Financial sector resolution: broadening the regime (Cm8419)

A response paper by the Futures and Options Association

SEPTEMBER 2012

FINANCIAL SECTOR RESOLUTION: BROADENING THE REGIME

HM Treasury Consultation Paper (Cm8419)

1. Introduction

1.1 This response is submitted on behalf of the Futures and Options Association ("the 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 supports the introduction of a legal and regulatory framework that allows the well-ordered winding down of any non-bank investment firm with a minimum of disruption to the markets and a minimum of loss and/or delay to its clients or other market participants in the execution, clearing and settlement of all open transactions.

In this context, the FOA recognises that investment firms and parent undertakings, central counterparties, non-CCP financial market infrastructures and insurers have the potential to be systemically important, but:

- that potential is heavily dependent upon a variety of external factors, including the state of the market; and
- does not believe that this is true in the majority of cases and welcomes therefore HM Treasury's recognition that *"in each case, it is likely that only some, if any, of each type will actually be so"* (para 1.11), which is emphasised further in para 2.12, in the expectation that *"the vast majority of investment firms in the UK are non-systemic"*.

1.3 The FOA agrees with HM Treasury that, in many areas, *"competition is essential"* to the extent that, aside from other factors, it *"potentially mitigates"* systemic risk and facilitates the resolution of failing institutions by ensuring product/service substitutability between providers, i.e. there should be enough competing providers to assume the functions and responsibilities of a failing institution within their group/class (para 1.13). In this context, it is noteworthy that the FCA is to be given a new role in the area of monitoring and maintaining competition in the financial services sector.

1.4 The FOA understands the priority that has to be given by HM Treasury in terms of ensuring that there will be an adequate resolution framework in place in the UK and this may involve introducing such a framework in advance of finalisation of the European Commission's Recovery and Resolution Directive (RRD), which is a complex piece and could be the subject of protracted negotiation.

The FOA is concerned, however, over the risk that firms may be subject to a two-step change agenda in this area, firstly, involving the introduction of the UK framework and then its adaptation to comply with, once it has been finalised, the RRD and that this could generate a cost and resource burden of changing resolution plans, recovery plans, restructuring resolution funds, etc. The FOA notes the assurance in the CP that HM Treasury will *"pay close attention to developments in Europe and also to other international work, so that UK action to ensure that non-banks can fail safely both supports the strengthening of the Single Market, and adequately reflects the cross-border nature of financial markets"* (para 1.15) and that it has every intention that the framework will be designed *"to be consistent with the proposed RRD, the FSB's Key Attributes and the existing Banking Act 2009"* (para 2.8).

1.5 The FOA accepts that there are a significant number of variables that have to be taken into account in defining the systemic risk posed by a particular firm or market infrastructure, but even though a prescriptive definition may not be possible, the FOA believes that regulatory transparency and predictability require HM Treasury to set out the criteria that will fall for consideration in determining whether or not systemic risk is posed by a particular firm. As HM Treasury will appreciate, it is important that all steps are taken to ensure that, so far as possible, investment firms can predict with reasonable confidence whether or not they are, or are likely to be, regarded as systemic and therefore subject to the requirements and obligations in the new resolution framework. It would clearly not be appropriate for investment firms which would not be regarded as systemic in any reasonably predicted scenario to have to incur costs and a burden on their resources that may be both irrelevant and unnecessary.

The FOA supports therefore the intention that the new legislation will:

- where proportionate and appropriate, adopt the same arrangements as exist for deposit-taking institutions;

- even though certain trigger conditions are met, will only justify resolution action in the case of a firm that was systemically important (para 2.19); and

- set out specific exclusions from the definition.

As previously stated, the FOA welcomes HM Treasury's recognition that it expects that *"the vast majority of investment firms in the UK are non-systemic"* (para 2.12).

1.6 The FOA supports the additional objectives of:

- protecting client funds and client assets; and

- avoiding unnecessary interference with the operators of financial market infrastructures, including adverse effects on investment exchanges and clearing houses.

The FOA believes that, in order to achieve benefits for clients, counterparties and creditors of failed firms (which, in many cases, will involve an international client base) and to maintain financial stability and effective functioning of markets, there should be a focus on increased pre-insolvency monitoring and supervision of firms holding clients' money and assets and on the implications of cross-border insolvencies where clients' money and assets may be held overseas and subject to a different insolvency regime.

