



Insight into the Current Status of Clearing Members' Brexit Contingency Plans



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About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry.

FIA's mission is to:

- *support open, transparent and competitive markets,*
- *protect and enhance the integrity of the financial system, and*
- *promote high standards of professional conduct.*

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EXECUTIVE SUMMARY

Following the publication in December 2017 of FIA's white paper *The Impact of a No-Deal Brexit on the Cleared Derivatives Industry*¹, FIA has interviewed 15 of its primary members, representing a cross-section of the industry's clearing firms by jurisdiction, market segment and size to discuss their Brexit implementation plans with respect to their client clearing business². Collectively, they represent the vast majority by volume of client clearing activity on UK and EU27 CCPs, for both cleared OTC derivatives and listed derivatives such as futures and exchange traded options.

This paper provides high level insight into institutions' progress with their contingency plans, the issues they face when structuring and executing such plans, and the policy proposals that would help address these issues.

The main priority of all institutions interviewed was business continuity. Clearing firms need to retain access to their clients and to market infrastructure, with a minimum amount of disruption to, or fragmentation of, their services to clients.

The concern expressed by a number of EU27 clearing firms is that they may be forced to close some or all of their client clearing business if UK CCPs (i) are not recognised under EMIR and/or (ii) fail to retain their QCCP status under the EU's Capital Requirements Regulation. In light of recent UK Prudential Regulatory Authority statements made in December 2017 and March 2018, which indicated that, for at least a temporary period, the UK would not prohibit UK firms from membership of EU27 CCPs, most firms are comfortable about being able to continue access EU27 market infrastructure from the UK. However, in the absence of reciprocal confirmation by the European Commission, such access is not currently so certain from an EU perspective. One clearing firm has indicated that they will cease providing access to EU27 CCPs for clients if they are unable to do so from the UK post-Brexit. Failure to retain current levels of access between the UK and EU27 would have a significant negative impact on two of the European Commission's key post-Financial Crisis policy objectives: access to clearing and the recoverability of CCPs.

"This snapshot survey reveals that significant uncertainty remains among clearing firms regarding the UK and EU regulatory environment post-Brexit."

- Walt Lukken, FIA President & CEO

¹ <https://fia.org/articles/fia-publishes-white-paper-impact-no-deal-brexit-cleared-derivatives-industry>

² This survey is a purposive sample carried out for general informational purposes and includes anecdotal information.



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RECOMMENDATIONS

Based on the results of the survey, it is clear that although clearing brokers are endeavouring to adapt to Brexit, significant concerns and uncertainties remain.

We urge UK and EU policymakers to consider the following steps:

1. The European Commission confirms whether, and from when, UK firms may be permitted to benefit from the third country passport under Articles 46/47 or MiFIR;
2. The European Commission confirms whether, and from when, UK CCPs will be capable of recognition under EMIR;
3. The European Commission confirms that UK CCPs will retain their "QCCP" status under the EU's Capital Requirements Regulation;
4. The European Commission confirms whether EU27 CCPs will be able to continue to service UK clearing members and clients;
5. The UK and EU27 each confirm whether the UK will continue to participate in the EU Emissions Trading Scheme during the Brexit transition period and whether the UK will adopt a domestic version of the scheme thereafter; and
6. The UK confirms whether and when it will implement a domestic version of the EU's REMIT regulation.



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KEY FINDINGS

FIA has met with firms headquartered in the US, UK, EU27 and Switzerland. Some firms already book trades to a European entity or operate in London via a branch of an EU parent; others book everything to London. Some firms have a significant EU client base and provide access to a number of EU financial market infrastructures (FMIs); others have very limited EU business on the client and/or FMI side. Some firms have little to no EU presence for their clearing business at this time and will need to set up their EU operation from almost nothing, i.e. to incorporate it, capitalise it, staff it and obtain licences and credit ratings. Other firms have as large a presence on the continent as they do in London and/or are already headquartered in an EU member state.

Accordingly, there is no one-size-fits-all solution to Brexit contingency planning. Each firm has to tailor their plans to their own business model, product suite and client base.

