22 The IFR contains two contributing components for K-CMH, relating to whether client money is segregated or non-segregated. In the UK any client money subject to CASS 7 must not be unsegregated, otherwise this will be a breach of the rules (see section CASS 7.13 in our Handbook).

6.23 In the UK an investment firm subject to CASS 7 may be able to receive money from non-retail clients through a title transfer collateral arrangement (TTCA) if the firm meets the requirements for appropriate use of TTCAs (CASS 7.11.4AR). Money received from clients in this way is not client money for the purposes of CASS 7. There is still potential for client harm if an investment firm receives monies under a TTCA, which would therefore not be caught by K-CMH. However, this is something we initially see as being assessed on an individual investment firm basis (see Chapter 11 on Risk management, governance and review process). A similar approach would also be taken for assets received from clients where not caught by K-ASA below.

6.24 The definition of client money held (CMH) within the IFR does not specify how to measure the amount of client money or funds an investment firm holds. In the absence of further clarification, we believe that consistency suggests that this should be the amount an investment firm holds as CMH in accordance with how Article 2 of MiFID Delegated Directive 2017/593 has been implemented in the UK. Further, this would suggest that an investment firm should measure such amounts by applying balances it uses for its internal client money reconciliations for segregated client money.

6.25 Recital 24 of the IFR states that CMH "excludes client money that is deposited on a (custodian) bank account in the name of the client itself, where the investment firm has access to the client money via a third-party mandate". Under our rules we could consider this to be controlling client money under CASS 8 (Mandates). As such, we do not propose that an investment firm should include client money it controls but does not hold within any K-CMH calculation applied in the UK.

6.26 An investment firm will be expected to calculate its K-CMH requirement on the first business day of each month. Using the total values of segregated and non-segregated client money held at the end of each business day for the previous 9 months, an investment firm should calculate the daily average for each of these for the first 6 months of that period, excluding the daily values for the most recent 3 months. This is intended to provide an element of both 'smoothing' and 'lagging'.

6.27 The daily average calculated for segregated client money will be multiplied by 0.4%, and the daily average calculated for non-segregated client money will be multiplied by 0.5%, the latter reflecting the greater risk of harm to clients. The sum of these 2 values represents the minimum capital requirement an investment firm must hold under K-CMH.

6.28 Where an investment firm has not held client money for the full preceding 9 months, it should use historical data for that period as soon as it becomes available. The competent authority may decide to replace missing data points by regulatory determinations based on projections the investment firm submitted when it applied for authorisation, as outlined within MiFID.

K-ASA

6.29 K-ASA, as set out in Article 19 of the IFR, is the K-factor own funds requirement assigned against the risk of harm associated with the safeguarding and administering of a client's financial instruments. This is irrespective of whether such assets are held on the investment firm's balance sheet or are in third-party accounts. As outlined in Chapter 3, any investment firms that safeguard and administer client assets would not be eligible to be classified as an SNI.

6.30 The significance and impact of risks to clients from the safeguarding and administration of client assets is deemed to require its own separate prudential treatment. It includes any client assets the investment firm holds which are not accounted for under K-CMH. While the coefficient for K-ASA is much lower than for

K-CMH, the value of assets safeguarded and administered may sometimes be much higher than the value of client money held.

6.31 Assets safeguarded and administered (ASA) have a clear link to CMH. So for consistency, our view is that investment firms in the UK should take ASA as being the total of client financial instruments that they must treat as such in accordance with how the provisions of Article 2 of MiFID Delegated Directive 2017/593 have been implemented in the UK under Chapter 6 of the Client Assets Sourcebook (CASS 6). We would also suggest that investment firms should calculate the value of ASA based on the market value of the relevant financial instruments or, where market value is not available, the estimated value performed on a best effort basis. These values should be consistent with those the investment firm has submitted in other regulatory data, such as custody reconciliations, the Client Money and Assets Return (CMAR) under Chapter 16 Annex 29 of the Supervision Manual (SUP) and records required under CASS 3 (Collateral).

6.32 The measurement of ASA should include both assets where the investment firm responsible for safeguarding and administration of assets has appointed a third-party institution with which to deposit assets (under CASS 6.3 in the UK), and assets received from another party. The intention is that an investment firm should hold adequate capital in relation to the risk of harm to clients associated with any involvement in this activity. This includes both their appointment of, or appointment as, a third-party to hold client assets for the purposes of safeguarding and administering.

6.33 K-ASA is calculated on the first business day of each month. Using the total daily value of client assets safeguarded and administered held at the end of each business day for the previous 9 months, investment firms will calculate the average of the daily values in relation to the first 6 months of that period. Investment firms should exclude the daily values for the most recent 3 months. This provides an element of 'smoothing' and 'lagging' before significant changes in the value of ASA would start to affect the amount of K-ASA. That daily average figure will then be multiplied by the coefficient 0.04%. The figure produced is the minimum amount of the own funds requirement an investment firm should hold under K-ASA.

6.34 Where an investment firm has not been safeguarding and administering assets for the full previous 6 months it shall use historical data as soon as it becomes available to calculate the daily average. The competent authority may also decide to replace specific data points with its own determinations based on projections submitted by the firm for the purposes of authorisation, as outlined within MiFID II.

K-COH

6.35 K-COH, as set out in Article 20 of the IFR, is the K-factor own funds requirement designed to cover potential risks from both the execution of orders in the name of the client and the reception and transmission of client orders. An investment firm's mistakes in handling of client orders, including failing to deliver best execution, may lead to client harm. This includes where a firm is receiving and transmitting client orders as part of a chain. However, orders executed in the name of the investment firm, including on behalf of clients, are captured under a separate K-Factor, K-DTF (see separate section of this chapter below).

6.36 An investment firm calculates its K-COH requirement on the first business day of each month. To do so, it will record separately the total daily value of client orders handled (COH) for both cash trades (measured as the total value either paid or received on each trade) and derivatives trades (measured as the notional amount of the contract traded), for each business day over the previous 6 months. Using the first 3 months of daily data (ie excluding the 3 most recent months' worth) an investment firm will calculate the average total daily value traded separately for both cash and derivatives trades. The average total daily value for cash trades is multiplied by the coefficient of 0.1% and the average total daily value of derivatives trades is multiplied by the coefficient of 0.01%. The sum of these figures for cash trades and derivatives trades is the minimum own funds requirement an investment firm is required to hold for its K-COH.

6.37 To measure interest rate derivatives, the notional amount to be used to calculate COH is to be adjusted for the time to maturity (in years) of those contracts. Investment firms will multiply the notional value of the contract by its duration, where duration is arrived at as follows:

Duration = time to maturity (in years)/10

6.38 Where a firm has not handled client orders for the full previous 6 months it should use historical data as soon as it becomes available to calculate the daily average. The competent authority may also decide to replace specific data points with its own determinations based on projections the investment firm submitted when it applied for authorisation, as outlined within MiFID.

6.39 While not explicitly outlined within the IFR, we believe some clarification could be made on the point at which and how the measurement of value of client orders takes place. To avoid 'double counting' and clearly distinguish between the execution of orders in the name of the client and the reception and transmission of orders, it is worth recalling that these are separate activities under MiFID (Activities 2 and 3 of Annex I respectively). Accordingly, in our view the reception and transmission of orders have only been fulfilled once both parts of the activity have been completed. Therefore, an investment firm receiving orders from another investment firm, and executing them in the name of the client, would count these under orders executed in the name of the client.

6.40 The time at which the price is measured would also benefit from clarification. In the case of orders executed by the investment firm we believe that measurement should be taken only once the investment firm has confirmation an order has been executed in the market, and the price is known. In the case of the reception and transmission of client orders, we believe that the measurement should be taken at the point at which the order is transmitted to another investment firm or credit institution. For orders transmitted to another investment firm or credit institution it seems appropriate to use the price within the order. Or, if no numerical price is stated, then investment firms should use the current market price at the time the order is transmitted.

6.41 The trades within scope of COH include transactions executed by the investment firm when providing delegated portfolio management services on behalf of investment funds managed by AIFM or UCITS management company. Also included within COH are transactions from investment advice where an investment firm does not calculate K-AUM.

6.42 However, COH does not include transactions handled by the investment firm for servicing a client's investment portfolio where those assets are under its management and included in its K-AUM calculation. Further, COH does not include transactions for asset management mandates delegated to the investment firm where the relevant amount of assets managed on behalf of the client is not required to be included within its measurement of AUM. That is, where the financial entity delegating to the investment firm already includes such assets within its own AUM-based capital requirement, in line with the calculation of K-AUM described above.

6.43 For clarification, our view is that the measurement of COH does not extend to third party buying and selling interests which come about due to the operation of a 'multilateral trading facility' (MTF) or when operating an 'organised trading facility' (OTF). Rather, the IFR does not initially include any K-factor requirement specific to these discrete MiFID activities (but see also K-NPR below in respect of an OTF). However, this is something that the EU has previously noted it may consider as part of any future review of the new prudential framework for investment firms.

6.44 We do not believe that COH would extend to situations where 2 or more investors are brought together to facilitate a transaction between themselves, where the investment firm is not part of a chain (with other investment firms or entities that may conduct MiFID investment business) for client orders. Such situations may be most likely to occur in corporate finance or private equity business.

6.45 Finally, we suggest several important technical clarifications when measuring DTF (daily trading flow) for trading firms which would also be relevant for measuring COH. Please refer to the section on K-DTF below.

K-DTF

6.46 The K-factor K-DTF, as set out in Article 33 of the IFR, only applies to investment firms that are dealing on own account, including where executing client orders in the name of the investment firm. It is an own funds requirement designed to capture operational risks related to the value of trading activity an investment firm conducts throughout each business day. An investment firm dealing on own account, or in its own name to execute client orders, needs to control operational risks from systems, processes, people and external events.

6.47 DTF (Daily Trading Flow) measures the daily value of transactions that an investment firm conducts through dealing on own account or when executing orders on behalf of clients in its own name. It excludes the value of orders handled for clients through the execution of orders in the name of the clients where they are already captured within the scope of COH. The DTF has 2 components that need to be measured separately, cash trades and derivatives trades.

6.48 Investment firms should determine a rolling average (for cash trades and for derivatives trades separately) using the value of their total daily trading flow over the previous 9 months. It is to be measured at the end of each business day as the total value of trades that have occurred throughout that day. The average is determined using the first 6 months of these daily values, with the 3 most recent months' worth of daily values not used. This feature allows for some 'smoothing' and 'lagging' to provide for where the investment firm's trading profile is changing, or there are altered market conditions.

6.49 For both DTF and COH what is included under a 'cash trade' is not defined within the IFR. We believe it should include transactions where purchase and settlement of the instrument takes place on the same trading day, or in line with a market standard settlement or delivery date (or earlier). This would include transactions covering transferable securities, money-market instruments, units in a collective investment scheme or exchange traded options.

6.50 For cash trades (for the purposes of both DTF and COH), we believe that the value should be regarded as the total amount paid or received for each trade, which for exchange traded options may be taken as the premium. Whereas for derivatives (apart from exchange traded options), the value should be the notional amount of the contract. However, for interest rate derivatives the notional amount should be adjusted for the time to maturity (in years) of those contracts with the notional amount to be multiplied by the duration, which is arrived at as follows:

Duration = time to maturity (in years)/10

6.51 The IFR does not explicitly outline how investment firms should calculate the notional amount of a derivative contract for DTF. However, in another K-factor, K-TCD (trading counterparty default), a set of requirements that does just this is described under paragraph 6.91 of this chapter). Accordingly, we believe that it would be consistent and proportionate to allow investment firms to calculate the notional value for derivates for DTF, and for COH, in line with the relevant provisions of K-TCD (as set out in the third paragraph of Article 29 of the IFR).

6.52 The own funds requirement for K-DTF is then to be calculated on the first business day of each month using the formula:

K-DTF Requirement = (Rolling average cash trades * 0.1%) + (Rolling average derivatives trades * 0.01%)

6.53 As with COH, where a firm has not had a daily trading flow for the full preceding 9 months, it should use historical data for that period as soon as it becomes available. The competent authority may also decide to replace specific data points with determinations based on projections the investment firm submitted when it applied for authorisation, as outlined within MiFID.

K-NPR and K-CMG

6.54 This section deals with 2 K-factors that only apply to investment firms that deal on own account, or execute for clients in the name of the investment firm.

6.55 K-NPR (Net Position Risk) is a direct application to investment firms of the standardised market risk provisions of the CRR, together with the revised approaches to market risk introduced by the CRR 2 in the future once these become applicable to credit institutions for binding own funds requirement purposes.

6.56 K-CMG (Clearing Margin Given) is an alternative to K-NPR to provide for market risk, that builds upon the systemic resilience created by EMIR and use of a clearing member. K-CMG is based on the total margins an investment firm is required to give to a clearing member. Investment firms may only use K-CMG when the competent authority permits this.

6.57 Investment firms should apply either the K-NPR or the K-CMG to their trading book activity. This includes the option to apply each requirement on a portfolio basis. This means that an investment firm that does not clear all its positions may apply K-CMG on those portfolios where it does use one or more clearing members, providing it meets all the other conditions that attach to K-CMG, and K-NPR on those trades that don't. An investment firm will need to seek prior regulatory permission to use K-CMG, as some of the specified conditions require supervisory assessment.

6.58 Both K-NPR and K-CMG apply to all positions in an investment firm's trading book. The IFR defines the 'trading book' as all positions in financial instruments and commodities held by an investment firm, either with trading intent or to hedge positions held with trading intent. It then defines 'positions held with trading intent' as any of the following:

a. proprietary positions and positions arising from client servicing and market making
b. positions intended to be resold in the short term, and/or
c. positions intended to benefit from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations

6.59 These are aligned with the current definitions in the CRR.

6.60 'Financial instrument' is as is defined for the purposes of MiFID. Also, according to paragraph 4 of Article 21 of the IFR, for the purposes of both K-NPR and K-CMG, the requirement is to include positions throughout the investment firm where they give rise to foreign exchange risk or commodity risk. That is, to include positions other than trading book positions.

6.61 The definition of 'on a portfolio basis' used within the IFR may be developed further by the EU in supplementary Level 2 legislation, as the term 'portfolio' is not defined in the IFR text. However, the CRR2 amendments package for banks uses the term 'trading desk'. This is defined as 'a well-identified group of dealers set up by the institution to jointly manage a portfolio of trading book positions in accordance with a well-defined and consistent business strategy and operating under the same risk management structure.' For example, under the alternative internal model approach for market risk in CRR2, institutions may be permitted to apply different internal models to separate trading desks. We believe that it would be consistent to read 'on a portfolio basis' to apply in a similar way, such that each of an investment firm's trading desks constitute a single portfolio, with some applying K-CMG and some applying K-NPR, as applicable.

K-NPR

6.62 The own funds requirements for net position risk, K-NPR, make use of the market risk requirements of the CRR, through cross-reference.

6.63 For at least the first 5 years of the IFR's operation an investment firm calculating K-NPR should apply either the current standardised, or where it has regulatory approval, the current internal models approach to market risk under Title IV of Part Three of the CRR.

6.64 The IFR also provides for a revised alternative standardised approach, and an alternative internal model approach, to become available for investment firms to use in the future. A series of reviews and adjustments to the relevant parts of the Basel global framework for banking regulation was completed in January 2019. This includes updated treatment of market risk known as the 'Fundamental Review of the Trading Book (or FRTB)'. As such, these revised approaches for implementing FRTB are not yet fully incorporated into the European framework. The CRR2 amendments package published in May 2019 introduced a reporting requirement based on the revised market risk framework. The Commission was also empowered to adopt a Delegated Act to make the reporting framework operational. Finalising a new own funds requirement for market risk will require further amendments to the CRR. In its targeted consultation document on an alternative standardised approach for market risk (which closed on 11 November 2019), the EU Commission said it was aiming to publish a proposal in June 2020. If the new alternative approaches do not become available for credit institutions within 5 years of the IFR's application, then the current CRR approaches to market risk will continue to apply for the purposes of investment firms calculating K-NPR.

6.65 Any UK investment firm that may be considering an internal model for the purposes of calculating K-NPR under any domestic rules for this should approach us at an early stage to discuss the process for gaining regulatory approval.

K-CMG

6.66 As an alternative to K-NPR, but subject to specific criteria and regulatory approval, an investment firm may apply K-CMG for cleared trading book positions. The minimum capital requirement for K-CMG is based upon the total amount of margin required to be given by the investment firm to a clearing member.

6.67 To calculate K-CMG an investment firm will need to record its total margin required, on a daily basis, for the previous 3 months, and use the third highest amount as its 'total margin' figure. This total margin figure is then multiplied by 1.3 to determine an investment firm's minimum capital requirement under K-CMG:

K-CMG = (Total margin) * 1.3

6.68 The IFR foresees further specification on what is meant by the 'total margin' within an EU Technical Standard. While this could be reasonably understood as including both initial margin and variation margin, a margin account can also contain amounts for other purposes than protecting the clearing member from market risk. So it may be helpful to have further clarity on how to conduct the daily reading of total margin, particularly in a period where multiple margin calls have been made and over different time zones.

6.69 For the exclusion of the 2 highest daily amounts of total margin required by the clearing member during a 3-month period, there is potential ambiguity in the IFR text where an investment firm uses multiple clearing members. For example, should it be the third highest combined daily total of margin given on a single day, or be the sum of the third highest amounts of margin given to each clearer, even if those amounts for each clearer occur on different trading days? Our view is that it would be more consistent with the overall concept of clearing margin given for an investment firm to first add up, across all clearing members used, the margins for each day. Essentially, that is the amount that was there at the end of that day, as the margin call made at the end of the day is typically what is 'given' to the clearer the next morning. The third highest such amount across the relevant observation period would then be taken. The alternative approach of adding margins from different clearing members from different trading days could be more prudent, but we understand that this is less likely to reflect how the underlying risk is managed in practice.

6.70 To use K-CMG an investment firm must meet the following conditions:

- It must not be part of a group which includes a credit institution.
- The clearing and settlement of transactions takes place under the responsibility of a credit institution (or an investment firm that deals on own account, and is still required to apply the CRD/CRR instead of IFD/IFR) which is a clearing member (of a CCP that is authorised or recognised under EMIR). Those transactions must be centrally cleared or settled on a delivery-versus-payment basis under the clearing member.
- Its total margin requirement is based upon a margin model of the clearing member.
- It has demonstrated to the competent authority that calculating market risk using K-CMG is 'justified by certain criteria', and
- The competent authority has judged that the use of K-CMG is not motivated by an investment firm seeking to arbitrage or game its minimum capital requirement 'in a disproportionate or prudentially unsound manner.'

6.71 We note there is an apparent discrepancy between the definition of 'clearing margin given' or 'CMG' (in point 32 of paragraph 1 of Article 4 of the IFR) and the operative provisions listed above (which reflect paragraph 1 of Article 23 of the IFR). The former says: 'the amount of total margin required by a clearing firm or qualifying central counterparty, where the execution and settlement … take place under the responsibility of a clearing member or qualifying central counterparty.' However, the latter operative conditions only provide for the use of a clearing member and do not mention direct use of a central counterparty. We welcome stakeholders' views on what may be appropriate for the UK market.

6.72 The margin model established by the clearing member is required to always 'achieve a level of prudence similar to' requirements established within EMIR. Further, competent authorities have to undertake periodic assessments to ensure the model continues to meet the risk characteristics of an investment firm's portfolio. This assessment will include the interval between margin collections, market liquidity and the possibility for changes over the duration of transactions. In introducing a margin method in the UK we would expect to incorporate these reviews into our routine supervisory assessments (as set out in the sections on Risk review in Chapter 11).

6.73 We propose that in any initial assessment on whether to permit the use of a margin method such as K-CMG in the UK, an investment firm would be required to justify to us that its use is not driven by interests to arbitrage capital requirements. We would expect an investment firm to provide justification based on its business model, that the relevant portfolio is traded under the responsibility of a clearing member. We would also expect them to demonstrate that the trading book and trading strategy applied fits more appropriately with use of a margin method in rules that reflect K-CMG, rather than applying the market risk rules of on-shored CRR through rules that reflect

K-NPR. This information would likely include a detailed comparison of the own funds requirements calculated according to the rules for the 2 alternative K-factors, K-NPR and K-CMG.

6.74 Finally, to further prevent arbitrage risk and introduce some consistency, we would consider the appropriateness of setting a commitment period once an investment firm begins using rules that reflect K-CMG, for instance 2 years. Within this period, an investment firm would be required to continue assessing market risk using these rules, unless it could justify to us that its circumstances had changed sufficiently to warrant changing to rules that reflect K-NPR.

K-TCD

6.75 K-TCD (Trading Counterparty Default) is a K-factor own funds requirement that only applies to investment firms dealing on their own account (or execute for clients in the name of the investment firm). It aims to capture risks from trading counterparties failing to meet their obligations to the investment firm. The components of K-TCD are outlined across Articles 25 to 32 of the IFR. This is one of the most detailed K-factors within the EU primary legislation. As such, we do not immediately expect the need for any further development through EU delegated acts or technical standards.

6.76 'TCD' means the exposures in the trading book of an investment firm in instruments and transactions referred to in Article 25 (see paragraph 6.79 below) giving rise to the risk of trading counterparty default. So K-TCD is an own funds requirement designed to capture the risk of an investment firm's exposure to the default of its trading counterparties when dealing on its own account, either for itself or when executing client orders in the name of the firm. It also includes exposures from client servicing, where this is part of the definition of 'trading intent' in the IFR.

6.77 Whilst based upon the concepts of standardised treatment of counterparty credit risk established by Basel and transposed into EU law through the CRR, K-TCD is designed specifically for investment firms and intended to be simpler and more appropriate for them. K-TCD is also used in calculation of K-CON (see in Chapter 9 on Concentration risk).

6.78 The following sections outline the requirements for:

- determining the contracts and transactions that are within the scope of K-TCD
- the formula for how to calculate the K-TCD
- determining the exposure value of those contracts and transactions, using:
  - replacement cost
  - potential future exposure, and
  - collateral
- where netting may be applied
- applying a credit valuation adjustment, and
- alternative calculation options

Transactions within scope

6.79 Article 25 of the IFR details the applicable contracts and transactions for which it is necessary to calculate K-TCD. These are:

- Derivatives, as outlined in Annex II of the CRR, with the following exceptions:
  - Exchanged-traded derivative contracts.
  - Derivatives contracts held for a hedging position of the investment firm.
  - Contracts directly or indirectly cleared through a CCP. Providing that:
    - The positions and assets of the investment firm related to those contracts are distinguished and segregated, at both the level of the clearing member and the CCP, from the positions and assets of the clearing member and the other clients of that clearing member. This must have the effect that the positions and assets on the investment firm are bankruptcy remote if the clearing member or any of its other clients defaults or becomes insolvent.
    - That there are legally or contractually enforceable provisions to require the clearing member to facilitate the transfer of the investment firm's position and associated collateral to another clearing member within the applicable margin period of risk, if the original clearing member defaults or becomes insolvent in the event of default or insolvency of the original clearing member, and
    - The investment firm has an independent, written legal opinion which finds that, in the event of a legal challenge, the investment firm would bear no losses on account of the insolvency of its clearing member or of any of its clearing member's clients.
- Derivative contracts directly or indirectly cleared through a CCP authorised or recognised under EMIR are deemed to meet all the above conditions.
- Long settlement transactions.
- Repurchase transactions.
- Securities and commodities lending or borrowing transactions.
- Margin lending transactions.
- Any other type of securities financing transactions, and
- Credits and loans granted to an investor to allow them to carry out a transaction in one or more financial instruments, if the investment firm granting the credit or loan is executing the trade in the name of the client or receiving and transmitting the order without executing it.

6.80 For the last item in the above paragraph, our view is that where an investment firm deals on its own account (or executes client orders in its own name) and so is subject to any K-TCD own funds requirement, it should include within its K-TCD calculation any credits and loans granted in line with providing the ancillary service in point (2) of Section B of Annex I of MiFID. This would amount to client servicing and so be seen as within the definition of 'trading intent', even though the transaction to execute or receive & transmit the order is in the name of the client.

6.81 The following counterparties are excluded from the calculation of K-TCD:

- central governments and central banks, where they would receive a 0% risk weight under the standardised approach for credit risk of the CRR
- multilateral development banks listed in the CRR, and
- international organisations listed in the CRR

6.82 The investment firm may also apply to the competent authority for prior approval to exclude intra-group transactions. The authority will be obliged to approve an application providing that the counterparty is:

- a credit institution, an investment firm or a financial institution subject to appropriate prudential requirements (in the view of the authority)
- included in the same prudential consolidation as the investment firm under either the CRR or Article 7 of the IFR, or both are subject to the same group capital test under Article 8 of the IFR (see Chapter 7 on Consolidation and Chapter 8 on the Group capital test)
- subject to the same risk evaluation, measurement and control procedures as the investment firm
- established in the same jurisdiction as the investment firm, and
- there are no current or foreseen material practical or legal impediments to the prompt transfer of own funds, or repayment of liabilities, from the counterparty to the investment firm

Calculating K-TCD

6.83 The minimum own funds requirement to meet K-TCD is calculated using the following formula, set out in Article 26 of the IFR:

6.84 Minimum own funds requirement = α (Alpha) * EV (Exposure value) * RF (Risk factor) * CVA (Credit valuation adjustment)

6.85 Alpha is fixed initially at 1.2.

6.86 The risk factor, RF, is determined according to the following Figure 6.2

Figure 6.2: Risk factors (RF) used for calculating K-TCD

Counterparty type	Risk factor
Central governments, central banks and public sector entities	1.6 %
Credit institutions and investment firms	1.6 %
Other counterparties	8 %

Calculation of exposure value

6.87 Determining the exposure value (EV) of contracts and transactions within scope of K-TCD uses a formula which has 3 inputs: replacement cost (RC), potential future exposure (PFE) and collateral (C). It is calculated using following formula:

Exposure value = Max (0; RC + PFE – C)

Replacement cost

6.88 Replacement Cost (RC) applies to all contracts and transactions within scope of K-TCD. It is determined in the following way for each contract or transaction type:

- Derivatives – the current market value (CMV) of the contract.
- Long settlement transactions. The cash the investment firm will pay or receive on settlement of the transaction (a receivable is positive and a payable amount is negative).

- Repurchase transactions and securities or commodities lending or borrowing transactions. The cash amount lent or borrowed (cash lent is positive, and cash borrowed is negative).
- Securities financing transactions where both legs of the transaction are securities. The CMV of the security lent by an investment firm, increased by the volatility adjustments outlined in Article 30 of the IFR and outlined in Figure 6.4 below under the section on collateral, and
- Margin lending transactions and ancillary credits and loans provided as part of client servicing. The book value of the asset (representing the credit or loan) in accordance with applicable accounting framework.

Potential future exposure

6.89 Potential future exposure (PFE) is determined for derivative contracts only. It is the product of the Effective Notional (EN) of the contract and a standardised supervisory factor (SF) outlined in the IFR:

PFE = EN * SF

6.90 EN is determined as the product of the notional amount of the contract, its duration and its supervisory delta.

6.91 Determining the notional amount, unless clearly stated and fixed until maturity within the derivative contract, is carried out in the following ways:

- Foreign exchange derivative contracts. The notional amount will be either the notional amount of the foreign currency leg converted into domestic currency, or where both legs are in a foreign currency the leg with the highest notional amount once both are converted into the domestic currency.
- Equity and commodity derivatives contracts (including emissions allowances and related derivatives). The product of the current market price of one unit of the instrument and the number of units referenced by the trade.
- Transactions with multiple, contingent payoffs (including digital options or target redemption forwards). The notional amount for each contingent event is calculated individually, and the firm uses the largest result.
- Where notional is determined as a formula of market values – an investment firm should use current market value to determine the trade notional amount.
- Variable notional swaps (eg accreting or amortising notional). An investment firm should use the average notional over the remaining life of the swap as the notional amount.
- Leveraged swaps. These should be converted to the notional amount of the equivalent unleveraged swap. This means that where all rates in a swap are multiplied by a factor, the stated notional amount is multiplied by the factor on the interest rates to determine the notional amount.
- Multiple exchanges of principal. The notional amount should be multiplied by the number of exchanges of principal in the derivative contract to determine the notional amount.

6.92 For foreign exchange derivative contracts, our view is that reference to domestic currency may also be read as the relevant currency in which the investment firm reports to the competent authority, where the competent authority has agreed this may be different from the domestic currency of that authority's jurisdiction. This may be the case where, for example, the investment firm is part of a third-country group and the currency is the domestic currency of its parent/group.

6.93 The duration for all derivative contracts, other than interest rate and credit contracts, is set at 1. For interest rate and credit derivative contracts an investment firm will adjust the notional amount for duration using the time to maturity (measured in years) according to the following formula:

Duration = (1 – exp (-0.05 * time to maturity))/0.05

6.94 The maturity of a contract will generally be the latest date on which it may be executed. However, for options the maturity shall be the latest contractual exercise date as specified by the contract.

6.95 Where the contract references another interest rate or credit instrument then the time period of the underlying contract or instrument will be the basis of determining the maturity date.

6.96 For a derivative contract that is structured so that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity shall equal the time until the next reset date.

6.97 The supervisory delta will be 1, except for options and swaptions where an investment firm has an internal model approved by the competent authority and the modelled value may apply. The model shall estimate the rate of change of the value of the option for small changes in the market value of the underlying.

6.98 The supervisory factor (SF) is determined based on the asset class of the derivative contract, in the following Figure 6.3:

Figure 6.3: Supervisory factors (SF)

Asset class	Supervisory factor
Interest rate	0.5 %
Foreign exchange	4 %
Credit	1 %
Equity single name	32 %
Equity index	20 %
Commodity and emission allowance	18 %
Other	32 %

6.99 To calculate PFE of a netting set, the investment firm will calculate the sum of the PFE of all transactions included in the netting set. They will then multiply this sum by 0.42 for netting sets of transactions with financial and non-financial counterparties for which collateral is exchanged bilaterally with the counterparty, if required, and in accordance with the conditions laid down in Article 11 of EMIR. For all other netting sets an investment firm shall multiply by 1.

Collateral

6.100 Collateral (C) is the final part of the EV calculation, and is subtracted from the combined RF and PFE.

6.101 All collateral, whether exchanged for bilateral or cleared transactions within the scope of K-TCD, is subject to mandatory volatility adjustments in line with the following Figure 6.4:

Figure 6.4: Volatility adjustments

Asset class		Volatility adjustment repurchase transactions	Volatility adjustment other transactions
Debt securities issued by central governments or central banks	≤ 1 year	0.707 %	1 %
	> 1 year ≤ 5 years	2.121 %	3 %
	> 5 years	4.243 %	6 %
Debt securities issued by other entities	≤ 1 year	1.414 %	2 %
	> 1 year ≤ 5 years	4.243 %	6 %
	> 5 years	8.485 %	12 %
Securitisation positions (excluding re-securitisation positions)	≤ 1 year	2.828 %	4 %
	> 1 year ≤ 5 years	8.485 %	12 %
	> 5 years	16.970 %	24 %
Listed equities and convertibles		14.143 %	20 %
Other securities and commodities		17.678 %	25 %
Gold		10.607 %	15 %
Cash		0 %	0 %

6.102 The competent authority has discretion to change the volatility adjustment for certain types of commodities, should it determine that there are different levels of volatility in prices and can explain the reasons for such a modification. Please refer to Chapter 18 where use of options and discretions are discussed.

6.103 The value of the collateral (C) shall be determined according to the following:

- Derivatives contracts, margin lending transactions and ancillary credits or loans as part of client servicing. This will be the notional amount of collateral an investment firm received from the counterparty, decreased in accordance with volatility adjustment outlined in Figure 6.4 above.
- Long settlement, repurchase, securities or commodities lending/borrowing, or any other securities financing transactions. This will be the sum of the CMV of the security leg and the net amount of collateral the investment firm has posted or received. For securities financing transactions, where both legs of the transaction are securities, collateral is determined by the CMV of the security the investment firm has borrowed. Where the investment firm is purchasing or has lent the security, the CMV of the security should be treated as a negative amount and should be decreased to a larger negative amount, using the volatility adjustments in Figure 6.4. Where the investment firm is selling or has borrowed the security, the CMV of the security shall be treated as a positive amount and be decreased using the volatility adjustment in Figure 6.4.

6.104 Where an investment firm has a contractual netting agreement in place covering different types of transactions, and which meets the netting requirements outlined in the next section below (from Article 31 of the IFR), the applicable volatility adjustments will be the ones for 'other transactions' column in Figure 6.4. The investment firm should apply these to the respective amounts of collateral as determined for each type of contract and transaction types as noted in the previous paragraph 6.105 on an issuer basis within each asset class.

6.105 Where the currency of the contract or transaction and the currency of the collateral received or posted is different, the investment firm will apply an additional volatility adjustment of 8% due to the currency mismatch.

Netting

6.106 Article 31 of the IFR outlines 3 circumstances where an investment firm may undertake netting, to be applied in the following sequential order, so as to treat net positions as a single exposure. Where these do not apply transactions should be assessed individually.

6.107 Firstly, an investment firm may treat perfectly matching contracts included in a netting agreement as if they were a single contract, with a notional principal equal to the net receipts.

6.108 Secondly, an investment firm may net other transactions subject to novation with its counterparty under which all obligations between the investment firm and its counterparty are automatically amalgamated in such a way that the novation legally substitutes one single net amount for the previous gross obligations.

