8 March 2018

FIA Response to the legislative proposal for a Directive and Regulation on the prudential regime for investment firms

We refer to the legislative proposals for a prudential regime for investment firms published by the European Commission on 22nd December 2017 in the form of a Directive and a Regulation.

The European Commission's intention is to create a prudential regime better suited to investment firms as an alternative to CRR / CRD IV, which had been geared towards credit institutions.

FIA members welcome the legislative proposals and support the idea of a calibrated regime taking into account the business of investment firms.

However, FIA members have raised a number of concerns regarding the proposals and make the following recommendations, which are explained in further detail below.

Executive summary

- **Risk to Market (RtM) – K-CMG**

FIA members' key concerns relate to Article 21 and Article 23.

Article 21 - FIA recommends that the language of Article 21 be redrafted to (i) align with recitals (20) and (24) and (ii) make clear that rather than investment firms having to apply the "higher of" K-NPR and K-CMG, the requirement is that when calculating RtM, investment firms must apply K-NPR under Article 22, unless they have been permitted by their competent authority to apply K-CMG under Article 23.

Article 23 - FIA recommends that the proposed Article 23(1)(d) (which limits the availability of K-CMG to those investment firms whose clearing member is a credit institution) is deleted. Otherwise, such differentiation in capital treatment (based upon whether or not the clearing member is a credit institution) would likely result in several non-credit institution clearing members ceasing to provide client clearing services and/or relocating their business outside of the EU. Each such outcome would have a very negative impact on an area of great concern to the European Commission – namely, it would further reduce access to clearing, reduce competition between clearing members, result in clearing being concentrated in a smaller number of firms and could potentially result in investment firms reducing the amount of hedging that they conduct via cleared derivatives, thereby increasing systemic risk.

- **Own Funds requirements**

Article 9 in Part 2 of the proposed Regulation - FIA members recommend that investment firms should be permitted to hold evergreen subordinated debt, with the provision that it can only be repaid if the resulting capital surplus is above a certain threshold.

- **Risk to Market – K-NPR**

Article 22 of the proposed Regulation - FIA members recommend that more time is spent considering these provisions and that consideration be given to the development of some form of FRTB "lite" regime in the intervening five years.

- **Risk to Firm – K-TCD**

Article 26 of the proposed Regulation – FIA members request clarification of the rationale for the application of an 18% supervisory factor for commodities and encourage further analysis before committing a specific percentage to primary legislation.

Article 30 of the proposed Regulation - FIA recommends adding highly liquid commodities (e.g. LME warrants) as eligible collateral to Table 4 of Article 30 of the proposed Regulation.

- **Concentration Risk – K-CON**

Article 36 of the proposed Regulation – FIA members believe that the reference to "regulatory capital" is a typographical error and should be replaced with a reference to "own funds".

- **Liquidity requirement**

Article 42 of the proposed Regulation - FIA recommends that the Commission considers assets in addition to cash and those in Articles 10 to 13 of Commission Delegated Regulation (EU) 2015/61.

FIA member comments

1. **Risk to Market (RtM) – K-CMG**

FIA welcomes the introduction of the concept of calculating RtM by using initial margin (K-CMG).

(a) Aligning Articles 21, 22 and 23 with Recitals 20 and 24

However, FIA echoes the comments made by its affiliate, FIA EPTA, regarding the apparent inconsistency of approach between Articles 21, 22 and 23 of the proposed Regulation.

Recitals (20) and (24) of the proposed Regulation clearly indicate that K-CMG may be used as a credible alternative to K-NPR, where permitted by the competent authority. This is supported by Article 23, which states that a competent authority may allow an investment firm to calculate K-CMG, subject to meeting certain conditions, "by way of derogation from Article 22". However, Article 21 appears to require a different approach and, rather than permit K-CMG to be a legitimate alternative, requires an investment firm to use "the higher of K-NPR calculated in accordance with Article 22 or K-CMG calculated in accordance with Article 23" as the RtM K-factor.

The potential benefit of providing a mechanism under Article 23 which allows investment firms to make a relatively straightforward calculation based on initial margin posted to the clearing member (subject to meeting certain conditions), appears to be contradicted by the Commission requirement for investment firms to undertake not one but two separate calculations of K-NPR and K-CMG in parallel, which will only add complexity and cost to the process of establishing the RtM K-factors.

Recommendation: FIA therefore recommends that the language of Article 21 be amended to permit the use of either K-NPR or K-CMG in order to reflect the intent that, where appropriate, investment firms may be permitted by the competent authority to use K-CMG to calculate RtM.

(b) Deletion of Article 23(1)(d)

FIA would also like to comment on the one of the conditions that an investment firm must meet in order to be able to use K-CMG, specifically Article 23(1)(d), which requires the clearing member of the investment firm to be a credit institution. As the Commission will be aware, a number of EU CCPs currently have as their clearing members investment firms that are not credit institutions (and will not fall under the new definition of credit institution, extended to include Class 1 investment firms). The requirement for clearing members to be credit institutions for K-CMG purposes will unfairly discriminate against investment firm clearing members, creating an un-level playing field for the provision of clearing services (and add an additional barrier to entry for clearing members), which may lead to a reduction in clearing member capacity in Europe, thus concentrating risk in a smaller number of clearing members, in turn increasing systemic risk.

