BANK OF ENGLAND

Speech

The UK's approach to cross-border clearing

Speech given by

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Good morning/good afternoon.

Today I am going to speak about the UK's approach to tiering, recognising and supervising cross-border central counterparties (CCPs).

Before I jump into that, I thought I would share a quote that could provide context for why I believe getting this right is so important.

On September 25 2009 G-20 leaders met in Pittsburgh. It was one year after the collapse of Lehman Brothers and five months after Gordon Brown hosted the second ever G-20 meeting in London amid a rapidly escalating global financial crisis. Their statement[1] is quite remarkable.

> *'When we last gathered in April, we confronted the greatest challenge to the world economy in our generation.*
>
> *Global output was contracting at pace not seen since the 1930s. Trade was plummeting. Jobs were disappearing rapidly. Our people worried that the world was on the edge of a depression.*
>
> *At that time, our countries agreed to do everything necessary to* ***ensure recovery, to repair our financial systems and to maintain the global flow of capita****l.*
>
> ***It worked****.'*

Why am I showing you this? Well aside from being notable for having possibly the only 2 word paragraph you will ever see in a leaders' communiqué (I think the shortest sentence from the communiqué two weeks ago had 28 words), I think it captures very well why it is so important to get cross-border supervision of CCPs right. The triumph of this statement, of the work that came before and after it is that – rather than turning inward to nationalism, protectionism and fragmentation– the world's major economies committed to work together to address the lax regulation that had enabled the crisis, to repair our financial systems and to maintain global capital flows. We were going to make the system safe. But we were also going to keep it open at the same time.[2]

[1] G20 Leaders Statement, September 24-25 2009. http://www.g20.utoronto.ca/2009/2009communique0925.html
[2] M. Carney. 'The High road to a responsible open financial system' (7 April 2017) https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/the-high-road-to-a-responsible-open-financial-system.pdf?la=en&hash=0264C2348F1C0E8225C7ACCC83ABF85AE827394A.

Safe Openness: Today's Challenge

This project is not over. If we learned anything from the 2008 crisis it was the importance of ensuring that regulation and supervision of the financial system keeps up with the evolving shape of the system. Safe openness requires tending.

One of the ways that the system has changed is that the reforms that made global derivatives markets safer have made CCPs more important than ever before. This is deliberate – a feature not a bug. We've moved away from the spaghetti bowl of bilaterally cleared trades that was a major reason why Lehman's failure sparked a global crisis.[3]

It worked. The market turmoil last year sparked by the global pandemic could very easily have tipped into a panic and a financial crisis. Thanks in part to derivatives reforms, instead there was no panic about counterparty credit risk – no tangled web of vulnerability.[4,5]

The ongoing task for regulators is to make sure CCPs, which are inherently large and cross-border, continue to make the system safer.

Because CCPs operate cross-border, UK regulators and supervisors cannot stop with just making sure the CCPs headquartered here in the UK are safe. We need to ensure that the CCPs on which the UK financial system relies are appropriately supervised and regulated regardless of whether they are based in London, Hong Kong, Chicago or Frankfurt. Users of UK CCPs are looking to the UK for the same assurances. We take that responsibility very seriously.

But we also recognise that a system in which every jurisdiction that uses a CCP insists on imposing its own regulation and supervision on the CCP cannot work. If every jurisdiction that used major global CCPs were to regulate them, we could be talking about several dozen sets of rules, regulations and supervision. This would create either complexity, as we all regulate the same entity, or fragmentation, as we require the entity to split itself into smaller parts. Both risk unravelling the very reforms that have made our system safer – if we want safe derivatives markets with central clearing a major feature we need a better approach.

[3] C. Segal-Knowles. 'Lessons from the pandemic: Has the simpler post-2008 financial system held up? And where do we go from here?' (29 January 2021) https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/january/has-the-simpler-post-2008-financial-system-held-up-speech-by-christina-segal-knowles.pdf?la=en&hash=1D5368CE3851806186CCC076627CBC8461914606.
[4] J. Cunliffe. 'Financial System Resilience: Lessons from a real stress' (9 June 2020), https://www.bankofengland.co.uk/speech/2020/jon-cunliffe-speech-at-investment-association.
[5] As stated in the recent consultative report on margin practices, 'the Covid-19 market turmoil of March 2020 was the most significant test of the resilience of financial markets since the Great Financial Crisis (GFC) of 2008. Financial markets generally proved resilient, with no widespread concerns about counterparty credit risk. In part, this reflects global financial regulatory reforms following the GFC. Reforms were put in place expressly to increase the role of central counterparties (CCPs) through mandating and incentivising centrally cleared derivatives activity, simplifying counterparty credit exposures and increasing transparency to regulatory authorities. ' BIS, CPMI, IOSCO. Consultative Report: Review of margining practices' (October 2021), p. 1, https://www.bis.org/bcbs/publ/d526.pdf.

