A TALE OF TWO PILLARS

IFD/IFR INTRODUCES NEW CAPITAL REQUIREMENTS FOR INVESTMENT FIRMS

Investment firms provide a range of services and activities to investors in financial markets that are crucial for the functioning of the financial markets and include, among others, the reception and transmission of orders, the provision of investment advice, discretionary portfolio management and trading on own account.

The specific risk profiles of investment firms are not always properly captured by the banking prudential framework (CRD IV[1]/ CRR[2]). Taking this diversity into account, the European Parliament has adopted the Investment Firm Directive (IFD[3]) and the Investment Firm Regulation (IFR[4]).

Among other things, the IFD/IFR framework introduces a whole new way to determine capital requirements for investment firms. This article summarizes the key elements of these new requirements and provides an initial assessment of their impact for the investment firms.

1. Directive 2013/36/EU
2. Regulation (EU) No 575/2013
3. Directive (EU) 2019/2034
4. Regulation (EU) 2019/2033

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Categorization of investment firms

The new IFR/IFD framework is built upon the principle of proportionality and classifies investment firms alongside four categories:

- **"Class 1":** Investment firms that have over €30 billion in assets and perform services that carry bank-like exposures, such as underwriting or dealing on own account will be required to apply for a banking license and will be subject to the CRD IV/CRR rules;
- **"Class 1 minus":** Similar to Class 1 firms, but with balance sheet sizes between €15 billion and €30 billion. These firms will also be subject to the CRD IV/CRR regime but will remain authorized as investment firms;
- **"Class 2":** All investment firms that do not meet the criteria for the other categories. They will fall under the remit of the new IFR/IFD framework;
- **"Class 3":** These are the "small and non-interconnected firms" which do not undertake any high-risk activities and whose activities fall below relevant thresholds. Firms in these categories will be subject to the new IFR/IFD, but with lighter requirements and exemptions (proportionality).

Introducing new capital and liquidity requirements

The new regime will introduce rules related to minimum regulatory capital and liquidity requirements. The framework introduces a minimum liquidity requirement of one-third of the fixed overheads requirement. Competent authorities may exempt Class 3 firms from this requirement. For regulatory capital requirements (Pillar I), firms should use the highest of the following:

- A permanent minimum (determined by services provided) - the permanent minimum capital (PMC) is the minimum to obtain and maintain authorization;
- 25% of fixed overheads of the preceding year. This is in line with the current requirement to support an orderly wind-down;
- The requirement determined by a new risk-sensitive approach, known as K-factor methodology (only for Class 2), to better fit the impact that investment firms can have on customers and markets.

Among other things, the IFD/IFR framework introduces a whole new way to determine capital requirements for investment firms. This article summarizes the key elements of these new requirements and provides an initial assessment of their impact for the investment firms.

	Permanent Minimum Capital requirement	Fixed overheads cost	K-factor
Class 2 firm	✓	✓	✓
Class 3 firm	✓	✓	N.A.

A closer look at the K-factors

The K-factor requirement is deemed to be a closer fit for the risks typically incurred by the broad range of investment firms. The K-factor requirement will lead to different capital requirements than those observed under CRD IV/CRR, as the three Pillar I blocks (credit, market and operational risk) are replaced by quantitative indicators that represent the risks that an investment firm can pose to customers, the wider markets and the firm itself:

There are three categories of K-factors: (i) Risk-to-Client (K-RtC), (ii) Risk-to-Market (K-RtM), and (iii) Risk-to-Firm (K-RtF). The K-factor capital requirement is the sum of the values of the individual K-factors, with one exception: Firms can use either K-CMG or K-NPR to determine the K-RtM requirement.