6.109 And thirdly, an investment firm may net other transactions where it ensures that the following conditions have been met:

- that the netting contract or other agreement with a counterparty, which creates a single legal obligation, covers all included transactions ensuring that the investment firm would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included transactions in the event a counterparty fails to perform due to any of the following:
  - default
  - bankruptcy
  - liquidation or
  - similar circumstances
- that the netting contract does not contain any clause which, in the event of default of a counterparty, permits a non-defaulting counterparty to make limited payments only, or none at all, to the estate of the defaulting party, even if the defaulting party is a net creditor
- that it has an independent, written and reasoned legal opinion that, if there is a legal challenge of the netting agreement, the investment firm's claims and obligations would be equivalent to those referred to in the first bullet point above, under the following legal regime:
  - the law of the jurisdiction in which the counterparty is incorporated
  - if a foreign branch of a counterparty is involved, the law of jurisdiction in which the branch is located

- the law that governs the individual transactions included in the netting agreement, or
- the law that governs any contract or agreement necessary to effect the netting

Credit valuation adjustment

6.110 The final part of the K-TCD calculation is to apply the credit valuation adjustment (CVA). CVA is an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty. This adjustment reflects the CMV of the credit risk of a counterparty to the investment firm, but does not reflect the CMV of the credit risk of the investment firm to the counterparty.

6.111 For all transactions CVA will be set at 1.5, except for the following, where CVA should be set at 1:

- transactions with non-financial counterparties as defined in EMIR or with non-financial counterparties established in a third country, where those transactions do not exceed the clearing threshold defined in (Article 10 of) EMIR
- intragroup transactions as provided for in (Article 3 of) EMIR
- long settlement transactions
- securities financing transactions, including margin lending transactions, unless the competent authority determines that the investment firm's CVA risk exposures from those transactions are material, and
- ancillary credits and loans provided as part of client servicing

6.112 The treatment of securities financing transactions here is similar to their current treatment in the CRR. So in introducing rules in the UK to reflect K-TCD we would not generally expect to have to override the ability of an investment firm to exclude securities financial transactions from the CVA component of K-TCD (see Chapter 18 on Competent authority discretions).

Alternative calculation options

6.113 The IFR also provides that an investment firm may seek approval from the competent authority to calculate the exposure value of all contracts and transactions (except for those relating to ancillary lending activity) on the basis of either the mark-to-market, original exposure or standardised methods outlined in (Section 3, 4 or 5, Chapter 6, Title II, Part Three of) the CRR. The investment firm would then calculate its K-TCD own funds requirement by multiplying these exposure values by the relevant risk factor according to the counterparty type as set out in (Table 2 in Article 26 of) the IFR and as replicated in Figure 6.2 above.

6.114 The investment firm should then apply a credit valuation adjustment (CVA) factor by multiplying the own funds requirement using the above option by the CVA. They should use the CVA requirement under the IFR to do this.

6.115 Where the investment firm is included in the supervision on a consolidated basis under the CRR, it may calculate its related own funds requirement by multiplying the risk weighted exposure amounts, calculated according to the standardised approach (Section 1 of Chapter 2 of Title II of Part Three of) the CRR, by 8%.

6.116 Rather than applying the CVA factor multiplier under IFR, an investment firm included in the supervision on a consolidated basis in line with the CRR may calculate its own funds requirements for credit valuation adjustment risk according to the own funds requirements for CVA risk in (Title VI of Part Three of) the CRR.

6.117 For information on our initial view of these alternative calculation options, please refer to Chapter 18 on Competent authority discretions.

K-CON

6.118 K-CON is a further own funds requirement that only applies to exposures in the trading book for investment firms that deal on own account, or execute for clients in the name of the investment firm. It seeks to provide additional own funds to manage concentration risk to a single counterparty or group of connected counterparties. As K-CON is part of a wider set of requirements for concentration risk, we describe it separately in Chapter 9 on Concentration risk.

Q3: What are your views on how any negative values or liabilities an investment firm manages within a portfolio, for example from derivatives or leverage, should be treated when measuring AUM? (See paragraph 6.13)

Q4: Do you have any comments on delegation from or to another financial entity when calculating K-AUM? (See paragraphs 6.17 to 6.18)

Q5: Do you agree with our view on how to measure CMH and ASA? (See paragraphs 6.24 and 6.31)

Q6: Do you agree with our views on how to measure COH, and when it does not apply? (See paragraphs 6.39 to 6.40, and 6.43 to 6.44)

Q7: Do you agree with our views on the treatment of 'cash trades' for DTF and COH? (See paragraphs 6.49 to 6.50)

Q8: Do you agree with our views on how to calculate the notional value for derivatives for DTF and COH? (See paragraph 6.51)

Q9: Do you have any comments on the use of K-CMG 'on a portfolio basis'? (See paragraph 6.61)

Q10: When calculating K-TCD for foreign exchange derivative contracts, do you agree with our view on what 'domestic currency' can mean? (See paragraph 6.92)

7 Prudential consolidation

Overview

- Prudential consolidation is also known as consolidated supervision. It is an important complement to, but not a substitute for, individual (or 'solo') supervision of the authorised investment firm. An investment firm which is part of a group must consider and manage the risks it may be exposed to or may pose to clients and to markets, both directly and indirectly, due to its membership of that group.
- The IFR sets the scope and composition of a consolidation group in a similar way to that currently under the CRR. But a key difference is that it uses the concept of an 'investment firm group', which does not include credit institutions.
- Unlike the CRR, the obligations under a prudential consolidation in IFR would now fall upon parent undertakings (including an investment firm where it is a parent undertaking), rather than the authorised entity. This means parent undertakings which may otherwise be unregulated will have to meet regulatory obligations.
- Prudential consolidation treats the whole investment firm group as if it was an investment firm. Consolidated own funds requirements will be determined on the basis of a consolidated permanent minimum requirement, consolidated fixed overheads requirement and a consolidated K-factor requirement. See Chapters 5 and 6 for an explanation of these own funds requirements on an individual investment firm basis.
- As well as applying consolidated own funds requirements, a prudential consolidation also includes the provisions of liquidity, concentration risk, disclosure and reporting.

What this chapter covers

7.1 In this chapter, we cover:

- the scope of application of consolidation for investment firms
- the application of consolidated own funds requirements
- how to consolidate own funds and liquidity requirements
- the application of proportional consolidation, and
- expectations for consolidated supervisory reporting

7.2 This chapter does not cover the group capital test, which is available under Article 8 of the IFR as a derogation from prudential consolidation under Article 7. We explain the group capital test separately in Chapter 8 of this DP.

7.3 Under Article 7 of the IFR, prudential consolidation applies where there is an 'investment firm group', as defined in point (25) of paragraph 1 of Article 4 of the IFR. This will consist of a parent undertaking and its subsidiaries (or entities over which it has similar control), of which at least one is an investment firm and which does not include a credit institution.

7.4 Article 7 of the IFR does not apply to an investment firm group which also includes a credit institution. This is because a credit institution would instead trigger the application of prudential consolidation for a banking group by that credit institution, under the provisions of the CRD/CRR. The IFR avoids the need for parallel consolidation of the same set of entities by both an investment firm under IFR and a credit institution under CRR, through deferring to the CRR.

7.5 Based on the text of the legislation, this non-application to avoid 'double consolidation' does not apply where there is an investment firm subject to the IFR and another investment firm subject to the CRR but no credit institution in the same group. See Chapter 3 on Application to investment firms for details of where this may exist. That situation would still meet the definition of an 'investment firm group' and so the investment firm subject to the IFR would trigger prudential consolidation according to Article 8 of the IFR. The investment firm subject to CRR would trigger consolidation according to the CRR).

7.6 However, where there is a discrete investment firm (sub)group that is also part of a wider banking group, but that investment firm (sub)group does not itself contain a credit institution, the application of prudential consolidation to the investment firm (sub)group under Article 7 of the IFR will be triggered if the parent entity of the (sub) group is a relevant consolidating entity for the purposes of Article 7 of the IFR.

7.7 One major difference from any existing prudential consolidation under the CRR is that the IFR obligation to ensure compliance with the relevant requirements on a consolidated basis falls directly on a parent undertaking, not on an investment firm as a subsidiary. But there is a joint obligation on the parent and its subsidiaries that are subject to the IFR to set up a proper organisational structure and appropriate internal controls to ensure the exchange of any data necessary for consolidation. So replicating these provisions in the manner the IFR envisages would require us to be given specific power to enable enforcement where a parent undertaking, such as a holding company, is not currently regulated.

7.8 The first paragraph of Article 7 of the IFR specifies that a prudential consolidation includes compliance with the obligations laid down in Parts Two, Three, Four, Six and Seven of that regulation. That is, own funds, capital requirements, concentration risk, disclosure and reporting respectively. Paragraph 3 of Article 7 also requires compliance with Part Five, liquidity, on a consolidated basis.

Scope of application of consolidation of Investment Firm Groups

7.9 Point 11 of paragraph 1 of Article 4 of the IFR gives the following definition which is key to identifying the scope of a prudential consolidation under the IFR:

"'consolidated situation' means the situation that results from applying the requirements of this Regulation in accordance with Article 7 to a Union parent investment firm, Union parent investment holding company or Union parent mixed financial holding company as if that undertaking formed, together with all the investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group, a single investment firm; for the purpose of this definition, the terms 'investment firm', 'financial institution', 'ancillary services undertaking' and 'tied agent' shall also apply to undertakings established in third countries, which, were they established in the Union, would fulfil the definitions of those terms;"

7.10 This means the scope of a prudential consolidation starts with identifying where an investment firm is itself, or is a holding of, a parent undertaking which is either an investment firm, an investment holding company, or a mixed financial holding company.

7.11 Instead of the term 'financial holding company' as currently used under the CRR, the IFR introduces the new term of 'investment holding company', as well as redefining the definition of 'financial institution'. This is so that for the purposes of the IFR neither of these terms includes a credit institution. This means the scope of prudential consolidation under IFR will only capture investment firm groups, ie groups that do not include a credit institution.

7.12 The definition of consolidated situation also sets out the type of constituent entities within the group that will then fall within scope of prudential consolidation of an investment firm group. These are subsidiary undertakings, and in our view also participations, of a parent undertaking that meet one of the following definitions in the IFR:

- investment firm
- financial institution, which include asset management companies – ie AIFMs and UCITS management companies – and payment institutions
- ancillary service undertaking, and
- tied agent (Appointed Representative)

This definition also states that entities of the parent group established in a third country, which would be any of the above had they been established within the European Union, shall be classified as such and included within the consolidation group.

7.13 The definition of 'financial institution' in point 14 of paragraph 1 of Article 4 of the IFR includes financial, mixed financial and investment holding companies. This means the constituents of an investment firm consolidation group include such entities where they are intermediate parents, as well as the ultimate or 'Union parent' undertaking (according to one of the definitions in the IFR).

7.14 Under the CRR, whether a subsidiary undertaking or a participation exists is not only based on where there are capital ties. The concept of 'control' can also exist because of 'common management' or where it is possible to determine 'control' exists by other means. While the IFR text does not explicitly address this, our view is that there is no change under the IFR from existing policy. As a result, determining scope would include assessment of 'control' of an undertaking in its widest sense. In this context, while the IFR does not include an express definition of 'control', we note that the IFR definition of a 'subsidiary' cross-refers to the concept of a subsidiary undertaking in Article 22 of the Accounting Directive. In turn, that definition includes concepts such as common management, management on a unified basis, dominant influence and control.

7.15 It is also our view that the concept of an ancillary service undertaking is broad enough to include a group service company. This is because this would be an undertaking that performs a function that supports an investment firm in providing investment services and activities. This is particularly relevant when considering the consolidated fixed overheads requirement (see below), as inclusion should prevent the potential for regulatory arbitrage through booking expenditure in these service companies which otherwise may not be fully accounted for by an investment firm or at consolidation group level when establishing its fixed overheads.

Applying the Consolidated Own Funds Requirements

7.16 As well as clarifying scope, the definition of consolidated situation also clarifies what is intended by a prudential consolidation. All relevant types of individual entities within an investment firm group are to be treated as if, together, they formed a single (or 'enlarged') investment firm. So the requirements of the relevant parts of the IFR (outlined above in the introduction section to this chapter of our DP) will apply to this 'enlarged investment firm'.

7.17 While this gives the intended required outcome, it does not by itself necessarily set out exactly how to achieve this in practice. However, paragraph 5 of Article 7 of the IFR requires the EBA to draft technical standards that should include the methods for prudential consolidation of an investment firm group. In particular, methods to calculate the fixed overheads requirement, the permanent minimum capital requirement, and the K-factor requirement based on the consolidated situation of the investment firm group.

7.18 So the same approach to own funds requirements that applies to an investment firm on an individual basis under Article 11 of the IFR would be applied to an investment firm group on a prudential consolidation basis.

7.19 This means that for the purposes of prudential consolidation of investment firm groups containing one or more investment firm (including any third country and unregulated entities) that is not (or would not be) an SNI, the consolidated own funds requirement would be the higher of the consolidated Fixed Overhead Requirement (consolidated FOR), the consolidated Permanent Minimum Requirement (consolidated PMR) and the consolidated K-Factor Requirement (consolidated KFR).

7.20 Only where all investment firms (including any third country and unregulated entities) in the consolidation group are (or would be) SNIs, would the consolidated own funds requirement be the higher of just the consolidated FOR and the consolidated PMR. In accordance with paragraph 2 of Article 12 of the IFR, certain of the conditions set out in paragraph 1 for determining whether an investment firm may be deemed to be an SNI apply on a combined basis for all investment firms that are part of a group (see Chapter 3 on Application to investment firms).

7.21 The following sections set out what we believe this means for calculating these various requirements on a consolidated basis.

Consolidated Fixed Overhead Requirement

7.22 To calculate a consolidated FOR the parent undertaking must first establish its consolidated fixed overheads. Should the group prepare consolidated expenditure according to an applicable accounting framework then it should use those figures. The relevant deductions under a new technical standard to be developed for the purposes of Article 13 of the IFR (which will replace the current standard on fixed overheads that supports Article 97 of the CRR) should then be applied.

7.23 Where such a consolidated expenditure statement is not prepared, or does not match the scope of the prudential consolidation group, the parent undertaking should first calculate the fixed overheads for each entity within the consolidation group (whether or not that entity is itself subject to an FOR at individual level). In doing so it should apply the new technical standard as above, but only needs to count once any items that relate to intra-group charges and would otherwise result in 'double counting'. That is, they need only be included for one of the two or more relevant entities within the consolidation group. Then these amounts should be added together to arrive at consolidated fixed overheads.

7.24 The consolidated FOR should be at least one quarter of the amount of consolidated fixed overheads.

Consolidated Permanent Minimum Requirement

7.25 The IFR requires a consolidated PMR to be calculated. The PMR is an on-going flat minimum amount of own funds derived from the amount of the initial capital required for authorisation of an investment firm and depends on its activities. This is different from current prudential regimes, where the initial capital requirement (or on-going base capital requirement) is not part of the consolidated capital requirement.

7.26 The IFR does not say how a consolidated PMR should be applied. We believe that a pragmatic and proportionate approach, if considering how to apply this to a domestic regime, could be to calculate this as the sum of the individual PMRs for each authorised investment firm and asset management company in the consolidation group. This would ensure that the parent undertaking has at least enough own funds to support the total of the minimum amount of own funds each investment firm and asset management company in the group is required to hold individually. This would prove relevant if neither the consolidated FOR nor the consolidated KFR prove to be 'higher than' the consolidated PMR.

Consolidated K-Factor Requirement

7.27 When it comes to the consolidated KFR, the principle is that this is to be calculated on the basis of the consolidated situation, so that the group is treated as if it was a single investment firm. We explore below what this might mean when applying each of the K-factors to the consolidated situation.

7.28 As is the case when applying own funds on an individual investment firm basis, determining which K-factors are relevant to the consolidated situation will depend on precisely what business the entities within the group are doing. Where there is a relevant investment service or activity, or one analogous to it even if within an entity that is unregulated or is regulated under a different regime to IFR (including in a third country), the relevant K-factors should be applied to the consolidated situation. This should be done according to the relevant provisions for the K-factors set out in the IFR as if they are applied to an investment firm on an individual basis.

Consolidated K-AUM

7.29 To calculate a consolidated K-AUM requirement, we believe that the total of all assets under management (under both discretionary portfolio management and non-discretionary advisory arrangements of an on-going nature) across all entities in the consolidation group that manage assets on behalf of others, should be captured.

7.30 The measurement of AUM at individual level (see section on K-AUM under Chapter 6 on the K-factors) should help ensure that there is no 'double counting' where an entity in the consolidation group delegates to another entity in the same consolidation group to manage those same assets. The intention is that only the total of assets managed on behalf of clients that are external to the consolidation group need to be captured to calculate a consolidated K-AUM.

7.31 The relevant coefficient from Table 1 of paragraph 2 of Article 15 of the IFR should then be applied to the total amount of assets managed on behalf of (external) clients to arrive at the amount of the consolidated K-AUM requirement.

Figure 7.1: Worked example:

An investment firm group contains:

- a parent investment firm undertaking MiFID discretionary management with a value of AUM of £10 billion
- an AIFM subsidiary (CPMI) managing portfolios of investments on a discretionary, client-by-client basis with a value of AUM of £5 billion
- a subsidiary providing nondiscretionary advisory arrangements of an ongoing nature with a value of AUM of £4 billion, and
- a subsidiary portfolio management entity in a third country with a value of AUM of £3 billion.

Assuming there is no intra-group delegated mandates between any of the entities the amount of the consolidated K-AUM is calculated as follows:

- the amount of AUM for the MiFID investment firm is added to the amounts of AUM for the CPMI, the advisory subsidiary and the third country entity, to give a total value of AUM = £22 billion, then,
- the coefficient from Table 1 of paragraph 2 of Article 15 of the IFR, which in the case of K-AUM is 0.02%, is applied to this total value of AUM, giving the group a consolidated K-AUM requirement = £4.4 million.

7.32 It does not matter that an authorised collective portfolio manager already calculates its own individual K-AUM on a solo basis, under AIFMD in this case. Our view is that, for the purposes of the consolidated K-AUM requirement, the IFR provisions are applied to the 'consolidated situation'. So the coefficient in the IFR applies to the total amount of relevant AUM in the consolidation group. That is, including the portfolios of investments managed by the CPMI on a discretionary, client-by-client basis, as this amount is not included on an individual basis under paragraph 3 of Article 9 of the AIFMD.

Consolidated K-CMH, K-ASA, K-COH and K-DTF

7.33 We believe the consolidated K-factor requirements for each of K-CMH (client money held), K-ASA (assets safeguarded and administered), K-COH (client orders handled) and K-DTF (daily trading flow) should be undertaken in a similar way as explained above for the K-AUM.

7.34 The total of each relevant activity metric, for each relevant entity in the consolidation group should be arrived at by aggregating across the group. This includes amounts for entities that may be regulated according to different requirements, unregulated, or located in third countries, and which conduct comparable business activity. The relevant coefficient from Table 1 of paragraph 2 of Article 15 of the IFR is then applied to the relevant total metric to arrive at the relevant consolidated K-factor requirement.

7.35 The IFR does not say what to do about any intra-group amounts of the above K-factor metrics that do not relate to business external to the prudential consolidation group. We believe a proportionate approach is desirable, to remove any potential 'double-counting' when aggregating. Paragraph 2 of Article 19 of the IFR states that any amounts that have been delegated to another entity for safekeeping should be included within the calculation of K-ASA. However, in our view, when applied on a consolidated basis, this is intended to apply only to delegation outside the consolidation group.

Consolidated K-NPR (and/or K-CMG) and K-TCD

7.36 For both K-NPR (net position risk) and K-TCD (trading counterparty default) there is no metric or coefficient (in paragraph 2 of Article 15 of the IFR). These own funds requirements are instead based upon the concept of positions and exposures.

7.37 As such, the relevant provisions as determined by the IFR for an individual investment firm should also be applied to the consolidated situation. This should take account of all relevant types of exposures that may relate to trading intent and may be incurred by an entity (whether it be an investment firm, unregulated or in a third country) within the consolidation group.

7.38 Firms should calculate K-NPR – at least for an initial 5 years – using the standardised approach for market risk (or where permission has been granted, the internal model approach) according to the requirements for the CRR. We note that Article 325 of the CRR allows for positions in one undertaking in a group to offset positions in another undertaking, subject to the permission of the competent authority where certain conditions are met. We believe that the same approach to calculating net positions should be available to investment firms for calculating consolidated K-NPR.

7.39 When calculating K-TCD at individual investment firm level, paragraph 3 of Article 25 of the IFR allows for intra-group transactions to be excluded, as long as the competent authority has given prior approval. As long as certain conditions are met, including the application of Article 7 of the IFR (see section on K-TCD in Chapter 6), the authority must give their approval. We believe that the same approach should be available for the purposes of calculating consolidated K-TCD.

7.40 The IFR provides for an investment firm to calculate K-CMG (clearing margin given) instead of K-NPR on an individual basis, either in part on a portfolio basis or for the whole trading book, where the conditions are met and regulatory approval has been given. For consolidation, we believe that it would also be possible to use K-CMG instead of K-NPR, or a combination of K-CMG and K-NPR on a portfolio basis. We further believe that investment firms would have to get prior regulatory approval for each entity (regulated or unregulated) in the consolidation group, and for each trading portfolio, for which they want to use K-CMG.

7.41 The consolidated K-CMG requirement would then be the sum of all individual K-CMG calculations (using Article 23 of the IFR) for each entity/portfolio in the group for which the authority has approved the use of this alternative method.

7.42 Where an investment consolidation group uses both the K-NPR for some portfolios and the K-CMG for others, it should calculate a consolidated K-NPR requirement for the former and a consolidated K-CMG requirement for the latter. Both amounts would then be included within the parent undertaking's total consolidated KFR.

Consolidated K-CON

7.43 Part Four of the IFR requires investment firms with a trading book to calculate a further K-factor for own funds requirements purposes, K-CON (concentration risk). They should use this for all relevant trading book exposures that exceed 25% of the investment firm's own funds or, where applicable, an adjusted limit for exposures to investment firms and credit institutions (see Chapter 9 on concentration risk). Article 7 of the IFR states that Part Four is included within the parts of the IFR that the parent undertaking must comply with on the basis of its consolidated situation. Consolidation of an investment firm group therefore includes a consolidated K-CON requirement where the group conducts trading book activity.

7.44 We believe that the provisions for calculating the K-CON requirement on an individual investment firm basis, and as set out in Chapter 9 of this DP on concentration risk, also apply when calculating any consolidated K-CON requirement, although with 2 key differences.

7.45 The first is that the total exposure value (as measured for the purposes of K-NPR and K-TCD) to any individual counterparty or group of connected counterparties should be undertaken based on all relevant exposure across the consolidated situation to that counterparty. It should also take account of any further offset that might arise due to the calculation of consolidated K-NPR and consolidated K-TCD requirements for that counterparty.

7.46 The second difference is that the measure of own funds to be used for the purposes of concentration risk on a consolidated basis would be the amount of consolidated own funds (and not the own funds of the investment firm on an individual basis), as set out below.

Consolidated Own Funds

7.47 Article 7 of the IFR requires that an investment firm group's total consolidated own funds requirements should be met by consolidated own funds. Consolidated own funds should at least satisfy the requirements of Part Two (Articles 9 and 10) of the IFR.

7.48 We believe this means consolidated own funds are composed in accordance with paragraph 1 of Article 9 of the IFR. But they are modified so that 'D' (in the equations in that paragraph) would refer to the amount of the highest of the component own funds requirements upon consolidation. That is, the highest of the consolidated FOR, consolidated PMR, and, where relevant, the consolidated KFR. We also believe that any deductions to consolidated own funds must be applied as required for own funds under the CRR, but as modified by Part Two of the IFR when establishing consolidated own funds. (See Chapter 4 for more details on own funds under the IFR).

7.49 Article 7 of the IFR also specifies that the provisions on minority interest and additional Tier 1 and Tier 2 instruments issued by subsidiaries (as set out in Title II of Part Two of the CRR) should apply to investment firms. However, only the references to paragraph 1 of Article 92 of the CRR should apply and be read as referring to the corresponding own funds requirement provisions of the IFR.

7.50 Determining consolidated own funds should be consistent with any reporting of consolidated financial statements. Investment firm groups could do this by starting with an accounting consolidation and making necessary adjustments for entities that are part of this accounting consolidation but not part of the prudential consolidation. An alternative could be by using management information to construct this for the prudential consolidation group. We consider it may be appropriate to ask for the calculation to be independently verified.

Proportional Consolidation

7.51 Article 7 of the IFR does not say anything about this. But we believe that to deal appropriately with participations (ie where these are not subsidiary undertakings) within a consolidation group, the regulator should be able to agree to a request from a parent undertaking to apply proportional consolidation. In effect, to only include within the consolidated group a percentage share that reflects the degree of ownership or economic or management control that the parent has over the entity in which it has a participation.

7.52 We also believe it would be appropriate to follow the approach currently used under the CRR where proportional consolidation is permitted as long as:

- the liability of the parent undertaking is limited to the extent of control or shareholding that parent holding has in that subsidiary
- the liability of the other shareholders or members is clearly established in a legally binding way, and
- the solvency of the other shareholders or members is satisfactory

Consolidated Liquidity Requirements

7.53 Paragraph 3 of Article 7 of the IFR requires the parent undertaking to comply with the obligations on liquidity (in Part Five of the IFR) on the basis of its consolidated situation. The IFR does not say what this then means in practice. However, given that 'consolidated basis' means treating the group as if it were a single investment firm, we believe it would be for the parent undertaking to ensure that the group holds liquid assets (as defined) equivalent to 1/3rd of the consolidated FOR (as above), plus 1.6% of the total amount of any guarantees provided to clients by entities within the group.

7.54 The IFR applies these obligations to the parent undertaking, which would suggest that it is the parent entity itself which is required to hold the relevant amount of liquid assets. However, we believe it should also be possible for the parent to demonstrate compliance if the relevant liquid assets are held elsewhere in an entity or entities within the scope of the consolidation group, such as by an authorised investment firm or group treasury function. Investment firms in the group would already need to hold liquid assets to meet their own liquidity requirements on an individual basis. For a domestic regime, we would have no preference as to where liquid assets are held to meet the consolidated liquidity requirements, provided that the entity which holds the liquid assets is located in the UK.

7.55 There is also a derogation in paragraph 4 of Article 7 giving the competent authority the discretion to exempt the parent undertaking from complying with the liquidity requirements on a consolidated basis, taking into account the nature, scale and complexity of the investment firm group. In general, we consider it would be appropriate to expect investment firm groups that are not complex in nature or scale and that do not want to be subject to consolidated liquidity requirements to seek to take advantage of the derogation from prudential consolidation provided in Article 8 of the IFR (see Chapter 8 on the group capital test). However, where this is not the case cases could be considered on an individual basis – see Chapter 18 on Competent authority discretions for details.

Consolidated Supervisory Reporting

7.56 We deal with supervisory reporting in Chapter 12. But, considering the scope of obligations covered by Article 7 of the IFR, a prudential consolidation group might expect to report, as a minimum, its consolidated own funds, consolidated own funds requirements, consolidated concentration risk and consolidated liquidity requirements (and potentially, to a similar level of detail as at individual investment firm level).

7.57 We also note that currently, in addition to consolidated prudential information, we also require investment firms in the UK to report consolidated financial statements (balance sheet and profit and loss) which are not covered by the current CRR (except where FINREP applies) or by the IFR. We would not expect this to change.

Q11: **Do you have any comments on the composition of an investment firm group including the concepts of 'control' and 'ancillary service undertaking'. (See paragraphs 7.14 and 7.15)**

Q12: **Do you have any comments on how to calculate consolidated FOR, consolidated PMR, and consolidated KFR? (See paragraphs 7.22 to 7.46)**

8 Group capital test

Overview

- The IFR introduces the Group Capital Test (GCT), the purpose of which is to ensure that an investment firm in a group is not exposed to unnecessary financial strain due to its membership of that group. It seeks to reduce the risk that being part of a group may lead to potential sources of harm to clients, markets and to the investment firm itself, but without needing to apply all the relevant provisions of a prudential consolidation.
- The GCT seeks to address a situation where an investment firm may appear to have sufficient own funds at individual level, but its parent entity is leveraged and has funded the own funds instruments of the subsidiary with debt.
- The GCT uses many of the same terms and related concepts that are used for prudential consolidation, to identify where there is an investment firm group and its constituent parts. So this chapter should be read together with the scope of application section of Chapter 7 on Prudential consolidation.
- The GCT is similar to, but not the same as, a derogation from prudential consolidation for certain types of investment firm that currently exists in (Article 15 of) the CRR. The differences include important conditions that must first be met, a group structure that is sufficiently simple, with no significant risks to clients or to market from the investment firm group that would otherwise require supervision on a consolidated basis.
- Unlike the CRR, the obligations under a GCT would now fall upon each entity in the group that is a parent undertaking, rather than an investment firm which is not a parent. This extends regulatory obligations to parent undertakings which may otherwise be unregulated. It also means that the GCT would be applied at more than one level in a group that has a multi-layered structure.

What this chapter covers

8.1 In this chapter, we:

- set out how the group capital test should be applied
- cover the monitoring and notification requirements
- explain how acquisitions may affect the test

Applying the group capital test

8.2 The GCT is set out in Article 8 of the IFR. It is a derogation from the requirement for an investment firm group to have to comply with all the obligations of prudential consolidation (as set out in Article 7 of the IFR). The competent authority has the discretion whether to allow this derogation. Our preference in a UK regime is to make rules that reflect our willingness to make use of the GCT (see Chapter 18 on Competent authority discretions).

8.3 Article 8 of the IFR clarifies that the terms 'investment firm', 'financial institution', 'ancillary services undertaking' and 'tied agent' also apply to undertakings established in third countries which, were they established in the European Union, would fulfil the definitions of those terms in Article 4 of the IFR. This reflects the same requirement found under the definition of 'consolidated situation' when prudential consolidation is applied under Article 7 of the IFR.

8.4 However, Article 8 of the IFR also includes its own definition of 'own funds instruments', which is only used for the purposes of paragraph 3 of that article.

8.5 There are two conditions, both of which must be met, before an investment firm group may make use of the permitted GCT. These are:

- the authority deems the group structure is sufficiently simple, and
- there are no significant risks to clients or to market from the investment firm group as a whole that would otherwise require supervision on a consolidated basis

8.6 Our initial expectation is that, in general, many investment firm groups in the UK would be able to meet these requirements, should they want to apply to us to be able to use a GCT instead of prudential consolidation.

8.7 The requirements for the GCT under Article 8 of the IFR apply directly to:

- Union parent investment firms;
- Union parent investment holding companies;
- Union parent mixed financial holding companies, and
- to any other parent undertakings in the investment firm group that are:
  - investment firms;
  - financial institutions;
  - ancillary services undertakings; or
  - tied agents

The definition of 'financial institution' in point 14 of paragraph 1 of Article 4 of the IFR includes financial, mixed financial and investment holding companies. So the constituents of an investment firm group include such entities where they are intermediate parents (as well as ultimate or Union parents).

8.8 The fourth bullet point above means that, depending on the group structure, an investment firm group may require more than one application of the GCT. This is because a separate GCT applies directly to each parent undertaking within the group, rather than just a single calculation for the Union parent undertaking. In effect, a GCT applies at each level within the group structure to ensure that, having addressed any risk of leverage or capital gearing at the top level of the group, the financial situation is then not weakened lower down the group structure.

8.9 As a result, the IFR obligation to ensure compliance with the GCT (when the Article 8 derogation from the obligations of Article 7 is applied to an investment firm group) falls directly upon parent undertakings. So, for the purposes of implementing the IFR, a competent authority will likely need to be given specific power to ensure this is enforced where a parent undertaking, such as a holding company, is not currently regulated.

8.10 Applying the GCT under paragraph 3 of Article 8 of the IFR requires that each of the above 'parent undertakings' in an investment firm group must itself hold enough 'own funds instruments' to cover the sum of the following:

- the sum of the full book value of all of their holdings, subordinated claims and instruments referred to in point (i) of the first paragraph of Article 36, point (d) of Article 56, and point (d) of Article 66 of the CRR (i.e. CET 1, Additional Tier 1 and Tier 2 instruments respectively) in investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group, and
- the total amount of all their contingent liabilities to investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group

8.11 The GCT has its own definition of 'own funds instruments', but this is only used when applying the GCT according to paragraph 3 of Article 8. In this definition, 'own funds instruments' means own funds as defined in Article 9 of the IFR (see Chapter 4 on Capital and own funds), without applying the deductions in point (i) of paragraph (1) of Article 36, point (d) of Article 56, and point (d) of Article 66 of the CRR.

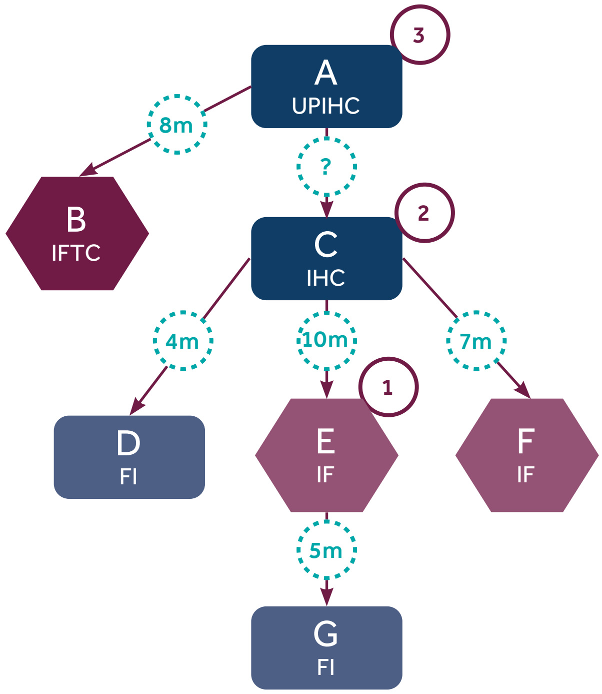
8.12 This specific definition of 'own funds instruments' ensures that a parent undertaking does not need to deduct significant investments in CET1, Additional Tier 1 and Tier 2 instruments of financial sector entities in the investment firm group when applying the GCT using the method set out under paragraph 3 of Article 8 of the IFR. This is to avoid 'double counting' of the same amount.