The UK Approach

Today we have launched a consultation on the policies that will define the UK's approach going forward.

Many of you will recall that last year the EU finalised a new framework for recognising non-EU CCPs wishing to serve EU clearing members and clients known as EMIR 2.2. Under this framework, CCPs are categorized or "tiered" according to the level of systemic risk they pose to the EU. "Tier 1" CCPs may operate in the EU without direct EU regulation and supervision. Systemically important or "Tier 2" CCPs are brought into direct supervision by the European Securities and Markets Authority. "Tier 3" CCPs are subjected to a location policy – they cannot operate in the EU unless they establish an EU presence through which to operate. This tiering system sits on top of an equivalence process, in which CCPs' home jurisdictions must also receive a positive equivalence decision from the European Commission, deeming their regulatory and supervisory frameworks equivalent to those in the EU.

When it left the EU, the UK "on-shored" EMIR 2.2 and transferred the responsibility for tiering, recognising and, where needed, supervising non-UK CCPs to the Bank of England. Contrary to any rumours about divergence, we are implementing EMIR 2.2. HM Treasury has assumed responsibility for the equivalence process deeming CCPs' home jurisdictions' regulatory and supervisory frameworks equivalent to those in the UK The Bank has taken on the responsibility to set the policy for how we will determine which CCPs pose systemic risk to the UK – it is those polices on which we're consulting today.

In designing these policies, our guiding principle was "safe openness". How do we do we make sure that non-UK CCPs providing services, cross-border into the UK don't make the UK financial system unsafe without sacrificing the global financial stability benefits of open, cross-border financial market infrastructure. Luckily it turns out these are not incompatible. Our approach has 3 major features.

Risk-Based

The first is that it is designed to be risk-based. We will supervise non-UK CCPs based on the risks that they could potentially pose to the UK.

The starting point here should be size: how much do UK financial system participants rely on the CCP and in the event of a problem at the CCP how large is the potential liability of UK financial system participants. We reflect this in our proposed approach by including triage indicators focused on the CCP's importance to UK clearing members. We will consider supervising a non-UK CCP directly (i.e. placing it in Tier 2) if:

a. The CCP has more than £10bn Initial Margin (IM) from UK clearing members[6], or

[6] Measured at any point in the last 5 years, across all services and including non-UK subsidiaries of UK headquartered firms.

b. The CCP holds more than £1bn Default Fund Contribution (DFC) from UK clearing members, or[7]
c. The CCP is interoperable with a UK CCP.

As these triage indicators are blunt, any CCP that meets them will be subjected to a more holistic and detailed systemic risk assessment. This is to reflect the full set of criteria set out in EMIR 2.2 and to ensure we don't get false positives.

Cooperation-centric

The second feature of our approach is that it places cooperation at the heart of our tiering decisions. When it comes to assessing whether something poses a financial stability risk, size is a starting point. But it is only a starting point. You can't determine how much risk a CCP may pose to the UK financial system based on size criteria alone.

Imagine two non-UK CCPs that provide very significant levels of clearing service to UK clearing members – they are potentially systemic in the UK:

- For the first hypothetical CCP we have minimal cooperation with its home supervisor. We have little understanding or continuing visibility into its supervision and regulation. We can't assess whether its home supervision continuously adequately addresses risks to UK financial stability. We have no relationship of trust or experience of collaboration with its home authorities.

- For the second hypothetical CCP, we have a deep relationship with its home supervisor based on mutual trust and cooperation. We are invited to join in supervisory visits. We receive regular updates either via a supervisory college or bilaterally. We have opportunities to discuss our priorities with the home supervisor and input into their supervisory programme. Its home supervisors recognise and take seriously their duty to reduce not just risks to their home jurisdiction but to any jurisdiction that uses the CCP.

Even if these two hypothetical CCPs are identical in terms of size of UK clearing member reliance and exposure, the risks of letting them operate in the UK without direct UK supervision and regulation are hardly identical.

For the first CCP – into which we have little visibility, limited cooperation and no trusted relationship – our duty to protect financial stability in the UK would mean we need direct supervision – and we would need to place them in Tier 2.

[7] Measured at any point in the last 5 years, across all services and including non-UK subsidiaries of UK headquartered firms. The DFC indicator will be £5bn for CCPs that hold IM and DFC in a single fund.

