FIA response to PRA Consultation Paper on Implementation of Basel standards (CP5/21)

(electronic submission to PRA via email)

London, 30 April 2021

FIA[1] welcomes the opportunity to comment on the PRA consultation paper (5/21) on the implementation of Basel standards (the Consultation).

This letter predominantly focuses on the treatment of derivatives client cleared in the context of Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR).

1. NSFR

a) RSF factors – interdependent assets and liabilities

In paragraph 12.37 of the Consultation, the PRA notes that there could be circumstances in which strict criteria are met that ensure interdependent assets and liabilities do not present a stable funding risk. In such cases, it may be appropriate to set RSF and ASF factors to zero. In practice, the PRA states and it has not identified circumstances in which this treatment would be warranted.

Derivatives client clearing in Europe is typically conducted on a principal basis, whereby two equal and opposite ('back-to-back') transactions are created between (i) the clearing member (CM) and the CCP, which is governed by the CCP rules and (ii) the CM and its client under the terms of the client clearing agreement that governs their relationship. In this context, the clearing member is often referred to as 'riskless principal', because it does not guarantee CCP's performance to its clients.

The EU authorities have concluded that derivatives client clearing meets the strict conditions for treating assets and liabilities as interdependent for the purposes of NSFR under CRR II Article 428f(2)(d). We think there is no reason as to why the PRA would not arrive at the same conclusion under the UK prudential framework as the clearing models in the UK and in the EU are the same.

[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.

Against this backdrop and to create a level playing field with the EU regime, **we request that the PRA treat derivatives client clearing as an activity that meets the conditions for interdependent assets and liabilities, and therefore allow impacted institutions to set RSF and ASF factors to zero**. We are of the view that client clearing activity, both in the context of exchange traded derivatives and cleared OTC derivatives, meets all the Basel III requirements and CRR II requirements for interdependent assets and liabilities, and consequently does not require any stable funding as it does not present a stable funding risk. We also do not believe that each institution should be required to apply to the PRA for permission to benefit from this exemption, as envisaged in the EU rules, and that the PRA rules should explicitly confirm that derivatives client clearing ***is exempt from required stable funding and from NSFR in its entirety*** without the need to obtain specific regulatory approval.

b) RSF factors – gross derivatives liabilities

As explained in point 1.a) above, we believe that derivatives client clearing should be distinguished from the treatment of OTC derivatives under the NSFR rules and that it does not require any stable funding.

However, the 5% required stable funding factor will still apply in the context of CM's proprietary derivatives clearing, which raises a practical and implementation concern, because of operational complexities of grossing up liabilities for transactions where variation margin (VM) is settled to market (STM) on a daily basis (as opposed to where it is treated as collateral). It is operationally challenging for clearing firms to determine the fair value of a derivative contract gross of the margin posted, where that margin is settled to market (e.g. futures and cleared OTC, where STM applies), as grossing up liabilities that are settled to market is not really tracked anywhere, commonly defined or published by CCPs.

2. LCR

a) Treatment of client cleared derivatives

The CRR II LCR rules which are being transposed into UK rules treat all derivatives equally, with no differentiation between cleared derivatives (e.g., exchange-traded derivatives) and bilateral OTC derivatives, or between proprietary derivatives clearing and derivatives client clearing. We believe that derivatives client clearing should be exempt from the LCR requirement.

The current LCR approach in the EU, which the PRA proposes to adopt, can make it more onerous for firms subject to the inflow cap. The inflow cap is more likely to apply to subsidiaries, and more likely to apply to entities engaged in securities activities with large matched books as this tends to inflate the gross notionals. At a parent level, most banks look a bit more diversified and the inflow cap is less likely to apply. The cap states that firms can only use weighted inflows to cover 75% of their weighted outflows in the LCR calculation, so the residual 25% has to be met with HQLA (i.e. unencumbered central bank cash and securities). For firms/CMs subject to the inflow cap, this means cleared derivatives (e.g., exchange-traded derivatives) can be a larger driver of the overall liquidity requirement in the entity for an activity that is largely riskless (at least for the client clearing part, as explained above).