8.13 Figure 8.1 provides a worked example of how we believe the GCT is intended to operate according to paragraph 3 of Article 8 of the IFR. To simplify matters, this example assumes that there are no contingent liabilities under point (b) of paragraph 3 of that article. In practice, there is more than one level of GCT, because the requirements in Article 8 of the IFR apply to each parent undertaking within the investment firm group.

Figure 8.1: Worked example using the GCT as per paragraph 3 of Article 8 of the IFR

Key

UPIHC	Union parent investment holding company	FI	Financial institution
IFTC	Investment firm established in a third country	IF	Investment firm
IHC	Investment holding company		
○	Separate GCT for each parent entity		Book value of investment



There are 3 parent undertakings, entities E, C and A. So, 3 levels of GCT apply in this group.

GCT 1 – IF E must hold own funds of at least the book value of its investments in entity G. This is at least **5m.**

Note 1: A specific definition of 'own funds instruments' applies only for the purposes of the GCT under paragraph 3 of Article 8 of the IFR. Under this definition, the **IF E** is not required to deduct its 5m investment in the **FI G** when measuring the (net) amount of its individual own funds. (Without this, IF E would need (gross) own funds items of at least 10m before the deduction required under the CRR by virtue of Article 9 of the IFR. This would be 'double-counting'.)

Note 2: As **IF E** is already subject to the IFR at individual level, in practice it should already satisfy GCT1. This is because it should already hold a level of own funds of at least the amount of the sum of its investment in entity G (a financial sector entity) and its individual own funds requirements.

GCT 2 – IHC C must hold own funds of at least the book value of its investments in entities D, E, and F. This is 4m+10m+7m=**21m**.

Again, C does not need to deduct these amounts in determining the positive amount of own funds items to hold.

GCT 3 – UPIHC A must hold own funds of at least the book value of its investments in entities B and C. C is required to hold **21m**.

Therefore, in answer to the 'missing' value ? A must hold own funds of at least 21m + 8m = 29m.

Again, A does not need to deduct these amounts in determining the positive amount of own funds items it should hold.

8.14 Paragraph 4 of Article 8 of the IFR gives competent authorities the discretion to allow a parent undertaking to calculate the GCT on a different basis than would otherwise be the case under paragraph 3 of that article (and as set out above). This amount must be no lower than the sum of the following:

- the own funds requirements imposed on an individual basis on the parent undertaking's subsidiaries, and
- the total amount of contingent liabilities in favour of those entities

8.15 However, paragraph 4 of Article 8 of the IFR does not use the specific definition of 'own funds instruments' that is used for the purposes of paragraph 3 of the same article. Instead the text deliberately only refers to 'own funds'. This means that a parent entity's investment in the relevant financial instruments of financial sector entities in the investment firm group would need to be deducted. This deduction should take place before arriving at the amount of own funds needed to be held to meet the above own funds requirements under this alternative calculation method for the GCT.

8.16 We are not minded to make rules that reflect this method (see Chapter 18 on Competent authority discretions). If looking at own funds requirements – including notional own funds requirements for third-country subsidiaries – is considered more relevant (than investment in subsidiaries), then we believe that the general application of prudential consolidation as set out under Article 7 of the IFR is likely to be more appropriate to an investment firm group.

Monitoring requirements

8.17 Paragraph 5 of Article 8 of the IFR requires Union parent undertakings to have systems in place to monitor and control the sources of capital and funding of all investment firms, investment holding companies mixed financial holding companies, financial institutions, ancillary services undertakings and tied agents within the investment firm group.

8.18 This provision should help ensure that each parent undertaking within an investment firm group is itself capable of complying with its direct obligations under the GCT.

Notifications requirements

8.19 To use the GCT, we believe it would be appropriate to require either the ultimate parent entity of a UK investment firm group or one of the authorised investment firms within it, to send us a request. We would consider it would be appropriate to expect this request to include:

- a group structure chart that identifies each entity within the investment firm group, including the type of each one and the extent of ownership or control
- reasoning the firm believes the group structure is sufficiently simple
- reasoning why there are believed to be no significant risks to clients or to market from the investment firm group as a whole that would otherwise require supervision on a consolidated basis, and
- calculations which show how each parent undertaking within the investment firm group meets the GCT

Acquisitions and the Group Capital Test

8.20 It is worth noting the likely effect of the GCT where an investment firm group intends to acquire a new subsidiary. Suppose a parent undertaking pays a 'premium' to acquire a new entity. Under a prudential consolidation, the parent would be required to deduct any goodwill arising shown at consolidated level (eg in consolidated financial statements) from CET1. However, at individual parent entity level it is assumed that the same amount would instead tend to be reflected in an increase in the book value of its investment in subsidiaries, which a GCT then requires to be supported by own funds held by that parent entity. Hence under a GCT, the effect of making an acquisition at a 'premium' would be similar to that under a prudential consolidation – leveraged acquisitions not funded by capital could lead to a deficit in the required amount of CET1/own funds held by the parent undertaking.

Q13: **What are your views on the conditions, both of which must be met, before an investment firm group may be given permission to use the GCT? (See paragraph 8.5).**

9 Concentration risk

Overview

- The IFR introduces a similar regime to that in the CRR that limits the size of exposure permitted to a counterparty. It also sets out associated large exposure capital requirements that only apply to certain investment firms that deal on own account. It applies this to all investment firms that deal in their own name, even if for clients.
- The CRR contained a separate definition of 'eligible capital', for measuring large exposure limits. To align with the general intention of a more simplified prudential regime for investment firms, the IFR does not keep this separate definition, but instead uses the same definition of own funds for concentration risk exposure limits in Part Four of that Regulation as it does for the own funds requirements in Part Three.
- The IFR also introduces a broader requirement for all investment firms. That is, both those which deal in their own name and those investment firms which do not, including SNIs. This requires investment firms to monitor and control certain aspects of concentration risk from sources other than any trading book, including those which could pose a risk to the investment firm's clients.
- The reporting requirements of the IFR also extend to concentration risk.

What this chapter covers

9.1 In this chapter, we:

- explain how the IFR provisions for concentration risk apply to investment firms, including any relevant exemptions
- set out the specific provisions that apply to investment firms with trading book exposures, and
- discuss the possible supervisory arrangements that would be necessary to introduce UK rules to address concentration risk, including notifications, regulatory reporting, waivers and modifications

Applying the provisions

9.2 The concentration risk provisions in Part Four of the IFR apply as follows:

- the general provisions on monitoring and control of concentration risk apply to all investment firms, while
- the provisions on limits and own funds requirements for concentration risk (K-CON) apply only to investment firms with a trading book

9.3 Additionally, Article 54 of the IFR states that all investment firms that are not SNIs need to report concentration risk. See separate Chapter 12 on Regulatory reporting.

9.4 For the purposes of concentration risk, clients are defined as any counterparty of the investment firm. A group of connected clients are to be treated as if they were a single client.

Exemption from concentration risk provisions

9.5 The provisions on concentration risk do not apply to commodity and emission allowance dealers where all the following conditions are met (according to Article 42 of the IFR):

- the other counterparty is a non-financial counterparty
- both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures, and
- the transaction can be assessed as reducing risks directly from the commercial activity or treasury financing activity of the non-financial counterparty or of that group

9.6 To use this exemption, a commodity and emission allowance dealer investment firm must first notify its competent authority. We believe that it would be reasonable to expect any such notification to include details of how the investment firm meets the three required conditions listed above.

Concentration risk provisions for all investment firms

9.7 This section sets out the concentration risk provisions that apply to all investment firms.

Monitoring and controlling concentration risk

9.8 Article 35 of the IFR requires all investment firms to monitor and control concentration risk. To be consistent, we would suggest that this means looking at the concept of concentration risk set out in the second paragraph of Article 54 of the IFR. This is not limited to exposure values in a trading book, but also requires an investment firm to take account of any concentration in assets including, for example, debtors and off-balance sheet items not recorded in a trading book. It also includes any concentration risk from the following broader aspects:

- the location of client money
- the location of custody assets
- a firm's own cash deposits, and
- earnings

9.9 We believe this approach best matches the intended purpose of the new regime. This is that all investment firms monitor and control various sources of concentration risk (not just trading book exposures), even for SNIs, which are not required to report such information to the competent authority. So it therefore seems a reasonable basis on which to develop a policy for monitoring and controlling concentration risk. We note that Article 54 of the IFR requires the EBA to provide technical standards that include the reporting of concentration risk, which may also be relevant to the monitoring and control of concentration risk.

Concentration risk provisions for investment firms with trading book exposures

9.10 This section describes the provisions in Articles 36 to 41 of the IFR for investment firms that have trading book exposures.

9.11 The IFR applies a 'soft' limit to the total exposure value in a trading book that an investment firm may have to any individual client or group of connected clients. The total exposure value may exceed this limit, as long as the investment firm applies an additional K-factor own funds requirement, known as 'K-CON', to the concentration risk incurred. There are also 'hard' limits on the maximum size of both the exposure value to an individual client or group of connected clients, and to all these concentrated exposure values in aggregate. However, if these values are exceeded, the competent authority may grant an investment firm a limited time in which to move back into compliance with the relevant limits.

9.12 Unlike for large exposures under the CRR, the IFR has no specific limit for non-trading book exposures. This is because investment firms with a trading book are generally not expected to have any material non-trading book exposures. However, if they do, then the investment firm would be expected to take account of this concentration risk as part of its individual review process. This may include setting aside an appropriate amount of own funds to mitigate the risk (see Chapter 11 on Risk management, governance and review process). It will then be dealt with on an individual basis as part of the supervisory review process set out in the IFD.

Exposure value calculation and 'soft' limits

9.13 The exposure value (EV) to any individual client or group of connected clients is calculated by adding together both items shown in the table below:

Exposure value item	Notes
The positive excess of an investment firm's long positions over its short positions in all the trading book financial instruments issued by the relevant client, with the net position of each instrument calculated in line with the provisions for the K-NPR (see Chapter 6 on K-factor requirements).	When calculating own funds requirements for K-NPR on foreign exchange and commodities, including both trading book and non-trading book positions are required. However, for concentration risk limits and K-CON, only trading book positions are included. According to Article 36 of the IFR, an investment firm that uses K-CMG to calculate its own funds requirements for trading book positions, shall instead calculate the net position for concentration risk in accordance with the provisions of the standardised approach for K-NPR (see Chapter 6 on K-factor requirements).
The exposure value of derivative contracts and securities financing transactions to which K-TCD applies, calculated in the manner laid down for K-TCD (see Chapter 6 on K-factor requirements).	According to Article 36 of the IFR, where an investment firm is able to make use of the derogation to calculate exposure values for the purposes of K-TCD according to the counterparty credit risk rules of the CRR, it shall also use the same calculation of exposure values for the purposes of concentration risk limits and K-CON (see Chapter on Competent authority discretions).

9.14 As noted, where an investment firm breaches the 'soft' limit it must inform the competent authority (in accordance with paragraph 2 of Article 37 of the IFR). It must also calculate an additional K-factor own funds requirement, K-CON (under Article 39 of the IFR). These limits are in line with those currently set out for large exposures purposes in the CRR (albeit now based on own funds and not 'eligible capital'), and are:

Type of client(s)	'Soft' Limit
a. Individual client or group of connected clients	25% of own funds of the investment firm
b. Where individual client is a credit institution or investment firm; or **c.** Where a group of connected clients includes one or more credit institutions or investment firms	The higher of: 25% of own funds of the investment firm or EUR150 million. However, where the EUR150m is higher than 25%, the amount of the 'soft' limit to concentration risk shall not exceed 100% of the investment firm's own funds.
N.B. Where an investment firm has exposure to connected clients which include both credit institutions or investment firms and other types of client, the limit for connected clients who are not credit institutions or investment firms remains at 25% of own funds.	

9.15 These limits set the maximum concentration risk exposure value allowable in a trading book before an investment firm is required to calculate the own funds requirement for K-CON on the Exposure Value Excess over the relevant 'soft' limit.

Exposure Value Excess

9.16 The Exposure Value Excess (EVE) for each individual counterparty or group of connected counterparties, used in the calculation of K-CON, is obtained as follows:

EVE = EV – L

Where:

EV = the exposure value

L = is the relevant 'soft' limit

K-CON

9.17 K-CON is an additional K-factor own funds requirement for concentration risk in the trading book, where exposure values exceed the 'soft' limits set out above. Determining the own funds requirement involves a 2-step calculation. The first step is an exposure-based calculation, known as the own funds requirement for the excess (OFRE). The second involves applying a multiplying factor to the OFRE (or applying different multiplying factors to tranches of the OFRE) based on the length of time the exposure has existed and by how much (as a percentage of own funds) the exposure value exceeds the 'soft' limit.

9.18 Under the first step, the OFRE is determined by applying the following formula:

$$OFRE = \frac{OFR}{EV} * EVE$$

Where:

OFRE = own funds requirement for the excess

OFR = own funds requirement of total exposure to an individual client or group of connected clients

EV = total exposure value (for the purposes of concentration risk)

EVE = exposure value excess

9.19 For the purposes of this calculation, the own funds requirement of total exposure to an individual client or group of connected clients (OFR) is the total amount calculated for K-TCD and of the specific-risk requirements for K-NPR (see Chapter 6 on K-factor requirements) for the relevant exposure. For the purposes of calculating K-CON, investment firms should ignore any requirement for general risk calculated as part of K-NPR, as it is only the specific-risk that is relevant in terms of concentration to the client (or issuer) in question.

9.20 Under the second step the OFRE then has a multiplying factor applied to it, determined by the length of time for which the exposure has exceeded the 'soft' limit and by how much (as a percentage of own funds) the exposure value exceeds the 'soft' limit. This determines the individual K-CON requirement. The multiplying factor applied is as follows:

<table>
<tr><td>For the first 10 days</td><td colspan="2">OFRE x 200%</td></tr>
<tr><td rowspan="8">After 10 days</td><td colspan="2">As per Table 6 in Article 39 (repeated here) more than one factor may apply to a proportion of the OFRE, dependent on the value of the EVE as a percentage of the investment firm's own funds.
The factor is determined through tranches. The first tranche of EVE up to 40% of the investment firm's own funds is multiplied by 200%. Any additional EVE amount beyond 40% of own funds – split into tranches as set out in column 1 – is multiplied by the relevant factor for that tranche as set out in column 2.</td></tr>
<tr><td>Column 1:
Exposure value excess as a percentage of own funds (of the investment firm)</td><td>Column 2:
Factors</td></tr>
<tr><td>For the amount up to 40 %</td><td>200 %</td></tr>
<tr><td>For the amount over 40 % and up to 60 %</td><td>300 %</td></tr>
<tr><td>From 60 % to 80 %</td><td>400 %</td></tr>
<tr><td>From 80 % to 100 %</td><td>500 %</td></tr>
<tr><td>From 100 % to 250 %</td><td>600 %</td></tr>
<tr><td>Over 250 %</td><td>900 %</td></tr>
</table>

9.21 An individual K-CON requirement is calculated on any exposure value excess for an individual client or group of connected clients. The total K-CON own funds requirement for an investment firm is then the aggregate of all individual K-CON requirements.

9.22 How we believe the above calculation of an individual K-CON requirement for an exposure to an individual client or group of connected clients operates is illustrated in the worked examples shown below.

9.23 Worked example 1, where all exposures to an individual client/group of connected clients have persisted for 10 days or less:

A firm has:

Own funds = 1000

'Soft' Limit = 250 (i.e. 25% of 1000)

Exposure value (EV) of, say, 262

Exposure value excess (EVE) of 12 (i.e. 262 – 250 = 12)

The exposure is all due to debt securities which have a specific risk own funds requirement of 8% (according to Table 1 in Article 336 of CRR) for the purposes of K-NPR.

OFR = 262 x 8% = 20.96

OFRE = 20.96/262 x 12 = 0.96

K-CON = 0.96 x 200% **= 1.92**

9.24 Worked example 2, where the excess exposure (or any part of it) to an individual client/group of connected clients has persisted for more than 10 days:

A firm has:

Own funds = 1000

'Soft' Limit = 250 (i.e. 25% of 1000)

Exposure value (EV) of, say, 780,

Exposure value excess (EVE) of 530 (i.e. 780 – 250 = 530)

The exposure is all due to debt securities which have a specific risk own funds requirement of 8% (according to Table 1 in Art. 336 of CRR) for the purposes of K-NPR, and has exceeded the 'soft' limit for more than 10 days.

OFR = 780 x 8% = 62.4

OFRE = 62.4/780 x 530 = 42.4

K-CON = 95.2

Details of the K-CON calculation are set out below.

K-CON factor bands	EVE split by bands in Table 6	OFRE (allocated across K-CON bands by EVE split)	K-CON (OFRE x factor)
Up to 40%	400	400/530 x 42.4 = 32	32 x 200% = 64
40 – 60%	130	130/530 x 42.4 = 10.4	10.4 x 300% = 31.2
Totals =	**530**	**42.4**	**95.2**

'Hard' concentration risk limits

9.25 The third paragraph of Article 37 of the IFR imposes 'hard' limits on the concentration of an investment firm's exposure values above those set out above, to both an individual client or group of connected clients and to all concentrated exposure values to clients in aggregate. By 'hard' we mean limits which, in general, should not be exceeded. These are:

For a single concentrated exposure to a client or group of connected clients	500% of the investment firm's own funds, where 10 days or less have elapsed since the excess occurred
For all concentrated exposures of the investment firm, in aggregate	600% of the investment firm's own funds, for any excesses that have persisted for more than 10 days

9.26 In our view:

- How long an excess has existed for relates to how long an investment firm has had a concentrated exposure to an individual client or group of connected clients. This is irrespective of whether the constituent parts that make up that total exposure change over the period of that total exposure.
- The 600% 'hard' limit applies to the total of all individual exposures over the applicable 'soft' limit, to all clients or group of connected clients in aggregate. That is, even though the individual concentrated exposures may not be connected to each other.

9.27 Article 38 of the IFR directs investment firms to inform their competent authority 'without delay' when they exceed either of these 'hard' limits. The authority may grant the investment firm a limited time to comply.

Notification, reporting and limit breaches

Notifications requirements to Competent Authorities

9.28 The notification requirements to the Competent Authority for concentration risk (under Article 38 of the IFR) arise for an investment firm:

- When exposures:
  - exceed the 'soft limit' for exposure values (above 25% of Own Funds or for exposures to institutions and investment firms the lower of 100% of own funds and EUR150m) and
  - exceed the 'hard limit' for exposure values (above 500% or 600%)
- When the investment firm is a commodity and emission allowance dealer that wants to use the exemption from concentration risk set out in Article 42 of IFR.

Regulatory reporting of Concentration Risks to Competent Authorities

9.29 For the purposes of this section we view the elements of concentration risk as those in line with the wider concept set out in the second paragraph of Article 54 of the IFR. The

IFR requires all investment firms that are not SNIs to report these elements quarterly. SNIs are exempted from concentration risk reporting.

9.30 The EBA is required to develop technical standards related to reporting, which will include concentration risk. We would welcome your views on whether investment firms should be required to provide information on all concentration risk 'events' that occur during a reporting period, or only on the level of this risk outstanding as at each reporting reference date.

9.31 We intend to discuss the format and framework for regulatory reporting, including draft Handbook rules and guidance, as part of any subsequent consultation on a new prudential regime for investment firms.

Limit breaches

9.32 Unlike Article 396 of the CRR, which allowed competent authorities to consider individual applications to exceed the exposure limits, IFR Article 38 allows competent authorities to grant investment firms a limited period to comply if they exceed the limits in Article 37.

9.33 We interpret this as the possibility for a competent authority to provide a waiver or modification for the 'hard' limits set out in paragraph 3 of Article 37. We do not believe the provision allows a competent authority to waive or modify the 'soft' limit in paragraph 1 of that article, which defines Excess Exposures. This is because the IFR provides for that limit to be exceeded, if necessary, subject to satisfying K-CON. Additionally, unlike the CRR, the IFR does not contain any 'hard' limit of 25% of own funds for non-trading book exposures.

> **Q14:** **Do you have any comments on our views on the limits that apply for K-CON and our worked examples for calculating it? (See paragraphs 9.23 to 9.24, 9.26, and 9.33)**

10 Liquidity

Overview

- The IFR introduces for the first time minimum quantitative liquidity requirements to all investment firms, including SNIs.
- These requirements aim to help ensure that investment firms have some resilience to sudden liquidity shocks. This should help ensure they can continue to function or otherwise exit the market without disruption, by continuing to fund their overheads for a given period and without having to rely upon continued income.
- Currently, not all UK investment firms must satisfy quantitative liquidity requirements under BIPRU 12. Under a UK regime we would support a similar approach of extending new liquidity rules to all UK investment firms.
- We believe the IFR requirements are proportionate at one-third of the FOR, but that this should be recognised by investment firms as a baseline. An investment firm or its supervisor might decide it is necessary for it to meet additional liquidity standards through the review process (as set out in Chapter 11).

What this chapter covers

10.1 In this chapter, we:

- summarise the new requirements
- list assets that can be used, and minimum 'haircuts' (or reductions) where applicable
- explain what this means for existing liquidity requirements

Summary of the new requirements

10.2 The IFR sets out a minimum quantitative liquidity adequacy requirement for all investment firms. This requirement is to hold an amount of certain types of liquid assets equivalent to at least one third of the amount of their fixed overhead requirement (FOR) (see Chapter 5 for more details on the FOR). The intention is that, by basing the minimum liquidity requirement on a proportion of the fixed overhead requirement, an investment firm should be able to meet its relevant overheads for at least a month by using such liquidity, even if other sources of cash-flow are unavailable.

10.3 Investment firms which provide guarantees to clients need to hold additional liquid assets equivalent to 1.6% of the total amount of the guarantees they provide.

10.4 The liquidity requirements in the IFR only give a minimum standard for all investment firms to use, whatever their particular investment services or activities. They do not prevent an investment firm from holding more liquid assets or applying stricter measures, for example, if they decide this is appropriate due to their business model.

10.5 Article 43 of the IFR allows the competent authority to exempt SNIs from the liquidity requirement. The EBA is required to issue guidelines for competent authorities to consider when using this discretion. (See Chapter 18 on Competent authority discretions). We believe it is important for all investment firms to hold a minimum amount of liquid assets to support their resilience. In our view, the amount as set (by reference to the FOR) is appropriate as a minimum. Taking into consideration the flexibility about what may count as a liquid asset (for example, the inclusion of trade debtors), we consider it is proportionate to meet its main purpose.

Components of the requirement

10.6 Under the IFR, an investment firm can only include specific assets as part of its liquidity requirement, with various minimum 'haircuts' applied to reduce the value that may be counted, as in Figure 10.1 below. For example, a 'haircut' of 15% would mean that only 85% of the value of the relevant liquid asset may count towards meeting the investment firm's liquidity requirement.

10.7 While the list is based primarily on the assets set out in Commission Delegated Regulation (EU) 2015/61 (for the Liquidity Coverage Ratio of the CRR), it is broader in scope. There are few restrictions on the composition of the liquid assets from this list (see Eligibility column in Figure 10.1 below). This is to recognise the different liquidity risk profiles and needs of investment firms compared to credit institutions.

Figure 10.1 – Eligible liquid assets and their haircuts

Asset	Eligibility	Minimum haircut
Coins & banknotes	Unlimited	None
Assets representing claims on or guaranteed by central banks, central or local governments as set out in Article 10.1(b), (c) or (d) of Commission Delegated Regulation (EU) 2015/61	Unlimited	None
Reserves held in a central bank as set out in Article 10.1(b)(iii) of Commission Delegated Regulation (EU) 2015/61	Unlimited	None
Assets issued by credit institutions as set out in article 10.1(e) of Commission Delegated Regulation (EU) 2015/61	Unlimited	None
Assets issued by a credit institution which is a promotional lender	Unlimited	None
Extremely high quality covered bonds as set out in Article 10.1(f) of Commission Delegated Regulation (EU) 2015/61	Unlimited	7%
Assets representing claims on or guaranteed by the multilateral development banks and international organisations listed in Articles 117(2) and Article 118 of CRR	Unlimited	None

Asset	Eligibility	Minimum haircut
Assets representing claims on or guaranteed by regional governments, local authorities or public-sector entities in an EU member state where exposures to them are assigned a 20% risk weight (see Articles 115 & 116 of CRR)	Unlimited	15%
Assets representing claims on or guaranteed by the central government, central bank, regional governments or public-sector entities in third countries where assigned a 20% risk weight	Unlimited	15%
High quality covered bonds which meet the requirements set out in Article 11.1(c) of Commission Delegated Regulation (EU) 2015/61	Unlimited	15%
Covered bonds issued by credit institutions in third countries as set out in Article 11.1(d) of Commission Delegated Regulation (EU) 2015/61	Unlimited	15%
Corporate debt securities as set out in Article 11.1(e) of Commission Delegated Regulation (EU) 2015/61	Unlimited	15%
Asset-backed securities as set out in Article 13 of Commission Delegated Regulation (EU) 2015/61	Unlimited	25-35% depending on the sub-category of assets
Corporate debt securities as set out in Article 12.1(b) of Commission Delegated Regulation (EU) 2015/61	Unlimited	50%
Shares as set out in Article 12.1(c) of Commission Delegated Regulation (EU) 2015/61	Unlimited	50%
High quality covered bonds as set out in Article 12.1(e) of Commission Delegated Regulation (EU) 2015/61	Unlimited	30%
Non-interest-bearing assets as set out in Article 12.1(f) of Commission Delegated Regulation (EU) 2015/61	Only for firms which can't hold interest-bearing assets for religious reasons	50%
Shares or units in CIU subject to the conditions set out in Article 15 of Commission Delegated Regulation (EU) 2015/61	Up to EUR 50 million or the equivalent in GBP	0-55% depending on the underlying asset
Any other financial instrument traded on a trading venue for which there is a liquid market as defined in point (17) of Article 2(1) of Regulation (EU) 600/2014 (MiFIR) and in Articles 1 to 5 of Commission Delegated Regulation (EU) 2017/567	Unlimited	55%
Unencumbered short-term deposits at a credit institution	Unlimited	None

Asset	Eligibility	Minimum haircut
Items related to trade debtors and fees or commissions receivable within 30 days	Only available to investment firms that are not authorised to carry out any of MiFID activities (3) and/or (6). Limited to a maximum of one third of the minimum liquidity requirement. Cannot be counted towards any additional liquidity requirement set following a supervisory review.	50%

10.8 The EBA will be reviewing these assets, their eligibility, and respective haircuts in the future.

10.9 Cash, short-term deposits and financial instruments belonging to clients, even where held in the investment firm's name, do not count towards meeting an investment firm's liquidity requirement.

10.10 In exceptional circumstances, investment firms may apply for permission to reduce the amount of liquid assets they must hold. They can only make this reduction after the competent authority has given this approval. If a request is approved, the investment firm will have to restore liquidity within 30 days to meet the minimum liquidity requirement of at least one third of the FOR plus 1.6% of the total amount of any guarantees given to clients.

10.11 The competent authority may set additional liquidity requirements for investment firms under the individual assessment process set out in the IFD. They may do this, for example, if the firm has a material liquidity risk that is not otherwise covered or sufficiently covered by the minimum requirement. (See also Chapter 11 on Risk management, governance and review process).

10.12 The third paragraph of Article 6 of the IFR allows competent authorities to exempt investment firms from applying the liquidity requirements in Part Five of the IFR on an individual basis. (See Chapter 18). All of the following conditions must be satisfied:

- the investment firm is included in the supervision on a consolidated basis in line with the CRR or with Article 7 of the IFR
- the parent undertaking, on a consolidated basis, monitors and has oversight at all times over the liquidity positions of all investment firms (and credit institutions) within the group or sub-group that have an exemption and ensures sufficient liquidity for all those investment firms (and credit institutions)
- the parent undertaking and the investment firm have entered into contracts that, to the satisfaction of the competent authorities, provide for the free movement of funds between the parent undertaking and the investment firm to enable them to meet their individual obligations and joint obligations as they become due
- there is no current or foreseen material, practical or legal impediment to the fulfilment of the contracts referred to in the above condition, and
- the consolidating supervisor (where different from the supervisor of the investment firm) agrees to the exemption

What this would mean for existing liquidity requirements

10.13 Currently, some investment firms have liquidity requirements under our Handbook, as set out in Chapter 12 of the BIPRU Sourcebook. This is because most investment firms were exempted from the liquidity requirements in the CRR and so competent authorities were free to set their own domestic rules.

10.14 Our current Handbook requires standard ILAS BIPRU firms to carry out an Individual Liquidity Adequacy Assessment (ILAA) and simplified ILAS BIPRU firms to carry out an Individual Liquidity Systems Assessment (ILSA). These are set out in BIPRU 12.5 and 12.6 respectively. We also carry out a Supervisory Liquidity Review Process (SLRP) for all ILAS BIPRU firms. While other investment firms must still manage their liquidity risk and carry out liquidity stress testing, this is currently not assessed through a formal process.

10.15 However, the new liquidity requirements in the IFR were designed to be an appropriate starting point for the management of liquidity risk by all types of investment firm. If we replicated these in our rules they would replace our existing Handbook requirements on liquidity. All investment firms would then have to meet a minimum quantitative liquidity requirement, including those which were previously exempt. Any existing intra-group waivers or modifications granted under BIPRU Chapter 12 would then cease.

10.16 Under the IFR, unless competent authorities exercise discretion to permit otherwise, all investment firms would further need to consider their liquidity as part of an internal capital adequacy and risk assessment (ICARA) process according to the IFD. We consider it would be appropriate to review an investment firm's liquidity risk management strategies as part of its supervisory review and evaluation, which would also be part of the ICARA process. (See Chapter 11 on Risk management, governance and review process).

Q15: **Do you have any comments on the list of assets that may count towards meeting an investment firm's minimum liquidity requirement? (See Figure 10.1)**

11 Risk management, governance and review process

Overview

- The financial resources requirement in the IFD/IFR is determined through a:
  - ***rules-based requirement*** – An own funds requirement determined under Article 11 of the IFR and a minimum liquidity requirement determined under Article 43 of IFR, typically referred to as 'Pillar 1' requirements, and a
  - ***risk-based assessment*** – Assessing and maintaining financial resources, ie own funds and liquidity, for risks not otherwise captured or inadequately met by the rules-based requirement. These, together with the competent authority's supervisory review, are typically referred to as 'Pillar 2'.
- The IFD introduces the concept of the internal capital and risk assessment (ICARA) process for non-SNI investment firms, although it may also be applied to SNI investment firms if regulators deem it appropriate. This is a continuous internal review process meant to support the investment firm's management body in the decision-making process and their exercise of oversight and control over the firm. Policies, procedures, systems and controls which form and make the ICARA operate effectively are also necessary. At least annually, the investment firm should undertake a review of the adequacy of its ICARA process and document this.
- The IFD also introduces the requirement for non-SNIs above a certain size to introduce a risk committee. This committee would provide advice and oversight on risk appetite and implementing risk appetite strategies.
- Under the IFD, competent authorities will be able to assess the arrangements, strategies, processes and mechanisms implemented by a firm to comply with the IFD, and evaluate if an investment firm has a sound understanding, management and coverage of its risks. The process for doing this is called the supervisory review and evaluation process (SREP).

Overview of potential application in the UK

- Introducing a UK regime along the lines of the IFD/IFR would lead to a significant change in our approach to setting prudential standards for investment firms. However, equally important is how we, and investment firms, approach the supervisory and internal risk assessment and governance process under any such regime.
- This change is both in terms of the risks we would expect investment firms to consider, and how they should assess what are appropriate financial resources to cover these risks. For the former, we would expect investment firms to also consider risks they can pose to consumers and markets. For the latter, investment firms would need to consider how to account for these risks through additional financial resources, where they are not addressed by the 'Pillar 1' requirements. For many investment firms, this would be the first time they needed to include consideration of additional liquidity requirements.

- Under a domestic regime we would expect both SNI and non-SNI investment firms to assess the adequacy of their financial resources to ensure it corresponds with the risk of harm and complexity of their business. Similar expectations to those set out in the IFD around risk management and governance would be key to help investment firms achieve this.
- If we decided to adopt a similar approach to that in the IFD, an investment firm's documentation of its review of the adequacy of its ICARA process, along with supporting information and evidence, would provide the basis for us to review whether an investment firm has a sound management and coverage of its risks. This is an important component of our supervisory work.
- While superficially similar to the Internal Capital Adequacy Assessment Process (ICAAP) in the CRD, as we set out in this chapter, there are key differences in how we would expect investment firms to think about risks as part of their ICARA process, compared to the CRR. It is important that investment firms which currently undertake an ICAAP understand these differences.
- If we chose to adopt a similar approach to that in the IFD when conducting a SREP, we would also consider changing how we set supervisory requirements under 'Pillar 2' as part of the overall new prudential regime. We suggest it should be a legal minimum requirement (P2R), replacing the current Individual Capital Guidance (ICG), and, where appropriate, also an additional buffer to sit on top of the minimum requirements (P2G). This is in relation to both the amount of own funds and liquid assets we assess the investment firm should hold.
- Ultimately, the investment firm's governance and internal review process should support it to:
  - remain financially viable and to provide services through the economic cycle; and
  - undertake an orderly wind-down, without causing undue economic harm to clients or to the integrity of the UK financial system
- Our subsequent review and feedback on investment firms' own assessment of adequate financial resources should help to:
  - ensure investment firms have robust systems and controls, governance leadership and a culture that reduces the risk of harm to clients and markets
  - ensure investment firms hold adequate resources that reflect the harm they may cause to clients or UK financial markets
  - reduce the likelihood that failure would impact clients and the UK financial system; and
  - minimise harm if an investment firm fails as they exit the market, by ensuring they hold adequate resources and have effective wind-down arrangements
- We consider that this approach is consistent with that set out in our recent Finalised Guidance, 'FG20/1 Our framework: Assessing adequate financial resources'. This sets out how we intend to improve the way firms operate so that they can take effective steps to prevent harm from occurring.

