ISDA Safe, Efficient Markets

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Non-Bank Resolution
HM Treasury
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Sent by email to: non-bank.resolution@hmtreasury.gsi.gov.uk

Response to 'Amendments to the recognition requirements for investment exchanges and clearing houses'

This letter contains the response of the International Swaps and Derivatives Association, Inc.[1] ("ISDA") to the HM Treasury ("HMT") Consultation Paper on *'Amendments to the recognition requirements for investment exchanges and clearing houses'*. We are grateful for HMT raising this matter with us and providing additional time for response.

We emphatically support the aim of HMT to protect CCPs from financial shock and agree that CCPs should have in place recovery plans and loss allocation rules to cover losses arising as the result of members' default. We also acknowledge that service interruption for systemically important CCPs must be avoided. Accordingly, CCPs must have robust recovery plans that provide clear procedures setting out how to deal with losses that exceed a CCP's financial resources above the minimum regulatory capital requirement, regardless of whether they are the result of member defaults or non-default losses ("NDL"). However, the need to prevent service interruption does not necessarily entail that all losses must be allocated immediately; service continuity only implies that a CCP must be able to make all payments as and when due. Loss allocation mechanisms cannot be developed in isolation but must be part of a CCP's overall recovery strategy.

ISDA believes that the most appropriate recovery strategy for CCPs, which could avoid ungovernable moral hazard and distortion of incentive systems, could be provided by a bail-in regime in combination with a change of ownership of the operating company that provides the clearing services. The bail-in regime could be effectively supplemented by insurance contracts which cover a limited amount of losses in excess of a CCP's minimum regulatory capital requirements. However, appropriate bail-in and insurance markets would first have to develop and the six month time window suggested in the regulation is too short to develop, agree, and implement an effective bail-in and/or insurance regime.

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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Accordingly, we are concerned about the proposed requirements on CCPs to have in place loss allocation arrangements to cover NDL , and that those requirements be in place within six months of entry into force of the regulations.

We refer to the text of these proposed requirements:

> 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.

We understand that the development of rules of the nature envisaged in paragraph (a) is already the subject of joint CCP and clearing member work streams.

However, paragraph (b) is of significant concern as CCPs and members have not been engaged in discussions in respect of these NDL to the same extent and depth as those which have been taking place in respect of the rules contemplated by paragraph (a).

We consider that regulatory standards should be explicit that the losses resulting from NDL (for example, CCP operational failures[2]) should accrue through the CCP ownership and control structure, without reference to default waterfall procedures. As such, NDL should be borne first by the holders of the central counterparties' equity and would impact members only to the extent that a CCP is owned on a mutual (or quasi-mutual) basis. In such a CCP insolvency, members with mutual ownership, like shareholders, would stand to lose their initial investment on a pro-rata basis.

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[2] It is difficult to conceive of circumstances that would lead to such a catastrophic outcome. Possible scenarios could be an extremely large credit loss arising from unauthorised trading activities undertaken by a CCP's Treasury or large-scale fraud and breakdown in operational controls/ business risks. These activities as you know are subject to stringent regulation – CCPs are prohibited from entering into derivatives transactions (except for FX or to hedge a defaulted member's exposures) and any unauthorised activities would be picked up not only through internal controls but also by market participants – the very same entities that have a vested interest in the CCP's survival. In addition, the European Banking Authority has promulgated technical standards for CCP capital rules. These require CCPs to hold capital to cover costs for a certain time span for winding-down its activities.

Competitive placing within the EU

Paragraph (b) may put UK CCPs at a significant disadvantage to their Continental Europe and US competitors and could cause banks to consider moving clearing activity to other jurisdictions due to the possibility that they may otherwise suffer uncapped and unquantifiable liability under the proposed loss allocation. It also appears to conflict with article 43 of EMIR which requires clearing members to have limited exposures towards the CCP. As you know, CPSS-IOSCO and the European Commission consulted on Non-Bank Recovery and Resolution in 2012 and we expect them to propose rules this year. We would urge HMT to work to ensure UK regulation is harmonised to international standards as they are phased in. Otherwise, there is a significant risk of an uneven playing field vis-à-vis other EC CCPs which could result in a competitive disadvantage for UK CCPs. Some of the UK CCPs may also be a part of non-EC corporate groups which could also lead to the same issue vis-à-vis their non-EC affiliate CCPs. We consider that alternatives to the allocation of NDL to market participants need to be explored within multinational forums. This is particularly critical in the event that a UK CCP participates in an interoperable arrangement and is subject to a loss allocation mechanism contemplated by other regulators.

Difficulty in formulating a priori rules for NDL

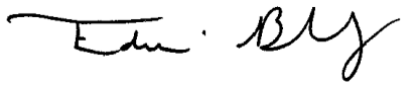
One possible option to absorb residual loss that exists following CCP insolvency could be a "bail-in"-type mechanism (assuming investors could be found) involving the negotiation of all of the commercial aspects of the proposal with relevant stakeholders. For example, the coupon of any bail-in instrument could be related to the amount of capital held by the CCP against the risks it faces. Debt securities are common bail-in instruments for banks but are not usually available to CCPs as they do not issue such instruments. Given that *a priori* bail-in rules appear very difficult to formulate per se and an unrealistic exercise in 6 months.

CCPs could also choose insurance (assuming an appropriate insurance solution were possible). They would also need to find an insurer and negotiate all of the commercial aspects of the proposal with relevant stakeholders in a market process. Accordingly, as per bail-in, a priori rules for insurance for NDL seem difficult to formulate and an unrealistic exercise in 6 months

CCPs also vary by size, systemic importance and the ease with which their rules allow participants to switch to alternative providers and it is critical that recovery plans be sufficiently flexible to allow regulators to tailor the approach to the specific situation of a particular CCP. In addition, the recovery plans should focus on maintaining continuity of service as opposed to preserving the CCP itself. A distinction should be drawn between the ownership and operations of a CCP so that bankruptcy/ failure of ownership do not automatically result in cessation of operations.

We welcome the opportunity to share these comments and would be pleased to have further discussions with HMT in implementing an appropriate regulation within a more workable time frame. We consider this work would reduce risk and foster financial stability. If you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,



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