



Resolution Regime Consultation
Financial Services Branch
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar, Hong Kong

20 April 2015

CONSULTATION PAPER: AN EFFECTIVE RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

Dear Sirs,

This letter provides the submission of LCH.Clearnet Group Limited (“**LCH.Clearnet**”) to the consultation paper ‘An effective resolution regime for financial institutions in Hong Kong’ issued by the Hong Kong authorities¹ in January 2015.

LCH.Clearnet² is a leading multi-asset class and multi-national clearinghouse, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes including securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro and sterling denominated bonds and repos. LCH.Clearnet works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes. LCH.Clearnet is majority owned by the London Stock Exchange Group, a diversified international exchange group that sits at the heart of the world’s financial community.

As a global multi-currency clearing house, LCH.Clearnet has an interest in the policy frameworks for CCP recovery and resolution that exist or are under development in various jurisdictions. We welcome this consultation by the Hong Kong authorities and have provided responses on proposed resolution powers (Chapter 3); safeguards and funding (Chapter 4) and cross-border resolution and information sharing (Chapter 5).

¹ The Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority.

² LCH.Clearnet Group Limited consists of three operating entities: LCH.Clearnet Limited, the UK entity, LCH.Clearnet SA, the Continental European entity, and LCH.Clearnet LLC, the US entity. For further information, please refer to the Legal and Regulatory Structure of the Group:
http://www.lchclearnet.com/about_us/corporate_governance/legal_and_regulatory_structure.asp

Overarching comments

- Post-crisis regulatory reforms have done much to strengthen the resilience of the financial system, and banks in particular. Clearing members themselves are now subject to recovery and resolution regimes, and this has benefits for CCP resilience.
- Nonetheless, we support the introduction of a resolution framework for FMIs. We believe such framework should recognise the specific requirements for CCPs, as these are different to those of banks or insurers.
- We welcome the fact that the authorities have taken into account the FSB guidance on resolution. In particular, we agree that the FMI's rules and procedures on loss mutualisation or allocation should generally be exhausted prior to the entry into resolution, unless it is necessary for achieving the resolution objectives. This approach allows CCPs to execute their (pre-planned) default management process and exercise their recovery tools they have available, for example assessment calls, before authorities intervene.

CHAPTER 3 – RESOLUTION POWERS

Comment on application of bail-in tool in resolution of CCPs

We appreciate that the authorities intend to address the possible application of the bail-in tool in the context of the resolution of FMIs in a subsequent consultation. However, we would note that while bail-in may be appropriate for a bank or other financial institution we do not believe that it is appropriate for a CCP. CCP operators are typically equity funded and under the relevant regulatory framework are obliged to hold high-quality, liquid resources. Instead of obliging the CCP operator to raise debt or contingent equity simply in order to be able to bail in, the priority should be to ensure that the operator's regulatory capital is sized correctly in the first instance, and that there are sufficient pre-funded resources available to cover a member's default (i.e. margins and default fund contributions).

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

We strongly support the inclusion in the list of liabilities identified in paragraph 108 of liabilities arising from participation in a CCP or owed to a CCP. The exclusion of such liabilities from any bail-in supports one of the objectives of an effective resolution regime noted in the consultation paper and also in the FSB guidance³, which is to ensure continuity of systemically important clearing and settlement functions including those provided by CCPs. The ability of a CCP to continue to clear for a clearing member in resolution is indeed dependent upon the continued performance of obligations (such as the payment of margins) owed to the CCP by the clearing member or a successor firm.

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

³ Key Attributes at p. 71.

We believe that liabilities arising from derivatives cleared with a CCP should be excluded from any bail in, in line with our answer to question 15. However, these may be excluded by virtue of the exclusion outlined under point (viii) in paragraph 108. We suggest that the authorities clarify this point in the final framework. Including liabilities arising from cleared derivatives in the scope of bail-in could have negative consequences, for example:

- Bail-in of the positions of a clearing member in resolution would leave the CCP with an unmatched book which is contrary to the fundamental design of CCPs. The existence of an unmatched book would complicate the efforts of the CCP to handle a potential default of the clearing member in resolution
- Bail-in of the collateral posted to the CCP to cover derivative contracts would reduce the resources available to the CCP to manage a potential default of the clearing member in resolution, jeopardising the effectiveness of a CCP's default procedures

