FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Response by the FIA European Principal Traders Association (FIA EPTA) to the FCA Consultation Paper on a new UK prudential regime for MiFID investment firms

5 February 2021

FCA CP20/24

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Introduction

The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to provide feedback to the Financial Conduct Authority (FCA) on its Consultation Paper regarding the implementation of the new UK prudential regime for MiFID investment firms.

FIA EPTA represents 30 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. Our members are independent market makers and providers of liquidity and risk transfer for exchanges and end-investors across Europe, including the UK. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands and the UK (~70% of our members having been licensed by the FCA).

Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

This document constitutes FIA EPTA's response to the FCA's Consultation Paper on a new UK prudential regime for MiFID investment firms (CP20/24). We very much welcome the FCA's approach as set out in the Consultation Paper and generally agree that the FCA's proposed rules are clear, proportionate and fit for purpose. In our response we focus on a number of key areas where we believe further improvements or clarifications could be made to enable a proportionate, effective and practicable prudential regime for investment firms. FIA EPTA members appreciate the FCA's consideration of our comments and suggested solutions and stand ready to provide any further input as required.

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Q1: Do you agree that FCA investment firms with permission to deal on own account and/or underwrite or place financial instruments on a firm commitment basis (as indicated by a permission to deal as principal in financial instruments) should not be considered an SNI? If not, please include in your response what you consider to be a suitable quantitative threshold for these activities.

Yes, FIA EPTA members agree with the FCA's proposals.

Q2: Do you agree with the quantitative thresholds, as set out in Figure 1, that we are proposing? If not, please include in your response what you consider to be suitable quantitative thresholds.

Yes, FIA EPTA members agree with the FCA's proposals

Q3: Do you think that any other criteria should be considered for determining if an FCA investment firm can be an SNI? Please provide examples and thresholds as appropriate.

N/a

Q4: Do you have any specific comments on our proposals for the scope and methods of prudential consolidation? Please provide evidence to support any changes? Is there anything relevant to consolidation that is not covered in our rule proposals?

FIA EPTA members would like to specifically comment on the proposed interaction of prudential consolidation under IFPR and the UK CRR, as detailed within sections 3.18-3.19. FIA EPTA members understand the desire for the FCA to continue to operate the existing approach for dual supervision of PRA designated firms. However, as a result of the divergence between the UK CRR and IFPR, FIA EPTA members are of the opinion that the additional burden of having to implement two separate prudential requirements on a consolidated basis would not provide for additional mitigation of prudential risk.

FIA EPTA members are of the opinion that the key principles of both the UK CRR and IFPR are ensuring the orderly wind-down of a supervised entity, with the UK CRR going beyond this by additionally protecting depositors by ensuring that it is difficult for a bank to fail. As such, FIA EPTA members believe the UK CRR should be the principle framework for consolidation of Investment Firm Groups containing a PRA-designated investment firm. This would take into account the systemic nature of PRA-designated investment firms and apply the ensuing prudential requirements across the entire group, ensuring concentration risk of prudential requirements is captured across all entities within the group.

In addition, FIA EPTA members would also request the FCA to consider extending such an approach further, to allow for the FCA to grant approval via a waiver or modification for individual FCA investment firms to elect to become subject to the UK CRR in the case where they are part of an investment firm group that contains a PRA designated firm or credit institution, and therefore avoiding the necessity to meet the requirements of two separate regulatory frameworks.

Q5: Are our proposals for how to calculate the consolidated own fund requirements (including the consolidated fixed overheads requirement, the consolidated permanent minimum requirement and the consolidated K factor requirement) clear and sufficient? If not, do you have any specific suggestions for how to improve this?

FIA EPTA members consider that the FCA's requirements are generally clear and sufficient. We would, however, appreciate confirmation by the FCA of our long-standing understanding that consolidation would only apply to UK Parent Entity.

Additionally, we would like to draw the FCA's attention to the interaction of the consolidation and FOR requirements. We are aware that the current Consultation Paper does not specifically address the computation of FOR (other than on a consolidated basis) and understand that this will be discussed in a later Consultation Paper. Nonetheless, we would kindly remind the FCA of the comments FIA EPTA has previously made to section 5.13 to 5.15 of the FCA's earlier discussion paper.[1]

As the capital requirement for firms will be defined as the higher of the Permanent Requirement or FOR or the K-factors, we note that it is very important that FOR will be properly calibrated (in particular for the provisions around staff bonuses and trading fees), given that any potential miscalibration will be magnified by the consolidation provisions.

Q6: Do you agree with our approach towards the use of the group capital test (as an alternative to prudential consolidation), including our proposal for a transitional provision to allow its use as part of our initial implementation of the IFPR?

FIA EPTA members welcome the availability of the Group Capital Test (GCT) to allow the FCA to apply an alternative approach toward prudential consolidation. In addition, FIA EPTA members welcome the proposed two-year transition period during the initial implementation phase as it is expected that a large number of investment firm groups will seek the FCA's authorisation to apply the GCT.