Key findings in this report are:

- **Firms are not willing to restructure their business at any cost.** If contingency plans are uneconomic, they may either cease servicing certain clients, providing access to certain FMIs and/or close entire business lines. Our findings indicate that some firms would consider responding to UK CCPs losing EMIR authorisation, and failing to receive EMIR recognition, by exiting OTC derivatives client clearing. One firm has indicated that it will cease providing access to EU27 CCPs for clients if that firm would be required to establish a new EU27 affiliate in order to retain such access. Another firm proposes to resign its memberships of EU27 CCPs and continue to access the same via a non-affiliated intermediary broker, rather than transfer the membership of its UK affiliate to its new EU27 affiliate;
- **Many firms anticipate fragmenting their client relationships across their UK and EU affiliates, by client jurisdiction and/or by product,** with the result of a duplication of exchange and CCP memberships, reduced netting benefits, increased capital requirements, increased default fund contributions, increased margin calls, duplication of systems and processes, etc. This will ultimately result in a significant upfront and ongoing increase in costs for market participants;
- **The number of indirect clearing relationships will increase significantly for listed derivatives** with respect to EU27 clients clearing on EU27 CCPs due to the use of routing trades via a clearing broker in the UK;



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- **However, direct clearing via an EU clearing member will continue to be the norm for cleared OTC derivatives** that are cleared on an EU27 CCP for EU27 clients. The typical clearing chain will be comprised of “*EU27 client - EU27 clearing member - EU27 CCP*”. Indirect clearing will be rare for cleared OTC derivatives, in part because cleared OTC derivative clients want their positions and assets maintained in an individually segregated account (ISA) at the CCP and in part because there is no industry standard way of documenting an indirect clearing relationship for cleared OTC derivatives;
- **Almost all clearing brokers propose to service their EU27 clients from an EU27 affiliate**, rather than their UK affiliate;
- **Thus far there has not been a meaningful shift in client clearing from UK CCPs to EU CCPs**;
- **There is significant uncertainty as to how certain EU regimes will operate in practice in the UK post-Brexit**. This is particular issue in the commodities sector as it is unclear how the EU Emissions Trading Scheme and REMIT will operate (if at all) in the UK post-Brexit and who will be responsible for supervising market participants in the UK.



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KEY RESPONSES TO FIA'S SURVEY QUESTIONS

Set out below is a summary of the responses received from the 15 FIA members that were surveyed.

1. What is the main Brexit priority for firms?

All firms say that business continuity is the most important issue they face. Business continuity requires maintaining full access to clients and financial market infrastructure in both the UK and EU27.

2. What is the worst case scenario for which firms are planning?

Save for two firms, all firms interviewed are assuming that there will be no transition period and no third country passport under MiFIR that would enable UK established clearing brokers to service their EU27 clients from the UK.

Over half of the firms surveyed are planning on the basis that UK CCPs will not become recognised under EMIR, such that they become prohibited from having EU27 clearing members and that companies cannot use UK CCPs to meet their mandatory clearing obligations under EMIR.

A similar number assume that EU27 CCPs will not be permitted to have UK clearing members. A couple of firms are planning on the basis that UK CCPs will be required to have UK clearing members. The statements made by the UK's Prudential Regulatory Authority in December 2017 and March 2018 have given some assurance to participants that EU27 CCPs will be recognised by the UK and that UK CCPs will be permitted, under English law, to have EU27 clearing members. On 28 March 2018, the Prudential Regulatory Authority published confirmation of its approach to the authorisation and supervision of international banks, insurers and central counterparties (CCPs). That roadmap has provided some assurances to members. However, in the absence of reciprocal statements from the European Commission and ECB, that PRA guidance is only being relied upon by a small number of firms surveyed.

Firms are considering a range of options for responding to a scenario of no UK CCPs being recognised under EMIR, from moving business to the EU27 or the US to closing down entire business lines. If UK CCPs are not recognised then some firms have indicated they may shut their client clearing business with respect to OTC derivatives.



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3. When will firms commence executing their 'worst case scenario' plans?