But for the second CCP, where we have a deep ongoing relationship with its supervisor, it isn't clear that the benefits of direct supervision by UK regulators would outweigh the potential detriment to post-crisis reforms or global financial stability from having multiple supervisors and regulators of global market infrastructure.

This is why a key feature of our approach to tiering is an "informed reliance" test. Where a jurisdiction has a robust regulatory and supervisory framework and is clearly committed to meeting our expectations with respect to cooperation, trust and, information sharing, we will deem that CCP Tier 1. In other words we will <u>not</u> bring that CCP into direct UK supervision provided that we can see on a continuing basis that its home regulators are delivering the outcomes we need to protect UK financial stability.

Recognising the importance of clarity and predictability in our regime, we will do this based not on judgement, but on a clear set of informed reliance test criteria, which we detail in the consultation we released today. This ensures we can deliver on our statutory objectives to protect and enhance UK financial stability without sacrificing the global good of well-regulated and supervised central clearing.

Proportionate

The third feature of our approach is proportionality. We recognise that a system where every authority insists on deep cooperation for systemic CCPs could in itself become unmanageable. Imagine thirty different regulators on every supervisory visit, thirty different voices with significant weight in setting supervisory priorities. I imagine that for some of you in the audience who run CCPs I've already given you nightmares.

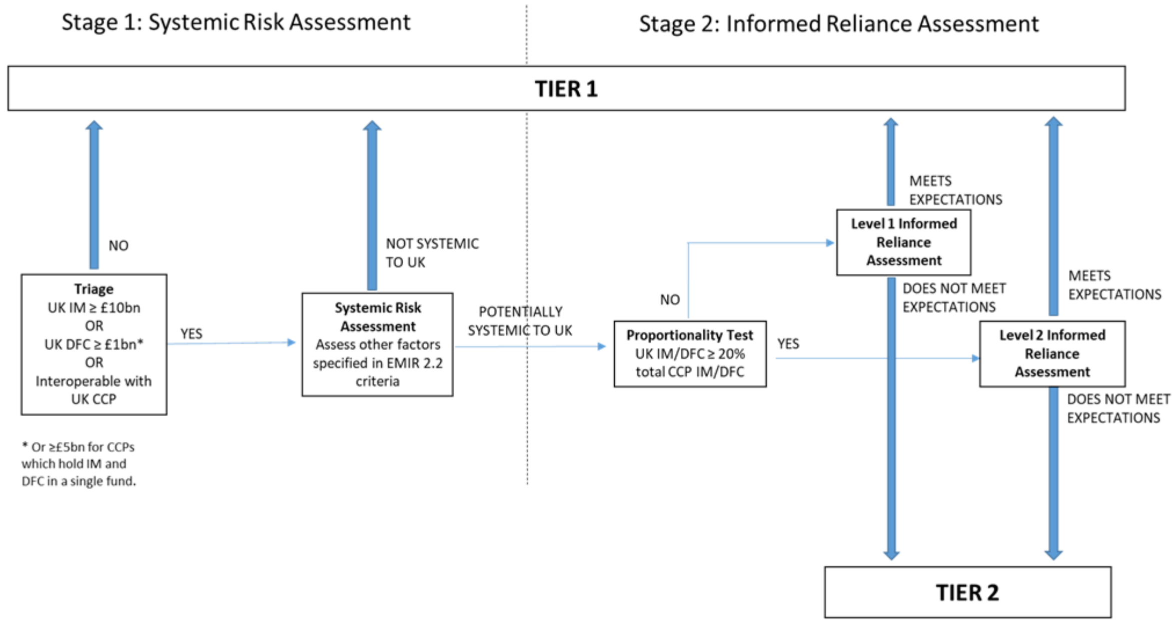
Therefore, even for systemic CCPs that might justifiably be placed in Tier 2, our approach distinguishes between CCPs in which we – the UK – have a very large interest and would expect to be among the lead authorities, and CCPs where the UK has less at stake.

Our goal is to ensure that the authorities with the greatest interest in a CCP in the event of its failure have the greatest input in its regulation and supervision. This reflects the fact that jurisdictions representing the highest default fund contributions to a CCP will bear the burden in the event of CCP failure as their clearing members will contribute most to mutualised losses.

Where the UK has a smaller interest in a CCP relative to other jurisdictions, the Bank will be more inclined to rely on the home authority. But where the UK has a greater interest in a CCP relative to other authorities, we should expect a greater level of assurance that the home authority is delivering robust and equivalent supervisory outcomes and that we have a relationship on which we can rely.