FIA EPTA members recognise that the Group Capital Test is a continuation of the existing CRR Article-15 waiver and note that the consolidation methodology contained therein, which allows the FCA to grant the use of third-country own-funds requirements to be used for consolidation, has been omitted from the FCA's proposed rules for IFPR. The relevant provision in Article 15 (2) CRR is as follows:

> *2. The competent authorities may also apply the waiver if the financial holding companies holds a lower amount of own funds than the amount calculated under paragraph 1(d), but no lower than the sum of the own funds requirements imposed on an individual basis to investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated and the total amount of any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated. For the purposes of this paragraph, the own funds requirement for investment undertakings of third countries,*

[1] https://www.fia.org/sites/default/files/2020-09/20200917_FIA%20EPTA_FCA%20DP%20response_FINAL.pdf (see pp. 19-22).

financial institutions, asset management companies and ancillary services undertakings is a notional own funds requirement.

FIA EPTA members would request that the FCA include such an allowance within the IFPR, whereby the investment firm group can obtain approval to hold the lower of the local requirements and the book value, if the prudential requirements to which the third country investment firm is subject are deemed to be of an equivalent nature as the IFPR.

Q7: Do you agree with the proposals for the definitions and types of, and deductions from, regulatory capital that investment firms should use to calculate their own funds? Do you think that any additional simplification is needed? If yes, please provide suggestions.

Prudential valuation adjustments

FIA EPTA members note that prudential valuation adjustments (AVAs) still need to be deducted from own funds as per CRR Article 34, and Article 105 under the EU IFR regime. In CRR there are two methods for applying these AVAs: one being the simplified approach and the other the core approach. The simplified approach is available for firms with gross trading assets plus liabilities of less than EUR 15bn, and simply takes 0.10% of the gross trading assets plus liabilities as the deduction.

FIA EPTA members are of the view that the simplified approach should be available to all FCA investment firms, irrespective of their total gross assets and liabilities. By contrast, the use of the core approach should be made available on a voluntary basis or under direct instruction from the FCA.

FIA EPTA members would like to note that balance sheet size is by no means an effective metric for assessing risk in valuation uncertainties and fails to take into account the varying risks among different trading books. We illustrate this as follows for a firm dealing on own account and acting as a market maker in exchange traded derivatives (in this case options):

An options market maker would typically carry many different option positions in the same options series (i.e., the same product and expiry date, but across many different strike prices); this can give rise to a large balance sheet size, but low market risk, as typically opposing positions (hedges) are taken across strike prices. This minimizes the directional exposure faced by a market maker. A good example would be a long synthetic position (long call-short put in the same expiry and strike) and a short future (same expiry and same product). This position would carry a zero market risk charge under K-NPR and would have no valuation uncertainty to the underlying asset, but would still give rise to a balance sheet size. The long call option would feed into assets, the short put option would feed into liabilities, and the future would not end up on the balance sheet at all.

In view of such scenarios, FIA EPTA members consider that the core approach will not normally be proportionate for FCA investment firms, as it adds quite needlessly high implementation costs and data requirements for firms. We consider that the simplified approach will be a sufficiently conservative measure for FCA investment firms and is more appropriate, as most instruments which what those firm trade are on exchanged listed and trade and have a ready market, meaning that market price uncertainty, and close-out-cost AVAs will be close to zero.

Tier-2 capital

With regard to the question of whether any additional simplification is needed, we would suggest to the FCA that it may be appropriate to provide firms with greater flexibility regarding the FCA approvals required to reduce Tier-2 capital when own funds are above a certain buffer in excess of regulatory requirements. We note that firms will increase own funds in response to near term anticipated needs but may find those needs either are only temporary or do not materialise to the extent anticipated. Where a firm has sufficient excess capital, permitting a reduction of Tier-2 capital pursuant to a simplified or streamlined FCA sign-off process would enhance the timeframe in which excess Tier-2 capital could be repaid, with attendant cost savings and no additional risk to the soundness of the firm's capital position.

Q8: Do you agree with our proposals for trigger events for the conversion or write-down of AT1 instruments, including setting the minimum the same as under the UK CRR but expressed in a different way to reflect the structure of capital under the IFPR? If not, please let us know why and what trigger events you think there should be instead?

Yes, FIA EPTA members agree with the FCA's proposals.

Q9: Do you agree with our proposed transitional provisions for existing permissions in respect of own funds instruments (under UK CRR)? Do you think that any additional transitional provisions are necessary and if so, please identify what they should be and why?

Yes, FIA EPTA members agree with the FCA's proposals.

Q10: Are our proposals for the PMR sufficiently clear, including how it interacts with the ICR? If not, please explain what else could help.

Yes, FIA EPTA members agree that the FCA's proposals are clear.

Q11: Do you agree with our approach to K-NPR, which carries forward the current approaches to calculating market risk used in the UK CRR, including relevant rules and guidance from our current prudential sourcebooks?

FIA EPTA members support the carry forward of UK CRR provisions to the extent that they meet the policy objective of the new IFPR to achieve a more proportionate regime applicable to the size, nature and complexity of investment firms.

In respect of the provisions related to internal models, FIA EPTA members consider that the existing requirements in UK CRR are not proportionate which explains why, to the best of our knowledge, no investment firm (which is not a credit institution) has obtained approval for an internal model under UK (or EU) CRR. Should it be decided to carry forward these provisions without amendments, it is likely that the current situation will continue, i.e., that the provisions enabling firms to apply an

internal model would not be used in practice by any category of the investment firms subject to the new IFPR regime.

