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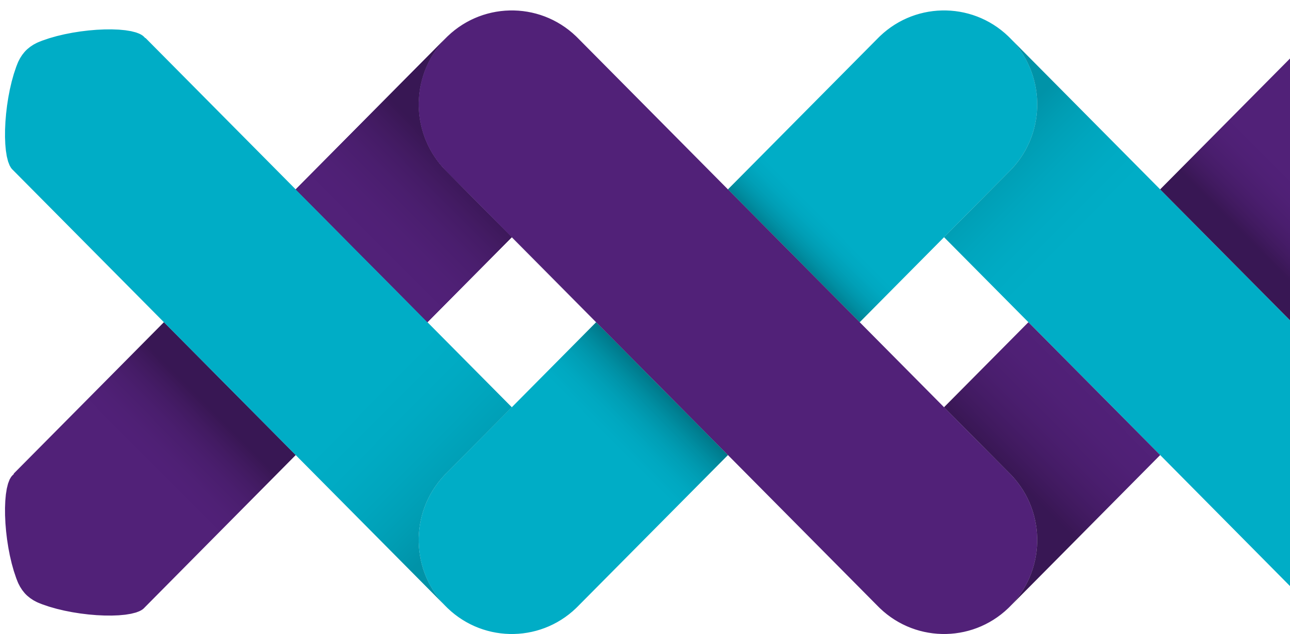
A guide to the new prudential regime

Understanding the new rule book for investment firms



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A new regime for investment firms

Investment firms authorised under the Markets in Financial Instruments Directive II (MiFID II) are currently subject to prudential requirements set out in the Capital Requirements Regulation (CRD IV) and Capital Regulations Requirements (CRR).

But these regulations are too broad to effectively capture the risks faced by both credit institutions and investment firms. Credit institutions are vulnerable to market, credit, operational and liquidity risks, due to their lending and deposit taking activities. But most investment firms face risks around the impact of their activities on customers and markets, either during the course of their day to day operations or in the event of a wind down.

To address these different sensitivities, the European Commission has proposed a new regime consisting of the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD) to establish a new framework for prudential requirements for investment firms. This new regime takes a more focused approach, which is more relevant and proportionate to investment firms.

Some degree of re-categorisation is required between what constitutes a credit institution, versus what constitutes an investment firm. Certain systemically important investment firms will be now 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, replacing the requirements set out in CRD IV/CRR. Small and non-interconnected investment firms will be subject to limited prudential requirements.

This brochure is a guide to the new regime and outlines the key points firms should be thinking about.

