IFPR Regulation

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Action ahead – firms to plan for IFPR compliance

By A. Paris

January 2022 may seem far away but the preparations financial services firms in the UK need to make to comply with the incoming Investment Firm Prudential Regime (IFPR) are considerable and they need to think about it now, if they haven't done so already. The new rules are going to usher in significant change for a large swathe of firms active in the UK market.

Though there are no industry-wide statistics on how many firms have set plans in motion to ensure compliance, a poll taken during a webinar organised by Wolters Kluwer in April 2021, found 11 percent of attendees had not yet started their preparations. A third of the audience on the other hand had begun their IFPR project and half were either in the process of conducting analysis in this regard or looking for a market solution.

The Financial Conduct Authority's aim in introducing the regulation is to develop a single prudential regime for all FCA-regulated investment firms, to reduce barriers to entry and allow for better competition.

The new law also means several firms will, for the first time, have meaningful capital and liquidity requirements, in line with the potential risk they post to their clients, themselves and the broader industry. These risks are categorised by a "K factors" approach. In the law these are divided into three groups – risks to client (RtC); risks to market (RtM); and risks to firm (RtF).

Before this regulation was announced firms did carry out thorough risk assessments on these factors however, Priya Mehta, Head of FCA Advisory and Regulatory Reporting Services, Buzzacott points out: "Very rarely did we see any capital set aside to cover those risks. It was not something mandated by the FCA. Under the IFPR firms cannot get away with the old approach of quantifying and identifying risks but not putting aside additional funds to meet those requirements."

According to the association of Personal Investment Management and Financial Advice (PIMFA), the IFPR is likely to be comparable in size and complexity to MiFID II in terms of its impact and will require fundamental changes to how firms approach risk, liquidity and capital.

Giulia Lupato, Head of Regulatory Policy and Compliance at PIMFA comments in a press release: "The IFPR will have a significant impact on MiFID investment firms and involves fundamental changes to the way in which they work. It is vital that firms begin to analyse how these changes will affect them and to begin to make preparations."

Higher burden

The K factors are typically inherent in small and mid-sized investment firms and these are the types of entities expected to be most impacted by this new legislation.

Lawyers at Freshfields Bruckhaus Deringer elaborate: "The effect of the FCA's proposals in these two consultations will be to change the regulatory capital regime that applies to those firms currently classified as exempt CAD firms. These firms have historically benefited from a comparatively 'light touch' regulatory regime with a minimum initial capital requirement of EUR50,000 (or professional indemnity insurance meeting the requirements prescribed by the FCA)."

The regulatory burden on these firms is set to rise under IFPR. Previously exempt-CAD can now be subject to GBP75,000 as a permanent minimum requirement if carrying out limited investment activities. They may also be liable for a new fixed overheads requirement amounting to a quarter of the firm's fixed overheads from the previous accounting year. In addition, the new regime stipulates that, depending on what activities they undertake and the risk their investment business carries, some of these firms may also have a new 'K-factor' requirement.

Outlook and potential concerns

Although the regulatory burden will increase in the short-term, Mehta expects that a few years down the line, the industry will start to appreciate the simplicity ushered in by the new rules.

Jamie Cooke, managing director of fscom, writes: "We regard the measures envisaged for the prudential regime as pragmatic and welcome."

Lupato at PIMFA notes: "We are pleased to see the FCA has recognised that achieving operational resilience is a journey personal to each firm, as well as the challenges posed by third parties and supply chains. We hope this will result in a proportionate approach to supervision when it comes to firms' mapping of complex supply chains.

"We also appreciate the FCA agreeing to soften the initial, proposed deadline of three years from the date the rules come into effect by introducing a 4-year 'staged' approach."

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>
> Giulia Lupato, PIMFA

Partners at Macfarlanes however highlight: "The FCA has stated that the ongoing regulatory costs for firms should be lower as a result of the changes. However, our view is that this may not always be the case and firms should scrutinise the changes carefully to identify the impact upon them.

"It does seem clear that the simplification of the regime should free up management time and reduce time spent on complex capital calculations that do little to help firms manage risk. The FCA has indicated its view that the changes should also reduce barriers to entry to the market and allow for better competition."

Cooke signals areas that fscom feels may present some concerns: "In assessing the elevated level of interest in a firm's use of custodians, we make the reasonable assumption that the regulator would have a strong preference for a firm to hold accounts (client and proprietary) with multiple providers, not just one.

