LSEG Response to the FSB Consultation on Effective Resolution of Systemically Important Financial Institutions

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INTRODUCTION

The London Stock Exchange Group plc (LSEG) welcomes the Consultation on Effective Resolution of Systemically Important Financial Institutions and supports the objective of developing a comprehensive package of policy measures to improve the capacity of authorities to resolve these firms.

LSEG has significant practical experience of the impact of large scale bank insolvencies, including that of Lehman Brothers International (Europe) (LBIE). LBIE was one of its largest trading firms and the London Stock Exchange has been managing the default in respect of unsettled non-CCP trades since 15 September 2008; the process is still ongoing. In addition, CC&G (our clearing house and central counterparty) worked in close cooperation with the General Clearing Members of Lehman Brothers to manage its insolvency for the Italian cash equity and equity derivatives markets; this process was closed smoothly within a few weeks, without any impact on other members.

Based on this experience we comment below on the discussion notes regarding conditions for imposing temporary stays on early termination rights (Section II.2 and Annex 8 of the Consultation), in particular the suspension of close out netting.

We provide a consolidated response to the individual questions posed. This submission represents the views and experience of London Stock Exchange plc, Borsa Italiana, CC&G and other market operators and investment firms within the LSEG.

1. Overall comments on suspension of obligations

Whilst the ability to suspend obligations under contracts to which a failing institution is a party and to temporarily suspend close-out netting may be desirable in order to maintain the position of that failing institution, the implications for unsettled market contracts that may be subject to the default rules of a regulated market or a CCP must not be overlooked. Nor should the rights of non-failing counterparties to treat a failing party as in default under a bi-laterally negotiated contract. Often, the right to treat a party or member of an exchange or clearing house as being in default does not depend on a technical act of insolvency but may simply be a failure to pay for, or deliver, securities (or the likelihood that such an event will occur). We therefore agree with the FSB's argument that a stay should not extend to all payment and delivery obligations and would not prevent close-out for reasons of failure to pay or deliver. Nevertheless, any rules allowing the effective freezing of financial markets contracts must be carefully designed so as not to frustrate the operation of any default rules and custom and practice in various financial markets.

2. Specific points on the suspension of close out netting

2.1. Financial stability/systemic risk

The primary function of a CCP is to minimise systemic risk by removing the credit risk of a defaulting participant from the market. It is, therefore, essential that all of the regulatory initiatives with which central counterparties (CCPs) are required to comply are coordinated. In particular, a crisis management framework should ensure that no unnecessary obstacles are imposed that contradict, and thereby undermine, the overall objectives outlined by the G20 to create incentives to use CCPs.

An important aspect of clearing transactions through a CCP is the mandatory collateralisation of risk positions of the clearing member as counterparty to a CCP and the on-going calculation of required collateral (margining) for open positions. These margins form part of the risk management function of the CCP whereby, in the event of a default (of a clearing member), all open positions of that clearing member can be closed or liquidated, or losses can be balanced. Any delay in the operation of this procedure through suspensions of rights, even temporary, could have serious effects on the operation of a CCP as a key infrastructure in the financial markets and subsequently have significant detrimental effects on the whole financial system.

Any limitations imposed in terms of suspension of payments and delivery obligations should not restrict the CCP from acting appropriately in a default situation, i.e. providing client asset protection via a close-out netting mechanism and performing payments and delivery obligations in time to avoid market disruptions. Any limitation of the close-out right could lead to a disadvantage for a CCP and might potentially endanger the stability of the CCP and subsequently the financial market.

2.2. Provisions in national legislation

In some countries, national legislation recognises the need for market infrastructure to operate default procedures and is designed to safeguard the operation of financial markets. For example, in the UK[1] this is achieved by modifying domestic

[1] Part 7 of the UK Companies Act 1989

insolvency law to give priority to, and to protect, the actions of Recognised Clearing Houses (RCH) and Recognised Investment Exchanges (RIE)[2] in the operation of their default rules applied when a member defaults on their obligations.

The protections given to RCHs and RIEs enable them to take action to close out a defaulter's unsettled market contracts in accordance with their default rules. This may include offsetting profits and losses on different contracts and setting off assets provided as margin against net losses. The liquidator for the defaulter is prevented from unpicking, or disclaiming, these transactions.

Similar provisions are also in force in Italy: the market insolvency discipline is provided under the Consolidated Law on Finance and is governed through regulation by Consob, by agreement with the Bank of Italy[3]. Such regulations expressly ensure that close-out netting clauses are valid and take effect in compliance with the provisions established by CCPs and Recognised Exchanges, including in the event of opening restoration or liquidation proceedings with regards to an insolvent market counterparty.

These protections safeguard the integrity of financial markets, and public confidence in them, by minimising the disruption caused by the default of the member of a clearing house or the member of an exchange. They are designed to try and ensure that the market is immunised against repercussive effects from an individual insolvency or default, and ultimately against systemic failure.

Clearing houses that act as central counterparties manage the risk that clearing member counterparties to market trades will become unable to fulfil their obligations when they become due. The operation of their default rules is central to their ability to manage the risks that they assume. To the extent that they are unable to enforce their default rules, the benefits and economic efficiency of their role in the market would be compromised.

2.3. Impact on collateral requirements and costs of trading

Any stay or moratorium on close-out netting will prevent the CCP from taking action to close out positions and apply collateral (in whatever form) to offset realised liabilities. During this time the markets will continue to trade – or even if they do not, prices will change – and the values of both the positions and of the collateral will remain volatile. A stay on the actions of a CCP to take these steps will increase the likelihood that the margin that it holds from the defaulter may be insufficient to cover any losses and so the CCP will be forced to mutualise the loss through its default fund.

When operating under its default Rules or similar provisions, it is vitally important that a CCP can take whatever actions it chooses in order to protect surviving clearing members, clients of the defaulting member and the CCP itself. In these situations a CCP's primary defence is the collateral held as margin for the cleared

[2] As defined in the UK by the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001
[3] Consolidated Law on Finance, Article 72, Market insolvency regulations

positions, which under all but the most extreme circumstances should suffice to enable close-out or transfer of a member's positions.

In order to determine how much margin (and default fund) is necessary, and also what liquidity facilities a CCP needs, it will make judgements about how long it could take to execute offsetting positions (whether on organised markets or over-the-counter) and to realise collateral. If this period were to be longer as the result of allowing for a potential suspension of close out netting then margin levels will increase. As an example, we estimate that doubling the time required to be able to complete a close out would lead to an increase in margin levels of approximately 40%, although this could be higher in times of volatile markets under stress, where prices could fall for a significant number of consecutive days. This increase would have to be applied at all times, given that defaults are not predictable.

Any provision that has the effect of preventing a CCP from taking these actions immediately upon the declaration of its member's default will both introduce greater uncertainty in, and disruption to, the affected markets and significantly increase the margin and therefore collateral requirements that a CCP is likely to require from its members (and which its members will require from their clients). As a result, the costs of trading will increase.

2.4. Exemption from temporary suspension of obligations

As we argue above, any temporary suspension of early termination rights could affect a CCP's ability (and also that of other infrastructure providers such as Security Settlement Systems, payment systems and Regulated Markets) to manage the risk it faces in the case of a default of one of its clearing members. Any crisis management framework must, therefore, be carefully designed so as not to frustrate the operation of any default rules.

Accordingly, as part of such a framework, we believe that there is a strong case for exempting CCPs and other infrastructure providers from any provisions for the suspension of obligations to protect their unique role and function as part of the financial market infrastructure.