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Establishing regulations which are risk-responsive

The current prudential regime in Europe is rooted in the original 1993 Investment Service Directive (ISD) and the Capital Adequacy Directive (CAD). They were subsequently replaced, and further built on, by MiFID, CRD IV and CRR.

The CRD IV/CRR requires the European Commission to carry out a review on certain aspects of the Prudential Framework. As a result, the commission asked the EBA to carry out an investment firm review. The review recommended a new prudential framework for investment firms, which is more proportionate and risk-responsive.

In its 2015 'Report on Investment Firms', the EBA highlighted the deficiencies of the present regime for being disproportionately complicated and non-risk-responsive. It actively sought feedback and proposals for reform, including:

- 'EBA Opinion (Part 1)', October 2016 (EBA/Op/2016/16) – addressing the criteria to identify systemically important firms
- 'Discussion Paper', November 2016 (EBA/DP/2016/02) – addressing the prudential regime for non-systemic investment firms
- 'EBA Opinion (Part 2)', September 2017 (EBA/Op/2017/11) – containing an annex as the 'Final Report'.

The Commission considered this feedback and issued the following draft legislation on 20 December 2017, ahead of the commencement of MiFID II:

- Investment Firms Directive, COM (2017) 791
- Investment Firms Regulation, COM (2017) 790

The proposed timeline for IFD and IFR implementation is as follows:

A new categorisation for investment firms

The new firm classification system remains driven by the permission types granted to a firm under MiFID. There will be a distinction between systemically important firms and those which are not. Amongst the non-systemic firms, a range of factors will be taken into account, eg balance sheet size or client money, for further classification. These factors will be known as K-factors.

Summary of the new categorisation of investment firms:

	Meaning	Current prudential regulation	New prudential regulation	Current supervision	New supervision
Class 1 (Systemically important)	Assets > €30 bn Bank-like risk profile	CRD IV/CRR	CRD IV/CRR	National supervisors	Single Supervisory Mechanism (SSM) for the banking union
Class 2/Class 3 (Non-systemic)	**Class 2:** Large firms above certain thresholds	CRD IV/CRR	New prudential regime	National supervisors	National supervisors
	Class 3: Small and non-interconnected	CRD IV/CRR	New prudential regime	National supervisors	National supervisors

Class 1 firms

Several options were proposed to identify systemically important investment firms which can be considered as bank-like. The European Commission eventually decided to amend the definition of a 'credit institution' in Article 4 of CRR.

According to the draft legislation, for a solo entity to be a Class 1 firm, it needs to satisfy the following criteria:

i. Whose business consists of either:
   - Dealing on own account
   - Underwriting of financial instruments or placing of financial instruments on a firm commitment basis

ii. Whose total assets exceed €30bn

However, to prevent regulatory arbitrage, firms also need to consider the wider group context. If a firm has less than €30bn assets, but it is part of a wider group, and that group contains other entities which carry out the above regulated activities; then the regulator will check if all these entities have a combined asset value over €30bn. If so, and if the regulator has financial stability concerns, it can make one or more of these entities to be a Class 1 firm.

Capital requirements

Class 1 firms will not be subject to IFR and IFD. They will follow the CRD IV/CRR regime, as per other credit institutions.

The initial capital requirement will now be €5m (as per Article 12 of CRD IV directive), which represents a steep rise from the present €730k initial capital requirement.

There will be a Liquidity Coverage Ratio requirement.

Class 2 firms

A set of thresholds for Class 2 firms are set out in IFR Article 12. A firm will be Class 2 if any of the following thresholds are met:

i. Balance sheet total ≥ €100m
ii. Total annual gross revenue from investment services/activities of the firm ≥ €30m
iii. Assets Under Management ≥ €1.2bn
iv. Client Orders Handled ≥ €100m a day for cash trades or €1bn a day for derivatives
v. Assets Safeguarded and Administered > 0
vi. Client Money Held > 0
vii. Daily Trading Flow > 0
viii. Net Position Risk/Clearing Member Guarantee > 0
ix. Trading Counterparty Default > 0

Note: (i)-(iv) thresholds are treated on combined basis. This means that the threshold applies to all investment firms that are part of a group. (iii)-(ix) are K-factors, see page 10 for definitions.