Category	K-Factor[5]	Description
K-RtC	K-AUM	0,02% of the arithmetic mean of assets under management, measured as a rolling average of the past 15 months, excluding the last three months.
	K-CMH	A percentage of the rolling arithmetic average of daily balances of client money held (CMH) over the past nine months, excluding the last three months. The percentage is dependent on whether client funds are held on segregated accounts. Firms will hold 0,4% of CMH in capital for segregated client accounts, 0,5% for non-segregated accounts.
	K-ASA	0,04% of the rolling arithmetic average of daily balances of client assets safeguarded and administered, measured over the past nine months, excluding the three most recent months.
	K-COH	A percentage of the rolling arithmetic average of the daily value of client orders handled over the previous six months, excluding the last three months. The percentage depends on the instruments traded: It is 0,01% for derivatives, 0,1% for other instruments.
K-RtM	K-NPR	K-NPR is identical to the CRR own funds requirement for market risk, using the standardized approach, the alternative standardized approach or the alternative internal model approach. Firms may use K-NPR, K-CMG, or both to determine K-RtM.
	K-CMG	The third highest amount of total margin required on a daily basis over the preceding three months, multiplied by 1,3. K-CMG may only be used for cleared trades or portfolios, for non-cleared trades K-NPR must be used.
K-RtF	K-TCD	The required capital for trading counterparty exposure depends on the replacement cost of the portfolio, the type of counterparty, the adjusted amount of collateral posted, the potential future exposure of derivatives and the type of transaction. Netting is allowed.
	K-DTF	A percentage of the rolling average of the sum of the absolute value of daily buy and sell orders (amount paid or received for cash trades, notional amount for derivatives) over the previous nine months excluding the last three months. There is a duration correction for interest rate derivatives. The percentage is 0,01% for derivatives, and 0,1% for cash trades. In periods of extreme volatility, the percentages are adjusted.
	K-CON	K-CON refers to concentration risk with respect to counterparts, not just clients. It uses elements of the methodologies to calculate K-NPR and K-TCD, to calculate an exposure value per counterpart, or group of closely connected counterparts. Only positions in specific types of instruments are considered for calculating the exposure value. Where this exposure value exceeds 25% of own funds, a capital requirement exists. The size of the capital requirement depends on the duration and size of the excess.

5. EBA/CP/2020/06

Contribution to the capital requirement and comparison with CRD IV/CRR

When assessing the application of the K-factors to class 2 firms and comparing the results with the current pillar one requirements, we notice that the impact can vary significantly across business lines as outlined in the below tables.

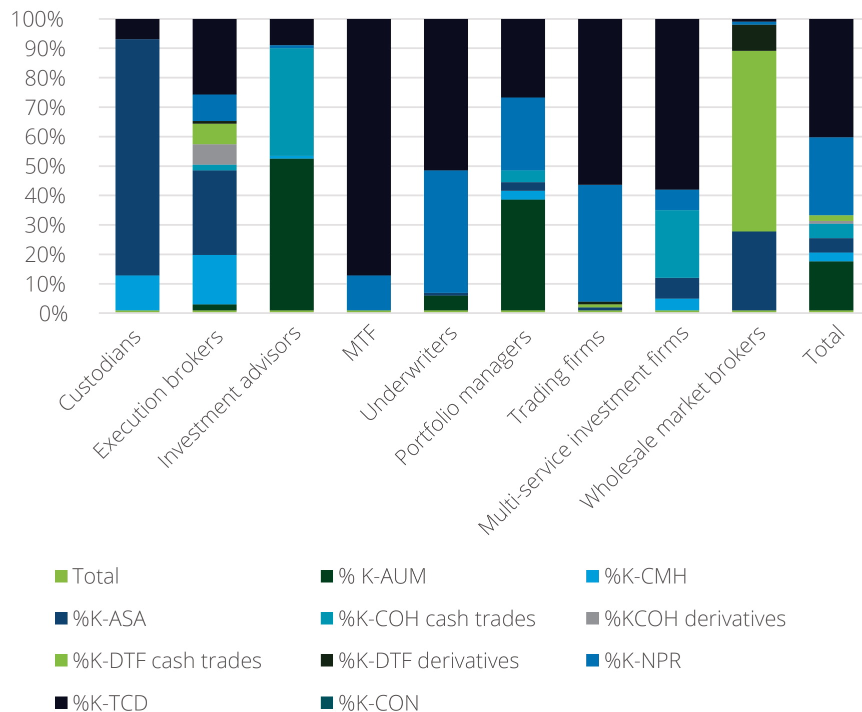
Business Model	Change in pillar 1 capital requirement
Custodians	26%
Execution Brokers	48%
Underwriters	42%
Investment Advisors	306%
MTF	0%
Multi-service Investment Firms	14%
Portfolio Managers	31%
Trading Firms	-14%
Wholesale Brokers	12%

