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FIA response to FCA Consultation Paper on a new UK prudential regime for MiFID investment firms (CP20/24)

(electronic submission to FCA via email)

London, 5 February 2021

FIA[1] welcomes the opportunity to respond to the FCA consultation on a new UK prudential regime for MiFID investment firms (CP20/24). Our response focuses on a subset of questions raised in the consultation, namely those that are of interest to investment firm clearing clients and investment firm (and bank) clearing members, including commodities firms. Some of our comments below on K-CMG build on the points we made in our previous submission to the FCA in response to the Discussion paper (DP20/2).

We look forward to engaging further with the FCA on these important questions for our members.

Question 4:
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?

1. Scope of application of prudential consolidation

a. Prudential consolidation of groups not headed by a UK parent entity

We believe the actual draft rules make clear that groups, which are not headed by a 'UK Parent Entity' (*defined as one which is either an investment firm, an investment holding company or a mixed financial holding company*) would not be required to consolidate. However, we are concerned by the more expansive language in paragraphs 3.6 and 3.7, which seem to indicate that the FCA might be (hopefully mistakenly) saying that all that is required for the consolidation rules to be operative is that there is an investment firm within the group. ***We therefore request a confirmation from the FCA that prudential consolidation under UK IFPR does not apply to groups that are not headed by a UK Parent Entity.***

[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.

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b. ***Prudential consolidation of groups with Connected Undertakings***

The draft FCA UK IFPR rules, as described in Chapter 3, provide for certain entities to be within the scope of an investment firm group and so be subject to the application of prudential consolidation. This includes subsidiaries (paragraph 3.13) and Connected Undertakings (CU) (paragraph 3.16). Where an entity falls to be considered as a CU, it will be considered part of the investment firm group. The criteria for determining if an entity is a CU are set out in MIFIDPRU 2.4.6 – 2.4.16. Thus, an entity may be determined to be a CU where there is participation and, where there is no participation or capital ties, in circumstances where there is majority common management, significant influence or single management (without any contractual nexus).

In accordance with MIFIDPRU 2.4.19G, where an investment firm group includes one or more CUs, it is unlikely that the investment firm group will be sufficiently simple for the purposes of the application of the first limb of the requirements of the Group Capital Test (as set out in MIFIDPRU 2.4.17R) in that it would not be considered to be sufficiently simple. Under the EU IFR, the definition of investment firm group is '*a group of undertakings which consists of a parent undertaking and its subsidiaries or of undertakings which meet the conditions set out in Article 22 of the [Consolidated Accounts Directive (213/34/EU)], of which at least one is an investment firm and which does not include a credit institution*'. It would appear that the FCA proposed rules impose a greater burden on UK investment firm groups versus those EU investment firms subject to the IFR/D, which would create an unlevel playing field and put the impacted UK firms at a competitive disadvantage compared to their EU counterparts. ***This may be an intended consequence of the proposed FCA rules, so we would be grateful for a confirmation of policy that the FCA wishes to pursue in this regard.***

Question 11:
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?

1. Calculating notional amounts for futures, forwards and contract for differences on a single commodity

For equity and commodity derivatives contracts and emissions allowances and derivatives thereof, the notional amount is the product of the market price of one unit of the instrument and the number of units referenced by the trade (draft rules 4.12.36/7). We believe that this means investment firms should use forward prices rather than spot prices, however ***a confirmation of this point by the FCA would be helpful***.

Question 12:
Are the requirements relating to the application and calculation of K-CMG sufficient, or do you have any specific suggestions for improvement?

1. K-CMG

a. ***Clearing member entity type***

FIA members are of the view that the proposed K-CMG requirements are overly restrictive as regards the clearing member entity type in that they envisage a very limited and narrow list of clearing member entity types, namely the clearing member can only be one of following if its investment firm clients wish to apply for K-CMG:

- the firm itself;

- a UK credit institution; or
- a designated investment firm (draft rule 4.13.9R (2)(c)).

This requirement creates an unlevel playing field between clearing members that fall into one of the categories above and those that do not, and will have commercial and other implications for both clearing members that do not fall in any of the above categories and their UK investment firm clients. If UK investment firm clients clear transactions via an *investment firm* clearing member, then K-CMG would not be available to them, which will have an impact on the competitive landscape of clearing service providers. UK investment firm clearing members would be at a competitive disadvantage as their investment firm clients would not be able to choose to apply for K-CMG, and will be required to use K-NPR in all circumstances. This may have undesirable effects in terms of concentration risk, because the impacted clients may wish to move their clearing activity to a clearing member that is either a UK credit institution or a designated investment firm.

In addition, firms not categorised as UK credit institutions or designated investment firms, provide clearing services for clients, which in some cases would not be able to open accounts with the larger UK credit institutions or designated investment firms, due to differences in minimum monthly revenue requirements. Many of these same firms provide significant liquidity into financial markets for both existing products and new product launches, hence potential impact to market quality. Some non-UK based exchanges do not support remote clearing, hence the investment firm is required to clear with a non-UK clearing member as set out in more details below. Due to the calculation methodology applied to certain asset classes, interest rate for example, there is a significant difference between K-CMG and K-NPR value, with the latter being significantly the higher.

