Investment Firms: New regulatory regime

The Investment Firm Regulation[1] (IFR), combined with the Investment Firm Directive[2] (IFD), introduce a bespoke prudential regime for the vast majority of EU's investment firms; the latter being currently subject, along with credit institutions, to Basel-derived prudential rules set out in the Capital Requirements Regulation[3] (CRR) and Directive[4] (CRD IV), as revised by CRD V[5]. The CRR/CRD regime has been criticised for failing to address the differences, in terms of business models and risk profiles, between most investment firms and credit institutions. Against this background, the IFD and IFR were introduced to ensure that said differences are reflected in the EU's prudential framework. The new regime will apply from the 26th of June 2021, with limited transitional provisions. This article briefly outlines the key points of convergence and divergence between the two aforementioned prudential frameworks:

1. Classification of investment firms – Reclassification as credit institutions

The IFR/IFD establish a new, three-tier classification system for investment firms, based on their size, activities, interconnectedness and systemic importance. Systemic investment firms that satisfy the criteria for being treated as Class 1 firms under this system will be reclassified as credit institutions within the meaning of Article 4(1) CRR and therefore will continue to be prudentially regulated under the CRR and CRD IV/V[6]. Class 2 firms, on the other hand, which can be identified as larger, non-systemic firms, will be subject to the full application of the new IFD/IFR regime, whereas small and non-interconnected firms, known as Class 3 firms, while still subject to the new prudential framework, will be faced with less extensive requirements[7].

2. Authorisation

[1] Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 [2019] OJ L 314/1 (Investment Firm Regulation).

[2] Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU [2019] OJ L 314/64 (Investment Firm Directive).

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L 176/1 (Capital Requirements Regulation).

[4] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L 176/338 (Capital Requirements Directive IV).

[5] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures [2019] OJ L 150/253 (Capital Requirements Directive V).

[6] Investment Firm Regulation, art 1(2).

[7] Ibid art 12.

Under the IFR/IFD framework, Class 1 investment firms, by virtue of their new status, will be required to obtain authorisation as "credit institutions" under CRD IV/V, as is the case with all other credit institutions[8]. By contrast, Class 2 and Class 3 firms will still be licensed under the EU Markets in Financial Instruments Directive[9] (MiFID II).

3. Pillar I requirements

i. Own funds requirements

While both the IFR/IFD and the CRR/CRD prudential regimes impose own funds' requirements to investment firms and credit institutions respectively, under the former said capital requirements will be calculated using a new, so called "K-factor", methodology[10], as opposed to the credit risk, market risk and operational risk approach applied in the latter[11]. The K-factors reflect the risks that the new prudential regime intends to address with respect to non-systemic investment firms; namely, risk-to-client, risk-to-market and risk-to-firm. That said, following the introduction of CRR II[12], which will apply to credit institutions from the 28th of June 2021, amending CRR, a, not risk-based, binding minimum leverage ratio will also form part of the own funds requirements, intended to protect credit institutions against excessive indebtedness.

ii. Liquidity requirements

Both prudential frameworks further stipulate quantitative regulatory standards for liquidity, by way of a minimum of 1/3 of the fixed overhead requirement under IFR/IFD[13], and the liquidity coverage requirement[14] (LCR) and net stable funding requirement[15] (NSFR) under CRR/CRD.

4. Pillar II requirements

The IFD contains qualitative requirements that are largely comparable to those prescribed under CRD IV, and revised by CRD V; namely, internal governance[16] and remuneration[17]

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[8] Ibid recital 34· Capital Requirements Directive IV, art 8-8a, as amended by the Capital Requirements Directive V, art 1 para 4 & the Investment Firm Directive, art 62 para 6.

[9] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L 173/349 (MiFID II), art 5.

[10] Investment Firm Regulation, art 11.

[11] Capital Requirements Regulation, art 92.

[12] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposure, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (Capital Requirements Regulation II).

[13] Investment Firm Regulation, art 43.

[14] Capital Requirements Regulation, art 412.

[15] Ibid art 413.

[16] Investment Firm Directive, art 26· Capital Requirements Directive IV, art 74, as amended by the Capital Requirements Directive V, art 1 para 19.

rules, as well as requirements concerning risk management systems and internal control systems, including internal capital[18] and liquidity[19] adequacy assessment processes (ICAAP & ILAAP). In terms of risk management, specifically, Class 2 and Class 3 investment firms will be subject to concentration risk monitoring[20] and concentration risk limits[21] analogous to the large exposures monitoring[22] and large exposures limits[23] imposed on credit institutions.

5. Pillar III requirements

Under the IFR, investment firms will be subject to a wide range of public disclosure requirements[24], akin to the Pillar III requirements applicable to credit institutions[25]. Most notably, in line with the EU's prevalent interest in sustainable finance, certain investment firms will be required to further disclose information on environmental, social and governance (ESG) -related risks[26]. As to credit institutions, such a provision can also be found in CRR II[27].

Conclusion

Although largely similar, the IFR/IFD and CRR/CRD prudential frameworks present minor, targeted differences, mostly in terms of Pillar I capital requirements. Overall, each prudential regime appears to be tailored to the respective risk profiles of non-systemic investment firms and credit institutions, while the reclassification of Category 1 investment firms ensures a level playing field for institutions similar to credit institutions.

[17] Investment Firm Directive, art 30· Capital Requirements Directive IV, art 92, as amended by the Capital Requirements Directive V, art 1 para 26.
[18] Investment Firm Directive, art. 24· Capital Requirements Directive IV, art 73.
[19] Investment Firm Directive, art. 24· Capital Requirements Directive IV, art 86.
[20] Investment Firm Regulation, art 35.
[21] Ibid art 37.
[22] Capital Requirements Regulation, art 387 ff.
[23] Ibid art 395.
[24] Investment Firm Regulation, art 46-53.
[25] Capital Requirements Regulation, art 431 ff.
[26] Investment Firm Regulation, art 53.
[27] Capital Requirements Regulation II, art 449a.