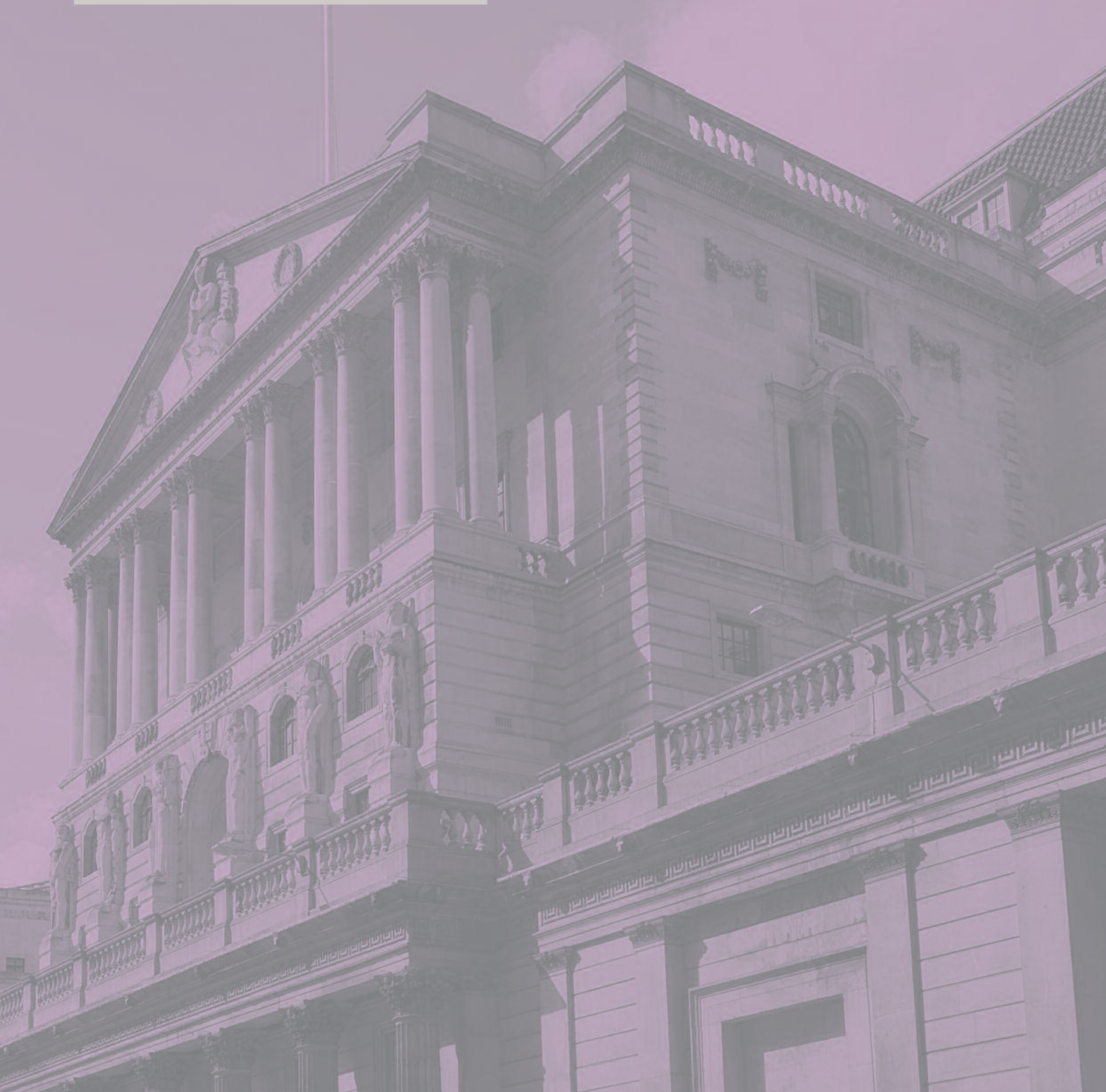
Implementation by the Bank of England of ESMA's Guidelines and Recommendations on CCP interoperability arrangements: summary of feedback received and policy response

