

Chapter 4

Own funds requirements

4.13 K-CMG requirement

- 4.13.1** **R** (1) Subject to (2), the *K-CMG requirement* applies to a *MIFIDPRU investment firm* for *portfolios* for which the firm has been granted a *K-CMG permission*.
- (2) A *MIFIDPRU investment firm* must include a position specified in ■ MIFIDPRU 4.11.8R within the calculation of its *K-NPR requirement* if that position:
- (a) is included in a *portfolio* for which the *firm* has been granted a *K-CMG permission*;
 - (b) is a proprietary position of the *firm* that results from a trade that has settled;
 - (c) is not included in the calculation of the required margin under the margin model of the *clearing member* or *authorised central counterparty* in ■ MIFIDPRU 4.13.9R(2)(b); and
 - (d) is not a position to which the *clearing member* or *authorised central counterparty* has applied a “haircut” of the type specified in ■ MIFIDPRU 4.13.6R(2).
- 4.13.2** **G** ■ MIFIDPRU 4.13.1R(2) is intended to cover the risks arising from proprietary trades that form part of a *portfolio* for which a *firm* has a *K-CMG permission*. Where trades have settled, the resulting proprietary position of the *firm* may no longer be included within the margin requirement calculated by the *clearing member* or *authorised central counterparty* for that *portfolio* and therefore would not contribute to the *firm's K-CMG requirement*. The *firm* should therefore include these positions within its calculation of the *K-NPR requirement* to take account of the resulting market risk. For these purposes, a *firm* is not required to apply this approach to a position that results from client servicing.
- 4.13.3** **G** In an application for a *K-CMG permission*, a *firm* must identify each *portfolio* for which it wishes to calculate a *K-CMG requirement*.
- 4.13.4** **R** ■ MIFIDPRU 4.11.8R(2) includes positions held outside the *trading book* that give rise to foreign exchange or commodities risk. The *FCA* considers that it is unlikely that such positions would be eligible for a *K-CMG permission*. Therefore, even if the *FCA* has granted a *K-CMG permission* in relation to all *portfolios* in the *firm's trading book*, a *firm* may need to calculate a *K-NPR requirement* in relation to positions it holds outside of the *trading book*.

- 4.13.5** **R** The *K-CMG requirement* of a *MIFIDPRU investment firm* must be calculated using the following formula:
- $$K-CMG\ requirement = TM * 1.3$$
- where TM is the third highest amount of total margin as calculated under **■ MIFIDPRU 4.13.6R** required from the *firm* on a daily basis over the preceding 3 months.
- 4.13.6** **R** For the purposes of **■ MIFIDPRU 4.13.5R**, the total margin must be calculated as the sum of the following in relation to all *clearing members* and to the extent that **■ MIFIDPRU 4.13.9R(2)(c)(i)** applies, all *authorised central counterparties*:
- (1) the amount of margin required by the margin model referenced in **■ MIFIDPRU 4.13.9R(2)(e)**; plus
 - (2) the value of any “haircut” applied by the *clearing member* or *authorised central counterparty* to positions included in the *portfolio* that represent settled trades and which the *clearing member* or *authorised central counterparty* is treating as collateral to secure the present or future obligations of the *MIFIDPRU investment firm*.
- 4.13.7** **G** **■ MIFIDPRU 4.13.6R** requires a *MIFIDPRU investment firm* to determine the amount of margin that is required under the relevant margin model of each *clearing member* (or, for a self-clearing *firm*, of each *authorised central counterparty*) for *portfolios* in respect of which the *firm* has been granted a *K-CMG permission*. For these purposes, the *clearing member’s* (or, where applicable, *authorised central counterparty’s*) margin model must satisfy the criteria in **■ MIFIDPRU 4.13.14R**. The effect of **■ MIFIDPRU 4.13.6R** is that if, notwithstanding the requirement under the margin model, the *MIFIDPRU investment firm* agrees with the *clearing member* or *authorised central counterparty* to provide a different amount of margin, it is the amount required under the model that must be used for the purposes of calculating the *firm’s K-CMG requirement* and not the amount of margin that is actually provided by the *firm*. This ensures that the *firm’s K-CMG requirement* is not artificially reduced by commercial negotiations that may result in the *clearing member* or *authorised central counterparty* accepting a lower amount of margin than the model requires.
- 4.13.8** **G** The calculation in **■ MIFIDPRU 4.13.5R** means that for each trading day during the calculation period, the *firm* must calculate the total combined margin in accordance with **■ MIFIDPRU 4.13.6R** provided to all *clearing members* in aggregate in respect of the relevant *portfolios*. The *K-CMG requirement* is then calculated on the basis of the third highest daily aggregate amount.
- 4.13.9** **R** To obtain a *K-CMG permission* for a *portfolio*, a *firm* must:
- (1) complete the application form in **■ MIFIDPRU 4 Annex 7R** and submit it using the *online notification and application system*;
 - (2) in the application, demonstrate to the satisfaction of the *FCA* that:
 - (a) the *firm* is not part of a *group* containing a *credit institution*;

