20th February 2013

HM Treasury

1 Horse Guards Road

London
SW1A 2HQ

HMT consultation response: Amendments to the recognition requirements for investment exchanges and clearing houses

Dear Sir / Madam

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.

The comments within this consultation response were prepared by the Post Trade Division in co-operation with AFMEs Prudential Regulation Division (Resolution and Crisis Management).

Of the broader AFME membership (see http://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

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Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs & Co; HSBC; J.P.Morgan Chase; KAS Bank; Morgan Stanley; Nomura International; Nordea Bank; Royal Bank of Scotland; Société Générale; UBS; UniCredit Group.

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 me.

Yours sincerely

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Consultation response

HMT: Amendments to the recognition requirements for investment exchanges and clearing houses

20 February 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the HMT consultation: Amendments to the recognition requirements for investment exchanges and clearing houses. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Overview

We strongly support the efforts of HMT to enhance the mechanisms for dealing with the failure of systemically important financial institutions other than banks (including financial market infrastructures or FMIs). It is clear 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. The design of any recovery regime for central counterparties will need to take into account other EU rules such as CSDR and EMIR, as well as the resolution and recovery regime for banks, as certain EU FMIs may well be part of the same corporate group as a bank). Such a regime would also have to consider international rules and principles relating to recovery (and resolution) regimes, as EU FMIs may well be part of a non-EU corporate group.

It is important that all such rules be compatible, so as to minimise the risks of double regulation, and conflicts between different regulatory regimes.

FMIs will vary considerably with respect to their size and systemic importance, and with respect to their competitive situation and the ease by which their participants can switch to an alternative provider. Accordingly, it is important that the future FMI recovery regime be sufficiently flexible to allow regulatory authorities to tailor their specific regulatory approach to the specific situation of a particular FMI. AFME members believe that any loss allocation framework for CCPs should be based on the premise of capped liability structure for clearing members. We would also like to note the opposition towards forced allocation on clearing members at the end of the default waterfall. It may be beneficial to reflect on the uncertainty to liabilities created by loss allocation at the end of the waterfall. For clearing members to manage their exposure risk to CCPs, it is critical that such risk is known, i.e. that it cannot be unascertainable or 'uncapped'.

For purposes of this response, references to recovery mean those mechanisms utilised to stabilise an FMI and restore its financial strength and viability when the FMI comes under severe stress and to ensure the continued provision of critical operations and services. (References to resolution mean those processes established to deal with the closure of an FMI entity without severe systemic disruption and with minimal cost to the taxpayer while preserving systemically important functions.)

We agree in principle with the Financial Stability Board's (FSB) *'Key Attributes of Effective Resolution Regimes* [Key Attributes]*,'* endorsed by the G20, that resolution regimes be put into place for all systemically important financial institutions and for FMIs[1]. We believe that the appropriate regime for central counterparty recovery depends on the infrastructure concerned. It is important to differentiate the FMIs from the banks and subsequently the Recovery and Resolution Directive (RRD). We would also recommend noting that it would be advantageous for Exchanges / MTFs to offer a choice of CCPs to alleviate single points of failure at the clearing level, thus addressing the matter of choice for clearing participants and the matter of having a level playing field for CCPs as well as the clearing members.

[1] 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.

Consultation Questions

1) Is the intended wording of this requirement clear?

Intended wording:

> **A central counterparty must have in place within six months of these Regulations coming into force-**
>
> **a) Rules to allocate losses that arise as a result of member default that remain after the resources to which the central counterparty has access (pursuant to paragraph 16 [of this schedule] or Article 45 of the OTC derivatives, central counterparties and trade repositories regulation, as relevant at the time) are exhausted; and**
>
> **b) Effective arrangements (which may include rules) to allocate losses that arise otherwise than as a result of member default; such that these rules and arrangements ensure that the central counterparty may, consistent with its statutory obligations (including, where relevant, the OTC derivatives, central counterparties and trade repositories regulation), allocate losses capable of threatening its financial viability, with a view to the central counterparty being able to continue to provide clearing services.**
>
> **A central counterparty must have in place a recovery plan that sets out the steps that it will take with a view to maintaining continuity of clearing services in the event that such continuity is threatened.**

AFME members are of the opinion that it is important to articulate and ensure that a clear line is established between business as usual mechanisms, recovery mechanisms (and, in certain circumstances, resolution mechanisms).

