A new European prudential framework for investment firms

Investment firms have so far been monitored within the European Union (EU) using the same prudential legal framework as for credit institutions. Since this framework is geared to traditional banking business, it only partly addresses the particular features characterising investment firms in terms of their business model and the riskiness of the investment services they provide. The Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) will now place Europe's legal framework for investment firms on a fresh footing that will be more straightforward and fit for purpose than the existing regime.

In Germany, this new prudential framework will be implemented not via the usual channel – which is to modify the Banking Act (Kreditwesengesetz) – but by rolling out an entirely new piece of legislation, the Investment Institutions Act (Wertpapierinstitutsgesetz, or IIA) to stand alongside the directly applicable IFR. Going forward, investment firms will be assigned to three categories of institutions that are subject to different degrees of prudential supervisory intensity proportionate to their size and complexity.

The new prudential framework does not create an entirely separate supervisory regime for investment firms. Indeed, only some of the rules it now includes are completely new. In some instances, the relevant provisions of the Capital Requirements Regulation (CRR) have merely been modified, while larger investment firms will still be expected to meet requirements that remain very closely aligned with the CRR.

Very large, systemically important investment firms with total assets of €30 billion and more will in future be defined as credit institutions according to the new regulatory classification, with their supervision being based on the regime used for banks. At the same time, these institutions meet the definition of a significant institution under the regulations governing the Single Supervisory Mechanism (SSM), which is why they will fall under the direct supervision of the European Central Bank (ECB).

All things considered, the new legislative framework improves significantly on the existing set-up by taking into account the particular characteristics of investment firms' specific business models and risk profiles. It is highly appropriate, then, for the different sectors to each have a separate legal basis that can be applied more easily and more comprehensibly by the enterprises concerned. All in all, the Bundesbank considers that the objectives of the revision process have been accomplished, which is why the new prudential framework offers a sound functional basis for the future supervision of investment firms in the EU.

According to the relevant provisions under EU law, investment firms are required to start applying the new rules as from 26 June 2021.

Introduction

25 December 2019 saw two new pieces of EU legislation enter into force that will create a new European prudential framework for investment firms. This legislative package comprising the Investment Firms Directive (IFD)[1] and Investment Firms Regulation (IFR)[2] will be effective across the EU from 26 June 2021 following an 18-month transition period. While the IFR is directly applicable, the IFD needs to be transposed into national law. In Germany, the IFD will be implemented by way of a new piece of legislation, the Investment Institutions Act (*Wertpapierinstitutsgesetz*, or IIA).

The existing regulatory requirements for the ongoing monitoring of investment firms are heavily based on those applicable to the banking sector, notably the Capital Requirements Regulation (CRR).[3] This new legislative package is now geared specifically to the business models of investment firms and aims to achieve two objectives. Besides providing better coverage of activities and risks in this sector, this will also help the enterprises concerned apply the rules.

The prudential definition of an investment firm is any firm engaged in the provision of investment transactions as a service to customers. The nature of said investment transactions determines whether prior authorisation to conduct such business is required under European law, specifically the Markets in Financial Instruments Directive (MiFID).[4]

Current regime for investment firms

Current regime for investment firms based on CRD/CRR and Banking Act

Under the existing regulatory regime, investment firms are still supervised based on the legal framework for the prudential supervision of credit institutions (the Capital Requirements Directive, or CRD)[5] as well as the CRR. Hence, these prudential requirements are transposed at the national level in Germany's Banking Act *(Kreditwesengesetz)*. The Banking Act designates investment firms requiring authorisation under EU law as securities trading banks, securities trading firms, or financial services institutions, depending on the activities they conduct.[6]

Furthermore, there are financial services in Germany that fall outside the scope of applicability of EU law but within the perimeters of supervision, such as enterprises engaged in factoring or financial leasing activities. Altogether, there are currently 15 different activities requiring authorisation in the Banking Act for which authorisation as a securities trading bank, securities trading firm or financial services institution is mandatory. To this end, institutions are assigned to eight different groups (see classification of institutions),[7] each subject to prudential requirements proportionate to their risk profile. Only institutions providing financial services as defined in MiFID (investment transactions) will be covered by the new prudential framework. Activities subject to supervision at the national level only will continue to be governed by the Banking Act.

Prudential intensity proportionate to nature of investment transactions conducted

Which parts of the existing framework an investment firm is required to apply depends on the nature of the investment transactions it conducts. As hitherto, the new provisions are geared to risk – that is to say, riskier investment

1 Directive (EU) 2019/2034 on the prudential supervision of investment firms of 25 December 2019.
2 Regulation (EU) 2019/2033 on the prudential requirements of investment firms of 25 December 2019.
3 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms of 26 June 2013.
4 Directive 2014/65/EU on markets in financial instruments of 15 May 2014.
5 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms of 26 June 2013.
6 The Banking Act defines securities trading bank in Section 1(3d) sentence 5, securities trading firm in Section 1(3d) sentence 4, and financial services institution in Section 1(1a).
7 The Bundesbank's classification of institutions can be found at https://www.bundesbank.de/resource/blob/838498/eb83dd6c58f8c5204a01f0961e051fcb/mL/institutssystematik-fuer-finanzdienstleistungsinstitute-und-investment-firms-data.pdf

transactions will attract stricter prudential requirements. For instance, providers that are able to obtain ownership or possession of client money or securities will be subject to more intense supervision and stricter own funds requirements than providers that are not authorised to do so.

Why a new regime?

Long-standing debate over whether rules for credit institutions are appropriate for investment firms, too

Even back in the days when the CRR was being drafted, there was debate about whether investment firms should have a regulatory regime of their own. This culminated in review clauses being incorporated into the CRR[8] that required the European Commission to review whether a standalone prudential framework is needed for investment firms. Work on this issue was entrusted to the European Banking Authority (EBA), which judged that a separate prudential framework was needed and drafted proposals for its design. The objective was to make the rules less complex and granular, and to gear prudential intensity to a far greater degree to firm-level characteristics, such as business models and volumes.

IFD and IFR applicable from 26 June 2021

The EBA's preparations formed the groundwork for the new regulatory framework for investment firms under European law in the shape of the IFD and IFR package.[9] These new requirements will be applicable with effect from 26 June 2021.