- (b) the clearing and settlement of the transactions in the relevant *portfolio* take place under the responsibility of a *clearing member* of an *authorised central counterparty*;
- (c) the *clearing member* in (b) is one of the following:
 - (i) a *MIFIDPRU investment firm* (which may be the *firm* itself, where it is self-clearing);
 - (ii) a *UK credit institution*;
 - (iii) a *designated investment firm*;
 - (iv) a *third country investment firm*; or
 - (v) a *credit institution* established in a *third country*;
- (d) transactions in the relevant *portfolio* are either:
 - (i) centrally cleared in an *authorised central counterparty*; or
 - (ii) settled on a delivery-versus-payment basis under the responsibility of the *clearing member* in (b);
- (e) the *firm* is required to provide total margin calculated on the basis of a margin model that satisfies the criteria in ■ MIFIDPRU 4.13.14R and is operated by:
 - (i) where the *clearing member* in (b) (where applicable, including the *firm* itself) is a *MIFIDPRU investment firm* or a *third country investment firm*, the *authorised central counterparty* in (b); or
 - (ii) in any other case, the relevant *clearing member* in (b);
- (f) the reasons for the *firm's* choice of calculating a *K-CMG requirement* for the *portfolio* have been clearly documented and approved by the *firm's management body* or risk management function; and
- (g) the choice of the *portfolio* to be subject to a *K-CMG requirement* has not been made with a view to engaging in regulatory arbitrage between the *K-NPR requirement* and the *K-CMG requirement* in a disproportionate or prudentially unsound manner.

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- (1) A *firm* that has been granted a *K-CMG permission* for a *portfolio* must notify the *FCA* immediately if it becomes aware that any of the conditions in ■ MIFIDPRU 4.13.9R are no longer met in relation to the *portfolio*.
- (2) The notification in (1) must be made using the form in ■ MIFIDPRU 4 Annex 8R and submitted via the *online notification and application system*.

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The *FCA* may revoke a *K-CMG permission* for a *portfolio* where one or more of the conditions in ■ MIFIDPRU 4.13.9R is no longer met in relation to that *portfolio*. The *FCA* may review the appropriateness of any *K-CMG permissions* as part of any *SREP* it undertakes in relation to the *firm* in accordance with ■ MIFIDPRU 7.