To address this situation, FIA EPTA members are of the view that the provisions for applying an internal model should be modified so that the internal model will be simple to operate while the outcome of the VAR models to be used should be consistent and appropriate to the risk of the portfolio across all products and asset classes.

As regards simplicity, FIA EPTA previously suggested therefore, in its comments to section 6.65 of the FCA's earlier Discussion Paper, that investment firms should be able to use, for the purpose of their internal model, third party platforms that specialise in VAR models. In this regard we noted as well that external verification of those VAR models may help alleviate any resource constraints on the part of the FCA.[2]

As regards the suitability of the internal model, FIA EPTA members consider that VAR and stressed VAR do not provide for a capital requirement that is commensurate to the risk of some instruments, which is particularly true for fixed income instruments but also of various other types of instruments. Such provisions may be varied to integrate a combination of VAR and scenarios analysis. In addition, it is not clear to us why a 2-day holding period (for cleared instruments) should considered prudent and adequate in both the clearing member and CCP margin model, while an internal model requires a 10-day holding period. FIA EPTA members consider that the holding period of the internal model should therefore be aligned the clearing member and CCP margin model to ensure a proportionate outcome for firms.

Q12: Are the requirements relating to the application and calculation of K-CMG sufficient, or do you have any specific suggestions for improvement?

FIA EPTA members very much welcome and support the additional clarifications provided by the FCA in respect of the use of K-CMG which are in line with a proportionate and prudentially sound regulatory regime for investment firms. Below, we offer some additional suggestions where we believe further improvements or clarifications would be helpful. These can be summarised as follows:

- We consider K-CMG should be also allowed to be applied by investment firms which use a non-UK clearing member or an investment firm clearing member which is not a PRA designated investment firm;
- We further consider K-CMG should be allowed for certain types of portfolios which are settled free-of-payment under the responsibility of the clearing member;
- We would request further clarification regarding the adjustment of K-CMG in certain circumstance and in regard to the application of K-CMG in the context of settled trades and in relation to K-NPR.

1. Scope of K-CMG

[2] https://www.fia.org/sites/default/files/2020-09/20200917_FIA%20EPTA_FCA%20DP%20response_FINAL.pdf (see pp. 6-7).

FIA EPTA members particularly support the extension of the scope of K-CMG to CCP margin and to indirect clearing. We believe that this reflects the diversity of the trading ecosystem while safeguarding the soundness of the prudential requirements.

However, we are still concerned by two limitations arising from the proposed definition of clearing member under IFPR, namely (a) the restriction on localisation and (b) on the status of the clearing member.

a. Restriction to UK clearing members

We believe that narrowing the scope of clearing members to UK based credit institutions or UK designated investment firms may have unintended consequences on liquidity, market stability and on the openness and competitiveness of the UK financial market, as explained below:

Markets and liquidity are interrelated

Investment firms trade on international markets and spread their trading activity across a wide range of products that are correlated in order to achieve hedging and a balanced portfolio. A firm may, for example, trade or provide liquidity on UK gilts and hedge those positions with U.S. treasuries.

Depending on their operational set up, investment firms trading the same portfolio with the same risk profile may end up with very different capital requirements depending on whether the pool of UK based "eligible" clearing firms have the capability to clear all the relevant instruments traded in the global portfolio. If the hedge is subject to a punitive capital requirement and other hedges are too expensive, this **could deter investment firms from providing liquidity in the UK based instrument and impact the liquidity, well beyond the UK, of other correlated instruments.**

Although investment firms may want to use a UK based clearing member to prevent an unjustified high capital charge, this may not be always possible for the reasons further explained below.

Increased imbalance in demand and supply of client clearing services

Recent trends have shown an imbalance between demand and supply of clearing services that would be exacerbated by limiting investment firms to only use a UK clearing firm for the purposes of K-CMG.

Investment Firms use UK and non-UK clearing members based on a variety of factors: pricing, capabilities, infrastructure and market access. Conversely, clearing members decide to clear a product and to accept clients if they have the operational capability (funding, stock lending, market access, etc.), balance sheet capacity, experience in the specific products and trading strategies or clients (derivatives vs. equities, market makers vs. asset managers, etc.) and the relevant risk appetite (which also depends on the diversity of the existing clients that impact netting and internationalisation).

Recent regulations have already severely constrained the capacity of clearing members to take on clients, for example, by the introduction of the mandatory clearing of OTC derivatives, the introduction of the leverage ratio and the more stringent capital requirements. Therefore, the market for offering clearing services has already been significantly reduced.

As a result, **restricting the use of UK clearing members means that an Investment Firm may be forced (in order to be able to use the K-CMG model) to take on a clearing member that is not**

appropriately equipped or suitable, or in the worst case, not wiling at all, to clear a specific product. (Such unwillingness could be well foreseeable, e.g., if the instrument has a high notional that significantly impacts the clearing member's balance sheet capacity). This is particularly true for the client clearing of listed derivatives with a high notional amount for liquidity providers operating sophisticated hedging strategies, which is currently offered by very few clearing members who are not necessarily based in the UK. In the worst-case scenario, an investment firm may also be left with no client clearing solution at all should the small pool of UK clearing members decide that the instrument is not worth clearing or that the client is not eligible for reasons that may be beyond the control of the investment firm.

