IFR / IFD - THE INVESTMENT FIRM PRUDENTIAL REGIME

BDO REGULATORY UPDATE AND SERVICE OFFERING

EU Investment firms must prepare for the new prudential requirements by 26th June 2021.

THE NEW EU PRUDENTIAL REGIME

EU Member States will implement the Investment Firm Directive and Regulation (IFD/IFR) by 26 June 2021.

This new regime takes a more focused approach, which is more relevant and proportionate to investment firms authorised under MiFID. IFR and IFD introduce a new classification system for investment firms, based on their activities, systemic importance, size and interconnectedness. Each class of firms will be subject to a different set of prudential requirements.

NEW INVESTMENT FIRM CLASSIFICATION

Systemic investment firms (Class 1) will be re-classified as credit institutions and will continue to follow the prudential requirements set out in CRD IV/CRR.

All other investment firms will fall under the new prudential framework:

- Small and non-interconnected investment firms with simple and low risk business model, **"SNI"(Class 3)**, will be subject to limited prudential requirements and
- **"Non-SNI" (Class 2)**, including Large Investment Firms that exceed specific thresholds on a range of metrics, will have a global application of the IFR/ IFD.

NON-SNI THRESHOLDS

Firms meeting any one of these thresholds will be a non-SNI firm:

CRITERIA	AMOUNT
Balance sheet total	≥ €100m
Total annual gross Total annual gross revenue from investment activities	≥ €30m
Assets Under Management	≥ €1.2bn
Daily client orders handled: ▸ for cash trades (amount paid/received) ▸ for derivatives trades (notional value)	 ≥ €100m ≥ €1bn
Assets Safeguarded and Administered	> 0
Client Money Held	> 0
Deals on own account	yes

IFR/IFD OWN FUNDS REQUIREMENT

NON-SNI (CLASS 2)	SNI (CLASS 3)
Highest of: ▸ Permanent Minimum Capital Requirement (PMR); ▸ Fixed Overhead Requirement (FOR); ▸ K-Factor Capital Requirement (KFR).	Higher of: ▸ Permanent Minimum Capital Requirement (PMR); ▸ Fixed Overhead Requirement (FOR).

IFR/IFD OWN FUNDS COMPOSITION

ELIGIBLE CAPITAL	AMOUNT
Common Equity Tier 1 (CET1)	> 56% TOFR
CET1 + Additional Tier 1 (AT1)	> 75% TOFR
Assets Under Management	≥ 100% TOFR

PERMANENT MINIMUM REQUIREMENT (PMR)

Initial capital requirements refer to the absolute amount of capital required at the point of authorisation. The current prudential regime stipulates the initial capital could be €50k, €125k and €730k (CRD IV, Article 29) according to the firm's permitted activities.

Under the new regime the initial capital requirement is referred to as the Permanent Minimum Capital (PMR). The base own funds requirement is set on the basis of the regulated activities and services provided:

€75k: firms not holding client money/ assets authorised for:

- Receiving and transmitting orders;
- Executing orders on behalf of clients;
- Portfolio management;
- Investment advice;
- Placing financial instruments without firm commitment.

€750k: firms authorised for:

- Dealing on own account (incl. matched principal broker);
- Underwriting/placing financial instruments with firm commitment.

€150k: all other Investment Firms.

Most of investment firms will be in the €75k and €150k bracket.

FIXED OVERHEAD REQUIREMENT (FOR)

The FOR is calculated as ¼ of the fixed overheads of the preceding year, following deductions. All variable expenses can be excluded unless they represent 'recurring, unavoidable or contract based costs incurred in the regular course of business'. The EBA, in consultation with ESMA, has proposed technical standards for the calculation of the fixed overhead requirement which includes at least the following items for deduction:

- Staff bonuses and other remuneration, to the extent that they depend on the net profit of the investment firm in the respective year;
- Employees', directors' and partners' shares in profits;
- Other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary;
- Shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue, and where the payment of the commission and fees payable is contingent on the actual receipt of the commission and fees receivable;
- Fees to tied agents;
- Non-recurring expenses from non-ordinary activities.

These previous elements for deduction are a non-exhaustive enumeration. They illustrate the characteristics that the deductions should have and are in accordance with the purpose of the IFR/IFD.

K-FACTOR REQUIREMENT

The K-Factor capital requirement (KFR) is based on metrics and coefficients applied to different base values according to the size/volume of each activity:

RtC	Risk-to-Client

Sum of:
- K-AUM Assets Under discretionary/advisory Management;
- K-ASA Client Assets Safeguarded and Administered;
- K-CMH Client Money Held;
- K-COH Client Orders Handled.

RtM	Risk-to-Market

Higher of:
- K-NPR Net Position Risk; or
- K-CMG Clearing Member Guarantee.

RtF	Risk-to-Firm

Sum of:
- K-TCD Exposure to Trading Counterparties Default;
- K-CON Concentration risk based on large exposures to specific counterparties;
- K-DTF Operational risks from Daily Trading Flow.

Investment firm that do not deal on own account through a trading book will only need to apply RtC K-Factors.

REPORTING REQUIREMENTS

Reporting are required each quarter for Class 2 investment firms and each year for Class 3 investment firms. Reporting required are as follows:

- Level and composition of own funds;
- Capital requirements;
- Calculation of capital requirements;
- Concentration risk;
- Liquidity requirements;
- Level of activity in relation to the conditions set out in Article 12(1), including the breakdown of the balance sheet and income by investment service and the applicable K-factor.

