

# IRSG

INTERNATIONAL  
REGULATORY  
STRATEGY GROUP

## HM TREASURY CONSULTATION

### Financial sector resolution: *broadening the regime*

## RESPONSE FROM INTERNATIONAL REGULATORY STRATEGY GROUP POST TRADE WORKSTREAM

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## **IRSG Post Trade Workstream**

*The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation and to TheCityUK.*

*The Post Trade Workstream includes representatives from financial services firms, investors and financial market infrastructures. A list of the members of the Workstream is attached.*

*The objective of the Post Trade Workstream is to provide a cross-sectoral review of post-trade services. It has therefore limited its comments to those questions relating to market infrastructures that have broader, market-wide implications. These comments reflect a consensus of views within the Workstream. The views of individual members may differ from the consensus in some areas.*

### • **CHAPTER 3: CENTRAL COUNTERPARTIES**

**Question 1: Do you agree with the scope of the intended resolution regime extending to all Recognised Clearing Houses incorporated in the UK which offer central counterparty clearing services?**

Clarifying what would happen if a CCP were to fail and ensuring the means are in place to limit the repercussions for the financial system are topics of fundamental importance. We believe that the whole of the regime should only apply to systemic institutions, and that there should be a distinction between utilitarian and for profit CCPs. We welcome the UK authorities taking the initiative to lead the debate on these issues and would be supportive of the development of a set of high level principles, which would put the UK authorities in a strong position to advocate for the establishment of a European resolution regime. However we would have reservations if the UK were to introduce legislation solely in the UK in advance of developments at the EU or international level, because of the risk that it might later need to be reversed in order to avoid the UK operating a regime that was incompatible with regimes elsewhere. In particular we would highlight the current work of CPSS-IOSCO which is well underway, therefore awaiting its conclusions would not result in any significant delay to the work of HM Treasury in this area.

However, it should be noted that there is a minority view in favour of the UK legislating without waiting for an EU consensus.

**Question 3: Do you agree that measures that support substitutability of clearing services (e.g. through non-discriminatory access provisions and access to licences on a reasonable commercial basis) are an important underpinning to an effective regulatory and resolution regime?**

We agree that a structure which supported alternative providers of clearing services in a market (ie open access CCPs) provides a more robust structure in terms of systemic stability, from the perspective of disaster recovery, and competition. Non-discriminatory access provisions are important from both a competition and systemic risk mitigation perspective, especially where a clearing house is the only authorised CCP to clear a given asset class. Where a clearing house is

exclusively integrated with an associated trading platform, the risk of that CCP failing and then inducing either operational or counterparty risk into its associated trading platform dramatically increases systemic risk considerations. Whilst an uncoupled CCP which is also the sole authorised clearer of an asset class will also occupy a position of crucial systemic importance, the failure of such a CCP may be less marginally less disruptive than if it were integrated into a similarly systemically important trading platform.

We note that creating open access to CCPs gives rise to other issues concerning access requirements and interoperability, which need to be addressed, but they are not directly relevant to the issue under consideration here.

**Question 8: Do you agree with the intended objectives of a resolution regime for clearing houses?**

We are broadly supportive of the objectives identified. However, in relation to objectives 1 and 2, we have concerns about the workability of an assessment based solely on the implications for UK financial systems. Few, if any, CCPs in the UK serve only the domestic market. Therefore it seems inevitable that the issue of resolution will need to be considered in a broader cross-border context. In addition it will be important to recognise that some CCPs operating in the UK (eg CMECE) will need to be resolved at parent level in the US.

The growing emphasis on CCPs providing client clearing services – for example, by segregating client assets – means that the protection of client assets should be taken into account in the objectives of the regime. It will also be necessary to consider how to handle the situation of CCPs outside the UK who deal in products related to sterling or UK sovereign bonds.

**Question 11: Do you agree that the resolution authority should be able to impose losses on members of a failing clearing house as part of resolution action? Should this be applicable to losses arising from any circumstance?**

Given the international character of CCPs in the UK, as explained in our response to Question 8 above, we believe that there could be significant difficulties in imposing losses on members or owners of a CCP operating cross-border. Many CCPs already impose some form of contractual obligation on clearing members to replenish the resources of a clearing house following a default. In the first instance defaults should be dealt with via the CCP's default waterfall structure. Any loss allocation that happens in a resolution setting should be spread across all relevant participants, with the loss allocation being clearly structured and limited.

Even if the resolution authority had no intention of exercising its power to impose liabilities on a clearing member, the fact they exist at all would add considerable uncertainty when calculating a clearing member's potential exposure to a failing CCP. This might render a clearing member's ability to access short-term liquidity – whether for the purpose of restoring a failed CCP or for other more general uses – more difficult or costly.

It may also be important to distinguish between a CCP failure due to clearing member or multiple clearing member defaults and CCP failure due to fraud or mismanagement by the CCP's executive. In the latter case, losses should be based on the CCP's ownership and control structure without reference to default procedures (unless specified in the CCP's rules) with resources coming from the CCP's equity and debt structure. This approach would ensure that those with responsibility for the failure bear the appropriate cost.

Given our reservations about the UK adopting legislation in advance of an agreed approach at EU level (see Question 1), we believe there should be analysis of the systemic implications of creating an uneven playing field by creating a potential liability in the UK, which might not apply to non-UK CCPs.

In summary, we believe that the possibility of imposing a statutory requirement on top of the existing contractual requirements should be considered at a much later stage in the process.

**Question 12: Should any such liabilities be capped and, if so, how should such a cap be structured and its level determined?**

We do not agree with the principle of unlimited liability as this will have significant implications for the ability of financial institutions to manage their potential risk exposures for capital adequacy purposes. An uncapped liability structure for clearing members or owners would result in greater systemic risk. We recommend a variation margin clawback solution that would clawback variation margin gains from variation margin receivers to return the CCP back to solvency. Please also see our response to Question 11.

- **CHAPTER 4: NON-CCP FINANCIAL MARKET INFRASTRUCTURES**

**Question 17: Do you agree that the regulatory framework for dealing with the failure of at least some non-CCP FMIs needs to be enhanced?**

**Question 18: If so, what should be the criteria for determining whether a non-CCP FMI should be covered? Should companies providing critical services to FMIs be included?**

It is important to recognise that the approach to CCPs will differ considerably to that required for non-CCP FMIs and should ultimately be considered on a case by case basis. CCPs, for instance centralise and mutualise risk; CSDs (in the UK), however, take no credit risk on their participants and are structured in a way to mitigate risk as far as possible (e.g. they are exposed to operational and legal risk only, and limit their liability). While CCPs clearly present the potential for systemic risk, the case is less clear cut for non-CCP FMIs, where the risk is likely to be predominantly of an operational nature. In drawing up the objectives for a resolution regime for non-CCP FMIs, the emphasis should be on ensuring continuity of access to the services of the FMI and to any cash or securities held in the system.

We would also question at what stage an institution will be considered "systemic" ie at the point of failure or before. We believe that much of this area is already covered by existing regulatory

measures. Can additional measures be justified on the basis of the importance of these institutions for the broader health of the economy? We believe that more discussion is required on this issue.

**Question 21: What are the competition implications of taking forward the sorts of approaches discussed in this chapter? How could the reforms contemplated here be designed so that they promote competition?**

There are complex issues in balancing the treatment of an incumbent service provider (which is likely to have systemic importance) and the treatment of a new entrant (which is unlikely to be systemically important). We do not have clear views on how to resolve this at present, but agree that this question should be given further consideration.

#### **Membership of the IRSG Post Trade workstream**

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