Reduction of competition

A restriction to use UK clearing members would also lead to a **reduction of competition among clearing firms that will reduce innovation on the UK capital market and can be expected to drive prices up**. In turn this would impact liquidity to the detriment of end-users: increased trading costs may reduce the amount of capital that a firm can deploy and/or increase the spreads to the detriment of end users.

Increased concentration and systemic risk

Also, the reduction of the diversity of clearing members would **increase concentration risk as each UK clearing members will be left with an increased number of clearing clients**. This would potentially increase exposure risks for clearing members themselves, the investment firms (disruption of critical service should a clearing member fail and increase counterparty credit risk) and wider financial stability (disruption of supply of liquidity, contagion risks to UK and non-UK CCPs and difficulty to port positions).

Concerns with inconsistent policy outcomes and creation of unlevel playing field

We would finally observe that the potential adverse policy outcomes sketched above would be conflicting with the FCA's general approach for international firms, in which the FCA reconfirmed that it is "committed to a competitive and open financial system. International firms are an established part of the UK's financial services landscape, and help the UK to maintain open markets. Open and vibrant markets, driven by the ability of international firms to efficiently conduct business in the UK, help us meet our objectives".[3]

In particular, we note that clearing members, whether based in the UK or in third counties, are subject to strict supervision by their competent authority and subject to the same CCP supervision rules regardless of their localisation. It is therefore **not clear to us what the supervisory policy rationale would be for the proposed restriction**. While many non-UK clearing members may decide to set up UK entities to be able to offer clearing services to UK clients (following the end of the Temporary Permissions Regime), they may not replicate their full infrastructure and product scope, and if they do, they may still not have the requisite capabilities to service a particular segment or client forcing a firm that trades a global portfolio to use either a combination of UK clearing firms (removing the

[3] https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf (see p. 4).

netting effect on the portfolio) or a combination of UK and non-UK clearers (forcing the use of K-NPR) with both scenarios resulting in an unnecessary increase of the firm's capital requirement.

Further, the restriction of clearing members to only the UK, for UK investment firms, would in our view be **inconsistent with the policy to allow consolidation of K-CMG with third country firms**. Under the calculation of consolidated K-CMG, third-country firms are not subject to the restrictions on where their clearing member is located or their firm designation as long as that clearing member is subject to appropriate regulation and supervision. This is inconsistent with the restrictions placed onto UK based firms and would create an unlevel playing field by advantaging firms who are not solely based in the UK. This can only encourage investment firms to move assets and talent to third countries so that they may benefit from a more proportionate application of the requirements.

This would also be Inconsistent with other policies, decisions and regulatory regimes that are based on the **principle of mutual recognition and the equivalence regime**. It also would treat non-UK clearing members less favourably compared to non-UK CCPs (to the extent that non-UK CCPs qualify for central clearing) with no apparent justification.

b. Non-designated investment firm clearing members

FIA EPTA members question the policy rationale behind restricting the use of K-CMG for clearing members which are not credit institutions or PRA designated investment firms (which we understand to be a limited group of eight very large and systemically relevant investment firms akin to banks) as it will further exacerbate the concerns raised above. We note also that in the EU, the EBA is not proposing such a distinction, allowing all investment firm clearing members to qualify under K-CMG.[4]

Clearing members that are investments firms have started to replace the traditional banking institutions in providing clearing services. This is because they do not lend or take deposits and therefore maintain a higher balance sheet capacity. They are more agile and play a key part in capital market innovation, as set out in more detail below. They have also developed offerings for more niche products and are focused on providing client services to smaller investment firms. Restricting client clearing will further exacerbate the supply-demand imbalance in the clearing space referred above and increase barriers to entry, which would in turn, significantly impact smaller investment firms that may then be forced to use K-NPR where this is not appropriate for them. Consequently, this may imbalance the playing field between large investment firms and smaller investment firms, with the latter being subject to a more punitive capital regime should it be unable to use a UK credit institution or UK designated investment firms.

Finally, this would also put investment firm clearing members at a competitive disadvantage compared to Credit Institution clearing members again creating an unjustified level playing field. Some investment firm clearing members may even find that their business models are no longer viable and may decide to exit the market.

[4] Article 4 IFR defines clearing member as an undertaking established in a Member States that fulfills the definition of point 14 of Article 2 Regulation 648/2021. Article 2(14) defines a clearing member that participates in a CCP and which is responsible for discharging the financial obligations arising from that participation.

Innovation and clearing in the context of the financial system

A further consideration, both in regard to the restriction of K-CMG to UK clearing members and to PRA designated investment firm clearing member, is specifically in relation to the expected negative impact on the Libor transition process.

The Libor reform effort has benefitted greatly from a network of innovation across the financial markets. Early in the reform process, working groups in the UK and US pinpointed the development of futures liquidity in Sonia and SOFR would be a key early milestone for the transition process. Exchanges and their clearing members have been working closely to innovate and create solutions to support the transition road map. It should be noted in particular that non-bank (investment firm) clearing members have played a significant role in supporting the development of these products. There is more work to be done over the coming years with respect to, for example, the development of liquidity in Alternative Reference Rate (ARR) futures and options. To this end, the continued support of such non-bank clearing members will continue to be vital.

