Loco London precious metals

Guide to regulatory and capital considerations for exchange trading and clearing of loco London precious metals

An HKEX Company

SETTING THE GLOBAL STANDARD

Introduction

This paper has been prepared by the London Metal Exchange (LME) and provides an overview of the main regulatory considerations for market participants. It first covers the regulatory obligations of trading and clearing LMEprecious products, followed by an overview of the capital considerations attached to derivatives trading.

LMEprecious will enable market participants to trade loco London gold and silver as exchange-traded and cleared daily and monthly futures. Further phases will cover platinum and palladium futures and subsequently options contracts across all four metals.

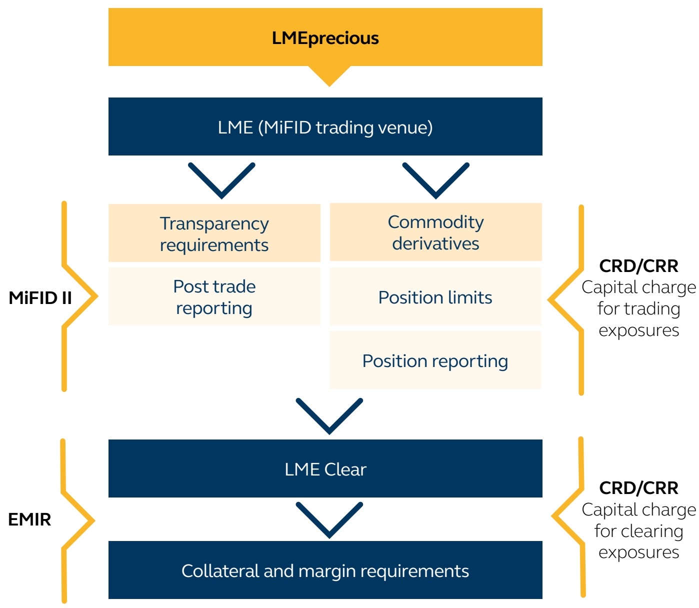
Trading a precious metals contract through an exchange and clearing through a CCP brings with it new regulatory considerations, and represents a departure from current market practice in the London bullion market, which has lagged many other markets in adopting trading, clearing and reporting standards that are common practice in related markets. LMEprecious products are classed as commodity derivatives and will be traded, cleared and settled within one regulatory jurisdiction.

The European Markets Infrastructure Regulation (EMIR), implements the G20 commitment to promote central clearing by providing financial incentives to clear via a CCP. Margin requirements for derivatives cleared via a CCP allow for efficiencies to be gained through portfolio margining and multilateral netting. Furthermore, the process for calculating and enforcing both initial and variation margin and collateral requirements arising from bilateral transactions will be a major obligation for counterparties to carry out themselves. A significant advantage of a centrally cleared derivative transaction is that the CCP is responsible for calculating and collecting margin requirements, which reduces the burden on the investment firm.

CRD/CRR complements EMIR by seeking to encourage derivative trading to be centrally cleared. It does this by introducing further capital charges to bilateral trades and in particular, the Credit Valuation Adjustment (CVA charge). Alongside the margin requirements for non-cleared trades set out in EMIR, this will significantly increase the cost of bilateral trading.

Furthermore, clearing offers multi-lateral netting which gives market participants a number of efficiencies by allowing them to offset their assets and liabilities with different counterparties, resulting in a lower overall net margin requirement.

The key regulatory initiatives for LMEprecious are summarised in the diagram below:



Regulatory overview for trading LMEprecious products

LMEprecious products will be traded on the LME and subject to the Markets in Financial Instruments Directive (MiFID) regime. The revised MiFID regime (MiFID II) will apply from 3 January 2018 and introduces new requirements for a range of asset classes, including commodities. Of particular interest are the requirements relating to the holding of large positions, and those regarding transparency.

