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In June 2021 a new prudential regime for investment firms will come into effect. The prudential regime will now be more tailored for investment firms, and is a significant revision of the current prudential requirements for investment firms.

Overview and Classification

Overview

The new IFR/IFD prudential regime revises capital requirements, capital composition, liquidity requirements, reporting, disclosure, governance, remuneration and supervision of investment firms as set out in CRR/CRD and MiFID.

The aim of the new framework is to introduce more proportionate and risk-sensitive rules for investment firms. Under the new framework, the vast majority of investment firms in the EU will no longer be subject to rules that were originally designed for banks. The largest and most systemic investment firms, however, will remain subject to the same prudential regime as European banks (i.e. CRR and CRD).

The IFR/IFD prudential regime applies to all MiFID authorised investment firms and therefore captures all investment firms that carry out the following activities:

- Reception and transmission of orders in relation to financial instruments;
- Providing investment advice;
- execution of client orders;
- dealing on own account;
- portfolio management;
- underwriting financial instruments, and/or placing financial instruments on a firm commitment basis;
- placing of financial instruments without a firm commitment basis;
- Operating trading facilities - MTF/OTF

Classification
Under the IFR/IFD framework, investment firms fall under one of the following four classifications:

'Class'	Authorisation	Prudential Regime
'Class 1'	Credit Institution – CRD	CRR and CRD
'Class 1 Minus'	Investment firm - MiFID	CRR and CRD
'Class 2'	Investment firm - MiFID	IFR and IFD
'Class 3'	Investment firm - MiFID	Reduced IFR and IFD

This is a significant reduction when compared with the CRR/CRD prudential framework that has 11 different categories of investment firm.

Class 1 and **Class 1** minus investment firms remain subject to the CRR/CRD prudential framework. **Class 1** investment firms, who are the largest and most systemic, are required to apply for authorisation as credit institutions.

Class 2 and **Class 3** investment firms are subject to the new IFR/IFD prudential regime, albeit **Class 3** investment firms benefit from a proportionate lighter touch regime under the IFR/IFD than **Class 2** investment firms.

If the Central Bank considers that a Class 2 investment firm poses a systemic risk, then they can on a case-by-case categorise that investment firm as Class 1 minus.

There will only be a handful of **Class 1** and **Class 1** minus firms in Ireland, therefore, this new prudential regime will have an impact on the majority of investment firms operating in Ireland. As such, this article in the main will explore the impact of the new regime to **Class 2** and **Class 3** investment firms.

Capital and Own funds

Own funds composition

Requirement	Class 2	Class 3
Definition of Capital	Broadly the same as the CRR with some derogations relating to deductions	

The own funds composition requirements of the IFR/IFD are broadly the same as the own funds requirements of the CRR/CRD.

The IFR/IFD utilises the CRR/CRD capital framework but includes some specific derogations which are tailored towards investment firms in relation to deductions from capital.

Requirement	Class 2	Class 3
Capital Requirements	Higher of: Fixed overhead requirement (FOR); Permanent Minimum Requirement (PMR); K-Factor requirement.	Higher of: Fixed overhead requirement (FOR); Permanent Minimum Requirement (PMR).

Fixed Overhead Requirement (FOR)
The FOR of the CRR was only applicable to a subset of investment firms. Under the IFR all investment firms must now calculate their FOR.

The FOR is set as one quarter of the previous year's fixed overheads. The way in which the FOR is calculated under the IFR is largely similar to that of the CRR method, however, some additional clarity has been provided in relation to deductions from expenses.

Permanent Minimum Requirement (PMR)
Under the IFR an investment firm's PMR is the same as the initial capital required (ICR) for authorisation.

For some firms there is a significant increase or decrease in their initial capital amount. Investment firms that were previously categorized as 'local firms' would have been subject to an initial capital requirement of €50,000 but under the IFR/IFD would be subject to an initial capital requirement and a capital floor of €750,000.

The PMR thresholds are included in Appendix I.

K-Factor requirement
The K-Factor requirement is a new requirement under the IFR which is only applicable to Class 2 investment firms. These firms are required to calculate their Own Funds Requirements based on the extent to which they are exposed to certain risk-related activities. Some elements of this requirement are completely new for investment firms, while others are either direct applications of, or comparable to, existing CRR provisions.

Class 3 investment firms will have to monitor their K-factor metrics to ensure they have not breached their categorisation threshold.