What the new framework is based on

As is the case in many other fields, investment firm supervision is another area where directly applicable European legislation in the form of a regulation (the IFR in this case) that has immediate effect across all Member States will exist side by side with requirements in the form of a directive (the IFD) that need to be transposed into national law by Member States.

Overarching European supervisory framework

IFD/IFR similar to CRD/CRR in terms of design and regulatory structure

The regulatory structure of the IFD and IFR is very similar to their counterparts from the field of banking supervision. The EU requirements set out the responsibilities, rights and duties of the competent authorities involved in the process of supervising investment firms, and they furthermore contain the prudential and organisational standards for enterprises requiring authorisation.

Fleshed out by regulatory and implementing technical standards

Though the IFD and IFR are themselves already comprehensive regulatory texts, some of their individual provisions still need to be fleshed out in even greater detail by the European Commission (using instruments such as regulatory technical standards and implementing technical standards). Furthermore, the EBA can issue guidelines[10] on how the legislation should be applied in supervisory practice, though national authorities can choose not to follow these guidelines in justified cases.

Transposing European provisions into German law

National implementation in IIA, not Banking Act

In a departure from how requirements for investment firms have been transposed into national law to date, implementation of the IFD will take place not by modifying the Banking Act but by creating a dedicated piece of legislation governing the supervision of investment firms in Germany: the IIA. In future, enterprises that fall within the supervisory scope of the IFD

8 See Article 498(2) and Article 508(3) of the CRR.
9 These two pieces of legislation entered into force on 25 December 2019.
10 Since guidelines, unlike regulatory standards, are non-binding, supervisory authorities are expected to either comply with them or state their reasons for non-compliance. According to this "comply or explain" principle, supervisory authorities must inform the EBA within two months of publication of the guidelines whether they will comply or intend to comply with them. Supervisory authorities that do not intend to comply with guidelines have to state their reasons for non-compliance. As a rule, however, supervisory authorities are required to make every effort to comply with EBA guidelines and recommendations.

Key areas governed by IFD and IFR (extract)

IFD	IFR
Level of initial capital	Definition of own funds
Prudential powers and responsibilities	Own funds requirements
Internal capital adequacy	Liquidity requirements
Organisational provisions	Disclosure requirements
Remuneration provisions	Reporting requirements
Supervisory review and evaluation process (SREP)	–
Prudential measures	–

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and IFR will be called investment institutions *(Wertpapierinstitute)* in Germany.[11] There are two reasons for this particular choice of name. First, in the German legal system, "firm" *(Firma)* is a term used exclusively in the Commercial Code *(Handelsgesetzbuch)*. Second, the term "institution" will provide a degree of continuity with the Banking Act term of the same name designating investment firms within the meaning of EU legislation.

The IIA is broadly similar to the Banking Act in terms of its regulatory classification, which means that institutions will not need to find their bearings anew if they move out of the regulatory scope of the Banking Act into that of the IIA. A draft version of this Act prepared by the Federal Ministry of Finance was adopted by the Federal Cabinet on 16 December 2020 and is in the process of being passed into law.[12] The idea is that once the Act has passed through the Bundestag and Bundesrat, it will enter into force in early June 2021, i.e. in good time before the IFD and IFR become applicable.

Future categorisation of investment firms in Germany

The new regime will be implemented into German supervisory law by creating three categories of investment institutions in the IIA: large investment institutions,[13] medium-sized investment institutions,[14] and small investment institutions.[15] Each category is subject to a different level of prudential requirements which investment institutions are required to satisfy once they have been assigned to that particular category. For instance, the methods an investment institution is required to use to calculate the level of its own funds requirements will depend on how it is categorised, as will its remuneration policies,[16] organisational requirements[17] and the scope of mandatory reporting[18] to supervisory authorities. Investment institutions are assigned to a category based on their business model and volume.

New national categorisation of investment firms

One exception to this rule and thus, strictly speaking, a fourth category of investment firms within the meaning of the EU legislation concerns systemically important investment firms. These are investment firms which, on account of the bank-like activities they conduct,[19] combined with their very large business volumes, will no longer be treated as investment firms on the basis of the IIA (IFD) and the IFR but as

Certain investment firms directly supervised by ECB in future

11 This article uses "investment firm" whenever it is referring to provisions based on the European prudential framework and "investment institution" when it is talking about the national (German) implementation of those provisions.
12 Referred to in the text as the draft IIA. This article is based on the 2 December 2020 version of the Government draft, which can be found at https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_VII/19_Legislaturperiode/2020-08-17-Gesetz-Umsetzung-Richtlinie-Beaufsichtigung-Wertpapierfirmen/1-Regierungsentwurf.html
13 See Section 2(18) of the draft IIA.
14 See Section 2(17) of the draft IIA.
15 See Section 2(16) of the draft IIA.
16 See Section 46 in conjunction with Section 38(1) of the draft IIA. According to the European regulatory framework, the term "staff" also includes members of management boards and of administrative or supervisory boards.
17 See Section 38(1) in conjunction with Section 41 and Section 43 of the draft IIA. Small investment institutions are required to comply with general corporate governance principles since they also fall within the scope of Section 41 sentence 1 numbers 1 to 3 of the draft IIA. This means that the application of these provisions to small investment institutions goes beyond the minimum requirements set forth in the IFD.
18 See Sections 64 to 66 of the draft IIA.
19 The investment services provided are considered bank-like in terms of their nature and the potential risks they might present.

credit institutions within the meaning of the CRR. In effect, then, they will fall entirely within the regulatory scope of the Banking Act (CRD) and the CRR. This applies to any investment firms that engage in dealing on their own account[20] or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis[21] as an investment service and whose total assets have a value of at least €30 billion.[22]

Being credit institutions within the meaning of the CRR and by virtue of the level of their total assets, these institutions will be supervised in future not by the supervisory authority of their home country but by the ECB under the Single Supervisory Mechanism (SSM).[23] In light of these institutions' systemic importance, the Bundesbank considers this form of supervision to be correct and appropriate.