Class 2 firms are regarded as larger non-systemic investment firms. They are subject to more restrictive prudential requirements because:

- non-systemic investment firms can collectively create a system-wide impact
- some investment firms can have significant trading activities and failure could lead to a deterioration in market confidence
- there is the potential for a significant and adverse impact on customers and markets.

Class 3 firms

Class 3 firms are those which are small and non-interconnected. A firm will be Class 3 if all of the following criteria are met:

i. Balance sheet total < €100m
ii. Total annual gross revenue from investment services/activities of the firm < €30m
iii. Assets Under Management < €1.2 bn
iv. Client Orders Handled < €100m a day for cash trades or €1bn a day for derivatives
v. Assets Safeguarded and Administered = 0
vi. Client Money Held = 0
vii. Daily Trading Flow = 0
viii. Net Position Risk/Clearing Member Guarantee = 0
ix. Trading Counterparty Default = 0

Firms that hold even small amounts of client money, or have only one trade on their books, will be categorised as Class 2 and will be subject to higher capital requirements.

Firms that transition from Class 3 to Class 2 must apply the K-factor requirements immediately, except for the K-AUM and K-COH, where firms will be allowed three months from the date they exceed the categorisation thresholds before being reclassified to Class 2. Meanwhile a Class 2 firm should meet the criteria for being in Class 3 for at least six months before being confirmed as belonging to Class 3.

Operationalisation for firms

The new categorisation system requires constant monitoring of the relevant data with respect to the thresholds and K-factors. Therefore, it would be logical that the regulators will expect reporting of such data on a periodic basis, or when the thresholds are breached.

Many firms will face challenges around the establishment of appropriate monitoring/reporting systems to operationalise the thresholds and K-factor measurement.

Establishing new capital requirements

The new regime will also bring changes to capital requirements. Initial capital requirements will continue to serve as the absolute minimum, but there will be a greater emphasis on Fixed Overhead Requirements. To calculate the new capital requirement, firms must apply a new risk-responsive computation, known as K-factor methodology.

Class 1 firms' own funds requirements will continue to be the sum of:

- Credit risk
- Market risk
- Operational risk

Class 2 firms' own funds requirements (highest of):

- Permanent Minimum Capital requirement (PMC)
- Fixed Overhead Requirement (FOR)
- K-factor capital requirement

Class 3 firms' own funds requirements are simpler (highest of):

- PMC
- FOR

Initial capital requirements refer to the absolute amount of capital required at the point of authorisation. The current 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 requirement and the figure will be increased, according to the firm's activities:

Initial capital/PMC for Class 2/Class 3 firms	Investment firms activities
€750k	Carry out one or more of the following: • Dealing on own account • Underwriting/placing of financial instruments on a firm commitment basis • Operation of MTF/OTF
€150k	All other investment firms
€75k	**Not permitted** to hold client money or securities and carry out one or more of the following: • Receiving and transmitting orders • Executing orders on behalf of clients • Portfolio management • Investment advice • Placing of financial instruments without a firm commitment

Ongoing capital requirements

With the initial capital requirement as an absolute minimum, there are also own fund requirements which an investment firm will need to satisfy at all times.

Own funds requirements

On an ongoing basis, a firm must meet its own funds requirements, which must be no less than the initial capital amount (CRR, Article 93). There will be prudential filters (for example DTA) to be deducted from CET1, just like the present treatment.

Definitions of Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 remain as per CRR.

