

The HMT Treasury Financial Sector Resolution: Broadening the Regime Consultation Response

AFME's position on key topics of the Consultation Document

Introduction

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities. AFME shares the overriding objective of a single and integrated post trading system in Europe through harmonisation and competition.

These comments were prepared by the Post Trade Division in co-operation with the Prudential Regulation Division (Resolution and Crisis Management).

Of the broader AFME membership (see www.afme.eu) the following members – investment banks, global custodians and universal banks – actively participate in the Post Trade Division: Banco Santander; Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; J.P.Morgan; Kas Bank; Morgan Stanley; Nomura; Nordea; RBS; Société Générale; UBS; UniCredit.

Overview

We strongly support the HM Treasury's efforts to enhance the mechanisms for dealing with the failure of systemically important non-banks, as it is now beyond a doubt that any disorderly failure of a variety of different types of non-bank institutions could lead to significant, systemic disruptions in the financial markets, domestically and globally. In particular, we welcome the HM Treasury's focus on the following four broad groups:

- Investment firms and parent undertakings
- Central counterparties (CCPs);

- Non-CCP financial market infrastructures (non-CCP FMIs); and
- Insurers.

We agree as a general matter with the Financial Stability Board's (FSB) 'Key Attributes for Effective Resolution Regimes,' endorsed by the G20, that resolution regimes be put into place for all systemically important financial institutions (banks and non-banks) and for FMIs. In that regard, we note the Dodd-Frank Act's broad scope that allows the US to use stabilisation powers over any financial institution if, among other things, its failure under insolvency law would have a serious adverse impact on financial stability.

The proposed EU framework for the recovery and resolution of credit institutions and investment firms (RRD) is also correct to include investment firms.

Our comments to the Consultative Paper will focus on investment firms and parent undertakings and to FMIs responsible for the clearing and settlement of cash securities. Our comments on FMIs are drawn from AFME's response, which we intends to submit on Friday 28 September, to the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) regarding the Consultative Report on recovery and Resolution of Financial Market Infrastructures (the Recovery and Resolution Report). AFME is providing these overarching comments in lieu of submitting specific responses to the consultative questions.¹

Investment Firms and Parent Undertakings

We strongly support the UK government having stabilisation powers over investment firms and parent undertakings, as previously expressed in our responses to the HM Treasury's consultation on the special administration regime and the FSA's consultation on recovery and resolution plan.

The definition of 'investment firm' as a UK institution which is an investment firm for the purposes of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions' is appropriate to align resolution with prudential supervision. AFME supports applying the Banking Act's public interest condition for deposit-taking institutions to investment firms, which effectively requires a test of systemic importance. It makes sense that the Bank of England, as resolution authority and in consultation with the HM Treasury and the firm's regulator, be satisfied that the exercise of stabilisation powers are necessary and in the public interest to ensure the stability of and confidence in the UK's financial system. Including an additional objective concerning the protection of client funds and client assets that the Bank must have regard in exercising stabilisation powers is also

¹ This submission does not address insurance companies.

sensible in order to avoid contagion and to protect pension fund, insurance company and other clients.

We also strongly endorse the Bank of England's ability to exercise stabilisation powers over parent undertakings, and not just investment firms but also that of deposit-taking institutions. This is critical to ensure that the sole stabilisation option with regard to holding companies of either sort is not to put them into temporary public ownership.

Consultation Questions on CCPs

Scope of the Intended Resolution

We welcome the UK authorities' work on an intended resolution regime and its applicability to all Recognised Clearing Houses within the UK. However, we do feel that due to the current legislations being proposed on a larger scope than within the UK that this should be kept in consideration so as not to risk later having to reverse the process and regime which may then not be compatible with regimes elsewhere.

We agree that open access is an essential tool that could assist in the resolution of a failed CCP. It will be important that there is no legal constraint to the portability of positions from one CCP to another.

Transparency

We are in full support of a more transparent market practice in terms of risk management and mitigation. Members will be able to assess risk on a broader basis with the help of transparency in the market and it will aid in ensuring that the structure currently being suggested is sound and efficient for not only UK based CCP providers but also on a global scale.

The margin algorithm is not provided by all CCPs. This would greatly assist members.

We would also like to advocate the publication by CCPs of their risk methodology and key parameters, to allow members and the market, as a whole, to assess the risk profile of the CCP.

Intervention by Authorities

We believe, in line with our GFMA CPSS-IOSCO response, that recovery should be the initial port of call in instances of a CCP failing in its clearing duties. The conditions on which it would recognise that a CCP is in failure should be stringent and in line

with global measures in order to keep the harmonised structure of safety surrounding CCPs.

We would again like to reiterate the need for more transparency on how the authorities would accomplish this and based on what criteria they would act. It is also not clear which authorities the document is referring to and therefore we would like to ask for more specific information at this stage.