What this chapter covers

11.1 In this chapter, we cover:

- The governance requirements for investment firms set out in the IFD for assessing and mitigating the risk of harm. This includes requirements when establishing internal risk committees.
- The ICARA process, its level and scope of application, and our proposed expectations.
- Were we to adopt a similar approach in a domestic regime:
  - the supervisory review and evaluation process we would apply
  - our supervisory powers and application of additional 'Pillar 2' capital and liquidity requirements

Internal governance and controls

11.2 The governance requirements of the IFD are designed to help investment firms' governance arrangements to be more effective in identifying, managing and mitigating the risk of harm.

11.3 Chapter 13 sets out what our approach would be to the IFD governance requirements on remuneration if we were to adopt a similar approach in a domestic regime. This would entail a new remuneration code for non-SNI investment firms. Other governance-related requirements would be included in a new prudential sourcebook for investment firms or in the Senior Management Arrangements, Systems and Controls (SYSC) sourcebook, with suitable cross referencing.

11.4 Under the IFD, non-SNI investment firms must have robust governance arrangements that are appropriate and proportionate to their nature, scale and complexity (paragraph 1 of Article 26 of the IFD). These arrangements must include the following:

- a clear organisational structure with well defined, transparent and consistent lines of responsibility
- effective processes to identify, manage, monitor and report the risks investment firms are or might be exposed to, or pose or might pose to others
- adequate internal control mechanisms, including sound administration and accounting procedures
- remuneration policies and practices that are gender neutral and are consistent with and promote sound and effective risk management (Chapter 13 gives more information on gender neutral remuneration policies)

11.5 When establishing these arrangements, non-SNI investment firms must take into account the detailed requirements on risk management (Articles 28 and 29 of the IFD) and remuneration (Articles 30 to 34 of the IFD – see Chapter 13). The first subparagraph of paragraph 4 of Article 26 of the IFD requires the EBA, in consultation with ESMA, to issue guidelines on applying the governance arrangements. The EBA has already developed guidelines on internal governance for the purposes of the CRD requirements.

Risk committee

11.6 The IFD requires non-SNI investment firms whose value of on-and off-balance sheet assets average is more than EUR 100 million over the 4-year period immediately before the given financial year to establish a risk committee (first subparagraph of paragraph 4 of Article 28 of the IFD).

11.7 The management body retains overall responsibility for ensuring the investment firm has effective risk-measurement strategies in place. However, having a separate risk committee gives larger non-SNI investment firms, with more assets on- and off-balance sheet, more focused support and advice on implementing risk-measurement strategies.

11.8 The risk committee must be made up of members of the management body who do not perform any executive function in the firm.

11.9 Members of the risk committee must have appropriate knowledge, skills and expertise to fully understand, manage and monitor the investment firm's risk strategy and risk appetite (second subparagraph of paragraph 4 of Article 28 of the IFD) to be able to:

- provide sound advice on the firm's overall current and future risk appetite and strategy to the management body and
- help the management body oversee senior management's implementation of that strategy

11.10 Both the management body and the risk committee must have access to all relevant information on risks to which the investment firm is or may be exposed (paragraph 5 of Article 28 of the IFD). This will allow the risk committee to support the management body implement its risk management strategy.

11.11 The IFD does not allow national competent authorities to waive the risk committee requirement in the same way that they can under the CRD. However, it does provide a Member State discretion to increase and/or decrease the EUR 100 million threshold (paragraphs 5 and 6 of Article 32 of the IFD – see Chapter 13 on remuneration).

Internal capital and risk assessment process (ICARA process)

Outline of the ICARA process

11.12 The IFD introduces the ICARA process as a new requirement for investment firms (Article 24 of IFD). Investment firms must have processes in place to assess the amount and type of own funds and liquid assets (financial resources) they should hold to cover the type and amount of risk they might pose to others, or to which they themselves face. These processes should be appropriate and proportionate to the nature, size and complexity of the investment firm's activities.

11.13 We believe this process requires investment firms to do a risk assessment and quantify the amount and type of financial resources required to cover the nature and level of the risks they may pose to others. This assessment should take account of its business model, internal governance and risk-management processes. The risks should be based on the potential harm the investment firm could cause to clients and to financial markets. It should also consider the risk to which the firm itself is, or might be, exposed to as these risks could, in turn, lead to further potential harm to others.

Level of application and proportionality

11.14 The ICARA process is intended to apply to an investment firm on an individual basis and paragraph 1 of Article 24 of the IFD requires all non-SNI investment firms to do this. However, the second sub-paragraph of paragraph 2 of that article provides competent authorities with the ability to request SNI investment firms to also adopt the ICARA process, where they deem it appropriate.

11.15 We believe that, in general and including for the ICARA process, the IFD requires investment firms to implement arrangements, strategies and processes to assess and maintain adequate financial resources, in a way that is appropriate and proportionate to the nature, scale and complexity of their activities. While this proportionality principle applies to all relevant firms, this is particularly relevant for SNI investment firms.

11.16 The IFD is silent on whether the ICARA process should also apply on a consolidated basis where a firm is part of an investment firm group to which consolidation applies under Article 7 of the IFR. However, paragraph 4 of Article 25 of the IFD requires an investment firm to comply with certain other risk-management obligations. This includes the obligation to monitor and manage risks to own funds and liquid resources under Article 29 of the IFD, on both an individual and consolidated basis in that situation. In our view, there is considerable practical overlap between the obligation to operate an ICARA process in Article 24 of the IFD and the treatment of risks obligations in Article 29 of the IFD.

11.17 So, while the IFD does not legally require a consolidated ICARA process in every instance where Article 7 of the IFR applies, we consider that it also does not preclude regulators from requiring an investment firm group to operate a consolidated ICARA process in that context. Where a consolidated ICARA process is not required, the obligations in Article 29 of the IFD would still apply on a consolidated basis where Article 7 of the IFR applies and therefore some risk monitoring obligations would still be required at a group level.

Treatment of risks

11.18 Under paragraph 1 of Article 29 of the IFD competent authorities must ensure that investment firms have robust strategies, policies, processes and systems for the identification, measurement management and monitoring of the following:

- **i.** material sources and effect of risks to clients and any material impact on own funds
- **ii.** material sources and effect of risks to markets and any material impact on own funds
- **iii.** material sources and effect of risks to the investment firm, in particular those which can deplete the level of own funds available
- **iv.** liquidity risk, including intra-day where appropriate, so that the investment firm maintains an adequate level of liquid resources

Supervisory review and evaluation process (SREP)

Purpose of the SREP

11.19 The SREP allows competent authorities to review a non-SNI investment firm's compliance with the IFD and IFR. It includes evaluating the management and coverage of risks. Paragraph 1 of Article 36 of the IFD sets out the risks to be evaluated. These include:

- **i.** risks set out above in paragraph 11.18
- **ii.** the geographical location of an investment firm's exposures
- **iii.** the business model of the investment firm
- **iv.** an assessment of systemic risk
- **v.** the security of investment firm's network and information systems
- **vi.** any interest rate risk arising from non-trading book activities
- **vii.** governance arrangements

11.20 The second sub-paragraph of paragraph 2 of that article also allows competent authorities to conduct a SREP on SNI investment firms on a case-by-case basis.

Level of application

11.21 The SREP applies on an individual basis. However, where prudential consolidation is applied in accordance with Article 7 of the IFR and the group has also implemented a consolidated ICARA process, we believe that the SREP should also be done at the consolidated level.

11.22 Where Article 7 of IFR (i.e. full consolidation) applies, the relevant parent undertaking is responsible for compliance with the consolidated 'Pillar 1' own funds requirement. Please see Chapter 7 on prudential consolidation for more information.

Supervisory powers

Additional own funds requirements

11.23 Article 39 of the IFD allows competent authorities to impose an additional own funds requirement following a SREP in certain situations. These include where the competent authority decides that risks are not sufficiently covered by the 'Pillar 1' requirement or that the investment firm does not have robust governance arrangements or an adequate ICARA process. It also allows competent authorities to impose specific liquidity requirements on firms.

11.24 We believe that the SREP will take account of where an investment firm's ICARA has identified that additional financial resources are necessary. It will then determine if these are sufficient to cover the risk or if additional requirements are necessary.

Additional capital guidance

11.25 Article 41 of the IFD allows the competent authority to set own funds for non-SNI investment firms in addition to 'Pillar 1' and those required following a SREP. This is meant to act as a 'buffer' with the aim of allowing for economic cyclical fluctuations so they do not lead to a breach of own funds requirements or threaten the ability of the investment firm to wind-down and cease regulated activities in an orderly manner.

Specific liquidity requirement

11.26 Article 42 of the IFD sets out the circumstances in which a competent authority may set specific liquidity requirements following a SREP. These are either:

i. the liquidity requirements set out in the IFR do not cover the material liquidity risks the investment firm is exposed to; or
ii. the investment firm has inadequate governance arrangements for assessing the liquidity risks it is exposed to and other administrative measures are unlikely to improve this

Disclosure

11.27 Under Article 50 of the IFR a competent authority can request investment firms to include information about any additional own funds requirements resulting from their ICARA process or SREP in their public disclosures.

Impact of adopting a similar approach in a UK domestic regime

11.28 This section contains more information on how we see the ICARA process would work if the UK adopted a similar approach to that set out in the IFD.

Internal governance and controls

11.29 Both non-SNI and SNI investment firms would need to continue to comply with those provisions of SYSC 4.3A which derive from paragraphs 3 and 4 of Article 9 of MiFID. These define the management body's role and the high-level requirements of members of the management body. To reflect that these rules would create a new, more proportionate regime for investment firms, we would amend SYSC 4.3A to ensure that the governance arrangements from Articles 88 and 91 of the CRD no longer apply to non-SNI or to SNI investment firms.

Risk committee

11.30 We believe that if we were to increase the threshold at which certain remuneration requirements relating to payment of variable remuneration in instruments and deferral of variable remuneration apply, that same threshold would apply for the purposes of the requirement to establish a risk committee. So, if we were to increase the threshold to, for example, EUR 300 million, for a particular investment firm, it would only need to establish a risk committee if its average on-and off-balance sheet assets over the previous 4 years was over EUR 300 million.

The ICARA process

11.31 The ICARA process would help an investment firm to demonstrate how it is meeting its obligations in COND 2.4. This sets out the threshold condition relating to appropriate resources – meaning both financial and non-financial resources.

11.32 Under a domestic regime we would expect the assessment to:

i. reflect the risks to which the firm is exposed and the amount of risk it poses to clients and to markets
ii. apply a forward-looking approach to consider how these risks could evolve throughout the economic cycle
iii. determine the appropriate level of financial resources required to cover these risks beyond what is covered under 'Pillar 1'
iv. consider business model viability and the strategy's sustainability, including through reverse stress testing, to determine vulnerabilities in the business model, and
v. consider necessary financial resources and planning to allow for a credible wind-down of the firm if it closes

Scope and level of application

11.33 We would want to require SNI investment firms to put in place an ICARA process in a proportionate manner (see Chapter 18 on Competent authority discretions).

11.34 Generally, we would expect the ICARA process would apply to both SNI and non-SNI investment firms only on an individual basis, even where a firm forms part of a larger investment firm group. However, where a firm is part of a group which is subject to full consolidation under any domestic equivalent of Article 7 of the IFR, we would retain the discretion to require the firm or its relevant parent entity to operate a consolidated ICARA process for the group in appropriate cases. Irrespective of whether we have directed a firm or parent entity to implement a consolidated ICARA process, we would expect that individual investment firms within an investment firm group would take into account any potential risks resulting from their membership of that group as part of their individual ICARA processes.

Documenting the ICARA process

11.35 We believe that the ICARA process should be supported and documented effectively to ensure this happens on an ongoing basis. At least annually, investment firms should review the adequacy of their ICARA process. This annual approach is necessary to reflect the changing nature of the business environment.

11.36 We expect that an investment firm would use the ICARA document to clarify why it believes its ICARA process is fit for purpose, what has changed as a result of the annual review, a review of risk management since the last annual review, plus an overview of the capital and liquidity planning and scenario and stress testing. This should provide us with a basis to conduct our own review of whether an investment firm is complying with the requirements, and to evaluate if it has a sound management and coverage of its risks, which is an important component of our supervisory work. For an SNI investment firm with a very simple business model, we would not expect the assessment to be lengthy and over-detailed.

Treatment of risks

11.37 We believe that, while the ICARA process may appear to be superficially similar to the current ICAAP under the CRD, there are some key differences that investment firms currently subject to ICAAP should be aware of.

Figure 11.1 – Comparison of current ICAAP and potential ICARA process

Current ICAAP	ICARA process
A specified list of risk categories sets out how investment firms are expected to identify, manage and assess their risks. This can mean that risks are put into categories that are not a natural fit.	The focus should be on the investment firm's business model and its activities. From there it will identify, assess and estimate the potential harm to clients, to markets, and to the firm itself.
Investment firms assess their different exposure risks according to the detailed capital requirements set out in CRD/CRR.	Investment firms will focus on risks to their financial adequacy from potential changes in book value of assets, changes in value of trading book positions, and losses from potential failure of counterparties. Investment firms should consider risks to themselves in light of the knock-on effect they may have upon their clients and the markets they operate in.
Wind-down plan not required as part of the ICAAP.	Investment firms will have to consider wind-down as part of the ICARA process.

11.38 In adopting a similar approach domestically, we would also expect:

- an increased focus on assessing adequate levels of liquid resources, including potential payments directly related to harm and additional risks that affect the amount of liquid resources available and timing of cash flows
- it to capture where the investment firm identifies the need for additional liquidity requirements, beyond what is set out as a minimum requirement under any new liquidity rules
- the process to focus on identifying vulnerabilities in an investment firm's business model and strategy and how they affect an investment firm's ability to generate profits and CET1 capital
- this assessment to be carried out to the point where the ICARA process determines the point of non-viability for the investment firm, which would lead it to wind-down its business in an orderly manner

Identifying and assessing harm

11.39 Identifying and assessing the potential harm to clients and markets is a fundamental part of a firm's ICARA process. This should help an investment firm understand what can go wrong, so it can consider if its controls and financial resources are adequate to minimise the risk of harm to clients and markets. Some of the risks may already be partially or fully captured by applying minimum K-factor own funds requirements (see Chapter 6 of this DP). But we would still expect all investment firms to perform their own risk assessment of the relevant activities of their individual business model.

Figure 11.2: Examples of potential harm to clients or markets

Examples of where harm can be caused to clients or markets, resulting in a loss to the investment firm, include:

- Mandate breaches, exposing investors to risks outside of their profile or losses from unsuitable investments.
- Trading/dealing errors that cause losses to customers.
- System outages affecting continuity of service which may affect customers by preventing them seeing the value of their assets or buying or selling investments, and resulting in potential claims or redress.
- Corporate finance advice that results in a lawsuit.
- Customer losses caused by the activity of tied agents.
- Financial advisers providing unsuitable advice, for example on pension transfers or other investments, such as minibonds, resulting in customers losing money from mis-selling.
- Money received in the form of title transfer collateral arrangements (TTCAs) not captured as client money under K-CMH. Investment firms should consider the risks from these TTCAs, as they can be required to return the assets immediately to the client whose positions have closed. The inability to do so can result in harm to clients who do not receive their money back.
- Where investment firms, on both the 'sell' or 'buy' side, do not properly manage the transition away from the use of LIBOR as a reference rate/benchmark, this presents a risk of potential harm, to themselves, to the market and to any ultimate clients.
  - Accordingly, this is the sort of risk we would expect investment firms to consider and address as part of the ICARA process. For example, has the investment firm and its counterparties signed up to the ISDA protocol replacing references to LIBOR in derivatives contracts when LIBOR ceases or is declared no longer representative by the FCA. If necessary, we might apply additional requirements on an investment firm to help encourage its senior management to take action.

11.40 In our view, when assessing the risks they might pose to clients and financial markets, and to which they themselves are or might be exposed, investment firms need to consider 'what-if' scenarios for the activities they undertake, the harm that can be caused and the events leading to that harm. The assessment would need to factor in the likelihood of the events materialising, and that different events might occur at the same time.

11.41 Investment firms would be expected to estimate any potential loss impact based on their knowledge and experience, which, where the control framework is sophisticated enough, may be further supported by statistical models. When using such models, we would expect investment firms to understand how appropriate the inputs and outputs of the model are, which include the scenarios and assumptions. Investment firms should:

- consider the risks before they take the controls into account
- look at each significant risk and assess what controls are in place to remove or reduce it
- assess how much risk of harm remains and, where appropriate, estimate potential losses or payments to others may be required, and

- while not for the purpose of estimation, this assessment should help an investment firm identify and consider if any improvement in control is necessary, or to decide to accept the risk as is

Investment firms would be expected to allocate these estimates to each of their activities and compare them against their K-factor calculations, if applicable. This will determine if the risk is already adequately covered by 'Pillar 1' requirements, or if additional financial resources are required.

11.42 Investment firms would also be expected to estimate the potential impact from operational events on their financial resources (both own funds and liquid resources) based on their knowledge and experience. The risk of these events occurs when there are failed internal processes, people, systems, or from external events, causing harm to clients or financial markets and resulting in a loss to a firm and/or threatening operational resilience. It includes risks related to legal issues but excludes impacts of reputational events and other risks related to business model viability and the sustainability of an investment firm's strategy.

Additional risks affecting an investment firm's capital

11.43 Investment firms would also need to consider and account for other risks that can reduce the level of their own funds. This may require a more conceptual approach to assessing the risk than that which those familiar with the current ICAAP may be used to. For example, rather than considering and calculating credit risk, securitisation risk, interest rate risk, dilution risk etc. according to the detailed specifications of the CRD/CRR, investment firms would need to consider as appropriate and explain the impact (including on their ability to service clients or markets) of:

- losses from changes in book value of assets, including claims on tied agents
- losses from failure of clients or counterparties to transactions in financial instruments
- changes in the value of positions in financial instruments, foreign currencies and commodities, and/or
- obligations to defined benefit pension schemes

11.44 Losses in book value of assets: An investment firm's own funds may be depleted because of changes to the book value of its assets. This can include, for example, realising assets below book value, impairments due to revaluations, write-downs due to non-recoverability, or internal or external operational events. An investment firm would also need to consider off-balance sheet items, such as guarantees and commitments, because if it is required meet its obligations it will hold a claim on its balance sheet. The following factors may be relevant as part of an investment firm's assessment:

- **Creditworthiness:** Changes in creditworthiness and default, where the credit quality, or the default, of a client or counterparty may result in an investment firm realising assets below book value if trying to sell them in a period of stress. This is because the risk of the client or counterparty failing to meet obligations would have increased. Even when not selling the assets an investment firm may have to record impairments due to revaluations, or have to write-down assets because they are non-recoverable.
- **Market conditions:** Changes in market prices and conditions, including interest rates. This also includes change in market prices of equity, debt and foreign

exchange, which might be relevant, for example, if an investment firm is holding units in investment funds on its own balance sheet.

- **Operational events:** Operational events that can, for example, result in loss or damage to physical assets from natural disaster or other events.
- **Asset concentration:** For example, a large number of assets representing claims on a specific issuer (single name concentration), including other group companies or related parties, economic sectors or markets. This would be alongside but independent of any K-CON charge as part of a broader assessment of the concentration risk the investment firm is exposed to.
- **Complexity:** Complex structures or products that can make it more likely for unexpected losses to materialise. For example, in the case of more complex securitisation transactions where an investment firm is investor, originator or sponsor.
- **Excessive leverage:** For example, excessive use of leverage or contingent leverage can make a firm more vulnerable as it may be required to make unplanned changes to its business plan, including distressed selling of assets.

11.45 Losses from failure of clients or counterparties: A client's or counterparty's failure to settle a transaction in a financial instrument can cause a loss to a firm. From the trade date, or the date an investment firm enters into a transaction, it is exposed to the risk of potential losses from revaluation or having to replace failed transactions. The risk may be higher if these transactions are still unsettled after their due delivery dates. This risk is captured initially in the IFR by the K-TCD and K-CON K-factors. In a domestic regime, we would also expect investment firms to assess if the risk is adequately covered by own funds. The following factors may be relevant as part of an investment firm's own assessment:

- Changes in creditworthiness and default as the investment firm may have to revalue or replace transactions in different instruments. This is because the risk of the client or counterparty failing to meet their obligations would have increased.
- Changes in market conditions when an investment firm is required to replace a transaction that fails to settle and the market has moved against it.
- Ineffective use of collateral. An investment firm may use collateral to protect itself from risks from changes in the credit quality or a client or counterparty's failure. However, this use of collateral may not be as effective as expected.
- Counterparty concentration when an investment firm does a large number of transactions with a specific counterparty (single name concentration) or with counterparties in specific economic sectors or markets.

11.46 Changes in the value of positions: Movements in market prices or other events, including operational failures, may result in losses. These relate to positions in financial instruments, which are held or traded to support an investment firm's business activities and generate returns. We would expect an investment firm to consider the impact on positions in financial instruments they hold with trading intent (which must be free of restrictions on their tradability or ability to be hedged), and all positions in foreign exchange and commodities. This risk is initially captured in the IFR by the K-NPR or K-CMG and K-CON K-factors, but not necessarily in full. In a domestic regime we would also expect investment firms to assess themselves if the risk is adequately covered by own funds.

11.47 Defined benefit pension exposure: Investment firms may be required to make payments or other contributions to defined benefit pension schemes, resulting in a loss. In these cases, investment firms should consider the accounting framework and the impact of adverse circumstances in the funding status of the pension plan, due to change in value of its assets and liabilities. Unfunded plans may be exposed to higher risk.

11.48 More generally, an investment firm should perform a comprehensive assessment of the risks which are relevant to the composition of its portfolios and trading strategy and the impact of these risks under severe, but plausible, adverse circumstances. This should include an appropriate stress testing framework tailored to those risks and should cover, for example:

- Risks or products which are not captured or not captured accurately under the 'Pillar 1' approach. For example, where basis risk between certain products or non-linear risks are not captured, large movements in pegged currencies are underestimated, approximate valuation is applied to non-linear products or inadequate proxy market data is applied to particular products.
- Illiquid or distressed positions or those which have the potential to become so under severe, but plausible, adverse circumstances. Investment firms should determine a realistic holding period during which it might not be possible to close or hedge such positions.
- Difficult-to-value positions whose value cannot easily be determined based on recent observable market data, eg illiquid bonds, long-dated derivatives or exotic derivatives.
- Intra-day exposures where they differ significantly from end-of-day exposures.
- Known model weaknesses. For example, where the internal model approach or a domestic approach for K-CMG are used, back-testing the model may highlight such weaknesses.
- Concentrated portfolios, especially due to the small size of a portfolio or a large number of exposures to a specific issuer, economic sectors or markets.

Additional risks affecting an investment firm's liquid resources

11.49 As noted in Chapter 10 of this DP, the IFR sets out a minimum quantitative liquidity adequacy requirement for all investment firms. However, the liquid assets requirement under Article 43 of IFR is a basic requirement which does not capture all potential liquidity risks. So we would expect the investment firm's ICARA process to cover such risks.

11.50 As with own funds, an investment firm must always maintain liquidity resources which are adequate, both in amount and quality, to ensure that there is no significant risk that its obligations cannot be met as they fall due. In business-as-usual an investment firm may not experience any problems. However, stressed financial conditions can cause a lack of adequate liquid resources, where an investment firm may be unable to convert different types of resources into available 'cash', despite holding a minimum requirement such as the one set out in the IFR.

11.51 As part of the ICARA process we consider that an investment firm would need to cover both the assessment of the amount and quality of liquid resources it has available and the amount and quality of liquid resources it needs for the risks it faces, and in what timeframe.

11.52 In the assessment of the quality and amount of liquid resources available, an investment firm would need to consider:

- *Ability to monetise liquid assets* – Quality of assets and legal or operational restrictions may affect the ability, timescale and loss of value when converting assets into 'cash' in a period of stress.
- *Diversification of liquid resources* – Depending on the circumstances, diversification may help to monetise liquid resources quickly without causing significant loss of value.
- *Currency convertibility* – Investment firms should assess the currency of liquid resources and its conversion as a potential obstacle to meeting stressed liquidity outflows in a specific currency.
- *Transferability of funds* – In severely stressed circumstances, liquid resources might not be freely transferable between and within group entities, and across national borders. So adequate liquid resources should be maintained on a legal entity specific basis unless they can freely move between entities.

11.53 In our view, an investment firm should cover in its assessment of the amount and quality of liquid resources it needs, for the risks it faces, at least the following sources of risk:

- *Funding management* – The impact of stressed financial conditions on an investment firm's liquidity position from: 1) funding concentration across products, currencies and counterparties; 2) acceleration of cash outflows from large withdrawals in the short term and gradual long-term leakage of funds; and 3) mismatched cash flows across different currencies and maturities.
- *Intraday and collateral management* – The potential for intraday liquidity positions and any related risks affecting an investment firm's ability to meet its payment and settlement obligations on a timely basis. This includes all obligations from margin calls from exchanges, central clearings or clearing members. Margin calls may refer to own positions or clients' positions for which the investment firm has legal obligation to meet the margin call.
- *Off-balance sheet* – Arising from contractual obligations and the circumstances in which an investment firm may choose to provide liquidity support for its off-balance sheet activities beyond its contractual obligations. This includes the impact on the investment firm's liquidity position due to outflows from: 1) commitments on credit and liquidity facilities given on a committed basis, including the ones cancellable at any time, 2) liquidity facilities to support securitisation programmes and 3) client money (including maturity and FX transformation).
- *Franchise viability* – An investment firm may decide to make payments that it is not legally obliged to, but does so to maintain its franchise and reputation, to avoid serious damage to the viability of its business.
- *Unexpected obligations* – An investment firm may have to pay direct or indirect costs of litigation, redress or fines, which affect its liquidity position.

11.54 Investment firms can assess risks from franchise viability and unexpected obligation as part of the risks of harm to clients and markets and added to other sources of risk referred to here to assess the total amount and quality of liquid resources needed.

Viability of business model and strategy

11.55 Every investment firm's business model is exposed to existing and emerging risks and vulnerabilities from changes in operational and economic circumstances. These changes can affect a business model and business strategy's sustainability and viability.

11.56 A clear explanation of an investment firm's business model and strategy, as used for the purposes of the ICARA process and clearly documented in the ICARA's policies and procedures and addressed in the at least annual ICARA review document, helps identify vulnerabilities and emerging risk of harm. It also helps identify any misalignment between an investment firm's profit incentive and the interests of clients and financial markets.

11.57 The risks of harm may be greater if investment firms are under significant pressure for financial performance or on the verge of failure. Understanding an investment firm's financial vulnerabilities and proximity to failure is important to minimise its impact.

11.58 As part of the ICARA process, our view is that an investment firm should consider scenarios of severe but plausible adverse circumstances affecting its business model and strategy, which are considered against its own risk appetite for survival. This should include scenarios where the ability to generate returns is within an investment firm's risk appetite to stay in business. It would also need to include a reverse stress test where the investment firm is beyond its risk appetite to stay in business or where it is unable to meet its legal requirements to remain solvent, determined as the point of non-viability, which may be reached well before the investment firm runs out of financial resources.

11.59 A reverse stress test must result in an investment firm reaching a point of non-viability. It should provide useful information about vulnerabilities in the business model and strategy. This should help when designing measures to prevent and mitigate the risk of business failure.

11.60 Examples of the scenarios include where:

- the market loses confidence in an investment firm, resulting in the loss of a substantial portion of counterparties or clients
- complications from material dependencies on group entities, such as services, funding, reputation, etc
- existing shareholders are unwilling to provide the investment firm with new capital

11.61 We expect that investment firms that would be required to hold initial capital of EUR 750k (see Chapter 5 on Own funds requirements) will remain caught within the scope of the obligations from the 'on-shored' Recovery and Resolution Directive (RRD). We envisage that these investment firms would therefore need to consider how their ICARA and, specifically its wind-down component, relate to its recovery plan and any requirements of the Bank's Resolution Directorate.

Wind-down

11.62 The purpose of wind-down planning is to reduce the impact of an investment firm's closure, related to potential harm from the inability to pay redress, inability to return or transfer client assets and money, interruption to continuity of service, or from any resultant market disruption. We have previously published a Wind-Down Planning Guide (WDPG) to help establish an adequate wind-down plan: https://www.handbook.fca.org.uk/handbook/WDPG/1/?view=chapter. This guidance may be a helpful reference for investment firms given our proposed approach to wind-down planning under any new regime.

11.63 If Article 11 of the IFR is reflected in a domestic regime, investment firms will have an own funds requirement which may be based on a fixed overhead requirement (FOR). If Article 43 of the IFR is reflected similarly, investment firms also have a minimum liquid assets requirement calculated as one third of their FOR. Historically, the FOR has been considered to represent a minimum level of own funds which is a 'proxy' for the resources required to wind-down an investment firm's business.

11.64 As part of their ICARA process, investment firms are required to take into account all risks to which they are or might be exposed, including (at a minimum) any risks covered by the minimum rules-based requirement. As a result, in our view, all investment firms should consider the risk of a disorderly wind-down and assess the level of financial resources required to ensure that their businesses can close without undue disruption to clients or to the market. For Non-SNI investment firms, the IFD supplements this general obligation with additional specific requirements that we are minded to reflect. These are that, taking into account the viability and sustainability of their business models and strategies, they must give due consideration to what is both necessary and realistic, in terms of timescale and maintenance of own funds and liquid resources, throughout the process of exiting the market.

11.65 In a wind-down plan we think it would be appropriate to look for the reasons where an investment firm's senior management would decide to wind-down its business. We would consider the investment firm's risk appetite for business model viability and the different scenarios in which it would decide or be forced to wind-down its business. We would also consider how different scenarios would affect financial resources available at the point a decision is made. As a result, we think that a wind-down plan should be linked to the outcomes of reverse stress testing. It also needs to consider both the qualitative and quantitative (eg own funds and liquid assets) aspects and any applicable provisions of the Recovery and Resolution Directive. For example, the operational tasks that need to be completed, including communications with customers, and the liquid resources such as redress that need to be available to cover costs, and 'what if' scenarios.

11.66 Once an investment firm has calculated the level of financial resources necessary to wind-down its business, we intend to review whether this level is appropriate. We anticipate calculating an 'ordinary course' wind-down requirement as part of setting additional requirements under the SREP (see below for details on 'Pillar 2R').

11.67 For non-SNI investment firms, we would also be likely to consider whether to issue individual guidance (separate from, and additional to, any 'Pillar 2R') on further own funds to cover wind-down in stressed economic conditions.

Summary of changes between ICARA and ICAAP

11.68 To help investment firms understand the points above and plan for a transition to the proposed new ICARA approach, the following Figure 11.3 provides a summary view of the expected elements of the ICARA process and – to the extent that they are comparable – how we believe the current ICAAP risk categories would hypothetically map into this structure:

Figure 11.3: elements of ICARA process under IFD (compared to current risk framework under CRD)

New IFD framework		Current CRD framework
Identifying and assessing harm	Harm to clients	• Operational risk • Liquidity risk (liquidity guidance is applicable only to ILAS firms as per BIPRU 12) • Group risk
	Harm to markets	
Additional risks affecting a firm's capital	Changes in book value of assets	• Credit risk • Operational risk • Concentration risk • Residual risk • Securitisation risk • Interest rate risk in the non-trading book • Group risk • Risk of excessive leverage
	Failure of counterparties	• Counterparty risk • Concentration risk • Residual risk • Risk of excessive leverage
	Changes in value of positions	• Market risk • Concentration risk • Securitisation risk
	Obligation to defined benefit pension schemes	• Pension obligation risk
Additional risks affecting liquid resources	Availability – quality and amount of liquid resources available	• Liquidity risk (liquidity guidance is applicable only to ILAS firms as per BIPRU 12)
	Needs – quality and amount of liquid resources needed	
Viability and sustainability of business model and strategy	Business-as-usual	• Business risk • General stress and scenario testing (applicable only to BIPRU firms and to significant IFPRU firms) • Group risk
	Stressed circumstances	
	Reverse stress test	• Reverse stress test (applicable to all IFPRU firms and BIPRU firms subject to quantitative thresholds – in line with SYSC 20)
Wind-down planning	Qualitative assessment	Currently not a requirement. Provided guidance as a best practice and required on a firm by firm basis
	Capital assessment	
	Liquid resources assessment	

11.69 We intend to further elaborate on our expectations for the ICARA process and the content of the ICARA document, and on our approach to wind-down planning, in future publications.

Supervisory review and evaluation process (SREP)

Purpose of the SREP and our approach to it

11.70 Our supervisory work aims to minimise harm to clients and/or the integrity of the UK financial system. Disorderly failure can cause harm through loss of money, loss of confidence and participation in financial markets, or where services provided are not easily replaced by other firms, or a firm cannot pay redress.

11.71 We would anticipate adopting an approach to SREPs under the new regime that is broadly similar to our existing approach for IFPRU and BIPRU firms, but reflecting the new focus of IFD/IFR on the potential for wider harm. We would envisage carrying out reviews of investment firms' own assessments of adequate financial resources and wind-down planning in a consistent and proportionate manner. The questions we would typically seek answers to in our review include:

- Does an investment firm have a risk management framework which includes a clear risk appetite?
- Does an investment firm appropriately and adequately identify the potential harm that it may pose and the risks to which it is exposed?
- How material is each risk?
- How adequate are systems and controls in place?
- Does the risk assessment process meet the 'use test' i.e. is it used day-to-day and for decision making, consistent with the expectations of the ICARA that we set out above?
- Does the investment firm have adequate financial resources based on the potential harm that it may pose and the risks to which it is exposed?

