



# PILLAR III DISCLOSURES

of

MeritKapital UK Limited

FOR THE YEAR ENDED 31 DECEMBER 2020

June 2021

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## 1. OVERVIEW

### 1.1. Scope of application

**MeritKapital UK Limited** (the 'Firm' or 'MKUK') is categorized as an IFPRU €730k "Full Scope" firm subject to prudential oversight by the Financial Conduct Authority ("FCA"). The FCA implements the Pillar 3 requirements in the UK by way of Part Eight of the Capital Requirements Regulation ("CRR").

MKUK was incorporated in the United Kingdom on 16 September 2015, and on 23 June 2016 was given permission to provide regulated products and services with reference number 720609 and Firm number 09779913. MKUK's license includes the investment services of "Dealing on Own Account", "Investment Advice", "Custody and Safekeeping" (CASS Small firm) and "Prime Brokerage".

The Firm is publishing the disclosures on an individual (solo) basis. The Firm is regulated as a standalone entity in the UK and is not part of a UK consolidation group and this disclosure has been prepared in relation to the Firm only.

Overall the Firm offers a range of corporate credit investment strategies that seek to meet the performance, risk control, liquidity and transparency requirements for Professional Clients and Eligible Counterparties (as defined in the FCA Handbook).

Annual Reports and Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS) and the requirements of the Companies Act 2006. The financial statements are presented in Sterling and all values are rounded to the nearest dollar (\$) except when otherwise stated.

### 1.2. Scope of Business

MKUK specialises in fixed income brokerage of securities within the global fixed income marketplace. Although the Firm is not restricted to high yield and emerging markets bonds, it prides itself on its niche in this sphere. Relationships with large buy side funds that span from the western capital markets to the emerging markets are a testament to this specific market expertise. The Firm's other institutional relationships utilise its efficient platform for treasury book rebalancing, capital preservation strategies and allocation requests for the primary market amongst other service offerings.

As the Firm's primary business focus is that of fixed income securities and specifically in the emerging markets, the securities that makes up the proprietary book is a mixture of small clips of these securities and also of developed markets. The former is held for a short-term

horizon and will be largely utilized to promote the firm's core business of matched principal broking.

The latter is held on the book for the purpose of taking a directional bet on the markets and capitalizing on resulting profits or for the purpose of optimally employing the Firm's funds in bonds yielding higher than deposit rates.

#### Prime Brokerage

MKUK facilitates financing transactions under repurchase agreements (REPOs) for clients by acting as an intermediary between collaborating banks and clients requesting such services.

#### Fixed Income Trading

MKUK market their Eurobonds execution services to professional clients, who have the necessary technical and professional experience in an array of instruments for which they wish to engage the Firm's services. Such clients benefit from the established trading lines of MKUK with numerous market makers, interdealer brokers, regional banks and asset managers.

#### Equity Trading

Although the Firm is a predominantly fixed income player it also became more active within equities as an asset class. Equity trading transacted on an electronic trading platform which routes orders directly to the markets through outsourcing brokers but it is also performed via other mediums where Direct Market Access ("DMA") is not available; such mediums may include Bloomberg EMSX platform, Bloomberg chats, email, recorded phone, fax etc.

#### Custody & Clearing

A further service which the firm was authorised was that of depositary services, holding securities on behalf of clients through collaborations MKUK forms with third party sub-custodians. Within the scope of custodial services, MKUK develops clearing of securities by transmitting clients' RVP/DVP FOP messages on behalf of the clients with respective counterparty agents. The clients for such services are institutional clients classified as eligible counterparties who have all necessary licenses to transact in their respective jurisdictions supervised by their relevant regulatory authorities. Such custody services are available for clients that approach the Firm merely for custody transactions, mainly as they wish to capitalize on such a custody platform that is otherwise not available to smaller clients.

#### Investment Advice

Investment Advice service entails the provision of advisory services to a client, either upon request or upon the initiative of the Firm, in relation to one or more transactions concerning

financial instruments investments opportunities presents mainly in the Eurobonds market and EM fixed income. This service is offered to institutional clients only.

The provision of investment advice is subject to an explicit written agreement concluded between the Firm and the client, which shall be signed. No transactions are carried out without the client's approval. Whereby the client makes the decision to make the investment by virtue of that MKUK shall execute the trade. The Firm generate revenues by charging a fee for execution or making a margin on the buy or sell leg of the trade.

### 1.3. Regulatory framework overview

The purpose of this document is to outline the Pillar 3 disclosures for MKUK for the period up to 31 December 2020 required by the Financial Conduct Authority (FCA) Prudential Sourcebook for Banks, as set out in General Prudential Sourcebook ('GENPRU') rules implement in the United Kingdom, Prudential Sourcebook for Investment Firms ('IFPRU') and Regulation 575/2013 ('CRR').

The Regulatory framework consists of a three "Pillar" approach:

- **Pillar I** establishes minimum capital requirements, defines eligible capital instruments, and prescribes rules for calculating RWA.
- **Pillar II** requires Firms and supervisors to take a view on whether a Firm should hold additional capital against risks considered under Pillar I that are not fully captured by the Pillar I process (e.g. credit concentration risk); those risks not taken into account by the Pillar I process (e.g. interest rate risk in the banking book, business and strategic risk); and factors external to the Firm (e.g. business cycle effects). Pillar II connects the regulatory capital requirements to the Firm's internal capital adequacy assessment process ("ICAAP") and to the reliability of its internal control structures. The function of Pillar II is to provide communication between supervisors and institutions on a continuous basis and to evaluate how well the institutions are assessing their capital needs relative to their risks. If a deficiency arises, prompt and decisive action is taken to restore the appropriate relationship of capital to risk.
- **Pillar III - Market Discipline** requires the disclosure of information regarding the Risk Management policies of the Firm, as well as the results of the calculations of minimum capital requirements, together with concise information as to the composition of original own funds.

### 1.4. Disclosure Policy

MKUK has a formal policy which details its approach in complying fully with the disclosure requirements laid out in IFPRU. The following sets out the Firm's Disclosure Policy as applied to Pillar III Disclosures, according to BIPRU, IFPRU and GENPRU requirements.

## **Materiality, Confidentiality and Proprietary Information**

To achieve an appropriate balance between the information needs of stakeholders and the potential drawbacks of disclosures for institutions, both in terms of costs and business impact, the CRR contains specific provisions whereby firms may omit one or more items of information included in the disclosure requirements in cases where the information provided by such disclosures is not regarded as material or is regarded as proprietary or confidential. One or more disclosures may be omitted (except for disclosures on Diversity, Own Funds and Remuneration in line with CRR Article 432(1)).

The firm has reviewed the guidelines on materiality, proprietary and confidentiality and frequency, detailing the information that institutions in the EU banking sector should disclose under Part Eight of the CRR. In determining the relevance of these guidelines, the firm may omit information that is not material. In this context, materiality can be taken to mean where its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

The firm regards information as proprietary if sharing that information with the public would undermine its competitive position. Proprietary information may include information on products or systems which, if shared with competitors, would render the firm's investments therein less valuable. Further, the firm must regard information as confidential if there are obligations to customers or other counterparty relationships binding the firm to confidentiality. In the event that any such information is omitted, the firm shall disclose such and explain the grounds why it has not been disclosed.

The Firm is also permitted to omit one or more of the required disclosures where it believes that the information is regarded as proprietary or confidential. Proprietary information, if it were shared, would undermine the Firm's competitive position. Proprietary information may include information on products or systems which, if shared with competitors, would render the Firm's investments therein less valuable.

Furthermore, the Firm must regard information as confidential if there are obligations to clients or other counterparty relationships binding the Firm to confidentiality. In the event that any such information is omitted, we shall disclose such and explain the grounds why it has not been disclosed. We have made no omissions on the grounds that it is proprietary or confidential.

### **1.4.1. Frequency of publication**

The Firm's policy is to publish the disclosures required on an annual basis. The frequency of disclosure will be reviewed should there be a material change in approach used for the

calculation of capital, business structure or regulatory requirements as per the provisions of the law.

#### 1.4.2 Media and Location of publication

Institutions may determine the appropriate medium, location and means of verification to comply effectively with the disclosure requirements. In this respect, the Firm's Pillar III disclosures are published on the Firm's website: [www.meritkapital.co.uk](http://www.meritkapital.co.uk).

#### 1.4.3 Verification

Pillar 3 disclosures are reviewed and approved by the Board before publishing on the Firm's website. The disclosures are not subject to external audit.

### 1.5. Risk Management objectives and policies

The Board of Directors is the Governing Body of the Firm; it has the daily management and oversight responsibility. The role of the Board is to provide entrepreneurial leadership of the Firm within a framework of prudent and effective controls which enables risks to be assessed and managed. The Board meets on a quarterly basis and is responsible for the entire process of Risk Management, as well as forming its own opinion on the effectiveness of the process.

