FESE response to the EBA consultation paper on the Draft RTS related to the implementation of a new prudential regime

4th September 2020, Brussels

Q1 - Is the proposed articulation of the K-factors calculation methods, in particular between AUM and CMH and ASA, exhaustive or should any other element be considered?

Art. 8(1) and 10(1) of the Draft RTS 7[1] set out the instruments that investment firms ("IFs") must include as cash trades when calculating client orders handled ("COH") and daily trade flows ("DTF") pursuant to Art. 33 of IFR. Art. 9 and 11 of the Draft RTS 7 set out methods of measuring derivatives for the purpose of COH and DTF respectively. The wording used in Art. 8 & 10 and in Art. 9 & 11 of Draft RTS 7 are broadly similar.[2]

Our understanding of EBA's intentions is that all exchange traded options (including options on futures) be subject to the charges for cash trades described in Art. 8(2) of RTS 7. While we support EBA's intention, we would like to highlight that further amendments may be required to result in such a state of affairs.

The term "derivatives", is defined in the Level 1 text, Art. 4(1)(10) of IFR, which in turn refers to Art. 2(1)(29) of the Markets in Financial Instruments Regulation ("MiFIR"),[3] which in turn refers to Art. 4(1)(44)(c) and Annex I, Section C (4) to (10) of the Markets in Financial Instruments Directive.[4] This includes a broad range of options, including on futures, commodities and securities.

Art. 9 and 11 of RTS 7 make provision for the COH and DTF charges respectively for all derivatives, which in principle will therefore include all options. However, "exchange-traded options" have also been included within "cash trades" pursuant to Art. 8(1)(d) and 8(2) and 10(1)(d) and 10(2) of RTS 7.

It seems tolerably clear that the relevant COH and DTF charges for over-the-counter options would be governed by Art. 9 and 11 of the RTS. However, the current drafting is potentially problematic as regards (i) exchange traded options in general, because it is unclear whether these are always included as cash trades, derivatives or both; or (ii) exchange traded options on securities versus other kinds of exchange traded options, which even less naturally fall under the definition of "cash trades". The treatment of any exchange traded options as both derivatives and cash trades would doubtless be a perverse

1 Draft RTS to specify the methods for measuring the K-factors, EBA Consultation Paper, pp. 49 *et seq.*

2 Subject to a typographical error, namely the use of "(a)" when "(d)" is presumably intended in Art. 10(2).

3 Regulation (EU) No 600/2014.

4 Directive 2014/65/EU.

interpretation of RTS 7, since it could lead to a double counting, yet as it stands, this is the more natural interpretation of the words currently proposed.

There would be two conceptual ways of resolving the potential unclarities in the current drafting: (a) introduce a provision allowing the options premium approach to be applied for options that are derivatives, reflecting the approach available for those options which are included in the "cash trades" sections, or (b) exclude exchange-traded options from the scope of derivative transactions for the purposes of calculating COH and DTF, by inserting a cross-reference for the provision relating to cash trades (with the available options premium). We understand that the latter is the intended approach, since the higher charge for cash trades in general is supposedly intended to apply to exchange-traded options, as well as the usage of options premium. [5]

It should be noted that introducing a distinction between sub-categories of derivatives might give rise to a perception that the adjustment for the time to maturity available under Art. 33(2)(b) of IFR would apply only to "true" derivative transactions (i.e. excluding exchange traded options, which are counted as cash transactions). Wording should be introduced to clarify that this is not intended.

Art. 8(2) and 10(2) of RTS 7 provide that, where the transferable security to be measured for the purposes for COH or DTF is an exchange traded option, the IF must use the option premium used for the execution of that exchange traded option. The reason to include exchange traded options, with premium paid for such options, is that the buyer is buying the option (financial instrument) and settles the market value of that option, which is the premium of the option.

However, it is unclear how these provisions relate to portfolios. As currently drafted, it is arguable that the option premium to be used should be calculated on a leg-by-leg basis, rather than based on the spread of the options taken as a portfolio, which is more reflective of the way the market operates in practice.