- 4.13.12** **R** A *firm* that is an *indirect client* of a *clearing member* may obtain a *K-CMG permission* if:
- (1) the indirect clearing arrangement satisfies all of the conditions in **■ MIFIDPRU 4.13.9R** and both the *clearing member* and the *client* of the *clearing member* that is providing clearing services to the *firm* are entities that are listed in **■ MIFIDPRU 4.13.9R(2)(c)**; and
 - (2) the *FCA* is satisfied that the relevant arrangement does not result in undue risks.
- 4.13.13** **R**
- (1) A *firm* that is relying on a *K-CMG permission* must ensure that:
 - (a) the *individuals* in the *firm* who are responsible for the *firm's* risk management function, or for the oversight of that function, have a reasonable understanding of the operation of the margin model referred to in **■ MIFIDPRU 4.13.9R(2)(e)**; and
 - (b) the *firm* integrates this understanding of the margin model into its *ICARA process* for the purposes of considering whether:
 - (i) the resulting *K-CMG requirement* is sufficient to cover the relevant risks to which the *firm* is exposed; and
 - (ii) the *K-CMG permission* remains appropriate in relation to the *portfolio(s)* for which it was granted.
 - (2) For the purposes of (1), a *firm* may use suitable advice or analysis provided by an appropriate third party, but the *firm* is responsible for ensuring that the *individuals* in (1)(a) have the necessary knowledge and understanding of the margin model.
 - (3) An appropriate third party under (2) includes:
 - (a) a suitably qualified professional adviser;
 - (b) the relevant *clearing member*; or
 - (c) another *undertaking* within the same *investment firm group* as the *firm* where individuals within that *undertaking* have the requisite knowledge and understanding of the margin model.
- 4.13.14** **R**
- (1) The criteria referred to in **■ MIFIDPRU 4.13.9R(2)(e)** are that:
 - (a) the margin requirements are sufficient to cover losses that may result from at least 99% of the exposures movements over an appropriate time horizon with at least a two-*business day* holding period; and
 - (b) the margin model used by the *clearing member* or *authorised central counterparty* to call the margin is always designed to achieve a level of prudence similar to that required in the provisions on margin requirements in article 41 of *EMIR*.
 - (2) If the parameters of a margin model operated by a *clearing member* or *authorised central counterparty* do not meet the criteria in (1)(a), those criteria shall nonetheless be deemed to be met if:
 - (a) an adjustment mechanism is applied to produce an alternative margin requirement; and

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- (b) the alternative requirement in (a) is at least equivalent to the margin requirement that would be produced by a margin model that meets the criteria in (1)(a).
- (3) An adjustment mechanism under (2) may be applied by either of the following, provided that the conditions in (4) are met:
 - (a) the relevant *clearing member*; or
 - (b) the *MIFIDPRU investment firm* that has been granted the relevant *K-CMG permission*.
- (4) The conditions are that the *MIFIDPRU investment firm* that has been granted the relevant *K-CMG permission*:
 - (a) can provide to the *FCA* upon request a reasonable explanation of the adjustment that has been applied under (2); and
 - (b) monitors and reviews the effectiveness of the adjustment mechanism on an ongoing basis as part of its *ICARA process*.

- (1) ■ **MIFIDPRU 4.13.14R(2)** permits the output of a margin model of a *clearing member* or *authorised central counterparty* to be adjusted to meet the criteria in ■ **MIFIDPRU 4.13.14R(1)(a)**. The adjustment is used solely to determine the *K-CMG requirement* of a *firm*. It does not affect the actual amount of margin that the *clearing member* or *authorised central counterparty* will receive from the *firm*, which will continue to be determined by the underlying (unadjusted) model.
- (2) For example, the *clearing member's* or *authorised central counterparty's* original margin model may produce margin requirements that are sufficient to cover losses that may result from at least 95% of the exposures movements over a *two-business day* holding period. This would not meet the minimum criteria in ■ **MIFIDPRU 4.13.14R(1)(a)**. To determine the *firm's K-CMG requirement*, the output of that model may be adjusted to produce a requirement that would cover losses that may result from at least 99% of the exposures movements over that same holding period. If the conditions in ■ **MIFIDPRU 4.13.14R(3)** and ■ **(4)** are satisfied, the minimum criteria in ■ **MIFIDPRU 4.13.14R(1)(a)** will be deemed to be met when the adjustment is applied. This is the case even though the actual margin received by the *clearing member* or *authorised central counterparty* is determined by the underlying (unadjusted) model.