Large, medium-sized and small investment institutions within the meaning of the IIA

Investment firms running effectively identical business models but with smaller business volumes (total assets amounting to less than €30 billion and more than €15 billion) are defined as large investment institutions. These institutions also deal on own account[24] and conduct underwriting business.[25] It makes sense, then, for this group of institutions to continue to be subject to much of the Banking Act and the CRR.[26] Any other investment firms not classified as CRR credit institutions or large investment institutions fall into the categories of medium-sized or small investment institutions.[27] Classification here is based on quantitative thresholds set forth in Article 12(1) of the IFR.[28] These thresholds measure, first, the nature and volume of the investment services provided[29] and, second, total assets and gross revenue from investment services for use as additional indicators.

National competent authorities in Germany

Germany's national competent authorities for monitoring compliance with the prudential requirements associated with the authorisation requirement for any investment institutions that fall within the scope of the IIA are the Federal Financial Supervisory Authority (BaFin) and the Bundesbank.[30] These two institutions perform this task based on a binding work-sharing arrangement.[31] BaFin is the competent administrative authority for supervision of these institutions, in which capacity it issues any legal acts to institutions. These include granting au-

20 See Annex I Section A point (3) of MiFID.
21 See Annex I Section A point (6) of MiFID.
22 See new Article 4(1) number (1) letter (b) of Regulation (EU) 575/2013, added with effect from 26 June 2021 by Article 62 number (3) of Regulation (EU) 2019/2033. The €30 billion threshold applies to investment firms individually and also in collective (consolidated) terms where a group of supervised institutions includes multiple investment firms of this kind. In addition, the consolidating supervisor can use its discretion to classify smaller investment firms as systemically important investment firms as well.
23 Having total assets of €30 billion is one of the conditions set out in Article 6(4) subparagraph 2 of Council Regulation (EU) No 1024/2013 of 15 October 2013 (SSM Regulation) for classification of an institution as significant. Significant institutions within the meaning of this Regulation are supervised by the SSM.
24 See Section 2(2) number 10 of the draft IIA, which corresponds to the investment service set out in Annex I Section A point (3) of MiFID.
25 See Section 2(2) number 2 of the draft IIA, which corresponds to the investment service set out in Annex I Section A point (6) of MiFID.
26 See Section 4 of the draft IIA.
27 In addition, Article 5(1) of the IFD allows national supervisory authorities to exercise discretion, subject to the conditions set forth therein, to apply the regime for large investment institutions to an institution providing the investment services stated in Annex I Section A points (3) and (6) of MiFID and whose total assets have a total value equal to or exceeding €5 billion.
28 The definition of a small and non-interconnected investment firm in Article 12 of the IFD corresponds to that of a small investment institution in Section 2(16) of the draft IIA.
29 The K-factors used in Article 12(1) of the IFR to classify an investment institution cover both investment services and ancillary services pursuant to Annex I Section B of MiFID. Investment firms/institutions are only allowed to provide ancillary services in conjunction with investment services. Examples of ancillary services include the safekeeping and administration of financial instruments for the account of clients (Annex I Section B point (1)) and granting credits or loans to investors to allow them to carry out investment transactions where the investment firm/institution granting the credit or loan is involved in said transactions (Annex I Section B point (2)).
30 Where a large investment institution's total assets exceed the €30 billion threshold for more than a temporary period, supervision of that institution should move from the national level to the SSM. It is for this reason that investment firms need to apply for authorisation under the CRD or the respective implementing legislation (see the version of Article 8a of the CRD that will be in force as from 26 June 2021).
31 See the Guideline on the Implementation of and Quality Assurance for the Ongoing Monitoring of Credit Institutions and Financial Services Institutions by the Deutsche Bundesbank – Prudential Supervisory Guideline, available at https://www.bundesbank.de/resource/blob/597830/dff524802a575d18b754991cb39221ef/mL/aufsichtsrichtlinie-data.pdf

thorisation to provide investment services, for instance, but they can also involve measures against management board members and members of the administrative or supervisory board of an institution in cases of misconduct. Responsibility for monitoring institutions on an ongoing basis, meanwhile, lies with the Bundesbank's regional offices. This task notably includes assessing investment institutions' capital and liquidity situation and the adequacy of their risk management procedures by analysing submitted reports, inspection and audit reports and annual financial statements.

At year-end 2020, 745 securities trading banks and financial services institutions providing investment services were being supervised in Germany. Of that number, up to ten institutions will fall within the scope of CRR credit institutions or large investment institutions,[32] around 70 within the scope of medium-sized investment institutions, and around 665 within the scope of small investment institutions once the new regime comes into effect.

Future own funds requirements for investment institutions

Own funds requirements differ according to category

Classification as a large, medium-sized or small investment institution is also the deciding factor for the methods to be applied to determine own funds requirements. This is intended to ensure that the risks posed by an investment institution's business activities are at all times proportionate to the own funds[33] it holds.[34] The next sections focus on the requirements for investment institutions under the IIA.[35] The requirements under EU law for investment firms that will be classified as CRR credit institutions going forward will not be discussed in further detail here or in the remainder of this article, as these requirements are already known and established.

Large investment institutions

Own funds requirements based on CRR

The provisions that apply to large investment institutions' calculation of own funds requirements will remain largely unchanged. While these institutions will be governed by the new legal framework, it makes reference in many regulatory areas – including the determination of own funds requirements – to CRD and CRR provisions that were already applicable to these investment firms.[36] This reference to the regulatory scope of the CRD and CRR is duplicated in the IIA.[37] There is, however, one change, affecting the initial capital requirement, which will be raised from €730,000 to €750,000.[38]

Medium-sized investment institutions

Determination of own funds requirement through comparison of permanent minimum capital requirement, FOR and K-factor requirements

Unlike in the case of large investment institutions, own funds requirements for medium-sized investment institutions will be determined using a new method involving a combination of three different metrics. The first metric is an institution's permanent minimum capital requirement,[39] which amounts to either €75,000