July 2015

BANK OF ENGLAND



BANK OF ENGLAND

Implementation by the Bank of England of ESMA's Guidelines and Recommendations on CCP interoperability arrangements: summary of feedback received and policy response

July 2015

1 Introduction

In November 2014, the Bank of England ('Bank') published a consultation paper(1) on the supervisory approach that the Bank was considering taking to implement the European Securities and Markets Authority's Guidelines and Recommendations for establishing consistent, efficient and effective assessments of interoperability arrangements ('the ESMA Guidelines').(2) The aim of the consultation paper was to elicit feedback from interested parties to help inform the Bank's supervisory approach to interoperability arrangements. This consultation closed on 16 January 2015.

The Bank received five written responses.(3)

The Bank would like to thank all respondents for their constructive feedback on the consultation paper.

Section 2 of this document provides a factual summary of the responses. It follows the structure of the consultation paper itself, setting out respondents' views on each of the key elements of the proposed supervisory approach.

Section 3 of this document describes the supervisory approach that the Bank will take towards central counterparty (CCP) interoperability arrangements, taking into account the feedback received.

The Bank's final standards for assessing interoperability arrangements for UK CCPs are set out in the Appendix.

2 Summary of feedback on the consultation paper

(i) The level of inter-CCP margin

The Bank's proposed standard was for CCPs to mitigate exposures to interoperable CCPs by collecting margin from the CCP with whom they interoperate ('inter-CCP margin') equal to at least the level of pre-funded resources that the CCP would collect in initial margin and default fund contribution combined from a clearing member with the same positions.

Respondents representing clearing members broadly agreed with the Bank's proposal and noted that the higher level of margin would further protect a CCP from an interoperable CCP's default, without increasing contagion.

One respondent suggested that the level of inter-CCP margins should be higher than the Bank proposed. That respondent suggested that inter-CCP margin should be calibrated to cover all potential losses arising from the default of the interoperable CCP in extreme but plausible market conditions. This would mean that a CCP's exposure to an interoperable CCP would be covered by that interoperable CCP's margin, and the default fund would only cover clearing member losses. The respondent argued that this is justified because interoperability exposes CCPs to incremental risk that is substantially greater than the risk it is exposed to from a clearing member, as the margin would need to be sufficient to manage the default of a CCP in what would likely be very stressed market conditions (whereas a clearing member default may be more idiosyncratic and manageable).

One respondent considered that the Bank's proposed standard was unnecessary. The respondent argued that the existing approach taken by CCPs to determine inter-CCP margin, together with implementation of the Bank's proposed standard under point (iii) below, would provide sufficient resources to manage and mitigate the risks highlighted in the ESMA Guidelines.

Another respondent also disagreed with the Bank's proposed standard, arguing that the existing inter-CCP margin collected by CCPs may already be too conservative. In that respondent's view, inter-CCP margins could be reduced from their prevailing levels because the inter-CCP positions are a function of clearing members' positions, which have already been collateralised, and the collateral protects against the default of another CCP (which it argues, should occur with a lower probability than that of a clearing member).

(ii) The sourcing of inter-CCP margin

All respondents agreed with the Bank's proposed standard that any inter-CCP margin posted by one CCP to another should be separate from and additional to the margins already collected from the CCP to cover its exposures to its clearing members.

Some respondents also noted that it is important for CCPs to provide transparency to their clearing members over the method used to calculate this inter-CCP margin, so that clearing members may make their own assessments of the risks that interoperability arrangements present.

(iii) CCP default resources other than inter-CCP margin

(a) The proposal that a CCP include exposures to interoperating CCPs when calculating the loss to its largest two members in extreme but plausible market conditions

In order to ensure that CCPs 'address any weakening of the CCP's overall risk standards due to the interoperability

(1) 'Implementation by the Bank of England of ESMA's Guidelines and Recommendations on CCP interoperability arrangements', November 2014; www.bankofengland.co.uk/markets/Documents/cpesma1114.pdf.
(2) 'Guidelines and Recommendations for establishing consistent, efficient and effective assessments of interoperability arrangements: final report', 10 June 2013; www.esma.europa.eu/system/files/2013-323_annex_1_esma_final_report_on_guidelines_on_interoperability.pdf.
(3) One respondent only provided a response to the questions under standard (iii).

arrangement'(1) compared to a counterfactual scenario without interoperability, including in extreme but plausible market conditions, the Bank's proposed standard was for a CCP to size its default resources to include exposures to its interoperating CCP(s) where the exposure is one of the CCP's two largest exposures.

