October 14 DTCC-CSFI Post Trade Fellowship Round Table

Summary

The Fellowship’s second lunch-time round-table meeting in London welcomed Sharon Bowles, MEP, Chair of the European Parliament’s Economic and Monetary Affairs (ECON) Committee, as the main speaker in a session devoted to the post-trade issues on the parliament’s agenda, with a special focus on their relevance to the City of London. Kevin Milne, Director of Post Trade, London Stock Exchange Group, and Barry King of the Markets Infrastructure & Policy department of the Financial Services Authority were invited to respond to Sharon’s remarks.

The discussion was wide-ranging. It took place in a period of intense activity on Post-trade issues in Brussels: a week after the EU Council of Ministers agreed its position for the final negotiations with Parliament on EMIR (the European Market Infrastructure Regulation) and just a few days after the first of the “Trilogue” negotiating sessions on EMIR between Council and Parliament in which the European Commission plays a supporting role. The meeting was held just a few days before the Commission published its draft legislation to update MiFID.

The round table met under the Chatham House rule. The following summary therefore focuses on the issues raised rather than providing a chronological account of the debate. It does not attribute remarks to any named participant.

CCPs and questions of risk:

With EMIR in the news, a good deal of the discussion focused on clearing houses and risk. It was pointed out that of 24 CCPs in Europe, only two or three are multi-asset class CCPs. This was important from a regulatory perspective and raised the issue of balance between safety and competition.

One participant noted how politicians associated moving asset classes onto CCPs with safety and risk reduction. But assets moved from bank balance sheets to CCPs were netted, offset and mutualised to an extent. They did not go away. This fact was very important when considering OTC derivatives and some other difficult to value assets, such as those for physical delivery in the future. Recalling that the role of a CCP is to assess, manage and offset risk, the speaker said pushing assets headlong into clearing houses would add to risk unless CCPs had a profound understanding of the risks involved. This was doubtful if only two or three CCPs understood multiple assets, their interrelationships and risk correlations. These factors explained his concern about competition among CCPs. It was fine to have competition at the trading level. In Post-Trade, one must be sure to have regulations and laws in place, which would apply for many years and which increase the quality and safety of the financial system.

The subject of OTC risks being injected into CCPs was taken up later by another participant, who argued that luck played a part in the ability of CCPs to cope with the Lehman bankruptcy. Arguing that no CCP in Europe has the knowledge, skills or systems to measure the risks being placed in them through new legislation, he asked whether the people responsible for risk in infrastructures were being heard in Brussels.
The meeting heard that the Parliament was concerned about risk and this was reflected in its version of the EMIR text. It was argued that all players needed a much better understanding of business models and risk models in banks and CCPs. Parliamentarians had no wish to put tax-payers’ money at risk.

The issue of risk led on to a consideration of CCP structures. One view was that financial infrastructures would become large quasi-monopolies, which should somehow avoid the disadvantages of monopoly.

The discussion raised several issues of concern, including concentrations of risk in CCPs, which then became systemically important. The interests of CCPs, clearing members and clients were not necessarily the same although the European Parliament text of EMIR was said to recognise this. The issue of whose money was at stake could be important when considering the re-use of collateral. There was a fear that a shock in one asset class could cause shocks across the whole regulatory-prudential sphere. Many things were having to be learnt as events progressed. Among these, was the folly of treating sovereign debt as risk free.

On the other hand, as one participant recalled, the legislation around mandatory clearing does not force CCPs to clear products they do not want to clear. This was a crucial point in the implementation of the G20 pledge to have clearing of all standardised OTC derivatives by the end of 2012 and led this speaker, at least, to sleep a bit better at night.

Problems of content and timing

During discussion of the G20 commitment, it became apparent that some problems were only now beginning to surface. What, it was asked, would happen if two counterparties, one EU and one US, do a trade, are required to clear respectively with an EU and US clearing house, but cannot find one authorised by both regimes? Another question related to the provision, in CRD IV and Basel III, for a capital charge for banks dealing with clearing houses: Would this reduce the willingness of clearing member banks to contribute to default funds? Was this a case of the unintended consequences of otherwise well meaning legislation? Another question concerned segregation and the new concept of portability of client accounts. The latter could be a big challenge for a CCP in a crisis when it would be faced with having to deal with tens of thousands of client accounts. Finally, there was a timing issue regarding access to CCPs which, leaks suggested, would be taken up in the MiFID draft: Emir was scheduled to take effect by the end of 2012; but MiFID II would be perhaps three or four years later.