Three firms have already started and another will commence in June 2018. The vast majority of firms are still determining the deadline date, with target dates ranging from end of summer to Q3 2018. Others are awaiting further confirmation from within their firms.

4. How do firms propose to access EU CCPs for EU clients with respect to listed derivatives post-Brexit?

"EU client – EU affiliate – EU CCP" is the preferred clearing chain for half of the firms surveyed, because they consider that it fully mitigates the risk of UK firms not being able to service EU27 clients from the UK and the risk that EU27 CCPs cannot have UK clearing members post-Brexit.

About a third of firms will instead establish an indirect clearing relationship to provide access to EU27 CCPs for EU27 clients, most of which will be routed via a clearing broker in the UK.

Some EU CCPs only permit EU clearing brokers. As a hedge, some members are therefore applying for their EU affiliate to become a clearing member of the CCPs in those jurisdictions.

If UK clearing members of certain EU27 CCPs are no longer permitted membership of those CCPs post-Brexit, one clearing firm has indicated that they will give up their EU27 CCP membership and instead clear their client business through a non-affiliated clearing member of that CCP, rather than transfer the membership of its UK affiliate to its new EU27 affiliate. Another clearing firm has indicated that it would completely cease providing access to EU27 CCPs for clients in that scenario. The firm would then have more capital available to increase its client clearing business with respect to exchange traded derivatives cleared on UK and US CCPs. It is the cost of capitalising a new EU affiliate, meeting intra-day margin calls and of being a clearing member on EU27 CCPs that is driving these two firms to consider taking these actions.

5. How do firms propose to access EU CCPs for US clients with respect to listed derivatives post-Brexit?

Firms will take one of two indirect clearing routes – there is a slight preference to route trades via the EU affiliate rather than the UK affiliate as part of firms' contingency plans:

- *US client – US affiliate – UK affiliate – EU27 CCP; or*
- *US client – US affiliate – EU27 affiliate – EU27 CCP.*

6. How do firms propose to access EU CCPs for UK clients with respect to listed derivatives post-Brexit?

For UK clients, firms typically propose to take one of two direct clearing approaches – again, there is a slight preference to route trades via an EU27 affiliate:

- *UK client – UK affiliate – EU27 CCP; or*
- *UK client – EU affiliate – EU27 CCP.*

A couple of firms propose to mirror their approach for US clients, by adopting an indirect clearing arrangement of UK client – UK affiliate – EU27 affiliate – EU27 CCP.

7. How do firms propose to access EU CCPs for EU clients with respect to cleared OTC derivatives post-Brexit?

In contrast to listed derivatives, no clearing broker interviewed by FIA proposes to use their UK affiliate as the clearing member of the EU CCP to clear OTC derivatives. Instead, their EU27 affiliate will be the clearing member.

For cleared swaps, clients typically require an individually segregated account (ISA) at the CCP for their positions and assets. Clients can only obtain an ISA if they face the clearing member directly. In theory, they could achieve a similar level of protection via indirect clearing if they opted for a Gross Omnibus Segregated Account (GOSA) into which only their positions and assets (but not those of other clients) are credited, but in practice there is no industry standard documentation solution for the indirect clearing of swaps, so bespoke arrangements would be required.

8. How do firms propose to access EU CCPs for non-EU clients with respect to cleared OTC derivatives post-Brexit?

There are a very diverse range of approaches across firms. Several propose to offer access to EU27 CCPs via a UK affiliate, either directly or indirectly.

9. Have clients voluntarily increased the amount of trading / clearing / reporting in Europe as part of their contingency planning and/or started to migrate that activity to Europe?

Almost every firm surveyed confirmed that they are *not* seeing a voluntary increase in clients clearing activity through EU27 CCPs at present. Whilst clients are increasingly asking questions, only a small number of clients are proceeding to set up accounts with respect to EU27 CCPs. Almost no clients are reported to have commenced clearing via EU27 CCPs voluntarily where more liquid alternatives currently exist in the UK.

EU27 client awareness of the potential for loss of market access to UK CCPs is low.