Some respondents agreed that this is a prudent standard that would enable the CCP to withstand the default of its two largest counterparties, irrespective of whether they are clearing members or interoperable CCPs.

One respondent agreed that a CCP should consider its exposure to an interoperating CCP if that CCP is one of its largest two exposures, but suggested that CCPs should cover this exposure through increased commitment of its own capital ('skin in the game').

Another respondent suggested that the proposed standard was too conservative, noting that inter-CCP positions are a function of the clearing members' positions which have already been stress tested and covered in the CCP's own default fund.

(b) The proposal that the default fund should be available to meet losses incurred following the default of an interoperating CCP

Most respondents agreed with the Bank's proposed standard that the CCP's default fund should be available to meet the losses incurred by the default of an interoperable CCP.

In addition, one respondent expressed a preference for the default fund contributions of clearing members that do not use the interoperability arrangement to be deemed senior to (and therefore used after) those that do, or alternatively to be entirely excluded from the default waterfall used to manage an interoperable CCP's default.

(iv) Loss allocation rules and post-default arrangements

No respondents suggested that the Bank should require a CCP to include interoperating CCPs within the scope of its loss allocation arrangements.

However, one respondent did note that there could be benefits to loss allocation arrangements agreed between interoperating CCPs. Another noted that CCPs could consider voluntary arrangements to access collateral pledged by interoperating CCPs in a wider range of failure-to-pay scenarios, without placing linked CCPs into default.

(v) Interoperability for derivatives products

All respondents agreed with the Bank's proposed standard that the ESMA Guidelines, as implemented through the Bank's supervisory approach, should be the minimum necessary standards for any interoperability arrangement for derivative products in which UK CCPs participate, or propose to participate.

Many respondents also noted that it would be necessary to amend the ESMA Guidelines to cover further risk features of over-the-counter (OTC) derivatives, should proposals for interoperability covering these instrument classes emerge, due to the higher risk and longer-term exposures associated with derivatives contracts.

3 The Bank's supervisory approach to interoperability

The ESMA Guidelines are addressed to National Competent Authorities (NCAs) and they state that 'NCAs should comply with the Guidelines and Recommendations by incorporating them into their supervisory practices'.

The following section sets out the supervisory approach that the Bank, as NCA, will take when assessing interoperability arrangements for UK CCPs, taking into account the feedback received to the Bank's consultation paper. This should be read in conjunction with the Bank's published paper on its supervisory approach to Financial Market Infrastructures (FMIs).(2) As a general matter the Bank expects CCPs to consider the systemic implications of their actions and to mitigate risk both to themselves and to the broader market.

The Bank will henceforth apply this supervisory approach. The Bank may consider providing additional guidance on the implementation of the ESMA Guidelines in the future.

(i) The level of inter-CCP margin

The Bank considered the impact of applying the more conservative standard suggested by one respondent that CCPs should collect inter-CCP margin to cover the full stressed exposure to its interoperable CCPs. This would lead to significantly higher inter-CCP margin requirements than under the Bank's proposed approach, which would increase the cost of establishing such arrangements notwithstanding the benefits they may bring. There would be other drawbacks. For instance, the additional margin requirements would be more volatile and the mutualised default fund could be significantly smaller, as interoperating CCPs would not have uncovered stressed exposures to the CCP (if sized in accordance with standard (iii)). The Bank does not agree that this would strike an appropriate balance between safeguarding against the systemic risk of contagion between CCPs and maintaining the benefits of interoperability.

(1) Ibid. *Guideline and Recommendation*, 3(f)(ii), page 31.
(2) 'The Bank of England's approach to the supervision of financial market infrastructures, April 2013; www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf.