In addition, the Board of Directors decides the Firm's risk appetite or tolerance for risk and ensures that the Firm has implemented an effective, ongoing process to identify risks, to measure such risks' potential impact and to ensure that such risks are actively mitigated and/or managed. Senior Management is accountable to the Board of Directors for designing, implementing and monitoring the process of Risk Management and implementing it into the day-to-day business activities of the Firm. Risk identified through the operation of the Risk Management framework is assessed as part of the Firm's ICAAP and Pillar 2 processes. The day to day Risk Management, control & reporting is carried out by the risk and operations team and supervised by the Risk Manager.

The Firm's compliance monitoring procedures are designed around risks considered to be relevant to the Firm. These will be updated annually through a process taking input from senior management and from the Board. The compliance monitoring process also highlights the processes in place which are designed to mitigate any identified risks.

#### 1.5.1 Risk Management Framework

Managing risk effectively in a continuously changing risk environment requires a strong Risk Management culture. As a result, the Firm has established an effective risk oversight structure and the necessary internal organisational controls to ensure that the Firm undertakes the following:

- The adequate risk identification and management
- The establishment of the necessary policies and procedures
- The setting and monitoring of the relevant limits and
- Compliance with the applicable legislation

The Board meets on a regular basis, receives and updates risk and regulatory capital matters from management and Risk Manager. The Board reviews regularly (at least annually) written reports concerning compliance, Risk Management and Internal Audit policies, procedures and work as well as the Firm's Risk Management policies and procedures as implemented by Management. The Board accepts that in its pursuit of its strategic and business goals, the Firm will be exposed to risk. Some risks will be consciously taken in the pursuit of profit. Other risks will be an indirect consequence of profit taking activities. Accordingly, it is important that the Firm's overall risk-taking activities are undertaken within a set of prescribed limits and tolerances in order that the potential impact of such risks on the earnings and capital ratios of the Firm can be managed.

It is accepted that the risk profile of the Firm will vary and at times and thus the Firm may be exposed to a higher level of risk particularly at times when market or environmental conditions may be volatile. As part of its business activities, the Firm faces a variety of risks, the most significant of which are described further below. To ensure effective Risk Management, the Firm has adopted the Three Lines of Defence model, with clearly defined roles and responsibilities.

First Line of Defence: Managers are responsible for establishing an effective control framework within their area of operation; identifying and controlling all risks so that they are operating within the organisational risk appetite and are fully compliant with Firm's policies and where appropriate defined thresholds. First Line of Defence acts as an early warning mechanism for identifying (or remedying) risks or failures.

Second Line of Defence: The Risk Management Function is responsible for proposing to the Board appropriate objectives and measures to define the Firm's risk appetite and for devising the suite of policies necessary to control the business including the overarching framework and for independently monitoring the risk profile, providing additional assurance where required. The Risk Management Function will leverage their expertise by providing frameworks, tools and techniques to assist management in meeting their responsibilities, as well as acting as a central coordinator to identify enterprise wide risks and make recommendations to address them. Integral to the mission of Second Line of Defence is identifying risk areas, detecting situations/activities, in need of monitoring and developing policies to formalise risk assessment, mitigation and monitoring.

Third Line of Defence: Comprises of the Internal Audit Function which is responsible for providing assurance to the Board on the adequacy of design and operational effectiveness of

the systems of internal controls. Internal Audit undertakes on-site inspections/visits to ensure that the responsibilities of each Function are discharged properly (i.e. soundly, honestly and professionally) as well as reviews the Firm's relevant policies and procedures. Internal Audit works closely with both the First and Second Lines of Defence to ensure that its findings and recommendations are taken into consideration and followed, as applicable.



### 1.5.2 Risk Statement

The Firm's activities expose it to a variety of risks, and in particular to credit risk, market risk, operational risk, compliance risk, regulatory risk, reputational risk, group risk, strategic risk, liquidity risk, conduct risk etc. The Firm, through its operations, has significant exposure to the economies and financial markets.

Even though the global economy has recorded growth in the latest year after overcoming the latest economic recession, the overall future economic outlook of the economy remains unstable due to the recent developments on the outbreak of Coronavirus (COVID-19).

In particular and following the outbreak of COVID-19, the Firm has taken the required measures to ensure that its employees have access to its technology infrastructures necessary for the completion of their tasks and that additional systems for critical functions are being provided. The risk function of the Firm has formed a crisis plan as well as necessary

measures to ensure the health and well-being of societies, employees and clients. This crisis plan consists among others the following adjustments to the business operations model:

- A heavy reliance on remote work;
- Provide directives for the way some tasks must be accomplished in the crisis environment;
- Loan/provision of equipment especially computers and ancillaries;
- Cancelling overseas travel;
- End or dramatically reduce face-to-face contact among employees, stakeholders and the public;
- Intensive short-term training in the use of various software and IT platforms;
- Management of IT systems from off-site locations;
- Reorder short-term priorities;
- Purchase higher levels of cleaning and hygiene supplies;
- Distribute additional personal protective gear.

### **Risk Strategy**

The risk strategy of the Firm is the responsibility of the BoD, which formulates it and is responsible for monitoring its implementation. This is achieved through the development of Risk Management processes and procedures as well as through an assessment of the risks undertaken and the effectiveness of the Risk Management framework, given the Firm's business model. One important characteristic of the Firm's risk strategy is the alignment with the strategic and operational targets that are set by the Board. The risks that arise from the implementation of the Firm's strategic and business plans are regularly analysed in order to ensure the adequacy of the relevant policies, procedures and systems.

The risk strategy of the Firm aims to provide to both Senior Management and employees a general risk framework for the management of the different types of risk in line with the overall Risk Management and risk bearing capacity of the Firm. The Firm recognizes the importance of Risk Management to its business success and therefore the overall objective is to establish effective Risk Management policies that are able to mitigate the Firm's exposure to the various risks.

### **Risk Appetite**

Risk appetite is the level and type of risk a firm is able and willing to assume in its exposures and business activities, given its business objectives and obligations to stakeholders. Risk appetite is generally expressed through both quantitative and qualitative means and should consider extreme conditions, events and outcomes. In addition, risk appetite should reflect potential impact on earnings, capital and funding/liquidity.

The Firm has a low risk appetite in respect to investing and to managing business and operational activities.

According to Financial Stability Board (FSB) an appropriate risk appetite framework (RAF) should enable risk capacity, risk appetite, risk limits and risk profile to be considered for business lines and legal entities as relevant, and within the group context. The Risk appetite framework is defined as the overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored.

It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.

The Firm is assessing its risk appetite in respect to investing and to managing business and operational activities while the Firm's Risk Appetite Statement is prepared by the Risk Manager and approved by the Board of Directors.

**Table 1: Risk Appetite areas**

Indicator	Normal <sup>1</sup>	Warning <sup>2</sup>	Limit <sup>3</sup>
Own Funds	≥€850k	<€850k	€730k
Common Equity Tier 1 Ratio <sup>4</sup>	≥9.00%	<9.00%	7.00%
Tier one Capital Ratio <sup>4</sup>	≥10.50%	<10.50%	8.50%
Total Capital Ratio <sup>4</sup>	≥12.50%	<12.50%	10.50%
Leverage Ratio	≥5.00%	<5.00%	3.00%
Liquidity Coverage Ratio	≥110.00%	<110.00%	100.00%
Return on Assets	≥5.00%	<5.00%	0.00%
Retained Earnings / Total Equity	≥10.00%	<10.00%	5.00%
Concentration of Funds <sup>5</sup>	≤10.00%	>10.00%	25.00%

Notes:

1. The level of the indicator is within the acceptable limits as per the Firm's risk appetite.
2. The Firm should take proactive actions in order to ensure that the level of the indicator will remain above the acceptable limits.
3. The level of the indicator falls below the acceptable limits and as such the Firm should proceed with the required actions in order to restore the level of the said indicator to the normal predefined levels.

4. *Capital Buffers + ICAAP add-on have been taken into consideration for Normal and Warning thresholds*
5. *Large exposure on a single counterparty or a group of connected counterparties*

The Risk Appetite framework has been designed to create links to the strategic long term plan, capital planning and the Firm's Risk Management framework.

The Board approves the Firm's corporate strategy, business plans, budget, long term plan and ICAAP. The Firm employs mitigation techniques defined within the Firm's policies, to ensure risks are managed within Risk Appetite.

### 1.5.3 Risk Culture

Risk culture is a critical element in the Firm's Risk Management framework and procedures. Management considers risk awareness and risk culture within the Firm as an important part of the effective Risk Management process. Ethical behaviour is a key component of the strong risk culture, and its importance is also continuously emphasised by the management. The Firm is committed to embedding a strong risk culture throughout the business where everyone understands the risks they personally manage and are empowered and qualified to take accountability for them. The Firm embraces a culture where each of the business areas is encouraged to take risk-based decisions, while knowing when to escalate or seek advice.

### 1.5.4 Capital Requirements

The Firm falls under the definition of Small and Medium Sized enterprises in accordance with the provision of European Commission Recommendation 2003/361/EC and as such it is exempted from the requirement to maintain countercyclical capital buffer as per the provisions of chapter 10 of IFPRU.