1.7 While the FOA recognises that there are Commission competencies in this area, it is important that the proposed new UK framework:

- provides for co-operation with third-party country authorities and facilitates support of foreign resolution actions (to the extent that they provide fair and equal treatment for all depositors and creditors and do not jeopardise the financial stability of the UK); and

- ensures the existence of a residual power to apply resolution tools to national branches of third-country institutions, where exercise of a power is justified and necessary for reasons of UK financial stability / the protection of local depositors.

The FOA recognises that the process of recognition of third-country laws on recovery and resolution of credit institutions and investment firms, and the process of increased harmonisation of those laws is a matter for the European Commission and a strong focus of IOSCO at the moment, but introduction of national legislation in the UK would have to manage the fact that such laws are divergent and ill-suited for dealing with cross-border crises.

1.8 The FOA has seen and supports the response made by GFMA to the recent IOSCO CP on resolution CPPS-IOSCO Recovery and Resolution Consultative Report.

2. Investment firms and parent undertakings

Do you agree that the four types of non-bank identified above – investment firms and parent undertakings, CCPs, non-CCP FMIs and insurers – are those that are most likely to have the potential to be systemically important?

2.1 Yes, although the FOA would emphasise its support for HM Treasury's view *"that the vast majority of investment firms operating in the UK are non-systemic"* (para 2.12) and, while the FOA would make no comment in relation to insurers (because this falls outside its remit), it believes that a significant number of non-CCP FMIs would fall into the similar category of being not systemic.

What other types of non-bank – if any – might have the potential to be systemically important? If there are any others that may be systemically important what policies should the Government adopt to mitigate the risk they pose to financial stability?

2.2 The FOA is aware of the concentration on shadow banking and, while it believes that, in the current climate where traditional banks are not in a position to adopt the levels of lending that was once the case and therefore shadow banks have a real role to play in filling that gap, it is conceivable that some such banks could become systemic. The same is true of hedge funds and any other high-volume, high-risk and highly-leveraged institutions that meet the criteria of scale and systemic dependency.

What are your views on the UK introducing resolution powers for these firms in advance of conclusion of the negotiation of the RRD?

2.3 The FOA would refer to its response in para 1.4 in the Introduction.

Is the definition for investment firms set out above appropriate?

2.4 Yes, subject to the introduction of appropriate exclusions to make clear which firms are subject to which resolution framework and the pre-conditions governing the exercise of the proposed stabilisation powers, including particularly the pre-condition that the firm must be *"systemic"*.

Further, given the significant differences in nature, scale and complexity of MiFID for investment firms, it is critical that the proposals are applied in a proportionate and cost-efficient way in order to avoid placing undue burdens on smaller firms in the unusual circumstances of any such firm being deemed to be *"systemic"*.

Are the conditions by which the Bank is required to judge the necessity of exercising stabilisation powers correct?

2.5 Yes.

Should any further safeguards be applied to qualify the use of powers within a financial or mixed holding company?

2.6 Yes, subject to full consideration being given to the importance of sustaining the stability of a group and its other affiliates (e.g. when assessing the extent to which critical assets/staff should transfer to a bridge entity or purchaser) and that, contrary to the assumption in para 2.16, the scope of consideration should not be restricted to reviewing the impact on only the *"wider, non-financial activities"* of a holding company and its affiliates, but on all other activities.

What should be considered the financial elements of a holding company? Should the authorities define 'financial elements' in the face of the legislation or in the accompanying code of practice?

2.7 The FOA believes that it would be appropriate to indicate factors that would point to whether or not any elements of a holding company were capable of being deemed *"financial"* rather than seeking to define the term closely. The FOA believes that it would be acceptable for the issue to be addressed in the accompanying code of practice, providing subsequent changes are well-publicised, transparent and accompanied by appropriate consultation.

Is the existing public interest test sufficient for defining the level of the authorities' possible intervention in a holding company?

2.8 Yes, subject to the caveats referred to in paras 2.6 and 2.7 above.

Do you agree with the trigger condition for enabling the exercise of stabilisation powers?

2.9 The FOA supports the view in para 2.18 that any decision to exercise stabilisation powers in relation to systemic investment firms would be *"a very significant step"* and should only be taken therefore *"where absolutely necessary"* and only in relation to a firm that is deemed to be *"failing, or likely to fail, its regulatory threshold conditions and that it is not likely that action (other than resolution action) will be taken to enable the firm to meet its threshold conditions)*. These policy statements should completely govern the interpretation of whether or not conditions are met and the FOA notes that, even if met, resolution action would only be taken *"if the firm's failure were also considered to be of systemic importance"* (para 2.19).

