# ASSOCIATION OF PROPRIETARY TRADERS RESPONSE TO THE EBA DISCUSSION PAPER ON THE ROLE OF ENVIRONMENTAL RISKS IN THE PRUDENTIAL FRAMEWORK

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**Q32: WITH REFERENCE TO THE THREE RISK CATEGORIES THE IFR IS BASED ON (RISK-TO-CLIENT, RISK-TO-MARKET AND RISK-TO- FIRM), WHICH OF THESE COULD BE RELATED TO ENVIRONMENTAL RISKS, AND TO WHAT EXTENT?**

1. Firstly, we would like to provide a short introduction. The Association of Proprietary Traders APT represents 22 independent proprietary trading firms based in the Netherlands, trading professionally in financial instruments for own account and risk, contributing to price discovery and providing continuous liquidity on exchanges and trading platforms across the EU, US and APAC, often in the capacity of designated market makers.

2. Proprietary trading firms/market makers have very short risk cycles and their positions are typically hedged. Because they appropriate the spread between bid and ask prices as a business model and not by investing for the longer term, the direction of the market and economic cycles are largely irrelevant. Firms manage their risks well during turbulent markets in order to fulfil their market making obligations. Position risk (which should be almost flat, as these are typically fully hedged with related instruments) and liquidity risk is closely managed during such events in the ordinary course of business. Because the result of a trade is (almost) immediately cleared and settled, profits or losses are not subject to longer term exposures. The result of a trade (P&L) is immediately known and will not change over time. Therefore, cyclical risk and economic fluctuations are largely irrelevant to the risk profile of the firm. Unlike banks and asset managers, trading firms do not manage assets for clients and do not have credit risk or commercial exposure. Therefore, the Risk-to-Client risk category is not relevant for our sector.

3. In our view, for the following reasons the Pillar 1 Risk-to-Market (RtM) and Risk-to-Firm (RtF) risk categories do not seem appropriate to address environmental risks for proprietary trading firms. Due to the nature of their activities, for proprietary trading firms, the environmental risk contribution to the RtM is expected to be neutral as market makers and liquidity providers operate in market risk neutral way (see above). Furthermore, as the CP notes, market risk is typically characterised by a short time horizon. For proprietary trading firms, with their very short risk cycles, the time horizon is (even) shorter than for most other investment firms. The CP p. 21 notes that most chronic physical environmental risks will fully materialise over a relatively long time horizon, spanning several decades. This means that where RtM is concerned, exposure to 'chronic' climate risks is well-neigh non-existent. (More) acute physical risks emerging from climate change, such as extreme weather events causing losses in equity prices due to destruction of firms' assets or capacity to produce (cf. page 48 of the CP), in our view are very firm and/or sector specific, depending on where the firm is based, what its activities are etc. Therefore, these risks do not seem appropriate to address in Pillar 1, as proprietary trading firms trade in a very wide and varied range of financial instruments across many different industry sectors/countries/trading venues.

4. Incorporating environmental risks into the generic Pillar I also seems somewhat at odds with the risk based approach set out in Chapter 4 of the CP and would go beyond its sensible limitations. More specifically, as p. 13-14 of the CP point out, Pillar 1 prudential requirements are designed to only cover 'unexpected losses' which may arise under *specific* circumstances. Pillar 1 sets out the calculation of the generic minimum required level of own funds for all firms at all times, but does not cover specific Pillar 2 additional own funds requirements, which are based on the institution-specific analysis (such as the type of instruments and/or type of sectors traded) as well as more systemic aspects of environmental risks, which would need be addressed by the macroprudential framework. E.g. in case equity prices across the spectrum would become more volatile than historically observed or are subject to severe jumps this is a macroprudential matter not fitting Pillar 1.

5. As pointed out in the CP p. 18, a gradual build-up of environmental risks may allow for indirect channels in the Pillar 1 framework to partially translate such risk into higher financial risk over time, e.g. through increased expected losses, higher probability of default (PD) or loss given default (LGD), or lower valuations. That seems sensible, as it aligns with starting point of the CP that prudential requirements should accurately reflect the risk profiles of exposures and support institutions' resilience to such risks. Expanding the EU Taxonomy to cover to environmentally (significantly) harmful economic activities (cf. CP p. 13) and/or the establishment of a common, standardised and complete ESG classification system (cf. CP p. 19) might enhance such a process.

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