Chapter 5

Concentration risk

5.1   Application and purpose

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Application: Who?

5.1.1   R   This chapter applies to:

(1) a *MIFIDPRU investment firm*; and

(2) a *UK parent entity* that is required by ■ MIFIDPRU 2.5.7R to comply
with ■ MIFIDPRU 5 on the basis of its *consolidated situation*.

5.1.2   R   Where this chapter applies on the basis of the *consolidated situation* of the
UK parent entity, any reference to a "*firm*" or "*MIFIDPRU investment firm*"
in this chapter is a reference to the hypothetical single *MIFIDPRU investment
firm* created under the *consolidated situation*.

5.1.3   G   ■ MIFIDPRU 2.5.45G and ■ 2.5.46G contain additional *guidance* on how a *UK
parent entity* should apply the requirements in this chapter on a
consolidated basis.

5.1.4   G   ■ MIFIDPRU 5.2 to ■ 5.10 do not apply to a *commodity and emission allowance
dealer* in the circumstances set out in ■ MIFIDPRU 5.11.

Application: What?

5.1.5   R   ■ MIFIDPRU 5.2 applies to all of a *firm's* activities that may give rise to
concentration risk.

5.1.6   G   ■ MIFIDPRU 5.2 is therefore relevant to both a *MIFIDPRU investment firm* that
deals on own account and one that does not (e.g. an *SNI MIFIDPRU
investment firm*).

5.1.7   R   ■ MIFIDPRU 5.3 to ■ 5.10 apply to a *firm* when *dealing on own account* in
relation to transactions that are recorded in the *trading book*.

5.1.8   G   ■ MIFIDPRU 5.3 to ■ 5.10 apply whether a *firm* is *dealing on own account* for
itself or on behalf of a *client*.

5.1.9   G   A *MIFIDPRU investment firm* that has *permission* to *operate an organised
trading facility* may rely on that *permission* to:

(1) engage in *matched principal trading* in certain types of *financial instruments* with *client* consent, in accordance with ■ MAR 5A.3.5R(1); and

(2) *deal on own account* in illiquid *sovereign debt instruments* in accordance with ■ MAR 5A.3.5R(2).

Purpose

5.1.10   G | This chapter contains:

(1) *Rules* and *guidance* on how a *MIFIDPRU investment firm* must monitor and control *concentration risk* (■ MIFIDPRU 5.2).

(2) *Rules* and *guidance* on the *concentration risk* requirements that apply to the *trading book* exposures of a *MIFIDPRU investment firm* that is *dealing on own account* (■ MIFIDPRU 5.3 to ■ MIFIDPRU 5.10). ■ MIFIDPRU 5.3 sets out an overview of these requirements.

(3) *Rules* and *guidance* on when a *commodity and emission allowance dealer* is exempt from the requirements of this chapter (■ MIFIDPRU 5.11).

Interpretation

5.1.11   G | In this chapter, references to *client* include any counterparty of the *firm*.

5.1.12   R | Subject to ■ MIFIDPRU 5.1.13R to ■ MIFIDPRU 5.1.16R, a *group of connected clients* means:

(1) two or more *persons* who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has *control* over the other or others; or

(2) two or more *persons* between whom there is no relationship of *control* as described in (1) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would also be likely to encounter funding or repayment difficulties.

5.1.13   R | Where a central government has direct *control* over, or is directly interconnected with, more than one *person*, they do not all have to be treated as a single *group of connected clients*. Instead, the existence of a *group of connected clients* may be assessed separately at the level of each *person* directly *controlled* by or directly interconnected with the central government, which must include all of the natural and legal *persons* which are *controlled* by or interconnected with that *person*, including the central government.

5.1.14   R | Regional governments and local authorities, whether in the *United Kingdom* or a *third country*, may be treated in the same way as central governments under ■ MIFIDPRU 5.1.13R if there is no difference in the risk they pose compared to central governments.

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5.1.15　　G　(1) There may be no difference in the risk posed by a regional government or local authority if it has specific revenue-raising powers, or if there are specific institutional arrangements which reduce the risk of default.