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

We note that the authorities refer to the EU Directive on recovery and resolution of banks⁴ in the consultation as an example of legislation already in force which includes provisions on a temporary stay on early termination rights. We would like to point out that the EU Directive includes provisions to preserve the ability of a CCP to take action to default a participant in resolution, or the successor of a participant, that fails to perform its obligation to the CCP⁵. This is consistent with the FSB guidance which states unequivocally that: 'If a participant in resolution fails to meet any margin, collateral or settlement obligations to the FMI, the FMI should retain the right to exercise any acceleration or early termination rights that arise as a result of that failure.'⁶ We encourage the authorities to adopt a similar approach in the final framework.

Question 22

Do you have views on how best to implement a temporary stay of early termination rights such that it is effective in supporting resolution of FMIs in particular?

We agree with the authorities that a stay on early termination rights may be particularly important in the resolution of CCPs. We support the approach outlined in the FSB guidance that the entry into resolution of an FMI should not in itself allow any counterparty of a FMI to exercise contractual acceleration and/or early termination rights, unless the FMI fails to meet payment or delivery obligations, but subject to any application of loss allocation to margin or collateral under the rules of the FMI or through the exercise of statutory loss allocation powers. We believe this approach is central to any successful CCP resolution.

To ensure that a stay on early termination rights effectively supports the resolution of a CCP, we suggest that the authorities consider the following. The resolution of a CCP may require two separate steps: i) the transfer of one or more clearing services to another CCP or a bridge institution and ii) winding up of other, non-viable elements. Depending on the complexity of the CCP in resolution, it is difficult to envisage how long the implementation of these measures may take, and therefore we believe that the authorities should recognise that there may be circumstances where the duration of a temporary stay enforced by them would

⁴ Directive 2014/59/EU (May 2014)

⁵ Directive 2014/59/EU, Article 71(3) (May 2014)

⁶ FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Section 3.1 at p. 73., (October 2014)

need to be extended beyond a prescribed time, which should also be reflected in the CCPs' rulebooks and membership agreements.

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

Although the FSB envisages the transfer to a temporary bridge institution or a sale of business tool as possible resolution options that could be available to the resolution authorities, in practice we consider it will be challenging to exercise these in a crisis scenario. Speed and certainty will be key – but a sale of a business will first require a valuation, which may be difficult to complete in the short timeframe one would envisage in a resolution. Further consideration will need to be given to how one could ensure that the relevant bridge institution meets the requisite requirements to be an authorised CCP under the applicable domestic legislation.

One of the key potential problems raised around the sale of a business or the transfer to a bridge institution is the ability to separate the business being sold/transferred from the critical support functions or the otherwise healthy parts of the troubled entity, as noted in the consultation. These considerations are similar to those which are identified by banks in drafting "living wills". Some practical considerations include:

- Maintaining technological support operations for both the part of the business sold/transferred and any part retained (including outsourced contracts) would be one of the most challenging considerations given that many CCPs rely on bespoke technical systems;
- Meeting capital requirements for the business sold and any business retained; and
- The ability to distinguish collateral pools so that collateral for solvent services could be transferred separately from the service in financial difficulty.

In addition, there may also be challenges in selling different service lines to different buyers because of set-off rights under the rulebook. Consideration should also be given to the potential impact of a transfer of client assets (margin) and the rights under which a CCP would be able to perform such a transfer. Finally, authorities should consider the ability and likelihood to resolve separately one or more clearing services with a segregated by default funds as opposed to resolving the entity as a whole.

Regardless of which of the two approaches proposed in the consultation paper the authorities will choose to secure the provision of the services and functions essential to continuity of the transferred business on a temporary basis, the above considerations will need to be made to assess the feasibility of the transfer of a business.

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the enforcement of security interests in line with proposals set out above? Do you have views as to the exclusions to which this power should be subject?

We agree that a moratorium should not apply to payments, property transfers or enforcement of security by or to the FMI in respect of the institution in resolution. This is consistent with the EU Directive on recovery and resolution of banks⁷.