### 1.5.5 Upcoming Regulatory Changes – IFPR

The FCA intends to adopt a new, comprehensive regulatory regime for investment firms: the Investment Firms Prudential Regime ("IFPR"), which aims to achieve the same overall outcomes as the Investment Firm Directive ("IFD") and Investment Firm Regulation ("IFR") adopted by the European Parliament but acknowledges that certain amendments are appropriate to account for the specifics of the UK market.

The FCA launched CP20/24: A new UK prudential regime for MiFID investment firms on 14 December 2020, the first of three consultations to implement the new IFPR. Moreover, the second consultation paper was issued on 19 April 2021. The FCA also intends to publish one further consultation to implement IFPR over the course of 2021. The FCA will publish a Policy Statement (PS) and near-final rules after each consultation.

The new UK final rules will enter into force on 1 January 2022.

The new regulatory regime applies to MiFID firms deemed to be non-systemic. The main regulatory changes in the prudential framework by IFPR:

- a. New Classification of Investment Firms
- b. Initial Capital Requirement and Composition
- c. Capital Requirements (K-Factors)
- d. Concentration Risk Requirement
- e. Liquidity Requirements
- f. Disclosures Requirements
- g. Reporting Requirements
- h. Other Supervisory Requirements

According to the new prudential regulatory framework the Initial Capital Requirements and classification for investment firms will be amended. Specifically, investment firms will be classified into three categories: Small and Non-interconnected investment firms (SNIs), non-SNIs and large investment firms which will continue to be supervised under UK CRR.

Moreover, the initial capital requirements will be amended (£750k, £150k and £75k) and it will be decided based on the investment services an entity is authorised to offer.

Further to the above, the regulatory capital ratio requirements will not be applicable anymore and investment firms will be requested to comply with the following at all times:

- a) CET 1 should constitute at least 56% of capital requirements;
- b) Tier 1 should constitute at least 75% of capital requirements;
- c) Tier 1 and Tier 2 should constitute at least 100% of capital requirements;

CET1, Tier 1 and Tier 2 will be calculated in accordance with the eligibility criteria of the capital instruments as per the provisions of the UK CRR.

As regards the capital requirements calculation, large Investment Firms will continue to calculate their overall capital requirements in accordance with the provisions of the existing regulation. However, medium Investment Firms will be requested to maintain own funds of at least the higher between a) Initial Capital, b) K-Factors requirement and c) Fixed Overheads requirement while Small and Non-interconnected investment firms' capital requirements will be calculated as the higher between only a) Initial Capital and b) Fixed Overheads requirement.

K-factors methodology which is applicable for medium Investment Firms will replace the current credit risk, market risk and operational risk approach in order to calibrate the capital needed to meet the risks of the investment firm. SNIs are not required to calculate their

capital based on the K-factor formula while they need to calculate the K-factors for categorisation purposes.

Capital requirement from applying K-factors formula is the sum of Risk to Customer (RtC), Risk to Market (RtM) and Risk to Firm (RtF). The K-Factors are calculated as shown below:

**Table 2: K-Factors as per IFPR**

Risk to Client (RtC)	Risk to Market (RtM)	Risk to Firm (RtF)
<b>Sum of:</b> <ul style="list-style-type: none"> <li>• K-AUM: Assets Under Management</li> <li>• K-ASA: Client Assets Safeguarded and Administered</li> <li>• K-CMH: Client Money Held</li> <li>• K-COH: Client Orders Handled</li> </ul>	<b>Higher of:</b> <ul style="list-style-type: none"> <li>• K-NPR: Net Position Risk (calculated in accordance to CRR) or</li> <li>• K-CMG: Clearing Member Guarantee</li> </ul>	<b>Sum of:</b> <ul style="list-style-type: none"> <li>• K-TCD: Trading Counterparty Default</li> <li>• K-CON: Concentration risk based on large exposures</li> <li>• K-DTF: Operational risks from Daily Trading Flow</li> </ul>

*\*K-AUM, K-ASA, K-CMH, K-COH and K-DTF relate to the volume of activity. The volumes should be multiplied by the corresponding coefficients set out in IFPR in order to determine the own fund requirement.*

Further to the above, the Company has reviewed its obligations under the new framework and its expected classification is Class 2 with the new capital requirements equal to the maximum of:

- a) Initial Capital Requirement of £750k
- b) Fixed Overheads Requirement
- c) K-Factors Requirement

## 1.6. Declaration of the Management Body

The Management Body is required to proceed with an annual declaration on the adequacy of the Firm’s Risk Management framework and ensure that the Risk Management arrangements and systems of financial and internal control in place are in line with the Firm’s risk profile.

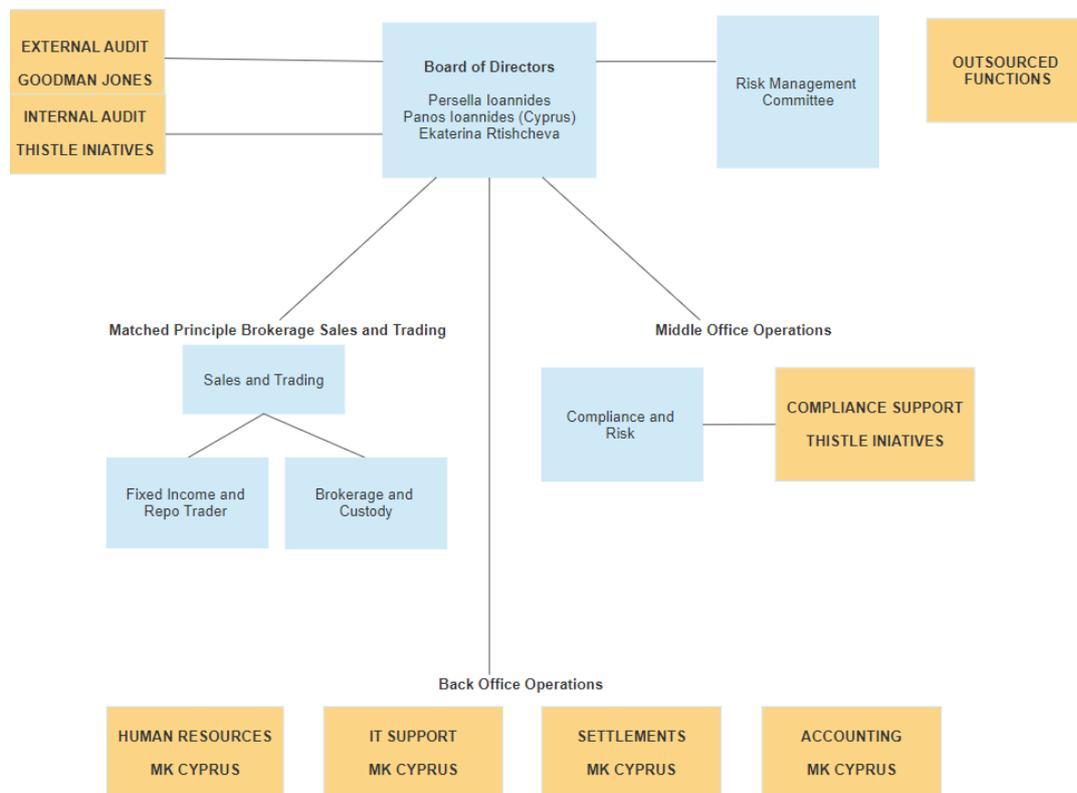
The Firm’s Risk Management framework is designed to identify, assess, mitigate and monitor all sources of risk that could have a material impact on the Firm’s operations. The Board considers that it has in place adequate systems and controls with regard to the Firm’s size, risk profile and strategy and an appropriate array of assurance mechanisms, properly resourced and skilled, to avoid or minimise loss.

## 2. CORPORATE GOVERNANCE AND RISK MANAGEMENT

The Firm’s systems of Risk Management and internal control include risk assessment, management or mitigation of risks, including the use of control processes, information and communication systems and processes for monitoring and reviewing their continuing effectiveness.

The Risk Management and internal control systems are embedded in the operations of the Firm and are capable of responding quickly to evolving business risks, whether they arise from factors within the Firm or from changes in the business environment.

The Firm’s organisational structure during the year ended 31 December 2020 is presented below:



### 2.1. The Board of Directors

The Board has the overall responsibility for the establishment and oversight of the Firm’s Risk Management Framework. The Board satisfies itself that financial controls and systems of Risk Management are robust. The Board comprises of two executive directors and one non-executive director.

The members of the Board possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the Board reflects an adequately broad range of experiences to be able to understand the Firm's activities, including the main risks to ensure the sound and prudent management of the Firm as well as sufficient knowledge, of the legal framework governing the operations of an Investment Firm.

The Firm has in place the Internal Policies which lays down the activities, processes, duties and responsibilities of the Board, Committees, Senior Management and staff of the Firm.

The Firm implements and maintains adequate Risk Management policies and procedures which identify the risks relating to the Firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the Firm. The Firm adopts effective arrangements, processes and systems, in light of that level of risk tolerance, where applicable.