Except for trading firms for which the application of the k-factor methodology suggests a decrease of the capital requirements, all other type of business model will be subject to higher capital:

- Trading firms, on average, see reduced own funds requirements. Firms trading on own account often use the exemption for operational risk under CRR and are required to hold funds based on fixed overhead instead. The closest proxy for operational risk under IFR is K-DTF. From the small marginal contribution of K-DTF to the K-factor requirement, we might expect this to work to the advantage of trading firms, and indeed this is in line with what clients tell us.
- Investment advisors display a substantial overall increase driven by large advisory firms, as the K-factor requirement is dominated by K-AUM, which applies to assets managed under advisory arrangements, and K-COH.
- The other types of business model will also support a capital requirement increase because of the calibration of the k-factors.

As part of its opinion paper[6] on the topic, the EBA published an analysis of the contribution of the different K-factors to the total K-factor requirement for different business models.

Contribution to K-factor requirement



6 Annex to the EBA Opinion EBA-OP-2017-11

The EBA analysis yields some interesting results:

- First, K-TCD is the biggest contributing factor for almost all investment firms. K-CON does not appear to contribute noticeably to the total K-factor requirement, indicating that investment firms in the sample did not exceed the exposure limit of 25% of own funds to a single counterparty or group of connected counterparties.
- Secondly, the K-factors related to derivatives trading (K-DTF and K-COH) also do not appear to contribute significantly to the K-factor requirement for any of the business models reviewed in contrast to the same K-factors for cash instruments.
- Also note that K-CMG, based on margin requirements for cleared trades is absent from the analysis.

The challenges introduced by the IFR

Capital & Business Model
While many investment firms will see a tailored regime as a positive step, the implications of the new regime will differ from firm to firm. Each firm will need to assess what the regime change means for it and take action accordingly.

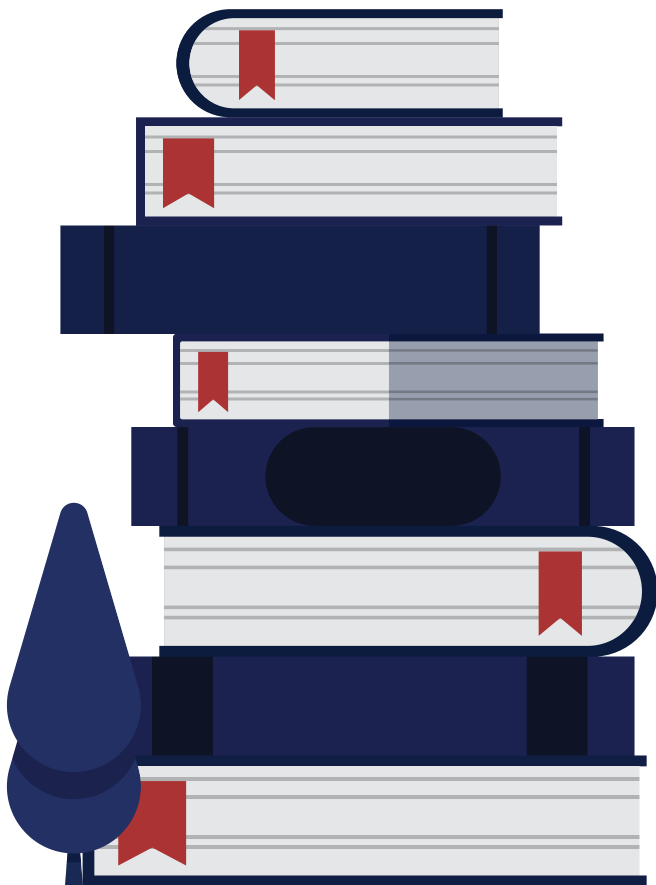
As outlined in the previous section of this article, many Class 2 investment firms will be subject to higher capital requirements. There will be a 5 year transition period where IFD/IFR capital requirements are capped to allow the hardest hit firms to increase their capital. Most importantly, investment firms should use that period to review and assess the sustainability of their business models as the new capital regime might put their revenue under pressure. To illustrate our comment, let's consider an entity authorised to provide a range of MIFID services (see figure 2) that is running a business model presenting the characteristics displayed in figure 1. Under the new framework, this entity will be subject to capital requirement corresponding to 6 bps of the asset under management held by this entity.