11.72 Where weaknesses are identified, we may provide feedback to the investment firm on:

- expected improvements to the quality of its risk management framework, controls, or wind-down planning, and
- a requirement to hold additional financial resources

Level of application

11.73 We expect the SREP to apply on the same basis as the relevant ICARA process operated by the firm being assessed. As we expect that the majority of investment firms will be required to implement the ICARA only on an individual basis, in most cases, the FCA will also be applying the SREP on an individual basis. Where an investment firm group is subject to consolidation under rules equivalent to article 7 of the IFR and we have directed that the group should implement a consolidated ICARA process, we will apply the SREP on:

- an individual basis to each separate investment firm within that group, to the extent that we consider it necessary to assess their individual ICARA processes (taking into account, for example, whether each firm is an SNI or non-SNI investment firm) and
- a consolidated basis in relation to the consolidated ICARA process operated by the group

11.74 Depending on the approach that we adopt to giving effect to the outcome of any SREP conducted on a consolidated basis, the FCA may need additional powers to impose direct requirements on otherwise unregulated parent entities. Our practical approach to applying corresponding 'Pillar 2' own funds requirements on a consolidated basis will therefore depend upon the nature of any such additional powers. Where necessary, we may consider whether any additional own funds requirements or guidance should be apportioned between the regulated entities forming part of the relevant group.

SNI – FCA discretion

11.75 We have finite resources to do our supervisory work. Our approach is proportionate and risk-based and aims to reduce harm, not eliminate it. As such, we do not envisage that SNI investment firms would be subject to regular, cycle-driven supervisory reviews. We envisage applying a risk-based approach to such reviews and setting resources accordingly. This could take form of firm-specific reviews or reviews undertaken on a thematic basis, based on potential harm caused by specific firms or sectors. However, we would still expect SNI investment firms to consider the risks which they may pose to others and to which they might be exposed themselves, although we would not expect any documentation of this to be lengthy and unnecessarily detailed.

11.76 To identify investment firms or sectors with the potential to create the most harm we use sources including data and intelligence, sector and portfolio views, market studies and information from the investment firms themselves. We may also consider a supplemental, data driven approach to support our supervisory work with respect to SNI investment firms, for example, this may be by way of a periodic questionnaire to complement the financial, capital and liquidity returns

Supervisory powers

Additional own funds requirements

11.77 In line with our existing approach, we would expect investment firms to identify through the ICARA process where additional financial resources are necessary to reflect risks that are not covered or not covered in full by the minimum ('Pillar 1') calculation, and hold any additional resources as appropriate. Through our SREP we would determine if these are sufficient to cover the risk, or if additional requirements are necessary.

11.78 A key difference moving from the BIPRU and IFPRU regimes to the proposed new regime would be how we apply the relevant own funds requirements to investment firms. Currently Individual Capital Guidance (ICG) is assigned. ICG is a form of individual guidance and therefore is not directly legally binding. However, where an investment firm fails to comply with ICG, our existing guidance in BIPRU and IFPRU makes it clear that we may exercise our statutory powers to convert ICG into a legally binding requirement.

11.79 Under the new regime, we would anticipate setting a legally binding requirement. For the moment, we are calling it 'Pillar 2R' (though see the end of this chapter in relation to this terminology). As part of our SREP feedback, we expect to invite investment firms to apply for a voluntary requirement (VREQ) imposing a formal legal requirement to hold the appropriate level of own funds or, if necessary, using a requirement imposed on the FCA's own initiative (OIREQ) to achieve that result.

11.80 A key difference between ICG and a formal requirement is that a breach of a VREQ or OIREQ could form the legal basis for enforcement action. Before taking enforcement action, the FCA would need to consider all relevant factors, including the gravity of the breach and its broader potential impact.

11.81 Investment firms would need to consider if setting 'Pillar 2R' as a formal legal requirement will have any impact on any relevant covenants (for example, in finance documents), as the VREQ/OIREQ approach would have a formal legal effect, whereas ICG does not.

Additional capital guidance

11.82 We would intend to use the ability to set an additional buffer where a 'buffer' is needed to allow for economic cyclical fluctuations. These fluctuations may be specific to an investment firm's business model. For example, the nature and duration of financial instruments or contracts and where they are traded could be relevant for investment firms with a trading book, whereas a concentrated exposure of clients to a particular economic sector or territory could be relevant for agency business. We are provisionally calling this 'Pillar 2G' and it may also feature as a wind-down component. We will consider if setting this is appropriate based on the nature of the investment firm's activities, and its potential to cause harm.

11.83 Similar to the current ICG, 'Pillar 2G' would not be a formal regulatory requirement. Not meeting the 'Pillar 2G' component would not automatically be grounds for enforcement action. 'Pillar 2G' is meant to act as a buffer and, like ICG, is linked to the overall financial adequacy requirement.

11.84 If an investment firm's resources dip into the 'Pillar 2G' component, we envisage that it would need to notify the us, and provide a plan for how it intends to replace the depleted resources. It should be noted that, unlike the CRD, the IFD does not contain a combined (capital conservation and counter-cyclical) buffer regime.

11.85 Should the failure to comply with the 'Pillar 2G' guidance remain unresolved or if the investment firm's capital resources decrease further, we would consider the situation with reference to the threshold conditions and the range of supervisory tools available to us.

Articulation of 'Pillar 2' requirements ('Pillar 2R') and 'Pillar 2' guidance ('Pillar 2G')

11.86 Following our request to an investment firm to submit its ICARA document, we envisage that we would review that investment firm's own assessment of adequate financial resources and wind-down planning in a consistent and proportionate manner, taking into consideration its potential to cause harm. Based on this review we would set the 'Pillar 2R' as one or a combination of the following, which would be a firm-specific determination reflecting the investment firm's business model, its risks, and how its minimum or 'Pillar 1' and additional or 'Pillar 2' requirements interact:

- *Percentage of 'Pillar 1'* – expressed as an amount which is at least equal to a specified percentage of an investment firm's minimum own funds requirements calculated according to domestic requirements which replicate Article 11 of the IFR. For example, a firm may be required to hold 120% of its overall 'Pillar 1' requirement or, for example, it may be required to hold the highest of its FOR and 120% of its K-factor requirement.

- *Variable add-ons* – expressed as an amount which is at least equal to a specified percentage of a metric related to an investment firm's business activity. For example, assets under management. In such a case, we would consider setting a higher coefficient for the calculation of K-AUM if we have identified there is a lack of control related to the risk of such activity. Where an activity isn't covered by a K-factor, and, if material risks are identified, we might require a firm to hold, for example, X% of a relevant metric or the revenue generated by such activity (for example, for corporate finance activity).
  We anticipate variable add-ons would be set where we find general deficiencies in an investment firm's governance and risk management practices
- *Static add-ons* – expressed as a static amount of own funds an investment firm must hold for a specified risk. This might be the case, for example, where there is no clear relationship between the minimum 'Pillar 1' requirement and the risk assessed under 'Pillar 2'. For example, risk related to pension obligations.

11.87 'Pillar 2G' could also be expressed as a static add-on and/or as a percentage of the total capital requirement. As an illustrative example: an investment firm may have a 'Pillar 2G' additional capital guidance of 110% of total capital requirement ('Pillar 1' plus 'Pillar 2R'), plus a fixed add-on of say £Xm. We anticipate the 'Pillar 2G' to be set as a percentage of the total capital requirement where the vulnerabilities of the investment firm's business model and its risks are also connected to a potential volatility in its total capital requirements. And it will be set as a fixed add-on where the risk is more specific and better captured by an absolute amount of capital.

11.88 We expect the total capital requirements, which include 'Pillar 1' and 'Pillar 2R', to be met with the same quality of capital as 'Pillar 1', while 'Pillar 2G' should be met by CET1 capital only.

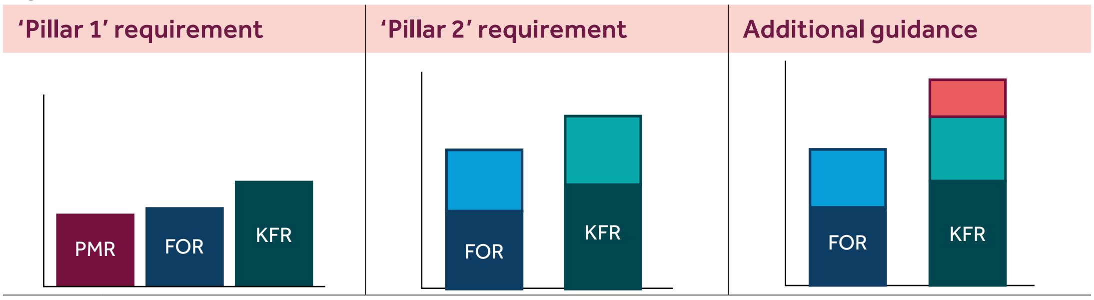
Stacking order of own funds requirements and guidance

11.89 In our view, 'Pillar 2' should comprise 'Pillar 2R' and, for non-SNI investment firms, also 'Pillar 2G'. 'Pillar 2R' would be the additional own fund requirements. These are capital resources over and above the minimum own funds requirement determined under 'Pillar 1'. Typically, the assessment of 'Pillar 2R' is meant to consider events, risks, and harm within a twelve-month period. 'Pillar 2G' typically needs to consider what may happen throughout an economic cycle. So it is independent of whether the total requirements are driven by the FOR or the KFR.

11.90 We anticipate that 'Pillar 1' and 'Pillar 2R' under a domestic regime reflecting the IFR and IFD would represent the legally binding minimum own funds requirement. As guidance, 'Pillar 2G' would act as a buffer; it would form part of the total amount of capital resources an investment firm should hold, but it would not be part of the minimum own funds requirement. For the 'Pillar 2G' component, we anticipate that an investment firm may temporarily fall below the level advised in the guidance in adverse circumstances. However, we expect the investment firm to notify us as soon as practicable of that fact, explaining how it expects to restore its own funds to the required level and the expected timeframe for doing so.

11.91 The following diagrams provide several examples of how we envisage that the 'Pillar 1', 'Pillar 2R' and 'Pillar 2G' can be stacked.

Figure 11.4 – Example A: A non-SNI investment firm



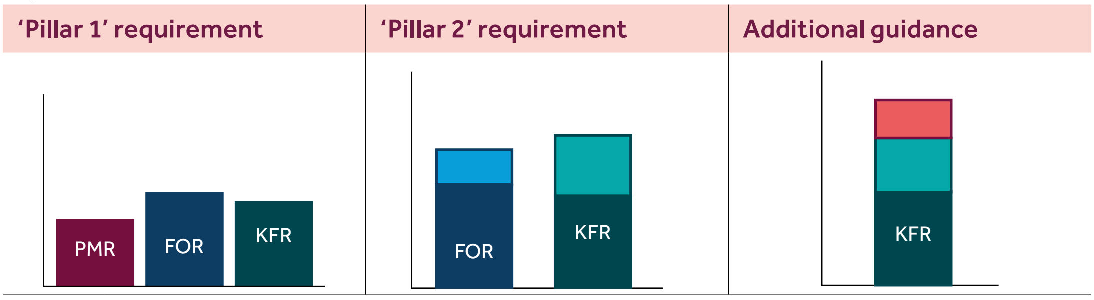
Key:

(blue)	Additional capital required for orderly wind-down in addition to FOR
(teal)	Additional capital required so that the firm can mitigate the harm that it poses to others and itself not captured or not fully captured by KFR
(red)	Additional capital guidance

An investment firm with a known PMR, calculates is FOR and KFR. It determines that KFR is its highest 'Pillar 1' requirement. The investment firm then calculates any additional own funds required for an orderly wind-down. This is added to its FOR. It also cacluates any additional own funds needed to mitigate the harm that it may pose to others and the risks it faces itself. This is added to its KFR. Either of these own funds requirements may be further adjusted by our supervisory review process. 'Pillar 2G' is additional to the highest component of 'Pillar 1' plus 'Pillar 2R'.

11.92 In Figure 11.4 above, the KFR plus the additional 'Pillar 2R' for harm not captured or not fully captured by the KFR, are higher than the other requirements. The competent authority may issue additional guidance to investment firms to mitigate potential effects from economic cyclical fluctuations, which can also be specific to a firm's business model.

Figure 11.5 – Example B: A non-SNI investment firm



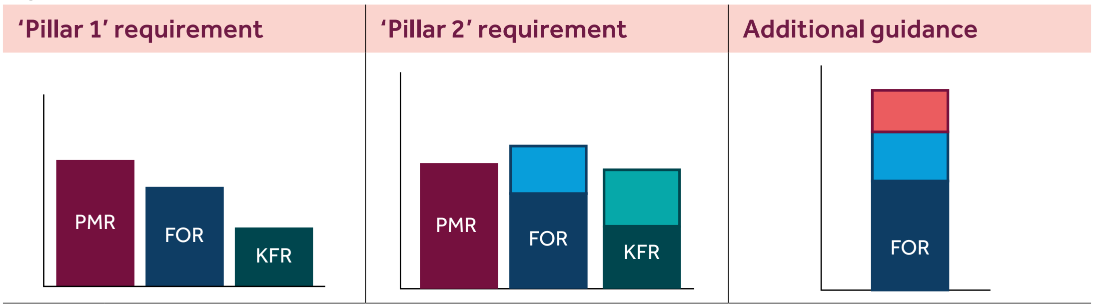
Key:

(blue)	Additional capital required for orderly wind-down in addition to FOR
(teal)	Additional capital required so that the firm can mitigate the harm that it poses to others and itself not captured or not fully captured by KFR
(red)	Additional capital guidance

An investment firm with a known PMR, calculates is FOR and KFR. It determines that FOR is its highest 'Pillar 1' requirement. The investment firm then calculates any additional own funds required for an orderly wind-down. This is added to its FOR. It also cacluates any additional own funds needed to mitigate the harm that it may pose to others and the risks it faces itself. This is added to its KFR. Either of these own funds requirements may be further adjusted by our supervisory review process. 'Pillar 2G' is additional to the highest component of 'Pillar 1' plus 'Pillar 2R'.

11.93 In Figure 11.5 above, the KFR plus the additional 'Pillar 2R' for harm not captured or not fully captured by the KFR, are higher than the other requirements. The competent authority may issue additional guidance to investment firms to mitigate potential effects from economic cyclical fluctuations, which can also be specific to a firm's business model.

Figure 11.6 – Example C: A non-SNI investment firm



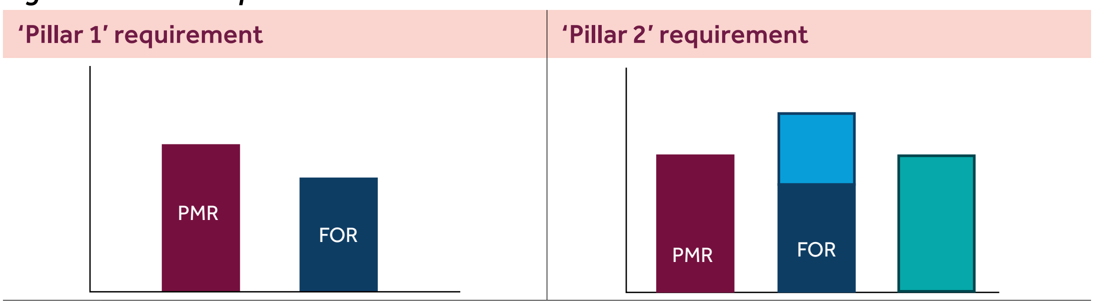
Key:

	Additional capital required for orderly wind-down in addition to FOR
	Additional capital required so that the firm can mitigate the harm that it poses to others and itself not captured or not fully captured by KFR
	Additional capital guidance

An investment firm with a known PMR, calculates is FOR and KFR. It determines that PMR is its highest 'Pillar 1' requirement. The investment firm then calculates any additional own funds required for an orderly wind-down. This is added to its FOR. It also calculates any additional own funds needed to mitigate the harm that it may pose to others and the risks it faces itself. This is added to its KFR. Either of these own funds requirements may be further adjusted by our supervisory review process. 'Pillar 2G' is additional to the highest component of 'Pillar 1' plus 'Pillar 2R'.

11.94 In Figure 11.6 above, the FOR plus the additional 'Pillar 2R' in respect of an orderly wind-down are higher than the other requirements. The competent authority may issue additional guidance to investment firms to mitigate potential effects from economic cyclical fluctuations, which can also be specific to a firm's business model.

Figure 11.7 – Example D: An SNI investment firm



Key:

	Additional capital required for orderly wind-down in addition to FOR
	The amount of capital the firm calculates is required so that the firm can mitigate the harm that it poses to others and to itself. This could include by reference to K-factors

An investment firm with a known PMR, calculates is FOR. As an SNI, it is not required to calculate a minimum KFR. It determines that PMR is its highest 'Pillar 1' requirement. The investment firm then calculates any additional own funds required for an orderly wind-down. This is added to its FOR. It also calculates what own funds it would need to mitigate the harm that it may pose to others and the risks it faces itself. This amount is considered alongside its PMR, and its total ('Pillar 1' plus 'Pillar 2R' FOR). Either of these own funds requirements may be further adjusted by our supervisory review process.

11.95 In Figure 11.7 above, the FOR plus the additional 'Pillar 2R' for orderly wind-down are higher than the other requirements.

Specific liquidity requirements

11.96 We anticipate that in setting any specific additional liquidity requirements on an individual basis, these could be as one or a combination of the following:

- *Liquid assets requirement* – the amount and quality of liquid resources which is appropriate, having regard to the liquidity risk profile of that investment firm.
- *Funding profile requirement* – a prudent funding profile, considering the extent to which the investment firm's liabilities and sources of liquidity risk are adequately matched by inflows or liquid resources, able to be monetised on a timely basis. This is likely to be based on a liquidity monitoring tool.

11.97 We are considering our approach to calculating and articulating 'Pillar 2R', 'Pillar 2G' and specific liquidity requirements and plan to include further detail in future publications.

Use of FSMA powers

11.98 In general, we envisage that VREQs will be used to set own funds requirements. This would occur typically after our assessment. The investment firm would be asked to apply for a VREQ which would require it to hold the level of own funds and liquid resources that we consider appropriate to satisfy the combined 'Pillar 1' and 'Pillar 2R' requirement. We expect that investment firms would apply for the VREQ to take effect immediately once it has been granted (unless there are exceptional circumstances). Where an investment firm is not cooperative or refuses to apply for the VREQ, we anticipate that we would consider using our power to issue an OIREQ.

11.99 The publication of information about VREQs and OIREQs on the Financial Services Register and the publication of information about OIREQ statutory notices would not be required, provided we are satisfied that it is not 'appropriate' to publish it. We are considering our approach to publishing VREQs and OIREQs in this context and will include additional detail in our future publications.

11.100 Currently, under section 55L FSMA, these requirements can only apply to regulated entities, although we also have certain powers over UK financial holding companies of investment firms under Part 12A FSMA. Future UK legislation would determine if the FCA would receive additional powers to impose direct requirements on otherwise unregulated parent entities. We will consider our practical approach further in light of any such additional powers.

Disclosure

11.101 We would support voluntary disclosure by investment firms of additional own funds requirements through the ICARA process or SREP in their public disclosures. If we adopt rules reflecting those in Article 50 of the IFR, we would exercise the ability to request disclosure in exceptional cases. Disclosure of an investment firm's 'Pillar 2R' (as set through the SREP, where relevant) would be on an aggregated basis (i.e. not breaking down the disclosure by the component elements of the 'Pillar 2R') where we believed it appropriate, and the investment firm was not doing this on a voluntary basis. However, we do not believe that 'Pillar 2G' should be disclosed.

Transition from existing IFPRU/BIPRU ICG

11.102 We acknowledge that some investment firms will currently have individual capital guidance (ICG) that may deliver an inappropriate outcome if directly applied to a new 'Pillar 1' requirement under a domestic regime reflecting the IFR. To facilitate transition, we envisage that those investment firms with capital guidance currently in force would undertake the following:

- Calculate their total capital requirement under the current BIPRU or IFPRU regime according to their most recent FCA SREP letter, as at the date immediately prior to the new regime coming into force.
- Calculate the new 'Pillar 1' requirement as at the date the new regime comes into force.
- Compare the absolute capital figures. Where the new 'Pillar 1' requirement is higher than the absolute amount under the previous regime, the current guidance would be considered no longer valid. The investment firm would assess the appropriate level of additional 'Pillar 2' capital as part of its ICARA process under the new regime. In due course, we would inform investment firms of any new 'Pillar 2R' requirement and, where applicable 'Pillar 2G', that we have determined as part of our future supervisory work.
- Where the absolute amount under the old regime is higher than the new 'Pillar 1' requirement, we envisage that investment firms would take the difference between the new rules based amount and the additional necessary to meet the old absolute amount. They would then use this to generate a new percentage multiplier above the 'Pillar 1' requirement which would apply for the purposes of the new regime. The investment firm would then apply to us for a VREQ to confirm its rebased capital requirement, for the purposes of transitioning the existing ICG when the new regime takes effect.
- Thereafter, investment firms would continue their ongoing assessment of the appropriate level of additional 'Pillar 2' capital as part of their ICARA process, which would be subject to review as part of our future supervisory work.
- For those investment firms that have capital planning buffers (i.e. not buffers introduced by the CRD), we expect that these would remain in place.

11.103 We are also considering in general the appropriateness of the terminology of 'Pillar 1' and 'Pillar 2'. These are concepts taken from the Basel Committee on Banking Supervision and, as we move away from a balance sheet approach to risk assessment to one that focuses on harm, we feel it may be more appropriate to adjust the terminology accordingly.

Q16: What are your views on the structure and content of the elements being covered in the proposed new 'Pillar 2' framework. (See Figure 11.3 – paragraph 11.68)

Q17: Do you agree with our proposal regarding additional own funds requirements and specific liquidity requirements? This includes the articulation of requirements and guidance, stacking order and the use of VREQs to set own funds and specific liquidity requirements. (See paragraphs 11.77 to 11.100)

Q18: What are your views on the proposed approach for the transition from existing IFPRU/BIPRU ICGs? (See paragraph 11.102)

12 Regulatory reporting requirements

Overview

- The IFD/IFR introduces a more appropriate and proportionate reporting regime for investment firms compared to requirements set out under the CRR.
- Much of the detail of what exactly investment firms will be required to report still has to be agreed through the EBA's level two process, but the intention is to limit requirements to those data points relevant to the business model of investment firms, rather than the wider set relevant to credit institutions.
- We support this approach, and would look to introduce something similar in our domestic regime. We believe it will reduce unnecessary regulatory costs for investment firms while providing supervisors with enough information to undertake informed analysis of an investment firm's risks and how these can be addressed.

What this chapter covers

12.1 In this chapter, we cover:

- the regulatory reporting requirements for different categories of investment firm (Articles 54 and 55 of the IFR)
- the frequency of this reporting
- additional reporting for firms that undertake any of the activities set out in points (3) and/or (6) of Section A of Annex I to MiFID

12.2 Reporting requirements for remuneration are not covered in this chapter and are dealt with separately in Chapter 13.

Regulatory reporting that applies to all firms

12.3 Most of the regulatory reporting requirements are set out in IFR Article 54. SNI firms must meet annual reporting requirements. All other investment firms must meet quarterly reporting requirements. All investment firms have to report the following items:

- level and composition of own funds
- own funds requirements
- own funds requirement calculations
- the level of activity for the conditions set out in paragraph 1 of Article 12 of the IFR, including:
  - balance sheet
  - revenue breakdown by investment service, and
  - applicable K-factor

- concentration risk requirement
- liquidity requirements

12.4 We do not expect the reporting forms will be as complex or detailed as the current common reporting (COREP) forms in the CRR. Some of the concepts are new, such as the K-factors and the areas of concentration risk that firms must monitor. This means that new reporting forms will need to be developed.

12.5 In accordance with paragraph 3 of Article 54 of the IFR, the EBA is required to produce draft technical standards that specify reporting formats, reporting dates and associated instructions for investment firms under the IFR. We will monitor these developments when considering the appropriate requirements in this area.

Concentration risk reporting

12.6 Investment firms that are not SNIs have to report the level of concentration risk from:

- default of counterparties and trading book positions (both for an individual counterparty and on an aggregate basis)
- location of client money
- location of custody assets
- location of a firm's own cash deposits, and
- earnings

Additional reporting for firms that undertake any of the investment activities set out in points (3) and/or (6) of Section A of Annex I of MiFID

12.7 Article 55 of the IFR requires investment firms that undertake any of the activities set out in points (3) and/or (6) of Section A of Annex I of MiFID to verify the total value of their consolidated assets, calculated as an average of the previous 12 months. They must report them to the competent authority on a quarterly basis if this result is equal to, or more than, EUR 5 billion. This excludes the value of any individual assets of subsidiaries established outside the EU that carry out either or both of these activities.

12.8 When the total value of a firm's consolidated assets is equal to, or more than, EUR 15 billion, the firm must meet the prudential requirements of the CRR as set out in point (a) of paragraph 2 of Article 1 of the IFR.

12.9 Where one of these firms is part of a group where at least 1 other investment firm that also undertakes any of the activities set out in points (3) and/or (6) of Section A of Annex I of MiFID, all the following requirements apply:

- each individual investment firm in the group that undertakes any of these activities should verify the value of its total assets on a monthly basis if the total value of the assets of the group is equal to or exceeds EUR 5 billion, calculated as an average of the previous 12 months
- each such investment firm shall inform all other such investment firms within the group of its total assets on a monthly basis, and

- each such investment firm shall report the group's consolidated total assets to the competent authority on a quarterly basis where this is equal to or more than EUR 5 billion

12.10 The reporting requirements in paragraph 12.7 also apply to investment firms that meet any of the criteria set out in paragraph 2 of Article 1 of the IFR.

12.11 Chapter 3 (Application to investment firms) gives more information on the application of CRR to firms that undertake any of the activities set out in points (3) and/or (6) of Section A of Annex I of MiFID.

12.12 In accordance with paragraph 5 of Article 55 of the IFR the EBA is mandated to produce draft technical standards dealing with the monitoring of the above thresholds.

Q19: What are your views on the level of detail required to meet regulatory reporting requirements?

13 Remuneration

Overview

13.1 The IFD sets out a remuneration regime that aims to ensure all investment firms in its scope have remuneration policies that are consistent with, and promote, effective risk management. The regime is based on the same core remuneration principles as CRD but differs in some areas, including a different approach to proportionality.

13.2 At present, solo-regulated investment firms are subject to either the IFPRU Remuneration Code in SYSC 19A or the BIPRU Remuneration Code in SYSC 19C. The exception is 'exempt-CAD firms', which are not subject to any of our remuneration codes.

13.3 If we were to adopt a similar approach to the IFD in a domestic regime, we would delete the IFPRU and BIPRU Remuneration Codes entirely, and create a new remuneration code based on the IFD remuneration provisions.

13.4 Our general approach to a new remuneration code would be to:

- base it on the IFD provisions (where possible and appropriate for the UK market) while mirroring the structure of the existing remuneration codes
- supplement these with guidance where we believe this will help investment firms better understand our expectations
- create a proportionate remuneration regime for investment firms which furthers the objectives of ensuring alignment between risk and individual reward, discouraging excessive risk-taking, and promoting effective risk management

13.5 Full-scope UK alternative investment fund managers would remain subject to the AIFM Remuneration Code in SYSC 19B. The UCITS Remuneration Code in SYSC 19E would still apply to UK UCITS management companies. Dual-regulated investment firms would remain subject to the Dual-regulated firms Remuneration Code in SYSC 19D. We will consult in the coming weeks on proposals to update SYSC 19D to reflect the CRD V remuneration provisions. The MiFID remuneration requirements in SYSC 19F.1 would continue to apply to all MiFID investment firms.

What this chapter covers

13.6 In this chapter, we cover:

- the scope and application of the IFD remuneration regime
- the IFD approach to proportionality
- remuneration principles
- the structure of variable remuneration
- other IFD remuneration requirements, including reporting requirements

Scope and application

13.7 Investment firms in scope of the CRD/CRR must currently meet broadly the same remuneration requirements as credit institutions. This will no longer be the case under the IFD. The exception will be investment firms that continue to apply the CRD/CRR, which will include the remuneration requirements of the CRD regime. (See Chapter 3 on Application to investment firms). We will consult in the coming weeks on how we propose to update the SYSC 19D remuneration rules for these investment firms to reflect the CRD V amendments.

13.8 Non-SNI investment firms will, in principle, have to meet all the remuneration requirements set out in the IFD. This chapter explains these requirements. SNIs are exempted from the remuneration requirements of the IFD (paragraph 1 of Article 25).

13.9 A non-SNI investment firm may become a SNI investment firm from one year to the next, and vice-versa. The IFD sets out when the remuneration provisions will apply during any such transition (paragraphs 2 and 3 of Article 25).

Application of remuneration requirements to investment firm groups

13.10 Non-SNI investment firms in an investment firm group are to apply the IFD remuneration requirements:

- on an individual and consolidated basis where Article 7 (prudential consolidation) of the IFR applies, or
- on an individual basis where the competent authority has allowed an investment firm to apply Article 8 (the group capital test) of the IFR.

13.11 The obligation to apply the remuneration provisions on a consolidated basis is found in the third sub-paragraph of paragraph 4 of Article 25 of the IFD. We give more information on prudential consolidation in Chapter 7 and on the group capital test in Chapter 8 of this DP.

13.12 Where an investment firm group contains 1 or more investment firms that remain authorised under MiFID but subject to the prudential requirements of the CRD/CRR (see Chapter 3 on Application to investment firms), those investment firms would need to apply the CRD remuneration requirements on both an individual and consolidated basis. Non-SNI investment firms in the same group would apply the IFD remuneration requirements on both an individual and consolidated basis. We explain why both consolidations are required in paragraph 7.5 of Chapter 7 on Prudential consolidation.

Applying remuneration requirements to SNI investment firms in investment firm groups

13.13 The IFD remuneration requirements do not apply to SNI investment firms on an individual basis. They also do not apply to an investment firm group that contains SNI investment firms but no non-SNI investment firms. But where an SNI investment firm is part of an investment firm group that includes a non-SNI investment firm, and that group is subject to prudential consolidation under Article 7 of the IFR, then the SNI investment firm would apply the IFD remuneration requirements as part of the consolidation.

Applying remuneration requirements to investment firm groups containing non-investment firms

13.14 If an investment firm group with a non-SNI investment firm is subject to prudential consolidation (Article 7 of the IFR) and that group contains AIFMs and/or UCITS firms, then the AIFM and/or UCITS firms would apply their sectoral remuneration requirements (such as those set out in SYSC 19B and SYSC 19E respectively) on an individual basis. The IFD remuneration requirements would apply on an individual basis to the non-SNI investment firm, and to the investment firm group on a consolidated basis (ie including the AIFM and UCITS firms).

13.15 We will further explore how remuneration requirements apply to groups with 1 or more credit institutions in our later consultation paper on updating SYSC 19D to reflect the remuneration provisions of CRD V.

Application to subsidiaries established in third countries

13.16 The IFD provides that subsidiaries (but not branches) of UK investment firms that are established in third countries and are included in a prudential consolidation group (Article 7 of the IFR) may be exempted from applying the IFD remuneration requirements on an individual basis. The parent entity must be able to demonstrate that it would be unlawful under the laws of the third country where those subsidiaries are established to apply those remuneration requirements (fourth subparagraph of paragraph 4 of Article 25).

13.17 We could require UK parent entities to apply to us for a waiver if they consider that the remuneration requirements should not apply to their subsidiaries established in third countries for this reason. This would enable us to assess applications on a case-by-case basis while ensuring a consistent approach to exemptions.

13.18 There may also be other circumstances in which it may be appropriate to waive the requirement to apply the remuneration requirements to subsidiaries established in third countries. We would welcome stakeholders' views on these.

Timing of application

13.19 We would expect non-SNI and SNI investment firms to continue to comply with the existing IFPRU or BIPRU Remuneration Code (to the extent either is applicable) until any new remuneration code for non-SNI investment firms comes into force.

13.20 We know this may raise a number of questions about the performance year to which non-SNI investment firms would first have to apply the new remuneration requirements. We will set out our proposals in our future consultation paper on the regime. In the meantime, we would welcome any views stakeholders may have.

Proportionality

13.21 The IFD aims to form part of a prudential regime that more appropriately reflects the business model and activities of investment firms. As the investment firms within its scope are diverse in terms of size, scope and complexity of activities, the Directive foresees that its remuneration provisions are applied in a proportionate way. This is done by providing for clearly defined exemptions and a general principle of proportionality.

Exemption for smaller non-SNI investment firms

13.22 Three of the provisions on variable remuneration, which would otherwise apply to non-SNI investment firms, do not apply to firms with average on-and off-balance sheet assets of EUR 100 million or less over the 4 years immediately before the given financial year (point (a) of paragraph 4 of Article 32). In addition, investment firms with assets below this threshold will not be required to establish a risk or remuneration committee.

13.23 The variable remuneration requirements which do not apply to these firms are those on:

- pay-out in shares or other instruments (point (j) of paragraph 1 of Article 32)
- deferral (point (l) of paragraph 1 of Article 32)
- the holding and retention periods for discretionary pension benefits when an employee leaves the investment firm (third subparagraph of paragraph 3 of Article 32)

13.24 We will refer to these requirements in this DP as the 'provisions on pay-out, deferral and pensions holding/retention periods'.

13.25 If we were to replicate this approach to exemptions, we would expect firms to consider whether it might be appropriate to apply some or all of the provisions from which they are exempt, for example if this would contribute to promoting sound and effective risk management.

