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Brexit – CCP Location and Legal Uncertainty

The UK's withdrawal from the European Union (EU), set for March 2019, is now little more than 18 months away. Negotiations between the UK government and the European Commission (EC) on an exit deal are still in their early stages, and there is a very long list of details to be squared away, covering a whole range of legal and economic areas.

The shape of any final Brexit deal will have far-reaching consequences for ISDA's members and the broader derivatives market. This is the opening whitepaper in a series that will examine Brexit-related issues, and highlight the need for a smooth transition.

One of the highest-profile issues for the financial sector post-Brexit is central counterparty (CCP) location. The vast majority of EU clearing currently takes place in London, but there are suggestions that EU regulators might introduce a location policy for euro-denominated swaps to be cleared in the EU.

The EC published proposed regulation for CCP supervision on June 13, 2017. Ahead of that proposal, ISDA highlighted the issues associated with a possible location policy in a letter to EC vice-president Valdis Dombrovskis. This paper outlines the analysis contained in that letter. ISDA and its members are working through the EC's proposed rules on CCP supervision, and will summarize the results of this analysis in a future whitepaper.

Another important issue is the need to secure legal certainty for derivatives trading between UK and EU counterparties after March 2019. ISDA urges both the UK and EU to agree on post-Brexit transitional provisions for contracts under English law to reduce complexity and costs for all market participants.

CCP LOCATION

A location requirement for euro-denominated swaps could increase risk and costs in the EU and raise overall initial margin levels by 15%-20%

Central clearing volumes have increased significantly since the Group-of-20 (G-20) nations identified the clearing of standardized derivatives as a key commitment following the financial crisis. More than 70% of total interest rate derivatives notional outstanding is now cleared, compared with less than 20% prior to the crisis.

This shift is not solely due to clearing mandates put in place by regulators in the US, Europe, Japan and elsewhere. Dealers have embraced clearing as a means to manage counterparty risk, and because of the economic and operational efficiencies it provides.

Those benefits depend on economies of scale, which arise from the ability of globally active firms to clear contracts on a cross-border basis. The greater the participation at a CCP, the greater the potential to realize offsets and reduce margin requirements. The ability to net all exposures to one CCP from instruments in the same asset class – known as multilateral netting – is risk reducing and cost-efficient for clearing members and clients.

The EC has stated[1] there is a need for safeguards to support the financial and monetary policy responsibilities of EU and member-state institutions, particularly after Brexit. From that point, a substantial volume of cleared derivatives denominated in euros and other EU currencies might no longer be subject to the European Market Infrastructure Regulation (EMIR) or EU supervisory architecture.

In a letter sent to the EC's Valdis Dombrovskis on June 8[2], ISDA set out the economic and financial implications from any potential location policy for the clearing of euro denominated derivatives.

ISDA's analysis identified several issues with a location policy:

- Price volatility and execution costs, especially for eurozone end users;
- Increased systemic risk because of smaller, weaker CCPs;
- Unprecedented complexity and operational risk if legacy transactions have to be migrated to the EU27;
- Cost of splitting netting sets and increased capital cost;
- Access to CCPs for end users

ISDA believes that the UK and EU authorities should instead agree appropriate arrangements for oversight and cooperation with respect to UK CCPs.

[1] https://ec.europa.eu/info/sites/info/files/170504-emir-communication_en.pdf

[2] http://www2.isda.org/attachment/OTQ2Ng==/ISDA%20FINAL%20response%20to%20EC%20Communication%208%20June%202017.pdf

Price Volatility and Execution Costs

Any location policy that applies to certain contracts traded from a specified date in the future would artificially exacerbate differences in pricing (basis) that currently exist between CCPs. This basis often exists because different CCPs have diverse sets of participants, with varying objectives in their derivatives use. This is typically driven by exceptions from the clearing mandate.