Own funds requirements will continue to be met from:

- At least 56% of the sum (of Tier 1 and Tier 2 capital) is CET1
- Up to 44% of the sum (of Tier 1 and Tier 2 capital) may consist of AT1
- Up to 25% of the sum (of Tier 1 and Tier 2 capital) may consist of Tier 2

Fixed Overhead Requirement

The formula for FOR is the same as in the current regime:

FOR = ¼ of the fixed overhead of the preceding year

Currently, there is a Commission Delegated Regulation 2015/488 stipulating the method to calculate fixed overhead, which is total expenses less eligible variable costs. There are stipulations as to what variable costs can be deducted. Under IFR there is potential for a new regulatory technical standard to define the computation of fixed overhead for the new regime.

Understanding the K-factor methodology

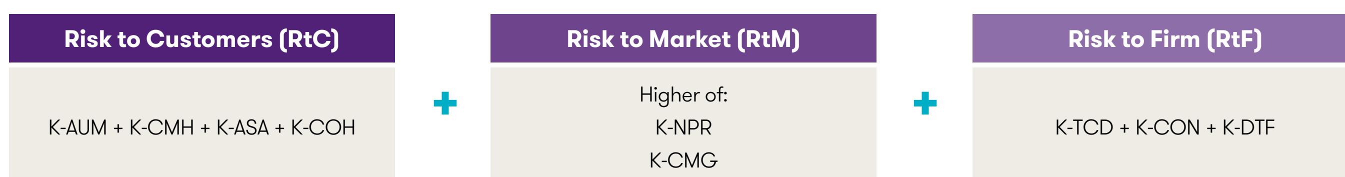
The K-factor methodology aims to calculate ongoing capital requirements based on a number of capital factors. It aims to measure the risks posed by a firm to the customers, to the market and to the firm itself.

K-factor methodology

The EBA recommended a K-factor methodology to capture a range of risks which an investment firm will present.

For Class 2 firms, the K-factors will replace the current credit risk, market risk and operational risk approach in order to calibrate the capital needed to meet the risks of the investment firm.

Broadly speaking, K-factors are quantitative indicators or factors which represent the risks that an investment firm can pose to customers, market/liquidity and the firm itself. There will be three K-factor groups, and the capital requirements are worked out as follows:



The tables below define the K-factors above and the coefficients to be applied to each factor.

Risk to Customers (RtC) calibration

RtC	Meaning	Capital requirement = respective amount x coefficient as below
K-AUM	**Assets Under Management (AUM)** This is the value of assets that an investment firm manages for its clients under discretionary portfolio management and non-discretionary arrangements constituting investment advice.	0.02%
K-CMH	**Client Money Held (CMH)** This is the amount of client money that an investment firm holds or controls.	0.45%
K-ASA	**Assets Safeguarded and Administered (ASA)** Value of assets that an investment firm safeguards and administers for clients.	0.04%
K-COH	**Client Orders Handled (COH)** Value of orders that an investment firm handles for clients, through the reception and transmission of client orders, and through the execution of orders on behalf of clients.	Trades: 0.01% Derivatives: 0.01%

Risk to Market (RtM) calibration

RtM	Meaning	Measurement
K-NPR	**Net Position Risk (NPR)** Value of transactions recorded in the trading book.	Three possible approaches (IFR, Article 22): 1. Simplified standardised approach 2. Standardised approach 3. Internal model approach
K-CMG	**Clearing Member Guarantee (CMG)** Amount of initial margins posted with a clearing member, where the execution and settlement of transactions of an investment firm dealing on its own account take place under the responsibility of a general clearing member.	Highest total amount of the initial margin posted to the clearing member by the investment firm over the preceding three months.