10. What difference, if any, has the recent announcement on transitional arrangements made to contingency planning?

With two exceptions, firms are still planning for their worst case scenario. Firms note statements made by the UK's Prudential Regulatory Authority and Financial Conduct Authority shortly after the transition period was politically agreed between the UK and the EU27 earlier this year but, in the absence of equivalent statements from the European Commission and ECB, firms are not willing to rely on such statements for the purposes of their contingency planning, as they do not provide sufficient certainty. The UK policymaker statements are undoubtedly welcome, but there is still a tangible risk of the political deal unravelling.

11. What issues are arising for clearing brokers with respect to contingency plans?

In this section, we set out a non-exhaustive overview of the various issues raised by clearing brokers with respect to the preparation of their Brexit contingency plans.

Establishment of EU entities

Some clearing brokers have to set up new EU27 entities from scratch. They need to be established, capitalised, licenced, staffed and credit-rated. Clients may be reluctant to sign the legal documentation that will govern their new relationship with that new EU entity until it is fully operational.



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Licensing in EU Member States

It takes a significant amount of diligence to ascertain the licensing regime in each EU jurisdiction in which firms wish to operate. Licences will typically be required (i) to establish a subsidiary in an EU member state and (ii) to service clients in an EU member state from the UK.

Capital and netting fragmentation

Many firms are fragmenting their client relationships across their UK and EU affiliates, by client jurisdiction and/or product, with the result of a duplication of exchange and CCP memberships, default fund contributions, reduced netting benefits, increased margin calls, duplication of systems and processes, etc. This will ultimately result in an increase in costs for market participants.

Leverage balance sheet constraints

Some firms' businesses are constrained by the leverage ratio and note that their EU entities may have a leverage problem as, at least initially, their only business lines will be with respect to products that are low risk and yet big consumers of leverage.

Exchange and CCP migration

A number of firms are establishing new exchange and/or CCP memberships for their EU affiliates. This process takes time. Firms have expressed concern at the ability of exchange and CCPs to cope with so many applications, as well as coping with the increase in clients seeking to open accounts at EU CCPs.

Client repapering

For most firms, including certain EU27 clearing brokers, the client repapering exercise will be one of the most challenging aspects of their Brexit contingency plans with one firm considering moving 4,000 separate client accounts to its EU entity.

For a very small number of EU27 headquartered entities, client repapering is not so complex or not applicable at all, as their European clients are either papered to an EU entity already or are papered to the London Branch of their EU parent.

Indirect clearing – documentation issues

As noted above, indirect clearing arrangements will become much more prevalent post-Brexit. No such template exists for OTC derivatives.



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Novation of parties to existing give-up agreements

Give up agreements have three counterparties, the client, the executing broker and the clearing broker.

Any or all of these counterparties could change as a result of firms' and clients' contingency plans, e.g. a UK affiliate that current performs one of those roles could seek to novate its rights and obligations to an EU27 affiliate.

As noted by one FIA member "If we have to migrate 500 clients in one day, how do we do that without having to change each give up agreement one at a time via a manual process?"

IT costs

Firms have to consider whether to build the necessary technology to introduce another legal entity into their IT platforms. They also have to reconfigure how data flows through their systems through the trade lifecycle. This IT work is both expensive and time-consuming.

Impact of migrations on hedge accounting for cleared OTC derivatives

Some firms are investigating whether the migration of clients' cleared OTC derivatives from one affiliate to another could have a negative impact on clients' hedge accounting treatment for their cleared OTC derivatives.

Limitations in EU27 central bank and regulator capacity

Some firms are reporting that they see evidence of certain EU27 central banks and regulators struggling to commit sufficient resource to queries relating to the establishment of new affiliates in their jurisdiction.

Lack of clarity on the UK regulatory arrangements post-Brexit

Whilst the general approach of the UK is simply to "copy and paste" all applicable EU financial services regulation, and change the references to "European Commission" or "ESMA" to the relevant UK authority, there is significant uncertainty as to how certain EU regimes will operate in practice in the UK post-Brexit.

This is particular issue in the commodities sector. It is unclear how the EU Emissions Trading Scheme and REMIT will operate (if at all) in the UK post-Brexit and who will be responsible for supervising market participants in the UK.