The restriction in Article 23(1)(d) means that those investment firm clients of non-credit institution clearing members will not be permitted to make use of the K-CMG calculation and will be required to calculate K-NPR. The calculation of K-NPR involves the far more complex set of calculations set out in Regulation (EU) No 575/2013, which is considered by FIA members to produce a higher set of capital

requirements than that calculated through K-CMG. The added complexity and cost associated with calculating K-NPR will tend to influence the commercial decisions of investment firm clients, with the result that they may seek to migrate their clearing business to a credit institution clearing member in order to benefit from K-CMG. In consequence, the profitability of a number of non-credit institution clearing members may be severely impacted by the loss of such clearing revenues and may face difficult choices on whether it is viable to continue to provide clearing services. Similarly, a number of investment firm clients of non-credit institution clearing members may not be able to meet the capital requirements of K-NPR but are not sufficiently attractive commercially to be taken on as clients of credit institutions. Accordingly, such investment firm clients may (i) reduce the amount of hedging that they engage in via cleared derivatives, thereby increasing systemic risk and/or (ii) be forced to cease their clearing activity, thus potentially reducing access to clearing for indirect clients.

It is not clear to FIA what particular objective is desired to be attained by the Commission in restricting investment firms to be clients of credit institution clearing members for the purposes of calculating K-CMG, which seems to unfairly discriminate against investment firm clearing members.

Recommendation: In order to remove the potential adverse consequences of Article 23(1)(d) on access to clearing, clearing capacity and diversity in Europe, FIA recommends that proposed Article 23(1)(d) is deleted.

2. Own Funds requirements

One of our biggest areas of concern is the composition of own funds. The proposed Regulation in Article 9 currently broadly copies out the provisions of the CRR. FIA members would welcome some flexibility in terms of the ability to hold evergreen capital instruments.

Many investment firms deal in financial instruments with very short holding periods. Such positions can be liquidated and risk-reduced very quickly. Many investment firms do not hold long term structural positions, which would warrant having long- dated or permanent capital to support them. Furthermore, these markets are often very cyclical, meaning that there are times when markets are quiet that firms will have less risk on their books and therefore need less capital.

Whilst we accept the proposals contain some smoothing or averaging of the capital requirements, which we welcome as it can greatly assist in capital planning, they are limited to six months in duration. Therefore, we are concerned that firms will not have the flexibility to adjust their capital bases, leading to potentially significant capital surpluses, which in turn may reduce the attractiveness of new firms entering these markets and thereby reduce the opportunities for further competition and choice in the sector.

Recommendation: FIA members recommend that the proposed Regulation should allow investment firms to hold evergreen subordinated debt, subject to the proviso that it can only be repaid if the resulting capital surplus is above a certain threshold.

We also believe that the complex myriad of capital instruments allowed under the CRR is unnecessary for commodity firms, whose capital structures we believe to be much simpler.

3. Risk to Market – K-NPR

In Article 22 of the proposed Regulation, the Commission introduces the concept of the Basel Fundamental Review of the Trading Book (FRTB). Whilst FIA members welcome that there is a 5 year transition period to introduce this calculation, and that the K-factor will be discounted by 35% for the standardised approach and the internal model approach, this calculation is not straight forward and investment firms have had very little time to assess the impact. Additional complexity was added by not splitting the positions by asset class, as they are currently under the CRR. Consequently, if a firm is interested in, for example, commodity market risk, it will have to through a significant amount of work to understand the requirements, unlike under the CRR.

FIA members that are active in metals highlight that Article 359 2(b) of the CRR allows positions in contracts maturing within 10 days of each other to be netted if the contracts are traded on markets which have daily delivery dates, such as the London Metal Exchange. Although firms have not had the opportunity to assess the impact of not being able to offset positions within 10 days, the nature of LME member firms' business is such that the capital impact is likely to be prohibitive.

Recommendation: FIA members recommend that more time is spent considering these provisions and that consideration be given to the development of some form of FRTB "lite" regime in the intervening five years.

4. Risk to Firm - K-TCD

FIA members note that the supervisory factor for commodities in Article 26 of the proposed Regulation of 18% is much higher than the equivalent calculation in the CRR. Consequently, FIA members would like to enquire how this figure was determined. As with the K-NPR, investment firms have not had sufficient time to assess the impact of this factor and we therefore suggest that the Commission conducts further analysis of this factor before committing a specific percentage to primary legislation.

Further, FIA members note that Table 4 under Article 30 of the IFR proposal does not include commodities as eligible collateral. FIA commodity investment firm members believe that LME warrants, which LME Clear have obtained regulatory approval for clearing members to use as collateral against margin, should be included in this table.

Recommendation: FIA recommends adding highly liquid commodities (e.g. LME warrants) to Table 4 of Article 30 of the proposed Regulation and to review the supervisory factor for commodities in Article 26 of the proposed Regulation.

5. Concentration risk

FIA's commodity firm members welcome the exemption for commodity firms under Article 41 of the proposed Regulation.

However, Article 36 of the proposed Regulation states that an exposure cannot exceed 25% of regulatory capital, unless it notifies the competent authority and sets aside capital (K-CON). Article 4.1 (42) defines "regulatory capital" as the capital requirement under Article 11 of the proposed

Regulation. FIA members believe that the reference in Article 36 may be a drafting error and that the concentration limit should be calculated as 25% of own funds, as it is in the CRR.

Recommendation: Article 36 should be amended accordingly.

6. Liquidity requirement

FIA members broadly welcome the Commission's proposals for a liquidity regime, which is based on having adequate systems and controls. However, commodity investment firms are disappointed that highly liquid physical commodities cannot be included in the liquidity requirement. For example, many commodity firms active in metals trading hold LME warrants and include them as liquid assets in their internal liquidity monitoring programmes and there would be a disconnect between what the firms consider as liquid assets and what are treated as liquid assets for regulatory purposes. Commodity firms believe that such assets are far more liquid than trade debtors and fees/commissions receivables, which can be included, subject to certain conditions.

Recommendation: For the purposed of Article 42 of the proposed Regulation, FIA recommends that the Commission considers assets in addition to cash and those in Articles 10 to 13 of Commission Delegated Regulation (EU) 2015/61.