32 In the case of institutions currently resident in the United Kingdom, it is not yet entirely certain to what extent they will relocate their business activities to Germany.
33 See Article 9(1) and (2) of the IFR in conjunction with Part Two, Title I, Chapters 2, 3 and 4 of the CRR. The IFR's definition of own funds largely matches the definition found in the CRR.
34 The primary objectives of own funds requirements for investment firms are the preservation of market integrity and investor protection. But unlike depositor protection, which constitutes one of the main objectives of the prudential supervision of credit institutions, investors need only fear losing their investments in exceptional cases in the event of an investment firm becoming insolvent.
35 The IFR outlines transitional arrangements lasting up to five years in Article 57(3) and (4) for investment institutions established prior to 26 June 2021.
36 Article 1(2) of the IFR refers to CRR provisions.
37 See Section 4 of the draft IIA. This provision explicitly lists the Banking Act provisions that remain applicable for this type of investment institution.
38 See Section 17(1) number 1 of the draft IIA.
39 Investment institutions are required to hold this in reserve at all times and independently of their own funds requirements, which may be lower; see Article 14 of the IFR.

Future categorisation of investment firms

Type of institution	National categorisation	Governing supervisory law	Competent supervisory authority/authorities
Investment firm providing investment services pursuant to Annex I Section A points (3) or (6) of MiFID and with total assets > €30 billion	CRR credit institution	CRD/CRR as well as Banking Act	ECB/BaFin/Bundesbank
Investment firm providing investment services pursuant to Annex I Section A points (3) or (6) of MiFID and with total assets < €30 billion and > €15 billion	Large investment institution pursuant to IIA	Limited regulatory scope of IFD/IFR and IIA; CRD/CRR as well as Banking Act provisions largely applicable	BaFin/Bundesbank
Investment firm exceeding Article 12 IFR thresholds	Medium-sized investment institution pursuant to IIA	IIA (higher prudential requirements)	BaFin/Bundesbank
Investment firm not exceeding Article 12 IFR thresholds	Small investment institution pursuant to IIA	IIA (lower prudential requirements)	BaFin/Bundesbank

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or €150,000,[40] depending on the institution's business model. The fixed overhead requirement (FOR) is the second metric to take into consideration. This concept could also be found in the CRD/CRR prudential framework for determining own funds requirements for investment firms. The aim of the FOR is to derive the scope of an investment firm's business activities from the sum of the fixed overheads in its income statement. The starting point for this is the firm's total expenses in the preceding financial year. A clearly defined set of expense items are deducted from this, such as staff bonuses and other variable remuneration (which depend on the investment firm's net profit in the previous financial year), as well as taxes paid and non-recurring expenses from non-ordinary activities.[41] The remainder of the investment firm's fixed overheads is then used to determine its own funds requirements based on the FOR. These are 25% of the remaining sum.

K-factor requirements as new method for measuring own funds requirements based on business model

While the first two metrics for determining own funds requirements are familiar – albeit partially modified – metrics from the CRD/CRR regime, the third, known as the K-factor requirement,[42] is an entirely new metric introduced by the IFR. The aim of this new method is to determine institution-specific own funds requirements based on an investment firm's actual business model. The investment services provided and their scale are taken into account here.

Initial work on developing the methodology involved defining three specific risk categories to which risks arising from an investment firm's investment services can be assigned. The three categories represent the risk posed to three distinct groups: Risk-to-Client (RtC), Risk-to-Market (RtM) and Risk-to-Firm (RtF).

Method covers fundamental risk categories: RtC, RtM and RtF

The RtC risk category captures the risks to which an investment firm's clients are exposed in connection with the firm's investment ser-

40 See Section 17(1) numbers 2 and 3 of the draft IIA. The amount of €150,000 applies to institutions that, in providing investment services, are authorised to obtain ownership or possession of client money or securities. These amounts, too, will be higher than they are under the current CRD rules once the IFD becomes applicable (the amounts stipulated under the CRD are €50,000 and €125,000, respectively).
41 The existing Commission Delegated Regulation (EU) 2015/488 as regards own funds requirements for firms based on fixed overheads of 4 September 2014 based on Article 97(4) of the CRR already prescribes a certain number of items for deduction. Article 13(4) of the IFR and the draft of a delegated regulation based on the same passage expand on that list of items for deduction to include further appropriate items, e.g. losses from the institution dealing on own account.
42 The formulas for calculating K-factor requirements are presented in Articles 15 to 33 and 36 to 42 of the IFR.

Categorisation of K-factors

Risk category/ K-factor	Description	Investment service or ancillary service pursuant to Sections A and B of Annex I of MiFID	Investment service or ancillary service pursuant to Section 2 of the draft IIA
Risk-to-Client (RtC)			
K-AUM	Assets under management	– Portfolio management (A 4) – Investment advice (A 5)	– Portfolio management – Investment advice (ongoing)
K-CMH	Client money held	–[1]	–[1]
K-ASA	Assets safeguarded and administered	– Safekeeping and administration of financial instruments for the account of clients, including custodianship (B 1)	– Safekeeping and administration of financial instruments, including custodianship[2]
K-COH	Client orders handled	– Reception and transmission of orders in relation to one or more financial instruments (A 1) – Execution of orders on behalf of clients (A 2) – Placing of financial instruments without a firm commitment basis (A 7)	– Investment broking – Contract broking – Placement business
Risk-to-Market (RtM)			
K-NPR	Net position risk	– Dealing on own account (A 3) – Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (A 6)	– Dealing on own account – Principal broking business – Underwriting business
K-CMG	Clearing margin given	– Dealing on own account (A 3)	– Dealing on own account – Principal broking business
Risk-to-Firm (RtF)			
K-DTF	Daily trading flow	– Execution of orders on behalf of clients (A 2) – Dealing on own account (A 3)	– Contract broking – Dealing on own account – Principal broking services
K-TCD	Trading counterparty default	– Dealing on own account (A 3) – Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (A 6)	– Dealing on own account – Principal broking business – Underwriting business
K-CON	Concentration risk	– Dealing on own account (A 3) – Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (A 6)	– Dealing on own account – Principal broking business – Underwriting business

1 Client money or securities can be held in connection with a wide variety of investment services and ancillary services. **2** See Section 2(3) number 1 of the draft IIA.