Resources

Some firms expressed concern at the level of available resources to spend on either Brexit contingency planning or on other opportunities and client requests for new markets that they want their clearing brokers to join. The constraints seem most acute on the technology side and, in a few months' time once client repapering begins, on the client management side.



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Asset protection

Some clients are enquiring about the detail of EU27 client money and client asset protection regimes and how they compare to the UK's client money and client asset protection regimes (CASS).

Client asset protection frameworks in Germany and elsewhere in the EU27 are different to, and not as comprehensive as, the UK's CASS regimes. The client money calculations, audit process and booking models are all different to the UK regime. Some regimes require a trust account for excess client collateral and firms can only fund what's required from the client trust account.

Real money clients such as pension funds and other investors who do not borrow funds in order to invest are very focused on client asset protection post-financial crisis, but they do not typically have an awareness of EU27 segregation regimes.

12. Are clients concerned about EU access to UK markets?

Generally, yes. Assuming EU access to UK markets is not permitted, firms would want to maintain the economic position. The main way to transfer a cleared derivative position from a UK CCP to an EU27 CCP is to close out the position at the UK CCP and open a new position at an equivalent EU27 CCP (where possible). Following such a process could be prohibitively expensive. Some firms felt that whilst some hedge funds have the expertise to trade around the risks, most clients are less sophisticated.

13. Are you worried about contractual continuity with respect to cleared derivatives?

Many firms initially perceived this issue as a bilateral OTC derivatives issue.

However, firms are concerned by the risk that UK CCPs will not ultimately be recognised under Article 25 of EMIR, with the result that UK CCPs will become prohibited under EMIR from having EU27 clearing member and EU27 users will be unable to satisfy their EMIR mandatory clearing obligation (for both legacy trades and new trades) on UK CCPs. Whilst EU27 clearing members could seek to gain on-going access to UK CCPs via a non-EU27 carry broker, in practice that would be unprofitable as a result of the non-QCCP status of UK CCPs under CRR resulting in the loss of ability of those EU27 firms to apply a risk weight of 2% or 4% to their exposures.

Firms are also contingency planning for the possibility that EU 27 CCPs will not be permitted to have UK clearing members.

All firms are contingency planning on the assumption that the UK will not benefit from the 3rd country passport under MiFIR post-Brexit. The majority of firms propose to transfer their client facing relationships with respect to their EU27 clients to an EU27 affiliate, to the extent that those clients do not already face an EU27 affiliate.

14. Noting ESMA's Q&A #25 under MiFID II, which states ESMA's view that providers of Direct Electronic Access (DEA) with respect to European trading venues have to be established in an EU Member State, are you moving DEA provision to an EU27 jurisdiction?

All firms who provide DEA with respect to EU trading venues confirmed that they are migrating, or have already migrated, their DEA provision to an EU27 affiliate.

15. Are there certain asset classes that are more adversely affected if UK CCPs do not obtain recognition under EMIR?

Firms noted that a number of commodities contracts that are capable of being executed and cleared at UK CCPs are not capable of execution or clearing on EU27 trading venues or CCPs (nor, in some cases, anywhere other than in the UK).

As commodity derivatives are not currently subject to the mandatory clearing obligation under EMIR, it would still be permissible for EU27 firms to continue to clear commodities contracts on UK CCPs post-Brexit in the event that UK CCPs are not recognised under EMIR. EU27 firms would not, however, be permitted to remain clearing members of UK CCPs and would have to clear their trades via a non-EU27 clearing member.

However, if a UK CCP becomes a non-QCCP under the Capital Requirements Regulation as a result of non-recognition under EMIR, the capital requirements for EU27 firms who continue to clear derivatives on those UK CCPs would rise to such a significant extent that the trades cleared at such UK CCPs unprofitable as a result. So whilst not legally precluded from clearing commodities on UK CCPs in that scenario, they would become economically precluded from doing so.

As a result, many members felt that their only option will be to trade commodities on an OTC basis or to stop participating in that business line. Some firms would trade and clear more of their metals business in the US. At least one firm would close its metals clearing business if UK CCPs do not obtain recognition under EMIR Article 25.



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