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From: To:	FR Delegation Working party on Financial Services (IFS)
Subject:	K-CMG case study from the French delegation

France

K-CMG case study – Council WP on Financial Services (IFS)

France welcomes the Commission's aim of increasing proportionality and risk-sensitivity of the requirements applicable to investment firms (IF) and fully subscribe to the EBA statement in its 2017 opinion that the "principal objectives of the new prudential framework for investment firms are to **strengthen the stability of financial markets**, protect customers and ensure an orderly wind-down of failing investment firms".

During the last WP, we had discussions on the soundness of the new prudential framework applicable to IF, the so-called K-factor regime. In this regard, the K-factors for determining the capital requirements for market risk (K-NPR; K-CMG) was one of the most controversial issue. Over the last meetings, we have voiced our hesitation on the direction of the IFS prudential regime. Among our concerns is the move to have K-CMG as a full alternative method for the computation of market-risk along K-NPR.

In our view, using K-CMG would entail the following consequences:

- Reduce capital requirements for market risk ;
- Move to a situation where prudential requirements would effectively be set by private actors operating in a competitive environment ;
- Entail important conflict of interests between the clearing members / QCCP and the investment firms ;
- Undermine the single rulebook as clearing members / QCCP could have very different margining requirements ;
- Reduce the ability of supervisors to effectively control market-risk models, as clearing members are not necessarily within reach of EU authorities.

Some of these concerns could be illustrated by the following market event that happened in September 2018: a Norwegian trader, carrying out derivatives operations in European electricity markets, underwent severe losses. See the following links for a brief description of the case:

- https://www.ft.com/content/43c74e02-b749-11e8-bbc3-ccd7de085ffe ;
- https://www.bloomberg.com/news/articles/2018-09-13/trader-gets-expelled-from-nasdaq-power-market-after-defaulting.

In summary, the prop trader had a direct access to a CCP (Nasdaq Clearing OMX). He built a significant spread position on German and Nordic electricity price plus a directional position on Nordic electricity price. Following spread widening and prices moves, the trader was not able to honour margin calls from the CCP and eventually defaulted on Tuesday 11th. Nasdaq Clearing liquidated the portfolio and final losses (**114M€**) were much higher than margin posted by the defaulted member. The losses has been absorbed by the default fund (107M€) and CCP own funds (7M€). Clearing members were called in urgency to restore the fund.

From this case, we are inclined to draw the following lessons:

- **Using margining requirements for estimating market-risks capital requirements could be inappropriate**
    - *(i)* They could be under-calibrated (margin requirements reached 36M€ the day before default[1] but were significantly lower than the 114 M€ final loss). Current safeguards regarding margining models in article 23 of IFR compromise text are also not sufficient[2] ;
    - *(ii)* They aim to capture short-term risks (~2 days), to be compared with a 10 days horizon in CRR world (VaR models for market risk).
- **IF can suffer from large losses due to CCP exposure.** Current IFR falls short of setting own funds requirements for firms' exposures to CCP, in contrast to CRR.
- **Even relatively small market players can build significant positions and impact the markets in a sizeable manner**. In this case, an individual (smaller than a current class 2 investment firms), operating on his own account, ended up consuming 2/3 of the mutual default fund of a Member State CCP. This individual was most probably not the main exposure of the CCP.

We would like to ask if other Member States share the following conclusions:

- **1/ Using K-CMG could underestimate IF capital requirements and have unintended consequences, as illustrated by the default of the Norwegian trader ;**
- **2/ The use of K-CMG should be framed by appropriate safeguards (e.g. MAX of [K-NPR; K-CMG] as drafted in the Commission's initial proposal) ;**
- **3/ Own funds requirements related to CCP exposures (art. 300 to 311 of CRR) should be introduced in IFR, in relation with the K-TCD framework.**

We would also kindly request the Presidency and the Commission to provide its views on how to address the fundamental shortcomings of kCMG, especially in light of item 3 above (treatment of IF exposures to CCP, which are left unaddressed in the proposal) need to strengthen K-factor regime in light of the previous example.

Since the event happened very recently, we prepared this brief analysis at short notice, but we stand ready to work with other Member States on relevant safeguards and drafting suggestions for the next WP.

[1] And potentially much lower in previous month

[2] According to the CCP public website, margin requirement for electricity derivatives are calculated with a SPAN model, 2 days horizon and confidence level of 99,2% which could have met article 23 requirements with the current drafting