So our approach has two levels of the informed reliance tests I just described. For CCPs for which UK clearing members are less than 20% of both the CCP's total global IM and total default fund contributions we will use a lighter-touch "level 1" informed reliance test.   For those CCPs for which the UK is at least 20% of either the CCP's IM or default funds will we insist on a more-detailed "level 2" informed reliance test. In both cases the outcome will be that the CCP will be categorised in Tier 1 if the regulatory authorities meet our informed reliance expectations.

Summary of the Bank's proposed approach to tiering non-UK CCPs'



Together these principles: Risk-based, Cooperation-centric, and Proportionate, will enable us to ensure that the CCPs on which the UK financial system relies are safe – The Bank will be able to fulfil with confidence our duty to Parliament and ultimately the people of the UK, to protect UK financial stability. This is because the Bank will have proportionate, fair and continuing visibility into the supervision of the financial market infrastructure that serves as the backbone of the financial system. And the Bank will be able to do this without sacrificing the openness that was at the heart of that triumphant G-20 declaration 12 years ago. Where we need to, we will directly regulate and supervise cross-border CCPs. But where we can achieve the same outcomes with confidence through cooperation, we will not.

Holding Up the Mirror

I've just spent quite a bit of time explaining what we expect of others in order for us not to step in and directly supervise their CCPs - cooperation and trust. Now I'm going to turn the tables and give you a bit of a self-assessment – how does the UK fare as the home supervisor of some of the world's largest CCPs?

This is important – throughout the process of designing our tiering criteria my team and I have had a mantra: it has to work both ways. In other words we need to be happy that it keeps the UK safe from risks posed by *incoming* non-UK CCPs. And we need to be happy about what would happen if someone applied this to *UK CCPs* serving other markets. If we want a global system that preserves safe openness we can't have one-way beggar thy neighbour approaches. Or, more colloquially: we shouldn't dish it out if we can't take it.

The UK takes its responsibility as a supervisor of financial infrastructure in a global financial centre very seriously. UK is home to a global clearing market used by market participants from around the world. And our supervision and regulation of these firms should reflect not only their domestic importance but also the vital services they provide to other jurisdictions. The government will publish a consultation on the Future Regulatory Framework Review soon. One issue to be addressed through that Review is the governance and accountability framework for CCP regulation. This will be an opportunity to more explicitly recognise in our objectives the key role that CCPs play in safeguarding global financial stability and the impact that they can have on other jurisdictions.

So what does being a responsible supervisor of infrastructure used by participants around the world mean in practice? I think there three tests (1) Are they a good and proactive supervisor day-to-day? (2) Do I have the visibility and cooperation I need? and (3) Can I trust them in a crisis?

Good and proactive supervision and regulation

So how do we do on day to day supervision and regulation?

The UK has long been recognised as a world leader in the regulation of clearing services.[8] And we have time and time again stressed that we are committed to maintaining at least the current levels of resilience for CCPs. For example in June, Chancellor Rishi Sunak emphasised that 'The UK already has one of the world's most robust regulatory regimes for central counterparties. And our plan is not to weaken but strengthen that regime, because we believe in high-quality regulation".[9]
But it's not enough just to say these things. So I thought I would highlight just a few of our recent actions to strengthen CCP regulation in the UK.

For example, the Government published a consultation proposing the introduction of a Senior Managers and Certification Regime for Financial Market Infrastructure (FMIs), which would enhance the accountability of senior managers and improve governance arrangements at CCPs.[10] This would give the Bank of England new tools to ensure that CCP senior managers are well qualified, and ensure that they have legal responsibility and accountability of the firms they run. As we have seen for other financial institutions that

[8] United Kingdom: Financial Sector Assessment Program--Financial System Stability Assessment; IMF Country Report 16/167; June 1, 2016United Kingdom: Financial Sector Assessment Program--Financial System Stability Assessment; IMF Country Report 16/167; June 1, 2016
[9] R. Sunak. 'Mansion House Speech' (1 July 2021) https://www.gov.uk/government/speeches/mansion-house-speech-2021-rishi-sunak.
[10] HM Treasury. Senior Managers & Certification Regime (SM&CR) for Financial Market Infrastructures (FMIs): consultation (20 July 2021), https://www.gov.uk/government/consultations/senior-managers-certification-regime-smcr-for-financial-market-infrastructures-fmis-consultation.

have a Senior Managers and Certification regime in place, this regime can be an important enhancement to the safety and soundness of firms.