## 2.2. Risk Management Function

### Risk Manager

In order to support effective governance and management of risks faced by the Firm, the Risk Manager and the Compliance Department were assigned a wide range of responsibilities. The role covered by the Risk Manager and the Compliance Department is to provide oversight, review and challenge of the material risks both current and future affecting the business whilst ensuring that there is effective management and control of all key risks and issues facing the Firm.

The Risk Manager, with the support of the Compliance Department, inter alia, scrutinises, and decides on various risks inherent with the operation of the Firm with the view to formulate internal policies and measure the performance of the said policies in dealing with the risks associated with the operation of the Firm. Moreover, they review the Risk Management procedures in place.

The Risk Management function operates independently and monitors the adequacy and effectiveness of policies and procedures, the level of compliance to those policies and procedures, in order to identify deficiencies and rectify.

The Risk Manager and the Compliance Department meet at least annually, unless the circumstances require extraordinary meetings. Extraordinary meetings can be called by either party.

Conclusively, the Risk Manager during the year under review was responsible for the following:

- establishing, implementing and maintaining adequate Risk Management procedures for the Firm's Risk Management Framework;
- monitoring the adequacy and effectiveness of the Firm's Office Risk Management policy and the level of compliance with which the Risk Management policy is adhered to;
- managing the risks associated with the outsourced Function and Operations;
- managing the risks associated with the Firm's Office Functions and Operations.

### 2.3. Policy on Recruitment

Recruitment into the Board combines an assessment of both technical capability and competency skills referenced against the Firm's leadership framework. Members of the Board possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the Board reflects an adequately broad range of experiences to be able to understand the CIF's activities, including the main risks to ensure the sound and prudent management of the Firm as well as sufficient knowledge, of the legal framework governing the operations a CIF.

Each Board member should possess different characteristics skills, knowledge, information and time to contribute. This can vary from being a leader, critical thinker, or specialist in tax or mergers. A number of different characteristics and skill will give a broad oversight to the operations of MKUK. Board members should be equipped with specialised experience which piece together to create a strong Board.

All Board recruitments must collectively reflect the diverse nature of the business environment in which the organisation operates and be made on merit, in the context of the skills, experience, independence and knowledge which the Board requires to be effective.

### 2.4. Policy on Diversity

The Firm is committed to promoting a diverse and inclusive workplace at all levels, reflective of the communities in which it does business. It approaches diversity in the broadest sense, recognizing that successful businesses flourish through embracing diversity into their business strategy, and developing talent at every level in the organisation. For this purpose, the Firm takes into consideration various aspects such as broad industry experience, knowledge, independence, gender, age, cultural and educational background, for the Board appointments.

The Firm promotes diversity and values the benefits that diversity can bring to its board of directors. Diversity promotes the inclusion of different perspectives and ideas. This will reduce the practice of groupthink, where thinking or decision making as a group, all from one social or culture will lead to poor decisions. The promotion of a diverse Board makes prudent business sense and promotes better corporate governance.

The Firm seeks to maintain a Board comprised of talented and dedicated directors with a diverse mix of expertise, experience, skills and backgrounds. The skills and backgrounds represented on the Board must reflect the diverse nature of the business environment in which the Firm operates. The composition of the Board includes, but is not limited to, business experience, geography, age, gender, and ethnicity.

Having a board composed of men and women with diverse skills, experience, backgrounds and perspectives means:

- competitive advantage;
- robust understanding of opportunities, issues and risks;
- inclusion of different concepts, ideas, and relationships;
- enhanced decision-making and dialogue; and
- heightened capacity for oversight of the organization and its governance.

For purposes of Board composition, diversity includes, but is not limited to, business and industry skills and experience, gender, and ethnicity. The Board will make good use of these differences and distinctions among individuals in determining the optimum composition of the Board.

The following principles will guide the way in which MKUK will deliver diversity within the Board:

- Diversity is enhanced through intentional effort. MKUK will be intentional in ensuring diversity. It is important to note, though diversity is a factor to consider, the Board members' merits, skills and experience will be taken into consideration.
- Credibility is enhanced through the Board and leadership diversity. There is a significant relationship between Board and leadership gender diversity and corporate performance. MKUK will pursue a well-rounded, diverse, and credible approach to ensuring Board and leadership diversity.
- Legitimacy is enhanced through respected, experienced, senior leaders. To ensure the diversity strategy of MKUK is viewed as a legitimate process, all appointments will be made on merit.
- Visibility is enhanced through the promotion of broad and common goals. Visibility enhances reputation. Gender diversity and inclusion imperatives are prominent on today's public stage and across industries. Going public with a Board diversity strategy is a helpful step in holding ourselves accountable, setting an example, and providing thought leadership in the industry.

- Accessibility is enhanced through a powerful collective voice. MKUK will balance the intent of this policy with its need to be a powerful voice for diversity in all of its forms.

## 2.5. Governance Committees

### Risk Management Committee

The Risk Management Committee of the Firm is formed with the view to ensure the efficient monitoring of the risks inherent in the provision of the investment and ancillary services to Clients, as well as the overall risks underlying the operations of the Firm. To this effect, the Firm has adopted and maintains an applied Risk Management framework/policy, which identifies the risks relating to the Firm's activities, processes and systems and sets the risk tolerance levels of the Firm.

The Risk Management Committee bears the responsibility to monitor the adequacy and effectiveness of the said Risk Management framework/policy and procedures that are in place, the level of compliance by the Firm and its relevant persons with the policies and procedures adopted, as well as the adequacy and effectiveness of measures taken to address any deficiencies with respect to those policies and procedures that are in place, including failures by the Firm's relevant persons to comply with those policies and procedures.

The Risk Management Committee meets at least annually, unless the circumstances require extraordinary meetings.

### Risk Manager

Further to the formation of the overall Internal Governance Framework, it should be noted that the Board has appointed a Risk Manager to ensure that all the different types of risks taken by the Firm are in compliance with the Law and the obligations of the Firm under the Law, and that all the necessary procedures, relating to Risk Management are in place and are functional on an operational level from a day-to-day basis. The Risk Manager reports directly to the Senior Management of the Firm while as previously discussed, the Risk Management Committee is responsible to control and overview the Risk Manager's actions/ performance at work.

## 2.6. Other Governance Functions

### Internal Audit Function

The Firm has appointed a qualified, experienced and independent Internal Auditor outsourced from **Thistle Initiatives**. The Internal Auditor reports to the Senior Management and the Board of the Firm and is separated and independent from the other functions and

activities of the Firm. The Internal Auditor has access to the Firm’s premises, systems, information, personnel and financials. The Board ensures that Internal Audit issues are considered when presented to it by the Internal Auditor and appropriate actions are taken according to the Board’s assessment and prioritization.

### Compliance Function

Pursuant to the regulatory obligations of the Firm and with the view to complement the Internal Governance framework of the Firm, the Board has appointed a Compliance Officer, to head the Compliance Function of the Firm in order to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the Firm to comply with its obligations, to put in place adequate measures and procedures designed to minimize such risks and to enable the competent authorities to exercise their powers effectively. The Compliance Officer is independent and reports directly to the Senior Management of the Firm, having at the same time the necessary authority, resources, expertise and access to all relevant information.

**Table 3: Roles and Responsibilities**

Role	Responsibilities
<p><b>Risk Management Committee</b></p>	<ul style="list-style-type: none"> <li>• Scrutinize and decide on various risks associated with the operation of the Firm with the view to increase the awareness of, formulate internal policies and measure the performance of the said policies</li> <li>• Review the Risk Management procedures in place</li> <li>• Review the ICAAP on a yearly basis</li> <li>• Monitor and control the Risk Manager’s and Risk Management Department’s performance and effectiveness</li> <li>• Ensure that the Firm has clear policy in respect of the assumption, follow up and management of risks duly notified to all interested parties or organizational units of the Firm.</li> <li>• Break down of such risk limits further where necessary, for example, per class of investment service or Financial Instrument, or Client or market</li> <li>• Implement stop loss-control limits</li> <li>• Follow up open positions within the approved limits</li> <li>• Ensure the immediate tracking down and scrutiny of important abrupt changes in the Firm’s financial figures, procedures or personnel, as well as the regular control of the volume and causes underlying deviations between projections and corporate end results, as submitted to the Board</li> <li>• Approve Client and counterparty limits</li> </ul>

