DEUTSCHE BÖRSE GROUP

Deutsche Börse Group

Response on EBA´s consultation paper

"Consultation Paper on Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms"

Frankfurt am Main, 4 September 2020

A. Introduction

Deutsche Börse Group (DBG) welcomes the opportunity to comment on EBA´s "Consultation Paper on Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms ".

We welcomed the new prudential rules for investment firms, which have been introduced 2019 in the Directive (EU) 2019/2034 (IFD) and the Regulation (EU) 2019/2033 (IFR), as they recognized the important role investment firms play in the overall eco-system of EU financial markets.

We would like to respond to this consultation paper, as our company is affected directly by the new prudential regime for investment firms, due to several investment firms within our group structure (Eurex Repo, Eurex STS and 360T), and indirectly, through our clients.

Besides this, DBG is operating in the area of financial markets along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments, hence as a provider of regulated Financial Market Infrastructure (FMI).

Please find hereunder a short summary of our key comments (paragraph B).

Further, DBG wants to comment explicitly on questions referring to K-DTF, K-CMG, the application of the aggregation method, the scope of consolidation and other important issues/sections, which are not covered by EBA`s questions (paragraphs C and D).

If you have further questions, do not hesitate to reach out.

B. Executive summary

Q3 (section 9): 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?

- From our point of view, we think that the 9-month rolling average mandated in Article 33 IFR is still not enough to smooth out volume spikes during trading spikes.
- DBG recommends amending Article 1 and 2 of the draft Regulatory Technical Standards (RTS) for K-DTF and to replace the reference to "exceptional circumstances" with "stressed market conditions". In our opinion and according to our calculations, a definition of "stressed market conditions" as trigger for an amended coefficient in the calculation of K-DTF would bring valuable and important relief compared to the current draft RTS.

Q5 (section 10): Which other conditions should be considered to avoid double counting or to prevent regulatory arbitrage in the use of the K-CMG approach?

- DBG highly appreciates the inclusion of K-CMG as a full alternative to K-NPR to calculate an investment firm's Risk-to-Market.
- However, the text of the draft RTS is somewhat ambiguous on whether the margin requirement or the collateral deposited by an investment firm to fulfill their margin requirement towards a clearing member shall form the basis of the K-CMG calculation. DBG strongly recommends the use of the former.
- In the case of multiple clearing members and contrary to the proposal of the draft RTS, DBG strongly recommends defining that investment firms should first sum up their margin requirements across all their clearing members, and subsequently use the third highest requirement for the K-CMG calculations.
- Finally, we believe that the wording around an investment firm's choice of K-CMG versus K-NPR could be further enhanced to embrace the introduction of K-CMG as a fully-fledged alternative to K-NPR in the Level 1 regulatory text.

Additional comments on section 4: Draft RTS on the information to be provided for the authorization of investment firms as credit institutions (Article 8a(6) point a) of the CRD)

- It is our understanding that large investment firms, that (i) deal on own account, underwrite financial instruments or place financial instruments on a firm commitment basis, (ii) exceed the EUR 15bn threshold as stipulated in Article 1(2) IFR, but (iii) do not exceed the EUR 30bn threshold from Article 4(1)(1)(b) CRR (as amended), will continue to qualify as investment firms while being obligated to comply with the prudential requirements in CRR/CRD instead of IFR/IFD. For complete certainty and clarity, it would be desirable to have a recital inserted which confirms that such firms do not need to seek authorization as a credit institution according to Article 8a CRD (as amended).

Additional comments on section 5: Draft RTS on the calculation of the threshold referred to in Article 4(1)(1b) CRR (Article 8a(6) point b) of the CRD)

- We strongly believe that within each category of investment firms, a level playing field must exist across all investment firm (groups), independent of where they are headquartered. However, we fear that this level playing field is not achieved by the current draft RTS.
- We are particularly concerned, that the current draft provisions around the group test computation to determine whether an investment firm group has to apply for a credit institution authorisation, would result in a disadvantageous treatment of investment firm groups headquartered in the EU.
- DBG strongly recommends a clarification in the RTS that only the assets of EU entities shall be considered in the group test to validate whether an investment firm group must apply for a credit institution authorization, independent of where such investment firm group is headquartered.