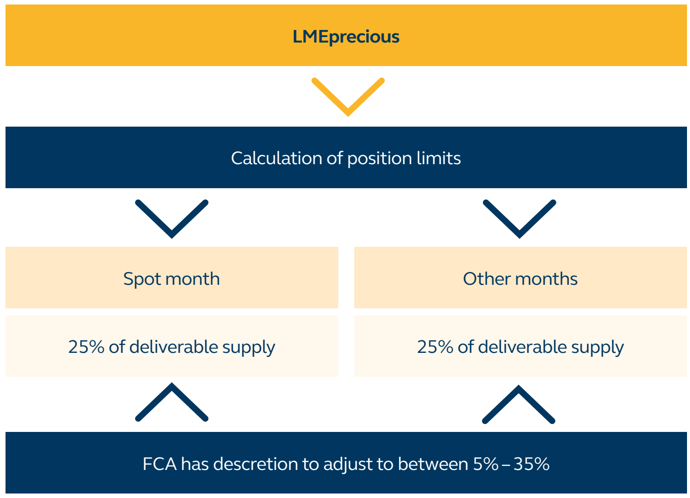
Commodity derivative position limits

MiFID II introduces for the first time the concept of position limits set and manged by national competent authorities (for the UK this will be the FCA). Previously, such arrangements have been put in place by trading venues/ exchanges as a means of managing large and/or dominant positions that are held on the market. The policy objective is to prevent large and/or dominant positions from having an undue influence upon prevailing fair market value. It should be noted that a large and/or dominant position is not inherently abusive. The use of position limits is not expected to impact the effectiveness of trading and clearing at the LME. The commodity derivatives regime consists of two elements. The first is to introduce limits on the positions in a contract that can be taken by a single entity. The second is to require the reporting of positions to competent authorities.

Position limits

Position limits are set at two levels: 'spot' months and 'non-spot' months. The definition of 'spot' is typically the next listed delivery month. However, for LMEprecious, which will offer daily expiries as well as the more typical monthly expiries, the intention is that spot will cover all expiries up to and including the first-listed monthly expiry[1]. 'Non-spot' will cover all other listed expiries. For spot months, the position limit will be based upon a percentage of deliverable supply (see below), whereas for non-spot, it will be a percentage of total open interest (i.e. open interest of all listed expiries, including spot). Enforcement of the position limits as they will apply to LMEprecious will be the responsibility of the FCA; the LME will not be involved in the enforcement of them.

Initial guidance suggests that position limits will be set at 25% of deliverable supply/open interest as appropriate, although the FCA will have the ability to vary the limit to between 5%-35% as they see fit. This means that a single entity will not be able to hold a position that represents more than 25% of the deliverable supply/open interest of an LMEprecious product.



Deliverable supply

EU regulators do not propose a set definition of deliverable supply due to the diversity of commodity derivative contracts. Instead, they propose that National Competent Authorities define deliverable supply for each market based on a set of factors that are specific to that market.

For a contract that delivers into loco London unallocated bullion that is consistent with the LBMA good delivery list format, the total deliverable supply is potentially large. Consequently, the resulting position limits may not be set at 25% of the deliverable supply, but at a lower level. This remains to be confirmed.

New and illiquid contracts

For new contracts such as LMEprecious, the position limit regime envisages a flat limit of 2,500 lots and these limits would apply until such point as total open interest exceeds 10,000 lots. This limit would also apply to those contracts which have total open interest of less than 10,000 lots. The level at which the position limits can be set will take into consideration the level of volatility in the contract, the number of participants, the maturity of the contract and such other characteristics of the contract that the competent authority feels appropriate in determining the relevant position limit.

1 This is subject to regulatory approval by the FCA.

Position management and reporting

In addition to the position limit regime, MiFID also requires trading venues to have in place arrangements to manage positions. The LME already has such arrangements for its base metals products, and will therefore extend these to cover LMEprecious contracts. It is proposed that both Accountability Levels and LME-determined Position Limits will be in place for LMEprecious contracts, and details will be published to market participants prior to launch. In addition, the LME will extend the requirement for members to report open positions daily to the LME, and will have the power to require a position to be reduced, either in part or in full, in the event that the LME, in its sole discretion, considers such action necessary to maintain a fair and orderly market.

Transparency requirements

EMIR requirements for trade reporting apply to both OTC and exchange traded derivatives, increasing overall market transparency. Furthermore, MiFID introduces new transparency requirements for commodity derivative transactions concluded on a trading venue. These transparency requirements build upon existing obligations which the LME discharges via the publication of market data on a real-time basis.

Post-trade transparency requirements

Trading venues have two sets of reporting requirements. Firstly, trading venues have an obligation to make available post-trade data (price, volume, time) as close to real-time as technically possible; they have to make available such data on a reasonable commercial basis and ensure non-discriminatory access to such information; such information shall be free of charge 15 minutes after publication. Secondly, there is a requirement for investment firms to report transactions to competent authorities by no later than the close of business on the following working day. Where the transaction in a financial instrument trading on a traded venue is executed by a firm which is not subject to the Markets in Financial Investments Regulation (MiFIR), then the operator of the trading venue is obliged to report the transaction. The transaction report is far more extensive than the trade report and covers 65 reporting fields. The report is designed to provide competent authorities with comprehensive transaction information that will allow them to build a detailed record and understanding of markets.