Do you agree with the suite of stabilisation powers proposed for systemic investment firms and parent undertakings?

2.10 In broad terms, yes. So far as possible, they should be approximated closely with the powers that exist within the SRR and in the draft RRD, but the FOA questions whether it is appropriate to exempt the explicit bail-in power in the RRD until the RRD comes into force. Bearing in mind that implementation of the RRD is of *"uncertain duration"*, is the Government at risk of denying itself the use of a power which, in certain circumstances, may be important? Further, it is not clear as to why this power has been exempted in this way.

2.11 Further, it is not clear why the other RRD stabilisation power facilitating the transfer of assets to an asset management vehicle has been deferred insofar as, even though it may not be used in conjunction with another RRD stabilisation tools. If the tools to be adopted by the UK are comparable to the RRD, then surely that power could be used in association with another UK stabilisation tool.

2.12 The FOA believes that the stabilisation powers designed to facilitate effective resolution should be broad-based and adequate for the purpose of, for example, simplifying complex legal operational structures, requiring the execution of service agreements and limiting the transactional exposures, business activities, etc.

Do you agree with the Government's intention not to include a power to transfer assets to an asset management vehicle in the suite of stabilisation powers?

2.13 See above.

Are any further safeguards necessary for the resolution of systemic investment firms and parent undertakings?

2.14 The FOA believes this question is best answered by those with a particular understanding of the resolution process.

Are there any additional areas a code of practice should cover that are particularly relevant to systemic investment firms or parent undertakings?

2.15 The FOA believes this question is best answered by those with a particular understanding of the resolution process.

Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime for investment firms?

2.16 Yes, but perhaps with a more inclusive name.

3. Central counterparties

3.1 The FOA wholly agrees that most major central counterparties (CCPs) are now of considerable systemic importance and should be the subject of a resolution framework, and that the failure of a CCP is likely to be (dependent on the product line) at its *"most extreme"* where it is the only clearer for a given asset class not subject to direct competition (para 3.11).

The FOA believes, however, that any proposed resolution framework for a CCP or a non-CCP FMI must take into account a number of factors, namely:

- the interconnectivity between a "defaulting" infrastructure and other infrastructure and the risk of contagion;

- in the case of a regulatory college, it is important that there is a clear decision-making process and responsibility which would largely sit with the primary location for the relevant infrastructure, but the consequences of failure and the resulting resolution process should take into account the impact and consequences for all effected host state authorities;

- proper consideration is given to whether or not a failing infrastructure could be corrected through a process of business and capital recovery as opposed to resolution, particularly since the risk to the financial system could be considerably less through the process of recovery than as a result of resolution.

3.2 Here again, the FOA welcomes HM Treasury's intention to legislate domestically *"in line with international principles"* and to approximate resolution powers to those available under Part 1 of the Banking Act 2009.

Do you agree with the scope of the intended resolution regime extending to all Recognised Clearing Houses incorporated in the UK which offer central counterparty clearing services?

3.3 Yes, but on the basis that the exercise of a stabilisation power in relation to a UK CCP is governed by where it is necessary in terms of maintaining financial stability and public confidence, i.e. that there is a tangible and well-defined financial stability impact.

Are there any further options available to CCPs, their members and markets to reduce the likelihood of a CCP failing?

3.4 The FOA would only make the general observation that the exercise of any stabilisation power should not compromise the importance of a CCP being able to take such actions as it deems necessary to manage or mitigate clearing risk, particularly at times of market stress, and believes that this should be specifically recognised in the indicative draft of the clause setting

out the power to direct UK clearing houses in para 3.25. That said, the FOA anticipates that this recognition is implicit in General Condition 3, which refers to *"maintaining the continuity of the provision of central counterparty clearing services"*.

Do you agree that measures that support substitutability of clearing services (e.g. through non-discriminatory access provisions and access to licences on a reasonable commercial basis) are an important underpinning to an effective regulatory and resolution regime?

3.5 Yes, for the reasons already provided in this response.

Are there any areas where you consider that CCPs should become more transparent about their risk management practices and resolution planning?

3.6 The FOA believes that these have been adequately addressed in the consultation on EMIR and by ESMA in developing the technical standards in support of EMIR.

Do you agree with the use of the failure, or likely failure, to meet its conditions for recognition as the general trigger for possible intervention in a clearing house?

3.7 Yes, on the basis that such intervention can only be carried out if other conditions are fulfilled. More particularly, it is important that the failure must be substantive or leading – or likely to lead – to the kind of impact envisaged in Specific Condition 1.