Additional comments on section 6: Draft RTS to specify the calculation of the fixed overheads requirement and to define the notion of a material change (Article 13 (4) of the IFR)

- For clarity purposes, the existing wording from Article 34b(2) of the Delegated Regulation (EU) No 241/2014 could be used regarding the principle of deduction.
- Moreover, the list in Article 1(6) of the draft RTS could be more comprehensive and therefore also include the items of deduction mentioned in Article 13(4) IFR.

Additional comments on section 7: Draft RTS to specify the methods for measuring the K-factors (Article 15(5), point a) of the IFR)

- DBG supports the approach in the draft RTS to use the options premium as a proxy for the operational risk, as this amended definition corresponds with the risk taken by the position. DBG is also in favour of the clarification regarding the use of a “cash trade” multiplier, including transactions, where a counterparty undertakes to receive or deliver exchange traded options.
- However, as there is no definition of “client money” in IFR, MiFID II or its delegated acts, an explicit exclusion of collateral from K-CMH would provide additional clarity. This could be inserted in Article 4 on the draft RTS specifying the methods for measuring the K-factors referred to in Article 15 IFR.

Additional comments on section 11: Draft RTS on the criteria for subjecting certain investment firms to the CRR (Article 5 (6) of the IFD)

- To protect and further strengthen the attractiveness and competitiveness of the EU financial market, the IFR/IFD framework should not be fully applicable to non-EU entities of EU investment firm groups, if a respective consideration of EU-entities of non-EU investment firm groups is not mirrored by third countries’ legislation.

Additional comments on section 12: Draft RTS on prudential consolidation of investment firms groups (Article 7(5) of the IFR)

- To provide continuity and minimize adaption costs for existing groups, EBA could make use of its mandate in Article 7(5) IFR to further specify the details of the scope of prudential consolidation by introducing a provision for investment firm groups comparable to Article 19 CRR.
- National Competent Authorities (NCAs) should be able to generally exempt investment firms from consolidation, including exemption of non-EU entities of EU investment firm groups from consolidation. This would contribute to protect and further strengthen the attractiveness and competitiveness of the EU financial market. As such, the full IFR/IFD framework should not be applicable to non-EU entities of EU investment firm groups, if a respective consideration of EU-entities of non-EU investment firm groups is not mirrored by third countries' legislation.

C. Responses to the questions for consultation

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?

As a general remark to the K-DTF, we think that the 9-month rolling average mandated in Article 33 IFR does help to smooth the volume spikes. However, this might still not be enough as firms still have to face high trading spikes, which can lead to volatile and disproportionate capital requirements for some investment firms, especially for those pursuing a market making strategy.

Periods of extreme volatility

Market making investment firms play an important role to increase liquidity and maintain the efficiency in the markets, and they represent an essential part of the overall market infrastructure.

Therefore, it is essential to safeguard well-calibrated prudential requirements for market making firms in order to not let them experience disproportionately high capital burden in relation to K-DTF compared with other types of investment firms.

This is relevant, as market makers (in contrast to other investment firms) are obliged to provide liquidity on trading venues, even in stressed markets conditions. This obligation is defined in the market making agreements between a trading venue and an investment firm, which is a provision prescribed in Delegated Regulation 2017/578. As stated in the Delegated Regulation, trading venues must set out parameters to identify stressed market conditions and define a scheme for incentives and requirements for market makers during these conditions, to incentivise them to provide liquidity (Article 6).

This overall concept is well-proven, widely accepted and in full alignment with trading venues' mandate to ensure proper trading conditions and works as intended. This was recently demonstrated by the COVID-19 induced strong market volatilities in Q1/Q2 2020.

In this context, while trading venues have implemented specific market design provisions to preserve liquidity provision, we think that it is important to support this objective also from a prudential perspective.

From our perspective, this can be achieved best by linking the application of adjusted coefficients and the adjacent alleviations for the calculation of capital requirements to stressed market conditions. Therefore, DBG recommends amending Article 1 and 2 of the draft RTS for K-DTF and to replace the reference to "exceptional circumstances" with "stressed market conditions", which would bring valuable and important relief compared to the current draft RTS.

While this would still result in decreased capital requirements during times of high volatility, spikes in capital requirements would be significantly smoothened and hence investment firms would be enabled to continue to provide liquidity during times of market stress.