⁷ Directive 2014/59/EU, Articles 69(4)(b) and 70(2), (May 2014)

The consultation notes that resolution authorities should have the power to apply a moratorium on payments to general creditors. A CCP would be adversely impacted in relation to general creditors such as landlords, suppliers, IT vendors and potentially even staff who are crucial for keeping the CCP running if it is to continue as a going concern – if the moratorium on payment does not also prevent the creditor in question from defaulting the CCP, or otherwise withholding the service it is supposed to be paying for, then the ability to resolve the CCP may be adversely impacted by the unavailability of crucial services required for the CCP's day to day operations. Given the CCP will hold wind up capital against these sort of costs, and that they are likely to be very small amounts compared to the CCP's liabilities under cleared trades, it is not clear what a moratorium like this would really achieve in terms of preserving the financial viability of a CCP that presumably has suffered considerable losses as a result of a member default.

Question 30

Do you agree that the regime should provide the resolution authority with the necessary powers to secure the continuity of essential services as set out in paragraph 156?

The consultation states that a resolution authority may need to secure the continuity of essential services offered by other regulated and non-regulated entities in a group, provided that such entities are in the same jurisdiction as the institution under resolution. We agree with this approach, as we question the extent to which such actions would be possible where related entities are domiciled in a different jurisdiction. It may be that the resolution authority would not have the required competence to give directions to such entities. We believe that this is most important where critical services are performed by group entities under service arrangements. Where this is the case, such service arrangements should be identifiable and subject to terms which require continuity of critical services. However, we would not expect resolution authorities to have the power to compel related entities to undertake activities that they had not been providing before the FMI went into resolution.

CHAPTER 4 – SAFEGUARDS AND FUNDING

General comment

We support the inclusion of set-off and netting arrangements in the list of arrangements which need to be protected under property transfer resolution procedures. This approach is in line with the UK law for CCPs⁸ and the EU Directive on recovery and resolution of banks⁹ as it is important to ensure that resolution measures do not affect the continued ability to use netting arrangements.

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is undertaken? Do you have views on other valuation principles that should underpin an NCWOL valuation?

In general, we agree with the valuation principles identified in the consultation. However, it should be clear that a CCP's default arrangements should be the first line of defence when dealing with the default of its members and this is reflected in the default waterfall provisions required of CCPs seeking authorisation. Any contributions that members or participants are obliged to make under default arrangements should be considered separately from the question of no creditor being worse off than in insolvency. To judge this test from where a CCP begins its default procedures would be premature and to do so would disincentive a

⁸ The Banking Act 2009 (Restriction of Partial Property Transfers) (Recognised Central Counterparties) Order 2013

⁹ Directive 2014/59/EU, Articles 68(3), 76 and 77 (May 2014)

member or participant from participating fully in the default management process. Instead, any such evaluation should be made at the time which the resolution authority intervenes to ensure that a CCP is prevented from otherwise going into insolvency.

CHAPTER 5 – CROSS-BORDER RESOLUTION AND INFORMATION SHARING

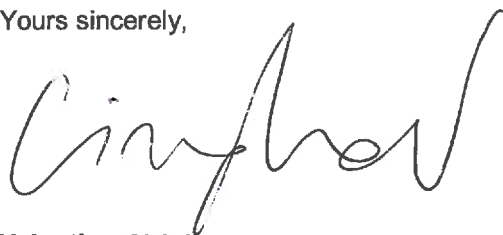
General comment

We would like to express our support for the establishment of CMGs as they will facilitate dialogue and discussion between the relevant supervisors, central banks and other public authorities. In addition we would like to highlight the point that, following the formation of such groups, the decision making should ultimately reside with a single resolution authority, which in our view should be the resolution authority of the jurisdiction in which the CCP is established.

We agree that it is important for key domestic and cross-border counterparts to have information sharing arrangements agreed in advance, and ideally to have tested these as part of a crisis management exercise (if possible, with the participation of the relevant FMI).

We hope that this response will assist the authorities in the preparation of a third stage consultation ahead of introducing a Bill into the Legislative Council by end-2015. Please do not hesitate to contact Valentina Cirigliano at Valentina.Cirigliano@lchclearnet.com regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours sincerely,



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