	<ul style="list-style-type: none"> <li>• Approve policy description concerning information systems and monitor the information systems in place</li> <li>• Establish policy regarding the amount of information provided to Clients about the nature and risks of Financial Instruments according to the Client classification</li> <li>• Supervise the Disaster Recovery Plan</li> </ul>
<b>Risk Manager</b>	<ul style="list-style-type: none"> <li>• Design the overall Risk Management system of the Firm</li> <li>• Comply and implement the relevant provisions of the Law</li> <li>• Prepare the Risk Management policies and procedures</li> <li>• Provide training to relevant employees and the Senior Management, on risk-related issues</li> <li>• Analyse the market and its trends</li> <li>• Evaluate the effect of the introduction of any potential new services or activities on the Firm's Risk Management</li> <li>• Measures for the monitoring of capital adequacy and large exposures</li> <li>• Draft written reports to the Management Body including recommendations.</li> <li>• Monitor Client and counterparty limits</li> <li>• Identify and manage the overall risks faced by the Firm</li> <li>• Establish methods for risk monitoring and measurement</li> <li>• Monitor the performance and overall actions of the Dealing on Own Account Department</li> <li>• Prepare and implement the ICAAP of the Firm</li> <li>• Apply stress testing scenarios and undertake analysis of the results,</li> <li>• Propose for additional, if necessary, capital allocation for Pillar 2 risks and other risks not covered by Pillar 1</li> <li>• Apply the relevant provisions of the CRDIV requirements, as amended from time to time</li> <li>• Review the policy on maximum limits with respect to liquidity risk and market risk</li> </ul>
<b>Compliance Function</b>	<ul style="list-style-type: none"> <li>• Liaise with all relevant business and support areas within the Firm</li> <li>• Monitor and assess the adequacy and effectiveness of the measures, policies and procedures put in place</li> <li>• Monitor and assess the level of Legal &amp; Compliance Risk that the Firm faces</li> <li>• Provide training to the staff of the Firm in respect with the compliance function according to the Law</li> </ul>

	<ul style="list-style-type: none"> <li>• Communicate the relevant statutes of the IOM to each employee and notify them of any relevant changes therein</li> <li>• Develop and design the appropriate procedures of the Firm, so as to prevent and resolve potential conflicts of interest</li> <li>• Ensure that all employees have the ability to identify cases of potential conflicts of interest.</li> <li>• Disclose to Clients the general nature and any potentially present conflicts of interest</li> <li>• Keep records regarding conflict of interest situations</li> <li>• Consent and approve the Firm's Replacement Policy</li> <li>• Establish and implement the measures as regards personal transactions and notify each relevant person of the restrictions on personal transactions</li> <li>• Review the Firm's website, on at least annual basis</li> <li>• Ensure that the termination process of Clients account is followed</li> <li>• Ensure that all relevant information is included in the Firm's outsourcing agreements</li> <li>• Ensure that the performance of multiple functions by the Firm's relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally</li> <li>• Follow up Client complaints or grievances in relation to the Administration/Back Office Department and filing these complaints.</li> <li>• Approve the information script and/or standard FAQ which shall state the information that can be shared with Clients</li> <li>• Monitor the development and periodic review of product governance arrangements</li> </ul>
<p><b>Internal Audit</b></p>	<ul style="list-style-type: none"> <li>• Establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the Firm's systems, internal control mechanisms and arrangements</li> <li>• Provide timely, accurate and relevant reporting in relation to Internal Audit matters to the Board of Directors and the Senior Management of the Firm, at least annually.</li> <li>• Provide the Firm with an Independent confirmation that the process followed by the Firm is according to the Board's requirements,</li> <li>• Provide the Firm with an Independent review of the risk assessment, stress testing and capital allocation exercises performed, and shall confirm their compliance with the policies and procedures approved by the Board of the Firm</li> </ul>

	<ul style="list-style-type: none"> <li>• Perform an Independent validation of all numbers included in the ICAAP Report and shall confirm their agreement with the financial records</li> </ul>
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### Outsourcing

The Firm outsources some functions and activities to reputable and skilled individuals or companies, as per the provisions of the Law.

In outsourcing the functions and activities, the Firm remains fully responsible for discharging all its obligations under the Law and complies in particular with the following conditions:

- a) the outsourcing must not result in the delegation by senior management of its responsibility;
- b) the relationship and obligations of the Firm towards its Clients under the Law must not be altered;
- c) the conditions with which the Firm must comply in order to be authorized in accordance with the conditions for granting a CIF authorization as stated by the Law, and to remain so, must not be undermined;
- d) none of the other conditions subject to which the Firm's authorization was granted must be removed or modified;
- e) where the compliance function is outsourced, the responsibility shall lay with the service provider (physical person) and in no case the responsibility shall be limited through the outsourcing agreement.

It is noted that the following principle is adhered at all times, during any outsourcing: in the case that outsourcing concludes the transfer of functions of the Firm to such a degree which renders the Firm's a letter box entity, it is considered to undermine the conditions for authorization of the Firm by FCA.

The Compliance Officer ensures that the outsourced functions are included in the relevant outsourcing agreements with the service providers or individuals, and the Managing Director ensures that these are adhered to at all times.

The Board passes a resolution for selecting a service provider or individual for outsourcing and the Internal Auditor receives all feedback on the performance of the outsourced duties, at least annually.

The Firm exercises due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any investment services or activities.

The respective rights and obligations of the Firm and of the service provider are clearly allocated and set out in a written agreement. In particular, the Firm keeps its instruction and

termination rights, its rights of information, and its right to inspections and access to books and premises. The agreement ensures that outsourcing by the service provider only takes place with the consent, in writing, of the Firm.

## 2.7. Information flow on risk to the Management Body

Risk information flows up to the Board directly from the business departments and control functions. The Board ensures that it receives on a frequent basis, at least annually written reports regarding Internal Audit, Compliance, Money Laundering and Terrorist Financing and Risk Management issues and approves the Firm’s ICAAP report as shown in the table below:

**Table 4: Information flow on risk to management body**

	Report Name	Owner of Report	Frequency
1	Risk Management Report	Risk Manager	Annual
2	ICAAP	Risk Manager	Annual or more frequent upon management request
3	Compliance Report	Compliance Officer	Annual
4	Internal Audit Report	Internal Auditor	Annual or more frequent upon management request
5	Anti-Money Laundering Report	Anti-Money Laundering Compliance Officer	Annual

Furthermore, the Firm believes that the risk governance processes and policies are of utmost importance for its effective and efficient operation. The processes and the policies are reviewed and updated on an annual basis or when deemed necessary and are approved by the Board.

## 3. CAPITAL RESOURCES

Capital resources (also referred to as own funds) is the type and level of regulatory capital that must be held to enable the Firm to absorb losses. The Firm is required to hold own funds in sufficient quantity and quality in accordance with CRD IV which sets out the characteristics and conditions for own funds.

During the year under review, the Firm was a €730k IFPRU Investment Firm and in accordance with GENPRU 2.1.40 the Firm maintained at all times capital resources equal to or in excess of its variable capital requirements.

The Directors constantly monitor the performance of the Firm and capital adequacy is regularly assessed by them. The Firm will also monitor risks throughout the year and decide if additional capital should be held against them. Additional risks that supplement the pillar 1 requirements are detailed below but the Directors have assessed that meeting the pillar 1 capital requirement is adequate to cover risks relevant to the business and no pillar 2 add-on is needed.

### 3.1. Tier 1 & Tier 2 Regulatory Capital

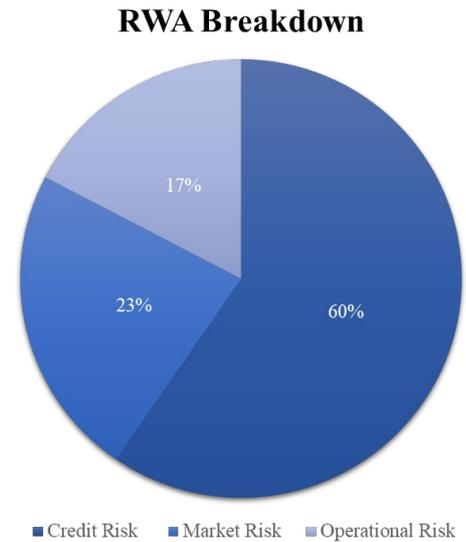
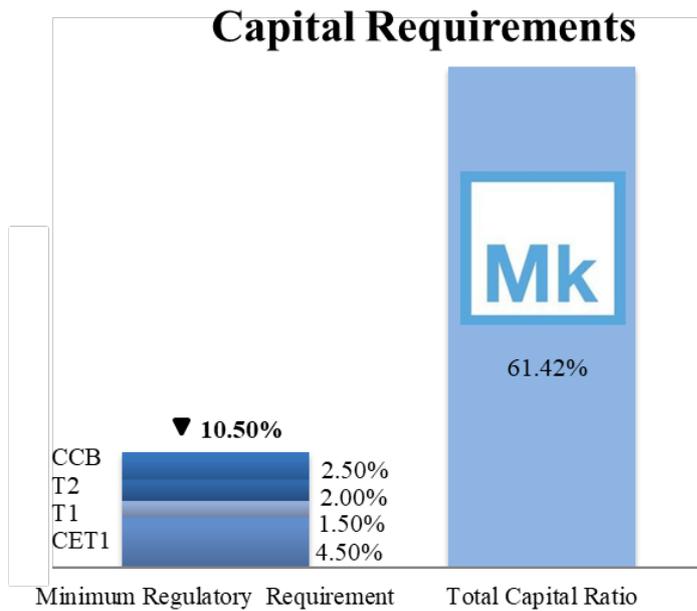
Institutions shall disclose information relating to their own funds. Furthermore, institutions shall disclose a description of the main features of the Common Equity Tier 1 (CET1 capital) and Additional Tier 1 (AT1) instruments and Tier 2 (T2) instruments issued by the institution. In this respect, the Firm's total capital is comprised of CET 1 capital.

