IFD/IFR requirements for Investment Firms

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What is IFD/IFR?

In December 2017, the European Commission adopted a proposal for an Investment Firms Directive "IFD" (EU 2019/2034) and an Investment Firms Regulation "IFR" (EU 2019/2033). The new regulation established a framework of prudential requirements for Investment Firms authorised under the Markets in Financial Instruments Directive II "MiFID II". These were entered into force on 25 December 2019 and are **scheduled to be transposed into Irish law by 26 June 2021.**

This regulation was introduced following the EBA determination that the CRR approach was inadequate; specifically, it failed to reflect risks that investment firms of different sizes pose to customers, the market and the firms themselves. This new regulation introduced **increased risk sensitivity into capital requirements** of certain investment firms, to provide **greater transparency of the risks** they pose.

Under these new requirements, investment firms will be classified according to their systemic importance. Among those firms considered of less systemic importance, the regulation sets out a number of factors which **determine classification based on risk surrounding the firm**. These considerations are known as **"K-Factors".** They have been implemented to **increase the level of granularity and sophistication around capital requirements calculations and risk disclosures**, to proportionately capture the risks of different sized investment firms.

The characteristics of firms which determine their "class" under the new prudential requirements:

Class 1: Systemically Important Firm

- Systemically important investment firms authorised as credit institutions.
- Business consists of either:
  - Dealing on own account; or
  - Underwriting financial instruments / placing financial instruments on a firm commitment basis.
- Have total firm assets equal to or in excess of €30bn.

Firms determined to be Class 1 will **remain under the prudential regulation of CRD IV / CRR.**

Class 2: Non-Systemically Important Firm

- **Have any of the following criteria met:**
  - Total balance sheet ≥ €100m;
  - Gross total revenues from provision of investment services of ≥ €30m;
  - Assets under management ≥ €1.2bn;
  - Handle ≥ €100m per day of client orders in cash trades or ≥ €1bn per day of derivatives;
  - Hold client assets or money; or
  - Trade on own account or incur risks arising from the trading of financial instruments.

Firms determined to meet the criteria for Class 2 classification **will be regulated under the new prudential regime**.

Class 3: Small and Non-Interconnected Firm

- **Have all of the following criteria met:**
  - Total balance sheet of < €100m;
  - Gross total revenues from provision of investment services of < €30m;
  - Assets under management < €1.2bn;
  - Handle < €100m per day of client orders in cash trades or < €1bn per day of derivatives;
  - Hold no client assets or money; and
  - Do not trade on own account or incur risks arising from the trading of financial instruments.

Firms determined to meet the criteria for Class 3 classification **will be regulated under the new prudential regime, with certain exemptions and lighter requirements.**

New capital requirements under IFR/IFD

The new requirements will bring changes to the capital requirements of investment firms. While initial capital requirements will continue to serve as the minimum requirement, the new requirements additionally apply **a risk responsive computation**, known as "K-Factors". These K-Factors **affect firms categorised as Class 2**.

Under the new requirements, the capital required by investment firms will be as follows:

Class 1 Firms

- Capital requirements will continue to be the sum of exposures to mitigate:
  - Credit risk;
  - Market Risk; and
  - Operational Risk.

Class 2 Firms

- Capital requirements will be determined as the highest of:
  - Permanent Minimum Capital (PMC);
  - Fixed Overhead Requirements (FOR); and
  - **K-Factor capital requirements.**

Class 3 Firms

- Capital requirements will be determined as the highest of:
  - Permanent Minimum Capital (PMC); and
  - Fixed Overhead Requirements (FOR).

K - Factor Requirements

The K-Factor methodology has been introduced as a way to **calculate a range of risks which an investment firm presents to the market, as well as to customers and to the firm itself**. This new methodology aims to quantify these risks in a risk sensitive manner.

Under the new requirements, the capital required by investment firms will be as follows:

Risk to Capital (RtC)		Risk to Market (RtM)		Risk to Firm (RtF)
K-AUM + K-CMH + K-ASA +K-COH	+	Higher of: K-NPR K-CMG	+	K-TCD + K-DTF + K-Con

Category	K-Factor	Description
Risk to Client (RtC)	K-AUM	Assets under management (discretionary and ongoing non-discretionary advisory).
	K-CMH	Client money held (on a segregated or non-segregated basis).
	K-ASA	Assets under safeguard and administration.
	K-COH	Client orders handles (cash trades and derivatives).
Risk to Market (RtM)	K-NPR	Net position risk on own account trading book positions.
	K-CMG	Total margins required by firm's clearing member (if permitted by component authority).
Risk to Firm (RtF)	K-TCD	Trading counterparty default (own account trading book exposures).
	K-DTF	Daily trading flow for cash trades or derivatives (trading book own account transactions + transactions executed for clients in the firm's name).
	K-CON	Concentration risk on own account trading book transactions.

How KPMG can help

We have developed a range of tools and methodologies to help you undertake your IFD/IFR assessment, and to assist in the integration of the new prudential requirements:

IFD / IFR regulation analysis and K-Factor assessment

- Perform underlying regulatory reviews, including the development of models and analytical tools to quantify the K-factors for investment firms;
- Perform sensitivity analysis on key drivers of firm capital requirements and changes in the underlying K-factor calculations;
- Provide workshops to assist firms in the understanding and integration of the new regulation.

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