For Class 2 firms' capital requirement: the higher of the above NPR and CMG measurement should be used

Risk to Firm (RtF) calibration

RtF	Meaning	Capital requirement
K-TCD	**Trading Counterparty Default risk (TCD)** This is relative to the exposure in the trading book of an investment firm. Exposure value = Max (0;Replacement Cost + Potential Future Exposure – Collateral).	Requirement = Exposure value x risk factor (for credit institutions and investment firms the counterparty risk factor is 1.6%)
K-DTF	**Daily Trading Flow (DTF)** Relative to the daily value of transactions that an investment firm enters through dealing on one account, or the execution of orders on behalf of clients in its own name.	Requirement = DTF measured according to IFR Article 32 multiplied by: • Cash trades: 0.01% • Derivatives: 0.01%
K-CON	**Concentration Risk (CON)** Relative to the exposures in the trading book of an investment firm to a client, or a group of connected clients, the value of which exceed the limit as set out in IFR Article 36.	Article 38 of IFR details a table of thresholds. The excess of each threshold will be multiplied by corresponding factors. Also, note that procedures have been included to prevent firms from avoiding K-CON requirements (Article 39 of IFR).

Measuring the RtC K-factors

With respect to the data needed to compute the RtC K-factors, there are specific stipulations in the IFR, as outlined in the table below:

Time dimension for the data needed to compute RtC K-factors	
K-AUM	AUM shall be the rolling average of the value of the total monthly assets under management, measured on the last business day of each of the previous 15 calendar months, excluding the three most recent monthly values (IFR Article 17).
K-CMH	CMH shall be the rolling average of the value of total daily client money held, measured at the end of each business day for the previous three calendar months (IFR Article 18).
K-ASA	ASA shall be the rolling average of the value of the total daily assets safeguarded and administered, measured at the end of each business day for the previous six calendar months, excluding the three most recent calendar months (IFR Article 19).
K-COH	COH shall be the rolling average of the value of the total daily client orders handled, measured at the end of each business day over the previous six calendar months, excluding the three most recent calendar months. (IFR Article 20).

Preparing for Brexit

Many investment firms will need to increase their capital in order to meet the new prudential requirements. As a result, the EBA and the European Commission have proposed a transitional period to support firms.

There are two main aspects of transitional provisions, which help investment firms across all three categories to achieve the required capital:

With respect to **initial capital requirement/PMC:**

- For existing investment firms whose initial capital could not achieve the required level under the new regime (ie some Class 2 firms will move from €730k to €750k, or Class 1 firms will have their initial capital requirements jumping from €730k, to €5m), they will have five years from the commencement date to build it up, with a minimum annual increase of €5,000.
- If the first five years are still not sufficient, national regulators could allow for an additional maximum five years to build up the required capital and will state the annual amount of increase required.

With respect to **own fund capital requirement**:

- There will be a limit to their capital requirements for the first five years from commencement of the new prudential regime, for example:
  - For firms authorised **before** the new prudential regime, it is capped at twice the current capital requirement level.
  - For firms authorised **after** the new prudential regime has commenced, the cap is twice the applicable FOR.

What about Brexit?

The new regime will be applicable to all EU Member States. As the UK has decided to leave the EU by the end of March 2019, there is uncertainty around the application of these rules to UK firms.

Note that after Brexit, the UK will become a third country. For an investment firm in the EU which has its parent undertaking in a third country, the Member State will need to assess if the firm is subject to supervision by the third-country regulator, equivalent to the supervision as set out in IFR and IFD.

Planning an orderly wind-down

CRD IV/CRR itself does not stipulate that wind-down costs are included as part of the capital requirement. Historically, at least in the UK, firms include wind-down cost estimations in the Internal Capital Adequacy Assessment Process (ICAAP) as a proxy to compare with the Fixed Overhead Requirement.

Wind-down planning could play a more significant role if an investment firm is subject to the Bank Recovery and Resolution Directive (BRRD). In light of the growing importance of wind-down planning, the FCA issued the non-binding Wind-down Planning Guide (WDPG) as part of the FCA Handbook.

The EBA has stated the policy objective of ensuring investment firms are able to wind-down orderly (See page 10 paragraph 21 of EBA/Op/2017/11). The report recommended that all investment firms falling outside the scope of BRRD be required to draw up and maintain a wind-down plan.