The composition of the capital requirements and capital surplus of the Firm is shown in the following table:

**Table 5: Composition of the capital base**

<b>CET1 capital: instruments and reserves</b>	<b>2020</b>
	<b>\$000</b>
Capital instruments and the related share premium accounts	2,500
Accumulated Reserves	(602)
<b>CET1 capital</b>	<b>1,898</b>
<b>AT1 capital</b>	<b>-</b>
<b>Tier 1 capital</b>	<b>1,898</b>
<b>Tier 2 capital</b>	<b>-</b>
<b>Total capital (TC = T1 + T2)</b>	<b>1,898</b>
<b>Capital requirements</b>	
Credit risk	1,841
Market risk	713
Operational Risk	536
<b>Total Capital Requirements</b>	<b>3,090</b>
<b>CET 1 Capital Ratio</b>	<b>61.42%</b>
<b>Tier 1 Capital Ratio</b>	<b>61.42%</b>
<b>Total Capital Ratio</b>	<b>61.42%</b>

The figures below illustrate the capital requirements and buffers and the risk weighted exposures breakdown for the Firm for the year ended 31 December 2020.



### 3.2. Main features of Common Equity Tier 1, Additional Tier 1 and Tier 2 instruments

In order to meet the requirements for disclosure of the main features of Common Equity Tier 1, Additional Tier 1 and Tier 2 instruments, the Firm discloses the capital instruments' main features as outlined below:

Table 6: Main features of capital instruments as of 31 December 2020

Capital Instruments Main Feature	CET1
Issuer	MeritKapital UK Limited
<b>Regulatory Treatment</b>	
Eligible at Solo/(sub-)consolidated/solo	Solo
Instrument type	Common Equity
Amount recognized in regulatory capital*	\$2,500,000
Nominal amount of instrument	\$2,500,000
Issue Price	\$1
Accounting classification	Shareholders' Equity
Perpetual or dated	Perpetual
Original maturity date	No maturity
Issuer call subject to prior supervisory approval	N/A
<b>Coupons / dividends</b>	
Fixed or floating dividend/coupon	Floating
Coupon rate and any related index	N/A

The Firm’s capital resources consist of CET1 Capital. No additional Tier 1 and Tier 2 Capital available.

### 3.3. Balance Sheet Reconciliation

Institutions shall disclose a full reconciliation of Common Equity Tier 1 items, Additional Tier 1 items, Tier 2 items, filters, deductions and the balance sheet in the audited financial statements of the institution as follows:

**Table 7: Balance Sheet Reconciliation**

	2020 \$000
<b>Equity</b>	
Share capital	2,500
Accumulated Profits	(602)
<b>Total Equity as per the Audited Financial Statements</b>	<b>1,898</b>
<b>Regulatory Deductions</b>	
Intangible Assets	-
<b>Total Own funds as per the CoRep Forms</b>	<b>1,898</b>

## 4. COMPLIANCE WITH THE REGULATION AND THE OVERALL PILLAR II RULE (IFPRU 2.2)

The Firm has established its ICAAP as required under Pillar 2. The process essentially formalised the Firm’s risk appetite/management framework and aligned it with the financial processes and procedures. As a consequence, potential risks are identified, assessed, evaluated, managed and quantified – where appropriate.

The Firm has adequate resources over the next three years to meet its strategic objectives and future increases in capital requirements will be satisfied by retention of future profit reserves. Senior Management of MKUK has a low risk appetite that is governed firstly by the regulatory requirements imposing the Firm to have in all cases own funds more or equal to the sum of its capital requirements, and more than the Firm’s initial capital.

Management considers the ICAAP to be comprehensive, relevant and proportional to the business of MKUK.

The Firm reviews and updates its ICAAP at least annually. The quality and quantity of the Firm’s capital resources are monitored on an ongoing basis.

## 5. PILLAR I CAPITAL REQUIREMENTS

The following sections show the overall Pillar I minimum capital requirement and risk weighted assets for the Firm under the Standardised Approach to Credit Risk, Market Risk and the Operational Risk requirements.

## **5.1. Credit Risk**

In the ordinary course of business, the Firm is exposed to credit risk, which is monitored through various control mechanisms. Credit risk arises when counterparties fail to discharge their obligations and this could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date.

The Firm has policies to diversify risks and to limit the amount of credit exposure to any particular counterparty in compliance with the requirements of the Directive. The Firm continuously monitors the fair value calculations, forecast and actual cash flows, and cost budgets so that to ensure that the carrying level of Firm's own funds.

In the ordinary course of business, the Firm is exposed to credit risk, which is monitored through various control mechanisms. Credit risk arises when a failure by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date.

The Firm has policies to diversify risks and to limit the amount of credit exposure to any particular counterparty in compliance with the requirements of the regulation. The Firm continuously monitors the fair value calculations, forecast and actual cash flows, and cost budgets so that to ensure that the carrying level of Firm's own funds and consequently the Capital Adequacy ratio meet the regulatory requirements at all times.

Trade receivables are shown net of any provision made for impairment. The management believes that no additional credit risk, beyond amounts provided for collection losses, is inherent in the trade receivables. Cash balances are held with high credit quality financial institutions and the Firm has policies to limit the amount of credit exposure to any financial institution.

The Firm assesses at the balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Trade receivables are recognized initially at fair value and are subsequently measured at amortized cost using the effective interest method, less provision for impairment. For those trading receivables that are 90 days or more past due, in non-accrual status, the Firm

classifies them as “in default”, thus an impairment test will emerge. A financial asset is past due if a counterparty has failed to make a payment when contractually due.

Other receivables are recognized initially at fair value and subsequently measured at amortized cost, using the effective interest method, less provision for impairment. A provision for impairment of other receivables is established when there is objective evidence that the Firm will not be able to collect all amounts due according to the original terms of receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or delinquency in payments are considered indicators that the trade receivable is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. When a receivable is uncollectible, it is written off against the allowance account for other receivables. Subsequent recoveries of amounts previously written off are credited in the statement of comprehensive income. None of the derivative financial instruments is either past due or impaired.

As of 31 December 2020, the Firm’s Credit Risk was \$1,841k. The following table shows the risk-weighted exposure amounts and the corresponding capital requirements broken down by exposure class.

**Table 8: Credit Risk by Exposure classes**

Exposure class	Risk Weighted Assets	Capital Requirements
	\$000	\$000
Institutions	24	2
Corporates	1,817	145
<b>Total</b>	<b>1,841</b>	<b>147</b>

**Use of ECAs**

The Firm shall disclose the names of the nominated External Credit Assessment Institutions (“ECAs”) and the exposure values along with the association of the external rating with the credit quality steps.

The Firm uses external credit ratings from Moody’s. These ratings are used for all relevant exposure classes. The general ECAI association with each credit quality step is as follows:

**Table 9: ECAI Association with each credit quality step**

CQS	Moody’s Rating	Corporate	Institutions		Sovereign
				Credit Assessment method	

			Sovereign method	Maturity > 3 months	Maturity 3 months or less	
1	Aaa to Aa3	20%	20%	20%	20%	0%
2	A1 to A3	50%	50%	50%	20%	20%
3	Baa1 to Baa3	100%	100%	50%	20%	50%
4	Ba1 to Ba3	100%	100%	100%	50%	100%
5	B1 to B3	150%	100%	100%	50%	100%
6	Caa1 and below	150%	150%	150%	150%	150%

Exposures to unrated institutions are assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the institution is incorporated, as specified in Article 121 of CRR. Notwithstanding the general treatment mentioned above, short term exposures to institutions could receive a favourable risk weight of 20% if specific conditions are met.

### Counterparty Policies with respect to wrong-way risk exposures

Wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the PD of the counterparty itself or where there is an adverse correlation between counterparty's PD and the mark-to-market value of the underlying transaction. A wrong-way trading situation can be defined as the condition where the exposure to the counterparty increases, while the counterparty's financial situation and its ability to pay on the transaction diminishes.

As part of the credit review process, basic assumptions are established regarding correlations for a given trading product.

The management of wrong-way risk is integrated within the Firm's overall credit risk assessment approach and is subject to a framework for identification and treatment of wrong-way risk, which includes governance, processes, roles and responsibilities, methodology, scenarios, reporting, review and escalation.

A conservative treatment for the purpose of calculating exposure profiles is applied to material trades with wrong-way risk features. The wrong-way risk framework applies to OTC, securities financing transactions and centrally cleared trades. If material correlation is identified, the collateral is deemed ineligible for regulatory risk calculations and risk is measured on an uncollateralised basis. The Firm does not have any Wrong-Way Risk Exposures.