As highlighted before, Short Term Interest Rate (STIR) futures and options are treated significantly different depending on whether K-NPR or K-CMG is applied for the risk-to-market calculation. Even after considering maturity adjustment factors, K-CMG provides a more consistent estimation of risk whilst maintaining prudence from a market risk perspective.

If the use of K-CMG would be limited as a consequence of unduly excluding non-designated investment firm clearing members, investment firms will be faced with come uncomfortable choices. Either, continue to support ARR futures and options and set aside higher capital requirements or simply reduce activity. The latter option would have a detrimental impact on liquidity, and possible restrict transition progress. Furthermore, clearing members will need to assess whether or not the economic incentives are strong enough to support these products if they are not able to effectively use K-CMG.

Finally, when considering the UK in the context of the broader international financial markets, third country based investment firms and clearing members may be better able to support the development of new ideas such as the development of liquidity in new products such as ARR futures.

c. Indirect clearing

FIA EPTA members welcome the FCA’s clarification that investment firms can use K-CMG for a portfolio that is subject to indirect clearing. However, we would welcome further specification as to whether the “standard conditions for a K-CMG permission” will apply at the level of the clearing member or, rather, the indirect clearing member. We believe that the comments made above on non-UK clearing members and Investment Firm clearing members should also be considered when assessing the conditions to be met.

Proposed amendment

Based on our considerations set out in section 1 (a-c) above, we would recommend amending IFPR 4.13.9 to read as follows:

4.13.9 R

To obtain a K-CMG permission in relation to a portfolio, a firm must: (1) complete the application form in [Editor's note: a reference to the relevant permissions form will be inserted following consultation on the form in a future Consultation Paper] and submit it in accordance with the instructions in that form; (2) as part of the application in (1), demonstrate to the satisfaction of the FCA that all the following conditions are met: (a) the firm is not part of a group containing a credit institution; (b) the clearing and settlement of the transactions in the relevant portfolio take place under the responsibility of a clearing member of an authorised ***or recognised*** *central counterparty; (c) the clearing member in (b) is one of the following: (i) the firm itself; (ii) a UK* ***or non UK*** *credit institution;* ~~*or (iii) a designated investment firm*~~ ***or (iii) a UK or non UK investment firm.***

2. Application of K-CMG for free-of-payment settled portfolios

FIA EPTA members note that, as currently proposed, IFPR will only allow the K-CMG approach for Risk to Market to be used for "transactions in the relevant portfolio are either: (i) centrally cleared in an authorised central counterparty; or (ii) settled on a delivery-versus-payment basis under the responsibility of the clearing member in (b)" (IFPR 4.13.9(d)).

We agree, and have consistently supported, that OTC derivatives should indeed be out of scope for K-CMG. However, we note that there are a limited number of scenarios where certain portfolios are not being centrally cleared or settled via delivery-versus-payment (DVP) but where the portfolio should in our view still reasonably be included in the scope of K-CMG. We would point in this regard to the limited number of examples whereby the industry standard is to conduct settlement on a free-of-payment (FOP) basis under the responsibility of the clearing member and where DVP settlement is not available. This is mostly prevalent in the settlement of foreign currencies (FX), primarily driven by the different time-zones in which the separate currencies settle. We would point out that the majority of these FOP settlements take place on an intraday basis, with a small number settling overnight such as GBP vs. AUD due to local market hours.

FIA EPTA members would therefore request that the FCA broaden the scope, in a targeted manner, of portfolios to which K-CMG can be applied to also include trades that are settled on a free-of-payment basis as a matter of globally accepted market practice. Alternatively, the FCA may wish to specifically exclude those trades that are specifically agreed on a bilateral basis to settle outside of standard market practice.

We believe the inclusion of such FOP trades would be substantively aligned with the policy intention behind the allowance for DVP transactions to be included for K-CMG, which was to facilitate the proportionate application of K-CMG for instruments (such as ETFs) where existing market practice was not (fully) relying on central clearing but where settlement under the responsibility of the clearing member provides for sufficient prudential safeguards.

Proposed solution

Based on the above reasoning and similar to the approach used within the Large Exposure methodology within CRR, we would recommend to the FCA an explicit exclusion for FX transactions from the

scope of K-NPR, provided they still meet the requirement that settlement takes place under the responsibility of a clearing member. Additionally, we would propose that IFPR specify a discretionary ability for the FCA to grant exemptions to certain market practices that involve free-of-payment settlements by default.

Addition of 4.13.9(d)iii

(iii) The transaction set out in point ii shall include any the following:

(a) foreign exchange transactions incurred in the ordinary course of settlement

(b) with the FCA's specific authority; transactions against custodial parties to facilitate the issuance of new securities. Such transactions include, but are not limited to, the creation of depository receipts and the creation or redemption of physically replicated UCITS ETFs.

3. Adjustment to K-CMG model

FIA EPTA members support the FCA approach to allow for an upward or downward adjustment of the margin model (section 5.46 and 5.47), should the parameters of the margin model not meet the criteria in order to achieve a margin requirement at least equivalent to the margin requirement that would have been produced should the criteria have been met.