Eurex has conducted a quantitative analysis for the K-DTF under "stressed market conditions" to support the argument with data evidence. In the simulation, the formula provided by the consultation paper was used and substituted by the definition of "stressed market conditions". We compared the average notional amount of trading volumes across all our trading members over two six months periods, with and without the “stressed market conditions” adjustment: January to June 2019, as it was considered a period with no specific events or increased volatility, and January to June 2020, as a volatile period due the COVID-19 crisis[1].

Results have shown that, under the assumption of “exceptional circumstances” as trigger point, there was a 35% increase of the average daily notional amount in June 2020 compared to the same period in June 2019. In contrast, under “stressed market conditions”, the increase in average daily notional from 2019 to 2020 was reduced to 11%. In terms of absolute average daily notional amount, the change of the coefficient using “stressed market conditions” for the period from January-June 2019, the adjustment reduced the average daily notional by 1%. The exclusion of stressed markets in the time from January-June 2020, the adjustment reduced the absolute average daily notional by 19%.

We believe these numbers demonstrate the urgent need to adjust the coefficient in the K-DTF calculation during times of market stress, and we believe that a reference to “stressed market conditions” as defined in MiFID II RTS 8 provides a reasonable approach of how such adjustment can be achieved to ensure investment firms’ continued provision of liquidity during times of market stress. Nonetheless, DBG is aware that a reference to “stressed market conditions” would not come without operational challenges for investment firms and appreciates that comparable results could also be achieved by a more generic statistical method reducing outliers in terms of notional trading volume.

[1] Please note that all Interest Rate Derivatives have been excluded from this analysis, as due to the large amount of data, it was not possible to include the maturity multiplier applicable for Interest rate derivatives according to Article 33 (2) IFR.

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

Generally, DBG 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 the foundation of ensuring investment firms can continue to provide liquidity in key asset classes and risk management products that are widely used by all types of market participants including end-investors. Further, well-calibrated requirements ensure continued competitiveness of EU investment firms with third-country participants.

Using the margin requirement of a clearing member as a proxy for an investment firm's market risk is very convincing. Not only are clearing firms and their models subject to wide-ranging regulatory oversight, but these models also have proven to be resilient and reliable over decades, including in crisis situations. The system prevents a "race to the bottom", with clearing members competing on margin requirements, as the clearing member would have to bear all liquidation losses not covered by the margin requirement provided by their clients (investment firms).

Calculation of the amount of the total margin required

With respect to the RTS, the trade-off between hedging against potential future risks and unduly tying-up capital and hence restraining trading, is of paramount importance for the calibration of all K-factors. With Eurex Clearing, one of the global leading central counterparties, being part of DBG, we have been addressing this very trade-off on a day to day basis for decades. Consequently, we would like to highlight the following points to ensure proportionality, prudential soundness and a level playing field between different types of market participants:

The text of the draft RTS is somewhat ambiguous on whether the margin requirement or the collateral deposited by an investment firm to fulfill their margin requirement towards a clearing member shall form the basis of the K-CMG calculation. DBG strongly recommends the use of the former.

It is common practice of market participants to over-collateralize their margin requirements. Over the last 12 months, clearing members of Eurex Clearing were, on average, overcollateralized by 20-25%. Over-collateralization increases operational efficiency, by decreasing the risk of intraday margin calls, stabilizes markets particularly in times of increased volatility and hence must not result in disadvantages for market participants.

Method of calculation of K-CMG in case of multiple clearing members

The same logic applies where an investment firm uses the services of multiple clearing members. Contrary to the proposal of the draft RTS, DBG strongly recommends defining that investment firms 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, the current proposal of "summing-up requirements" of different days would systematically overestimate the risk scenario, which would lead to disproportionally high capital restraints for the investment firms. Further, 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 clearly advantageous for the overall market:

Firstly, it increases the likelihood of successfully porting an investment firm's positions in case of a clearing member's default, and 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. Finally, 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 Financial Conduct Authority (FCA) intends to implement in the United Kingdom (UK) with respect to the prudential supervision of investment firms[2].

Further, depending on each clearing member's margin model, the margins required from an investment firm might not only cover the investment firm's market risk exposure but might also cover other types of risk exposures, e.g. 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 collateralized), investment firms should be entitled to focus solely on the requirements addressing market risk in their K-CMG calculations.