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Details of specific K-factors and how they are calculated

This box looks at three K-factors, explaining in greater detail the investment services they cover and how they are calculated.

K-AUM (assets under management), a Risk-to-Client K-factor, comprises the value of assets that an investment firm manages for its clients under both portfolio management[1] and investment advice of an ongoing nature[2] concerning specific assets. This includes assets and portfolios, the management of which the investment firm has delegated to another investment firm. It does not, however, include assets and portfolios that have been delegated from another investment firm to the investment firm which is itself required to calculate K-AUM.[3] AUM is measured as the rolling average of the values of the previous 15 months, excluding the three most recent monthly values. This smoothing of the results over time is intended to soften the impact of short-term market volatility on investment firms' own funds requirements.

K-COH (client orders handled), a Risk-to-Client K-factor, comprises the value of orders that an investment firm handles for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients. This includes the investment services of investment broking,[4] contract broking[5] and placement business.[6] COH is calculated as the rolling average of the value of the total daily client orders handled over the previous six months, excluding the three most recent months. COH is the arithmetic mean of the daily values from the remaining three months. Different methods are used to calculate the total daily values depending on whether the client orders relate to cash trades or derivatives.[7]

K-NPR (net position risk), a Risk-to-Market K-factor, represents the risk to an investment firm stemming from changing market prices of assets which it holds on behalf of clients in its own portfolio (trading book) on account of its investment services. The methods used to calculate net position risk for the different types of assets – also referred to as financial instruments[8] in the Investment Institutions Act (*Wertpapierinstitutsgesetz,* or IIA) – are based on the rules set out in the Capital Requirements Regulation (CRR) for calculating such risk.[9]

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1 See Section 2(2) number 9 of the draft IIA.
2 See Section 2(2) number 4 of the draft IIA.
3 This depends on which institution has the actual contractual arrangement with the client to provide asset management or investment advice. The assets are counted towards that institution.
4 See Section 2(2) number 3 of the draft IIA.
5 See Section 2(2) number 5 of the draft IIA.
6 See Section 2(2) number 8 of the draft IIA.
7 A distinction between cash trades and derivatives is also made when calculating the requirement for K-COH, and the two different coefficients shown in Table 1 in Article 15(2) of the Investment Firms Regulation are used to calculate the sub-item.
8 See Section 2(5) of the draft IIA.
9 See Article 22 of the Investment Firms Regulation.

vices. The RtM[43] category encompasses risks to other market participants (e.g. other investment firms or credit institutions) that could materialise due to the investment firm's investment services or ancillary services. The RtF category comprises risks of balance sheet losses to which an investment firm itself is exposed in connection with its investment business.

Risk quantification via individual K-factors each linked to investment services and ancillary services

The three risk categories are broken down into individual areas with specific K-factors that each capture and quantify a sub-category of risk. Investment firms that are required to calculate K-factor requirements need only do so for those K-factors that relate to the activities they actually perform, however. There is thus a firm link between individual investment services or ancillary services and the K-factors in each risk category.

Once an investment firm has calculated the individual K-factors that are relevant for its business model, the next step is to determine the overall K-factor requirement, which is the sum of all the K-factors.[44] To do this, the values that the investment firm has calculated for the respective K-factors are multiplied by coefficients for each K-factor, as specified in the IFR.[45] The weighted K-factors are then added together to produce a grand total.

The results of all three of the calculation methods presented in this section are used to determine the own funds requirements of an investment firm that will be classified as a medium-sized investment institution in Germany going forward. The own funds requirement for this category of investment institution is then equal to the highest of its permanent minimum capital requirement, FOR or K-factor requirement.[46]

Small investment institutions

The approach for small investment institutions remains in line with the CRD/CRR provisions previously applicable to this type of investment firm. The own funds requirement of a small investment institution is the higher of its permanent minimum capital requirement or FOR.

Determination of own funds requirement through comparison of permanent minimum capital requirement and FOR

This simplified calculation also accounts for the fact that the institutions in this category tend to be smaller institutions that are generally less risky.

K-factors as a calculation basis for classifying investment institutions as medium-sized or small

Although the K-factor requirement for this group of institutions plays no role in determining own funds requirements, it is still of crucial importance. The IFR thresholds that will serve as a basis for classifying an investment firm as medium-sized or small[47] are based on precisely these K-factors and need to be calculated as stipulated in the relevant IFR provisions.

Future liquidity requirements for investment institutions

Liquidity requirements to ensure the orderly winding-down of business operations

Besides own funds requirements, the liquidity requirements for these institutions are another core regulatory component. A prudentially defined minimum liquidity requirement is intended to ensure that institutions can meet their payment obligations at all times and thus guarantee their survival. The approach adopted here is not a going-concern approach, in which an institution has sufficient liquidity available at all times to continue operating, but rather a gone-concern approach. This is defined as an institution no longer having sufficient liquidity available to continue business operations, but still having sufficient liquid funds for the orderly winding-down of the firm once business operations have ceased.

43 The term "Risk-to-Market" should not be confused with the term "market risk" from the field of banking supervision. In the context of the IFR, the risks quantified are those to which market participants are exposed in connection with the investment institution's investment services. By contrast, the market risk quantified in a prudential CRR context is the risk that could arise for a credit institution itself due to its trading activities.
44 See Article 15(1) of the IFR.
45 See Table 1 in Article 15(2) of the IFR.
46 See Article 11(1) of the IFR.
47 See Article 12(1) of the IFR.

Prudential consolidation of investment institutions

As is the case for credit institutions, the supervision of investment institutions is not restricted to the single-entity level. In line with the provisions of the Investment Firms Regulation (IFR),[1] investment firms that are parent undertakings, subsidiaries or affiliated entities within a group structure are also supervised on a consolidated basis.[2] The aim is to measure and assess, as a whole, the risks emanating from all individual investment firms within such a group. This is intended to ensure that sufficient own funds and liquidity to cover existing risks are always available at the group level, too. The IFR provisions for pooling individual group entities to take a consolidated view of the group as a whole are based on the corresponding provisions of the Capital Requirements Regulation (CRR).