When comparing this figure with the net revenue that the entity should generate to overcome the capital requirement, we estimate that a service fees above 20 bps should be collected. This figure suggests the followings:

- investment firms charging 5 bps for the delivery of the service would need four years to reach the targeted level of capital;
- investment firms running a strategy based on the volumes rather than on the fees will be more impacted by the IFR/IFD framework and might not have enough time during the transition period to reach the new capital level. In this situation, the investment firm will need to adjust its business model to ensure a sustainable evolution.

Figure 1 - Business model characteristics	Figure 2 - MiFID Services
• Cost/Income ratio 60% • Tax rate of 20% • 50% of client assets are reinvested over a 1-year cycle • 5% of client assets are in the rom of "client money held"	• Reception and transmission of orders in relation to one or more financial instruments • Execution of orders on behalf of clients and the ancillary services • Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management

While many investment firms will see a tailored regime as a positive step, the implications of the new regime will differ from firm to firm. Each firm will need to assess what the regime change means for it and take action accordingly.



Consolidation
Similar to the CRD IV/CRR, Union investment firm groups will have to apply the Regulation on a consolidated basis. This will lead to the following challenges

- Under the consolidation perspective, the group might be subject to higher capital requirement by application of the k-factor methodology to all group entities;
- Applying EU rules on operating entities located in third countries where local rules are less stringent will create profound competitive challenges for EU groups.

Nevertheless, as long as an investment firm group is sufficiently simple, and there are no significant risks to clients or to the market due to the group structure, group members may opt for one of the proposed simplified approaches which consist, among others, of the application of the own funds requirements on an individual basis. The application of those consolidation rules will have to be carefully managed in order to avoid an over-complexification of the capital management From a liquidity perspective, a competent authority may exempt groups from meeting the liquidity requirements on a consolidated basis when it deems appropriate.

Pillar 2 Requirements
IFD/IFR contains an internal capital adequacy assessment (ICAAP) and supervisory review process (SREP) similar to the one under CRD IV/CRR. Based on the outcome of this review, the competent authority may require the firm to hold additional own funds. Additional own funds may be imposed if:

- The firm is exposed to risks not properly covered by the K-factor requirements
- The firm has insufficient measures in place to monitor and manage risk exposures, and is unlikely to be able to improve this within a reasonable timeframe
- The valuation of trading book positions is such that these cannot be sold or hedged in normal market conditions without material losses
- Internal models used are inadequate
- Own funds are considered insufficient to absorb cyclical economic fluctuations
- There are insufficient own funds for an orderly wind down if needed
- Interest rate risks emerge through the holding of a liquid portfolio

As the K-factor requirements are expected to be a closer match to the risk exposures resulting from the plethora of activities deployed by investment firms, we expect competent authorities will, on the whole, impose smaller pillar 2 related add-ons to own funds requirements. As competent authorities tend to err on the side of caution, we expect the reduction in pillar 2 add-ons to exceed the pillar 1 increase, and lead to a slight overall reduction in total own funds requirement.[7]

7 Fiche 1: Verordening en richtlijn herzien prudentieel kader beleggingsondernemingen

CONCLUSION

- The IFD/IFR regime represents a significant change in the way capital requirements are calculated for investment firms
- Several exemptions apply for small and non-interconnected firms
- Business models like investment advisory and execution brokerage incur much higher pillar 1 capital requirements than in the current regime. Conversely trading firms and custodians incur lower pillar 1 capital requirements
- IFD/IFR contains an ICAAP and SREP similar to the one under CRD IV/ CRR. Based on the outcome of this review, the competent authority may require the firm to hold additional own funds
- Overall, we expect the pillar 1 requirements to be higher under IFD/IFR, and the pillar 2 requirements to be lower
- **Investment firms will need to determine the impact of the IFD/IFR regime, and create a transition roadmap to be ready in July 2021**

TO THE POINT

As of July 2021, the new IFD/IFR regime transforms the way capital requirements for investment firms are calculated. Depending on business model, the impact on the Tier 1 capital requirement can be significant (up to 300%!). Updated capital requirements may have an impact on the cost structure.