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Where the margin model of a *clearing member* uses parameters that are more conservative than the minimum criteria in ■ **MIFIDPRU 4.13.14R(1)**, the output of the model may be adjusted downwards under ■ **MIFIDPRU 4.13.14R(2)** to produce margin requirements that are consistent with the minimum criteria. The requirements in ■ **MIFIDPRU 4.13.14R(3)** and ■ **(4)** still apply to a downwards adjustment. A *firm* is not required to apply a downwards adjustment to a more conservative model.

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The *FCA* will consider whether the *firm's* reasons for choosing a *K-CMG requirement* under ■ **MIFIDPRU 4.13.9R(2)(f)** have taken adequate account of the nature of, and risks arising from, the *firm's* trading activities, including whether:

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- (1) the main activities of the *firm* are essentially trading activities that are subject to clearing and margining under the responsibility of a *clearing member*; and
 - (2) other activities performed by the *firm* are immaterial in comparison to those main activities.
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- (1) For the purposes of ■ MIFIDPRU 4.13.9R(2)(g), the fact that a *K-CMG permission* for a *portfolio* may result in a *K-CMG requirement* that is lower than the equivalent *K-NPR requirement* for that *portfolio* does not automatically mean that the choice to apply a *K-CMG requirement* has been made with a view to engaging in regulatory arbitrage in a disproportionate or prudentially unsound manner.
 - (2) When considering whether the condition in ■ MIFIDPRU 4.13.9R(2)(g) is satisfied, a *firm* should consider whether the *K-CMG requirement* that would result from the relevant *K-CMG permission* more closely reflects the underlying economic risk of the relevant *portfolio* when compared with the equivalent *K-NPR requirement* for the same *portfolio*.
 - (3) The *FCA* considers that even in circumstances where the *K-CMG requirement* is considerably lower than the equivalent *K-NPR requirement*, this does not automatically prevent a *firm* from meeting the conditions for a *K-CMG permission*. A significant difference between the two requirements may result from the calculation of the *K-CMG requirement* being better adapted for capturing the economic risks of the particular *portfolio* in question. For example, the margin model underlying the *K-CMG requirement* may have been specifically designed for *firms* that specialise in trading that type of *portfolio*. A *firm* that is applying for a *K-CMG permission* should provide a clear explanation of how the conditions in ■ MIFIDPRU 4.13.9R(2) are satisfied for the *portfolio*. The *firm* should keep the appropriateness of a *K-CMG permission* under regular review as part of its *ICARA process*.

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- (1) Except where (2) applies, a *firm* that has a *K-CMG permission* for a *portfolio* must calculate a *K-CMG requirement* for that *portfolio* for a continuous period of at least 24 *months* from the date that the permission is granted.
- (2) The requirement in (1) does not apply if:
 - (a) the *FCA* revokes the relevant *K-CMG permission* in relation to that *portfolio* on its own initiative in the circumstances described in ■ MIFIDPRU 4.13.11G; or
 - (b) the business strategy or operations of the *trading desk* with responsibility for the *portfolio* have changed to such an extent that it has become a different *trading desk*.

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- (1) Where a *firm* that has been granted a *K-CMG permission* in relation to a *portfolio* subsequently chooses to calculate a *K-NPR requirement* for that *portfolio*, the *firm* must submit the notification in (2) to the *FCA* before the *firm* begins to calculate the *K-NPR requirement*.

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Where a *firm* has submitted a notification in ■ MIFIDPRU 4.13.20R(2), the *FCA* will not normally grant another *K-CMG permission* for the same *portfolio* until at least 24 *months* after the previous *K-CMG permission* ceased to apply.

(2) The notification in (1) must:

- (a) confirm that the requirement in ■ MIFIDPRU 4.13.19R(1) has been met in relation to the *portfolio*, or that the circumstance in ■ MIFIDPRU 4.13.19R(2)(b) applies;
- (b) specify the date on which the *K-CMG permission* should cease to apply to the *firm*; and
- (c) be made using the form in ■ MIFIDPRU 4 Annex 9R and submitted using the *online notification and application system*.