The provisions governing consolidated supervision state that requirements relating to own funds, concentration risk, liquidity, disclosure and reporting also need to be satisfied by an investment firm group as a whole. In order to ensure compliance with these requirements, parent undertakings[3] and their subsidiaries are obliged to set up a proper organisational structure and appropriate internal control mechanisms within the group. The methods specified for determining own funds and liquidity requirements at the consolidated level are based on the methods specified in the IFR for application at the individual investment firm level.[4]

The IFR[5] also provides an alternative simplified calculation method for the consolidated determination of own funds requirements at the group level – the group capital test. The national competent authority may allow the application of this calculation method if the structure of the investment firm group is deemed sufficiently simple and provided there are no significant risks to its clients or the market stemming from the investment firm group as a whole. The own funds requirements of the investment firm group are considered to be met on the basis of the group capital test if the parent investment firm has own funds that correspond to at least the sum of the book values of all of its holdings in, and contingent liabilities in favour of, investment firms belonging to the group as well as other group undertakings, such as financial institutions.[6]

1 See Article 7 of the IFR. Detailed information will follow in a delegated regulation that is based on Article 7(5) of the IFR and is currently being drawn up by the European Banking Authority.
2 Investment firms belonging to a group are supervised as if they were a single investment firm. An investment firm belonging to a group must therefore fulfil the prudential requirements at the single-entity level, whilst at the same time the parent undertaking within the investment firm group must ensure compliance with the group-level requirements.
3 Pursuant to Section 2(33) to (35) of the draft Investment Institutions Act *(Wertpapierinstitutsgesetz)*, the parent undertaking of an investment firm group can be a Union parent investment firm, Union parent investment holding company or Union parent mixed financial holding company.
4 In this context, it should be noted that an investment firm group to which a large investment institution belongs is subject to CRR consolidation requirements.
5 See Article 8 of the IFR.
6 See Article 4(1) number 14 of the IFR.

Up to now, exemption for investment firms under CRR

The CRD/CRR regime also already contains liquidity requirements for investment firms providing the following MiFID services: dealing on own account, providing the underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis. However, the CRR contains an exemption option for such investment firms, allowing national competent authorities to exempt them from applying these liquidity requirements. Use has been made of this option in Germany. These investment firms have continued to apply the national liquidity provisions pre-dating the introduction of the CRR, i.e. the Liquidity Regulation *(Liquiditätsverordnung)*.

Harmonised liquidity requirements for medium-sized and small investment institutions

The new prudential framework now establishes liquidity rules for all types of investment institutions, irrespective of the type of investment business they perform. In future, large investment institutions will be required to comply with CRR liquidity provisions. Medium-sized and small investment institutions will be subject to identical provisions based on the IFR.[48] An institution's FOR-based own funds requirement will serve as a foundation in this context. Going forward, every institution will be required to hold an amount of liquid assets equivalent to one-third of their FOR-based own funds requirement. The intention behind this provision reflects the above-mentioned gone-concern approach. While the FOR is roughly equal to an institution's necessary "core overheads" for one quarter of a year,[49] the institution must hold an amount of liquid assets equivalent to at least one-third of the FOR. The calculation performed here is thus to determine the amount of liquidity required by an institution to continue operating for exactly one month. This month is considered the amount of time necessary for the orderly winding-down of business operations.

Liquid assets that are eligible for use to meet liquidity requirements

In order to ensure that an institution's liquid assets can be used for their intended purpose, the IFR provides clear rules on the types of assets that are eligible for use as liquid assets to meet liquidity requirements. These include, for example, overnight deposits with credit institutions, equity and debt securities as well as investment fund shares/units.[50] Small investment institutions also have the option of counting up to one-third of their trade receivables and fees or commissions receivable falling due within 30 days as liquid assets.[51] In the Bundesbank's view, the liquidity requirements for medium-sized and small investment institutions represent an acceptable compromise between appropriate consideration of risk and ease of application.

New uniform reporting requirements

New standardised European reporting framework

Competent authorities need a sufficiently meaningful set of data at their disposal in order to assess investment firms' risk situation. They also need to be able to gauge compliance with the requirements put in place. Up to now, there have been a variety of different reporting requirements at the national level to accompany individual prudential requirements.[52] With the entry into force of the IFD and the IFR, there will, going forward, be a standardised European reporting framework for all investment firms – much like there has been for credit institutions since 2014.[53] This reporting framework defines the prudential areas for which reports have to be submitted, specifying the format

48 Under Article 43(1) of the IFR, national competent authorities may exempt investment institutions from liquidity requirements. The EBA must be duly informed thereof.
49 The FOR amounts to one-quarter of an institution's fixed overheads in a given year.
50 Article 43(1) of the IFR defines liquid assets as well as the eligibility criteria and thresholds for these. It also refers to Articles 11 to 13 and 15 of Commission Delegated Regulation (EU) 2015/61.
51 See Article 43(3) of the IFR.
52 An initial step towards standardisation was taken with the introduction of the CRR back in 2014. From that point onwards, all investment firms falling under the direct regulatory scope of the CRR (under existing law, financial services institutions in groups I, II and IIIc) were required to submit their reports on the basis of uniform CRR requirements.
53 See Articles 54 and 55 of the IFR.

Selected changes for investment firms and investment institutions

Institution category	Own funds requirements		Liquidity requirements		Reporting requirements	
	Existing law	New law	Existing law	New law	Existing law	New law
CRR credit institution	Initial capital €730,000; CRR require-ments for investment firms	Permanent minimum capital €5 million; CRR requirements for credit institutions	National requirements based on Liquidity Regulation	Liquidity requirements based on CRR	CRR reporting requirements, limited for investment firms	Full CRR reporting requirements
Large investment institution	Initial capital €730,000; CRR require-ments for investment firms	Permanent minimum capital €750,000; CRR require-ments for credit institu-tions	National requirements based on Liquidity Regulation	Liquidity requirements based on CRR	CRR reporting requirements, limited for investment firms	Full CRR reporting requirements
Medium-sized investment institution	Initial capital €125,000 or €50,000; also requirements based on FOR[1]	Permanent minimum capital €150,000 or €75,000; also whatever is the higher of permanent minimum capital, FOR or K-factors	National requirements based on Liquidity Regulation or none	Liquidity requirements based on IFR	CRR reporting requirements, limited for investment firms, or national reporting requirements	IFR reporting requirements for "class 2 investment firms" (medium-sized investment institutions)
Small investment institution	Initial capital €125,000 or €50,000; also requirements based on FOR[1]	Permanent minimum capital of €150,000 or €75,000; whatever is the higher of permanent minimum capital or FOR	None	Liquidity requirements based on IFR	National reporting requirements	IFR reporting requirements for "class 3 investment firms" (small investment institutions)

1 Not for institutions whose financial services comprise only investment broking or investment advice.

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and content[54] of these reports for each individual prudential area as well as the frequency of reporting and reporting dates.[55]

Submission dependent on institution category and business model

Here, too, whether an investment firm is actually required to submit reports for a particular prudential area and the scope of these reporting obligations within that prudential area will depend on the category of investment firms to which it belongs.