Do you agree with the specific conditions which must be satisfied before a stabilisation power may be exercised?

3.8 Yes.

Do you agree that the authorities should be able to intervene ahead of action taken by the clearing house to restore its financial position, but only in order to prevent disruption to or termination of critical clearing services consistent with the financial stability objective?

3.9 Yes, but on the basis that full consideration is given to the in-house expertise of the CCP to manage significant clearing risk and there is clarity around the powers and responsibilities that can be exercised by the FSA as well as the resolution authority and, further, by the CCP itself in order to avoid unnecessary cost and duplication.

Do you agree with the intended objectives of a resolution regime for clearing houses?

3.10 Yes, but the FOA believes that there should be an additional objective covering the management of clearing risk and would point out that Objective 9 is not in fact an objective, but a comment on the order in which the objectives are set out.

Do you agree with the proposed suite of stabilisation powers for clearing houses?

3.11 Yes.

Do you think there are any additional stabilisation powers necessary to be able to resolve a clearing house in all scenarios for failure?

3.12 The FOA believes that the current proposals are sufficient and is not aware of any additional powers that would be appropriate.

Do you agree that the resolution authority should be able to impose losses on members of a failing clearing house as part of resolution action? Should this be applicable to losses arising from any circumstance?

3.13 The FOA would point out that clearing members are already facing considerable increases in cost across the programme for regulatory and market repair/change and a decline in revenues. The FOA would urge HM Treasury to exercise considerable caution before loading up clearing members with additional and unforeseeable contingent and uncapped liabilities to meet uncovered losses / replenish default funds, and incur other costs and make other contributions in order to restore the clearing house to market viability. Any such obligation should, in any event, arise in connection only with a failure in the CCPs clearing activities and not, for example, losses arising from a general business, financial or operational failure unrelated to the delivery of clearing services. The FOA believes this is an issue that should be the subject of detailed consultation with clearing members.

Should any such liabilities be capped and, if so, how should such a cap be structured and its level determined?

3.14 Yes, but the level and structuring of any such cap should be a matter of separate discussion with affected firms.

Do you agree with the proposed safeguards? If not, what additional safeguards should the authorities consider in exercising the stabilisation powers in relation to a clearing house?

3.15 Yes, but it remains important that the pre-conditions for exercising a stabilisation power are met with strictly and that all other alternative processes, including the exercise of the FSA's powers, are given full prior consideration.

Are there any specific areas the code of practice should cover that are particularly relevant to CCPs?

3.16 The FOA believes this is best answered by CCPs and their clearing members. The FOA would only observe that multi-currency CCPs may require multi-currency liquidity support and full account should be taken of operational issues arising out of inter-connectivity and various offsets and netting arrangements.

Do you agree with the proposed power of direction over insolvency practitioners? Do you agree with the circumstances in which this power is intended to be exercisable? What safeguards do you consider should apply?

3.17 The FOA agrees with the powers of direction being exercised over insolvency practitioners, which would help to resolve the inherent tension between statutory obligations of an insolvency practitioner, which is to gather in the assets and not prefer one creditor over another; the regulatory duties and obligations owed to the clients of an insolvent firm as regards the return of client money and/or trust assets; and the role of the FSA to maintain the functioning of an orderly market. Further, the FOA has noted that the personal liability of insolvency practitioners often results in a protracted process and frequent recourse to the courts, yet prompt resolution is a key issue and the exercise of powers of direction over an insolvency practitioner could help to expedite the process.

Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime on CCPs?

3.18 Yes, subject to it being renamed to cover its wider scope.

4. Non-CCP financial market infrastructures

4.1 The FOA believes that the condition of the resolution regime applying to a FMI, namely, that it is systemically important, should appear right at the outset in para 4.2, particularly since it is likely

that most infrastructures, particularly exchanges and multilateral trading facilities (or, if they are introduced under MiFIR, OTFs) will not pose any risk to the financial system. It would be helpful if this recognition could be expressed publicly in the same way that it has been expressed in the context of investment firms (see para 1.2 in this response).

4.2 The FOA notes that little recognition is given to the powers of the FSA in terms of overseeing FMIs or to the fact that the FSA has specific and relevant statutory regulatory objectives in maintaining market integrity and confidence. The FOA believes it is appropriate that some consideration/recognition should be given to those powers in the context of determining whether or not to exercise powers of resolution.