13.26 Firms exempt from these 3 provisions are subject to all other remuneration requirements, including the use of ex-post risk adjustment arrangements (point (m) of paragraph 1 of Article 32). As malus cannot be applied where no deferral is used, these firms would need to use clawback where a risk crystallises after the award of the variable remuneration. Alternatively, they could choose to apply the rules on deferral to enable the use of malus.

13.27 Firms would need to recalculate annually what their average assets were over the previous 4 financial years to determine whether they may disapply the provisions on pay-out, deferral and pensions holding/retention periods in the new financial year. This would be particularly important for investment firms close to the threshold.

13.28 As remuneration policies need to be drafted and adopted before the beginning of each performance year, firms would need to perform the new calculation before the end of the preceding performance year. A firm's performance year may not necessarily correspond to the financial year.

13.29 If a firm does not have audited accounts available for the complete 4-year period immediately preceding the given financial year, we would expect the firm to use:

- its provisional, unaudited accounts for the financial year immediately preceding the given financial year

- accounts which have been finalised and approved by the management body (audited accounts) for the 3 financial years preceding that most recent financial year

13.30 We would welcome firms' views on this and any other timing issues which may arise from a requirement to include in the 4-year average the financial year immediately preceding the given financial year.

13.31 If we were to delete the IFPRU sourcebook, we would look to reproduce without amendment the definition of 'significant IFPRU firm' elsewhere in our Handbook because it applies to certain governance requirements in SYSC. We would consult in our future consultation on re-naming the term to ensure it remains relevant.

Discretion to set a different threshold

13.32 The Directive gives Member States discretion (in paragraphs 5 and 6 of Article 32) to increase or decrease the EUR 100 million threshold for individual investment firms. In both instances, it must be appropriate for the Member State to do so having regard to the nature and scope of the firm's activities, its internal organisation, and, where applicable, the characteristics of the group it belongs to.

13.33 A Member State may exercise this discretion by increasing the threshold up to a maximum of EUR 300 million where the investment firm in question satisfies all the criteria listed in paragraph 5 of Article 32. This includes the appropriateness requirement.

13.34 Currently, BIPRU firms, IFPRU limited licence firms, IFPRU limited activity firms, and full scope IFPRU investment firms with relevant total assets not exceeding £15 billion, fall into proportionality level 3. This means it may currently be appropriate for them to disapply certain remuneration rules, including those on retained shares or other instruments, and deferral.

13.35 Given the nature and scope of the activities of solo-regulated investment firms, and in the context of the overall UK market, we consider that it may be appropriate to apply a threshold of at least EUR 300 million to investment firms which satisfy all the criteria. These firms would then not be required to apply the provisions on pay-out, deferral and pensions holding/retention periods, or to establish a risk or remuneration committee.

13.36 It is possible that the internal organisation, the scope and/or nature of the main activities of some investment firms may make it appropriate to lower the threshold below EUR 100 million. If the Government gave us the power to do so, we would consider whether there may be firms for which this is appropriate. For example, we recognised in our April 2019 'Dear CEO' letter to the wholesale brokers sector that inappropriate remuneration models were a root cause of misconduct risk in this sector.

13.37 We will consult on any proposals on proportionality thresholds in our future consultation on the regime.

Exemption for individuals

13.38 The IFD does not consider it to be proportionate for all the remuneration requirements to be applied to individuals that receive variable remuneration below a certain level.

13.39 For this reason, it provides that the provisions on pay-out, deferral and pensions holding/retention periods do not apply to individuals whose annual variable remuneration is EUR 50,000 or less, and represents 25% or less of that individual's total annual remuneration (point (b) of paragraph 4 of Article 32).

13.40 We provide guidance in the IFPRU and BIPRU Remuneration Codes that we do not generally consider it necessary for firms to apply certain rules, including those on pay-out and deferral, in relation to individuals whose total remuneration is not more than £500,000 of which no more than 33% is variable remuneration. If we were to adopt the same approach as the IFD, which is based on lower thresholds than those set out in the IFPRU and BIPRU Remuneration Codes, it is likely that individuals would be brought into scope of the provisions on pay-out and deferral who do not currently apply our rules on these matters. We would welcome any feedback from firms about the likely number and type of individuals that would be affected.

13.41 The Directive permits Member States to disapply the exemption for individuals on the grounds of national specificities in remuneration practices or the responsibilities and job profile of these individuals (paragraph 7 of Article 32).

13.42 Even if given the power to do so by the Government, we would not make provisions to replicate the effect of this discretion. This is because we do not consider that applying the provisions on pay-out, deferral and pensions holding/retention periods to individuals with remuneration arrangements below the defined thresholds – which are considerably lower than those we currently apply – would substantially further the objectives of promoting effective risk management and discouraging excessive risk-taking.

13.43 We would clarify in guidance that we would expect firms to apply any annual variable remuneration threshold on a pro rata basis where an individual joins the investment firm during the performance year. For example, assuming the IFD threshold of EUR 50,000, if an individual joins the firm exactly half way through the firm's performance year, the threshold would be EUR 25,000. If the individual receives any form of guaranteed variable remuneration, for example a 'sign-on bonus', this should be treated as part of their total variable remuneration for the part-year concerned.

General proportionality principle

13.44 Our existing Remuneration Codes, including those for IFPRU and BIPRU firms, state that a firm must comply with the remuneration principles 'in a way and to the extent that is appropriate to its size, internal organisation and the nature, the scope and the complexity of its activities'. This is often referred to as the 'remuneration principles proportionality rule'.

13.45 In our General Guidance on Proportionality – The IFPRU Remuneration Code and the corresponding guidance on the BIPRU Remuneration Code, we interpret 'to the extent' as meaning that it may not be necessary for some investment firms, particularly those in proportionality level 3, to apply certain remuneration principles.

13.46 The IFD also foresees that firms can take a proportionate approach to compliance with the remuneration provisions. However, the requirement is that remuneration policies should be 'proportionate to the size, internal organisation and nature, as well as to the scope and complexity, of the activities of the investment firm' (point (a) of paragraph 1 of Article 30; see also paragraph 3 of Article 26).

13.47 In our view, the absence of the words 'to the extent' means that non-SNI investment firms may not disapply any of the remuneration principles in whole or in part on the basis of the general proportionality principle alone. Instead, proportionality is built into the IFD by designing a regime which is itself more proportionate to the risks faced and posed by the firms in its scope, and also by providing for objectively defined exemptions.

13.48 If appropriate, we would reflect the IFD wording by creating a new proportionality rule in our remuneration code for non-SNI investment firms. This would allow each firm to establish and apply a remuneration policy that reflects the risks of its activities while also complying with all the remuneration principles.

13.49 If we took this approach, we would also revoke the general guidance documents on proportionality under SYSC 19A and 19C. Much of their content would no longer be relevant. Where elements of the existing proportionality guidance may be helpful to investment firms, we would reproduce them (with any necessary amendments) in guidance provisions within the new remuneration code for non-SNI investment firms.

13.50 We would include these guidance provisions in our future consultation on the regime. We would also consult on any consequential amendments to other documents, for example our General Guidance containing Frequently asked questions on remuneration in SYSC 19A and 19D.

Remuneration principles

13.51 In this section, we summarise the remuneration principles set out in the IFD. These are intended to help investment firms establish policies and practices that contribute to discouraging risk-taking above the firm's own risk appetite and so to reducing the likelihood of harm.

Application: categories of staff

13.52 The IFD remuneration requirements apply to categories of staff whose professional activities have a material impact on the risk profile of the investment firm or of the assets that it manages (paragraph 1 of Article 30). These are often referred to as 'material risk-takers' (MRTs). They must include at least senior management, risk takers, staff engaged in control functions and any employee receiving overall remuneration equal to at least the lowest remuneration received by senior management or risk takers.

13.53 Including the assets the investment firm manages means the definition is broader than that currently used in the IFPRU and BIPRU Remuneration Codes. It is more closely aligned to the definition in our AIFM and UCITS Remuneration Codes.

13.54 We interpret the risk profile of the assets managed by an investment firm as including all aspects of the MiFID activities carried out by the firm, and not solely limited to the regulated activity of managing investments. We consider that a more limited interpretation would not meet the objective of having remuneration policies and practices that are consistent with and promote sound and effective risk management (point (d) of paragraph 1 of Article 26).

13.55 The EBA, in consultation with ESMA, is to develop draft technical standards to specify appropriate criteria by which to identify MRTs for the purposes of the IFD (paragraph 4 of Article 30). The technical standards must be broadly consistent with existing ESMA guidelines on identifying categories of staff in scope of the remuneration provisions of the UCITS Directive, AIFMD and MiFID.

13.56 The EBA has already developed technical standards in the Commission Delegated Regulation (EU) No 604/2014 on identifying material risk-takers for the purposes of CRD. It also submitted to the European Commission in June 2020 final draft technical standards under its updated mandate under CRD V. These set out quantitative and qualitative criteria to be included in firms' identification processes.

13.57 We recognise the important part played by the existing technical standards and guidelines on identifying MRTs for firms' application of remuneration regimes. We will consult as part of our CP on how firms should identify staff in scope of the new remuneration code. We would look to base our draft rules on the EBA's draft technical standards, while making any adjustments that might be appropriate to the UK market.

13.58 In any case, we would encourage investment firms to consider broader categories of roles that may have a material impact on the firm's risk profile or on the assets it manages. All types of risk involved in an employee's professional activities should be taken into account, not just those that are prudentially focused. In particular, firms should consider activities which may pose material conduct risks, for example those which may cause harm to clients because of the potential impact of the conduct on the assets the firm manages.

13.59 We consider remuneration to be a key driver of behaviour for all individuals in firms, so encourage firms to consider applying the remuneration principles on a firm-wide basis rather than limiting them to MRTs.

13.60 Firms should note that the remuneration requirements set out in SYSC 19F.1 and Article 27 of the Commission Delegated Regulation (EU) 2017/565 on organisational requirements under MiFID II (MiFID Org Regulation) will continue to apply in respect of all individuals who are directly or indirectly involved in providing investment services, such as frontline sales and broking staff. They apply regardless of whether the individual is an MRT.

13.61 In particular, a firm providing investment services to clients must ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients (SYSC 19F.1.3). Amongst other things, a firm must ensure that there is a balance between fixed and variable remuneration, and that remuneration is not solely or predominantly based on quantitative commercial criteria.

Key remuneration principles

13.62 When establishing and applying remuneration policies to MRTs, the IFD requires non-SNI investment firms to comply with a number of remuneration principles (paragraph 1 of Article 30). They cover 3 broad areas, which we outline in this section.

13.63 Where appropriate, we would replicate these principles in our new remuneration code for non-SNI investment firms, supplementing them with guidance where this would help firms understand our expectations.

Remuneration policy design

13.64 Some of the remuneration principles aim to ensure that non-SNI investment firms have remuneration policies which align risk and reward effectively. For example, policies must be consistent with, and promote, sound and effective risk management, take into account the long-term effects of investment decisions, and encourage responsible conduct and prudent risk-taking.

13.65 The IFD also requires remuneration policies and practices to be gender neutral (second subparagraph of paragraph 1 of Article 26; point (b) of paragraph 1 of Article 30). It defines a 'gender neutral remuneration policy' as one based on equal pay for male and female workers for equal work or work of equal value (point (12) of paragraph 1 of Article 3).

13.66 The Equality Act 2010 already applies the principle of equal pay for equal work or work of equal value to employers in the UK. The Act covers individuals in the same employment, and includes equality in pay and all other contractual terms, for example variable remuneration. It also prohibits discrimination in employment on the basis of any protected characteristic.

13.67 The IFD requirement also applies to subsidiaries established in third countries. The exception is where parent entities consider that applying this requirement is unlawful under the laws of the third country, and have been granted an exemption by their competent authority (see above section on application to subsidiaries established in third countries).

Governance of remuneration policies, including remuneration committees

13.68 Further remuneration principles concern the governance of the way firms adopt and review their remuneration policies. In particular, a remuneration committee must be established by non-SNI investment firms with average on-and off-balance sheet assets of over EUR 100 million over the 4 years immediately preceding the given financial year. Article 33 of the IFD sets out the role and responsibilities of remuneration committees.

13.69 The IFD does not provide for the possibility for the national competent authority to waive this requirement in the way allowed under CRD. The remuneration committee may, however, be established at group level (paragraph 1 of Article 33). In this context, 'group' refers not to the prudential consolidation group but to a parent undertaking and its subsidiaries (point (13) of paragraph 1 of Article 3 of the IFD).

13.70 We interpret the IFD as meaning that the modified threshold set out in paragraphs 5 and 6 of Article 32 of the IFD should also be applied for the purposes of the requirement to establish a remuneration committee. So, if we were to increase the threshold to EUR 300 million in respect of a particular investment firm, that firm would only need to establish a remuneration committee at individual or group level if its average on-and off-balance sheet assets over the preceding 4 years exceed EUR 300 million.

13.71 A new requirement is that remuneration committees must 'be gender balanced' (paragraph 1 of Article 33). However, the IFD does not define the concept of gender balance. We take the view that it requires firms to promote a culture of inclusion and ensure appropriate representation rather than prescribing equal representation on the remuneration committee.

13.72 If we were to incorporate this requirement into our new remuneration code, one way to comply with it might be for an investment firm to decide on a target for the level of representation of an underrepresented gender on the remuneration committee, and to establish a policy on how to meet that target. In that case, we would expect firms to be able to demonstrate to us, if asked, why they have chosen any particular composition or target, and to be able to justify why that particular gender balance is appropriate.

Fixed and variable remuneration

13.73 Other IFD remuneration principles cover the distinction and relationship between types of remuneration. In particular, a non-SNI investment firm's remuneration policy must:

- make a clear distinction between the criteria used to determine basic fixed remuneration on the one hand, and variable remuneration on the other (point (j) of paragraph 1 of Article 30 of the IFD), and
- set an appropriate ratio between variable and fixed remuneration (paragraph 2 of Article 30 of the IFD)

13.74 This means that while no maximum ratio ('bonus cap') is set, each non-SNI investment firm must set an appropriate ratio. When doing this, the IFD requires them to take into account the firm's business activities and associated risks, and the impact that different categories of MRTs have on the firm's risk profile.

13.75 We interpret this to mean that different ratios can, and where appropriate should, be set for different categories of staff. For this reason, we do not think it would be appropriate to provide further guidance on what constitutes an 'appropriate ratio'.

13.76 The IFD also requires that the fixed component represents a 'sufficiently high proportion' of the total remuneration to enable the operation of a fully flexible policy on variable remuneration. This must include the possibility of paying no variable remuneration in any given year (point (k) of paragraph 1 of Article 30).

13.77 Setting an appropriate ratio between variable and fixed components allows firms to reward good performance whilst also discouraging excessive risk-taking that may affect the investment firm, its clients and/or the wider financial market.

Variable remuneration

13.78 In this section, we explain in more detail the IFD's specific requirements for the structure of variable remuneration. If we incorporated these requirements into our new remuneration code, they would apply to the categories of staff identified as MRTs in non-SNI investment firms.

Assessment of performance

13.79 Variable remuneration is usually determined by performance. We consider other types of variable remuneration in the section 'Non-performance-related variable remuneration' below.

13.80 Point (a) of paragraph 1 of Article 32 of the IFD requires the total amount of performance-related variable remuneration to be based on a combination of the assessment of the performance of the individual, of the relevant business unit and the firm's overall results. This ensures that the individual's interests are aligned with those of their business unit and the firm as a whole. If we made provisions based on those in the IFD, we would not propose to prescribe the weighting of each of these components, as the appropriate combination will vary depending on the individual's role and responsibilities.

13.81 When a firm assesses an individual's performance, it must include both financial and non-financial criteria (point (b) of paragraph 1 of Article 32 of the IFD). We would clarify in guidance that a 50/50 split between financial and non-financial criteria will be appropriate for some investment firms, while a different split may better suit others. Each investment firm should be able to explain why it believes a particular split is appropriate.

13.82 We would not want to prescribe the criteria as it is more appropriate for each firm to decide on the most relevant metrics. They may differ between employees within a firm, for example depending on role and objectives.

13.83 We recognise that firms may experience challenges in identifying appropriate non-financial factors. In line with our approach under the Remuneration Code for investment firms in scope of CRD IV (SYSC 19A), we would likely provide guidance around our expectations. These include that non-financial performance criteria should:

- form a significant part of the performance assessment process and should, where appropriate, override financial criteria
- include metrics on conduct, which should make up a substantial portion of the non-financial criteria
- also include how far the individual adheres to effective risk management and complies with relevant regulatory requirements

13.84 Examples we have seen of non-financial criteria to measure an individual's performance include measures relating to positive customer relationships and outcomes, such as acting in the best interests of clients, and performance in line with firm values, ethics and culture.

Risk adjustment

13.85 Risk adjustment is an important element of measuring performance, which we would include in our new remuneration regime. When measuring performance to calculate pools of variable remuneration, the Directive (point (h) of paragraph 1 of Article 32) requires a firm to take into account all types of current and future risks as well as the cost of the capital and liquidity required. All types of current and future risks should also be considered when allocating the variable remuneration components within the firm (point (i) of paragraph 1 of Article 32 of the IFD).

13.86 In our future consultation on the regime, we intend to consult on guidance on these requirements to clarify our expectations of firms. For example, we interpret 'all types' as including both financial and non-financial risks such as reputation, conduct and client outcomes.

13.87 We do not consider it is appropriate to prescribe the process which firms should follow when risk-adjusting their bonus pools. However, we would expect a firm to be able to provide information about the adjustments it has made, including clear explanations of how they quantified them.

Pay-out in shares or other instruments

13.88 To better align the interests of individuals with the interests of the investment firm and its clients, the Directive requires that at least 50% of an individual's remuneration be paid in shares or other non-cash instruments (point (j) of paragraph 1 of Article 32). To reflect the diverse legal structures of investment firms, different types of instruments may be used:

- shares (or equivalent ownership interests)
- share-linked instruments (or equivalent non-cash instruments)
- instruments which can be fully converted to Common Equity Tier 1 instruments, or written down, and adequately reflect the firm's credit quality
- non-cash instruments which reflect the instruments of the portfolios managed

Discretion to restrict or prohibit the use of certain instruments

13.89 The Directive gives both Member States and competent authorities discretion to prohibit the use of certain instruments or to restrict the types and designs of those used for variable remuneration (first subparagraph of paragraph 3 of Article 32). We would not make rules to replicate the effect of this discretion. We do not want to limit the options available to investment firms that cannot make use of more common types of instrument. We have not used a comparable discretion in CRD, and have no evidence of harm arising as a result.

Discretion to permit alternative arrangements

13.90 Some investment firms do not issue any instruments which could be used in variable remuneration. In these cases, the Directive allows Member States to permit these firms (and only these firms) to use 'alternative arrangements' (point (k) of paragraph 1 of Article 32).

13.91 We anticipate that there are a number of UK non-SNI investment firms which do not issue instruments of the types listed above. We do not consider it would be proportionate to require them to issue instruments purely for use in variable remuneration. If given the power to do so by the Government, we would make provisions to replicate the effect of this discretion.

13.92 We could do this by requiring an investment firm that wants to use alternative arrangements to apply for a modification of the rule on paying out in shares or other non-cash instruments. This would require a firm to show how its proposed arrangements would effectively align the interests of staff with other stakeholders' longer-term interests, and help to align variable remuneration with the risk profile of the firm. We do not foresee being able to approve any alternative arrangement that would prevent or hinder a firm from complying with other applicable remuneration requirements such as deferral, retention, malus and clawback.

13.93 Paragraph 8 of Article 32 of the IFD requires the EBA, in consultation with ESMA, to develop draft technical standards which specify the classes of instruments that fall within the third bullet point of paragraph 13.88 above, and possible 'alternative arrangements'.

13.94 We will consult on the details of our proposed approach to classes of instruments and alternative arrangements in our later consultation paper on the regime. We would look to base our approach on the EBA's draft technical standards, while making any adjustments which might be appropriate to the UK market.

Retention

13.95 All instruments issued for variable remuneration must be subject to an appropriate retention policy (first subparagraph of paragraph 3 of Article 32 of the IFD). This means that they must be retained by the individual for an appropriate period of time after the date on which they vest. They may not be sold or accessed during the retention period.

13.96 We do not think it would be appropriate for us to specify a minimum or standard retention period because an 'appropriate' period may vary depending on other factors. This might include the length of the deferral period, the length of the business cycle, and how long it could take for the risks underlying the performance to crystallise.

Deferral

13.97 When variable remuneration is deferred, the employee does not gain legal ownership of the award until it vests. The length of time until the whole award has vested is known as the deferral period. This enables the firm to adjust some or all of the variable remuneration during the deferral period to reflect risk outcomes which had not yet materialised when the remuneration was awarded.

13.98 The Directive provides that:

- at least 40% of the variable remuneration awarded to an individual must be deferred for 3 to 5 years (point (l) of paragraph 1 of Article 32)
- where the variable remuneration is 'a particularly high amount' then at least 60% must be deferred (also point (l) of paragraph 1 of Article 32)
- the deferred variable remuneration must not vest faster than on a pro-rata basis, for example, if £60,000 is deferred over 3 years then no more than £20,000 may vest after each year (second subparagraph of paragraph 3 of Article 32)

13.99 Within these boundaries, an investment firm subject to the deferral provision must decide what proportion of variable remuneration awarded to an individual to defer and how long the deferral period should be. When making these decisions, the Directive requires firms to take into account the nature of the business, the business risks, and the activities of the individual. Investment firms must also decide at what speed the remuneration should vest.

13.100 As well as including these deferral requirements in our new remuneration code for non-SNI investment firms, we would provide some guidance around our expectations of firms. We provide an overview of the key points below.

Proportion and length of deferral period

13.101 It will usually be appropriate for an investment firm to have a firm- or group-wide policy on deferral. The higher the amount of the variable remuneration, and the higher the ratio of variable remuneration to fixed remuneration, the more appropriate it is likely to be to defer a greater proportion of the variable remuneration. We would expect a firm's deferral policy to reflect this.

13.102 Investment firms must defer both cash and non-cash variable remuneration. It may be appropriate for them to set different deferral proportions and/or periods, so long as these are within the boundaries set.

'A particularly high amount'

13.103 The IFD does not provide a figure above which variable remuneration is to be considered 'a particularly high amount'. We could set the amount at £500,000, as is presently the case under our rules transposing CRD. We would welcome stakeholders' thoughts on this.

13.104 Setting a threshold would not necessarily mean that only variable remuneration above that figure is 'a particularly high amount'. It may be appropriate in certain circumstances for amounts below the threshold to also be considered 'particularly high'.

Partnerships and limited liability partnerships

13.105 Under partnership tax rules, partners of partnerships or members of a limited liability partnership (LLP) are taxed on all their profit shares in the year the profits arise. This may result in a tax charge for the partner or member in respect of variable remuneration which is deferred. This tax charge would be payable even if the deferred remuneration will not vest until after the year in which the tax was paid.

13.106 We understand that specific tax provisions exist for deferred variable remuneration and partnerships which are AIFM firms. We will keep HM Treasury and HM Revenue & Customs, who are responsible for taxation policy, informed as our policy work on deferral progresses.

13.107 We would be grateful for stakeholders' views on whether the remuneration requirements of the IFD create any other issues specific to partnerships and LLPs.

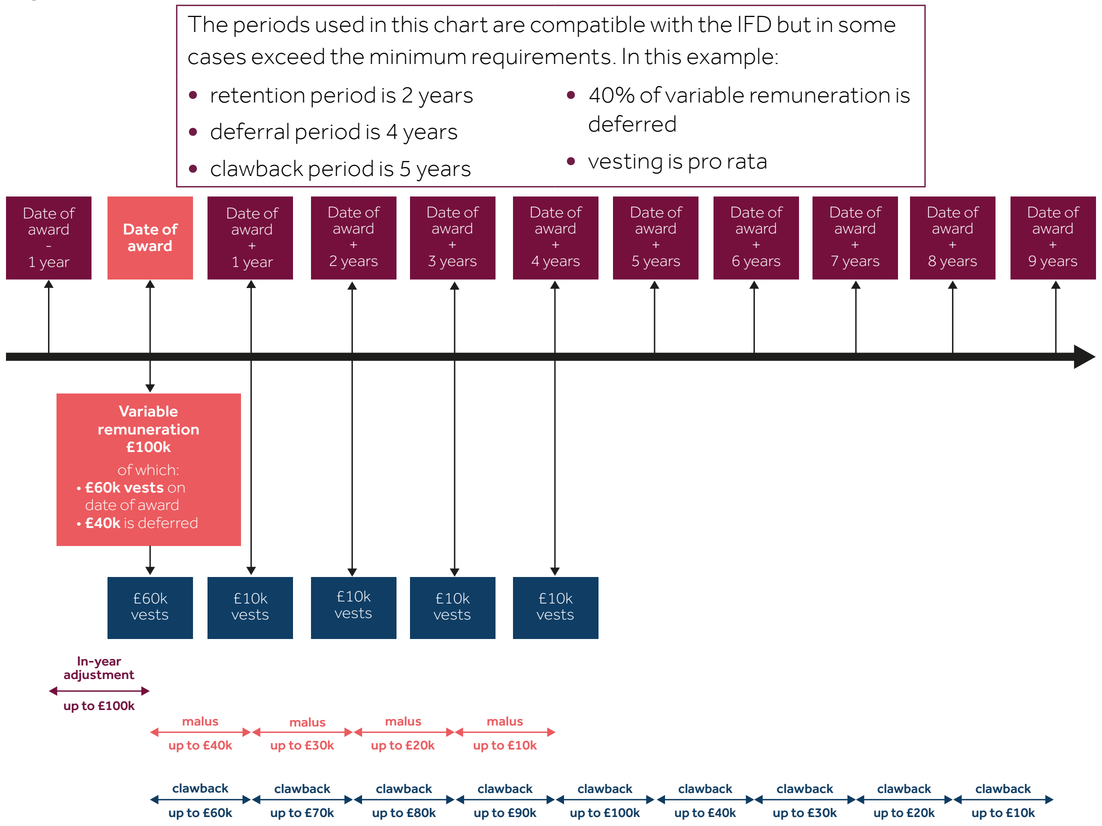
Ex-post risk adjustment

13.108 Ex-post risk adjustment refers to the adjustment of variable remuneration to take account of a specific crystallised risk or adverse performance outcome, including those relating to misconduct. This enables adjustments to be made throughout the performance year and beyond.

13.109 There are 3 key ex-post risk adjustment mechanisms, each covering a different period:

- **In-year adjustments** are made when a firm reduces the value of an award during the current performance year, before it has been awarded.
- **Malus** involves reducing or cancelling a variable remuneration award after it has been made but before it has vested, for example during the deferral period.
- **Clawback** is used to make an adjustment after the variable remuneration has vested, so requires the individual to give back remuneration received – the firm is 'clawing it back'.

Figure 13.1: Example of ex-post risk adjustment mechanisms



13.110 The IFD requires all investment firms in scope of the provisions on pay-out, deferral and pensions holding/retention periods to reduce an individual's variable remuneration by up to 100% when the financial performance of the firm is subdued or negative (point (m) of paragraph 1 of Article 32).

13.111 Our interpretation of a 100% reduction in variable remuneration is that firms should ensure they can reduce or cancel cash awards, the number or value of shares and also other non-cash instruments.

13.112 The Directive also requires firms to make both malus and clawback available. It is for each investment firm to determine the criteria for when these would apply, for example how and when they will use malus and clawback. The IFD specifies that the criteria should include situations in which the individual participated in or was responsible for conduct which resulted in significant losses for the firm, and is no longer considered fit and proper.

13.113 Including this high-level requirement in our provisions would give firms considerable discretion to develop appropriate ex-post risk adjustment policies for the types of risk the firm is exposed to or might pose to others. However, we recognise that some firms, especially those currently without malus or clawback policies, may welcome some further indication of what this involves. We intend to consult on guidance for firms around our expectations on malus and clawback as part of our future consultation on the regime.

13.114 We envisage that our guidance would cover at least the following areas

- criteria for application of malus and clawback

- direct and indirect participation in misconduct
- application of ex post risk adjustment to individuals, groups of staff and bonus pools
- factors for deciding by how much to reduce the variable remuneration
- time period for application of malus and clawback
- effective, timely, consistent and transparent use of malus and clawback policies

Non-performance-related variable remuneration

13.115 The IFD also covers types of variable remuneration which are not directly linked to performance:

- **Guaranteed variable remuneration** ('sign-on bonuses') and retention awards (Article 32(1)(e))
- **Buy-out awards**, when a firm buys out the remaining variable remuneration from a new employee's previous employer (Article 32(1)(g))
- **Early termination** ('severance pay') of an employment contract (Article 32(1)(f))

13.116 Similar provisions are already contained in the IFPRU Remuneration Code and remain relevant in the UK market. We would likely include requirements on these 3 types of variable remuneration in our new remuneration code for non-SNI investment firms, and clarify our expectations of firms in accompanying guidance. We would consult on these as part of our future consultation on the regime.

Other remuneration requirements

13.117 We consider it would also be appropriate to include provisions in our new remuneration code which cover the same topics as the remaining IFD remuneration requirements.

13.118 We would draw firms' attention in particular to the following topics:

- **Capital base:** A firm's variable remuneration costs must not affect its ability to ensure a sound capital base capital base (Article 32(1)(d)).
- **Bail-outs:** A firm which receives extraordinary public financial support must not pay any variable remuneration to members of its management body (Article 31).
- **Discretionary pension benefits:** These must be in line with the firm's business strategy, objectives, values and long-term interests (Article 32(1)(n)).
- **Circumvention and non-compliance:** Firms and individuals must not undermine or circumvent the remuneration rules, for example by using personal hedging strategies or paying variable remuneration by methods which facilitate non-compliance (Article 32(2)).

Reporting requirements

13.119 To enable effective oversight of non-SNI investment firms' remuneration policies and practices, the IFD requires competent authorities to collect certain information from firms (Article 34):

- The quantitative information on the remuneration of senior management and MRTs that investment firms must publicly disclose under Article 51, first subparagraph, points (c) and (d) of the IFR. This includes the information firms must disclose on aspects related to the gender pay gap.

- Information on the number of individuals in the firm that are remunerated EUR 1 million or more per financial year, along with details of their job responsibilities, the business area involved and the main elements of salary, bonus, long-term award and pension contribution.

13.120 We are considering whether to collect this information by requiring firms to complete templates with the relevant data. We could use a format similar to our existing Remuneration Benchmarking Report and High Earners Report. We will consult on the details of any reporting requirements in our future consultation on the regime.

13.121 The IFD allows competent authorities to request from time to time that non-SNI investment firms provide the total remuneration figures for members of the management body or senior management who are remunerated EUR 1 million or more per financial year. We could collect any such data in line with our supervisory processes.

Q20: **What are your views on the scope and application of a new remuneration code? (See paragraphs 13.7 to 13.18)**

Q21: **Do you think it would be appropriate for us to include in a new remuneration code a general proportionality rule similar to that contained in the IFD? (See paragraphs 13.44 to 13.50)**

Q22: **Do you agree with our interpretation of gender-balanced remuneration committee? Do you think it would be appropriate for us to include it as a requirement in a new remuneration code? (See paragraphs 13.71 to 13.72)**

Q23: **Do you agree it would be appropriate for us to include in a new remuneration code rules and guidance on retention, deferral and ex-post risk adjustment? (See paragraphs 13.95 to 13.116)**

See also Chapter 18 for questions on the specific options and discretions for remuneration.

14 Environmental, social & governance (ESG) issues

Overview

- Another new feature of the IFD/IFR compared to the existing regime are new requirements on investment firms for environmental, social & governance (ESG) issues.
- For now, these are limited to disclosure requirements for larger non-SNIs. However, the EBA is mandated to report on ESG risks and may recommend further requirements in this area.

What this chapter covers

14.1 In this chapter, we summarise the new ESG requirements and expectation on investment firms.

Summary of the requirements

14.2 The EBA will investigate whether any ESG-specific adjustments to the K-factors or their coefficients should be developed in future to ensure the appropriate prudential treatment of ESG-exposed assets. They will submit a report on this to the European Parliament, Council and Commission by 26 December 2021 and, depending on their findings, may introduce further legislation (Article 34 of the IFR).

14.3 The EBA is also required to report and develop, if appropriate, guidelines to introduce criteria related to ESG risks for the SREP (Article 35 of the IFD).

14.4 From 26 December 2022, certain investment firms subject to the IFD will need to disclose information on ESG-related risks, physical risks and transition risks every 6 months (Article 53 of the IFR). This requirement applies to firms which do not meet the criteria in paragraph 4 of Article 32 of the IFD. That is, investment firms whose 4-year average value of their on- and off-balance sheet assets is more than EUR 100 million for the period immediately before the relevant financial year. The intention is that disclosing these risks will help the market to price assets appropriately and make informed decisions.

14.5 To enable the market to work well in the UK, we would want to ensure that all firms integrate consideration of ESG-related risks and opportunities into the business, investment and risk decisions they make, particularly over the long term where appropriate. If firms do this effectively it will help them support the transition to a net-zero emissions economy and promote greater trust in the market. This is strongly aligned with our operational objective to protect and enhance the integrity of the UK financial system.

14.6 All investment firms in the UK are encouraged to consider material ESG-related risks when calculating their capital and liquidity requirements. For example, there may be a risk that assets become illiquid or of minimal value. In these cases, we may consider imposing additional individual requirements on firms if we do not think they have adequately considered these risks. In the EU the EBA will prepare a report on the introduction of technical criteria for ESG exposures to use as part of the supervisory review and evaluation process. These criteria will include impact metrics and a definition of ESG risks. They will submit their findings to the European Parliament, Council and Commission by 26 December 2021. Based on their findings, we may consider introducing our own guidelines for integrating ESG into the supervisory review process.