Prevention of arbitrage

Finally, we believe that the wording around an investment firm's choice of K-CMG versus K-NPR could be further enhanced to embrace the introduction of K-CMG as a fully-fledged alternative to K-NPR in the Level 1 regulatory text. In particular, it would be beneficial for the RTS to clarify that the mere existence of a (significant) difference between the amounts calculated under K-CMG and K-NPR is to be expected for certain investment firms and business models and that this difference is in itself is no indication of an attempted engagement in regulatory arbitrage.

[2] Please see: https://fca.org.uk/publication/discussion/dp20-2.pdf (as of 31 August 2020)

D. Additional comments to the draft RTS without specific questions for consultation

Section 4: Draft RTS on the information to be provided for the authorization of investment firms as credit institutions (Article 8a(6) point a) of the CRD)

Article 1(2) IFR requires specific investment firms with a value of consolidated assets exceeding EUR 15 bn to apply the requirements of CRR while Article 4(1)(1)(b) CRR classifies investment firms with a total value of consolidated assets exceeding EUR 30bn as credit institutions.

It is our understanding that large investment firms, that (i) deal on own account, underwrite financial instruments or place financial instruments on a firm commitment basis, (ii) exceed the EUR 15bn threshold as stipulated in Article 1(2) IFR, but (iii) do not exceed the EUR 30bn threshold from Article 4(1)(1)(b) CRR (as amended), will continue to qualify as investment firms, while being obligated to comply with the prudential requirements in CRR/CRD instead of IFR/IFD. For complete certainty and clarity, it would be desirable to have a recital inserted which confirms that such firms do not need to seek authorization as a credit institution according to Article 8a CRD (as amended).

Section 5: Draft RTS on the calculation of the threshold referred to in Article 4(1)(1b) CRR (Article 8a(6) point b) of the CRD)

DBG fully understands and appreciates the introduction of different classes of investment firms as part of the new prudential regime for investment firms.

We agree that investment firms vary quite significantly in terms of their activity, their size and ultimately the risk they pose to the overall financial market, and we welcome the regulators' careful consideration of these differences in defining a most appropriate regulatory framework for different categories of investment firms (most notably subjecting some investment firms to the CRR/CRD framework and others to the IFR/IFD framework).Further, we strongly believe that within each category of investment firms, a level playing field must exist across all investment firm (groups), independent of where they are headquartered.

However, we fear that this level playing field is not achieved by the current draft RTS. We are particularly concerned, that the current draft provisions around the group test computation to determine whether an investment firm group has to apply for a credit institution authorisation, would result in a disadvantageous treatment of investment firm groups headquartered in the EU.

According to Article 8*,* when calculating whether an investment firm group's consolidated assets exceed the threshold of EUR 30bn, investment firms who have their headquarter in the EU, must consider relevant subsidiaries and branches in third countries in the respective calculations. Meanwhile, investment firms headquartered in a third country must only apply for a credit institution authorization if the consolidated assets of their EU subsidiaries and EU branches exceed the EUR 30bn, leaving out of the calculation the assets of the third country headquarter and any potential further third country subsidiaries or branches.

This unequal consideration of assets depending on an investment firm groups headquarter would encourage investment firm groups to move their headquarters to outside of the EU, to receive a more preferential regulatory treatment, and would directly contradict with the goal of strengthening the Capital Markets Union.

To prevent any unintended consequences, DBG strongly recommends clarifying in the RTS that only the assets of EU entities shall be considered in the group test to validate whether an investment firm group must apply for a credit institution authorization, independent of where such investment firm group is headquartered.

Section 6: Draft RTS to specify the calculation of the fixed overheads requirement and to define the notion of a material change (Article 13 (4) of the IFR)

Article 1(6) of the draft RTS does not explicitly mention the principle of deduction (as currently explicitly stated in Article 34b(2) of Delegated Regulation (EU) No 241/2014, as amended). For clarity purposes, the existing wording from Article 34b(2) of the aforementioned Delegated Regulation could be used ("…by subtracting the following items from the total expenses…"). Moreover, the list in Article 1(6) of the draft RTS could be more comprehensive and therefore also include the items of deduction mentioned in Article 13(4) IFR.