(2) The *PRA* maintains a list of all regional governments and local authorities within the *United Kingdom* which it treats as exposures to the central government of the *United Kingdom*, in accordance with article 115 of the *UK CRR*. A *firm* may have regard to this list when applying the test in ■ MIFIDPRU 5.1.14R to regional governments and local authorities in the *United Kingdom*.

5.1.16　　R　Two or more *persons* do not constitute a single *group of connected clients* solely because of their direct exposure to the same *central counterparty* for clearing purposes.

Exposures to trustees

5.1.17　　R　For the purposes of this chapter, if a *firm* has an exposure to a *person* ('A') when A is acting on its own behalf, and also an exposure to A when A acts in the capacity of trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund (a "fund"), the *firm* may treat the latter exposure as if it was to the fund as a separate *client*, unless such treatment would be misleading.

5.1.18　　G　When considering whether such treatment would be misleading, a *firm* should consider factors such as:

(1) the degree of independence of control of the fund, including the relation of the fund's board and senior management to the *firm* or to other funds or to both;

(2) the terms on which the counterparty, when acting as trustee, is able to satisfy its obligation to the *firm* out of the fund of which it is trustee;

(3) whether the beneficial owners of the fund are connected to the *firm*, or related to other funds managed within the *firm's* group, or both; and

(4) for a counterparty that is connected to the *firm* itself, whether the exposure arises from a transaction entered into on an arm's length basis.

5.1.19　　G　In deciding whether a transaction is at arm's length, the following factors should be taken into account:

(1) the extent to which the *person* to whom the *firm* has an exposure ('A') can influence the *firm's* operations through, for example, the exercise of voting rights;

(2) the management role of A where A is also a *director* of the *firm*; and

(3) whether the exposure would be subject to the *firm's* usual monitoring and recovery procedures if repayment difficulties emerged.

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5.2　　Monitoring obligation

5.2.1　|R|　A *firm* must monitor and control its *concentration risk* using sound administrative and accounting procedures and robust internal control mechanisms.

5.2.2　|G|　■ MIFIDPRU 5.2.1R requires a *firm* to monitor and control all sources of *concentration risk*. This is not limited to *trading book* exposures, but also includes any concentration in assets not recorded in a *trading book* (for example, trade debts) and off-balance sheet items. It also includes any *concentration risk* that may arise from the following:

(1)　the location of *client money*;

(2)　the location of *custody assets*;

(3)　a *firm's* own cash deposits; and

(4)　earnings.

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5.3 Overview of concentration risk requirements for dealing on own account

5.3.1 |G| ■ MIFIDPRU 5.4 to ■ MIFIDPRU 5.10 contain the *concentration risk* requirements that apply to the *trading book* exposures of a *MIFIDPRU investment firm* that is *dealing on own account:*

(1) ■ MIFIDPRU 5.4 explains how a *firm* should calculate the value of its exposure to each *client* or *group of connected clients* (the *exposure value* or *EV*).

(2) ■ MIFIDPRU 5.5.1R explains how a *firm* should calculate the *concentration risk soft limit* for its exposure to a *client* or *group of connected clients*.

(3) ■ MIFIDPRU 5.5.3R explains how a *firm* should calculate the value by which its exposure to each *client* or *group of connected clients* exceeds the *concentration risk soft limit* (the *exposure value excess* or *EVE*). The *EVE* is relevant to the calculation of the *K-CON requirement*.

(4) ■ MIFIDPRU 5.6 contains the obligation to calculate the *K-CON requirement* and to notify the *FCA* if the value of a *firm's* exposure to a *client* or *group of connected clients* exceeds the *concentration risk soft limit*.

(5) ■ MIFIDPRU 5.7 explains how to calculate the *K-CON requirement*.

(6) ■ MIFIDPRU 5.8 contains *rules* designed to prevent *firms* from avoiding the *K-CON requirement*.

(7) ■ MIFIDPRU 5.9 contains the 'hard' concentration risk limits, and associated provisions.

(8) ■ MIFIDPRU 5.10 excludes certain exposures from the concentration risk requirements in ■ MIFIDPRU 5.4 to ■ 5.9.