The following amendment is suggested:

Where the transferable security is an exchange traded option as referred to in paragraph 1(d), the investment firm shall use the option premium used for the execution of that exchange traded option ***or, where the option forms part of a portfolio, the aggregate net option premium of that portfolio****.*

Furthermore, we would like to flag the risk of a disadvantageous treatment of IFs headquartered in the EU resulting from the current draft provisions around the group test computation to determine whether an IF group has to apply for a credit institution authorisation. IFs who have their headquarters in the EU must consider relevant subsidiaries and branches in third countries when calculating whether an IF group's consolidated assets exceed the threshold of 30bn EUR. IFs headquartered in a third country, on the contrary, must only apply for a credit institution authorisation if the consolidated assets of their EU subsidiaries and EU branches exceed the 30bn EUR. This leaves out the calculation of the assets of the third country headquarter and any potential further third-country subsidiaries or branches. The provisions create an unlevel playing field to the detriment of EU IFs and must be corrected to clarify that only the assets of EU entities shall be considered in the group test to validate whether an IF group must

[5] We note, however, that as cash trades, they are subject to a coefficient of 0.1%, rather than the coefficient for derivatives of 0.01% under Art. 15, IFR.

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apply for a credit institution authorisation, independent of where such IF group is headquartered.

Q2 - Are the requirements for notion of segregated accounts sufficient? Are there issues on segregated accounts which need to be elaborated further?

Q3 - Is there any example of situations of market stress which would not been taken into account applying the proposed approach but would be relevant for the measurement of the K-DTF?

FESE agrees with the objectives of EBA to harmonise the way investment firms can adjust the K-DTF coefficients in case of stressed market conditions and to recognise the nature of exchange traded options in the K-DTF formula.

Coefficient adjustments for stressed markets

Market making firms play a specific role within capital markets, and generally find themselves trading frequently throughout a day in order to facilitate end-user interest. This function creates sufficient liquidity for other investment firms to transfer risk in order to achieve their financial objectives. Art. 17 and 48 of MiFID II mandate the binding presence for market-making firms in the most liquid futures contracts. This acknowledges just how vital firms like this are in ensuring that financial markets are liquid in all market conditions. It is therefore likely that market-making firms will experience relatively high capital requirements in relation to K-DTF compared with other types of investment firms. In line with this, it is essential to safeguard well-calibrated prudential requirements to ensure that these firms will not be harmed by a possible disproportionately high capital burden.

K-DTF can fluctuate significantly, especially during stressed markets. Despite Art. 33 of IFR mandating 9-month averaging, volume spikes can still result in volatile and disproportionate capital requirements. Market makers could be forced to stop providing liquidity at times where their liquidity provision is most needed by end-investors. Hence, RTS should specify an operable methodology for realistic K-DTF coefficient adjustments in situations of high volatility.

We support the proposal to link a potential amendment of the K-DTF coefficient to the Commission Delegated Regulation (EU) 2017/578; however, we strongly disagree with amending the coefficient only in “situations of extreme volatility” as referred to in Art. 3 (a) of the Delegated Regulation. In “situations of extreme volatility”, market makers are completely exempted from fulfilling market-making requirements. Meanwhile, in “stressed market conditions”, as referred to in Art. 6 of the Delegated Regulation, market makers shall continue their activity albeit with relaxed conditions. For example, the size to be provided might be reduced and the allowable spread must be widened. This creates a situation where exchanges, in situations of extreme volatility, are strongly encouraged to trigger “stressed market conditions” rather than “exceptional circumstances”. If the requirements to market makers are completely taken away in times of market stress, liquidity risks to be further limited when it is needed the most.

Market reality shows that “situations of extreme volatility” have never been triggered at most FESE members, not even during extreme volatile peaks of the Covid-19 outbreak. We believe, therefore, that the proposed adjustment for K-DTF only in “situations of extreme volatility” would effectively have no real impact on K-DTF calculations and we do not support it. The intention of demanding trading venues to set out parameters to identify periods of market stress, and to incentivise market making during these periods,

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is to prevent the dry-up of liquidity during times of uncertainty. We recommend clarifying Art. 1 and 2 of the Draft RTS for K-DTF and to change the reference of "exceptional circumstances" to "stressed market conditions". This would allow trading venues to further incentivise the provision of liquidity by market makers in those phases.

The usage of the stressed markets condition triggered by exchanges does give rise to practical implementation issues that would need to be resolved. As a simpler alternative to the adjustment linked to MIFID market-making definitions for stressed markets, a more generic statistical method reducing deviations could be defined by EBA, in order to avoid burdensome market makers from identifying stressed markets, which may vary across products and exchanges.

Usage of an options premium

There is a strong ecosystem of principal trading firms who specialise in performing the role of market-making. This group is fundamental to the functioning of liquid exchange-traded options markets. Investment managers that employ the use of options can generate higher returns, particularly when the markets are in times of stress. The mere existence of this form of derivative acts as the backbone of many other forms of investment products, allowing consumers greater choice and varied ways to manage their investments.