Stabilisation Powers/Specific Conditions suggested

We would ask for more specific criteria which the Bank of England would look to use in order to determine whether a clearing house is indeed failing as well as greater transparency relating to the 'stabilisation powers' and in what circumstances this action is deemed appropriate. We agree that the proposed measures are necessary in order to reduce the risk posed to the overall financial markets and its participants, however, we would strongly urge that more clarity is provided in all matters as to how the HM Treasury envisages the Bank of England undertake this task. The paper suggests that systemic importance should be determined by reference to a public interest (which should be seen as the initial step but as mentioned more certain transparency is needed here in terms of the criteria which determine this). It remains unclear whether this provides sufficient certainty for CCPs and for clearing members and their clients.

We agree with the proposed suite of stabilisation powers, however, would urge that these be used as a basis and that it should be noted that clearing houses do operate on an international level. There will need to be certainty on the extent to which the authorities could or should act before certain or all of those protections have been completely exhausted (those of exercising and current resolution powers within the institutions and national laws) and the resulting impact on the members and participants. The systemic benefits further protections of failing CCPs (and FMIs as a whole) does outweigh the arguments against them, however, as noted previously further clarity and information is needed.

Losses passed onto members following the failing of a CCP

Given the international character of CCPs in the UK, as explained in our response above, we believe that there will be significant difficulties in imposing losses on members 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. 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.

We would like to suggest that 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 addition we would advocate limiting the loss distribution in certain specified circumstances to avoid moral hazard issues.

Relating to the notion of 'any circumstance' we would strongly suggest the methods and structure as proposed by the CPSS-IOSCO Recovery & Resolutions Paper. Negligence perpetrated by a CCP leading to its downfall should be treated in line with the guidelines set out by CPSS-IOSCO, thus ensuring that there is harmonisation for the CCPs and its members in this regard.

Liabilities- Capping

We would caution against unlimited liability as this will have significant implications for the ability of financial institutions to manage their potential risk exposures for capital adequacy purposes and to avoid additional contagion risk between CCPs and their members.

The Code of Practice

Clarity should be obtained on the impact of margin segregation and customer protection in case of CCP default (as per the HM Treasury's other consultation). More clarity is also welcome on the ability of members to port their positions and margin to another CCP in case of CCP default.

In addition to this we feel that the specific areas listed below should be covered by the code of practice in relation to CCPs:

- Corporate structure
- Cross border effects/impacts
- Protection of participants/members/indirect participants?
- Continuity of critical services
- No unlimited liabilities
- Interconnectedness

Safeguards as suggested by HMT document

The HM Treasury's proposal states that the Government expects that safeguards would include those that are already applied in relation to partial property transfers under the SRR for banks. Careful thought would need to be given to how property rights safeguards might need to interact under different regimes in a scenario where a CCP and one or more of its bank/investment firm clearing members are placed into resolution.

Consultation questions on other FMIs

The Importance of Non-CCP FMIs in the Industry

We fully believe that the financial markets need to extend their concerns for FMIs as a whole and that all FMIs (whether they be credit holding or not) be included in this new proposed structure of risk mitigation and recovery/resolution. It becomes therefore more important to note the role of FMIs on a global scale and the interaction which UK based FMIs have with other internationally based FMIs.

Non-CCP FMIs should ultimately be considered on a case by case basis as those rules/the structure determined to be suited to a CCP cannot be applied to, for example, a CSD. While non-CCP FMIs may present a smaller risk of financial loss, they may still pose a significant systemic risk, predominantly of an operational nature. The economic impact of such a failure should be taken into account, not just the potential for direct financial losses.

We would suggest that the consultation is reflective of the above and note that it is important to view all FMIs on a global rather than a domestic scale.

In addition, certain non-CCP FMI's take on credit and liquidity risks as set-forth in the CPSS-IOSCO consultation, and therefore the insolvency of such FMI might create substantial economic impacts and need for support.

We believe that the new resolution regimes suggested and being developed at this stage by CPSS-IOSCO will be an international regime which can be built upon if it is needed. At the present time with the EU regulations and the CPSS-IOSCO regulation being determined there is a lot of resolution and recovery regulation which is being proposed to be implemented. We therefore believe that any potentially new resolution regimes being put forward in the UK should be in line with these other more advanced (at this stage) proposed regulations. Each FMI must be looked at on an individual basis and should not be excluded dependant on its 'importance' but rather be included because of its systemic and operational value. All FMIs should be considered in all of the currently proposed regulations.

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.

Conclusion

We welcome the document produced by the HM Treasury and feel that it is a further step in the right direction to ensure the balance of safety and efficiency in the market. Due to the ongoing Regulatory improvements we feel that in order to help achieve this balance of safety and efficiency the HM Treasury may look towards the CPSS-IOSCO consultation on Resolution and Recovery in order to ensure that, from a structural point of view, work can be done on a global structure for the financial sector and recovery and resolution.

Thank you again for the opportunity to comment on the Recovery and Resolution Report. We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis. If you have any questions, please do not hesitate to contact Kristina Godau (.godau@afme.eu) and Gilbey Strub (.strub@afme.eu).