The K-Factor requirement is the sum of:
- the Risk to Client (RtC)
- the Risk to Market (RtM)
- the Risk to Firm (RtF)

The categories of risk and their constituent components are outlined in the table below:

Category	K-Factor	K-Factor description
RtC	K-AUM (Assets under management	K-AUM reflects the potential harm associated with the management of assets for clients such as incorrect discretionary management or issues relating to best execution.
	K-CMH (Client money held)	K-CMH covers potential risks associated with the holding of client money by an investment firm. CMH should be the amount of money that the investment firm holds, which is held in accordance with the Client Asset Regulations.
	K-ASA (Assets safeguarded and administered)	K-ASA captures the risk of safeguarding and administering client assets, and ensures that investment firms hold capital in proportion to such balances, regardless of whether they are on its own balance sheet or in third-party accounts. ASA have a clear link to CMH, as being the total financial instruments that must be treated as such under CAR, as CMH is the total client money in accordance with CAR.
	K-COH (Client orders handled)	K-COH captures the potential risk to clients of an investment firm which executes orders (in the name of the client, and not in the name of the investment firm itself), for example as part of execution only services to clients or when an investment firm is part of a chain for client orders.
RtM	K-NPR (Net position risk)	K-NPR is designed to cover potential risks of an investment firm dealing on its own account, or executing for clients in the name of the investment firm.
	K-CMG (Clearing margin given)	As an alternative to K-NPR, investment firms trading financial instruments with positions that are subject to clearing may, with the approval of the Central Bank, use K-CMG. In order to use K-CMG all or most of the investment firm's trading activity should be mostly encapsulated by this approach.
RtF	K-TCD (Trading counterparty default)	K-TCD reflects the risk of trading counterparties failing to meet their obligations to the investment firm. K-TCD only applies to investment firms dealing on their own account, including executing for clients in the name of the investment firm.
	K-CON (Concentration risk)	K-CON is the K-Factor own funds requirement for concentration risk in the trading book, which captures large exposures to specific counterparties, where exposure exceeds the limits set out in IFR.
	K-DTF (Daily trading flow)	K-DTF reflects the operational risks to an investment firm of trading large volumes on its own account or for clients in the investment firm's name, in one business day.

Internal Capital and Liquid Assets
Under the IFD Class 2 investment firms are required to have "sound, effective and comprehensive arrangements, strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and liquid assets that they consider adequate to cover the nature and level of risks which they may pose to others and to which the investment firms themselves are or might be exposed.". This requirement is conceptually the same as the internal capital adequacy assessment process (ICAAP) and internal liquidity adequacy assessment process (ILAAP) required by the CRD. The arrangements, strategies and processes should be proportional to the nature, scale and complexity of the activities of the investment firm concerned.

By default Class 3 investment firms are exempt from this requirement, however, the Central Bank has the discretion to request Class 3 to meet this requirement to the extent deemed appropriate.

The Central Bank of Ireland "considers it good practice to require all investment firms to review their own risks and ensure they have adequate capital and liquidity regardless of their size." Therefore, in CP135 the Central Bank has stated that it proposes to exercise its discretion and require all Class 3 investment firms to perform an assessment of internal capital and liquid assets.

Liquidity

Requirement	Class 2	Class 3
Liquidity	Minimum liquidity requirement set at 1/3 of FOR. Liquid asset eligibility largely based on the LCR DA with fewer restrictions on their composition.	

Liquidity requirements
The IFR brings a new approach to managing liquidity in comparison to the CRR. While both the IFR approach and the CRR approach, which is the liquidity coverage ratio (LCR), result in investment firms holding enough High Quality Liquid Assets (HQLA) to survive for a month, they differ in how they are calculated. Under the IFR, expenses in the form of the fixed overhead requirement are used as the relevant metric for the calculation whereas the LCR uses the expected net outflows over a 30 day stress scenario. As a result of these new requirements, firms must address technological, governance and reporting considerations and implications, which must be acknowledged through processes and control environment changes. The Central Bank had previously exempted investment firms, bar systemic investment firms, from the CRR liquidity requirements, therefore, under the IFR it will be the first time many Irish based investment firms will be subject to a liquidity requirement.

The IFR introduces a minimum quantitative liquidity requirement for all investment firms that requires investment firms to hold eligible liquid assets equivalent to at least one third of their fixed overhead requirements. 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, in the event that other sources of cash-flow are unavailable. There is an additional requirement where firms provide guarantees to clients.

