

May 2017

Brexit:

***FIA members' key messaging for
the global cleared derivatives
markets***



Why derivatives clearing matters

*“**All standardized OTC derivative contracts should be** traded on exchanges or electronic trading platforms, where appropriate, and **cleared through central counterparties by end-2012 at the latest**. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient **to improve transparency** in the derivatives markets, **mitigate systemic risk** and **protect against market abuse**.”*

G20 communiqué, Pittsburgh 2009



The challenges to derivatives clearing

- The leverage ratio under CRDIV/Basel III **limits the volume of derivatives that clearing brokers can clear** for end users.
- The Intermediary Holding Company (IHC) regime in the US, which may be mirrored in the EU, risks **driving EU clearing brokers out of US markets, driving US clearing brokers out of EU markets** and **making UK clearing brokers' position even more challenging**.
- This is all leading to a **significant concentration of business** through the top 5 clearing brokers.
- As regards pricing, **the cost of clearing for end users is increasing** and will continue to do so due to the above pressures.

The potential consequences of Brexit

If:

- cleared derivatives markets are disrupted;
- such markets, capital, collateral or liquidity is fragmented; or
- market participants and/or market infrastructure are cut off from one another as a result of Brexit,

there is a considerable risk that the challenges on the previous slide are compounded further, such that:

- **further clearing brokers will leave the market;**
- **end users will significantly reduce/cease hedging their risk; and**
- **systemic risk is increased**, as a result of the clearing of derivatives being concentrated through the hands of an even smaller pool of banks.

This puts the success of EMIR at considerable risk.

Overview of FIA members' position

What should be done to mitigate those risks?

- **Minimise disruption** in order to protect the integrity of global markets and mitigate system risk
- Reach an agreement on **transitional arrangements** in the first few weeks of negotiation:
 - only doing so at the end of 2017 will be too late, as firms will already have commenced execution of their contingency planning, with the aim of preparing for the worse case scenario
 - sufficient time must be afforded for the industry to implement their strategies in light of the new regulatory environments resulting from Brexit
- **Avoid fragmentation of markets, capital, collateral and liquidity** by regulatory fiat, as this will lead to increased costs, more clearing brokers leaving the market, increased operational risk, more complex risk management for UK and EU end users and clearing firms
- **Maintain UK / EU access** to markets, service providers, end users and talent

Minimise disruption

- Procure a **smooth transition** from today's state into the new relationship, via an appropriate **transitional arrangement**
- **Convert the body of existing EU law into domestic UK law**
- Agree the terms of withdrawal and the UK/EU future relationship **in tandem**
- **Ensure continuity and no adverse impact** of the rules relating to financial collateral arrangements, netting, set-off and settlement finality rules
- **Retain the jurisdiction of the ECJ and the applicability of EU law to UK market participants during the transitional period**, if necessary

Transitional arrangements

Transitional arrangements serve two very different purposes:

- To **avoid the cliff edge** of (i) EU entities being excluded from UK markets and (ii) UK businesses being unable to supply services into the EU
- To (i) allow businesses with activities that are currently carried out in the UK under the existing regime to **adapt their business model** and **make any necessary reorganisations** to permit them to provide services to EU customers once the post-Brexit regulatory regime is known and (ii) **allow EU customers to choose how they wish to receive services** in the post-Brexit regulatory regime once they know what is on offer

Transitional arrangements

- **Transitioning takes time** to move capital, obtain all necessary licences from regulators, move people and systems, update legal documentation and to connect to new market infrastructure – the process will take significantly longer than the two years permitted via the Article 50 process
- **Grandfathering** of existing business is a separate issue to transition, but is inherently linked to it, and **is an essential complement to avoid the cliff risk** of no deal on UK exit – grandfathering of existing contracts enables counterparties to wind down or transfer trades in a more certain and economic fashion for those in the UK and the EU
- Firms need to **plan for the worst case scenario**
- Accordingly, **announcing transitional and grandfathering arrangements at the end of 2017 would likely be too late** – firms would not be able to wait so long before taking pre-emptive action
- Ideally transitional arrangements and grandfathering would **form part of the withdrawal agreement** and Article 50 negotiations

Transitional arrangements

- Our members are fairly ambivalent as to how continued access to UK and EU market infrastructure, service providers and end users is achieved, whether that be via EMIR, MiFIR or a Free Trade Agreement: the key focus is to ensure that, **whatever approach is taken, such access must be *uninterrupted* throughout the Brexit process and beyond**
- **UK-located market infrastructure and service providers (such as execution and clearing brokers) could continue to be subject to EMIR, MiFIR and all other EU laws and EU regulatory oversight during any required standstill period**, in addition to supervision by their national competent authorities

Avoid fragmentation

- Euro-denominated derivatives should be **freely tradeable and clearable**
- The **market should determine where liquidity is located** – in the case of euro denominated cash equities and repo, there is already a significant market share cleared in the eurozone
- Forcibly moving trading/clearing into eurozone:
 - **would fragment liquidity** across numerous EU cities, with detrimental effect to EU end users and counterparties
 - **cannot be achieved by regulatory fiat**: if the US responds in kind with respect to USD trading and clearing, it risks becoming impossible to trade and clear an EUR/USD swap
 - **could further fragment banks' capital**, in the event that they are required to establish local entities to service local clients and/or to clear EU27 CCPs
 - would therefore likely result in **more clearing brokers leaving the market**
- The **imposition of thresholds that cap the amount of euro-denominated derivatives that may be cleared** in a given jurisdiction or at a single clearing house **would also result in fragmentation** that would ultimately come at the expense of end users whom seek to use cleared derivatives to manage their risk

Maintain UK / EU access

- Ensure **continuity of regulatory approvals and EU/UK access** for trading venues, CCPs and Trade Repositories –this can be achieved either as part of a Free Trade Agreement or through existing EMIR/MiFIR provisions:
 - EU firms should be able to meet the MiFIR trading obligation by using UK trading venues
 - Depending upon the approach taken to ensuring continued access by EU market participants to UK market infrastructure, UK CCPs may require “recognition” instead of “authorisation” and UK trade repositories may require “recognition” instead of “registration”
- **Minimise barriers to the provision of services** by:
 - EU-based trading and clearing members to UK clients
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Maintain UK / EU access

In terms of end-state, FIA consider that the UK and EU should collectively commit to seek to establish a process that is designed to achieve the mutual objective of common regulatory outcomes. To that end:

- There should be **no material change to UK legislation** relating to cleared derivatives or commodities in the short-term: if access to/from the UK is to be determined via the existing EMIR and MiFID II/MiFIR frameworks, then equivalence of the UK at point of exit and recognition of its market infrastructure is imperative
- The more **certainty, stability and permanence** that can be given to such access, the better – the equivalence and recognition mechanics of EMIR and MiFID II/MiFIR are vulnerable, as such equivalence and recognition can be withdrawn on short notice.
- Firms need to be able to develop their business in the reasonable expectation that they can **rely on the stability and permanence of regulatory approvals** that permit firms to access UK and EU market infrastructure, service providers and end users.
- FIA is supportive of **EU regulators having oversight of systemically important activity conducted in the UK** and of **UK regulators having access to such information from EU national competent authorities as may be reasonably required** for UK regulators to achieve their statutory and regulatory objectives.