For example, pricing at a CCP used predominantly by large derivatives dealers would diverge from that of a CCP used primarily by end users. That's because the majority of CCP participants would have similar transactions, due to the clearing mandate applying to some classes of end users but not others. As firms build new portfolios at EU-based CCPs, liquidity in euro derivatives trading in particular could see dramatic fluctuations, exacerbating the risks associated with this basis.

If the location policy was retroactive, then firms would have to reprice existing trades that are moved to the EU CCP. If a significant number of counterparties seek to unwind positions at one CCP and reopen them at another at the same time, then the pricing basis will be severely exacerbated, causing unwanted volatility and stress in the market.

It is not clear that global liquidity in euro-denominated cleared contracts would flow to an EU CCP in the event of a location policy. According to LCH, only 25% of its euro-denominated activity is cleared by EU firms. As a location policy can only be enforced on transactions where at least one counterparty is located in the EU, it is to be expected that the clearing pool in the eurozone will be less liquid compared to the current globally integrated pool. Less liquidity will lead to less competition and less choice, and potentially wider bid/ask spreads.

The impact of a basis between a non-EU and EU CCP will not only be felt by clearing members. The net effect of these factors will be most keenly felt by clients, with consequences for financial and corporate investment and hedging decisions.

Increased Systemic Risk Because of Smaller, Weaker CCPs

To the extent that a location policy has been considered in jurisdictions other than the EU, it has only been considered for small CCPs in much smaller local swap markets, and has either typically been abandoned as a policy option (in Canada and Australia, for example) or drastically scaled down (Japan).

In the Canadian case, a working group chaired by the Bank of Canada and including representatives from other Canadian regulatory agencies assessed the case for an onshore clearing requirement for Canadian counterparties from late 2010, but concluded against it in 2012. The working group recognized that global CCPs support liquidity and efficiency in the over-the-counter (OTC) derivatives market, making them more robust to financial shocks. This, in turn, supports the ability of derivatives users to prudently manage risk. The Canadian regulators view adherence to the Committee on Payments and Market Infrastructures (CPMI) and International Organization of Securities Commissions' (IOSCO) Principles for Financial Market Infrastructures as a sufficient safeguard[3].

[3] See http://www.bankofcanada.ca/2012/10/statement-by-canadian-authorities/

The Australian clearing regime stipulates mandatory clearing of certain interest rate derivatives denominated in Australian dollar, US dollar, euro, sterling and yen, but permits counterparties to these trades to clear at local CCPs or in a number of overseas CCPs. The Australian Securities and Investments Commission cited a wish to minimize disruption to Australian participants in OTC derivatives markets, and referred to the adequacy of CPMI-IOSCO standards for foreign CCPs in this regard.

Where an onshore clearing requirement has been mandated in derivatives markets of a material size in other jurisdictions, the requirement has been limited to local market participants trading swaps (with an identified local nexus) with each other. This is the case in Japan. Even here, volumes are insignificant in comparison to the volume of euro-denominated derivatives in LCH, and the final regime represents a scaling back from the original counterparty scope of the requirement. For example, average daily cleared volume in yen-denominated swaps at the Japanese Securities Clearing Corporation over 10 trading days (May 18-May 31) was ¥3,888 billion (€34.9 billion). That compares to €670.8 billion traded in euro-denominated swaps at LCH on May 31.

A CCP clearing only 25% of the euro-denominated interest rate swaps is expected to be a less liquid CCP, subject to higher margin and other costs, and with a greater burden on its members in terms of underwriting risk. That would be the case at times of market calm, but also in market stress, where the remaining clearing members would have to mutualize the default of one or more of the CCP's members. The remaining clearing members would also be more correlated.

Operational Risk

No regulator in any jurisdiction has to date attempted to implement a location policy involving the movement of such a vast amount of derivatives-related risk from one CCP to another, let alone from a CCP in one political and legal jurisdiction to another ($84 trillion notional volume of euro-denominated swaps has been cleared at LCH's SwapClear so far in 2017, $21 trillion between EU counterparties). The consequences are unpredictable.