Orderly wind-down and capital requirements

The new prudential regime sets a minimum standard for all investment firms, to ensure they hold sufficient capital to support an orderly wind-down. A wind-down scenario is to be considered in a 'gone-concern' context.

In capital requirement terms, this will be achieved by requiring firms to have the higher of a three-month FOR and a PMC. For Class 3 firms, this would be sufficient for the capital requirement. For Class 2 firms, this will be further compared with the K-factor driven capital requirement.

The PMC serves as the floor value for the risk due to failure, and this cannot be substituted by indemnity insurance.

Liquidity requirement

Liquidity plays an important role in wind-down. The wind-down period could go on for a number of months and firms need to have sufficient liquidity (cash/cash-like) to ensure expenses for winding-down can be paid during the wind-down period.

All firms will be required to maintain at least one month's fixed overheads in liquid assets. Cash and near cash are likely to be accepted as liquid assets. Only Class 3 firms will be allowed to include trade receivables and fees/commissions receivable within 30 days as liquid assets, subject to a 50% haircut.

Firms may be subject to Pillar 2 assessment and SREP

All investment firms currently subject to CRD IV/CRR must submit an ICAAP to evaluate their Pillar 2 capital, and go through the regulator's Supervisory Review and Evaluation Process (SREP) periodically. It is expected that there will still be a Pillar 2 assessment and SREP, though they should be more proportionate and risk responsive. Regulators will have similar powers as at present, especially the power to increase capital requirements via these assessment processes.

The current prudential supervisory framework comprises of: Pillar 1 (Minimum Capital Requirements), Pillar 2 (Firm Assessment and Supervisory Review) and Pillar 3 (Disclosures and Market Discipline). Broadly speaking, a similar structure will exist in the new prudential regime.

For Pillar 1 in the new regime, there are initial capital requirements, and own funds requirements. The IFD also sets out various supervisory powers and processes which form the backbone for Pillar 2 in the future.

IFD Article 22 states:

"investment firms shall have in place sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of risks to which they are or might be exposed."

Effectively, the ICAAP will continue under the new regime. However, it is expected that the ICAAP should be simpler as Class 2 firms will heavily rely on K-factor methodology, whilst Class 3 firms will focus on wind-down costs.

The current SREP will also continue as per IFD Article 33 and will review governance, business models, risk identification and risk assessment. The new regime will continue to allow the regulators to require firms to hold additional capital, known as Individual Capital Guidance in the current regime. In other words, it is believed that the current Pillar 2 approach will carry forward into the new regime.

Apart from increasing capital requirements, regulators will also have the following powers under IFD Article 36:

- Require reinforcement of strategies, governance arrangements and processes.
- Require specific provisioning policy or treatment of assets in terms of capital requirements.
- To use retained profits to strengthen own funds or to restrict distributions.
- To restrict or limit business, or operations, or reduction of the risk inherent in the business activities.

In other words, it is believed that the current Pillar 2 approach will carry forward into the new regime. This would imply that firms will need to carry out robust ICAAP and strong capital/liquidity planning to avoid punitive measures imposed by the regulators.

Despite the fact the Pillar 2 remains, the need to apply large adjustments to the capital requirement via Pillar 2 should be less, as the EBA is confident that Pillar 1 capital requirements would better capture the main risks posed by investment firms.

The new Pillar 2 should serve the following functions:	• Setting additional capital requirements in relation to firm-specific risks not covered by Pillar 1 • Provide for the risks underestimated under Pillar 1 • Qualitative assessment, including governance and risk management framework
The Pillar 2 framework will take into account the following factors, amongst others:	• Adjustments to FOR where there is a material change in the business of an investment firm • Additional liquidity risks • Concentration risk • Use of tied agents

Despite the fact that operational risk is not explicitly spelled out in the 'Final Report' for Pillar 2, it will continue to be one of the key drivers.

The draft IFD makes the following provisions:

Article(s)	Description
22	Investment firms must carry out the ICAAP process.
33-34	Regulators must review the arrangement, strategies, process and mechanisms of the investment firms.
35-37	Regulators will have the power to impose additional capital requirements subject to conditions stipulated in IFD, and can require firms to address breaches of IFR and IFD.

