
CRD IV

4 May 2012

Treatment of Exchange-Traded Derivatives

The Issue

AFME is seeking clarity and certainty in respect of the treatment of exchange-traded derivatives (ETDs) under CRD IV Regulation (CRR). AFME is recommending excluding ETDs from the transaction types set out in Annex II. The regulatory treatment of ETD transactions under an Over-the-Counter (OTC) derivatives approach has a number of impacts or consequences compared with the exposure methodology that regulators have permitted firms to utilise since the implementation of Basel II.

There are two main reasons why clarity and certainty around this issue is required: first, the impact on prudential calculations (capital & leverage) and second, the need to significantly change institutions' systems to feed ETD data into OTC calculation engines. This latter impact cannot be underestimated as it is a fundamental change and is one very few institutions have probably committed to at this point because of the drain on scarce resources and the cost should it turn out that ETDs should not be treated using OTC approaches.

Potential Impacts and Consequences

The regulatory treatment of ETD transactions under an OTC derivatives approach has a number of other impacts or consequences compared with the exposure methodology that regulators have permitted firms to utilise since the implementation of Basel II. Some of the changes that firms will need to consider which might require extensive systems changes and potential legal opinions will include:

1. The need for the calculation of a Potential Future Exposure (PFE) add-on or recognition of future exposure under derivative credit models.
2. Margin period of risk (MPOR) - likely to be 20 days given that the portfolio sizes of individual ETD trades are large and could easily top 5000. However, the Basel paper on CCPs (25 November 2011) indicated that MPOR provisions may not apply to exposures to qualifying CCPs under IMM as follows: Paragraph 110 "In the case of IMM banks, the 20-day floor for the margin period of risk as established in the first bullet point of paragraph 41(i) of Annex 4, included by the Basel III framework, will not apply, provided that the netting set does not contain illiquid collateral or exotic trades and provided there are no disputed trades. This refers to exposure calculations under IMM, or the IMM short cut method...". However, this carve out wouldn't help with non-qualifying CCP trades, non-modelled exposure approaches or with client or intermediate broker trades. Moreover, the CRR does not have the Basel III language at present.
3. Also, under IMM stressed Expected Positive Exposure (EPE) will need to be calculated for ETD trades.
4. ETD trade exposures would/could fall into the CVA requirement except for transactions with CCPs. The CRR and Basel III texts set the scope of the CVA capital charge specifically to OTC derivative instruments (paragraph 97 and Article 372 respectively), so there may be a way to technically exclude ETD. But

since neither text deals directly with ETD relying on an exclusion based solely on this may be dangerous and imprudent.

5. There is then the whole issue around how to make ETD transactions fit OTC exposure architecture. For instance, do we have only one day's Replacement Value (RV) because effectively each trade is settled to its End-of-Day (EOD) market value when variation margin is paid/received the following day? Consequently, if the trades are effectively settling on a daily basis then under Article 269(2)(c) the add-on applicable will be the lowest for each product in the standardised add-ons table. In respect of the relevant notional can we use the notional associated with the net position in each contract or do we have to apply an add-on to each open trade? Some exchanges close matching contracts to leave a net position so this might be helpful in avoiding multiple add-ons. But for those exchanges where matching contracts are not closed would we be able to utilise the perfectly matching contracts rule under Article 292(2), effectively matching ETD trades under an OTC rule to arrive a net position for the contract along with a matched position with a notional equal to the net receipts? There are other issues around applying the net-to-gross ratio using the mark-to-market method and, of course, how to recognise ETD in an EPE IMM model.
6. Finally, there is the issue of whether ETD is included within derivatives for the Leverage Ratio. If so then being able to calculate ETD exposure under the mark-to-market method, for example, will become a requirement for firms.