This minimum requirement is designed to act as an appropriate baseline for all investment firms. Firms should consider, as part of the internal risk assessment process whether additional liquidity should be maintained above the fixed overhead requirement.

Under IFR, the Central Bank can exempt 'Class 3' firms from the liquidity requirements, however the Central bank do not consider these requirements to be overly burdensome, and are therefore not proposing to apply a blanket exemption for 'Class 3' firms, and instead exercise this discretion on a case-by-case basis as outlined in its CP135.

Internal Governance and Remuneration

Internal Governance
In general, the internal governance requirements of the IFR/IFD are similar to those of the CRR/CRD. The internal governance requirements of the IFR/IFD are applicable to Class 2 investment firms in full with some requirements applicable to Class 3 investment firms such as the provisions relating to the treatment of risks.

The IFD requires Class 2 investment firms to have robust governance arrangements that are appropriate and proportionate to the nature, scale and complexity of the risks inherent in the investment firm. The EBA has published Draft Guidelines that provide clarity in how both the Central Bank and investment firms should apply the principle of proportionality.

The Guidelines:
- Specify the tasks, responsibilities and organisation of the management body;
- Specify the organisational requirements of investment firms including the need for transparent structures;
- Specify the requirements to ensure sound risk management across the three lines of defense; and
- Specify requirements for the independent risk management and compliance function and the internal audit function.

Class 2 investment firms should review these Guidelines and ensure that they will be able to comply with their internal governance requirements under the IFD.

Remuneration

Requirement	Class 2	Class 3
Remuneration	No bonus cap but similar core remuneration principles and approach to variable remuneration as CRD.	No additional requirements to those in MiFID II.

The IFD sets out remuneration requirements that aims to ensure all investment firms in its scope have remuneration policies that are consistent with, and promote, effective risk management.

The IFD requirements are based on the same core remuneration requirements as CRD IV but differs in some areas. Major deviations (compared to the CRD IV) mainly relate to variable remuneration and gender requirements.

Policies

The remuneration requirements have not changed materially from the existing CRD IV provisions. As is the case under CRD IV these requirements will apply to identified Material Risk Takers (MRT's). The types of staff considered as Identified Staff is somewhat broader than was the case with CRD IV. Firms must ensure that their remuneration policies are:

- 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; and
- Gender neutral.

Variable Remuneration

Under the IFD there will be changes to the way variable remuneration is calculated to include more consideration of risks and other instruments apart from purely a percentage relative to the fixed component. Furthermore, there is more governance surrounding the calculation and criteria that must be met to reach certain benchmarks.

The "bonus cap" will no longer apply to investment firms; however, they will be required to set appropriate ratios between the variable and the fixed component of the total remuneration of their MRTs.

The IFD will require 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.

To better align the interests of individuals with the interests of the investment firm and its clients, the IFD requires that at least 50% of an individual's remuneration be paid in shares or other non-cash instruments. To reflect the diverse legal structures of investment firms, the IFD simplifies the types of instruments which can be used when compared to CRD IV.

Additionally, at least 40% of variable remuneration, and 60% in case of particularly high amounts, should be deferred over a 3- to 5-year period.

The Department of Finance have issued a Consultation Paper, on the exercise of national discretions in IFD, in which they discuss the proposed exemption of some staff from certain thresholds in regard to variable remuneration. This is still under review and we await the final outcome.

A Gender-neutral Remuneration Policy and Practice

The IFD requires the remuneration policy and practice to be gender-neutral. This entails the principle of equal pay for male and female workers for equal work or work of equal value.

Remuneration Committee

Under IFD investment firms with average on-and off-balance sheet assets of over €100 million over the 4 years immediately preceding the given financial year must establish a remuneration committee. The remuneration committee should be able to exercise competent and independent

judgment on the remuneration policies and practices and the incentives created for managing risk, capital and liquidity. Unlike under CRD IV, the Central Bank cannot waive this requirement, however the committee may be established at group level.

A new feature in the IFD is the requirement to have a gender-balanced remuneration committee.

The EBA has published a consultation paper on sound remuneration policies.

Consolidation

Prudential consolidation means supervisors not only look at one single investment firm for the compliance with IFD/IFR prudential requirements, but also at other entities in a group. This may apply to parent undertakings, but also to other subsidiaries in the group, or subsidiaries of the investment firm. IFR mainly sets out terms on the application level of the new prudential requirements, while IFD covers more general terms on consolidated supervision.