Groups will be treated differently

All investment firms within the scope of this regime must first apply the rules on an individual basis, subject to exemptions in IFR. However, just like the present CRD IV/CRR, group treatment and consolidation play an important role from both the firm's and regulator's perspectives.

An investment firm group is defined as a group of firms, not including credit institutions, where the parent undertaking is either an investment firm, investment holding company or mixed holding company (see Article 4 of CRR for a detailed definition).

Treatment of groups

Group capital tests

For those with a parent company in the EU, a firm needs to hold at least enough own funds to cover the sum of the following:

1. The sum of the full book value of any holdings, subordinated claims and other prescribed instruments in investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group.
2. The total amount of any contingent liability in favour of investment firms, financial institutions, ancillary services undertakings and tied agents in the group.

K-factor combined basis for firm categorisation

The thresholds on AUM, COH, the balance sheet and annual gross revenue, will be applied on a combined basis for all investment firms that are part of a group, to determine if a firm is Class 2 or Class 3.

K-factor consolidated situation

The group supervisor may require the parent investment firm, parent investment holding company or a parent mixed financial holding company in the EU, to satisfy the K-factor capital requirement on a consolidated basis (IFR Article 8), if the following conditions apply:

- There are significant material risks to customers or to the market, due to the group as a whole, which are not fully captured by the individual firm's capital requirement; or
- If the group has a high degree of inter-connectedness.

In this situation, the capital rules in accordance with K-factors will be applied to the investment firm as if that firm is formed together with other entities in the group, as a single investment firm (IFR Article 4).

Meeting reporting and disclosure requirements

Under CRD IV/CRR, there is a Pillar 3 disclosure regime and COREP/FINREP reporting. The new regime will bring a simpler approach to disclosure and reporting, as stipulated in IFR sections six and seven.

Class 2 firms continue to have fairly extensive disclosure and reporting duties. Class 3 firms will have a more restricted disclosure regime, but the reporting extent will be largely the same as that for Class 2 firms.

Reporting

An investment firm will need to submit an annual report to regulators covering the following:

i. Level and composition of own funds
ii. Capital requirements
iii. Capital requirement calculations
iv. Data with respect to the thresholds determining if a firm is Class 2
v. Concentration risk (Class 3 firm will be exempt)
vi. Liquidity (Class 3 firm will be exempt)

The EBA will need to implement technical standards to specify formats, reporting data, definitions and IT solutions.

Disclosures

All Class 2 firms need to publicly disclose the following information on the date of publication of annual accounts:

i. Risk management objectives and policies
ii. Governance
iii. Own funds
iv. Capital requirements
v. Return on assets
vi. Remuneration policy and practices

Class 3 firms are exempt from disclosures, but if a Class 3 firm issues additional Tier 1 instruments, they will need to disclose the above items i, iii, iv and v.

As Class 2 and 3 firms will no longer be CRD IV/CRR firms, COREP will not be applicable to them. However, they will still have reporting responsibilities, as stated above. It is expected that there will be a new set of reporting templates which these firms need to complete.

Preventing management from taking undue risks

There continues to be an emphasis on robust governance and internal control in investment firms. Remuneration is controlled to ensure that it would not motivate management in investment firms to take excessive or undue risks. In line with the principle of proportionality, there will be a lighter approach for Class 3 firms, in comparison to that for Class 2.

IFD Articles 23-32 set out the requirements on governance and remuneration, which are broadly as follows:

Governance

There will be a requirement for investment firms to disclose every Member State and third country in which the investment firm has a branch or a subsidiary that is a financial institution.

IFD delegates discretion to national regulators to determine which investment firms are significant enough to require the establishment of a separate risk committee. For non-significant firms, the audit committee may also perform the risk committee function.