Please see below a few examples of how the LCR treatment of derivatives can be inappropriate for cleared derivatives, such as exchange-traded derivatives.

(1) Contractual flows – firms have to record contractual flows on derivatives, net of eligible collateral, over the next 30 days. For OTC derivatives, this is fine and generally picks up unsecured derivatives

maturing in the next 30 days plus IM on secured derivatives maturing in the next 30 days (VM is liquidity neutral, i.e. the MTM on the trade is offset by VM already paid/received, so net cash outflow on the day it matures should be near zero). For exchange-traded derivatives, these are often short dated, so the gross flows can be large. For client cleared activity, the firm usually has receivables at the CCP/seg accounts that offset their IM liabilities to their clients, but the inflow cap referenced above limits reliance on this. Firms with large exchange-traded derivatives business and subject to the inflow cap can find themselves to hold large amounts of LCR liquidity against essentially riskless activity.

(2) Non-Level 1 collateral – the LCR applies a 20% outflow to all collateral posted that is not cash and is not level 1 HQLA. This is designed to cover potential MTM losses on that collateral in a period of stress, leading to a need for the firm to 'top up' its margin posted. For exchange-traded derivatives, however, most firms are only accepting collateral that is onwardly accepted at the CCP, so any reduction in the value of collateral posted to the CCP would normally be met by calling additional margin from the client. But the LCR rule deals with this asymmetrically by requiring a 20% outflow on the margin posted, without recognizing any potential inflow from the client for margin received. For traditional (i.e. non-cleared) OTC derivatives, this is different as the offset to an OTC derivative may be a cash security, an exchange-traded derivative or another OTC derivative (none of which need to have symmetrical terms and may involve genuine liquidity risk).

(3) Collateral substitution – LCR requires a 100% outflow for collateral that is cash or level 1 HQLA but can be unilaterally substituted by the client and replaced with non-L1 HQLA. On OTC derivatives where the firm is trading as principal, this might be logical but in a listed context, firms usually have collateral terms that mirror the CCP and then add a layer of conservatism. This means if the client makes a substitution, the firm is usually only going to receive collateral it can onwardly pledge to the CCP, meaning the substitution is liquidity neutral.

(4) Excess collateral – LCR requires a 100% outflow for collateral received that can be contractually called by the client. On OTC books, where the population of trades may be fairly static, clients may genuinely find it easy to recall excess margin. But for exchange-traded derivatives, clients can be very active and they may need or want to hold excess margin so as to avoid making intraday payments to their broker, and/or avoid multiple margin calls at end of day. In this sense, it is more normal for clients to maintain excess margin at their broker, and may need to do so if they intend to continue to trading activity.

(5) Historical Look Back Approach – the LCR requires firms to calculate an LCR requirement that is designed to capture mark to market risk on derivative books. It is calculated by looking at each rolling 30 calendar day period in the prior two years, looking for the largest aggregate move in variation margin (or STM) in each 30 day period. The highest net flow – whether positive or negative – is turned into an LCR requirement. For client cleared activity, this should normally be neutral, plus/minus a bit of noise from one day differences in when the firm margins with the CCP vs when it might receive payment from clients, and plus/minus bit of noise if the firm's collateral schedules are more conservative than the CCPs. But the rule is also silent on how to treat placements with segregated client money accounts. These arguably are not flows of margin eligible to be taken into the HLBA calculation as they are placed with other banks as a segregated deposit. If they are excluded, the firm can end up having to reserve large amounts of LCR liquidity for this factor even though overall the firm is largely riskless on this activity.

On the basis of the comments above, we **ask that derivatives client clearing be exempt from the LCR calculation**, which we understand is the case under the US LCR rules, and that **a consideration is given to whether the UK LCR rules need to make a distinction between the treatment of bilateral OTC derivatives and cleared derivatives**. The EU LCR rules seem to be drafted with bilateral OTC derivatives in mind and do not cater well for the specifics of cleared derivatives, such as exchange-traded derivatives.

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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