5.4   Calculation of exposure value (EV)

5.4.1   **R**   For the purposes of ■ MIFIDPRU 5.5 to ■ MIFIDPRU 5.10, a *firm* must calculate an *exposure value (EV)* for each *client* or *group of connected clients* by adding together the following items:

(1) the positive excess of the *firm's* long positions over its short positions in all the *trading book financial instruments* issued by the *client* in question, using the approach specified for K-NPR in ■ MIFIDPRU 4.12.2R to calculate the net position for each instrument; and

(2) the exposure value of contracts and transactions referred to in ■ MIFIDPRU 4.14.3R with the *client* in question, calculated using the approach specified for K-TCD in ■ MIFIDPRU 4.14.8R.

5.4.2   **R**   For the purposes of ■ MIFIDPRU 5.4.1R(1), where a *firm* calculates a *K-CMG requirement* in relation to a *portfolio*, it must calculate its net position for the exposures in that *portfolio* using the approach specified for K-NPR in ■ MIFIDPRU 4.12.2R.

5.4.3   **R**   The *EV* with regard to a *group of connected clients* must be calculated by adding together the exposures to the individual *clients* within the group, which must be treated as a single exposure.

5.4.4   **R**   When calculating *EVs*, a *firm* must take all reasonable steps to identify underlying assets in relevant transactions and the counterparty of the underlying exposures.

5.5 The concentration risk soft limit and exposure value excess

The concentration risk soft limit

5.5.1 **R**

(1) The *concentration risk soft limit* for *EVs* to an individual *client* or *group of connected clients* is 25% of a *firm's own funds*, subject to (2) and (3).

(2) Where an individual client is a *MIFIDPRU-eligible institution*, the *concentration risk soft limit* for that *client* is the higher of:

(a) 25% of the *firm's own funds*; or

(b) £150 million or 100% of the *firm's own funds*, whichever is the lower.

Where a *group of connected clients* includes one or more *MIFIDPRU-eligible institutions*, the *concentration risk soft limit* for the group is the higher of:

(a) (a)25% of the *firm's own funds*; or

(b) £150 million or 100% of the *firm's own funds*, whichever is the lower, provided that for the sum of *exposure values* with regard to all connected *clients* that are not *MIFIDPRU-eligible institutions*, the *concentration risk soft limit* remains at 25% of the *firm's own funds*.

5.5.2 **G** The *Handbook* definition of *MIFIDPRU-eligible institution* includes private or public *undertakings*, including the branches of such *undertakings*, provided that those *undertakings*, if they were established in the *UK*, would be *UK credit institutions* or *MIFIDPRU investment firms*, and provided that those *undertakings* have been authorised in a *third country* that applies prudential supervisory and regulatory requirements comparable to those applied in the *UK*.

The exposure value excess (EVE)

5.5.3 **R**

(1) A *firm* that exceeds the *concentration risk soft limit* for a *client* or *group of connected clients* must calculate the *exposure value excess* (*EVE*).

(2) A *firm* must calculate the *EVE* for an individual *client* or *group of connected clients* using the following formula:

$$EVE = EV - L$$

where:

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L = the *concentration risk soft limit* specified in ■ MIFIDPRU 5.5.1R.

**5.6   Obligations for a firm that exceeds
the concentration risk soft limit**

5.6.1 |R| For as long as a *firm* exceeds the *concentration risk soft limit* for one or
more *clients* or *groups of connected clients*, it must calculate the *K-CON
requirement*.

5.6.2 |R| When a *firm* exceeds the *concentration risk soft limit* for a *client* or *group of
connected clients*, it must notify the *FCA* without delay of the amount of the
EVE, and the name of the individual *client* or *group of connected clients*.

5.6.3 |R| A *firm* must make the notification referred to in ■ MIFIDPRU 5.6.2R by
completing Part A of the form in ■ MIFIDPRU 5 Annex 1R and submitting it
using the *online notification and application system*.

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5.7 Calculating K-CON

5.7.1 [R] The *K-CON requirement* of a *MIFIDPRU investment firm* is equal to the sum of the *CON own funds requirement* for each *client* or *group of connected clients* for which the *EV* exceeds the *concentration risk soft limit*.