Furthermore, the availability of K-CMG to clients of UK bank clearing members only (and UK significant investment firms) deviates from the proposed EU K-CMG requirement, which is not limited by the clearing member entity type. ***We request that this proposed requirement be amended such that it does not discriminate against one or more clearing member entity types and that investment firm clients of all clearing members are eligible to apply for K-CMG (subject to other conditions).***

b. Location of clearing member

The current proposal also envisages a location requirement for clearing members of UK investment firm clients who would like to apply for and benefit from K-CMG. In other words, UK investment firm clients that access authorised and/or recognised CCPs globally via non-UK credit institutions or non-UK (designated) investment firms do not meet the conditions for K-CMG and cannot benefit from it. There does not appear to be a clear rationale for this limitation in availability of K-CMG, especially because market risk that K-CMG is designed to mitigate does not depend on the location of the clearing member. Restricting availability of K-CMG only to clients of UK clearing members will have adverse effects on liquidity, market stability and on the openness and competitiveness of the UK financial market. ***We respectfully request that the FCA amend the territorial scope limitation such that K-CMG is available to investment firm clients (or, indeed, indirect clients) of any clearing member, irrespective of where it is located and its regulatory status, as per the section above.***

c. Indirect clients

FIA members welcome the proposal to make K-CMG available to investment firm clearing members and to those investment firms that access markets indirectly as clients of clients (i.e. *indirect clients*). As regards the latter, it is not clear from the consultation and the draft rules as to the requirements that such investment firm indirect clients need to meet to be permitted to use K-CMG, specifically in relation to any conditions

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that may be attached to direct clients that provide clearing services to the in-scope indirect clients and with whom they have a direct contractual relationship. ***We request a clarification in the final rules, which would make the use of K-CMG for indirect clients in indirect clearing arrangements unambiguous.***

d. Calculation of total margin

We would welcome further clarity from the FCA on how settled positions of cleared trades are proposed to be taken into account when calculating total margin. Paragraphs 5.30 and 5.37 suggest that settled trades could be part of the "margin required by the margin model of the relevant clearing member". However, the second bullet point in paragraph 5.37 seems to imply that the clearing member needs to split the investment firm's portfolio into derivatives and non-derivatives transactions and calculate margin requirements separately. It is therefore not entirely clear whether an option position would be allowed to be hedged by an underlying shares position in a K-CMG calculation for the combined position, for example, or whether the clearing member should first calculate a combined margin requirement added by a haircut on the underlying.

In practice, clearing members calculate the risk on settled collateral by including it in their margin models, which would therefore form part of the K-CMG calculation. We also note that clearing members typically do not distinguish between settled and unsettled trades, margin being applied at trade date, and ***suggest that margin being calculated/applied from trade date is appropriate for the purposes of K-CMG***.

e. Margin model criteria

We understand that the margin model criteria set out in paragraph 5.45 (draft rule 4.13.14) would allow for parameters other than 99% and 2-business days holding period, as long as the margin requirements are sufficient to cover losses resulting from at least 99% of the exposures movements over an appropriate time horizon with at least a two-business days' holding period. We understand this to mean that even in cases when the model is not specifically designed with the 99% and 2-business days parameters, but reaches the same (or a higher) level of prudence, it would be deemed to be eligible for K-CMG, without the need for the adjustment mechanism. ***We would welcome a confirmation of this interpretation.***

f. Adjustment mechanism

FIA members are supportive of the FCA's proposal to allow a downward adjustment, should the margin model parameters exceed the standard criteria. This is crucial in preserving a level-playing field between clearing members and also prevents the introduction of unintended systemic risk by incentivising clearing members to lower their underwriting standard if their margin model parameters are more conservative.

With a view to not incentivising lower capital requirements, ***FIA members recommend that the adjustment mechanism should include the removal of amounts not related to market risk***, including:

- Liquidation Requirements: collected to cover for the cost of liquidating an investment firm's portfolio, in the event of its default;
- Minimum Equity Requirements: typically required to collateralise Operational Risk.

Relating to market risk, we ask for guidance from the FCA on permitted approaches to normalise both MPOR and confidence levels, namely:

- whether adjustment for MPOR via SQRT(t) can be applied; and
- if FCA could define a distribution that may be used to normalise for clearing member margin model's stated confidence level – whether a normal-distribution, or a distribution that exhibits greater skew.

Question 13:
Do you have any specific comments on our detailed proposals for calculating the K-TCD, including the approach to potential future exposure?

