FIA response to the FCA Discussion Paper 20/2 on a new UK prudential regime for MiFID investment firms

(electronic submission to FCA)

London, 25 September 2020

FIA[1] welcomes the opportunity to respond to the FCA Discussion Paper 20/2 on a new UK prudential regime for MiFID investment firms (IFPR) that was published in June 2020. Our response focuses on a few specific proposed requirements that have been identified as relevant primarily by our UK based clearing member investment firms, namely on issues arising out of certain K-factors (K-CMG and K-DTF/K-COH), the proposed transition from existing IFPRU/BIPRU Individual Capital Guidance, the proposed level of application of ICARA process and the application of Group Capital Test. We also identified a potential overlap between the proposed new UK prudential regime for investment firms and UK BRRD. We look forward to engaging further with the FCA on these questions and await a consultation paper on the draft IFPR rules later this year.

FIA has also submitted a response to the recent EBA consultation on draft regulatory technical standards under IFR, specifically the draft K-CMG RTS. We have attached it to this response as we believe that some of the comments also apply in the context of the FCA Discussion Paper 20/2, and that the FCA may find it helpful.

1. K-CMG

In addition to the comments in FIA's response to the recent EBA consultation on draft regulatory technical standards under IFR, FIA members[2] have also identified the following issues in the FCA DP20/2 proposal concerning K-CMG:

One of the conditions that an investment firm needs to meet to use K-CMG is that 't*he clearing and settlement of transactions takes place under the responsibility of a credit institution (or an investment firm that deals on own account, and is still* ***required to apply the CRD/CRR instead of IFD/IFR****) which is a clearing member (of a CCP that is authorised or recognised under EMIR)'.*

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.
FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

[2] Please note that FIA members contributing to this response have been UK based clearing member investment firms, however our response on K-CMG has also been informed by other clearing members.

This condition appears to be problematic for two reasons:

- Firstly, it limits the availability of K-CMG to investment firm clearing clients who use a clearing member that is either a bank/credit institution or an investment firm that is still required to apply CRDV/CRRII. Conversely, if the condition remained unchanged, K-CMG would not be available to investment firm clearing clients that clear through clearing members that are investment firms themselves (subject to IFR/IFD). This puts investment firm clearing members (subject to IFR/IFD, rather than CRD/CRR) at a competitive disadvantage, because their investment firm clearing clients will not have a choice to use either K-NPR or K-CMG, and therefore it may be more advantageous for them to use a clearing member organised as a credit institution or a large investment firm (subject to CRD/CRR). Consequently, this condition could undermine the competitiveness of the investment firm clearing members (subject to IFR/IFD) and lead to further concentration of client clearing activity in a few clearing members. FIA members recommend that K-CMG is available to investment firm clients that clear through a clearing member, irrespective of whether that clearing member is subject to CRD/CRR or IFR/IFD.
- Secondly, FIA members would like to ensure that the definition of 'credit institution' and 'investment firm' is broad enough to capture also non-UK credit institutions/banks and non-UK investment firms. We recommend that the UK prudential rules for investment firms are drafted such that availability of K-CMG is not limited by the location of the clearing member.[3] We note that the definition of investment firm is also important for other reasons, for example it affects the risk factors applied in K-TCD, so it is important that it is not confined to UK or UK and EU investment firms.

In relation to the question of scope, we thought it was important to emphasise that K-CMG is available to all 'in-scope' investment firms in the clearing chain, irrespective of whether they're direct members of the CCP (i.e. clearing members), clients of clearing members or clients of clients of clearing members (i.e. indirect clients). We note that IFR Article 23 appears to be limited only to clearing clients where they are direct clients of an EU clearing member. We ask the FCA to reconsider the territorial scope as outlined above, as well as the personal scope of K-CMG, so that K-CMG is also available to investment firms who are indirect clients (i.e. clients of direct clients of clearing members) and to those who are direct members of the CCP, as the nature of the underlying market risk and exposure that K factors for Risk-to-Market cover are comparable to those that direct clients face when clearing through a clearing member.

FIA members are supportive of the proposed FCA approach when it comes to the calculation of K-CMG by an investment firm that uses multiple clearing members, in that such investment firm client needs to first add amounts of total margin required for each clearing member on the same (i.e. single) trading day for the preceding three months, and then take the third highest amount of the total margins required across clearing members, before multiplying it by 1.3. We have also recommended to the EBA that they change their approach and adopt this proposal.

Finally, we wanted to draw the FCA's attention to our comments on the EBA definition of 'total margin required' in the draft K-CMG RTS. In addition to the points raised in our response to the EBA consultation, we would like to mention a point around how the calculation of the total margin required may be normalised for confidence level and/or margin period of risk (MPOR), given that each clearing member has a different underwriting standard in practice. FIA clearing members are of the view that those clearing members who have a more conservative/prudent margin methodology and require more margin from their

[3] Please see also FIA's response to the EBA consultation.

clients than required by regulation should not be at a competitive disadvantage when it comes to their clients using K-CMG, so ensuring a level playing field among clearing firms for the purposes of K-CMG is important. Therefore, we recommend that the FCA in the upcoming consultation clarifies that for the purposes of K-CMG, clearing members are allowed to report to their clients total margin figures that are normalised to cover losses that may result from 99% of the exposures movements with two-business days margin period of risk.