## 5.2. Market Risk

Market risk is the risk of losses arising because the value of assets and liabilities change as a result of adverse movements in market prices. Market risk includes Currency risk, Equity risk, interest rate risk and commodity risk.

In the ordinary course of business, the Firm is exposed to foreign exchange risk, equity risk and traded debt instruments risk, which are monitored through various control mechanisms, imposed through the Firm's Risk Management Framework.

The Firm manages its Market Risk through its well-designed in-house risk system, as well as by setting and controlling relevant risk limits, such as the establishment of maximum values/limits of exposure to a particular currency, as well as stop limits to open positions.

Risk policy and management tools:

The Firm implements the Standardised Approach to quantify the Capital Requirements that correspond to the Foreign Exchange Risk the Firm faces, while the ICAAP risk assessment methodology is used for comparisons.

The Firm implements the Standardised Approach to quantify the Capital Requirements that correspond to the Equity Risk the Firm faces, while the ICAAP risk assessment methodology is used for comparisons.

The Firm implements the Maturity Based Approach to quantify the Capital Requirements that correspond to the Traded Debt Instruments Risk the Firm faces, while the ICAAP risk assessment methodology is used for comparisons.

Capital requirements, as regards market risks, are calculated by the Risk Manager for capital adequacy reporting purposes.

As of 31 December 2020, the Firm has the following exposures in other than the reporting currency:

**Table 10: Foreign Exchange Risk**

Currency	Long \$000	Short \$000	Net Long \$000	Net Short \$000
EUR	700	8	692	-
AUD	0	-	0	-
GBP	53	32	21	-
<b>Total</b>	<b>752</b>	<b>40</b>	<b>713</b>	<b>-</b>
<b>Total RWA (\$000)</b>			<b>713</b>	
<b>Total Capital Requirements (\$000)</b>			<b>57</b>	

Further to the above, the Firm's overall net foreign exposure was \$713k.

### 5.3. Interest Rate Risk

Interest rate risk is the risk that the value of financial instruments will fluctuate due to changes in market interest rates. The Firm’s income and operating cash flows are substantially independent of changes in market interest rates. Other than cash at bank, which attracts interest at normal commercial rates, the Firm has no other significant interest-bearing financial assets or liabilities. Interest Rate risk regarding Firm funds on deposit and any impact on the Firm is limited and is regarded as negligible.

The Firm's management monitors the interest rate fluctuations on a continuous basis and acts accordingly.

**5.4. Operational Risk**

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk. It is inherent in every business organization and covers a wide range of issues. The Firm manages operational risk through a control-based environment in which processes are documented and transactions are reconciled and monitored. This is supported by continuous monitoring of operational risk incidents to ensure that past failures are not repeated.



In addition, the Firm has developed, implemented and maintains an Operational Risk Management Framework, congruent with the Policy and the principles of the Capital requirements (CRR/CRD IV) framework. The Operational Risk Management Framework provides the strategic direction and guidelines on operational risk in order to ensure that an effective operational Risk Management and measurement process is adopted throughout the Firm. The Framework also provides for the consistent and comprehensive capture of data elements needed to measure and verify the operational risk exposure, as well as to implement appropriate reporting systems and mitigation strategies.

Further to the above, the Firm has in place controls and procedures in order to reduce the operational risk as follows:

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MeritKapital UK Limited is authorised and regulated by the Financial Conduct Authority (No.720609)

- Monitoring of the effectiveness of policies, procedures and controls;
- Use of systems to automate processes and controls to eliminate risk due to human error;
- Ongoing maintenance of procedures to prevent unauthorised actions and errors;
- Use of training to reduce the likelihood of human error arising from lack of expertise
- Maintaining risk registers in the context of ICAAP; and
- Maintaining a four-eye structure and implementing board oversight over strategic decisions made by the heads of departments;

Furthermore, the Firm has in place additional policies and processes whose implementation assists with the evaluation and management of any exposures to operational risk. Such policy and process is the Business Continuity and Recovery Plan. The Firm acknowledges that a significant hazard exists to its ability to continue normal business procedures following unexpected incident. Moreover, the Firm has an important dependency with its automatic systems and processes. As a result, a recovery plan is needed in order to deal with the risk of potential disaster.

Moreover, in view of the Coronavirus (COVID-19) outbreak and the recent developments relating to the spread of the virus and implementing the decree and the measures announced by the Government, MKUK has taken extraordinary measures and arrangements to safeguard the health of the employees. MKUK and its risk functions has formed a crisis plan as well as necessary measures to ensure the health and well-being of societies, employees and clients. The government revealed that it is planning for a range of outcomes, from low to a severe and prolonged pandemic, and businesses are being asked to exercise the same caution.

In order to be prepared for the potential outcomes, the following will be taken into consideration:

- a) Established procedures and policies in order to ensure that all employees have always access from home to the Firm's emails and telephones as well as other needs in order to ensure that all employees are able to work from home efficiently;
- b) The Firm will closely monitor the developments on the outbreak of coronavirus;
- c) The Firm has put in place arrangements so that staff falling in the vulnerable groups could work from home;
- d) Established procedures in order to ensure office's cleanliness and sanitization;
- e) Established working arrangements in the Firm's offices;
- f) Established procedures requiring staff to report if they feel unwell or are absent, and to report possible infection or exposure to the virus (including following private

travel to high-risk areas) or concerns involving others they have been in contact with at work.

- g) Contacted all third-party providers to ensure that they have processes in place that will enable business continuity. The outsourced service providers have ensured the Firm that they will be able to meet their obligations.

For the calculation of the Operational Risk in relation to the capital adequacy reports, the Firm uses the Basic Indicator Approach (BIA). Under the BIA, the own funds requirement for operational risk is equal to 15% of the average over three years of the relevant indicator. However, the Firm has not completed business for three years as a Full Scope CIF, thus for the calculation of Operational Risk, the Audited Financial Statements for the years 2018, 2019 and 2020 were used in order to calculate the relevant indicator. Consequently, based on the relevant calculations the Firm's exposure to Operational Risk, as of 31 December 2020, was **\$536k**.

## 6. OTHER RISKS

### 6.1. Concentration Risk

Concentration Risk includes large individual exposures and significant exposures to companies whose likelihood of default is driven by common underlying factors such as the economy, geographical location, instrument type etc. Concentration risk was partly addressed through diversification of counterparties, namely banking institutions.

The Firm's experience in the collection of trade receivables has never caused debts which are past due and have to be impaired. The Firm has a policy in place to monitor debts overdue by preparing debtors ageing reports.

#### Large Exposures

The Firm shall disclose any additional capital requirements derived from large exposures in the Firm's trading book.

A large exposure is defined as the total exposure of a firm to a client or group of connected clients, whether in the banking book or trading book or both and its value is equal to or exceeds 10% of its eligible capital.

Where the amount of EUR 150 million is higher than 25 % of the institution's eligible capital the value of the exposure, after taking into account the effect of credit risk mitigation in accordance with Articles 399 to 403 shall not exceed a reasonable limit in terms of the institution's eligible capital. That limit shall be determined by the institution in accordance with the policies and procedures referred to in Article 81 of Directive 2013/36/EU, to address

and control concentration risk. This limit shall not exceed 100 % of the institution's eligible capital

As of 31 December 2020, the Firm's exposures were within the maximum allowable limits.

## **6.2. Reputation Risk**

Reputation risk is the current or prospective risk to earnings and capital arising from an adverse perception of the image of the Firm on the part of customers, counterparties, shareholders, investors or regulators. Reputation risk could be triggered by poor performance, the loss of one or more of the Firm's key directors, the loss of large customers, poor customer service, fraud or theft, customer claims, legal action and regulatory fines.

The Firm has transparent policies and procedures in place when dealing with possible customer complaints in order to provide the best possible assistance and service under such circumstances. The possibility of having to deal with customer claims is very low as the Firm provides high quality services to customers.

## **6.3. Strategic Risk**

Strategic Risk could occur as a result of adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment. The Firm's exposure to strategic risk is moderate as policies and procedures to minimize this type of risk are implemented in the overall strategy of the Firm.

## **6.4. Business Risk**

Business Risk includes the current or prospective risk to earnings and capital arising from changes in the business environment including the effects of deterioration in economic conditions. Research on economic and market forecasts are conducted with a view to minimize the Firm's exposure to business risk. These are analyzed and taken into consideration when implementing the Firm's strategy.

## **6.5. Capital Risk Management**

Capital Risk is the risk that the Firm will not comply with capital adequacy requirements. The Firm's objectives when managing capital are to safeguard the Firm's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders. The Firm has a regulatory obligation to monitor and implement policies and procedures for capital Risk Management. Specifically, the Firm is required to test its capital against regulatory requirements and must maintain a minimum level of capital. This ultimately ensures the going concern of the Firm. Such procedures are explained in the Procedures Manual of the Firm.