When does consolidation apply?

Investment firms are typically subject to individual regulatory requirements, however under prudential consolidation those requirements are also applied to an investment firm on the basis of the position of its wider 'consolidation group'.

By definition, an 'investment firm group' excludes credit institutions, and therefore IFR prudential consolidation rules do not apply to an investment firm who is part of a group which includes a credit institution.

What does this mean for firms?

The parent firm may have a higher own funds requirement at a consolidated level than the subsidiary firms need to hold individually. One potential implication is that union parents may have to hold capital for subsidiaries based outside the union (e.g. UK), leading to a competitive disadvantage.

Group Capital Test (GCT)

The Central Bank may allow a Group Capital Test for groups that are sufficiently simple, provided there are no significant risks to clients or market arising from the group as a whole (that would otherwise require supervision on a consolidated basis).

CRR/CRD IV Provisions which no longer apply

Capital Stack

Under CRD, where an investment firm is authorised under MiFID to provide investment services and activities of 'dealing on own account' and/or 'underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis', then the investment firm must maintain a Capital Conservation Buffer (CCB) and a Countercyclical Capital Buffer (CCyB). There is no equivalent provision included in IFD.

The diagram below highlights the differences and similarities between the capital stack under the CRR/CRD and the IFR/IFD.

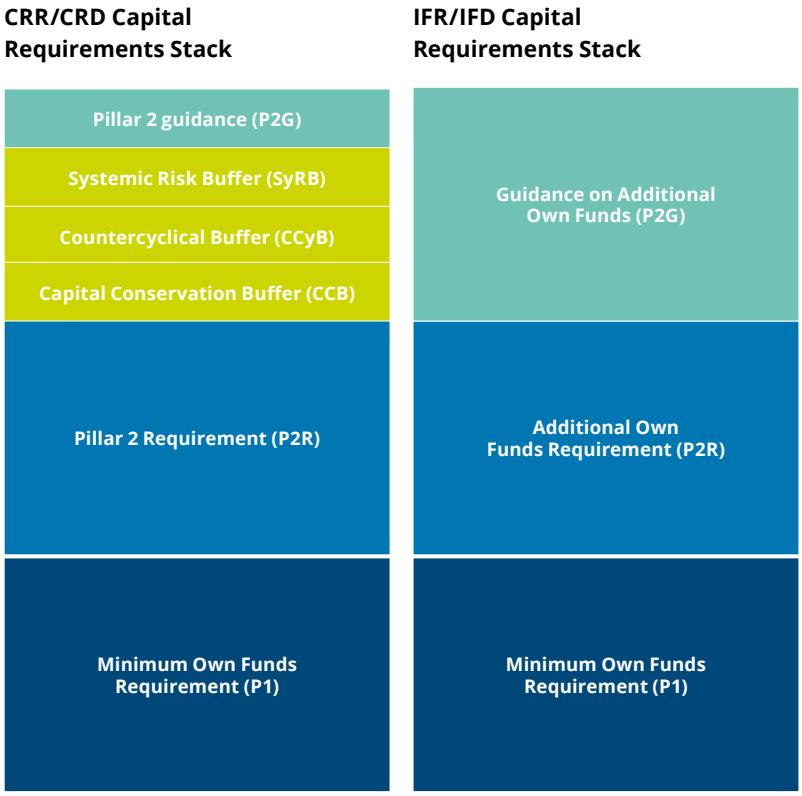
The IFD does however include provisions which allow the Central Bank to require Class 2 investment firms to hold 'additional own funds' (P2G). This 'additional own funds' requirement complements the additional capital required as per IFR (Pillar 1) and the SREP (P2R), in line with the investment firm's ICAAP.

As mentioned previously, there are no specific buffers under the IFR/IFD regime. In the absence of guidance from the Central Bank there is the potential for equivalent buffers to be prescribed, either as part of the Pillar 1 capital requirement or as a discrete capital add-on as part of Pillar 2 requirements.

Leverage

CRR outlines how institutions are to calculate their leverage ratio and the associated reporting requirements. This requirement was only applicable to commodity derivatives investment firms that are not exempt under the MiFID, and any investment firm that did not fall into any other investment firm category under the CRD framework.

From 1 January 2022 CRR2 makes a 3% leverage ratio a binding minimum requirement for banks. There are no leverage requirements included in the IFR.



