www.compliancemonitor.com

Compliance Monitor

May 2014

FEATURE › PRUDENTIAL

Financial resources for investment firms under CRD IV

Michael Wainwright outlines the framework for regulation of financial resources under CRD IV and suggests that, in the current climate, requirements are only likely to increase.

The Prudential Regulation Authority and the Financial Conduct Authority implemented a new prudential regime for investment firms from 1 January 2014. This regime is notable for the fact that a great deal of the content is set out in EU regulations, which have direct effect under English law, and much of the rest is dictated in an EU directive. It marks the first stage in the transition from harmonised national rulebooks to a single European rulebook as the basis for regulation of financial services in the European Union.

The options for the PRA and FCA to choose how the new rules apply in the UK were relatively limited and the consultations that they carried out were restricted in scope accordingly. So the changes came as something of a surprise to large parts of the industry, both as regards their extent and their significance.

Since the vast majority of investment firms in the UK are regulated by the FCA for prudential purposes, this article concentrates on the FCA implementation.

The European framework

The ultimate source of the new rules is the Capital Requirements Directive 2013/36/EU (CRD), which replaces the Capital Adequacy Directive. It is supplemented by the Capital Requirements Regulation 575/2013 (CRR) and by a host of regulatory technical standards (RTS) and implementing technical standards (ITS), many of which are still under negotiation.

The package as a whole is known as CRD IV, because it is the fourth iteration of capital adequacy standards in Europe. The impetus behind it was the need to implement new internationally agreed Basel III standards for banks in the wake of the financial crisis. Investment firms get caught up in these changes because they were already subject to the Capital Adequacy Directive, alongside the banks. The European Commission and Parliament took the opportunity to add to the Basel III agenda new rules

on executive remuneration, in parallel with similar rules in the Alternative Investment Fund Managers Directive. Although the new rules are primarily designed for bankers, investment firms are covered also.

The CRD IV package covers the following areas:

- Financial resources
- Governance
- Remuneration
- Reporting

This article deals with the framework for regulation of financial resources. It gives an overview of how different firms are affected on a solo basis, but does not consider consolidation aspects. It does not attempt to be comprehensive.

The CRR is a substantial piece of legislation in its own right – 521 articles. The FCA has not sought to copy its provisions into its handbook, but has built new sections of the handbook around it. The same will be the case with the various RTS and ITS instruments as these are finalised. They will stand alone, but may be referred to in the FCA rules where appropriate. In order to get a full picture of the regulatory requirements that apply, investment firms need to refer to these EU instruments alongside the FCA rules.

The CRR completely restates the framework and rules under which investment firms are required to calculate their financial

resources. It is designed to regulate the largest systemically important financial institutions, but it also covers potentially the full range of investment firms. This means that it is arguably a great deal more complex than is needed for the purpose of regulating most investment firms.

BIPRU firms

The European Commission has undertaken to carry out a review of the financial resources requirements that apply to smaller investment firms, reporting by the end of 2015. In view of this, article 95(2) of the CRR provides (in the last sentence) that national supervisors have the option to create an exception for smaller investment firms, provided that the firm's business model complies with certain conditions that can be summarised as follows:

- Cannot hold client money (but may operate a mandate over a client's own bank account),
- Cannot hold client assets or provide custody services (but may hold permission for arranging custody),
- May not provide any investment services listed in the annex to MiFID other than: reception and transmission of orders; execution of orders on behalf of clients; portfolio management; and investment advice, and
- Actually does provide the services of execution of orders on behalf of clients and/or portfolio management.

The UK has exercised the option to allow investment firms that can comply with the above conditions to continue to operate under the financial resources rules that applied immediately before CRD IV came into force. In order to do this, a firm needs to preclude itself from carrying on one of the activities listed in the annex to MiFID that is not separately regulated under the permissions regime operated by the FCA.

The relevant activity is placing investments without a firm commitment basis. The FCA has been reticent in commenting on what this activity involves in practice. However, in PERG 13.3 Q22 the FCA provides the following guidance: "We associate underwriting and placing of financial instruments with situations where a company or other business vehicle wishes to raise capital for commercial purposes, and in particular with primary market activity… Where a person distributes units in a UCITS fund to investors, in our view this does not amount to placing although it is likely to involve the reception and transmission of orders." In order to comply with the conditions for exemption from the new CRD IV financial resources rules, an investment firm needs to include a restriction on its regulatory permissions that precludes it from carrying on this activity.