5.7.2 [R] The *CON own funds requirement* for each *client* or *group of connected clients* in ■ MIFIDPRU 5.7.1R must be calculated by:

(1) determining the own funds requirement for the excess (*OFRE*) in accordance with ■ MIFIDPRU 5.7.3R; and

(2) applying the relevant multiplication factor or factors in accordance with ■ MIFIDPRU 5.7.4R.

5.7.3 [R] (1) The *OFRE* must be calculated using the following formula:

$$OFRE = \frac{OFR}{EV} \times EVE$$

(2) The *OFR* for an individual *client* is the sum of:

(i) the *TCD own funds requirement* for exposures to that *client*; and

(ii) the *K-NPR requirement* for the exposures to that *client*, subject to (b).

(2) Where exposures arise from the positive excess of a *firm's* long positions over its short positions in all the *trading book financial instruments* issued by the *client* in question, the net position of each instrument calculated using the approach specified for K-NPR in ■ MIFIDPRU 4.12.2R shall only include specific-risk requirements.

(2) A *firm* that calculates a *K-CMG requirement* for a *portfolio* must calculate the *OFR* using the approach specified for K-NPR in ■ MIFIDPRU 4.12.2R, subject to (b).

(2) The *OFR* for a *group of connected clients* must be calculated by adding together the exposures to individual *clients* within the group, and then determining a single own funds requirement for exposures to the group as if the group were a single *undertaking*.

5.7.4   R   (1) Where the excess has persisted for 10 *business days* or less, the *CON own funds requirement* is the *OFRE* multiplied by 200%.

(2) Where the excess has persisted for more than 10 *business days*:

(a) the *EVE* must be apportioned according to the tranches in each row of Column 1 of Table 1;

(b) the proportion of the *EVE* in each tranche must be calculated as a percentage of the overall *EVE*;

(c) the *OFRE* must be pro-rated according to the proportion of *EVE* falling within each tranche;

(d) each portion of the *OFRE* must be multiplied by the relevant Factor in Column 2 of Table 1; and

(e) the *CON own funds requirement* is the sum of the amounts calculated in accordance with (d).

(3) Table 1

Column 1:	Column 2: Factors
EVE as a percentage of own funds	
For the amount up to and including 40%	200%
For the amount over 40% up to and including 60%	300%
For the amount over 60% up to and including 80%	400%
For the amount over 80% up to and including 100%	500%
For the amount over 100% up to and including 250%	600%
For the amount over 250%	900%

5.7.5   G   (1) K-CON is an additional *K-factor* own funds requirement for *concentration risk* in the *trading book*.

(2) A *firm* must calculate a *CON own funds requirement* for each *client* or *group of connected clients* for which the *exposure value* exceeds the *concentration risk soft limit*. The *CON own funds requirement* for each *client* or *group of connected clients* is then added together determine the *K-CON requirement*.

(3) Determining the *CON own funds requirement* for each *client* or *group of connected clients* involves a two-step calculation:

(a) The first step involves an exposure-based calculation, known as the *OFRE* (the own funds requirement for the excess).

(b) The second step involves applying a multiplying factor to the *OFRE* (or applying different multiplying factors to tranches of the *OFRE*) based on the length of time for which the excess has persisted and by how much (as a percentage of own funds) the *exposure value* exceeds the *concentration risk soft limit*.

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(4) The reference to how long an excess has persisted relates to how long a *firm* has had an exposure to a *client* or *group of connected clients* that exceeds the *concentration risk soft limit*, irrespective of whether the constituent parts that make up that total exposure change over the duration of that total exposure.

(5) The 10-*business day* period referred to in ■ MIFIDPRU 5.7.4R runs from the start of the *business day* on which the excess occurred.

5.7.6 G The following example shows how to calculate the *CON own funds requirement* for an excess to a *client* that has persisted for 10 *business days* or less:

(1) A *firm* has:

(a) *own funds* of 1000;

(b) a *concentration risk soft limit* of 250 (25% of 1000);

(c) an *EV* of 262; and

(d) an *EVE* of 12 (262 - 250 = 12).