What next?

General

Investment firms must determine which classification they fall under and should carry out an impact assessment and gap analysis against the IFR/IFD and all level two texts published to date by the EBA to understand what their requirements are and where they have any gaps.

A number of MiFID investment firms may apply different definitions of capital than those prescribed under the CRR or IFR. The IFR will apply to all MiFID investment firms and this will mean that definitions of capital, such as the concept of 'Tier 3' capital (for example, short term subordinated debt), that firms previously may have been able to utilise would no longer apply.

The finance function, the risk function and the Board will be significantly impacted by the new prudential regime. In particular, risk and finance functions should consider how their current operating model will be impacted by the liquidity, reporting, disclosure and capital requirements.

Liquidity – Pillar 1

Investment firms should calculate their expected liquidity requirement and make sure that the assets they intend to hold to meet this requirement are eligible under the IFR and LCR DA. In Ireland, most firms will not have been subject to a liquidity requirement previously. Therefore, it is important that investment firms develop and implement processes and procedures to monitor and manage their liquidity requirement as well as a process to report on their requirement.

Disclosures and Reporting - Pillar 3

Investment firms should establish/update the necessary policies and procedures in order to be able to meet their reporting and disclosure requirements of the IFR. Investment firms should carry out an assessment of the new reporting templates and address any data gaps.

Investment firms that do not have an in house reporting solution should be looking to procure a solution from a vendor. See Appendix II for reporting and disclosure requirements.

Capital Requirements – Pillar 1

Class 2 investment firms should be developing the necessary calculators in order to be able to calculate their K-Factor requirement and identify any data gaps that need to be sourced.

Investment firms already subject to the FOR should update their policies and procedures to capture the changes made by the IFR. Investment firms who have not previously calculated the FOR should develop the appropriate policies and procedures.

Responsibilities of the Board

Board members of investment firms need to be familiar with the impending IFR/IFD legislation and the potential impact it will have on the investment firm's business. Boards should arrange for training to upskill on the new prudential regime.

Challenges and Getting ready

IFR/IFD Impact assessments:

- Carry out a Gap analysis against IFR/IFD;
- Impact assessment on IT systems, reporting operating model, data governance.

Project Plan:

- Following the impact assessment firms should develop a project and implementation plan to ensure compliance with the regulations in a timely manner.

Develop a K-factor calculator:

- Carry out data mapping, and source data for any gaps;
- Develop an internal calculation solution or implement a solution from a vendor.

ICAAP:

- Include forecasted capital requirements due to IFR/IFD in your firms ICAAP.

Quality Assurance (QA):

- Review project teams impact assessment;
- Perform a User Acceptance Testing (UAT) on K-factor calculator.

EBA Roadmap:

The level 2 text on Pillar 1 and Pillar 3 requirements are further developed than the same on Pillar 2. This has caused some uncertainty in regard to the internal additional capital and liquidity requirements.

SREP Guidelines will not be finalised until the end of 2022. The RTS on Pillar 2 add-ons and the RTS on liquidity risk measurement will not be finalised until June 2021.

Appendix I: Initial Capital Requirement under the IFD

Investment Activities	ICR/PMR
• Dealing on own account • Underwriting/placing of financial instruments on a firm commitment basis • Operation of an OTF (where that investment firm engages in dealing on own account or is permitted to do so)	€750,000
Any other MiFID activity	€150,000
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.	€ 75,000

Appendix II: Reporting and Disclosures

Requirement	Class 2	Class 3
Reporting	Required to report information quarterly on: • The level and composition of their own funds; • Their own funds requirements their own funds requirement calculation; • Their activity profile and size; • Concentration risk; and • Their liquidity requirements.	Required to report information annually on: • The level and composition of their own funds; • Their own funds requirements their own funds requirement calculation; • Their activity profile and size; and • Their liquidity requirements*. *There is a possible exemption from the liquidity reporting requirement if the investment firm is exempted from their liquidity requirement.
Disclosures	Class 2 investment firms are required to disclose information on the following: • Risk management objectives and policies • Governance • Own funds • Own funds requirements • Remuneration policy and practices • Investment policy* • Environmental, social and governance risks* *Subject to additional criteria being met. ESG disclosures are not applicable until 2022.	Class 3 investment firms that issue AT1 capital are required to disclose information on the following: • Risk management objectives and policies • Own funds • Own funds requirements

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