54 Investment firms are required to submit reports for the following prudential areas: level and composition of own funds, level of and compliance with own funds requirements, calculation of thresholds for classification of an investment firm as a CRR credit institution, utilisation of thresholds pursuant to Article 12(1) of the IFR for classification of an investment firm as one of the national categories of medium-sized or small investment institution, information on concentration risk as well as level of and compliance with liquidity requirements.

55 The details concerning the content and format of reports and reporting dates will be published in implementing technical standards. See https://www.eba.europa.eu/eba-issues-new-supervisory-reporting-and-disclosures-framework-investment-firms for the EBA Final Draft ITS on reporting and disclosures for investment firms.

Disclosure requirements

Producing transparency as core objective of disclosure requirements

Disclosure requirements are important in order to produce transparency about specific economically relevant information on an enterprise. Transparent information allows markets to better assess the risk situation for enterprises and, by responding to it, potentially exert a disciplining influence. Investment firms must consequently publish specific information as determined by supervisors at predefined times. Investment firms have the freedom to choose in what manner to make the disclosure, on the firm's official website, say, or through notes to the annual financial statements. Publication must take place on the same date as they publish their annual financial statements.

Scope of disclosure depends on institution category

What information needs to be disclosed again depends on which category the investment institution falls into.[56] Large investment institutions remain subject to the disclosure requirements set out in the CRR.[57] For medium-sized and small investment institutions, the IFR[58] explicitly stipulates whether disclosure is required and what subject areas must be covered. While medium-sized investment institutions are subject to general disclosure requirements, these apply to small investment institutions only if they have own funds that qualify as Additional Tier 1 instruments,[59,60] such as silent participating interests.

Uniform EBA rules on the contents of the information to be disclosed

The EBA has specified what information exactly the disclosure should contain in terms of own funds and own funds requirements.[61]

Investment firms must disclose investment policy

A novelty is that investment firms will, in future, also have to disclose details of their investment policy,[62] which will also be specified by the EBA.[63]

Graded remuneration rules

Going forward, the rules governing remuneration at investment firms will also involve graded requirements depending on which of the above-mentioned categories a firm belongs to. What are referred to as "systemic investment firms" as well as investment firms that will be classified as large investment institutions in Germany in future will continue to be expected to meet the CRD's requirements in terms of remuneration. In Germany, these investment firms will therefore continue to be governed by the relevant regulations of the Banking Act and of the Remuneration Regulation for Institutions *(Institutsvergütungsverordnung)*. If they are, moreover, classified as a significant institution pursuant to the Banking Act,[64] they must also meet the special requirements of the Remuneration Regulation for Institutions.

For the other investment firm categories, by contrast, the IFD provides varying degrees of relief. The IFD's specific rules on remuneration apply only to investment firms that will, in future, be classed as medium-sized investment institutions in Germany. None of the requirements in terms of remuneration systems will apply to investment firms that will be classified as small investment institutions in Germany going forward.

Remuneration requirements under the IFD

Based on the CRD approach, the IFD rules apply, first and foremost, to staff at investment firms "whose professional activities have a material impact on [either] the risk profile of the

56 See Article 46(1) of the IFR.
57 See Article 431 et seq. of the CRR.
58 Details can be found in Articles 47 to 53 of the IFR. The duty to disclose information on environmental, social and governance risks pursuant to Article 53 of the IFR is binding only from 26 December 2022.
59 See Article 46(2) of the IFR.
60 See Article 52 et seq. of the CRR.
61 See EBA Final Draft ITS on reporting and disclosures for investment firms, available at https://www.eba.europa.eu/eba-issues-new-supervisory-reporting-and-disclosures-framework-investment-firms
62 See Article 52(1) of the IFR.
63 To this end, the EBA is currently drawing up a regulatory technical standard.
64 See Section 1(3c) of the Banking Act.

EBA standards and guidelines on remuneration regulation

The Investment Firms Directive (IFD) gives the European Banking Authority (EBA),[1] in cooperation with the European Securities and Markets Authority (ESMA), a mandate to develop supplementary standards and guidelines concerning investment firms' remuneration systems. The EBA therefore published a draft regulatory standard in January 2021, defining criteria for identifying risk takers in investment firms.[2] The EBA's draft is essentially based on a corresponding regulatory standard on the Capital Requirements Directive (CRD), however it also takes into consideration the business models of the various investment firms. Proportionality is taken into account through specific thresholds.[3] In addition, the EBA has drafted a regulatory standard on the configuration of instruments and possible alternative arrangements.[4] At least 50% of a risk taker's variable remuneration must be paid out in these instruments or arrangements, provided:

– the investment firm exceeds certain thresholds;[5] and

– annual variable remuneration exceeds €50,000 or represents more than one-third of total annual remuneration.

The entry into force of the two above-mentioned regulatory standards still needs to be adopted by the European Commission as a Delegated Regulation and published in the Official Journal of the European Union.