(2) The exposure is all due to debt securities that have a specific risk own funds requirement of 8% (according to Table 1 in article 336 of *UK CRR)* for the purposes of K-NPR. There is zero K-TCD to this *client*.

In this example, the *OFR* = 262 × 8% = 20.96

(3) To calculate the *OFRE*:

OFRE = OFR/EV*EVE = 20.96/262 ×12 = 0.96

(4) As the excess has persisted for 10 *business days* or less:

CON own funds requirement = 0.96 × 200% = 1.92

5.7.7 G The following example shows how to calculate the *CON own funds requirement* for an excess that has persisted for more than 10 *business days*:

(1) A *firm* has:

(a) *own funds* of 1000;

(b) a *concentration risk soft limit* of 250 (25% of 1000);

(c) an *EV* of 780; and

(d) an *EVE* of 530 (780 - 250 = 530).

(2) The exposure is all due to debt securities that have a specific risk own funds requirement of 8% (according to Table 1 in article 336 of *UK CRR)* for the purposes of K-NPR. There is zero K-TCD to this client.

In this example, the *OFR* = 780 × 8% = 62.4

(3) To calculate the *OFRE*:

OFRE = OFR/EV*EVE = 62.4/780 × 530 = 42.4

(4) As the excess has persisted for more than 10 *business days*, the *CON own funds requirement* is calculated by apportioning the *OFRE* in

accordance with the relevant *EVE* tranche in Table 2, multiplying each part of the *OFRE* by the applicable factor, and then adding the resulting amounts together:

Application of Table 2			
K-CON factor tranche as per Table 1	*EVE* **split by tranche**	*OFRE* **allocated across K-CON tranche by** *EVE* **split**	*CON own funds requirement* (*OFRE* × **factor in Table 1)**
Up to 40%	400	400/530 × 42.4 = 32	32 × 200% = 64
40%-60%	130	130/530 × 42.4 = 10.4	10.4 × 300% = 31.2
Total:	530	42.4	95.2

(5) The *CON own funds requirement* is the total amount in the last column, 95.2.

MIFIDPRU 5 : Concentration risk

Section 5.8 : Procedures to prevent
investment firms from avoiding the K-CON
own funds requirement

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5.8 Procedures to prevent investment firms from avoiding the K-CON own funds requirement

5.8.1 **R** A *firm* must not deliberately avoid the *K-CON requirement* by:

(1) undertaking artificial transactions to close out an exposure and create a new exposure; or

(2) temporarily transferring an exposure to another *undertaking*, whether within the same group or not.

5.8.2 **R** A *firm* must maintain systems which ensure that any closing out or transfer that is prohibited by ■ MIFIDPRU 5.8.1R is immediately reported to the *FCA* in accordance with ■ MIFIDPRU 1.1.10R.

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5.9 The 'hard' limits on concentration risk

5.9.1 **R** (1) Whilst an exposure exceeding the *concentration risk soft limit* has persisted for 10 *business days* or less, a *firm's EV* for the individual *client* or *group of connected clients* must not exceed 500% of the *firm's own funds*.

(2) Whilst a *firm* has one or more exposures exceeding the *concentration risk soft limit* that have persisted for more than 10 *business days*, the aggregate *EVEs* for all such exposures must not exceed 600% of the *firm's own funds*.

5.9.2 **G** (1) An exposure exceeding the *concentration risk soft limit* persists for as long as the overall exposure exceeds the *concentration risk soft limit*, irrespective of whether the constituent parts that make up that total exposure change over the duration of that total exposure.

(2) For the purpose of ■ MIFIDPRU 5.9.1R(2), the 600% limit applies to the aggregate of all individual *EVEs* for excesses that have persisted for more than 10 *business days*, irrespective of whether the individual concentrated exposures are connected to one another.

(3) The 10 *business day* period referred to in ■ MIFIDPRU 5.9.1R runs from the start of the *business day* on which the excess occurred.