The LME and LME Clear have the infrastructure to capture and transmit the required information to meet transaction reporting obligations, but members of LMEprecious must enrich the trade data to provide the granular information contained in the transaction report. This includes detailed descriptors of the financial instrument and the buying and selling counterparties to the transaction.

Waivers

The reporting requirements provide for a number of waivers, depending upon the size of the transaction, the type of trading facility on which the trade was executed, and for those contracts that are considered to be illiquid. Waivers are requested by trading venues and are granted by the relevant competent authority. The LME is not proposing to apply for any waiver with respect to LMEprecious.

Clearing LMEprecious products

EMIR introduces rules governing the operation of central clearing houses and the requirement to exchange initial and variation margin during the lifetime of a derivative contract. Cleared contracts are subject to margin requirements. The table below provides an overview of the margin requirements when trading LMEprecious.

Margin requirements for LMEprecious

	Cleared
Margin methodology	Initial margin will be calculated using the market standard SPAN[2] algorithm. Variation margin is the same as for standard futures and is on a Realised Variation Margin (RVM) basis, which allows trading profits to be realised on T+1
Initial margin requirements	Initial margin requirements are established by LME Clear and reflect the underlying risk across all the open positions held by each clearing member. LME Clear keeps the margin levels under constant review and may revise margin levels to reflect market conditions
Default fund	Clearing members must contribute to CCP default fund subject to a minimum contribution of $1m
Eligible collateral	Cash (USD, GBP, EUR, JPY and CNH), a range of high quality government securities and gold. All with appropriate haircuts and, for non-cash, legal documentation
Exchange of collateral	Single net payments are made by currency and account

2 'SPAN' is a registered trademark of Chicago Mercantile Exchange Inc., used herein under licence.
Chicago Mercantile Exchange Inc. assumes no liability in connection with the use of SPAN by any person or entity.

Bilateral margin requirements

Forthcoming changes to global capital rules continue the G20 mandate of encouraging the central clearing of derivative contracts. The impending changes will require the exchange of initial and variation margin between financial and some non-financial counterparties to bilateral OTC derivative contracts. The rules will start coming into force on 1 March 2017 and will apply to all financial counterparties and the largest non-financial counterparties. The rules will progressively be implemented over the next few years to include more and more non-financial counterparties.

MiFID II extends the definition of derivative contracts which will increase the number of contracts that are in scope of both EMIR reporting requirements and incoming margin requirements. Legal analysis will need to be undertaken by counterparties to OTC precious metal derivative contracts to assess if they meet the criteria in MiFID II to be considered as C7 financial instruments that 'have the characteristics' of commodity derivatives traded on exchange and covered by MiFID II. If they are in scope of the C7 definition, then costly incoming bilateral margin rules may provide a strong financial incentive to clear via a CCP, where efficiencies can reduce the overall level of margin that is required.

CCPs already have their own methodologies for calculating initial margin requirements, which allows them to manage their risks in a manner that they consider appropriate[3] and which is consistent with the provisions of their local regulatory status including EMIR, Dodd-Frank and the global CPMI-IOSCO standards. By contrast, the European Commission's technical standards on the margin requirements for non-cleared derivatives[4] requires that counterparties follow a prescriptive standardised formula or develop their own model based on detailed criteria set out in the accompanying annex[5]. The result is that margin requirements calculated for bilateral transactions are likely to be significantly higher than those calculated by a CCP. When centrally cleared, margin requirements benefit from multi-lateral netting and the payments are managed by CCPs rather than market participants, which both reduces the overall cost and also the operational burden on firms.

Bilateral initial margin requirements will be phased in initially to groups who have an average notional amount of non-centrally cleared derivatives above €3trn, then over several phases until they will extend to the smallest counterparties, defined as when both counterparties belong to groups who have an average notional amount of non-centrally cleared derivatives above €8bn, on 1 September 2020.

Capital requirements

The Capital Requirements Regulation (CRR) requires that capital is held by a bank or investment firm to cover risks associated with derivative trading activity. It also introduces leverage and liquidity rules that put a cap on leverage (known as the 'leverage ratio') and requires a bank to hold sufficient short term funding (through the 'liquidity coverage ratio and the 'net stable funding requirement') to cover a liquidity crisis. A bank's exposure to LMEprecious and all derivatives trading activity (including OTC) will be factored into calculations for capital, leverage and liquidity requirements.

