Prudential challenges coming for UK investment managers

New prudential regime imposes new and increased requirements

Investment managers will be subject to significant new capital and liquidity requirements, enhanced governance standards and more extensive disclosure rules from 1 January 2022. Board members and other senior management of these firms have started to, and should continue to, plan and act early to ensure they have adequate financial resources, personnel and systems in place prior to the implementation date.

While it's considered that investment managers may have an easier time adapting to the new prudential framework than many other firm types, it's no time for complacency. With the new rules applying across all UK investment firms, there will still be plenty of work to do before the implementation deadline.

Compliance officers and their teams need to review the EU's proposals and understand how the changes could influence their business strategy decisions in the short and medium-term. With annual audits approaching, auditors are likely to require sight of IFPR-compliant capital projections looking out to mid-2022; in some cases, narrative disclosures may need to be made in the financial statements regarding how the firm intends to meet any increase in its prudential requirements.

To help investment managers better understand how they will be impacted by these changes, this article focuses on the key changes and the various actions firms should take early to achieve readiness.

WHAT IS CAUSING THESE CHANGES?

The EU's new prudential rules for investment firms were finalised in December 2019, starting an 18-month countdown to implementation. Since this time, the European Banking Authority (EBA) has published technical papers providing the necessary detail to the more complex rules . Further, the Financial Conduct Authority (FCA) has published its discussion paper outlining its implementation plan for UK investment firms, to be known as the Investment Firm Prudential Regime (IFPR).

The FCA's discussion paper clarifies that, despite Brexit, the UK will press ahead and implement an almost-identical regime to that which will affect EU investment managers. UK investment managers can use this paper in conjunction with the EBA's publications to better understand the impact on their business and act in good time to be ready.

WHY DO WE NEED THE IFPR?

Most investment firms are currently governed by the EU's prudential capital framework for banking, with the FCA making use of the various derivations and exemptions. It is widely accepted that a banking framework is ill-suited to most investment firms and the disparate application of these rules over time has made it difficult for national regulators to supervise effectively.

Regulators have long wanted to apply more appropriate arrangements for calculating regulatory capital in the sector. The IFPR creates a prudential capital framework that is more tailored to the investment firm industry.

While the initial objectives were to design a simpler and more proportionate regime, investment managers are unlikely to feel their regulatory burden lightening. In many cases, compliance with the new framework will bring fresh challenges.

IFPR IMPACT ON INVESTMENT MANAGERS

To begin with, investment managers may well need to increase their capital reserves once the new rules come into effect. The rules will also mean investment firms move away from bank-like capital requirements, such as credit risk, in favour of a new suite of risk-based measures more suited to their business known as 'K-factors'.

These K-factors will focus on:

- risk to customers – based on the type and volume of business a firm conducts;
- risk to the market – typically for firms operating a trading book; and
- risk inherent to the firm itself.

In addition, the time required to ensure compliance with more complex and onerous capital, liquidity, reporting, group consolidation, disclosure, remuneration and other governance requirements is sure to keep compliance teams, and finance teams alike, very busy.

Firm type	BIPRU firms	IFPRU firms
Reporting	More frequent reporting Possible technology requirement	Switch to new reporting templates
Capital required	Stricter fixed overheads requirement New K-factor requirements	New K-factor requirements
Categorisation	Not just based on regulatory permissions Analysis of volume and type of business required – standalone and group basis	
Liquidity	Quantitative calculations and ongoing monitoring	
Consolidation rules	Inclusion of 'ancillary services undertaking' within group determination 'Group capital test' to satisfy to avoid consolidated supervision	
ICARA Process	Change in approach to risk assessment Wind-down plan now a requirement Standalone ICARA assessment	
Remuneration	New provisions for deferral Requirements for non-cash awards Tighter malus & clawback rules	
Disclosure	New disclosures required on governance and ESG	
Capital resources	Minor changes to calculation	No changes to calculation

ACTIONS AN INVESTMENT MANAGER CAN TAKE NOW

Investment managers currently either operate within the CRD/CRR framework (for IFPRU firms) or under the FCA's simplified BIPRU framework. The new regime will mean a fresh set of capital and liquidity requirements as well as an updated reporting regime. As a first step, firms should explore the proposals to see which category they will fall under.

In particular, under the new rules, investment managers will need to assess the impact on their firm of the following key aspects:

Evaluate impact on capital

The new minimum, formula-based, requirements will mean most investment managers need to implement new data flows and calculations:

- The permanent minimum capital requirements (PMC) of €50,000 and €125,000 will increase to €75,000 and €150,000 respectively;
- The Fixed Overheads Requirement (FOR) – equivalent to a quarter of annual expenditure – will remain, but for BIPRU firms this is stricter and could mean an increase.
- Larger firms may face additional "K-factor" capital requirements, calculated with reference to the type and volume of business they conduct.