Options products are mechanically different from their underlying futures, stock or swap instruments. An option on a futures contract or stock gives the buyer the right, but not the obligation to buy or sell the underlying asset. Therefore, to measure operational risk, meaning to change the position in an option, the holder would need to sell an option if the position is long and buy an option if the position is short. Hence, the option holder would operate rather with an option fee or a premium than with the notional of an underlying. Thus, the maximum loss of an option, in case of a holder taking an incorrect position and not being able to correct it, would be equal to the premium amount. The seller has the obligation to buy or sell the underlying asset if the buyer exercises the agreement. An option can be thought of as a contingent claim where the payout is dependent on the realisation of some uncertain outcome. This is conceptually similar to the mechanics of an insurance policy.

FESE highly appreciates the approach in the draft RTS that an investment firm should include as 'cash trades' transactions where a counterparty undertakes to receive or deliver exchange traded options. As in the draft RTS, for trades that are executed the cash value should be the amount paid or received, for exchange traded options it shall be the premium.

Q4 - What would be appropriate thresholds or events that should trigger the comparison between the calculation under the K-CMG compared to the one under the K-NPR?

Q5 - Which other conditions should be considered to avoid double counting or to prevent regulatory arbitrage in the use of the K-CMG approach?

Art. 23 of IFR allows investment firms to calculate Risk-to-Market based on the margin requirements imposed by the general clearing member that is responsible for settling or clearing a trade for all positions subject to clearing, or on a portfolio basis (where the whole portfolio is subject to clearing or margining). FESE considers that the RTS should recognise the variety in models used by different general clearing members and welcomes EBA's openness to using, for the purposes of the total margin required, the required collateral as per the clearing member's margin model. In addition, FESE believes that it

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should be possible to use K-CMG for trading strategies between EU and third country markets.

FESE highly appreciates the inclusion of K-CMG as a full alternative to K-NPR to calculate an investment firm's Risk-to-Market. An adequate definition of investment firms' capital requirements is key to ensure that investment firms can continue to provide liquidity. Well-calibrated requirements allow for the continued competitiveness of EU investment firms with third-country participants. We also support the proposal to use the margin requirement of a clearing member as a proxy for an investment firm's market risk. Clearing firms and their models are subject to extensive regulatory oversight, plus these models have proven to be resilient and reliable. If a clearing member was to charge their customers (IFs) insufficient margins for their trading portfolios, the primary sufferer in case of an IFs default would be the clearing member themselves. As the clearing member would have to bear all liquidation losses not covered by the margin requirement, the system inevitably prevents a race to the bottom with clearing members competing on margin requirements.

Ensuring the right balance between securing potential future risks and unduly tying-up capital, and hence restraining trading, is of paramount importance for the calibration of all K-factors. We believe that the text of current draft RTS is rather ambiguous. It should be further clarified whether the margin requirement, or the collateral deposited by an IF to fulfil their margin requirement towards a clearing member, shall form the basis of the K-CMG calculation. We would support this as it is a common practice of market participants to overcollateralise their margin requirements. Over the last 12 months, clearing members of Eurex Clearing, a FESE member, were, on average, overcollateralised by 20 to 25%. Overcollateralisation increases operational efficiency, by decreasing the risk of intraday margin calls, stabilises markets particularly in times of increased volatility, and hence must not result in disadvantages for market participants.

Each clearing member, depending on its model, communicate margin requirements towards investment firms once or multiple times during a trading day. Where IFs are informed of their total margin requirement multiple times during a trading day, it seems reasonable to ask them to consider the highest number per day in their K-CMG calculations. However, in any case, the margin requirement considered for K-CMG must be the requirement for all positions in an IF portfolio at the same point in time. From an operational perspective, it would be difficult to combine requirements with different timestamps for different products and it would be also a factually incorrect representation of risk. A combination of different timestamps would result in a risk scenario that de facto has never occurred, and that IFs must not have to capitalise for. Similarly, this also applies when an investment firm uses the services of multiple clearing members. We recommend clarifying that IFs should first sum up their margin requirements across all their clearing members, and subsequently use the third-highest requirement for the K-CMG calculations. As highlighted before, summing up requirements of different days systematically overestimates risk scenarios leading to disproportional capital restraints.

