



POSITION PAPER

**HM TREASURY CONSULTATION ON AMENDING THE RECOGNITION
REQUIREMENTS FOR INVESTMENT EXCHANGES AND CLEARING HOUSES**

A response by the Futures and Options Association

FEBRUARY 2013

HM Treasury Consultation on Amendments to the Recognition Requirements for Investment Exchanges and Clearing Houses

1 Introduction

- 1.1 This response is submitted on behalf of the Futures and Options Association (**FOA**), which is the principal European industry association for 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).
- 1.2 The FOA notes and understands the reasons behind the proposal to require:
- that a CCP must introduce rules to allocate losses that arise as a result of member default once all other resources to which the CCP has access are exhausted;
 - that a CCP should have effective arrangements in place to allocate losses which arise otherwise than as a result of member default, but which are “capable of threatening its financial viability”.
- 1.3 However, the FOA is concerned that this could be implemented in a way that creates an additional and “unquantifiable add-on” to the existing contingent liability of clearing members. This would have consequences of the type foreseen in Question 2 below.
- 1.4 The FOA believes that further consideration should be given to the appropriateness for such a “top up” call to be met by alternative mechanisms such as commercially provided insurance or out of public finances for the following reasons:
- the creation of a further call on the capital of remaining CCP members when the stability of the CCP has already been damaged by “extreme circumstances, such as the default of several major clearing members” (quoting s.2.9) would have the probable consequence of tipping further members into individual default, creating a larger systemic failure.
 - CCPs are core market infrastructures at the heart of the financial system and their continued viability is very much in the public interest and it is reasonable to suppose that the public will be more accepting of a call on public finances in order to address an “*in extremis*” funding situation where the CCP itself comes under threat than the failure of an individual financial institution *per se*.
 - CCPs, as systemically important institutions, will be the subject of intense regulatory oversight by the Bank of England and if the funding shortfall is attributable to a failure of such regulatory oversight, then any “*in extremis*” “top up” loss allocation should be met by public finances;
 - another alternative would be a special purpose insurance solution to avoid yet another call on the industry. This solution has been previously proven to be effective as a resource available to CCPs.
- 1.5 In any event, HM Treasury should consider a more focused text to address the following issues:
- the exercise of any such power to allocate losses should be capped to a specific funding obligation and be subject to transparent criteria and defined objectives (e.g. as indicated in the response to the specific questions below);
 - requiring clearing members to accept an additional “unquantifiable” contingent liability will be an unnecessary burden which will impact on the risk/reward of clearing members and could

precipitate a market withdrawal by some of the smaller and/or more specialist clearing members;

- a significant cash call on clearing firms by way of loss allocation could generate a “domino” effect creating more failures at a time of market stress or which, in turn, could trigger a significantly more serious market crisis;
- this proposal has been made without regard to the consequent prudential capital cost to clearing member firms of an additional (and unquantifiable) contingent liability, and the FOA strongly encourages consultation with firms to determine what impact this proposal will have under the prospective requirements of Basel and the European Banking Authority.
- while it is unclear what add-on capital requirements could be imposed on clearing members to cover this additional exposure, it will almost certainly result in yet another “pass through” cost to end-users who are already being impacted significantly by the cumulative cost of the regulatory change agenda to the point where access to centralised clearing may become simply too expensive, particularly for small and medium size end-users, and especially those that are non-financial firms otherwise exempted from the scope of EMIR;
- the need for such an “*in extremis*” loss allocation process should take into full account the risk-mitigating features of the proposed resolution framework for CCPs.

1.6 In general terms, the FOA is deeply concerned that the political objective of avoiding any call on public finances may prejudice the continued healthiness of the UK financial sector by increasing the overall amount of contingent risk that must be accepted by clearing members.

1.7 Persistent overloading of the industry in this way will have an undoubted economic impact on market participation and liquidity, the viability of clearing access, and ultimately the risk management capability of end-user firms. Moreover, the creation of the kind of “domino” effect referred to above could leave the Government with no alternative but to make a call on public finances, but because of the inevitable exacerbation in a market crisis generated by cash calls of this nature, that call on public finances could be significantly higher than might otherwise be the case.