Most investment managers will focus their energies on the "risk to customer" area of the calculation, unless their business model is more diverse. Compliance teams should explore potential capital changes and start building the necessary infrastructure to monitor the variables on an ongoing basis.

Implement internal risk-based assessment

Investment managers are used to the ICAAP requirements, in which firms carry out an assessment of their capital requirements specific to the risks that they are exposed to. Historically, the expectation has been difficult to gauge with the steer provided through a combination of rules, guidelines, Dear CEO letters and observation papers, etc. The new framework seeks to instil much of these guidance items into a stricter requirement.

The FCA is calling this the Internal Capital Adequacy and Risk Assessment (ICARA) process and will retain supervisory powers to review and evaluate a firm's assessment, imposing capital add-ons in the event of any shortcomings.

As may be clear, the application of this more prescriptive "Pillar 2" regime could also give rise to the need to hold even more capital – depending on the outcome of the firm's or the regulator's assessment.

Further, Firms should also consider their group structure and whether their current ICAAP is conducted on a consolidated basis. Such groups which cover Pillar 2 risk capital requirements with consolidated capital resources may be concerned with the current plan to conduct the ICARA on a standalone basis only, which may cause firms a need to move capital around their group.

Assess group status

One area in which the European authorities could not agree on simplification is the rules governing consolidated supervision. Consequently, investment managers must continue to consider the impact of their group structure on their prudential supervision. The definition of the sorts of group entities which give rise to a group has been expanded to include "ancillary service undertaking", which could mean more groups are caught.

Those firms operating within a group which falls within scope of consolidation supervision rules, will need to assess the impact of the new capital rules and ICARA process requirements on a group basis as well as an individual one. This should not present a problem for groups which are suitably capitalised, but those which implement debt as part of their financing within the group structure might need to consider revisiting to ensure the group can comply with the new rules.

Hold liquidity resources

Investment managers have long been required to document their liquidity risk management framework, but the requirements were historically rather subjective and left quantification to a matter of firm policy. Firms will now have to hold one-third of their FOR as liquidity, as a base-line requirement. Larger firms will have to implement additional liquidity calculations and potentially will need to hold higher levels of liquidity.

Review remuneration practices and policy

The Remuneration Code is a long-established principle for investment managers. However, a handful of new aspects, designed to further align risk with reward, mitigate conflicts of interest and disincentivise adverse investment decision-making behaviours, might need some detailed thought prior to implementation.

Some aspects are, however, new for investment managers and, whilst many will have aligned to industry best-practice, such firms will need to review their current practices in line with the new requirements and formalise those in a Remuneration Policy.

Overlay with other regulations

Asset managers need to be mindful of how the new prudential capital framework could interact with other sets of regulations. For example, those who are also in scope for the Alternative Investment Fund Managers Directive (AIFMD) may need to continue to calculate capital under both the AIFMD and the new prudential framework.

WHAT IS NEXT?

Before the implementation date of 1 January 2022 there a still a few major milestones to watch out for. The FCA will finalise its implementation approach based on feedback received on its discussion paper. Further, the EBA will continue to issue further rounds of consultation papers in the planned phases for addressing the required technical standards intended to add clarity to the IFR and IFD.

Firms should keep abreast of these developments, particularly if there is a specific area of focus or concern to be covered by one of the aforementioned future publications. Wheelhouse Advisors will continue to provide updates in the event of key developments as these publications emerge.

IN CONCLUSION

It's important that compliance teams at asset manager firms take some time to consider the potential impact of this new prudential regime. While the change in capital held could be modest for some firms, others could potentially see a significant swing in their required capital figure – and could be caught out.

Firms should also consider if the shift in the prudential framework creates an opportunity for a change in business strategy or approach. For example, it may make sense for some firms to adjust or add to services offered given that a potential change in prudential category would previously have served as a disincentive. By engaging in proactive analysis now, compliance teams can actively add value to their organisation's medium-term approach to developing its client base and generating revenues.

Wheelhouse Advisors will continue to monitor the progress of the IFPR through the FCA and EU systems and provide updates as key developments emerge.

HOW WHEELHOUSE ADVISORS CAN HELP

Our clients benefit from a range of solutions designed to meet IFPR obligations. These include:

Impact assessment

To help you understand how the IFPR impacts your firm. This includes categorisation, capital requirements and resources, liquidity requirement and resources, group consolidation rules, regulatory reporting, ICARA process and public disclosure.

Regulatory reporting

We look after your on-going regulatory reporting burden allowing your team to focus on the core business.

ICARA process

All firms will be required to annually conduct and document their ICARA process to assess the level of capital that adequately addresses future and current risks in their business. Wheelhouse Advisors assists firms in developing and documenting their ICARA process as well as advising how the key underlying functions can be embedded in day-to-day governance.

Connect with Wheelhouse Advisors to learn how our experts deliver a comprehensive and integrated approach to prudential governance. Call our prudential team at **+44 (0)20 3404 0440** or email at **info@wheelhouse-advisors.com**