Later this year, EBA guidelines on sound remuneration policies for investment firms are also expected.[6]

1 For more information on the EBA and its regulatory products, see Deutsche Bundesbank (2011), pp. 86 ff.
2 See EBA Draft Regulatory Technical Standards on criteria to identify categories of staff whose professional activities have a material impact on an investment firm's risk profile or assets it manages under Directive (EU) 2019/2034 (IFD) of the European Parliament and of the Council on the prudential supervision of investment firms, available at https://www.eba.europa.eu/regulation-and-policy/remuneration/regulatory-technical-standards-criteria-identify-material-risk-takers-under-investment-firms
3 For example, a criterion is envisaged that would only apply to investment firms with total assets of at least €100 million. Another criterion presupposes a minimum of 1,000 employees.
4 See EBA Final Draft Regulatory Technical Standards on classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration, available at https://www.eba.europa.eu/regulation-and-policy/remuneration/regulatory-technical-standards-pay-out-instruments-variable-remuneration-under-investment-firms. This not only refers to "financial instruments" in the narrower sense; certain contractual arrangements can also be used as "alternative arrangements", provided they meet the requirements of the regulatory standard.
5 See Article 32(4) letter (a) in conjunction with (5) of the IFD.
6 On 17 December 2020, Draft Guidelines were put forward for consultation until 17 March 2021: https://www.eba.europa.eu/regulation-and-policy/investment-firms/guidelines-remuneration-policies-investment-firms#pane-new-3cd4feaf-807f-4122-9d50-97dc4859d840

investment firm or of the assets that it manages."[65] In the context of German supervision, these are usually referred to as risk takers. For the other staff, the only requirement that must be met is that contained in the IFD of (gender neutral) "remuneration policies and practices that are consistent with and promote sound and effective risk management."[66]

For all risk takers at investment firms that will be classified as medium-sized investment institutions going forward, the bonus cap contained in the CRD[67] will be replaced by the requirement of an "appropriate ratio" between the variable and the fixed components of remuneration, giving firms greater leeway. When determining this ratio, investment firms must consider their business activities and the associated risks as well as the impact that the staff in question have on the investment firm's risk profile.

In terms of the other demands on remuneration systems, the new regulatory framework is largely based on the requirements for credit institutions set out in the CRD and only undertakes individual fine-tuning adjustments, some of which make the requirements more stringent. For example, in the IFD, the thresholds for the proportionate application of the requirements in terms of what is known as ex post risk adjustment[68] differ from those in the CRD in order to take into account investment firms' special business models. Going forward, this could mean more investment firms having to meet these requirements than would have been the case pursuant to the CRD rules or their transposition into national law.

German implementation of the remuneration requirements set out in the IFD

Following the IFD approach, the government draft of the IIA stipulates that the remuneration rules should apply exclusively to medium-sized investment institutions. For medium-sized investment institutions, the IIA will include only general requirements,[69] while the more detailed regulations on remuneration are to be set out in a separate act.[70]

Conclusion

The new IFD/IFR prudential framework for investment firms will involve large-scale changes for financial services institutions that already have an authorisation based on the current legal framework for investment firms (MiFID with the references to the CRD and CRR). The scale of the amended requirements and their actual impact on an institution vary very considerably depending on the new investment institution category to which it is classified going forward.

Medium-sized investment institutions will be required to make the most adjustments. This category of institution will be confronted with very sweeping changes to its current supervisory requirements in the future. For example, this category of institution must apply a new method for calculating own funds requirements, the K-factor requirement. There will also be changes, some of them significant, in other areas, such as liquidity requirements as well as disclosure and reporting requirements.

The impact on large investment institutions will be relatively limited, meanwhile, as they will continue to be subject to the requirements of

65 See Article 30 of the IFD.
66 See Article 26(1) of the IFD.
67 Bonus cap refers to the limit on variable remuneration in relation to fixed remuneration. According to Article 94(1) letter (g) of the CRD, this ratio shall not exceed 100%. With shareholder approval, the ratio shall not exceed 200%.
68 Ex post risk adjustment refers to the retention of variable remuneration, ex post contraction (through malus and/or clawback arrangements) and payment in the form of instruments. As they are onerous in administrative terms, these regulations do not apply to all medium-sized investment institutions, but only to those that exceed the thresholds set out in Article 32(4) letter (a) in conjunction with (5) of the IFD.
69 See Section 41 sentence 1 number 4 and Section 46(1) of the draft IIA.
70 See Section 46(3) of the draft IIA.

the CRR, as before. The situation is similar for small investment institutions, which will fall fully within the scope of the IFR going forward. However, this category of institution will face very little change, especially in terms of calculating own funds requirements – a core area of the supervision of institutions – as the risk measurement procedures used are variations, modified only in certain areas, on their predecessors under the CRR regime.[71] Nonetheless, these institutions, too, will have to deal with changes in reporting and liquidity requirements.

When assessing the new prudential framework, a key question is whether the new regime achieves the original objectives that were established back in 2015: creating a framework that is simpler and more appropriate than the CRD/CRR regulations.

The new framework has been significantly simplified, especially in that there is a much smaller number of categories of institutions, resulting in a sharp reduction in the number of different supervisory requirements that apply in parallel. Greater clarity was, moreover, created as to what requirements are actually relevant for what institutions.

The new prudential framework has also been improved noticeably. For instance, it creates requirements that are much better suited to the special features of investment firms' business models than the previous CRD/CRR legal framework. This is particularly evident in the calculation of own funds requirements. The K-factors method creates a new procedure for calculating own funds requirements based on an investment institution's actual business model. At the same time, numerous minor improvements were put in place in the other procedures used to measure own funds so that they now better reflect the particularities of investment services. The new methods for calculating minimum liquidity for medium-sized and small investment institutions are now also more appropriate and a better fit than they used to be.

The definitions of own funds and the methods used to calculate market price risk using the K-factor K-NPR remain the same, for the most part, as the rules applicable to credit institutions. Especially in terms of determining market price risk, established procedures were used that deliver a valid result regardless of the supervised entity. In addition, level playing field considerations were also a factor, as the objective was for credit institutions and investment firms to remain subject to the same rules if they carry out the same business.

From the Bundesbank's perspective, the revision process has, overall, achieved its objectives. This new prudential framework creates a sound basis for the future supervision of investment firms in the EU.

71 A sub-group that will be more severely impacted are what used to be financial services institutions in group IIIb, which were previously subject only to an initial capital requirement.

List of references

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