1. Calculation of K-TCD

a. General

In general, our members would find it helpful if the FCA could provide more clarity on the calculation and definitions within potential future exposure, as well as examples of Notional and Duration across different asset classes, short term interest rates.

b. PFE calculation – supervisory factors

For K-TCD, the calculation of the exposure of OTC derivative contracts is outlined in IFR Article 29, which is based on the Potential Future Exposure (PFE) calculation. This is a similar approach as the mark-to-market method under Article 274 of CRR – however, the big difference is that the supervisory factors applied to the various asset classes, especially equities and commodities, are much higher under IFR than CRR. This is also partly because, in the case of interest rate and foreign exchange contracts, CRR takes into account the residual maturity of contracts (shorter term contracts have lower factors applied), but IFR does not. The below tables highlight the differences:

CRR Article 274 (2)

Table 1

Residual maturity	Interest-rate contracts	Contracts concerning foreign-exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities other than precious metals
One year or less	0 %	1 %	6 %	7 %	10 %
Over one year, not exceeding five years	0,5 %	5 %	8 %	7 %	12 %
Over five years	1,5 %	7,5 %	10 %	8 %	15 %

IFR Article 29(7)

Table 3

Asset class	Supervisory factor
Interest rate	0,5 %
Foreign exchange	4 %
Credit	1 %
Equity single name	32 %
Equity index	20 %
Commodity and emission allowance	18 %
Other	32 %

CRR Article 274(3)

Table 2

Residual maturity	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
One year or less	2 %	2,5 %	3 %	4 %
Over one year, not exceeding five years	5 %	4 %	5 %	6 %
Over five years	7,5 %	8 %	9 %	10 %

Furthermore, for firms with a significant diversified commodities portfolio which currently use Table 2 above, the increase in supervisory factors will be greater still.

Under Article 25(4) of IFR, there is a derogation available to firms for the calculation of the exposure under K-TCD as per the current CRR methodology (with approval of competent authority). However, there is no equivalent derogation available under the proposed UK IFPR rules, which would put UK investment firms at a competitive disadvantage against their EU counterparts. On a sample OTC book, our members have seen the exposure under IFR being more than 3 times higher than the same book under the CRR rules – this does not even include the application of the alpha factor of 1.2 under IFR. ***We kindly request that the FCA put this derogation back into MIFIDPRU 4.14 to achieve its aim of maintaining a level playing field.***

Similarly, Article 25(5) of IFR allows a derogation for firms to calculate the CVA calculation under the current CRR rules rather than simply applying a 1.5 uplift to relevant counterparties per Article 32. A 50% uplift yields significantly more punitive capital requirements than the old CRR calculation. ***We therefore kindly request that the FCA also add this derogation back into MIFIDPRU for the same reasons of level playing field and equivalence.***

We also note that transactions relating to gold or gold derivatives should be allocated to the foreign exchange asset class. Our members would like to seek clarity on how other precious metals should be treated. For example, would transactions relating to silver or silver derivatives fall under foreign exchange or commodities for the purposes of applying the correct supervisory factor?

Question 14:
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 in the proposed framework for calculating K-DTF?

1. Calculation of K-DTF

While K-DTF is clear, it uses K-TCD as a component. The calculation of K-TCD would benefit from additional clarity on the definitions and calculations of components of potential future exposure. Adjustments for extreme market stress and volatility are already included in Risk-to-Market calculations, K-CMG for example, with initial margin increasing in these instances. K-DTF is also a calculation of historical trading flow, so in the view of our members, it is not the appropriate component to support current market conditions.

Question 15:
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?

1. Transitional provisions for the fixed overheads requirement and the K-factor requirement for exempt commodities firms

We understand that IFPRU exempt firms which are currently applying IPRU-INV are going to be required to continue to hold capital levels as they currently do whilst other IFRPU exempt firms will be able to apply the five-year tiered transition arrangements (para. 6.23 – 6.26). We think it would be helpful to try and get IPRU

INV firms to be treated the same as other exempt IFRPU firms, on the basis that the IFR is meant to harmonise the treatment of firms and the IPRU INV requirements are not part of that regime.

Furthermore, those firms will have to run two calculations side by side for the next five years, which will be a significant administrative burden for them to ensure that both are always complete and accurate. Some firms may also face additional costs of supporting calculations using old legacy software, where the investment in maintaining this software has been limited in the anticipation that it will be retired.

If the FCA's concern is that the new rules may give rise to much lower capital requirements especially in the early years of the transitional period, maybe a compromise could be that the own funds should never drop below the average total financial resources requirement reported on the FSA033 returns for the four period ends 31/12/20, 31/03/21, 30/06/21 and 30/9/21.

Exemption for Commodities Dealers under UK CRR

Finally, we would also like to raise a point, which is not directly addressed in this consultation, however it is an important concern for our UK commodities firm members and relates to the prudential regime that would apply to them in a period of time between 26 June 2021 and the date of application of UK IFPR.

Following a recent Corrigendum of CRR, which we understand was onshored into UK law prior to the end of the transition period, an IFPRU (or BIPRU) Exempt Commodities Firm is eligible to apply the prudential rules in Chapter 3 of IPRU-INV (instead of CRR), however this exemption expires on 26 June 2021 when IFR/IFD start to apply.

After this period, we believe that UK CRR would start to apply to such firms automatically until the UK implements IFPR, which is now expected to be 1 January 2022, unless there is a further legislative change in the UK. We ask the FCA to discuss this unintended timing gap with HM Treasury as a matter of priority and provide an early confirmation of a legislative fix, so that the impacted commodities dealers would be able to continue to rely on the exemption from CRR for the period between 26 June 2021 and the end of 2021 (or another UK IFPR implementation date).

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,

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