The FCA Discussion Paper also does not mention liquidation costs or account minimum collateral levels. FIA clearing members believe that these should be out of scope of the total margin required and request that the FCA take that into account when developing the draft UK rules on K-CMG.

2. K-DTF and K-COH

FIA members' understanding is that clearing firms who provide market access on behalf of clients, but use their own name, will be caught by K-DTF and K-COH requirements, notwithstanding the 'matched principal' nature of the flow.

The FCA proposal appears to be for investment firms to calculate the notional amount for derivates for DTF, and for COH, in line with the relevant provisions of K-TCD (as set out in the third paragraph of Article 29 of the IFR). However, K-TCD includes a number of exemptions, among which are also exchange-traded derivatives (IFR Article 25(1)(a)(ii)). It is therefore unclear how firms are supposed to calculate K-DTF and K-COH for exposures arising out of exchange-traded derivatives.

It is important that investment firms receive clarity and confirmation as to which methodology they should apply to calculate K-DTF and K-COH for exchange-traded derivatives, so that they can run test calculations, as the calculation methodology for K-TCD seems to be tailored more for OTC derivatives.

3. Transition from existing IFPRU/BIPRU ICG

The FCA Discussion Paper suggests that Pillar 2 Requirement will be at least the same as current Pillar 1 + Individual Capital Guidance (ICG). Paragraph 11.102 of the Discussion Paper states "*Where the absolute amount under the old regime is higher than the new 'Pillar 1' requirement, we envisage that investment firms would take the difference between the new rules based amount and the additional necessary to meet the old absolute amount. They would then use this to generate a new percentage multiplier above the 'Pillar 1' requirement which would apply for the purposes of the new regime.*".

However, Pillar 1 under IFR is calculated in part on average values (e.g. for K-COH/K-DTF/K-CMH), whereas Pillar 1 under CRR is calculated at a point in time. Therefore, the investment firm would not be comparing like for like when generating the new percentage multiplier, which could lead to unfair results. In the event Pillar 1 under IFR is higher than the absolute amount under CRR, investment firms would assess their own appropriate level of "Pillar 2" capital as part of ICARA process. FIA members believe this approach should still be applied even if Pillar 1 under IFR is lower than the amount under CRR.

4. Level of application of ICARA process

It is suggested in the Discussion Paper that the FCA intends to replicate the IFD approach that requires each investment firm in scope of IFR to have its own ICARA process (para 11.14 – 11.17). However, in practice investment firms within the same group typically share the same risk framework, controls and governance

e.g. the Risk Committee for the group would have oversight over each regulatory entity, there is not separate Risk committees for each entity. It would be overly onerous to require each investment firm to apply the ICARA process individually when this is not how the firm manages its risk; it would result in a lot of duplication of work in the compilation and review of the documents in the process. The current FCA regime allows firms to compile an ICAAP on consolidated group basis and we propose that this approach is kept for the ICARA so that firms can choose whether to apply it.

5. Interplay between new UK prudential regime for investment firms and UK BRRD

FIA members would like to raise a point that is not directly addressed in the Discussion Paper, namely the interaction between a new UK prudential regime for MiFID investment firms and BRRD (as transposed in UK legislation).

The purpose of BRRD was to ensure firms are able to wind down in orderly fashion with no risk of wider contagion and it was designed with banks in mind (much like the CRR). The Bank of England have recognised that the majority of investment firms do not pose wider systemic risk to the market, hence the MREL for most investment firms is set at the minimum threshold of a firm's regulatory capital requirements. Given the ICARA process now requires firms to assess this risk as well through its wind down requirements, it would be duplicative and burdensome if investment firms are still required to maintain recovery plans separately also under BRRD. We propose that as part of designing a new UK prudential regime for investment firms the FCA considers this point and discusses it with HM Treasury and other stakeholders with a view that investment firms subject to the new UK prudential regime are taken out of scope of BRRD.

We acknowledge that changes to UK legislation would be likely required to achieve the suggested outcome.

6. Group Capital Test v Group consolidation

FIA members have identified an issue regarding the discretion the FCA will have in applying the derogation in IFR Article 8(1), whereby a national competent authority is able to permit the use of the Group Capital Test (GCT) in IFR Article 8, rather than automatically applying group consolidation under Article 7 IFR.

For investment firms with operations in other jurisdictions, for example in the US, applying prudential consolidation may lead to employees in that jurisdiction being treated as material risk takers (MRTs) with all of the attendant remuneration requirements under IFR/IFD.

The FCA have indicated in the Discussion Paper that they are minded to replicate this in the UK regime. The application of the derogation in Article 8 depends upon the relevant NCA finding that (1) the group structure is sufficiently simple and (2) no significant risks to clients/markets (see DP para 18.27).

Para 18.27 begins with the FCA stating "We expect many investment firm groups seeking permission to use GCT would be able to satisfy both conditions…".

It is appreciated that individual firm's circumstances would need to be assessed but any guidance on what (or what is not) "sufficiently simple" and what "significant risks" to clients/markets the FCA would consider would take an investment firm out of consideration for application of the GCT derogation could be helpful to investment firms.

Thank you for consideration of these comments. We would be happy to discuss them in more detail with you as required. Please contact the undersigned at +44 (0)20 7519 1831 or msiraj@fia.org in case of any questions or to schedule a follow-up call.

Respectfully submitted,

Mitja Siraj
Vice President of Legal, Europe
FIA