CRD measures

The CRD package contains a number of measures that aim to promote central clearing. The first is the bilateral counterparty credit risk weighting that is calculated based on the credit risk of the counterparty. This is set at a higher rate than the risk assigned to exposures to a CCP, making OTC non-cleared transactions more expensive. CRD also introduces a Credit Valuation Adjustment charge (CVA charge) that calculates the risk that the credit worthiness of a derivative counterparty deteriorates over the lifetime of the contract.

CRD also contains a large exposure limit that applies a punitive capital charge to large exposures to a single counterparty. Exposures to CCPs are exempt from this regime.

3 Recital 24, Commission Delegated Regulation on Requirements for CCPs under EMIR, 23.2.16

4 Commission Delegated Regulation on margin requirements for non-cleared derivative, 4.10.16

5 Annex to Commission Delegated Regulation on margin requirements for non-cleared derivative, 4.10.16

Capital charges

Trading LMEprecious rather than a similar non-cleared OTC contract will require market participants to factor in capital charges from exposures to LME Clear (including both initial margin and contributions to the default fund). However, the risk weight attached to a CCP is set at 2% which reflects the fact that a CCP is considered a highly reliable counterparty. The own fund requirement for exposure to a CCP's default fund accounts for the risk that a default fund is used to mutualise losses if another clearing member fails. While exposures to LME Clear will entail a cost for market participants, the own fund requirements are set at a far lower level than the equivalent transaction between two bilateral counterparties. For example, while the risk weight attached to a CCP is 2%, it is set at 20% for a bilateral transaction with a counterparty with a high credit rating, and up to 150% for lower rated counterparties. The regulatory objective is to incentivise firms to clear via CCP rather than trade bilaterally.

CRD/CRR complements EMIR by seeking to encourage derivative trading to be centrally cleared. It does this by introducing further capital charges to bilateral trades and in particular, the Credit Valuation Adjustment (CVA charge). Alongside the margin requirements for non-cleared trades set out in EMIR, this will significantly increase the cost of bilateral trading.

Net Stable Funding Ratio

The Net Stable Funding Ratio (NSFR[6]) determines the amount of 'stable funding' that is required for individual assets. The level of stable funding required for each asset is dependent on a haircut - described as a reserve stable funding factor (RSF) - that is attributed to an asset based on its level of risk. The objective of the NSFR is to require institutions to finance their long term positions with a stable source of funding.

The NSFR is also expected to apply different treatments to derivative transactions taking into account whether the transactions make use of margin. For unmargined and uncleared derivatives transactions, a 10% RSF factor applies to the gross derivatives liabilities. For margined and uncleared derivatives transactions, an option is introduced to either apply a 20% RSF factor to gross derivatives liabilities or to use the potential future exposure as calculated under the standardised approach for counterparty credit risk.

Positions cleared with a CCP are margined daily and, as such, are unlikely to require a significant amount of stable funding to be allocated to them compared to unmargined positions.

6 Articles 428 of the revised CRR on pages 209-228

Further developments

A number of other initiatives may also impact on the level of capital held by banks and consequently, their willingness to participate in derivative markets. In its forthcoming review of CRD, the Commission will implement into the EU measures for Total Loss Absorbing Capacity, which will introduce new requirements for own funds and eligible liabilities held by global systemically important institutions (G-SIIs). The amendments to CRD/CRR will also incorporate the Basel Committee's standards on the Fundamental Review of the Trading Book, which will be implemented through amendments to how own funds and market risk are calculated.

Finally, European regulators are preparing for the application of IFRS 9, which is due to apply from January 2018. Banks have raised concerns that changes to how loans are provisioned for under accounting standards could result in them having to hold higher levels of capital[7]. These initiatives have the potential to squeeze capital requirements further for LME's banking members, which may affect their ability to provide liquidity in OTC commodity derivative markets.

Consequently, while trading LMEprecious may create certain new charges for particular market participants (principally margining), the intention of regulation is to ensure that it is cheaper to centrally clear a derivative transaction than it is to trade bilaterally. LMEprecious provides an efficient trading solution, with potentially significant cost reductions to market participants through reduced capital and operational overheads, including lower capital costs, multi-lateral netting and reduced payments and reconciliations, whilst complementing the existing loco London precious metals market.

Implementation of LMEprecious is subject to regulatory non-objections.

7 Bloomberg, 'EU banks face 18% provision spike under new accounting rules', 10 November 2016.

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