Furthermore, we fully welcome the deduction of payments related to contract-based profit and loss transfer agreements.

Section 7: Draft RTS to specify the methods for measuring the K-factors (Article 15(5), point a) of the IFR)

With regard to Article 10 (2) of the RTS, DBG appreciates and supports the approach in the draft RTS use of the options premium as a proxy for the operational risk as this amended definition is aligned with the risk taken by the position. DBG is also in favour of the clarification regarding the use of a "cash trade" multiplier, including transactions, where a counterparty undertakes to receive or deliver exchange traded options.

Regarding K-CMH, it is our understanding that where a client transfers full ownership of money to a firm for the purpose of securing or otherwise covering present or future, actual or contingent or prospective its obligations, such money should not be regarded as "client money" for the purpose of calculating K-CMH. Although the exclusion of collateral from client money was explicitly mentioned in recital (27) of Directive 2004/39/EC (MiFID), there is no such provision in IFR or MiFID II. Moreover, as there is no definition of "client money" in IFR, MiFID II or its delegated acts, an explicit exclusion of collateral from K-CMH would provide additional clarity. This could be inserted in Article 4 on the draft RTS specifying the methods for measuring the K-factors referred to in Article 15 IFR.

Section 12: Draft RTS on prudential consolidation of investment firms groups (Article 7(5) of the IFR)

DBG fully understands the regulators' intention to harmonize, to the extent appropriate, the scope and methods of prudential consolidation between banking and investment firm groups and welcomes EBA's general approach of building upon existing material to specify the consolidation requirements in IFR. However, while prudential requirements for banking groups (including the definition of capital requirements) are common and widely applicable globally, comparable rules for investment firms remain a novelty.

In this context, it should be noted that Article 19 CRR enables the exclusion of certain group entities from consolidation in case the total amount of assets and off-balance sheet items does not exceed a certain threshold or in case such an exclusion is allowed by an individual decision by the competent authorities. Although Article 8 IFR enables NCAs to allow sufficiently simple group structures to comply with a group capital test instead of complying with IFR on a consolidated basis, it does not foresee a general exclusion comparable to the one of Article 19 CRR.

To provide continuity and minimize adaption costs for existing groups, EBA could make use of its mandate in Article 7(5) IFR to further specify the details of the scope of prudential consolidation by introducing a comparable provision for investment firm groups. Article 6 and 7 of the draft RTS only provide the group supervisor with the possibility to permit the use of another method than full consolidation or to permit the use of proportional consolidation. This is insufficient and should be extended to the possibility for the group supervisor to permit a full exclusion from consolidation on a case-by-case basis similar to the possibility for competent authorities as stipulated in Article 19 CRR.

Introducing appropriate objective thresholds comparable to those in Article 19 CRR will minimize the burden of individual assessments to be conducted by competent authorities, while it would provide additional certainty on the application of new requirements to investment firms. Investment firms certainly benefitting from one of the currently foreseen exemptions from full consolidation would not run into the risk of falling temporarily (i.e. until the competent authority's decision) under consolidated supervision, including the temporary but nevertheless cost-intensive implementation of consolidation requirements.

In addition to the above, we believe that the extent to which NCAs will make use of their power to allow for a group capital test pursuant to Article 8 IFR, instead of consolidation as described in Article 7 IFR, will have a very significant influence on investment firms' decisions to establish and maintain office within the EU vs outside of the EU. By introducing a possibility for NCAs to generally exempt an investment firm from consolidation (as described above), NCAs should be able to also exclude non-EU entities of EU investment firm groups from consolidation.

This would contribute to protect and further strengthen the attractiveness and competitiveness of the EU financial market. As such, the full IFR/IFD framework should not be applicable to non-EU entities of EU investment firm groups, if a respective consideration of EU-entities of non-EU investment firm groups is not mirrored by third countries' legislation.

Such consideration of maintaining a level playing field across jurisdictions is particularly important in light of the FCA's recent indication, that they expect many investment firm groups in the UK to be able to benefit from a group-capital-test-like provision, that is to be included into the UK's new regulatory framework for investment firms[3].

[3] Please see: https://fca.org.uk/publication/discussion/dp20-2.pdf (as of 31 August 2020)