CCPs will have internal rules and procedures to address significant issues such as member default, which establish the order in which various resources are called upon to absorb losses. This is commonly referred to as the financial 'waterfall'. A CCP may incorporate options near the end of their waterfall that are effectively 'recovery' actions (e.g. additional guarantee fund assessments, variation margin haircuts, etc.). To achieve systemic stability, it is essential to cap the liability of clearing members to a pre-determinable amount, otherwise a CCP may be left standing but as a result the financial system around it will be compromised. It is imperative that the waterfall is exhausted first, prior to resolution actions being taken. The CCP rulebook, including waterfall provisions, forms a contract between the CCP and its membership which must not be violated or pre-empted. With the exception of bail-in (we would assume in the context of equity), variation margin haircuts and tear-ups, the loss absorption tools might be considered as appropriate recovery measures, provided that they are specified as being part of the CCPs rules. However, it is imperative that any liquidity calls are subject to caps so that clearing members are not exposed to uncapped liability. AFME members also believe that the additional loss absorbency measures proposed in the consultation paper should be subject to regulatory oversight and approval.

A capped liability structure is essential in ensuring systemic stability because this enables clearing members to measure and manage their risks to CCPs and enables their regulators to easily monitor those risks. A capped liability structure will encourage members to continue clearing in a crisis because they will not be exposed to the risks of unlimited liability through loss mutualisation. Ultimately, with respect to any FMI, loss allocation should be governed by

principles emphasizing predictability and parity. In other words, participants should not be exposed to losses, or be required to provide new support, in ways that are not consistent with the rules and procedures of the central counterparty (particularly with respect to the waterfall).

Losses resulting from operational failures, including fraud, rather than from participant defaults, should be borne first by the holders of the central counterparties' equity. Where a central counterparty is owned on a mutual (or *quasi*-mutual) basis, the same principles should apply. The members, like shareholders, would stand to lose their initial investment on a pro rata basis. We believe that losses should be allocated based, in large part, on the nature of the loss. For example, losses arising from an operational, financial, or business failure of the FMI, or its owner, should accrue through the ownership and control structure, without reference to default procedures. Such situations are much closer to a typical insolvency of a public utility. In that circumstance, the owners of the FMI should stand to lose control of the FMI through the resolution procedure, with the resolution authority able to sell, merge, or otherwise change the ownership structure of the FMI while simultaneously preserving the positions of the participants. We believe the concept of a bail-in as proposed in the draft European RRD[2] could also provide a useful method to assist in the re-capitalisation and stabilisation of a failing FMI

In all cases AFME members believe that the concept of 'uncapped liabilities' for members of a CCP should not form part of any recovery framework. Uncapped liabilities are impossible to risk manage for firms as they cannot confirm the actual size of their exposure to the CCP. In a stressed market environment they also have the potential to cause liquidity strains on member firms who have to remain members of a CCP if they are to continue clearing client trades. This situation is exacerbated where there are no alternative providers of clearing services for a particular market. Whilst members can choose to leave a CCP should the amounts that they are being called for be deemed unreasonable, this may result in these businesses becoming unprofitable and/or lead to further market instability as investors have to seek alternative arrangements as members exit the CCP.

An FMI's recovery plan should be sufficiently comprehensive and robust such that it can effectively address stress scenarios prior to the point of failure, or likely failure, as supported by the ESMA Regulatory technical Standards. Even then, ensuring continuity of service should not mean preserving the entity but rather the services being provided - when a firm is no longer operationally viable, regulatory intervention should not be aimed at its rescue, but at its orderly resolution and the preservation of any systemically important services. To this end, regulators should encourage structures which separate the ownership and operations of FMIs, so that a failure of ownership does not cause a failure of operations. It is also important that the regulator ensures the rules are clear and complete in terms of the circumstances which put a CCP into recovery mode, triggering the waterfall provisions, and that the rules specify explicitly the recovery actions to be taken should the waterfall resources be exhausted.

Although we recognise the general objective under recovery of maintaining critical service, current insolvency procedures are generally designed primarily to protect creditors. The change of emphasis to maintenance of critical service may therefore disadvantage some creditors who would have been favoured by existing insolvency procedures, and care may be needed to control the extent of this effect.