We also believe that the current methodology discourages investment firms to use multiple clearing members, even though, from a macroeconomic risk perspective, the use of multiple clearing members is advantageous for the overall market. Firstly, it increases the likelihood of successful porting of an investment firm's positions in case of a clearing member's default. Secondly, it distributes overall market risk across an increased number of clearing members rendering the default of each clearing member's less significant, *ceteris paribus*. In addition, with a view on creating a level playing field with third-country jurisdictions, an amendment as proposed above would be in line with the rules the FCA intends to implement in the UK with respect to the prudential supervision of investment firms. Depending on each clearing member's margin model, the margins required from an investment firm might not only cover its market risk exposure but might also cover other

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types of risk exposures, like concentration risk. To the extent that other types of risk are already explicitly covered by other K-factors (and provided that a clearing member communicates margin requirements on a sufficiently granular level to differentiate between different types of risk exposures being collateralised), IFs should be entitled to focus solely on the requirements addressing market risk in their K-CMG calculations.

Under Art. 2 of RTS 10,[6] the amount of the total margin referred to in Art. 23(2) of IFR shall be the required amount of collateral in the collateral account comprising the initial margin, variation margins and other financial collateral, as required by the clearing member's margin model from the investment firm.

As drafted, this would include variation margin that has been subject to the settlement to market treatment under Art. 274(2)(c) of the Capital Requirements Regulation ("CRR").[7] The settlement to market treatment under the CRR provides that a CCP determines the current (end of trading day) value of a derivative for the purposes of its own risk management. The CCP then uses this determination to crystallise the contingent profit accruing to the relevant party (resulting from the change in the market value of the derivative since the previous determination), which then becomes due and payable as between the parties, by way of outright transfer of the accrued profit, in accordance with the CCP's procedures. The result is that the exposure of the relevant contracts has been re-set to zero (until the next determination period).

The effect of the settlement to market treatment is that the relevant settlement payment provided to the CCP should not be considered "variation margin" because it is not an asset of the clearing member investment firm recorded on the books and records of the CCP, and so there is no exposure to the CCP with respect to such payments.[8] The payment is an outright cash payment which extinguishes the exposure.[9]

The following amendment is suggested:

4. Any amounts due or paid under contracts in order to settle the outstanding exposure to market, where the terms are reset so that the market value of the contract is re-set to zero as referenced in point (c) of Art. 274(2), Regulation (EU) No 575/2013, shall be excluded from the scope of variation margin for the purposes of paragraph 1.

Q6 - Do you have any comment on the elements included in this Consultation Paper for the application of the aggregation method?

6 Draft RTS to specify the calculation of the amount of the total margin for the calculation of K-CMG, EBA Consultation Paper, pp. 66 *et seq*.

7 Regulation (EU) No 575/2013.

8 Where variation margin is due and payable to the clearing member investment firm by the relevant CCP but such amounts have not actually been transferred, such amounts are still reflected in the books and records of the CCP, and so ought to be included.

9 This is to be contrasted with the mark-to-market treatment, whereby the party out of the money is obliged to provide assets with an equal value to the exposure, without resetting/extinguishing the exposure. The assets used to collateralise the value of the contract are properly included within the scope of "variation margin".

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Q7 - Do you currently use the method of proportional consolidation for the consolidation of subsidiaries in accordance with Art. 18(4) of Regulation (EU) No 575/2013? If proportional consolidation is used, please explain if the conditions included in this Consultation Paper are met.

Q8 - Do you have any comments on the conditions established in this Consultation Paper to apply proportional consolidation to investment firms groups under Regulation (EU) No 2019/2033?

The provisions set in Art. 7 of IFR seem to extend their application on a consolidated basis, globally. At the same time, unlike for banking supervision, which is all rooted in the Basel Framework, no third country has similar, stringent, extraterritorial requirements for investment firm groups. The IFR consolidation regime at the RTS level must be scoped cautiously and proportionately to investment firms' risk profiles as the non-targeted application of the framework may render European investment firms uncompetitive by: o Over-assessing risk and overcapitalising the firms; o Introducing incompatibilities with prudential requirements in other jurisdictions; and o Requiring the use of metrics that are unfit for third-country market structures as they are calibrated to Europe. Therefore, FESE believes that Art. 8 of IFR Group Capital Test (i.e. granting a waiver from the Art. 7 of IFR requirement to consolidate and capitalise under IFR for all group-wide activities globally) should be widely available as originally designed. Additionally, consolidation under Art. 7 of IFR should be sensible and not include locally unregulated/uncapitalised entities or activities, and disapply the K-factor calculation for American and Asian-Pacific market structures for which the K-factors are not suitable (e.g. K-DTF). FESE agrees with EBA's approach, pursuant to Art. 7 of IFR, by which three types of consolidating entities are possible: Union parent investment firms, Union parent investment holding companies, and Union parent mixed financial holding companies.

Q9 - The methods for calculating the K-factors in a consolidated situation may allow for further specifications. Is there any K-factor for which the calculation in the context of the consolidated basis would require further specifications? What aspects should be considered?

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