Given that the K-factor methodology is new, investment firms need to establish robust policies, procedures and systems to adequately identify risks, and gather the necessary data to calibrate the three K-factor groups (RtC, RtM, RtF).

Remuneration

There will be fairly tight control over variable remuneration (eg bonuses) under Article 30, which is subject to exemptions if a firm satisfies certain thresholds.

The most important restrictions on remuneration are:

- Article 30(1)(j) 'At least 50% of the variable remuneration needs to be in shares, share-linked instruments or convertible AT1/T2 instruments'.
- Article 30(1)(k) 'At least 40% of the variable remuneration shall be deferred over a three to five year period'.

For these two provisions, if a firm/individual does not exceed the following thresholds, then it is exempt:

- For a firm, the asset value of the firm is on average no more than €100m over the preceding four year period.
- For an individual, the variable remuneration does not exceed €50,000 and does not represent more than 25% of this individual's total remuneration. Delegated legislation will specify which staff members will be subject to this threshold.

On literal reading, the threshold appears to be applied on solo basis, though national regulators may disapply it at their discretion.

Meeting the challenges head on

The objective of the new regime is to be proportionate and risk responsive to investment firms which are non-systemic. However, the feedback from the industry seems to indicate that the capital requirements may increase for many firms.

The reform in the prudential regime for investment firms is a radical one. From the regulators' perspective, it may have the benefit of a more risk-responsive and uniform prudential regime across Europe. It certainly simplifies the firm categorisation regime, which will be welcomed by the industry.

However, from the firms' perspective, several issues may emerge:

- The simplification of the categorisation regime may be welcomed, but not necessarily the criteria for Class 2 firms.
- It may eventually lead to higher capital requirements.
- In practice the rule book may not be much simpler than the current one.

Challenges to UK investment firms

01 Categorisation criteria	02 Increased costs generally	03 Single rulebook	04 K-factors	05 Risk management
There have been criticisms as to the proposed criteria for Class 2 firms, ie K-NPR, K-CMG, K-DTF and K-TCD > 0. It is suggested that this may create a barrier to entry for small proprietary traders – one single transaction on its own account could lead a firm to become Class 2 and lead to a significant increase in compliance costs.	As far as Pillar 1 cost is concerned, there is a consensus that there will be a rise in capital requirements. The investment advisors, execution brokers and firms placing financial instruments on a firm commitment basis will be most affected.	One of the objectives of the reform is to have one single rule book for non-systemic investment firms, and one single rulebook for systemic firms (ie CRD IV/CRR). However, the new rulebook for Class 2 and Class 3 firms is not expected to be simple or short.	Data and systems will be required to undertake the appropriate calculation of the relevant K-factors, on at least a monthly basis to calculate the firm's capital requirement. This may require new projects to undertake a data gap analysis, source missing data, and map data into the firms calculation engines – either databases/spreadsheets or external vendor systems.	A firm's risk management practices and processes may need to be enhanced or changed for Class 2 firms. New K-factors will need to be embedded into the risk profile and potentially the risk appetite of the firm, with ongoing monitoring by the Board.

How we can help

Grant Thornton UK LLP is part of one of the world's leading organisations of independent advisory, tax and audit firms. We help dynamic organisations unlock their potential for growth by providing meaningful, forward looking advice.

We have an experienced team of regulatory specialists with significant industry knowledge gained from working for regulators, banks and fund managers. With a detailed understanding of prudential change, we realise the implications the regime will have on your business, including the impact on capital requirements and your broader risk profile. Our experts draw on best practice they have seen across the sector, combined with proactive horizon scanning to offer forward looking advice in line with your wider strategic goals.

We can support your business in the following areas:

- Advising on technical interpretation of prudential rules and provide in-depth training
- Advising on prudential rules implementation and implications on capital/liquidity planning
- Providing assurance on various regulatory reporting and ICAAP/ILAAP
- Advising and assisting firms to prepare for regulator's visits/enquiries (eg SREP)

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GRT107815