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[2] DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL: establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC,

Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

We feel that in respect of the HMT proposed wording it may be beneficial to specify the wording slightly by highlighting that recovery plans can only lead to 'measurable' losses for members (given their need for a capped liability structure). As such, continuity of service beyond this point would have to be dealt via an orderly resolution with members and regulator intervention rather than through recovery.

The proposed HMT text above notes that a CCP must have these procedures in place within six months of these Regulations coming into force. AFME members feel that because the industry is currently awaiting recommendations from CPSS-IOSCO and other Regulatory body recommendations, that this is something which should be taken into consideration by HMT when addressing the notion of timing. The discussions on the recovery and resolution of FMIs are one that is ongoing and the industry continues to be engaged in the discussions in addressing the matters above.

2) Are there any unforeseen consequences in amending the recognition requirements in this way?

It is important, as noted above, that members and participants are able to see the loss allocation process and that this process not be one that leaves the participant vulnerable to unforeseen liability should the CCP fail or be in a position where it cannot continue.

AFME members would seek clarification on what triggers would be considered to indicate that a CCP has in fact reached a point of needing recovery so as to provide transparency once again to participants. It is important that any triggers incorporated into the framework are very clear and easily assessed. There should be an obligation on central counterparties to provide efficient plans and that they have fully considered how they could orchestrate their own recovery of capital, as well as on obligation on regulators to ensure that these plans are complete and practical.

It is important that a distinction is established between the functioning of a central counterparty's day-to-day workings and when a central counterparty reaches a stage of being in recovery mode.

We would also seek clarification and further information on what would occur in the scenario posed should the central counterparty be unable 'to continue to provide clearing services'. In accordance with recent consultations such as CPSS-IOSCO and the European Commission's recovery and resolution consultation for FMIs, the notion of resolution of a central counterparty is not addressed here.

An additional potential unforeseen consequence, which must not to be overlooked, is that of interoperability. Should UK CCPs be made subject to further and separate stages in the waterfall loss allocation process (to those already being explored by other regulators and institutions), then this may cause problems in the event that that CCP were to be in an interoperability arrangement with a CCP which has a capped liability structure.

3) Does the proposed requirement complement the draft EMIR Regulatory Technical Standards?

Contingency and risk planning is an essential part of being consistent with current and future regulation and the intended wording eludes to matters of what continuity would mean for those participants who have not had a hand in the initial failings of the central counterparty or

whether there is a cap on how much liability will be passed to the central counterparties' participants as a whole.

The intended wording notes that in the event of a default due to matters resulting as a fault of matters other than that of a member default, the central counterparty would be able to 'allocate losses capable of threatening its financial viability'. EMIR consistently notes the importance of ensuring that a correctly functioning and limited waterfall procedure is in place.

4) Are these transitional periods reasonable?

Certain recovery actions may be referenced in the central counterparties' contractual documentation and/or rulebook.

In accordance with existing regulation such as EMIR loss allocation (waterfall) mechanisms should already be in place at the CCPs and these mechanisms should and will be regulated and monitored regularly in accordance with ESMA RTS, noting a CCP is to conduct annual stress test. Recovery planning should also be in place in contractual form.

At this stage AFME members would also like to note that the industry is currently still awaiting the CPSS-IOSCO recommendations with respect to recovery & resolution of FMIs. As a whole, the industry continues to be engaged in discussions on the appropriate mechanisms for loss allocation and therefore this should be taken into account when considering timelines and transitional periods. We anticipate that CCPs will be applying to UK authorities for authorisation under EMIR within the next few months. The impact of enacting legislation will alter the rule books of CCPs which are going through the approval process, as we anticipate that detailed analysis of the default rules will be part of the authorisation process (together with exploration of their enforceability as a matter of law). It would be sub optimal to the industry if the CCPs were obliged to amend their default rules in the course of this process.

5) What, if any, further information do you require to implement these requirements?

AFME members would seek further transparency and clarity on loss allocation and waterfall procedures as well as a more in depth analysis on what triggers a central counterparty would be considered to be in the stage of 'recovery'. CPSS-IOSCO frameworks will enable an international perspective to be applied and these should therefore be complimentary with those existing regulations and frameworks that are already in place.

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:

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