The Firm is further required to report on its capital adequacy quarterly and has to maintain at all times a minimum total capital adequacy ratio which is set at 8%. The capital adequacy ratio expresses the capital base of the Firm as a proportion of the total risk weighted assets. Management monitors such reporting and has policies and procedures in place to help meet the specific regulatory requirements. This is achieved through the preparation on a monthly basis of management accounts to monitor the financial and capital position of the Firm.

## 6.6. Regulatory Risk

Regulatory risk is the risk the Firm faces by not complying with relevant Laws and Directives issued by its supervisory body. If materialized, regulatory risk could trigger the effects of reputation and strategic risk. The Firm has documented procedures and policies based on the requirements of relevant Laws and Directives issued by the Commission; these can be found in the Procedures Manual. Compliance with these procedures and policies are further assessed and reviewed by the Firm's Internal Auditors and suggestions for improvement are implemented by management. The Internal Auditors evaluate and test the effectiveness of the Firm's control framework at least annually. Therefore, the risk of non-compliance is very low.

## 6.7. Legal and Compliance Risk

The probability of such risks occurring is relatively low due to the detailed internal procedures and policies implemented by the Firm and regular reviews by the Internal Auditors. The structure of the Firm is such to promote clear coordination of duties and the management consists of individuals of suitable professional experience, ethos and integrity, who have accepted responsibility for setting and achieving the Firm's strategic targets and goals. In addition, the Board meets at least annually to discuss such issues and any suggestions to enhance compliance are implemented by management

## 6.8. IT Risk

IT risk could occur as a result of inadequate information technology and processing or arise from an inadequate IT strategy and policy or inadequate use of the Firm's information technology. Specifically, policies have been implemented regarding back-up procedures, software maintenance, hardware maintenance, use of the internet and anti-virus procedures. Materialization of this risk has been minimized to the lowest possible level.

## 6.9. Risk Reporting

The Firm maintains a system in place to record any risk event incurred on a special form duly completed by personnel of each department and is submitted to the Compliance officer and Risk Manager when such event occurs.

## 6.10. Liquidity Risk

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Liquidity risk is defined as the risk when the maturity of assets and liabilities does not match. An unmatched position potentially enhances profitability but can also increase the risk of losses. The Firm has policies and procedures with the object of minimizing such losses.

### **6.11. Conduct Risk**

Conduct risk is defined as the risk of an action, by an individual, financial institution, or the industry, which leads to customer detriment or undermines market integrity. This can bring sanctions and negative publicity. Moreover, EBA has defined conduct risk as the current or prospective risk of losses to an institution arising from inappropriate supply of financial services including cases of wilful or negligent misconduct. Consequently, conduct risk arises from failures of designated liquidity providers located in third countries associated with the Firm.

#### **Conflicts of interest**

The Firm takes all reasonable steps to identify conflicts of interest situations between the Firm and its employees/relevant persons, the Firm and its Clients or between its Clients during the course of the provision of investment and ancillary services.

The Compliance Officer is responsible for maintaining Chinese Walls, by means of regular checks and is monitored by the Firm's Internal Auditor. Moreover, the Firm has in place conflict of interest policy which set out the Firm's approach in identifying and managing conflicts of interest which may arise during the course of its normal business activities.

## **7. LEVERAGE RATIO**

The Firm shall disclose the Leverage Ratio and how it applies the definition of Tier 1 Capital.

The leverage ratio is a supervisory tool for the European Union, which it is in line with international agreements. Moreover, it is a supplementary non-risk based ratio that aims in monitoring the excessive built-up of leverage on the balance sheet of institutions. The leverage ratio is expressed as a percentage of Tier 1 Capital over the total leverage exposure measure.

The total leverage exposure measure is defined as the sum of exposure values of all assets and all off-balance sheet items not deducted when calculating Tier 1 Capital.

The Leverage Exposure measure includes:

- All on-balance sheet assets;
- Derivative exposures;
- Securities Financing Transaction exposures;
- Other non-trading book exposures.

The Basel Committee has set a benchmark of 3% for a minimum Leverage ratio.

The Firm's Leverage Ratio for the period up to 31 December 2020 was **97.99%**:

**Table 11: Leverage Ratio**

2020	Leverage Ratio Exposure
	\$'000
<b>Exposure Values</b>	
Derivatives: <i>Replacement cost associated with all derivatives transactions</i>	-
Derivatives: <i>Add-on amounts for PFE associated with all derivatives transactions</i>	-
Other assets: <i>On-balance sheet items (excluding derivatives, SFTs and fiduciary assets, but including collateral)</i>	1,937
<b>Total exposures</b>	<b>1,937</b>
<b>Capital and regulatory adjustments</b>	
Tier 1 Capital	<b>1,898</b>
<b>LEVERAGE RATIO</b>	<b>97.99%</b>

The Firm monitors leverage closely in order to ensure that any possible excess of the Leverage Limit will be identified and managed promptly. The Firm's leverage ratio of 97.99% is well above the minimum ratio of 3%.

## 8. REMUNERATION POLICY

The Firm has established a remuneration policy, which its purpose is to set out the remuneration practices of the Firm taking into consideration the salaries and benefits of the staff, in accordance with the provisions of Directive as well as to FCA's Remuneration Code set out in the SYSC Sourcebook of the FCA's Handbook on remuneration policies and practices, where these comply with specific principles in a way and to the extent that is appropriate to the Firm's size, internal organisation and the nature, scope and complexity of its activities.

The design of the Policy is approved by the people who effectively direct the business of the Firm, after taking advice from the compliance function, and implemented by appropriate functions to promote effective corporate governance. The people who effectively direct the business should be responsible for the implementation of remuneration policies and

practices and for preventing and dealing with any relevant risks that remuneration policies a practices can create. The Board discusses remuneration policy matters at least annually.

Furthermore, the Policy should also benefit from the full support of senior management or, where appropriate, the supervisory function, so that necessary steps can be taken to ensure that relevant persons effectively comply with the conflicts of interest and conduct of business policies and procedures.

Finally, the Policy should also adopt and maintain measures enabling them to effectively identify where the relevant person fails to act in the best interest of the client and to take remedial action.

### 8.1. Remuneration System

The Firm's remuneration system and policy is concerned with practices of the Firm for those categories of staff whose professional activities have a material impact on its risk profile, i.e. the Senior Management and members of the Board; the said practices are established to ensure that the rewards for the 'executive management' are linked to the Firm's performance, to provide an incentive to achieve the key business aims and deliver an appropriate link between reward and performance whilst ensuring base salary levels are not set at artificially low levels. The Firm uses remuneration as a significant method of attracting and retaining key employees whose talent can contribute to the Firm's short and long term success.

The remuneration mechanisms employed are well known management and human resources tools that take into account the staff's skills, experience and performance, whilst supporting at the same time the long-term business objectives. Operating within the scope of MKUK's risk appetite is an absolute pre-requisite to the award of any variable, incentive or performance related compensation.

The Firm's remuneration system takes into account the highly competitive sector in which the Firm operates, and the considerable amount of resources the Firm invests in each member of the staff.

The total remuneration of staff, whose professional activities have a material impact on the risk profile of the Firm currently, consists of a fixed and a variable component. The remuneration varies for different positions/roles depending on each position's actual functional requirements, and it is set at levels which reflect the educational level, experience, accountability, and responsibility needed for a staff member to perform each position/role. MKUK will not be awarding any variable remuneration that consist of shares or equivalent ownership interests at this time as the board have determined that the size and scale of MKUK does not currently allow for such a strategy. As MKUK grows, should it become appropriate to do so then such a scheme will be implemented. The remuneration is

also set in comparison with standard market practices employed by the other market participants/ competitors.

During the year under review there was no remuneration payable under deferral arrangements (with vested or unvested portions). Finally, the Firm did not pay any non-cash remuneration for the year under review.

## **8.2. Performance Based Measurements**

MKUK has determined that the following criteria to determine such payments will include but not be limited to (depending on the role undertaken):

- Individual performance against objectives for bringing in and maintaining clients
- Client satisfaction

Where assessments of financial performance are used to calculate variable remuneration components, these will be principally based on profits, where these have been adjusted for current and future risks.

MKUK takes into account the quality of business undertaken and services provided when assessing the performance of relevant employees.

## **8.3. Remuneration Of Senior Management Personnel and Directors**

The FCA rules require certain Firms to disclose aggregate information on remuneration in respect of its IFPRU Remuneration Code (SYSC 19A) Staff broken down by business area, senior management and other Code Staff, including “risk takers”.

The Firm’s activities include Financial Planning (advisory services) and Investment Management. The Firm’s Directors, Senior Management or staff members do not fall into the category of “risk takers”. The link between performance and pay is inevitable in a small Firm, but the Firm’s risk adverse strategy and robust Risk Management systems mitigate any risks. The total remuneration of the key management personnel of the Firm, including Board, for the year ended 31 December 2020 are presented in the table below:

Table 12: Remuneration analysis split by fixed and variable remuneration

2020	Executive Directors \$'000
Fixed Remuneration	48,000
Variable Remuneration	-
<b>Total Remuneration</b>	<b>48,000</b>
<b>Number of beneficiaries</b>	<b>1</b>