15 Public disclosure

Overview

- Similar to changes to reporting requirements, the IFR introduces a public disclosure regime that we believe better reflects the business model and potential risk of harm posed by investment firms than the CRR regime.
- It applies a proportionate approach by only setting minimum requirement for SNIs, requiring disclosure only where they have issued AT1 instruments and this disclosure can help investment decisions.
- The regime introduces new disclosure requirements around remuneration and ESG, in line with new requirements and expectations for investment firms in these areas.
- We support public disclosure as a way to allow third parties, whether investors in the firm, counterparties or clients, to monitor and compare the risks that investment firms take. It supports good corporate governance and also allows investors and counterparties to make more accurate company valuations.
- In our view, the benefit of disclosure is greatest when it applies to an investment firm that deals on its own account or issues securities that could be negatively affected by the way it manages its risks. The disclosure allows risks to be clearly conveyed to investors.

What is covered in this chapter?

15.1 In this chapter, we cover:

- the IFR disclosure requirements, by requirement type
- the expected means and frequency of disclosure

IFR disclosure requirements

15.2 The new disclosure requirements are in Part Six of the IFR – Articles 46-53. Generally, these requirements only apply to non SNI investment firms although, as previously mentioned, SNIs that issue AT1 do have some disclosure requirements.

Figure 15.1 – summary of the disclosure requirements for SNIs and non-SNIs

Article number of disclosure requirement	SNIs that have issued AT1	Non-SNIs
47 – Risk management objectives	√	√
48 – Governance		√
49 – Own funds	√	√
50 – Own funds requirement	√	√
51 – Remuneration policy and practices		√
52 – Investment policy		√[1]
53 – Environmental, social and governance risks		√[2]

[1] see paragraph 15.13 below
[2] see paragraph 15.14 below

15.3 The IFD contains 2 exceptions to this disclosure requirement. In both cases these can only be used by investment firms that make use of specific derogation on the remuneration requirements set out in Article 32 of the IFD, and covered in Chapter 13 on Remuneration. The relevant derogation and exceptions are as follows:

Figure 15.2 – Derogations to the disclosure requirements

Remuneration derogation used	Disclosure exception permitted
Point (a) of paragraph (4) of Article 32 of IFD	Investment policy (Art 52 of IFR)
	Information on environment, social and governance (ESG) risks (Art 53 of IFR)

Article 47 – Risk management objectives

15.4 The investment firm should set out risk management objectives and policies for each separate category of risk in the IFR. This will include a summary of strategies and processes to manage these risks and a statement describing the investment firm's overall risk profile from the business strategy.

Article 48 – Governance

15.5 The investment firm should set out information on internal governance arrangements:

- directorships held by the management body;
- diversity policy when choosing members of the management body, and
- if a risk committee has been set up, and the number of times it has met during the year

Article 49 – Own funds

15.6 The investment firm should provide a reconciliation of each of the tiers of capital along with the applicable filters and deductions it applied to its own funds and the balance sheet in its audited financial statements.

15.7 It should also provide a description of the main features of the own funds capital instruments it has issued and of the restrictions applied to the calculation of own funds.

Article 50 – Own funds requirement

15.8 The investment firm should set out a summary of its approach to the ICARA process. If requested by the competent authority, it should also disclose the result of its ICARA process, including the composition of any additional own funds requirement set as a result of the SREP.

15.9 The investment firm should also disclose its KFR, in aggregate form for RtC, RtM, and RtF, based on the sum of the applicable K-factors, together with its FOR.

Article 51 – Remuneration policy and practices

15.10 The investment firm should provide information on the most important design characteristics of its remuneration policy and practices, including:

- the level of variable remuneration and the criteria for awarding it
- the ratio between fixed and variable remuneration
- the gender pay gap

15.11 It is also required to disclose aggregated quantitative information on the amounts of various types and forms of variable remuneration that have been awarded to MRTs.

15.12 The investment firm should also include information on whether it benefits from either, or both, of the derogations for remuneration set out in paragraph 4 of Article 32 of the IFD.

Article 52 – Investment policy

15.13 The investment firm should provide information on voting rights and voting behaviour for shares that it holds directly or indirectly, where these shares are traded on a regulated market. This does not apply to investment firms that benefit from the derogation for remuneration set out in point (a) paragraph (4) of Article 32 IFD.

Article 53 – Environmental, social, governance related risks (“ESG”)

15.14 The investment firm should disclose its ESG risks from December 2022 onwards. This does not apply to investment firms that benefit from the derogation for remuneration set out in paragraph (4) of Article 32 IFD.

15.15 Further information on ESG reporting is set out in Chapter 14.

Means and frequency of disclosure

15.16 All investment firms with public disclosure requirements (all non-SNIs as well as any SNI that has issued AT1) are expected to publish them on the same date as they publish their annual financial statements. The exception is the ESG disclosure which needs to be reported twice a year after the first year.

15.17 As stated in Article 46 IFR, it is up to individual investment firms to determine the appropriate medium and location for their disclosures. As far as possible, all of an investment firm’s disclosures should be in the same medium and at the same location. If the information is provided in more than one medium, each medium should include a reference to the others.

16 Waivers and CRR permissions

Overview

- If we adopt an approach similar to the IFD/IFR, investment firms would no longer have to comply with the vast majority of existing prudential rules in our current prudential sourcebooks. This means that any existing waivers from these rules would also cease to apply.
- In general, we expect there will be less need for waivers under the new regime as it is designed with the business model of investment firms in mind.

What this chapter covers

16.1 In this chapter, we cover what the proposed new prudential regime would mean for existing waivers and modifications to prudential rules in the FCA Handbook that investment firms currently hold. We also cover the implications for current CRR permissions granted for prudential provisions that apply directly according to regulations.

16.2 In this chapter, we refer to rule waivers and modifications jointly as 'waivers'.

Existing waivers

16.3 Apart from some provisions in the CRR to which the IFR makes specific references, both the CRD and the CRR will no longer apply to investment firms. This means any relevant CRR permissions or rule waivers would also generally no longer apply.

16.4 However, if the requirements which no longer apply are replaced by requirements in the IFR that are materially the same and we decide to replicate these in our rules, we would expect an equivalent or similar permission or waiver to be possible. Figure 16.1 sets out the permission we have granted under the current regime for rules that are replaced by requirements under the new regime that we believe are materially unchanged in the IFR.

Figure 16.1 – CRR permissions that are materially unchanged in the IFR

Permission	Current CRR Article/ FCA Handbook rule (if applicable)	IFR Article and treatment
Permission to fully or partially exempt certain intra-group exposures from the limit to large exposures	CRR Art. 400(2)(c) as implemented by IFPRU 8.2.4R–8.2.7R (Intra-group exposures: non-core large exposures group)	Art. 41(2)(b) This competent authority discretion in IFR to exempt intra-group exposures from application of limits and calculation of the K-CON under concentration risk is materially unchanged from the existing discretion for exempting intra-group large exposures under the CRR. Existing permissions would therefore be substituted with a corresponding IFR permission. Please refer to Chapter 18 on Competent authority discretions.

CRR Permissions and waivers that continue to be in effect

16.5 Parts of the IFR cross-refer to certain CRR rules – in particular those relating to own funds (although with some differences spelt out in the IFR, for which see Chapter 4 on Capital and own funds) and market risk.

16.6 Figure 16.2 sets out the existing CRR-based permissions which we believe will continue to apply under the IFR. If we adopted rules reflecting these provisions in the IFR we would expect that firms currently holding these permissions would not be required to take any action.

Figure 16.2 – Existing CRR-based permissions that will continue under the IFR

Permission/waiver	CRR Article	IFR Article
Permission to include interim or year-end profits in CET1 capital	Article 26(2)	Article 9(1) CET 1 capital is defined in accordance with Chapter 2 of Title 1 of Part Two of CRR.
Permission to classify capital instruments issued by a firm as CET1 capital instruments	Article 26(3)	Article 9(1) CET 1 capital is defined in accordance with Chapter 2 of Title 1 of Part Two of CRR.
Permission to reduce own funds	Articles 77 & 78	Article 9(3) Relevant provisions set out in Chapter 6 of Title I in Part Two of CRR continue to apply.
Permission to calculate delta using an appropriate model for options and warrants on: **a.** interest rates; **b.** debt instruments; **c.** equities; **d.** equity indices; **e.** financial futures; **f.** swaps; and **g.** foreign currencies	Article 329	Article 22(1)(a) Relevant provisions set out in Chapters 2, 3 and 4 of Title IV of Part Three of CRR continue to apply.

Permission/waiver	CRR Article	IFR Article
Permission to calculate delta using an appropriate model for commodities risk for options and warrants on: • commodities; and • commodities derivatives	Article 358(3)	Article 22(1)(a) Relevant provisions set out in Chapters 2, 3 and 4 of Title IV of Part Three of CRR continue to apply.
Permission for the use of an interest rate sensitivity pre-processing model	Articles 331	Article 22(1)(a) Relevant provisions set out in Chapters 2, 3 and 4 of Title IV of Part Three of CRR continue to apply.

16.7 Currently, only investment firms under IFPRU are subject to the requirement under Article 26 of the CRR to get regulatory permission to classify capital instruments issued by them as CET1 capital instruments and to include interim or unaudited year-end profits in CET1 capital. Under the IFR all EU investment firms will be subject to this requirement and so will have to get the relevant regulatory permission.

Investment firm consolidation waivers

16.8 If we adopted rules reflecting the relevant provisions in the IFR, permissions granted under Article 15 of the CRR, and investment firm consolidation waivers granted under BIPRU Chapter 8, would no longer have effect because the existing provisions would cease to apply. Article 8 of the IFR deals with permission to use the GCT as an alternative to prudential consolidation. But it is different technically and has conditions that we consider are more prudent than those required under the existing regime. So any investment firms that currently hold permissions granted under Article 15 of the CRR, or consolidation waivers under BIPRU Chapter 8, that would otherwise run beyond the date on which a new regime would come into force, would need to seek a new permission under any rules reflecting the effect of Article 8 of the IFR, provided they can satisfy the new requirements on application. (Please see Chapter 8 on the Group capital test).

Waivers of large exposure limits

16.9 Under the existing regime, Article 396 of the CRR gives us the discretion to grant waivers that allow firms to exceed large exposure limits under certain circumstances and for a limited period of time for the firm to bring itself into compliance with the limit.

16.10 The IFR offers a similar option for limits in terms of the size of concentration risk. As concentration risk under IFR operates differently to large exposures under the CRR, the purpose of the limits under both regimes are not directly comparable.

16.11 There is no longer a need for approval to exceed the 25% exposure threshold, because this is no longer a 'hard' limit on non-trading book exposures. Rather, the 25% is only a 'soft limit' and only applies to trading book exposures. When a trading book exposure exceeds this threshold, it will be subject to an additional own funds requirement for concentration risk, known as the 'K-CON'.

16.12 The relevant exposure limits for which firms need permission are set out in paragraph 3 of Article 37 of the IFR, the 500% (for any counterparty) and 600% (in aggregate) of the investment firm's own funds. Whereas paragraph 2 of Article 38 of the IFR provides for investment firms to apply to the competent authority for a limited period of time in which to comply with these limits should they breach them.

16.13 Please see Chapter 9 on Concentration risk for more information.

Liquidity waivers

16.14 The IFR makes significant changes to the liquidity regime for investment firms. If we adopt rules reflecting the effect of the relevant provisions, they would replace the existing domestic regime under BIPRU 12. BIPRU 12 only captures certain types of investment firms, with a simplified liquid asset requirement capturing all investment firms.

16.15 As BIPRU is expected to cease to exist to implement a new regime, any waivers for liquidity requirements under the existing regime would cease.

16.16 The new liquidity regime requires firms to hold an amount of liquid assets equivalent to one month's worth of the amount of its fixed overheads requirement (FOR). We believe it is reasonable to expect all investment firms to be able to meet this minimum requirement. Therefore, while paragraph 1 of Article 43 of the IFR gives the competent authority a discretion to waive this requirement for SNIs, we would not expect to do this domestically in any but the most exceptional cases.

16.17 Please see Chapter 10 on Liquidity to find out more about the new liquidity regime under the IFR and Chapter 18 on Competent authority discretions to see how we would intend to approach the use of discretions.

Permission to apply zero risk-weighting for intra-group exposures

16.18 Under the existing regime we have granted waivers under paragraph 6 of Article 113 of the CRR and BIPRU 3.2.25R. These permit firms to benefit from applying zero risk weighting to intra-group exposures when calculating risk weighted exposure amounts for the purpose of credit risk capital requirements. The IFR does not make use of risk weights nor requires credit risk calculations.

16.19 Paragraph 3 of Article 25 of the IFR does allow firms to exclude intra-group transactions from the calculation of the K-TCD for trading counterparty default. However, the exemptions are not directly comparable.

16.20 Investment firms that want to take advantage of this option under Paragraph 3 of Article 25 of the IFR will need to seek prior approval of the competent authority to do so and must meet the conditions set out in that article. For more information please see the section of Chapter 6 on the K-factors that explains K-TCD.

Q24: **Do you agree with the list of existing CRR-based permissions that we have identified as continuing under the IFR? (See Figure 16.2 in paragraph 16.6)?**

17 Collective portfolio management investment firms

Overview

- Collective portfolio management firms (CPMs) are authorised under the Alternative Investment Fund Management Directive (AIFMD) as a full-scope alternative investment fund manager (AIFM), or under the Undertakings in Collective Investment in Transferable Securities Directive (UCITS) as a UCITS management firm.
- These firms may also be permitted to undertake discretionary client-by-client portfolio management (including pension funds), and provide the services of:
  - investment advice
  - safe-keeping and administration in relation to shares or units of collective investment undertakings; and
  - reception and transmission of orders in relation to financial instruments (AIFMD only).
- Where a CPM is permitted to do so, we then currently describe it as a collective portfolio management investment firm (CPMI) for the purposes of our rulebook. Although the above investment services, which would otherwise require authorisation under MiFID ('MiFID business'), can only be carried out in addition to the firm's collective portfolio management business, none of the prudential requirements set out in AIFMD and UCITS cover this additional business.
- In considering our approach to these firms for a domestic regime, our view is that the potential for harm is the same for these additional services regardless of who is carrying them out. This means that the treatment should also be the same. This is consistent with our current approach. It also supports the aims of the FCA Mission as well as our consumer protection and market integrity objectives.

What this chapter covers

17.1 In this chapter, we cover:

- the current prudential treatment of 'Collective Portfolio Management Investment Firms' (CPMIs)
- how we would intend to treat CPMIs once a new domestic prudential regime is in place for MiFID investment firms

Current treatment of CPMIs

17.2 CPMI firms are those defined as such in the glossary of the FCA Handbook and must meet the requirements of Chapter 11 of the Interim Prudential Sourcebook for Investment Firms (IPRU-INV).

17.3 CPMIs can undertake certain investment services that would otherwise require authorisation under MiFID, including individual portfolio management, in addition to their collective portfolio management business. We currently apply the same prudential requirements, based on CRR and CRD, to CPMIs as we do to any MiFID investment firm carrying out the same 'MiFID business'.

17.4 These requirements are in addition to the prudential requirements the investment firm is subject to for its AIFMD/UCITS business.

Intended future treatment of CPMIs

17.5 The requirements in IFD and IFR will replace those in CRD and CRR for investment firms. Our view is that CPMIs should be subject to the same prudential requirements for their additional 'MiFID business' as a MiFID investment firm would be for its MiFID business.

17.6 This means that a CPMI could be treated the same under our proposed rules as either an SNI or a non-SNI investment firm, depending on whether it meets the relevant conditions for being an SNI when applied to its 'MiFID business'.

17.7 Therefore, if the K-factor for assets under (discretionary and non-discretionary) management (K-AUM) applies (see Chapter 6 on K-factors) there would be no limit on the ultimate amount of the requirement. This is different to the similar capital requirement based upon the collective management of assets under the AIFMD.

17.8 We would also intend to use the same definition of own funds as we would for investment firms to specify the composition and quality of capital that CPMIs hold for their 'MiFID business'.

17.9 Having the same treatment for these activities also means that there is no competitive advantage for an investment firm that is not authorised under MiFID as opposed to one that is. There is also less incentive for any regulatory arbitrage.

17.10 In our view, the requirements of the IFD and IFR are more appropriate for the 'MiFID business' CPMIs undertake and the risks they pose than the requirements of the CRD and CRR that currently apply to them. They should also be more straightforward to apply.

Q25: Do you agree with our intended future treatment of CPMIs?

18 Competent authority discretions

Overview

18.1 The IFD and the IFR include 41 individual competent authority options and discretions, together referred to as 'discretions' in this paper. In this chapter we explore how we could be minded in a domestic regime to introduce provisions reflecting the exercise of those discretions in a way that introduces a simple and more proportionate regime, balanced with a sufficiently prudent approach that aligns with our operational and statutory objectives, and reflective of the nature and specifics of the UK's market.

What this chapter covers

18.2 We cover in some detail those discretions which we consider to be of key importance, in the following areas:

- the ongoing application of the CRD/CRR to investment firms
- the approach for SNIs
- technical discretions relating to K-factor requirements and to concentration risk
- group consolidation and the group capital test
- governance and remuneration
- assessment of third-country supervision

18.3 We summarise all the discretions available under the IFD/IFR, including those without a fuller explanation, in Figure 18.1 (IFR) and Figure 18.2 (IFD), together with our approach if replicating these under a domestic regime in the UK.

CRD/CRR

18.4 Please refer to Chapter 3 on Application to investment firms for details of those investment firms that would remain subject to the prudential requirements of CRD/CRR and those that would become subject to the new requirements of the IFD/IFR.

18.5 We agree with the EBA report of 2015 which concluded that CRD/CRR is not appropriate for most investment firms. (ie those which are not 'systemic' and 'bank-like'). And we would prefer to avoid having to supervise MiFID investment firms on the basis of a domestic regime mirroring the CRD/CRR for a small number of them, in parallel with a domestic regime reflecting IFD/IFR for all others. If we were to maintain a supervision regime mirroring the CRD/CRR, we would be bearing the costs of supervising a few firms subject to a prudential regime which we (and, within the EU, the EBA) regard as unsuitable.

18.6 As such, if we became the relevant regulator for this purpose and subject to consultation, we would not intend to replicate in our rules the discretion available in paragraph 5 of Article 1 of the IFR to allow firms we prudentially regulate to 'opt-in' to supervision on the basis of a regime mirroring the CRD/CRR.

18.7 If we did decide to allow an investment firm to 'opt-in', it would (if we followed the approach in paragraph 5 of Article 1 of the IFR) need to notify us. We would then have two months to inform the investment firm of our decision, providing full reasons if we reject the application.

18.8 If we were to allow investment firms to 'opt-in' to CRR/CRD-like supervision, we would develop a system to recover the full (additional) costs involved in maintaining the resources for supervision under a domestic CRD/CRR-like regime (including the ongoing maintenance of COREP reporting systems). We would do this through annual levies on the specific investment firms that have 'opted-in'. This is to avoid the investment firm population as a whole bearing this additional cost.

18.9 Paragraph 23 of Article 62 of the IFR amends point (b) of paragraph 4 of Article 382 of CRR so that intragroup transactions with a 'ring-fenced' retail bank can be included for credit valuation adjustment (CVA) risk when calculating K-TCD. This applies to investment firms that are part of a consolidated banking group who are using CRR counterparty credit risk rules, rather than the IFR method.

18.10 We are minded to apply rules reflecting this discretion if necessary, although we do not expect it to be frequently used.

Small and non-interconnected investment firms (SNIs)

18.11 Many discretions available in the IFR/IFD are specific to SNIs. We would propose to balance an increased allowance for proportionality with prudence, replicating the effect of some of the available discretions but not others. This is because smaller investment firms still have the potential to cause significant harm to consumers.

18.12 Article 24 of IFD requires investment firms that are not SNIs to regularly review their systems and controls around internal capital and liquid assets. This would be done as part of their internal capital adequacy and risk assessment (ICARA) process. Member States also have the discretion to request that an SNI carries out this process, if they deem it appropriate.

18.13 We would intend to replicate the effect of this discretion in a domestic regime, and require SNI investment firms to put in place an ICARA process. This is because we believe that all investment firms should review and manage their risks, regardless of their size. In detailing the subjects for review, the IFD requires investment firms to review the risk of potential for harm to clients and to markets, and these are relevant to our statutory objectives when supervising all firms. But we would seek an operationally efficient and proportionate means for smaller investment firms to comply with this requirement.

18.14 Article 40 of IFD allows Member States to require SNIs to hold additional capital once a supervisory review and evaluation process (SREP) has been completed. In our recently published Finalised Guidance, 'Our framework: assessing adequate financial resources', we set out our priorities for prudential supervision, including the importance of holding sufficient capital and liquid assets and our expectations of firms. In line with this approach, we would be minded to replicate the effect of the discretions available in Articles 36 and 40 of the IFD. So we would have the discretion to undertake a SREP on SNI investment firms and require the holding of additional own funds, where appropriate.

18.15 Article 43 of the IFR allows competent authorities to exempt SNIs from all liquidity requirements. We do not want to replicate the effect of this discretion, as the liquidity requirements in the IFR should be the minimum that all investment firms (including SNIs) should ordinarily meet. We would expect to allow this only in exceptional circumstances and only if the investment firm applied for a waiver from these requirements.

Technical discretions and allowances relating to K-factor requirements and concentration risk

18.16 We would be minded to replicate the effect of several technical discretions and allowances that the IFR allows subject to competent authority approval, to make the new regime run smoothly. These include:

- Replacing missing historical data points in relation to a specific component (K-factor) where the investment firm has carried out the activity for less than the number of months specified in the article as needed for the calculation of the K-factor. (Articles 17, 18, 19, 20 and 33 of the IFR).

The following bullet points describe discretions and allowances that are only relevant to investment firms that deal in their own names, whether for themselves of on behalf of clients.

- Allowing an investment firm to use K-CMG (based on margin given to a CCP), rather than K-NPR (based on CRR market risk rules), subject to certain criteria being met (Article 23 of IFR).
- The discretion to allow an investment firm to exclude certain, specified and closely linked counterparties from the calculation around counterparty default, subject to certain conditions being met (paragraph 3 of Article 25 of the IFR).
- The discretion to allow an investment firm to calculate the supervisory delta of options and swaptions using an appropriate model (paragraph 6 of Article 29 of the IFR).
- The discretion to change the volatility adjustment for certain types of commodities, where the standard volatility adjustment does not provide for investment firms that specialise solely/mainly in these instruments (Article 30 of the IFR).
- The discretion to grant an investment firm a limited amount of time to comply with the concentration limits where these have been exceeded (Article 38 of the IFR).

18.17 Paragraph 2 of Article 41 of the IFR provides competent authorities with the discretion to exempt (fully or partially) some exposures (covered bonds, and exposures to other entities within the same group) from the application of concentration limits and exposure value excess. We think we should replicate the effect of this discretion for exempting exposures to other group entities where they are included within the same prudential consolidation, scope of the same group capital test, or supervised in line with equivalent standards in a third country. We do not think we should do this for the exemption for covered bonds. This reflects our existing approach to both such discretions under the current CRR.

Group consolidation and the group capital test

18.18 Paragraph 1 of Article 6 of the IFR gives competent authorities the discretion to exempt an investment firm from applying certain requirements on an individual basis, subject to meeting the conditions set out in that paragraph. These requirements are: own funds, capital requirements, concentration risk, disclosure, and reporting.

18.19 This is similar to an existing CRR discretion that we have never used. We would not be minded to replicate the effect of this discretion as investment firms are authorised and granted permissions individually. It is the authorised investment firm that has to meet its regulatory obligations.

18.20 Paragraph 2 of Article 6 of the IFR gives competent authorities the discretion to exempt SNIs from applying disclosure requirements individually where they are part of an insurance or reinsurance group, subject to meeting the remaining conditions set out in that paragraph. We do not expect that many SNIs would meet these conditions.

18.21 However, we think we should replicate the effect of this discretion as disclosure requirements only apply to SNIs that issue AT1 capital instruments and this is limited to risk management policies, own funds and capital requirements. Any SNI that meets the relevant conditions would need to apply for a waiver from the disclosure requirements.

18.22 Paragraph 3 of Article 6 of IFR gives competent authorities the discretion to exempt investment firms from applying liquidity requirements on an individual basis where they are part of a banking or investment firm prudential consolidation group. Please see Chapter 10 on Liquidity for more detail about liquidity requirements generally.

18.23 Our view is that the liquidity requirements in the IFR should be the minimum that all investment firms should ordinarily meet. However, there may be certain cases where it is justifiable to amend the liquidity requirements for particular firms, on a case-by-case basis. So we propose replicating the effect of this discretion in a domestic regime in limited circumstances by receiving applications from firms for a waiver, but only where they have good reasons for wishing to diverge from the IFR liquidity requirements.

18.24 Paragraph 4 of Article 7 of the IFR gives competent authorities the discretion to exempt the parent undertaking of an investment firm group subject to prudential consolidation from applying the liquidity requirements on a consolidated basis (taking into account the nature, scale and complexity of the group).

18.25 We would do this under a domestic regime on a case-by-case basis, provided that all investment firms in the consolidation group apply the liquidity requirements on an individual basis.

18.26 A derogation in paragraph 1 of Article 8 of the IFR gives competent authorities the discretion to permit investment firm groups to apply the group capital test (GCT), subject to conditions, rather than automatically applying prudential consolidation under Article 7 of the IFR. For more detail on the GCT, see Chapter 8 of this DP. We would want to replicate the effect of this discretion. Investment firm groups would need to apply to us for permission, setting out how they meet the conditions.

18.27 We expect that many investment firm groups seeking permission to use the GCT would be able to satisfy both the conditions set out in paragraph 1 of Article 8 of the IFR if replicated. These are:

- the group structure is deemed to be sufficiently simple and
- there are no significant risks to clients or to market stemming from the investment firm group as a whole that would otherwise require supervision on a consolidated basis

18.28 A discretion is also available to the competent authority in paragraph 4 of Article 8 of the IFR to allow parent undertakings of the group to hold a lower amount of own funds than indicated at paragraph 3 of the same article. We consider replicating this 'quasi-consolidation' would be complicated for both investment firm groups to manage and for the FCA to oversee. We believe that the default GCT (in paragraph 3 of Article 8 of the IFR) is more appropriate, where investment firm groups wish to derogate from prudential consolidation (under Article 7 of the IFR). In practice, it also would not necessarily lead to a parent undertaking having to hold a 'lower' amount of regulatory capital.

Remuneration

Exemptions for smaller non-SNI investment firms and individuals

18.29 Three of the provisions on variable remuneration, which would otherwise apply to non-SNI investment firms, do not apply to firms with average on-and off-balance sheet assets of EUR 100 million or less over the 4 years immediately before the given financial year (point (a) of paragraph 4 of Article 32):

- pay-out in shares or other instruments (point (j) of paragraph 1 of Article 32)
- deferral (point (l) of paragraph 1 of Article 32)
- the holding and retention periods for discretionary pension benefits where an employee leaves the investment firm (subparagraph 3 of paragraph 3 of Article 32)

18.30 In addition, investment firms with assets below this threshold will not be required to establish a risk or remuneration committee.

18.31 The IFD gives Member States the discretion (in paragraphs 5 and 6 of Article 32) to increase or decrease the EUR 100 million threshold for individual investment firms. In both instances, it must be appropriate for the Member State to do so having regard to the nature and scope of the firm's activities, its internal organisation, and, where applicable, the characteristics of the group it belongs to.

18.32 A Member State may exercise this discretion by increasing the threshold up to a maximum of EUR 300 million where the investment firm in question meets all the following criteria (paragraph 5 of Article 32):

- it is not one of the three largest investment firms established in a Member State (by total value of assets)

- it is not subject to any obligations or simplified obligations in relation to recovery and resolution planning
- it has on- and off-balance sheet trading book business of EUR 150 million or less
- it has on- and off-balance sheet derivative business of EUR 100 million or less

18.33 If this were to be replicated and if the Government gave us the power to increase the threshold, we would make rules to increase it up to the IFD maximum of EUR 300 million in relation to investment firms which satisfy all the criteria. These firms would then not be required to apply the provisions on pay-out, deferral and pensions holding/retention periods or to establish a risk or remuneration committee.

18.34 The conditions for raising the threshold include two sub-thresholds, for investment firms with a 'trading book business', and for those with 'derivatives business'. These terms are undefined in the IFD. We are still considering how to measure these, but consider that referring to the total of exposure values as calculated under Article 36 of the IFR could be appropriate.

18.35 It is possible that the internal organisation, the scope and/or nature of the main activities of some investment firms may make it appropriate to lower the threshold below EUR 100 million, as allowed for in paragraph 6 of Article 32 of the IFD.

18.36 If the Government gave us the power to do so, we would consider whether there may be firms for which this is appropriate. This would mean they would be required to apply the provisions on pay-out, deferral and pensions holding/retention periods, and to establish risk and remuneration committees. We will consult on any proposals to make provisions to set a different threshold in our future consultation on the regime.

18.37 Point (b) of paragraph 4 of Article 32 of the IFD provides that the provisions on pay-out, deferral and pensions holding/retention periods do not apply to individuals whose annual variable remuneration is EUR 50,000 or less, and represents 25% or less of that individual's total annual remuneration. Paragraph 7 of that article gives a discretion to Member States to disapply this exemption for individuals on the grounds of national specificities in remuneration practices or the responsibilities and job profile of these individuals.

18.38 Even if given the power to do so by the Government, we would not make provisions reflecting this discretion. We do not consider that applying the provisions on pay-out, deferral and pensions holding/retention periods to material risk-takers with remuneration arrangements below the defined thresholds – which are considerably lower than those of the current CRD regime – would substantially further the objectives of promoting effective risk management and discouraging excessive risk-taking.

Instruments used for variable remuneration

18.39 The IFD gives both Member States and competent authorities discretion to prohibit the use of certain instruments or to restrict the types and designs of those used for variable remuneration (first subparagraph of paragraph 3 of Article 32).

18.40 We would not make rules to replicate the effect of this discretion. We do not want to limit the options available to investment firms that cannot make use of more common types of instrument. We have not used a comparable discretion in CRD, and have no evidence of harm arising as a result.

18.41 Some investment firms, such as non-joint stock companies, do not issue any instruments which could be used in variable remuneration. In these cases, the Directive gives Member States the discretion to allow these firms (and only these firms) to use 'alternative arrangements' (point (k) of paragraph 1 of Article 32). This is on the condition that these arrangements also fulfil the same objectives as set out in Recital 24 of the IFD, namely:

- aligning the interests of staff with the interests of various stakeholders, such as shareholders and creditors and
- contributing to the alignment of variable remuneration with the risk profile of the investment firm

18.42 If given the power to do so by the Government, we would make provisions to replicate the effect of this discretion. We would require an investment firm that wants to use alternative arrangements to apply for a modification of the rule on paying out in shares or other non-cash instruments. This would require an investment firm to show how its proposed arrangements would effectively fulfil the required objectives. We would look to base our approach on the EBA's draft technical standards while making any adjustments which might be appropriate to the UK market.

Assessing third-country supervision

18.43 Competent authorities are allowed to require the establishment of an intermediate holding company within the EU where they have concerns about the third country supervision of investment firm group members (Paragraph 3 of Article 55 of the IFD).

18.44 We would be minded to replicate the effect of this discretion for a non-UK parent company having two or more subsidiaries in the UK for the purposes of applying prudential consolidation or the GCT to the UK group of firms.

