MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

3 February 2021

The Investment Firms Regulation and Directive – 2nd Briefing

Introduction

The industry should already be familiar with the K-Factors being introduced by the Investment Firms Regulation ("the IFR") and the Investment Firms Directive ("the IFD"), together "the IFR Package". The MFSA has created a section on its website dedicated to IFR Package circulars and has also disseminated information regarding the K-Factors to the industry through EBA documents and this previous circular.

The purpose of this circular is to delve deeper into the K-Factors; their meaning, how are they regulated, how are they applied, and to whom they apply.

K-Factors

The IFR package introduces these quantitative indicators to accurately reflect the risks which investment firms face. There are three groups of K-Factors; risk to client, risk to market, and risk to the firm itself. Class 2 firms will be required to calculate their K-Factors when assessing their own funds requirements. Class 1 Firms have to calculate their own funds requirements as per the Capital Requirements Regulation, whereas Class 3 Firms have to apply either the Fixed Overheads Requirement or the Permanent Minimum Capital Requirement[1]

When doing such calculations, the K-Factor Requirement shall amount to the sum of the three K-Factor groups, calculated according to Chapters 2, 3, and 4 of Title 2 of Part Three of the IFR.[2]

a. Risk to Client (RtC)

RtC is calculated through the addition of the K-AUM, K-CMH, K-ASA, and K-COH, as defined and described below.[3]

K-Factor	Definition[4]	Methodology
K-AUM	"'assets under management' or 'AUM' means the value of assets that an investment firm manages for its clients under both discretionary portfolio management and nondiscretionary arrangements constituting investment advice of an ongoing nature".[5]	Articles 15 and 17 IFR
K-CMH	'client money held' or 'CMH' means the amount of client money that an investment firm holds, taking into account the legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm;	Articles 15 and 18 IFR

[1] Article 11 IFR
[2] Article 15 IFR
[3] Article 16 IFR
[4] Article 4 IFR
[5] Article 4 IFR

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K-ASA	'assets safeguarded and administered' or 'ASA' means the value of assets that an investment firm safeguards and administers for clients, irrespective of whether assets appear on the investment firm's own balance sheet or are in third-party accounts;	Articles 15 and 19 IFR
K-COH	'client orders handled' or 'COH' means 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	Articles 15 and 20 IFR

K-AUM – A practical example

Article 17 of the IFR states that AUM, for the purpose of calculating K-AUM, shall be the rolling average of the value of the total monthly assets under management, measured on the last business day of the previous 15 months converted into the entities' functional currency within the respective time period, excluding the values of the latest three months. AUM shall then be the arithmetic mean of the remaining (excluded the three most recent) monthly values. K-AUM shall be calculated on the first business day of each month.

Assuming a 31-December year-end, the K-AUM for Q1 shall be calculated on 01 April as the arithmetic mean of the last 12 AUM values excluding the three most recent - i.e. excluding AUM as at 31 March, 28 February and 31 January – multiplied by the K-AUM coefficient (0.02%), as per Article 15 of the IFR.

It is important to note that:

- Where the investment firm has formally delegated the management of assets to another financial entity, those assets shall be included in the total amount of AUM;
- Where another financial entity has formally delegated the management of assets to the investment firm, those assets shall be excluded from the total amount of assets under management;
- AUM shall also include the value of assets that an investment firm manages for its clients under nondiscretionary arrangements constituting investment advice of an ongoing nature. Whereby investment advice of an ongoing nature is defined as the recurring provision of investment advice as well as the continuous or periodic assessment and monitoring or review of a client portfolio of financial instruments, including of the investments undertaken by the client on the basis of a contractual arrangement, as per Article 4(21) of the IFR.

The MFSA encourages Licence Holders to familiarise themselves inter alia with the Final draft Regulatory Technical Standards on prudential requirements for investment firms.

b. Risk to Market (RtM)

RtM is used to calculate the trading book positions of an investment firm which deals on own account, whether for itself or on behalf of a client. There are two ways how to calculate RTM as detailed in the table below. The investment firm has the freedom to choose either method on a portfolio by portfolio basis, if it satisfies certain criteria laid down in Article 23 IFR.

K-Factor	Definition[6]	Methodology
K-NPR	'net position risk' or 'NPR' means the value of transactions recorded in the trading book of an investment firm;	Article 22 IFR

[6] Article 4 IFR

K-CMG	'clearing margin given' or 'CMG' means the amount of total margin required by a clearing member or qualifying central counterparty, where the execution and settlement of transactions of an investment firm dealing on own account take place under the responsibility of a clearing member or qualifying central counterparty;	Article 23 IFR

c. Risk To Firm (RtF)

RtF is calculated through the addition of the K-TCD, K-DTF, and K-CON, as defined and described below.

K-Factor	Definition[7]	Methodology
K-TCD	'trading counterparty default' or 'TCD' means the exposures in the trading book of an investment firm in instruments and transactions referred to in Article 25 giving rise to the risk of trading counterparty default	Articles 25, 26, 27, 28, 29, 30, 31, 32, IFR
K-DTF	'daily trading flow' or 'DTF' means the daily value of transactions that an investment firm enters through dealing on own account or the execution of orders on behalf of clients in its own name, excluding 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 which are already taken into account in the scope of client orders handled;	Articles 15 and 33 IFR
K-CON	'concentration risk' or 'CON' means the exposures in the trading book of an investment firm to a client or a group of connected clients the value of which exceeds the limits in Article 37(1);	Articles 35, 36, 37, 38, 39, 40, 41, 42 IFR

Conclusion

Whilst the MFSA trusts this is an informative briefing, it should not be treated as a comprehensive summary and/or advice of any nature. Furthermore, the European Banking Authority is working on various Regulatory and Implementing Technical Standards in relation to the K-Factors. The Authority actively encourages the Licence Holders to continue analysing the IFR Package and the Technical Standards thereof. The MFSA will keep Licence Holders updated as developments arise. In this regard, the MFSA is considering holding a webinar to inter alia provide further clarifications and exemplifications on the K-factors calculations.

Should you have any queries in relation to the IFR Package do not hesitate to contact the Investment Firms Team within the Securities and Markets Supervision Function on investmentfirms@mfsa.mt.

[7] Article 4 IFR