The Bank also considered the proposal by one respondent that the level of inter-CCP margin should be reduced from its current level. The Bank does not agree with this proposal because this would increase the probability that linked CCPs' resources will be insufficient. Linked CCPs could also fail for reasons other than the default of a clearing member. It is critical that NCAs assess interoperability arrangements with a view to ensuring that the failure of one CCP does not risk bringing about a chain of defaults from its linked CCPs.

Based on the feedback received, the Bank views its proposed standard as an appropriate balance between safeguarding against the risk of contagion between CCPs, without undermining the benefits of interoperability. As such, the Bank will adopt this standard as part of its supervisory approach towards assessing interoperability arrangements for UK CCPs.

(ii) The sourcing of inter-CCP margin

All respondents agreed with the Bank's proposed standard on the sourcing of inter-CCP margin.

Accordingly the Bank's proposed standard will be adopted as part of its supervisory approach towards assessing interoperability arrangements for UK CCPs.

(iii) CCP default resources other than inter-CCP margin

Most of the feedback received suggested that the Bank's proposed standard is appropriate, although some respondents noted that the precise design of the standard could be altered. As the Bank's aim is to implement the ESMA Guidelines, rather than to introduce new requirements, the Bank does not propose to provide such additional guidance. The specific formulation of the CCPs' default resources should be agreed between the CCPs and its participants, within the requirements of EMIR.(1)

The Bank does not agree with the suggestion that the level of default resources, other than inter-CCP margin, should be reduced from the proposed standard that is already applied by UK CCPs. As noted in (i) above, this would increase the probability that linked CCPs' resources will be insufficient. Linked CCPs could also fail for reasons other than the default of a clearing member. It is critical that NCAs assess interoperability arrangements with a view to ensuring that the failure of one CCP does not risk bringing about a chain of defaults from its linked CCPs.

Accordingly the Bank's proposed standard will be adopted as part of its supervisory approach towards assessing interoperability arrangements for UK CCPs.

(iv) Loss allocation rules and post-default arrangements

No respondents suggested that the Bank should require CCPs to include interoperating CCPs within the scope of their loss allocation arrangements, but some noted that there could be benefits to such loss allocation arrangements agreed between CCPs on a voluntary basis.

Accordingly, the Bank will not expect CCPs to include interoperable CCPs in loss allocation arrangements, but will review any voluntary arrangements agreed between CCPs and their respective regulators on a case-by-case basis.

(v) Interoperability for derivatives products

All respondents agreed with the Bank's proposed standard on the risk standards for interoperability arrangements for derivatives products.

Accordingly the Bank's proposed standard will be adopted as part of its supervisory approach towards assessing interoperability arrangements for UK CCPs.

(1) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

Appendix: The Bank's final standards for assessing interoperability arrangements for UK CCPs

These are the standards of assessment that the Bank will ordinarily apply, at a minimum, as part of its supervisory approach towards assessing interoperability arrangements for UK CCPs. However, the Bank will always consider the specific circumstances of each case.

Standard 1: level of inter-CCP margin
A CCP should, at a minimum, calibrate and collect inter-CCP margin equal to at least the level of pre-funded resources that it would collect in initial margin and default fund contribution combined from a clearing member with the same positions.

Standard 2: source of inter-CCP margin
Inter-CCP margin posted by one CCP to an interoperating CCP should be separate from, and additional to, the margins already collected by the CCP to cover its exposures to its own clearing members.

Standard 3: CCP default resources other than inter-CCP margin
A CCP should, at a minimum:

(a) include exposures to interoperating CCPs when calculating its exposure to its largest two members in extreme but plausible market conditions and use this to size the default fund and other pre-funded resources it holds; and

(b) make the default fund available to meet losses incurred following the default of an interoperable CCP.

Standard 4: loss allocation rules and post-default arrangements
The Bank will not expect a CCP to allocate losses that exceed its pre-funded resources to interoperable CCPs. The Bank will review any voluntary arrangements agreed between CCPs and their respective regulators on a case-by-case basis.

Standard 5: interoperability for derivatives products
The ESMA Guidelines, as interpreted through the Bank's supervisory approach, will be the minimum necessary standards for any interoperability arrangement for derivative products in which UK CCPs participate, or propose to participate.