However, we would welcome clarification whether such adjustment would still be necessary should the criteria not be met but nevertheless produce, overall, a margin requirement at least equivalent to the margin requirement under the criteria. We believe that as the adjustment's objective is driven by the outcome of the margin requirement, such adjustment should not, in this specific case, be made.

4. Additional prudential requirement on settled trades

FIA EPTA members would welcome clarification on the potential additional prudential requirement on settled trades (section 5.30 and 5.37). We believe the justification for this requirement is that settled trades are not risk free, as they still incur market risk, and therefore that market risk must be calculated for settled trades. There is, then, the provision of three methods by which this may be calculated, with only one of the three being applicable at any one time, listed in order of preference.

1. Inclusion in the margin model of the Clearing Member, forming part of the K-CMG calculation;
2. As a haircut on the collateral of the settled position;
3. As a separate calculation under K-NPR.

Given the above, our understanding is that there should be no additional add-on when the settled trades are already taken into account in the margin requirement of the clearing member's margin model (whether haircut on collateral is applied or not). When settled trades are not included in the margin model, there will be an add-on equivalent to the haircut applied by the clearing member on the collateral provided to fulfil the margin requirement. If the settled trades are not taken into

account in the margin requirement of the clearing member's margin model, and no haircut is applied on the collateral, then K-NPR applies. Note that, to the best of our knowledge, clearing members do not differentiate between settled and unsettled trades, margin being applied at trade date.

5. Use of K-NPR: error in drafting

FIA EPTA members would like to highlight a drafting error within the draft Handbook text, specifically within 4.13.1(2), when setting out the scope of the application of K-NPR. The current wording results in portfolios that have been granted the use of K-CMG to also be included within the scope of K-NPR. FIA EPTA members would expect that this is not the intention of the FCA, and propose the following amendment:

> *A MIFIDPRU investment firm must include a position specified in MIFIDPRU 4.11.7R within the calculation of its K-NPR requirement if that position:*
> *(a) is **not** included in a portfolio for which the firm has been granted a K-CMG permission;*
> *(b) is a proprietary position of the firm that results from a trade that has settled;*
> *(c) is not included in the calculation of the required margin under the margin model of the clearing member or authorised central counterparty in MIFIDPRU 4.13.9R(2)(b); and*
> *(d) is not a position to which the clearing member or authorised central counterparty has applied a "haircut" of the type specified in MIFIDPRU 4.13.6R(2).*

Finally, we note that it is not quite clear whether these points should be read as an **"and"** or **"or"** (particularly between point (b), (c) and (d)). As mentioned before, our understanding is that settled trades would only be subject to K-NPR if these positions are not included in the margin model and where no haircut has been applied by the Clearing Member or authorised central counterparty.

Q13: Do you have any specific comments on our detailed proposals for calculating the K-TCD, including the approach to potential future exposure?

FIA EPTA members welcome the improvements in regard to both the methodology and the scope of the credit risk measures within the proposed IFPR. Additionally, FIA EPTA members appreciate the detailed guidance provided on the calculation of the potential future exposures (PFE).

However, FIA EPTA would like to highlight a number of areas where the methodology sets requirements which we consider to be inappropriate or where we see a need for additional clarity. For these, we would request the FCA to make targeted changes along the lines of our suggestions set out below.

PFE Netting Methodology

FIA EPTA members welcome the introduction of the two netting approaches for measuring the potential future exposure. However, we would like to request clarity as to when to take the absolute value of the effective notional (EN) under each of the proposed methodologies:

Hedging Approach

The hedging approach stipulates that the effective notional should be calculated on a net basis at an asset class level. As such, it would be appropriate to use both positive and negative supervisory deltas in the calculation of the per-contract level, and then net all contracts within the netting set to

calculate the net EN per asset class. At that point, the absolute net EN should be used when applying the supervisory factor, before calculating the Potential Future Exposure. The following addition to 4.14.16(1) is therefore recommended:

> *multiplying the **absolute** net notional amount under MIFIDPRU 4.14.14R(1)(c) for each asset class within the netting set by the supervisory factor for that asset class specified in MIFIDPRU 4.14.22R;*

Netting Ratio Approach

Similar to the hedging approach, FIA EPTA members recommend that the FCA clarify at which point the absolute EN should be used within the calculation. We are of the opinion that this should take place at a derivative position level. As such, the following addition to 4.14.18(2) is therefore recommended:

> *PFEgross = the sum of the potential future exposure of all derivative contracts included in the netting set, calculated by multiplying the effective **absolute** notional amount of each derivative contract (as calculated in accordance with MIFIDPRU 4.14.20R) by the relevant supervisory factor for the corresponding asset class specified in MIFIDPRU 4.14.22R.*

Supervisory Delta

For ensuring that the netting methodologies are implemented correctly, FIA EPTA members would additionally request that the notion of supervisory delta be expanded to take into account both positive and negative deltas, and as such allow for netting within the 'hedging approach'. The following change to 4.14.20(5) is therefore suggested:

