A New Prudential Regime for UK Investment Firms

Introduction

For decades, investment firms in the UK and EU protested about being subjected to similar rules to banks despite their risk profiles being manifestly different. They were justified in their complaints and the regulators listened. In December 2015, the European Banking Authority (EBA), in consultation with the European Securities and Markets Authority (ESMA), published a ***Report on Investment Firms***. The Report considered the suitability of certain aspects of the prudential regime for investment firms.

The EBA reviewed the approach to investment firms which entailed a myriad of categories of such firms depending on their activities as defined under the Markets in Financial Instruments Directive (MiFID), such as execution of orders on behalf of clients, dealing on own account, portfolio management etc. In total, the EBA identified eleven categories of investment firms covered by the Capital Requirements Regulation (CRR) framework. The EBA put forward recommendations to the European Commission for developing a new regime for investment firms.

Following years of negotiation, the EU reached agreement on a new prudential regime for investment firms while the UK was still a Member State, consisting of an ***Investment Firm Regulation*** and an ***Investment Firm Directive***. However, unlike other existing rules (such as CRR, MiFID), the UK has not "onshored" the new EU prudential regime into UK law i.e. the legislation did not automatically become part of UK law following the UK's recent exit from the EU. Instead, the UK's future prudential regime for investment firms will be introduced via UK legislation and rulemaking by the Financial Conduct Authority (FCA).

The future UK regime – the initial proposals

Therefore, the FCA is currently developing a new Investment Firm Prudential Regime (IFPR) for FCA investment firms. This will be based largely on the EU's new legislation in this area (i.e. the Investment Firm Regulation and Directive mentioned above) but with modifications.

The current working assumption is that the UK regime will come into effect in January 2022 (six months after the EU's own planned implementation date of 26 June 2021). The FCA plans to publish three consultation papers (as well as policy statements) to introduce the different aspects of the future UK regime. In December 2020, the FCA published the first of these three consultations, "***A new UK prudential regime for MiFID investment firms***", which covers:

- Categorisation of investment firms;
- Prudential consolidation and the group capital test;
- Capital resources and capital requirements;

- Concentration risk; and
- Reporting requirements.

From the first consultation paper, it is clear that the future UK regime will entail significant changes for firms. UK firms currently categorised as “BIPRU firms” might, in particular, find the regime a major departure from the current, highly favourable approach that they are subject to because the UK used a derogation which allowed for a less onerous regime for such firms. In contrast, “IFPRU investment firms” may find the changes less significant (relatively speaking) since they are already subject to tougher requirements under the CRR.

The upcoming changes are detailed and extensive. For example, there will be a new risk-based methodology for calculating capital requirements, known as “K-factors”, based on the activities that an investment firm undertakes. There are also significant changes in the capital resources area which will raise the bar in terms of capital adequacy. We highlight some changes to capital resources below.

Capital resources (i.e. “own funds”) as an example

Below are some examples of the changes proposed for UK investment firms.

- Definition of capital - The FCA plans to adopt a similar approach to the CRR in terms of capital resources. The current tiers of capital used in the FCA’s BIPRU Sourcebook will be replaced entirely and the concept of ‘Tier 3’ capital will no longer apply.
- Full vs partial deduction from capital - The FCA proposes to require the full deduction from regulatory capital of certain items for which the CRR otherwise requires only partial deduction.
- Deduction of software assets - The FCA plans to deviate from the EU by requiring the full deduction of software assets from capital resources under IFPR.
- Investment firm consolidation waiver - This derogation, from which many asset management firms have benefited for years, looks set to be abolished. It will be replaced by a “Group Capital Test” (amongst other criteria) for groups wishing to be exempted from prudential consolidation.

The future UK regime – upcoming proposals

As noted earlier, two more consultation papers are expected in the coming months which will cover other aspects of the regime, including but not limited to the following:

- Liquidity
- Risk Management and Governance
- Individual Capital and Risk Assessment (ICARA)
- Supervisory Review and Evaluation Process (SREP)
- Remuneration

- Permissions and application forms
- Disclosure and ESG

The FCA has stated that it plans for its future IFPR regime to achieve the same overall outcomes as the EU legislation underpinning it. However, since the UK regime is being developed after the UK's exit from the EU, the FCA is not bound by EU law and may choose to deviate from any aspects of the EU legislation in this space.

Conclusion

A new era beckons for investment firms in the UK (and in the EU). It is clear that the future UK regime for investment firms, currently being developed by the FCA, will represent a seismic shift in the approach to ensuring the prudential soundness of UK investment firms. The timelines for finalising the regime are very tight given the implementation date of 1 January 2022. Investment firms will need to be on top of the new regime fairly quickly.

Firms should begin preparing for these new requirements immediately, including assessing the scope and impact of the future regime on their businesses. There will not be an abundance of time to get up to speed with the new regime before it comes into effect.

Midelatory Consulting can provide expert support to investment firms as part of their implementation activities. If you have any queries, please get in touch.

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