4.3 The FOA welcomes and supports:

(a) the recognition in para 4.11 that there are *"significant"* differences in the form and function of FMIs and that this will require, in many cases, fundamentally different approaches;

(b) the recognition in para 4.13 that, in developing its policy to address the consequences of a failure of a CCP, the different regulatory initiatives that are underway (set out in para 4.12) will be taken into account.

Do you agree that the regulatory framework for dealing with the failure of at least some non-CCP FMIs needs to be enhanced?

4.4 Yes, subject to non-CCP FMIs satisfying the 'systemically important' test.

If so, what should be the criteria for determining whether a non-CCP FMI should be covered? Should companies providing critical services to FMIs be included?

4.5 The FOA doubts that it will be necessary or appropriate for companies providing services to FMIs to be included, other than where they are either critical to the functioning of the market, or where their withdrawal will have a serious adverse systemic impact.

Is it sufficient to strengthen the existing insolvency framework, or should a new resolution regime be developed? Should the same approach apply to all non-CCP FMIs? Should some non-CCP FMIs be prioritised over others?

How should improvements to the insolvency framework, or development of a resolution regime, be designed? In particular, what objectives, triggers for intervention, powers and safeguards should be put in place?

What are the competition implications of taking forward the sorts of approaches discussed in this chapter? How could the reforms contemplated here be designed so that they promote competition?

4.6 The FOA believes these questions are better answered by organisations with specific expertise in resolution, the non-CCP FMIs themselves and their intermediaries.l

5. Insurers

5.1 The questions in this section are outside the remit of the FOA and are best addressed therefore by trade associations representing the insurance industry.

APPENDIX 1

LIST OF FOA MEMBERS

FINANCIAL INSTITUTIONS
ABN AMRO Clearing Bank N.V.
ADMISI
Altura Markets S.A./S.V
AMT Futures Limited
Jefferies Bache Limited
Banco Santander
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures
BNY Mellon Clearing International
Citadel Derivatives Group (Europe)
Citigroup
City Index
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe)
Deutsche Bank AG
ETX Capital
FOREX.COM UK
FXCM Securities
GFI Securities
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
International FC Stone Group
JP Morgan Securities
Liquid Capital Markets
London Capital Group
Macquarie Bank
Mako Global Derivatives
Marex Spectron
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities
Morgan Stanley & Co International
Newedge Group (UK Branch)
Nomura International Plc
Rabobank International
RBC Europe Limited
Saxo Bank A/S
Scotiabank Europe
S E B Futures
Schneider Trading Associates
S G London
Standard Bank Plc
Standard Chartered Bank
Starmark Trading
State Street GMBH London Branch
The Kyte Group
The RBS
UBS Limited
Valbury Capital Ltd
Vantage Capital Markets LLP
Wells Fargo Securities

EXCHANGE/CLEARING HOUSES
APX Group
CME Group, Inc.
Dalian Commodity Exchange
European Energy Exchange AG
Global Board of Trade
ICE Futures Europe
LCH.Clearnet Group
LMAX Limited
MCX Stock Exchange
MEFF RV
Nasdaq OMX
Nord Pool Spot AS
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange
Turquoise Global Holdings

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading
BASF SE. EIL
Cargill Plc
ED & F Man Capital Markets
Glencore Commodities
Gunvor SA
Hunter Wise Commodities LLC
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities
Natixis Commodity Markets
Noble Clean Fuels
Phibro GMBH
J.P. Morgan Metals
Sucden Financial
Toyota Tsusho Metals
Triland Metals
Vitol SA

ENERGY COMPANIES
BP International IST
Centrica Energy
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Trading Ltd
International Power plc
Phillips 66 TS Limited
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading
Shell International
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Ashurst LLP
ATEO Ltd
Baker & McKenzie
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Cadwalader, Wickersham & Taft LLP
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Deloitte
FfastFill
Fidessa Plc
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Holman Fenwick Willan LLP
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman LLP
Linklaters LLP
Kinetic Partners LLP
KPMG
McDermott Will & Emery LLP
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
Orrick, Herrington & Sutcliffe LLP
PA Consulting Group
R3D Systems Ltd
Reed Smith LLP
Rostron Parry
RTS Realtime Systems
Shearman & Sterling (London) LLP
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SmartStream Techologies
SNR Denton UK LLP
Speechly Bircham LLP
Stellar Trading Systems
SunGard Futures Systems
Swiss FOA
Trading Technologies
Traiana Inc
Travers Smith LLP
Trayport