"Theoretically, such a concern is perfectly understandable. On a practical level however the difficulties in securing trust accounts from UK banks are well documented and we would hope that commercial reality will be a factor in the FCA's consideration of this risk." ■

IFPR: the time to act is now

Interview with Priya Mehta

Firms falling within the remit of the FCA's new Investment Firm Prudential Regime (IFPR) cannot afford to be passive. They need to set themselves on the right path now if they are to meet the January 2022 compliance deadline. Some firms have a long road ahead as the new rules mean a ten-fold rise in their capital requirements.

"This regulation is meant to simplify the current regime," explains Priya Mehta, Head of FCA Advisory and Regulatory Reporting Services, Buzzacott. "At the moment, we have multiple versions of these regulations which worked together and have been imposed on different types of firms. This law unwinds those positions. As a result, there will only be two categories of FCA regulated investment firms, rather that the six or seven different types there are now."

This will be a challenge in the short-term but Mehta expects that a few years down the line, the industry will start to appreciate the simplicity ushered in by the new rules.

Although most firms regulated by the FCA are impacted by the IFPR, there is a bigger onus on smaller players as they will need to make more significant changes to their processes and business model than larger firms.

"Under the IFPR, firms will need to carry out a prescriptive risk assessment. However, the difference will be that they need to quantify the risks identified through that assessment and physically put capital aside to cover them. This is going to be the biggest challenge," Mehta outlines.

The new rules impose a 10 percent buffer on top of the capital requirements which needs to be maintained. If firms dip into that buffer, it triggers an early warning notification which the firm is obliged to report back to the FCA.

Firms are expected to set out triggers and the moment they breach any of those, they should technically start the wind down process. In truth, most firms will inject more capital to keep themselves going. However, those red flags now need to be properly quantified and monitored on an ongoing basis which is the biggest challenge.

"This is a big step and a significant change which is not really necessary for some of the firms in question. Essentially, nothing about their business has changed but their capital requirements are going to go up ten-fold as a result of this regulation. They have five years to build that up but we still think it's somewhat unnecessary," Mehta remarks.

She says that settling into the process of not dipping into the 10 percent buffer is something firms will need to get used to. An early notification warning will mean they need to take remedial action, which will, in turn, most likely be recorded as a breach on their register. "Having such breaches on your record as a firm is not ideal and these are things which investors could well pick up on. Therefore, keeping a clean record in this new environment will be very important," Mehta advises.

Planning ahead

In terms of client reactions to these new rules, Mehta acknowledges they are taking different approaches: "There are ones who want to know upfront how it's going to affect them. They jumped on board and wanted to get their risk assessment done straight away. This gave them the peace of mind of knowing what's going to change for them, if anything."

Worryingly however, she says a few firms have been passive about it. Mehta stresses the importance of planning ahead since the FCA has kept to its projected timeline. This means it's most likely going to stick to the January 2022 compliance cut off, which firms will have to adhere to if they want to remain in business. She notes that the guidance is mandatory and needs to be submitted: "The FCA expects to see a very detailed articulated plan."

Firms can do several things to prepare for the deadline and set themselves on the right path. Mehta says: "First of all, they can carry out a full impact assessment to know how the IFPR is going to impact part of their operations and compliance. Then they need to know what measures they need to take to meet the January deadline.

"Firms are simply expected to become compliant by first of January 2022. They cannot come to this realisation in November or December of this year and hope to meet that deadline. The to-do list to comply with the IFPR is not short so the sooner they start, the better it is."

No quick fix

The legislation speaks about identifying "harms" – harm the firm can potentially cause itself, its clients, counterparties or the market. "The FCA has published a lot of guidance around what different types of firms need to focus on," Mehta says. "For example if you trade on your own account, you need to consider some additional harms."

Buzzacott has been working with clients to help them identify the harms relevant to their firm. "A large part of the work we're currently doing is putting together different levels of checklists which the clients will need to work on. This is not always straightforward. If I ask an open-ended question about what harm a client thinks their business poses to the industry, I wouldn't get a satisfactory answer. Therefore, we need to ask closed-ended questions to identify the relevant harms as listed in the regulation."

The approach needs to be very tailored and structured. Mehta notes there is no template which will fit all firms, which is why she reiterates the importance of being prepared well ahead of the deadline: "It has to be considered on a bespoke basis and the answer is not a quick fix. There is not much time left to delay dealing with this anymore – firms need to address it now." ■

Priya Mehta
Partner, Buzzacott

Priya Mehta has worked in the financial services industry since 2000. She works closely with many FCA regulated entities including UK and US based fund managers, investment advisory firms, brokers and asset management companies. Priya provides clients with much needed guidance on key regulations including CRD IV, AIFMD, MiFID II, SMCR and the latest IFPR and helps them with on-going capital adequacy and liquidity monitoring, compliance with client money rules and documenting ICAAPs/ ICARAs and wind down plans.