The Bank has also been pushing forward with an ambitious new stress testing approach, which as well as fully testing credit and liquidity risks, will include consideration of a range of alternative default assumptions to help better assess individual and system-wide CCP resilience. This summer the Bank published a Discussion Paper on CCP supervisory stress testing and launched its first supervisory stress test of CCPs. We intend to use CCP supervisory stress testing as a key mechanism through which to undertake assessment of the resilience of individual CCPs and the broader resilience of the clearing network, as well as to promote transparency and help maintain public confidence in CCPs.

The Bank also released new policies on operational resilience for CCPs in March 2021.[11] This reflects the fact that operational disruption can impact financial stability, threaten the viability of individual firms, or cause harm to other participants in the financial system. Building on existing regulatory requirements, these policies set out a comprehensive approach to ensure firms and the financial sector are able to prevent, adapt, respond to, recover from, and learn from operational disruptions.

Visibility and Cooperation

How do we do on cooperation? The UK has a long tradition of cooperation and openness. The UK authorities established the world's first CCP colleges in 2012. Over the past twelve months alone, the Bank hosted five college meetings involving over 40 individual authorities from across the world.

Over the past two years we have signed new cooperation Memorandums of Understanding (MOUs) with the US Commodity Futures Trading Commission and the European Securities and Markets Authority. Both these MOUs establish that the supervision of central counterparties that operate in our jurisdictions is based on close co-operation and mutual respect. These MOUs also have extensive provisions on information sharing. We have committed to share information about our CCPs, our regulatory regimes, and our supervisory practices. And we are doing this! I can't count the number of times a week a member of my team or I are on the phone with one of our international counterparts.

What happens in crisis

Can you trust us to act transparently and fairly in a crisis? The UK was a pioneer in the development of crisis management arrangements for FMIs. In 2016, the International Monetary Fund described the Bank – the CCP resolution authority in the UK – as 'a global leader in the development of crisis management

[11] Bank of England policy on Operational Resilience of FMIs (29 March 2021), https://www.bankofengland.co.uk/paper/2021/bank-of-england-policy-on-operational-resilience-of-fmis.

arrangements for FMIs including recovery and resolution planning.'[12] We have set up crisis management groups for CCPs to enable information sharing with foreign authorities and to cooperate in the case of a cross-border crisis.

Perhaps more importantly, in a crisis we as a regulator, supervisor or resolution authority for UK CCPs cannot act in a way that favours certain members of a CCP over others solely based on their nationality.

The strength of London as a global financial centre is that users are confident in the robust legal framework that underpins it. English law is commonly used to govern international transactions in financial services due to its certainty and principle of non-discrimination. The rule of law does not favour any particular nationality. The expertise and efficiency of English courts make it one of the leading choices for wholesale financial market participants. Clearing is no different.

Our current resolution regime for CCPs – which when introduced in 2012 was one of the world's first – provides robust protections for non-UK users of UK CCPs.[13] In addition, our EMIR non-discriminatory provisions apply equally to all clearing members. The UK government has recently consulted on enhancements to the resolution regime for CCPs, including a proposal to introduce an explicit No Creditor Worse Off safeguard.[14] HMT's proposed No Creditor Worse Off regime would provide an even stronger legal basis for what is already the case in practice: the Bank cannot and will not discriminate in its actions on the basis of factors like the nationality of a clearing member.

Conclusion

Going back to the beginning of my talk, one question many of you must rightly have asked when I showed the G-20 statement from 2009 is: wasn't it a bit pre-mature?

Ensuring recovery, repairing our financial systems and maintaining the global flow of capital was of course not over in 2009.

In many ways it's not a task that's complete today and probably never will be. The financial system evolves. New risks emerge. Safe openness requires tending.

But in the narrower space of CCP cross-border supervision I hope we've today laid out a possible path forward that preserves both safety and openness.

[12] International Monetary Fund. Financial Sector Assessment Program: Supervision and Systemic Risk Management of Financial Market Infrastructures – Technical Note (June 2016), p. 5, https://www.imf.org/external/pubs/ft/scr/2016/cr16156.pdf.
[13] For an overview of the current resolution regime for CCPs see Section 2 of HM Treasury's Special Resolution Regime Code of Practice (1017), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945165/SRR_CoP_December_2020.pdf.
[14] HM Treasury. 'Expanded Resolution Regime for Central Counterparties (CCP): consultation' (24 February 2021), https://www.gov.uk/government/consultations/expanded-resolution-regime-for-central-counterparties-ccp-consultation.

By putting in place a system that is risk-based, cooperation-centric and proportionate, we can fulfil our mandate to protect UK financial stability without sacrificing the post-crisis reforms to derivative markets that have made us all safer.