Cost of Splitting Netting Sets

A location policy could mean that certain derivatives are removed from the netting set of a large non-EU CCP, and are instead cleared at an EU CCP. The smaller netting sets at both CCPs would lead to greater costs, because of reduced netting and collateral efficiencies for clearing members.

According to a survey of 11 banks conducted by ISDA, a requirement for euro-denominated interest rate swaps to be cleared post-Brexit at an EU-based CCP would result in an overall initial margin increase of between 15% and 20%. However, some larger clearing members have reported a more significant impact on initial margin (up to 54%), or a more significant impact on client accounts than on house accounts. The increased margin also indicates increased risk caused by fragmentation, and will lead to increased capital costs.

The costs for clearing members associated with this additional initial margin will ultimately be passed on to clients. End users would therefore experience higher costs associated with hedging commercial and treasury risk.

Reduced CCP Access

In the event of a location policy being implemented, it will take a long time for many end users to be able to access clearing of euro-denominated OTC derivatives at an EU CCP. Connecting to a CCP is a time-consuming and labor-intensive process, requiring legal, operational, financial and risk management expertise. A bottleneck in clearing may prevent access to OTC derivatives hedging business, meaning important financial and commercial risks cannot be adequately managed – an obstacle to investment in the wider economy.

G-20 Principles

The EU has implemented the 2009 G-20 commitments on derivatives reform, including a commitment to avoid "fragmentation of markets, protectionism, and regulatory arbitrage".

This approach is reflected in the EU's advocacy in favor of the principles of deference and international comity in international forums – for instance, IOSCO and the Financial Stability Board (FSB). These principles have been made explicit in successive FSB progress reports on the implementation of OTC derivatives reforms.

An EU CCP location policy would run contrary to the deference principle, and would fragment markets. Fragmentation is harmful to the wider economy, as well as to financial markets. ISDA believes it is appropriate for EU and non-EU regulators to agree arrangements ensuring that EU regulators have adequate oversight of risk managed at third-country CCPs that are relevant to the EU financial system. A CCP location policy would be damaging to EU economic interests, and should not be pursued.

LEGAL UNCERTAINTY

Post-Brexit transitional provisions for cross-border transactions are vital to prevent legal uncertainty, higher costs and greater complexity

With the clock ticking down towards the UK's exit from the EU, it is important that all parties work to establish transitional provisions safeguarding legal certainty for derivatives trading between UK and EU counterparties after March 2019[4].

If transitional provisions are not put in place, it may result in an increase in complexity, more uncertainty and higher costs for market participants.

What is Required?

The vast majority of cross-border transactions in complex financial instruments in the EU/European Economic Area (EEA) are governed by English law[5]. This allows for any legal adjudication between counterparties to take place in an English court.

It is currently uncertain whether the choice of English law and jurisdiction made prior to Brexit will be recognized once the UK leaves. This makes it difficult to establish commercial relationships, as these arrangements are commonly made at their outset.

There are currently two elements of contractual certainty for EU counterparties using UK law and jurisdiction provisions in their ISDA Master Agreements. First, there is the choice of law provision, which selects a governing law by which the transaction will be adjudicated if a litigation occurs sometime in the future.

Second, there is a jurisdictional provision that selects a court to hear disputes between the parties. Under current EU law, counterparties can rely on the recognition and enforcement of a judgement made in an English court, or a court in any other EU country[6].

This provides a very high degree of legal certainty that cases will be adjudicated under the law selected, by the court that they anticipate, and will be enforced after judgment anywhere in the EU.

Absent a transitional agreement between the UK and the EU providing safeguards for choice of law, choice of forum and the cross-border recognition of such elections, enforcement of court judgements could be lengthy and costly. Transitional arrangements should provide for the continued application of the rules for automatic mutual recognition and enforceability of judgments.