> *The supervisory delta must be determined as follows:*
>
> > *(a) for options and swaptions, the firm may calculate the supervisory delta itself by using an appropriate model if:*
> >
> > > *(i) the model the firm uses meets the minimum standards set out in MIFIDPRU 4.12.12G to 4.12.18G (Minimum standards for own estimates of delta), as modified by MIFIDPRU 4.14.21R, for each type of option or swaption for which it calculates delta; and*
> > >
> > > *(ii) the firm has notified the FCA that the minimum standards in (i) are met before the firm begins to use its own estimates for the relevant supervisory delta;*
> >
> > *(b) for transactions other than options and swaptions, or transactions in respect of which a firm is unable to use an appropriate model in accordance with (a), the supervisory delta shall be 1 **or -1.***
> >
> > ***(c) The supervisory delta shall reflect the relationship between the contract and the underlying. Whereby a contract that increases exposure (RC) as the underlying***

increases shall have a positive supervisory delta, and a contract that decreases exposure (RC) as the underlying increases shall have a negative supervisory delta.

Finally, FIA EPTA members would like to alert the FCA that there seems to have been an omission within the calculation of the PFE(net) within 4.14.18, whereby in the case of a netting set having a replacement cost of zero or negative, the PFE becomes zero. We would expect this not to be the FCA's intention, and would suggest that there should be a separate factor applied to the PFE(gross) which does not take into account the net-to-gross RC ratio. As such, we would suggest to the FCA that the calculation of the PFE(net) should resemble that contained within CRR Article 298(1)c(ii):

$$\mathrm{PCE}_{\mathrm{red}} = 0.4 \cdot \mathrm{PCE}_{\mathrm{gross}} + 0.6 \cdot \mathrm{NGR} \cdot \mathrm{PCE}_{\mathrm{gross}}$$

Q14: Are our proposals for how to calculate K-DTF sufficiently clear? And should there be the possibility of an adjustment to calculating the coefficients for K-DTF in periods of extreme market stress and volatility? What specific suggestions do you have, and how could any adjustment operate effectively within the proposed framework for calculating K-DTF?

FIA EPTA members welcome and support the FCA's proposals and consider that these are clear and proportionate.

We specifically welcome the FCA's approach in regard to cash trades. However, we would suggest to the FCA to additionally include a provision specifying that the amount paid or received for trades in government bonds, which are subject to a 0% specific risk own funds requirement according to Article 336 of the CRR, is also adjusted for the time to maturity (in years) of the bond for the purposes of calculating K-DTF under IFPR, for the reasons set out in our response to the FCA's previous Discussion Paper[5].

Further, we do indeed agree that K-DTF coefficients should be able to be adjusted in situations of extreme market stress and volatility. In this regard, we would reiterate here our suggestions which we made in our response to the previous FCA Discussion Paper:

We continue to consider that an approach based on an objective statistical methodology will most effectively deliver on the targeted supervisory and regulatory objectives. To this end, we are proposing two alternative statistical solutions which would allow for an objective assessment of the existence of 'stressed' vs. 'normal' market conditions, based on the comparison of short-term market behaviour vs. longer term historical norms. Either of these would efficiently deliver on the need to determine whether stressed market conditions are of a type that should result in a coefficient adjustment for the purposes of K-DTF.

Our suggested solutions are as follows:

Statistical method

[5] https://www.fia.org/sites/default/files/2020-09/20200917_FIA%20EPTA_FCA%20DP%20response_FINAL.pdf (see sections 3.30-3.32 on page 17).

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

FIA EPTA members believe that, rather than relying on trading venues, a simpler and more objective approach is to take a statistical view of stressed market conditions. This method removes volumes of transactions that are associated with statistically high volatility, high volume observation days. The great advantage of this method is that it is very simple, using generally available external market data and that the method can be used for every product on every exchange.

This approach is justified because during heightened volatility, end users of securities or derivatives increase their demands for liquidity. These periods tend to coincide with higher than average volume. Unless addressed, investment firms would be required to account for a higher K-DTF following a period of heightened volatility. This creates a disincentive to provide liquidity at a point in time when end users most need it.

To ensure that liquidity providers are not disincentivised through higher K-DTF readings during this time, we consider that firms should be allowed to remove volume from the calculation which coincides with higher than average price volatility or volume. Specifically, a threshold which defines higher than average volume is required in order to base this calculation.

The use of price volatility to statistically define 'stressed markets' is widely accepted practice. In retained MiFID II, Delegated Regulation (EU) No. 2017/578 places this exact requirement onto trading venues who must set out parameters to identify stressed market conditions in terms of significant short-term changes of price and volume. Trading venues must then consider the resumption of trading after volatility interruptions as stressed market conditions.

The use of the same approach to identify stressed market conditions for the purposes of adjusting K-DTF seems entirely appropriate and aligns purposefully with the approach taken by exchanges, while ensuring an objective and consistent methodology across exchanges and financial instruments.

A percentile approach offers an elegant and scalable approach that should be simple to calculate. A percentile can be defined as the N-th percentile derived from a list of observations sorted from greatest to least. This can be determined as follows:

Cadj = C * (DTFexcl / DTFincl)

Where:

DTFexcl = the daily trading flow (DTF) of derivatives measured in accordance with [IFPR], excluding the value of any trade that occurred during periods of stressed market conditions; and

DTFincl = the DTF of derivatives measured in accordance with [IFPR], including the value of any trade that occurs during periods of stressed market conditions.

