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The IFPR: What is the impact on capital structure?

In December 2020, the FCA issued its first consultation paper (CP1) on the new UK prudential regime for MiFID investment firms - the Investment Firms Prudential Regime (IFPR). CP1's focus is on the first batch of chapters of the prudential sourcebook for MiFID investment firms known as MIFIDPRU.

In this briefing, we unpack MIFIDPRU's third chapter and the related transitional provision on which the FCA is consulting in CP1.

MIFIDPRU 3 will contain the "own funds" rules (OFR), in essence, the rules on the composition of a MiFID firm's regulatory capital. In addressing its approach to the compatibility of MIFIDPRU 3's text with its duties in the Financial Services Bill when making rules under the IFPR, the FCA notes that its proposals are designed to build on the UK Capital Requirements Regulation (CRR), in essence, the on-shored EU CRR 2. This is to reflect the business models of investment firms and improve the financial resilience of firms not currently subject to the same quality of capital requirements as the UKCRR.

CP1 does not add anything material to what appeared on own funds in the FCA discussion paper, as covered in an earlier briefing. There is, however, increased clarity on what firms will have to do in order to comply with such requirements. While the MIFIDPRU 4 "own funds requirements" rules will set out the rules on how much regulatory capital a firm requires, the OFR will determine what types of equity and debt capital instruments, and in what proportions, a firm can use to meet those requirements. Whilst the MIFIDPRU transitional provisions (TPs) provide for a phased application of the full OFR, TP 1 will provide limited relief from the OFR, which will preserve some permissions granted under the UKCRR and allow alternative tier 1 instruments to be carried over.

The OFR will apply to all investment firms, including, for their investment business, collective portfolio management investment (CPMI) firms and SNI firms; the "proportionality rules" for SNI firms do not dis-apply the OFR. The OFR will also apply to the UK parent entities of investment firm groups, with special rules applying where the "group capital test" instead of the general rules on group consolidation applies. Much of the important detail that is contained in the UKCRR and European Bank Authority (EBA) guidance on the EU CRR2 should, therefore, remain relevant.

These are our five main points for firms that will become subject to the OFR:

- the scope for non-standard Core Equity Tier 1 (CET 1) instruments currently permitted is likely to be limited. See our previous briefing for more information;
- the rules on deductions from CET 1, including those on deferred tax assets and DB pension fund assets, will change;
- the ratio between Tier 1 and Tier 2 instruments will change;
- certain types of instruments, such as Tier 3 and perpetual fully paid non-cumulative preference shares, will no longer be allowed; and
- the FCA processes for CET1 pre-notifications and the redemption of CET1 and T2 instruments will become stricter.

In light of the above, firms will need to:

- revisit their capital structures;
- change their capital structures as necessary to take into account the changes to the rules on eligibility and ratios of instrument;
- reconsider their CET1 calculations in light of changes to the rules on deductions; and
- revisit their processes for issuing new OFR compliant capital instruments.

This table provides a summary of the provisions (which are, of course, subject to consultation and the final provisions may be different).

Type	Description	Percentage of highest own funds requirement – HOFR	Requirements	Notes
CET1	Core Equity Tier 1 – equity instruments with highest degree of permanence and subordination, able to absorb losses as they occur.	CET1 ≥ 56% of the HOFR, therefore CET1 never less than 56% of HOFR	Majority of CET1 Capital Rules in Ch 2,Title I, Part 2 UKCRR – See CP 1, Fig 3	▪ Special rules for deductions from CET1 replacing UKCRR, Art 36 and qualifications on deferred tax assets and DB pension fund assets. ▪ Special rules apply the perpetual capital and reduction of repayment requirements to Partnerships and Limited Liability Partnerships. ▪ FCA permission normally required for CET1 issuance but firm may rely on previous FCA permission where instrument "substantially the same". ▪ FCA permission required to include interim year-end profits in CET1 capital. ▪ Special rules for non-financial sector qualifying holdings and holdings in financial sector entities but dis-applied for same investment firm group.

AT1	Additional Tier 1 – debt instruments capable of being written down or converted into CET1 when a trigger event occurs.	CET1 + AT1 ≥ 75% of HOFR, therefore AT1 never more than 19% of highest HOFR	Majority of AT1 Capital Rules in Ch 3, Title I, Part 2 UKCRR – See CP 1, Fig 4	▪ Special rules setting level for writing down/conversion at 64% of OFR. ▪ One or more trigger events to be specified. ▪ Full principal amount to be written down/converted. ▪ Special rules for holdings in financial sector entities but dis-applied for same investment firm group.
T2	Tier 2 – subordinated debt instruments with an initial maturity of five years, only able to absorb losses in an insolvency.	CET1 + AT1 + T2 ≥ 100% of HOFR, therefore T2 never more than 44% of highest HOFR	Majority of T2 Capital Rules in Rules in Ch 4, Title I, Part 2 UKCRR – See CP 1, Fig 5	▪ Special rules for holdings in financial sector entities but dis-applied for same investment firm group.
All	See above	See above	Majority of General Requirements Rules in Ch 6, Title 1, Part 2 UKCRR	▪ Special rules on reductions, repurchases or redemptions of CET1, AT1 and T2 instruments which will require FCA approvals supplementing UKCRR, Arts 77 and 78.

This worked example of the differences between the current position and the position under MIFIDPRU 3 illustrate the changes for MIFIDPRU firms currently classified as BIPRU Firms.

GENPRU 2 Annex 4 Capital resources table for a BIPRU firm deducting material holdings (redacted)		**Worked example applying MIFIDPRU 3**	
Type of capital	**Stage**	**Type of capital**	**Stage**
Core tier one capital	A	CET1 capital	A
Hybrid capital B1+B2+C1	B	AT1 capital	B
Total tier one capital before deductions = A+B1+B2+C1	D	Total tier one capital before deductions = A+B	C
Deductions from tier one capital	E	Deductions from CET1 capital	D
Total tier one capital after deductions = D-E	F	Total CET1 capital after deductions = C-D	E
Upper tier two capital	G	T2 capital	F
Lower tier two capital	H		
Total tier two capital = G+H	I		
Deductions from tier two capital	J	Deductions from T2 capital	G
Total tier two capital after deductions = I-J	K	Total T2 capital after deductions = F-G	H
Total tier one capital plus tier two capital = F+K	L	Total CET 1 Capital plus T2 Capital = E+H	I
Deductions from the totals of tier one and two	M	Deductions from totals of CET 1 and T2 capital	J
Total tier one capital plus tier two capital after deductions = L-M	N	Total CET 1 plus T2 capital after deductions = I-J	K

Upper tier three	O		
Lower tier three	P		
Total tier three capital=O+P	Q		
Total capital before deductions = N+Q	R		
Deductions from total capital	S		
Total capital after deductions (R–S)	T	Total capital after deductions (K)	L

Macfarlanes LLP
20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com