Summary of proposed use of discretions

Figure 18.1 – Investment Firm Regulation

IFR Article	Overview of option/discretion	Minded to replicate in a UK regime?	DP paragraph reference
1(5)	To allow an investment firm that trades in its own name and is part of a CRD consolidation group to apply CRR/CRD requirements, rather than those in the IFR/IFD.	No	3.17 and 18.4 to 18.8
6(1)	To exempt SNIs from applying the following requirements on an individual basis where they are part of a banking or investment firm prudential consolidation group: own funds; capital; concentration risk; disclosure; and reporting.	No	18.18 to 18.19
6(2)	To exempt SNIs from applying disclosure requirements on an individual basis where they are part of an insurance or reinsurance group.	Yes	18.20 to 18.21

IFR Article	Overview of option/discretion	Minded to replicate in a UK regime?	DP paragraph reference
6(3)	To exempt SNIs from applying liquidity requirements on an individual basis where they are part of a banking or investment firm prudential consolidation group.	No (only in exceptional cases)	10.12 and 18.22 to 18.23
7(4)	To allow investment firms within a prudential consolidation group not to apply the liquidity requirements on a consolidated basis (depending on the nature, scale and complexity of the group).	Yes	18.24 to 18.25
8(1)	To apply the GCT to investment firm only groups rather than apply prudential consolidation.	Yes	18.26 to 18.27
8(4)	To allow the ultimate parent company within the EU to calculate the GCT differently than indicated in 8(1).	No	18.28
9	To allow investment firms to use an alternative type of instrument for own funds where they: **a.** are not legal persons or joint-stock companies, or **b.** are SNIs	**a.** Yes **b.** No	4.19 to 4.22
10(2)	To limit the qualifying holdings that an investment firm might hold.	No	4.28 to 4.31
11(3)	To vary the relevant component for an investment firm's own funds requirements where there has been a material change in the business model.	Yes	5.11
13(2)	To vary an investment firm's fixed overheads requirements where there has been a material change in the business model.	Yes	5.14
15	To vary an investment firm's capital requirement in relation to a specific component (K-factor) where there has been a material change in the business model.	Yes	5.16
17, 18, 19, 20, 33	To replace missing historical data points in relation to a specific component (K-factor) where the investment firm has not carried out the activity for long enough.	Yes	18.16
23	To allow an investment firm to use K-CMG (based on margin given to a CCP), rather than K-NPR (based on CRR market risk rules), subject to certain criteria being met.	Yes	18.16
25(3)	To allow an investment firm to exclude certain, specified and closely linked counterparties from the calculation around counterparty default.	Yes	18.16
25(4)	To allow an investment firm to use a 'hybrid' method, based on the CRR, to calculate its exposure value, and then apply the relevant IFR risk factor to determine its capital requirement. We are unclear if such an approach would work in practice.	No	6.113 to 6.117
29(6)	To allow an investment firm to calculate the supervisory delta (the speed at which market prices change) of options and swaptions using an appropriate model.	Yes	18.16
30	To change the volatility adjustment for certain types of commodities.	Yes	18.16

IFR Article	Overview of option/discretion	Minded to replicate in a UK regime?	DP paragraph reference
32	To allow investment firms to use apply a Credit Valuation Adjustment of 1.5 (rather than 1.0 which would otherwise apply) for securities financing transactions (SFTs), where the competent authority determines that the risk exposures arising from these are material.	No	6.110 to 6.112
38	To allow investment firms a limited amount of time to comply with the concentration limits where these have been exceeded.	Yes	18.16
41	To exempt some exposures from the application of concentration limits and exposure value excess. These are: **a.** covered bonds, and **b.** exposures to entities within the same group.	No for (a), but Yes for (b)	18.17
43	To exempt SNIs from having to hold liquid assets.	No (only in exceptional cases)	18.15
44	To allow an investment firm to temporarily reduce the amount of liquid assets it holds.	Yes	10.10
50	To require an investment firm to publicly disclose information relating to its ICARA process and as a result of a SREP.	Yes (only in exceptional cases)	11. 101
63(23)	Amendment to CRR Article 382(4)(b) that allows investment firms to be able to include intragroup transactions between structurally separated entities within a banking group (i.e. where the retail bank has been 'ring-fenced' from the other activities the bank carries out) for credit valuation adjustment risk. Only relevant for investment firms that are part of a consolidated banking group.	Yes	18.9 to 18.10

Figure 18.2 – Investment Firm Directive

IFD Article	Overview of option/discretion	Minded to replicate in a UK regime?	DP Reference
5	Allows authorities to require investment firms that trade in their own name to apply CRR, rather than IFR requirements where it meets certain criteria.	No	3.15
24	To require SNIs to have processes and procedures to manage their internal capital and liquid assets (under the ICARA process).	Yes	11.33 to 11.34 and 18.12 to 18.13
32(1)(k)	Variable remuneration – permitting investment firms that do not issue any of the types of instruments listed to use alternative arrangements instead.	Yes	18.41 to 18.42
32(3)	Variable remuneration – ability to place restrictions on, or to prohibit, the types/designs of instruments able to be used.	No	18.39 to 18.40

IFD Article	Overview of option/discretion	Minded to replicate in a UK regime?	DP Reference
32(5)	Some variable remuneration requirements only apply above a balance sheet threshold (EUR100m). This provides the ability to raise this threshold (to EUR 300m) where an investment firm meets specified criteria.	Yes (if FCA given power to do so)	18.32 to 18.35
32(6)	Some variable remuneration requirements only above a balance sheet threshold. This provides the ability to lower this based on the investment firm's activities, size, etc.	No (although specific cases still under consideration if FCA given power to do so)	18.36
32(7)	Some variable remuneration requirements do not apply to individuals where the 'bonus' part is EUR 50k or less, and is not more than a quarter of their total remuneration. The discretion provides the ability to override this and apply the full requirements to them.	No	18.37 to 18.38
36	To apply SREP requirements to SNIs on a case-by-case basis where deemed necessary.	Yes	18.14
40	Ability to require SNIs to hold additional own funds where a SREP has been conducted in certain situations.	Yes	18.14
41	Ability to require non-SNI firms to hold additional own funds in certain situations – in addition to any extra own funds requirement following a SREP.	Yes	11.82 to 11.85
55	This obliges the authority to consider group supervision where a third country parent undertaking has two or more subsidiary investment firms in the EU. It then provides the ability to require the establishment of an intermediate holding company within the EU where there are concerns about the third country supervision of investment firm group members.	Yes (where there are two or more subsidiary investment firms in the UK)	18.43 to 18.44

Q26: **What are your views on whether a MiFID investment firm should be able to 'opt-in' to a regime based on CRR? (See paragraphs 18.4 to 18.8)**

Q27: **What would be most appropriate way for SNI investment firms to report on the results of their ICARA process? (See paragraphs 18.11 to 18.14)**

Q28: **Do you agree that the group capital test should be made available as an alternative to prudential consolidation? (See paragraphs 18.26 to 18.27) And (if you are an investment firm) is it an option that you would be interested in?**

Q29: **Do you agree with our intended approach to remuneration exemptions for smaller non-SNI investment firms and individuals? (See paragraphs 18.29 to 18.38)**

Q30: **Do you agree with our intended approach to replicating the effect of the discretions on instruments used and alternative arrangements for variable remuneration? (See paragraphs 18.39 to 18.42)**

Q31: **Do you have any comments on the other competent authority options and discretions discussed in this chapter?**

19 IFR transitional provisions

Overview

- The transitional provisions of the IFR are intended to ease the change from any existing own funds requirements, or other type of capital requirements, to the full application of own funds requirements under the IFR.
- The IFR recognises that some investment firms will be subject to new own funds requirements which may represent a material increase upon their existing requirements. So the transitional provisions give investment firms up to five years to comply after IFR implementation.
- Different transitional provisions reflect the diversity of investment firms authorised under MiFID who will fall under the new prudential regime. These include a range of different investment firm types and business models, whose existing own funds requirements or other capital requirements may vary considerably. But in practice an investment firm should only need to look to one of those different provisions as potentially applicable to its own situation.
- The transitional provisions cover aspects of the minimum own funds requirements set under Article 11 of the IFR. They do not cover any additional own funds requirements set in line with the provisions of the IFD.
- Overall we are supportive of the purpose and design of these transitions, which we would look to apply similarly in a domestic regime.

What this chapter covers

19.1 We:

- explain how the transitional provisions in Part Nine of the IFR apply and
- summarise the key derogations by type of firm

19.2 Figure 19.1 helps firms to identify which transitional provision(s) might be available based upon existing prudential categorisations. If we do adopt a regime reflecting the effect of the IFR these investment firm types will no longer exist. But they are provided here for ease of identification.

Figure 19.1 – The transitional provisions that might apply to existing prudential categories of firm

IFR Article	DP Paragraph number(s)	Current UK firm categories						MiFID investment firm not in existence before 26 June 2021
		Exempt IFPRU Commodities firm	Exempt BIPRU Commodities firm	Exempt CAD	BIPRU[1]	IFPRU[1]	Locals	
57(1)	19.3 to 19.5	Y	Y	N	N	N	N	Y[2]
57(2)	19.6 to 19.7	Y[3]	N	N	N	Y[3]	Y[4]	Y[3]
57(3)(a)	19.8	N	N	N	Y	Y	N	N
57(3)(b)	19.8	N	N	N	N	N	N	Y
57(4)(a)	19.9 to 19.10	N	N	Y	N	N	N	N
57(4)(b)	19.9 and 19.11 to 19.14,	N	N	N	N	Y	N	N
57(4)(c)	19.9 and 19.15,	N	Y	N	Y	N	N	N
57(5)	19.16	Y	Y	Y	Y	Y	N	N
57(6)	19.20 to 19.22,	N	N	N	N	N	Y	N

Notes:

1 – Where an existing BIPRU or IFPRU investment firm is using the current 'matched principle exemption' it should also refer to paragraphs 19.17 to 19.19 in this chapter.

2 – An investment firm authorised on or after 26 June 2021, that will be a commodities and emissions allowance dealer should also refer to paragraphs 19.3 to 19.5 in this chapter.

3 – These transitional provisions are only relevant where the investment firm is dealing in its own name, including on behalf of clients.

4 – Only relevant for existing 'local' firms that are not already making use of paragraph 6 of Article 57 of IFR (see paragraphs 19.20 to 19.22 in this chapter).

Applying the transitional provisions

Commodity and emission allowance dealers

19.3 Commodity and emission allowance dealers may be exempt from certain provisions of the IFR, such as the concentration risk requirements (as provided for in Article 42 of the IFR). These exemptions are dealt with elsewhere in this DP.

19.4 The first paragraph of Article 57 of the IFR also provides a transitional provision for these types of investment firm, which delays the application of the following provisions of the IFR to commodity and emission allowance dealers until 26 June 2026:

- liquidity requirements (Part Five, Articles 43 to 45 of the IFR); and

- disclosure by investment firms, specifically the scope of disclosure requirements (Article 46 of the IFR) together with disclosure of:
  - risk management objectives and policies (Article 47 of the IFR)
  - governance arrangements (Article 48 of the IFR)
  - own funds information (Article 49 of the IFR)
  - compliance with own funds requirements (Article 50 of the IFR) and
  - remuneration policy and practices (Article 51 of the IFR)

19.5 However, commodity and emission allowance dealers must disclose details of their investment policy (Article 52 of the IFR) and environmental, social and governance risks (Article 53 of the IFR) in line with the full provisions of those articles from their respective dates of implementation.

Calculating net position risk requirement in line with CRR's Alternative Standard Approach or the Alternative Internal Model Approach

19.6 The transitional provision in paragraph 2 of Article 57 of the IFR requires that investment firms calculate their K-NPR in line with the Standardised Approach, or where it has regulatory approval, the internal models approach, in the CRR as it stood before the CRR2 amendments package, as if these had continued to apply. This is for at least 78 months after the date of entry into force of the IFR in the EU (i.e. until at least 26 June 2026).

19.7 After that date, the alternative standardised approach (or the alternative models approach, subject to necessary approval) as provided for under point (b) (or point (c)) of Article 22 of the IFR may be adopted, unless those alternative provisions are only implemented in subsequent amendments to the CRR at a date later than this (i.e. later than 26 June 2026). See paragraphs 6.62 to 6.65 in Chapter 6, K-factor requirements, for K-NPR.

Lower own funds requirement than the higher of IFR's fixed overheads requirement and K-Factor requirement for certain investment firms

19.8 According to paragraph 3 of Article 57 of the IFR, certain investment firms may choose, for five years from the date of implementation of the IFR in the EU (i.e. from 26 June 2021 until 25 June 2026), to limit their own funds requirements compared to those that would otherwise apply in respect of:

- point (a), the fixed overheads requirement (FOR), and
- point (c), the K-factor requirement (KFR), of paragraph 1 of Article 11 of the IFR.

This limitation may be as follows:

Current 'BIPRU' and 'IFPRU' Firms

- Point (a) of paragraph 3 of Article 57 of the IFR applies to the types of investment firms currently known in the UK as either 'BIPRU Firms' or 'IFPRU Firms', and which were authorised under MiFID before IFR implementation (i.e. 26 June 2021). Such firms may limit their own funds requirements derived from their FOR and their KFR, to twice their relevant own funds requirement as calculated in line with the provisions of the CRR as it stood before the CRR2 amendments package, as if these had continued to apply.
- However, our view is that in making use of this transitional provision an investment firm is required to re-calculate the comparison of its own funds requirements

according to the provisions of the CRR on a regular, updated basis (and at least as frequently as it reports its own funds requirements) over the whole of the period for which it makes use of the transitional provision. A single, historic calculation cannot be relied upon and is not permitted.

Investment firms not in existence at the time of implementation of the IFR

- Point (b) of paragraph 3 of Article 57 of the IFR applies to an investment firm which was not in existence before IFR implementation (26 June 2021). Such an investment firm may limit its own funds requirement, for a period of up to five years after the date of implementation in the EU (i.e. up to 25 June 2026), to twice its FOR as calculated in line with Article 13 of the IFR.

Determining the level of Permanent Minimum Requirement

19.9 Paragraph 4 of Article 57 of the IFR sets out three transitional provisions for calculating an investment firm's Permanent Minimum Requirement (PMR) under point (b) of paragraph 1 of Article 11 of the IFR. This can apply for five years from IFR implementation (i.e. from 26 June 2021). These provisions allow certain investment firms to determine their PMR during the transitional period as set out below.

Current 'Exempt CAD' Firms

19.10 Point (a) of paragraph 4 of Article 57 of the IFR applies to the type of firm currently known in the UK as an 'Exempt CAD' firm, i.e. investment firms that were previously subject only to an Initial Capital Requirement (ICR) of EUR 50k (but without counting any of the alternative measures of EUR 25k plus professional indemnity insurance (PII), entirely by PII or a combination) and no own funds requirement. These firms may limit their PMR to twice this amount, i.e. to EUR 100k.

Current 'IFPRU' Firms

19.11 Point (b) of paragraph 4 of Article 57 of the IFR applies to the type of investment firm currently known in the UK as an 'IFPRU' firm, i.e. investment firms that were authorised as such before IFR implementation (26 June 2021) and were subject to paragraph 1 of Article 93 of the CRR.

19.12 For those 'IFPRU' investment firms subject to an ICR of EUR 50k prior to the IFR, the PMR would be for each respective period, at least:

- 26 June 2021 to 25 June 2022 at EUR 50k
- 26 June 2022 to 25 June 2023 at EUR 55k
- 26 June 2023 to 25 June 2024 at EUR 60k
- 26 June 2024 to 25 June 2025 at EUR 65k
- 26 June 2025 to 25 June 2026 at EUR 70k
- 26 June 2026 and beyond EUR 75k

19.13 For those 'IFPRU' investment firms subject to an ICR of EUR 125k prior to the IFR, their PMR would be for each respective period, at least:

- 26 June 2021 to 25 June 2022 at EUR 125k
- 26 June 2022 to 25 June 2023 at EUR 130k
- 26 June 2023 to 25 June 2024 at EUR 135k
- 26 June 2024 to 25 June 2025 at EUR 140k
- 26 June 2025 to 25 June 2026 at EUR 145k
- 26 June 2026 and beyond EUR 150k

19.14 For those 'IFPRU' investment firms subject to an ICR of EUR 730k prior to the IFR, their PMR would be for each respective period, at least:

- 26 June 2021 to 25 June 2022 at EUR 730k
- 26 June 2022 to 25 June 2023 at EUR 735k
- 26 June 2023 to 25 June 2024 at EUR 740k
- 26 June 2024 to 25 June 2025 at EUR 745k
- 26 June 2025 and beyond EUR 750k

Current 'BIPRU' Firms

19.15 Point (c) of paragraph 4 of Article 57 of the IFR applies to the type of firm currently known in the UK as a 'BIPRU' firm, i.e. investment firms which were authorised as such before IFR implementation (26 June 2021). Their PMR would be for each respective period, at least:

- 26 June 2021 to 25 June 2022 at EUR 50k
- 26 June 2022 to 25 June 2023 at EUR 55k
- 26 June 2023 to 25 June 2024 at EUR 60k
- 26 June 2024 to 25 June 2025 at EUR 65k
- 26 June 2025 to 25 June 2026 at EUR 70k
- 26 June 2026 and beyond EUR 75k

Changes in PMR when an investment firm acquires new permissions

19.16 According to paragraph 5 of Article 57 of the IFR, the various transitional provisions under paragraph 4 in respect of PMR (as set out above) immediately cease to apply if the investment firm becomes subject to a higher Permanent Minimum Requirement. For example, where an investment firm that does not hold client money is subsequently given permission to do so, its PMR will increase from its then current transitional PMR to EUR 150k and the new PMR (in this case EUR 150k) will apply in full, with immediate effect.

Current 'Matched Principal' Limitation firms

19.17 Firms of the type currently known in the UK as 'BIPRU' and 'IFPRU' that hold permission to deal on own account, but which also have a 'Matched Principal' Limitation, may currently benefit from a prudential exemption under the CRD that leads to an ICR of either EUR 50k or EUR 125k (according to its other investment activities). However, under the IFR this current exemption falls away. This means that such investment firms will then be subject to an ICR of EUR 750k and, consequently, a PMR of EUR 750k.

19.18 However, we believe these firms will still be able to take advantage of the relevant transitional provision in point (b) of paragraph 4 of Article 57 of the IFR to limit their PMR, as outlined above but suitably modified. The starting position for its PMR will be its current level of ICR (i.e. either EUR 50k or EUR 125k), with annual increments of at least EUR 5k, but with the modification being that the full amount of the new PMR, EUR 750k, must be met by five years after IFR implementation (i.e. by 26 June 2026).

19.19 Further, we believe that the relevant transitional provisions that allow such a firm to limit its PMR may also apply to its ICR over the same period.

Local Firm own funds requirement transitional

19.20 Paragraph 6 of Article 57 of the IFR applies to firms that currently meet the CRR definition of a 'Local Firm'. This transitional provision permits them to limit their minimum own funds requirements in respect of paragraph 1 of Article 11 of the IFR (i.e. the highest of the FOR, the PMR and the KFR) for five years after IFR implementation (i.e. from 26 June 2021), for each respective period, to at least:

- 26 June 2021 to 25 June 2022 to EUR 250k
- 26 June 2022 to 25 June 2023 to EUR 350k
- 26 June 2023 to 25 June 2024 to EUR 450k
- 26 June 2024 to 25 June 2025 to EUR 550k
- 26 June 2025 to 25 June 2026 to EUR 650k
- 26 June 2026 and beyond the full IFR own funds requirement according to paragraph 1 of Article 11 of the IFR (i.e. the highest of its FOR, PMR and KFR) will apply.

19.21 According to the second sub-paragraph of paragraph 6 of Article 57 of the IFR, a 'Local Firm' is expressly not permitted to adopt the separate transitional provisions in respect of PMR in point (a) of paragraph 4 of Article 57 of the IFR.

19.22 A 'Local Firm' is currently subject to an ICR of EUR 50k. As these firms deal on own account, upon implementation of the IFR (26 June 2021) these firms will become subject to an ICR of EUR 750k with immediate effect and, consequently, a PMR of EUR 750k. However, in our view the transitional provision in paragraph 6 of Article 57 of the IFR that allows a 'Local Firm' to limit its own funds requirements in respect of paragraph 1 of Article 11 of the IFR – which includes the PMR – may also be applied to its ICR. The result would be that an existing 'local firm' would only have to meet the full EUR 750k amount of ICR with effect from 26 June 2026.

Scenario not covered by the IFR Transitional provisions

19.23 Our analysis of the text suggests that there is at least one scenario not covered by the transitional provisions in Article 57 of the IFR. This is in respect of firms that are currently known in the UK as 'Exempt CAD' firms, but for whom either the FOR or the KFR (rather than the PMR) would be their highest or binding minimum own funds requirement under the IFR. These 'Exempt CAD' firms are covered by point (a) of paragraph 4 of Article 57 of IFR, but this transitional only provides relief in respect of point (b) of paragraph 1 of Article 11 of the IFR, namely the PMR.

19.24 This is a matter that we would need to consider further as part of any subsequent consultation.

Q32: Do you agree that any transitional provisions for the PMR should also extend to the ICR? (See paragraphs 19.9 to 19.22)

Q33: Can you identify any other scenarios that are not covered by IFR transitional provisions? (See paragraph 19.23)

20 Changes to the CRR and to other legislation made via the IFR and IFD

Overview

- The IFR and IFD amend a range of existing directives and regulations to reflect the impact of the new regime on the wider regulatory landscape of the EU. These relate both to how investment firms should subsequently be treated under other regulatory regimes, and to replicate certain requirements in the IFR and IFD in other regimes.

What this chapter covers

20.1 We look at:

- the impact of changes made to the CRR and CRD by Article 62 of the IFR
- other, less material, changes made to other legislation

Changes to the CRR/CRD

20.2 Article 62 of the IFR makes various consequential changes to the CRR. Some of these are to make it clearer how the CRR applies to credit institutions once the IFR is implemented for investment firms. For example, the vast majority of investment firms will no longer form part of the definition of 'institution' in the CRR. But certain investment firms will remain authorised under MiFID and still be required to apply to the CRR after IFR implementation (see Chapter 3 on Application to investment firms and Chapter 18 on Competent authority discretions). Investment firms required to remain on CRD/CRR are to be treated by the competent authorities as if they were 'institutions'.

20.3 Other changes are intended to help ensure that credit institutions may, in general, continue to treat their exposures to investment firms in the same manner as they do currently under CRR. This is despite their investment firm counterparties being subject to the IFR rather than the CRR in future.

20.4 These changes do not, in general, alter how counterparties should treat investment firms after IFR implementation.

20.5 But we have identified two aspects that could have an impact upon a small number of investment firms:

- The CRR2 (amendments package for banks) already amends the first sub-paragraph of paragraph 1 of Article 395 of the CRR when applying the large exposure limits to any individual counterparty or group of connected counterparties that are institutions under the CRR. The CRR2 will now measure the relevant large exposure limits in terms of a credit institution's Tier 1 capital, and not the more expansive concept of 'eligible capital' as was previously the case in CRR. The IFR adds the term 'investment firm' to this, consistent with the general intention to maintain the same treatment when a credit institution has exposures to an investment firm. This means a relatively small credit institution with a relatively large exposure to an investment firm may now have to reduce its total exposure to that investment firm if the large exposures limit is now breached, as that exposure would now represent a higher percentage of its Tier 1 Capital (than when measured against eligible capital).

- There will no longer be any specific derogations in the CRR that apply only to investment firms. So any MiFID-authorised investment firm still subject to the CRD/CRR after IFR implementation (see Chapter 3 on Application to investment firms and Chapter 18 on Competent authority discretions) would, for example, have to apply the liquidity provisions of Part Six of the CRR.

Changes to other Directives potentially relevant to investment firms or to CPM and CPMI firms

20.6 The IFD makes the following relevant changes:

- Article 59 of the IFD refers to the Financial Conglomerates Directive and inserts the references to IFR and IFD regarding the definition of Sectoral Rules.
- Article 60 of the IFD refers to the UCITS Directive requiring UCITS management companies to hold, at all times, own funds of no less than an amount calculated from Article 13 of the IFR, the fixed overhead requirement (FOR).
- Article 61 of the IFD refers to AIFMD requiring AIFMs to hold, at all times, own funds of no less than an amount calculated from Article 13 of the IFR, the FOR.
- Article 63 of the IFD refers to the RRD and amends references to maintain the existing application of RRD in the context of the IFD/IFR, namely to those investment firms that will now be required to maintain initial capital of EUR 750,000.
- Article 64 of the IFD refers to MiFID by amending articles to reference the IFR in place of the CRR. This IFD Article also introduces a new MiFID II article, Article 95a, which addresses the provisions of existing MiFID investment firms transitioning to become authorised as credit institutions under CRD and as set out in the new definition of a credit institution in sub-point (b) of point (1) of paragraph 1 of Article 4 of the CRR. Otherwise this Article of IFD deals with the authorisation of branches of a third country firm and other changes to MiFID unrelated to the new prudential regime.

Annex 1
List of questions

Q1: What are your views on the instruments or funds used by non-joint stock investment firms that should count as CET1 capital? Please give specific examples (See paragraphs 4.18 to 4.21)

Q2: What level of detail would you find helpful when calculating the fixed overheads requirement (FOR)? (See paragraphs 5.13 to 5.15)

Q3: What are your views on how any negative values or liabilities an investment firm manages within a portfolio, for example from derivatives or leverage, should be treated when measuring AUM? (See paragraph 6.13)

Q4: Do you have any comments on delegation from or to another financial entity when calculating K-AUM? (See paragraphs 6.17 to 6.18)

Q5: Do you agree with our view on how to measure CMH and ASA? (See paragraphs 6.24 and 6.31)

Q6: Do you agree with our views on how to measure COH, and when it does not apply? (See paragraphs 6.39 to 6.40, and 6.43 to 6.44)

Q7: Do you agree with our views on the treatment of 'cash trades' for DTF and COH? (See paragraphs 6.49 to 6.50)

Q8: Do you agree with our views on how to calculate the notional value for derivatives for DTF and COH? (See paragraph 6.51)

Q9: Do you have any comments on the use of K-CMG 'on a portfolio basis'? (See paragraph 6.61)

Q10: When calculating K-TCD for foreign exchange derivative contracts, do you agree with our view on what 'domestic currency' can mean? (See paragraph 6.92)

Q11: Do you have any comments on the composition of an investment firm group including the concepts of 'control' and 'ancillary service undertaking'. (See paragraphs 7.14 and 7.15)

Q12: Do you have any comments on how to calculate consolidated FOR, consolidated PMR, and consolidated KFR? (See paragraphs 7.22 to 7.46)

Q13: **What are your views on the conditions, both of which must be met, before an investment firm group may be given permission to use the GCT? (See paragraph 8.5).**

Q14: **Do you have any comments on our views on the limits that apply for K-CON and our worked examples for calculating it? (See paragraphs 9.23 to 9.24, 9.26, and 9.33)**

Q15: **Do you have any comments on the list of assets that may count towards meeting an investment firm's minimum liquidity requirement? (See Figure 10.1)**

Q16: **What are your views on the structure and content of the elements being covered in the proposed new 'Pillar 2' framework. (See Figure 11.3 – paragraph 11.68)**

Q17: **Do you agree with our proposal regarding additional own funds requirements and specific liquidity requirements? This includes the articulation of requirements and guidance, stacking order and the use of VREQs to set own funds and specific liquidity requirements. (See paragraphs 11.77 to 11.100)**

Q18: **What are your views on the proposed approach for the transition from existing IFPRU/BIPRU ICGs? (See paragraph 11.102)**

Q19: **What are your views on the level of detail required to meet regulatory reporting requirements? (See Chapter 12)**

Q20: **What are your views on the scope and application of a new remuneration code? (see paragraphs 13.7 to 13.18)**

Q21: **Do you think it would be appropriate for us to include in a new remuneration code a general proportionality rule similar to that contained in the IFD? (See paragraphs 13.44 to 13.50)**

Q22: **Do you agree with our interpretation of gender-balanced remuneration committee? Do you think it would be appropriate for us to include it as a requirement in a new remuneration code? (See paragraphs 13.71 to 13.72)**

Q23: **Do you agree it would be appropriate for us to include in a new remuneration code rules and guidance on retention, deferral and ex-post risk adjustment? (See paragraphs 13.95 to 13.116)**

Q24: **Do you agree with the list of existing CRR-based permissions that we have identified as continuing under a new regime? (See Figure 16.2 in paragraph 16.6)**

Q25: **Do you agree with our intended future treatment of CPMIs? (See Chapter 17)**

Q26: **What are your views on whether a MiFID investment firm should be able to 'opt-in' to a regime based on CRR? (See paragraphs 18.4 to 18.8)**

Q27: **What would be most appropriate way for SNI investment firms to report on the results of their ICARA process? (See paragraphs 18.11 to 18.14)**

Q28: **Do you agree that the group capital test should be made available as an alternative to prudential consolidation? (See paragraphs 18.26 to 18.27) And (if you are an investment firm) is it an option that you would be interested in?**

Q29: **Do you agree with our intended approach to remuneration exemptions for smaller non-SNI investment firms and individuals? (See paragraphs 18.29 to 18.38)**

Q30: **Do you agree with our intended approach to replicating the effect of the discretions on instruments used and alternative arrangements for variable remuneration? (See paragraphs 18.39 to 18.42)**

Q31: **Do you have any comments on the other competent authority options and discretions discussed in Chapter 18?**

Q32: **Do you agree that any transitional provisions for the PMR should also extend to the ICR? (See paragraphs 19.9 to 19.22)**

Q33: **Can you identify any other scenarios that are not covered by IFR transitional provisions? (See paragraph 19.23)**

Q34: **Do you have any other comments on the content of a new prudential regime for investment firms as described in this DP?**

Q35: **Are there any specific areas where you believe that the requirements could be made even more appropriate for investment firms?**

Annex 2
Abbreviations used in this document

AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AT 1	Additional Tier 1 capital
Bank	Bank of England
BIPRU	Prudential Sourcebook for BIPRU firms
CA	Competent Authority
CASS	Client Assets Sourcebook
CET 1	Common Equity Tier 1 capital
CMV	Current Market Value
COREP	Common Reporting
CPM	Collective Portfolio Management firm
CPMI	Collective Portfolio Management Investment firm
CRD/CRD4	Capital Requirements Directive
CRR	Capital Requirements Regulation
CVA	Credit Valuation Adjustment
DP	Discussion Paper
EBA	European Banking Authority
ESG	Environmental, Social & Governance
ESMA	European Securities and Markets Authority
FCA	Financial Conduct Authority
FOR	Fixed Overheads Requirement
FSMA	Financial Services and Markets Act
GENPRU	General Prudential Sourcebook
HMT	Her Majesty's Treasury
ICAAP	Internal Capital Adequacy Assessment Process
ICARA	Internal Capital Adequacy and Risk Assessment
ICG	Individual Capital Guidance
IFD	Investment Firm Directive
IFPRU	Prudential Sourcebook for Investment Firms
IFR	Investment Firm Regulation
ILAA	Individual Liquidity Adequacy Assessment
ILAS	Individual Liquidity Adequacy Standards
IPRU-INV	Interim Prudential Sourcebook for Investment Firms

KFR	K-Factor Requirement
MiFID/MiFID2	Markets in Financial Instruments Directive
MRT	Material Risk Takers
OFRE	Own Funds Requirement for the Excess
OIREQ	Own Initiative Requirement
PFE	Potential Future Exposure
PII	Professional Indemnity Insurance
PMR	Permanent Minimum Requirement
PRA	Prudential Regulation Authority
RF	Risk Factor
RRD	Recovery & Resolution Directive
SLRP	Supervisory Liquidity Review Process
SNI	Small and non-interconnected investment firm
SREP	Supervisory Review and Evaluation Process
SUP	Supervision Manual
SYSC	Senior Management Arrangements, Systems and Controls (SYSC) Sourcebook
T2	Tier 2 capital
UCITS	Undertakings in Collective Investments in Transferable Securities
TTCA	Title Transfer Collateral Arrangement
VREQ	Voluntary Requirement

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Annex 3
Guide to how to navigate this document

The table below will help all MiFID investment firms access the detailed content of this document.

Each row of the table sets out the specific paragraphs that we believe would be most relevant to a particular type of investment firm characteristic or situation. We encourage an individual investment firm to consider each of the rows in the table to decide which ones may be relevant to its own circumstances and business activities.

We recommend all investment firms read Chapter 3, to determine if they are likely to be considered a 'small and non-interconnected investment firm' (SNI) under the proposed regime. This is a particularly important chapter because whether an investment firm is eligible to be an SNI will in turn determine whether other specific parts of the proposed regime apply. We then refer to an investment firm that is not eligible to be an SNI as a 'non-SNI' investment firm.

This table is a summary indication of the parts of this document that are most relevant to particular types of firms and is not intended to be definitive or exhaustive. It is not a substitute for an individual investment firm reading the document in full and deciding for itself which sections are most relevant to them and their business model.

Firm characteristic	Paragraph numbers
All MiFID investment firms	*Chapter 1*
	Chapter 2
	3.2 to 3.5
	3.19 to 3.23
	4.1 to 4.17, [4.23 to 4.27]
	Chapter 5
	9.1 to 9.4, 9.7 to 9.9
	10.1 to 10.4, 10.6 to 10.12, 10.16
	11.1, 11.12 to 11.24, 11.26 to 11.29, 11.31 to 11.36, 11.39 to 11.44, 11.47, 11.49 to 11.60, 11.62 to 11.66, 11.70 to 11.72, 11.77 to 11.81, 11.86, 11.88 to 11.91, 11.96 to 11.101
	12.1 to 12.5
	16.9
	18.1 to 18.3 and Tables of discretions in IFR and in IFD as may be relevant to an individual investment firm
	19.1 to 19.2 and Table of application to determine which other parts of Chapter 19 may be relevant to an individual investment firm
	20.1 to 20.5
SNI investment firms	*3.31*
	10.5
	11.75, 11.76, Figure 11.7 (Example D) and 11.95,
	13.13
	18.11 to 18.15

Firm characteristic	Paragraph numbers
SNI investment firms that have issued AT1 own funds	*15.1 to 15.2, 15.4, 15.6 to 15.9, 15.16 to 15.17*
All non-SNI investment firms	*3.24 to 3.29* *6.1 to 6.10* *9.29 to 9.31* *11.2 to 11.11, 11.25, 11.30, 11.67, 11.82 to 11.85, 11.87, 11.92 to 11.94, Figures 11.4 to 11.6 (Examples A, B and C)* *12.6* *13.1 to 13.6, 13.8 to 13.9, 13.14, 13.16 to 13.18, 13.21 to 13.121* *Chapter 14* *Chapter 15* *18.16, 18.29 to 18.42*
Non-SNI investment firms that do portfolio management or provide investment advice	*6.11 to 6.19*
Non-SNI investment firms that execute orders in the name of the client and/or receive and transmit client orders	*6.35 to 6.45, 6.49 to 6.51*
Any investment firm that holds client money	*6.20 to 6.28*
Any investment firm that safeguards and administers client financial instruments	*6.29 to 6.34*
Any investment firm that carries out MiFID activities (3) and/or (6) – i.e. deals on its own account, including where executing client orders in its own name	*3.6 to 3.18* *6.46 to 6.118* *9.10 to 9.28, 9.32 to 9.33* *11.61* *12.7 to 12.12* *13.7* *18.4 to 18.10, 18.16, 18.17*
Any investment firm that is part of a group	*Chapters 7 and 8* *11.73 to 11.74* *13.10 to 13.12* *18.18 to 18.21*
Commodity and emission allowance dealers	*3.32 to 3.35* *9.5 to 9.6 and 9.28*
Partnerships, LLPs, sole traders	*4.18 to 4.22* *18.41 to 18.42*
'ILAS firms' (subject to BIPRU 12)	*10.13 to 10.15*
Current 'BIPRU' and 'IFPRU' firms (with ICAAP/ICG)	*11.37 to 11.38, 11.68 to 11.69, 11.102 to 11.103*
Any investment firm with existing CRR permission or IFPRU/BIPRU rule waiver	*Chapter 16*
Current 'Exempt-CAD' firms	*19.23 to 19.24*
Collective Portfolio Management Investment Firms (CPMIs)	*Chapter 17* *20.6*

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