1.8 The FOA recognises that it is expressing what is likely to be a minority view in the current climate, but would nevertheless make the point that a last resort “*in extremis*” call on public finances to support a failing market infrastructure after all the existing industry resources to which the CCP has access are exhausted is not unreasonable and may deliver an outcome that is less costly to the UK economy when all aspects are considered.

1.9 The consequences of loading up the industry with additional and unquantifiable cost will have implications for the tax payer but not in terms of calls on the public purse, but in terms of lost income asset performance in terms of funding the additional cost of loss allocation, and also to the extent that regulatory change limits economic growth. Pension fund performance, in particular, may be impaired if hedging, maturity and credit transformations becomes too expensive. There will also be economic costs if cumulative regulatory costs and obligations become so significant that the ability to fuel growth through lending capability becomes impaired.

2 Response to Specific Questions

Q1: Is the intended wording of this requirement clear?

2.1 The FOA does not feel that the wording of the requirement is sufficiently clear. The FOA believes strongly that the rules to allocate losses should be subject to clear conditions, criteria and objectives to ensure that they are only exercised in appropriate circumstances. Against this background, the FOA would make the following observations regarding the use of these powers which, it believes, should be properly reflected in the text of the requirements, namely:

- consistent with the observation in para 2.9 of the Consultation Paper that loss allocation should only be deployed in “*in certain extreme circumstances*”, the FOA believes that this condition should be supplemented by a clear explanation of what is meant by “*certain extreme circumstances*” and that this wording should be incorporated within the text;
- the exercise of these powers should be applied fairly and required to take into full account the state of the market at the time of the cash call, their impact on systemic risk of possibly triggering the possibility further defaults and the size and financial circumstances of those to whom a percentage of the loss is allocated.

Q2: Are there any unforeseen consequences in amending the recognition requirements in this way?

2.2 The FOA would refer to para 1.5 in this response and reiterate that, if future potential losses are allocated to clearing members, they already face a significant increase in capital costs, and, as already stated, they currently bear a high degree of contingent loss on their balance sheets. This is generating a review of the risk/reward of being a clearing member in some firms. In the current climate of lower returns and expected higher clearing fees to cover the cost of increasing regulation, if this additional burden is to be borne by clearing members, it will have to be priced and, probably, will be passed through to the enduser (alongside other significant “pass through” costs).

This could further undermine the underlying economics of clearing, particularly in terms of affording economic access for small and low volume users of the markets; and, for some clearing members cause them to exit the market.

Q3: Does the proposed requirement compliment the draft EMIR regulatory technical standards?

2.3 The FOA agrees that the proposals are consistent with the international Principles for Financial Market Infrastructures produced by CPSS – IOSCO, but notes that the objective of the Principles is to put the CCP in a position that it “*can continue to operate in a safe and sound manner*”. The FOA believes that this wording should be incorporated in the text to ensure that the use of these powers should be limited to that objective rather than be capable of being applied “at large”.

2.4 The FOA accepts that the UK is not prevented from introducing these rules by EMIR or the supporting technical standards.

Q4: Are these transitional periods reasonable?

2.5 The FOA believes that they may be appropriate, but CCPs and the firms are better able to make an assessment as to whether or not the proposed transitional periods are reasonable and the FOA defers to their comments.

Q5: What, if any, further information do you require to implement these requirements?

2.6 The FOA believes that this is best answered by the parties to the proposed rules e.g. the CCPs themselves and their clearing members. However, we would reiterate the need for a clear assessment of the other options for loss allocation rather than further “loading up” of liabilities being placed on the industry, particularly clearing members.

2.7 As indicated earlier in para 1.4, the FOA continues to believe that it is not unreasonable for public finances to be asked to bear a last resort loss, particularly if it has the consequence of threatening the stability of the CCP.