We are proposing two different options, set out below, to define 'stressed market conditions', one based on historical volatility and another based on historical volume.

To ensure consistent outcomes from the calculation, we propose for the statistical method a longer look-back period than 6 months. This is to make sure the measurements can indeed empirically be assessed as substantive outliers over a longer time horizon; based on FIA EPTA members' quantitative analysis of market behaviour, we suggest to use a 3-year lookback period for this purpose.

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Option 1 – historical volatility:

Period of stressed market conditions

Periods of stressed market conditions shall be determined as the trading days where historic volatility is in the highest 10% of the last 3 years for a given market and product.

Historical volatility is measured by the difference between the high and low price of a product on a certain day. For derivatives, the price of the underlying product is used for the measurement. FIA EPTA members have analysed the proposed adjusted calculation, using this statistical method, based on Eurostoxx futures data. In doing so, we have used the year 2019 as the base data. When compared to this the calculated value for K-DTF, once March's volume begins to be included, increases by up to 51% compared to the same period for 2019.

Using this proposed statistical method, the increase in capital requirements would show an increase of only 5%, rather than the 51% increase. Without this statistical method the year-on-year changes for K-DTF range from -11% to 51%. With this statistical method the K-DTF value stabilises with the range tightening from -3% to 10% across 2019 and 2020. This achieves the desired effect of not disincentivising investment firms from providing liquidity during periods of market stress.

Option 2 – historical volume:

Period of stressed market conditions

Periods of stressed market conditions shall be determined as the trading days where market volume for that day was in the highest 10% of the last 3 years for a given market and product.

FIA EPTA members have analysed the proposed adjusted calculation, using this statistical method, based on Eurostoxx futures data. In doing so, we have used the first 6 months of 2019 as the base data and set this at 100. When compared to this, the volume of transactions in the first 6 months of 2020 increased by almost 50%.

Using this proposed statistical method, the increase in capital requirements would show an increase of only 2%, rather than the 50% increase. For 2019, this statistical method would show a decrease of only 5%. This demonstrates that there is a normalisation of capital requirement, with large increase in trading volumes, without the negative impact on normal times.

Additional prudence

Although stressed market conditions are quite unique, there could conceivably be a concern that such adjustments may lead to a reduction of K-DTF which is deemed too large. It could be an alternative to provide an additional floor to the calculation in such a way that the reduction is not greater than 50%. As follows:

Cadj = Max [0.50 * C ; C * (DTFexcl / DTFincl)]

FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Q15: Do you agree with our proposals for the various transitional provisions relating to own funds requirements and that they cover all relevant situations? If not, what specific suggestions do you have?

Yes, FIA EPTA members agree with the FCA's proposals.

Q16: Are our suggestions for the transitional provisions for the initial collection and use of K factor metrics practical? Do you have any specific suggestions for improvement?

Yes, FIA EPTA members agree that the FCA's suggestions are practical and fit for purpose.

Q17: If we did not introduce our proposed transitional provisions on advanced data collection of the K factor metrics, what alternative solution would you propose?

N/a

Q18: Do you have any comments on the proposal for monitoring and control of concentration risk? Please provide suggestions for any specific clarifications that you feel may be helpful.

FIA EPTA members consider that it is correct that all firms should have systems and controls for monitoring their concentration risk and do not believe that any further clarification is necessary.

Q19: Are the proposed concentration risk requirements for investment firms that deal on own account sufficiently clear? For example, how to determine the soft limit for exposures to a group of clients involving a mixture of banks and investment firms and corporates? If not, what improvements would you suggest?

FIA EPTA members consider that the examples and guidance provided by the FCA are very helpful and we think the text is clear including how the soft limit applies.

However, we do note that it is not clear from the proposed requirements how long a counterparty should remain to be considered a client for these purposes. For example, in a scenario where a firm may trade with a counterparty once and then at a later stage hold a security of that same counterparty: The question then arises whether the firm should still consider this a K-NPR position for the purposes of K-CON, even if the firms does not have a K-TCD exposure. FIA EPTA members would appreciate clarification by the FCA in this matter.

Q20: Would you suggest any specific changes to our proposals for commodity and emission allowance dealers?

N/a

Q21: Do you agree that all FCA investment firms should have the same basic regulatory reporting forms? If not, what changes to the regulatory reporting form do you suggest, and to which types of investment firm should they apply?

Yes, FIA EPTA members agree. We fully support the FCA's approach of applying the same basic regulatory reporting requirements across all types of investment firms. We consider that the proposed forms are proportionate given the nature, scale and complexity of investment firms' activities and welcome that these much less onerous than the current COREP and FINREP reporting.

Q22: Do you agree with the frequency of the reporting? If not, please state what the frequency should be and explain why.

Yes, FIA EPTA members agree with the FCA's proposed frequency of reporting, i.e., calendar quarters and note that the proposed approach is consistent with the current Common Reporting Framework and in line with providing proportionality to investment firms.

Q23: Do you think that the instructions for completing the regulatory forms are clear? If not, please specify where additional detail is required and what level of additional detail would be helpful.

Yes, FIA EPTA members consider that the instructions are clear and concise, with the majority cross referring to the current calculation methods. The instructions are as detailed as the current data item returns and are easy and straightforward to follow.