ICAAP

- Risk assessment to focus on risk to clients, and then risk to market and risk to firm;
- Pillar 2 – risk-based assessment for risks not captured under Pillar 1;
- Describe FOR and KFR methodology, consolidation, transitional provisions, risk governance;
- Identify strategic vulnerabilities affecting ability to maintain capital and be profitable;
- Stress testing and scenario analysis, including reverse stress testing;
- SREP and individual capital guidance – transition from CRR to IFR.

DISCLOSURES

Class 2 investment firms shall publicly disclose the following information on the same date as they publish their annual financial statements:

- Risk management objectives and policies;
- Governance;
- Own funds;
- Own funds requirements;
- Remuneration policy and practices;
- Investment policy;
- Environmental, social and governance risks.

TRANSITIONAL PROVISIONS

By way of derogation investment firms may apply lower own funds requirements for a period of five years from 26 June 2021. This transitional provision does, however, require a gradual annual increase in the amount of these requirements over the five-year period:

- The investment firm did not exist (or was not subject to CRR/CRD) before the date of application of IFR/IFD, the capital requirement may be limited to twice the Fixed Overhead Requirement (FOR);
- The investment firm was subject to a capital requirement under CRR/CRD, then under IFR the new capital requirement may be limited to twice the previous requirement;
- The investment firm was only subject to an initial capital requirement under CRR/CRD, so under IFR the capital requirement may be limited to twice the initial capital requirement.

FOCUS ON COMMODITY AND EMISSION ALLOWANCE DEALERS

One of the objectives of IFR/IFD is to create a more appropriate regime for investment firms, the main business of which consists exclusively of the provision of investment services or activities in relation to commodity derivatives, derivatives on emission allowances or emissions allowances. These commodity and emission allowance dealers will not be treated as a Class 1 investment firms even if their assets exceed the specified size threshold. Unless they are part of a consolidated group and elect to be treated as Class 1b firms, they will be treated as Class 2 or 3 investment firms according to whether they exceed any of the specified thresholds.

Under IFR there are specific transitional provisions for investment firms recognised as a commodity and emission allowance dealer. According to the IFR, this exemption allows for a staggered implementation on 26 June 2026 of the following elements:

- Requirement:
  - Liquidity requirement.
- Disclosure by investment firms:
  - Risk management objectives and policies;
  - Governance;
  - Own funds;
  - Own funds requirements;
  - Remuneration policy and practices.

HOW CAN BDO HELP?

BDO can offer a complete menu of services, covering all aspects of the prudential reform to assist investment firms with a smooth transition to the IFR/IFD:

SERVICE	DESCRIPTION
IMPLEMENTATION PLAN	Drafting an IFR implementation plan including all relevant objectives, required work streams, specific tasks, milestones, timeframes.
IFR/IFD TRAINING	Training session covering all aspects of the new prudential regime (half day session).
TECHNICAL WORKSHOPS	Bespoke modules providing a detailed analysis of specific technical aspects of the new prudential regime (upon request).
IMPACT ASSESSMENT	Analysis of scope of application of the new regime, firm classification, prudential requirements, and additional obligations to identify how the IFR/IFD rules apply to the firm, how the permission profile must be read under IFR/IFD, how the regulatory components of PMR, FOR and KFR apply, how the firm will transition from the CRR to IFR/IFD, what transitional provisions can be relied upon, what timeframe should be considered for full implementation.
FINANCIAL ASSESSMENT	Calculation of indicative financial impact of IFR prudential regime and assessment of new capital and liquidity requirements.
PRUDENTIAL CONSOLIDATION	Analysis of group structure, identification of 'investment firm group', IFR consolidation test, scope of application of consolidated requirements, analysis of group-wide capital adequacy.
DEVELOPMENT OF NEW IFR/IFD CAPITAL MODELS	Assisting with the development of new IFR/IFD capital adequacy methodology for Pillar 1 including k-factor model, financial projections, FOR calculations (if required depending on the quality of the Firm's models).
ICAAP	Assisting with the development of new ICAAP and all constituent parts including risk assessment tools, Pillar 2 capital buffers, liquidity risk assessment, stress testing, wind down planning.
ADDITIONAL IFR/IFD POLICIES	Assisting with the development of new policies including corporate governance, remuneration policy and Pillar 3 disclosure.
REGULATORY REPORTING	Guidelines on IFR/IFD reporting obligations and review of new regulatory returns for completeness and accuracy.
TEMPLATES	Templates of all policies, models, risk assessment tools can be provided as part of the relevant services mentioned above where required.
AD-HOC ADVICE	Additional prudential and regulatory support upon request.

For more information
To find out more about BDO's prudential service offering for Investment Firms please contact our Financial Services Advisory team :

Benjamin IZARIE
Partner
+33 6 31 65 74 05
benjamin.izarie@bdo.fr

Rê-Liré IVANGA
Senior Manager
+33 6 72 49 29 72
re-lire.ivanga@bdo.fr

BDO Paris audit & advisory
43-47 avenue de la Grande Armée
75116 Paris, France
Tel : +33 1 58 36 04 30
www.bdo.fr

BDO