5.9.3 **R** If a *firm* breaches the requirement in ■ MIFIDPRU 5.9.1R, it must notify the *FCA* without delay of:

(1) the amounts of the exposure or exposures which give rise to the breach;

(2) the name or names of the *clients* concerned; and

(3) any steps which the *firm* or any other *person* has taken or intends to take to rectify the breach and prevent any future potential occurrence.

5.9.4 **R** A *firm* must make the notification referred to in ■ MIFIDPRU 5.9.3R using Part B of the form in ■ MIFIDPRU 5 Annex 1R, and must submit it using the *online notification and application system*.

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5.10   Exclusions

5.10.1   **R**   The requirements in ■ MIFIDPRU 5.4 to ■ 5.9 do not apply to the following exposures:

(1) exposures which are entirely deducted from a *MIFIDPRU investment firm's own funds*;

(2) exposures incurred in the ordinary course of the settlement of payment services, foreign currency transactions, securities transactions and the provision of money transmission;

(3) exposures constituting claims against:

(a) central governments, central banks, public sector entities, international organisations or multilateral development banks and exposures guaranteed by or attributable to such *persons*, where those exposures would receive a 0% risk weight under articles 114 to 118 of the *UK CRR*;

(b) regional governments and *local authorities* of the *UK* or a *third country* which pose no difference in risk compared to a central government covered by (a); and

(c) *central counterparties* and default fund contributions to *central counterparties*;

(4) exposures incurred by a *firm* to its *parent undertaking*, to other *subsidiaries* or *connected undertakings* of that *parent undertaking* or to its own *subsidiaries* or *connected undertakings*, insofar as those *undertakings* are supervised on a consolidated basis in accordance with ■ MIFIDPRU 2.5 or with *UK CRR*, are supervised for compliance with the *group capital test* in accordance with ■ MIFIDPRU 2.6, or are supervised in accordance with comparable standards in force in a *third country*, and provided that the following conditions are met:

(a) there is no current or foreseen material practical or legal impediment to the prompt transfer of capital or repayment of liabilities; and

(b) the risk evaluation, measurement and control procedures of the *parent undertaking* include the *firm* and any relevant *subsidiary* or *connected undertaking*.

5.11 Exemption for commodity and emission allowance dealers

5.11.1 **R** A *commodity and emission allowance dealer* is not required to comply with ■ MIFIDPRU 5.2 to ■ 5.10 where all of the following conditions are met:

(1) the other counterparty is a non-financial counterparty;

(2) both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;

(3) the transaction can be assessed as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group; and

(4) the *firm* complies with ■ MIFIDPRU 5.11.2R.

5.11.2 **R** (1) Before relying on the exemption in ■ MIFIDPRU 5.11.1R, a *firm* must notify the *FCA*.

(2) A *firm* must notify the *FCA* annually thereafter in order to continue to rely on the exemption in ■ MIFIDPRU 5.11.1R.

(3) The notification must explain how the *firm* expects to meet or continue to meet the conditions in ■ MIFIDPRU 5.11.1R.

(4) If there is a material change to the information provided in (1) or (2), a *firm* must notify the *FCA* without delay.

(5) The notifications in (1), (2) and (4) must be made using the form in ■ MIFIDPRU 5 Annex 2R, and must be submitted using the *online notification and application system*.

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Notification under MIFIDPRU 5.6.3R and 5.9.3R that limits for concentration risk have been exceeded

[Editor's note: The forms can be found at this address: https://www.handbook.fca.org.uk/form/ MIFIDPRU 5 Annex 1R(A) Notification under MIFIDPRU 5.6.3R that the concentration risk soft limit has been exceeded.pdf]

https://www.handbook.fca.org.uk/form/MIFIDPRU 5 Annex 1R(B) Notification under MIFIDPRU 5.9.3R of the concentration risk hard limit breach.pdf

Notifications under MIFIDPRU 5.11.2R in respect of the exemption from K-CON requirement for commodity and emission allowance dealers

[Editor's note: The forms can be found at this address: https://www.handbook.fca.org.uk/form/ MIFIDPRU 5 Annex 2R Notifications under MIFIDPRU 5.11.2R in respect of the exemption from K-CON requirement.pdf]