[4] See ISDA's Brexit Q&A: http://www2.isda.org/functional-areas/legal-and-documentation/uk-brexit/

[5] ISDA Master Agreements are produced under English law, New York law and Japanese law. Generally parties enter into an ISDA Master Agreement at the outset of their relationship, and the original master agreement remains in place over many years

[6] The question of jurisdiction, especially regarding the jurisdiction of English courts under an English choice-of-court agreement, the application of English law and the enforcement of English judgments, are currently subject to automatic mutual recognition based on the relevant EU regulations (Rome 1 and Rome 2 Regulations plus Brussels 1 Regulation)

Mutual Recognition

There is no similar regime of mutual recognition available outside of the existing EU legal framework, the Brussels 1 regime. This regulates which courts have jurisdiction in civil or commercial legal disputes between actors in different EU member states. Neither the Lugano Convention, which extends the recognition regime to European Free Trade Association member states that are unable to sign the Brussels 1 agreement, nor the Hague Choice of Court Convention, which covers the EU and a select number of other signatory nations, provide the same type of protection as Brussels 1, nor have the same scope.

The Lugano Convention has not been amended to provide the same content as the latest version of Brussels 1. The Hague Choice of Court Convention only works for certain types of exclusive jurisdiction clauses, and cannot be applied retroactively to existing agreements.

It will take time for the UK to adhere to these conventions in its own right, requiring a transition period. A wholesale switch to arbitration clauses, which are not subject to EU regulation but are part of a wider global framework under the New York Convention, would not provide the same degree of coverage. For example, insolvency court decisions are not covered by arbitration agreements, and a global regime for the mutual recognition of insolvency judgments is years away from entry into force.

Bank Resolution

The mutual recognition of bank resolution regimes across the EU/EEA has been implemented in full by all EU member states, including the UK. The industry has worked closely with regulators to develop contractual amendments across all asset classes in order to enhance systemic stability (for example, the ISDA 2016 Bail-in Article 55 Bank Resolution Regime Directive Protocol, and the ISDA Resolution Stay Jurisdictional Modular Protocol).

This system of mutual recognition of English law contracts and UK resolution measures should be preserved. English law agreements are currently subject to the EU statutory bail-in regime without the need for contractual amendments to each contract with every counterparty. This will no longer be the case after Brexit, because the UK will be a third country in the eyes of the regime. Given the number of English law agreements entered into between EU and UK counterparties, it would require a major effort to insert such bank resolution regime clauses. This would be expensive and time-consuming, hence the need for preservation of mutual recognition of bank resolution regimes during any transitional period. A transitional agreement should also therefore ensure that any relevant bank resolution regimes currently in place, as well as any other material regulatory issues, are adequately safeguarded.

Insolvency Procedures for Corporates and Financial Institutions

The mutual recognition of insolvency procedures for corporates and financial institutions across the EU/EEA, including conflict of law rules, is well established. Given the complexity of cross-border insolvency involving such entities, the continued mutual applicability of these regimes would be an effective method for ensuring systemic stability and legal certainty.

If these regimes ceased to apply between UK and EU-based counterparties, a much less developed regime[7] based on national laws and the much less elaborate rules of each EU member states and the UK would apply. This patchwork of national rules and procedures would make harmonization all but impossible, resulting result in duplicative proceedings in multiple jurisdictions in any given insolvency. This will increase expense and diminish returns for stakeholders.

CONCLUSION

Clearing location and choice of English law are key issues affecting derivatives markets that need to be addressed

In summary, ISDA believes an EU CCP location policy would increase costs for market participants and create a more fragmented and less secure clearing house landscape.

ISDA also urges UK and EU policy-makers to remove any legal uncertainty over cross-border English law contracts by designing transitional arrangements to be put in place after the UK leaves the EU until a proper system of mutual recognition is introduced.

This whitepaper is the first in a series that will cover Brexit-related issues relevant to ISDA's membership and the wider derivatives market. It is important that any final Brexit deal creates a smooth transition for market participants and the wider economy, and allows for the maintenance of robust risk-management standards and legal certainty.

[7] The regime for mutual recognition of judgments has been in place since 1968 (via the Brussels Convention) and the choice of law regime has been in place since 1980 (via the Rome 1 Convention)