A firm that complies with the above conditions is referred to in the FCA handbook as a BIPRU firm. It is subject to the financial resources requirements set out in the BIPRU section of the handbook, which sets out the pre-CRD IV requirements and is relatively self-contained. Although this arrangement is presented as a kind of grandfathering provision, parity of treatment must require that new entrants to the market can also take advantage of it.

IFPRU firms

Those investment firms that do not fit within the BIPRU exception are subject to the CRR, the RTS and ITS regulations, and the new IFPRU section of the FCA handbook, which rivals the relevant parts of CRR in terms of depth, complexity and bulk. These instruments need to be read together, side by side.

This combination of rules is daunting, but upon examination many of the provisions are not relevant in practice to all but the most complex investment firms.

IFPRU firms are subject to a base own-funds requirement of €50,000, €125,000 or €730,000, as set out in IFPRU 3.1.8. The components of capital that make up this requirement are set out in the following provisions of the CRR, as supplemented by IFPRU 3.2:

- Common equity tier 1 – article 28
- Additional tier 1 – articles 52 to 54
- Tier 2 – article 63

The above provisions of the CRR are supplemented by RTS, some of which are still under negotiation. The conditions that share capital and other capital instruments must meet in order to count as regulatory capital have changed significantly under CRD IV. This is an area where it is necessary to refer to the text of the CRR and the relevant RTS for the detailed requirements.

In addition to holding capital to meet the base own-funds requirement, an IFPRU firm needs to maintain capital resources to meet the requirements of Part Three of the CRR (beginning at article 92). These requirements are calculated by reference to risk exposure amounts for the different kinds of risk that may exist in the investment firm's business. At least 8% of the total risk exposure amount must be met by own funds, and at least 4.5% must be met by common equity tier 1 capital.

There are also requirements to maintain a capital conservation buffer and countercyclical capital buffer. These will be phased in over the period to 2019. They only apply to IFPRU firms classed as significant as described below.

The requirements of the CRR are supplemented by Chapter 2 of IFPRU, which sets out the internal capital adequacy assessment process (ICAAP) that the FCA requires IFPRU firms to follow in practice. This includes provision for the FCA to review the ICAAP on request under the supervisory review and evaluation process (SREP) and to adjust the amount of the capital

requirement through giving individual capital guidance (ICG) and/or through requiring the firm to maintain a capital planning buffer as a contingency against adverse circumstances. Chapters 4 to 8 of IFPRU provide more detail on how to calculate the risk exposure amount for various categories of risk.

The complexity of the ICAAP will depend on the complexity of the investment firm's business. For many firms, most of the categories of risk identified in the CRR will not be relevant, because they are designed to cover banking business. A simplified approach is available for limited licence and limited activity firms.

Certain financial resources and other requirements only apply in relation to an IFPRU firm that is classified as significant in accordance with IFPRU 1.2, through meeting any of the following criteria:

- Total assets exceed £530 million,
- Total liabilities exceed £380 million,
- Annual fees and commission income exceed £160 million,
- Holds client money exceeding £425 million,
- Holds client assets exceeding £7.8 billion.

CPMI firms

There are two further categories of firms that are affected by the financial resources requirements under CRD IV. These are those UCITS managers and alternative investment fund managers that are permitted to carry on MiFID activities alongside their fund management activities. These are referred to in the FCA Handbook as collective portfolio management investment firms (CPMI firms). They are subject to the same requirements as pure fund management firms in respect of their fund management activities. In the case of UCITS managers, this will be UPRU until July 2014 and then IPRU(INV) 11. In respect of their MiFID activities, they will also be subject to BIPRU or IFPRU, depending on whether or not they meet the conditions to be treated as a BIPRU firm in respect of their MiFID activities.

Future review

The CRD IV financial resources regime divides investment firms into various categories. There are the IFPRU firms that are subject to the new regime to a greater or lesser extent, depending on their size and complexity, the BIPRU firms that can remain on the old rules for the time being, some BIPRU firms that are caught indirectly by the new regime because they are in a consolidation group with an IFPRU firm, and those investment firms that are regulated by the PRA. The European Commission is due to review the situation by the end of 2015. This will provide an opportunity to rationalise the position, but in the current climate it seems more likely that the Commission will increase rather than reduce existing requirements.

■ **Michael Wainwright** (michael.wainwright@dentons.com) is a partner at law firm Dentons, who specialises in non-contentious regulatory and commercial work for financial services institutions.

© Informa UK Ltd 2014