The timing problem extended to other issues. Some of the provisions in EMIR would depend on definitions due to be decided in MiFID II. For example, people were asking regulators whether FX short dated contracts are in the scope of EMIR. The answer seemingly will depend on how MiFID defines a derivative and that remains unclear. Similarly, in the case of some corporates: Are they financial firms under EMIR and so have greater obligations in the Post-trade space? Answer: it depends how they are defined in the MiFID review. The fact that MiFID comes last in a long line of legislative initiatives made it very difficult for participants to know how to lobby.

The international dimension:
The issue of implementing the G20 commitment moved the discussion onto the international aspects of the Post-Trade agenda with a focus on trans-Atlantic relations, where the problem of the extra-territorial provisions of the Dodd-Frank Act and risks of regulatory arbitrage loomed large. The European Parliament is an active participant in discussions with Washington.

Problems ranged from differences in wording between the Dodd-Frank Act and emerging EU legislation to differences in attitude. There was praise for US wording that promised to recognise rules in countries where regulation was “comprehensive and consistent” with the US. The EU had a variety of ways of making the comparable point and this weakness had emerged during legislative scrutiny of Commission drafts. There were said to be four different definitions of “comprehensive and consistent” in the draft of CRD IV, for example. The EU usage of “at least as stringent” was criticised as being less good than the US terminology.

But the better language in Dodd Frank did not extend to US attitudes. The US was criticised for trying to stop activities moving abroad through regulation. In the case of crisis management policy, it was alleged that the US wanted rules based on the home state principle so that when things went wrong, money would go back to the home state (the US). Yet at the same time, the US was saying subsidiaries in the US from third countries would have to put up capital. In addressing such issues, EU representatives had to resort to humour and humiliation, by suggesting, for example, that the US was behaving like a third world country. In this context, mention was made of Zimbabwe.

On the other hand, much depended on where in Washington the debate was taking place. Tough language was required at the political level on Capitol Hill. At the level of the regulatory bodies, the work was really going very well. One participant claimed never to have known such efforts. Gary Gensler (head of the CFTC) was said to be on the phone all the time. Commission representatives were always over in Washington.

There was some optimism that differences would be resolved because both sides had things to lose. The US was said to be frightened of being on the losing side of regulatory arbitrage regarding derivatives. Europe was frightened that the US would again not adopt capital requirements and not “do Basel”. The challenge then would be to ensure that trans-Atlantic also applied in third countries.

But recent discussions involving legislators also prompted words of caution. There was said to be much more hunkering down, ring fencing and protectionism in the US and in Asia too. While Europeans were focusing on how to have open markets, they might find that trends were shifting far more towards “subsidiarisation”. That could have a big impact on growth and economic capital.

One speaker from the floor voiced concern that the EU-US and US might compete on collateral standards, mentioning the fact that infrastructures in Europe were allowed to treat letters of credit as collateral, while in the US they were not. This prompted a suggestion that global standards for collateral might make matters clearer.

On the specific problem of data repositories, where Dodd Frank requires US registered data repositories to obtain indemnification agreements from foreign regulators before sharing critical market data with them, the US appeared to believe the problem could be resolved by releasing the data through the CFTC or the SEC. The discussion suggested that the European Parliament would be
unhappy with this idea because of a lack of symmetry in information flow. The EU’s policy was one of openness while the US was proposing to run its information through agencies.

CSDs

The meeting touched briefly on central securities depositories (CSDs), where the Commission is expected to put forward draft regulations before the end of the year.

A big challenge was harmonisation. CSDs had grown up inside national boundaries and were subject to national laws. They had have morphed over time and taken on different services. One speaker noted that it was very difficult to distinguish between a CSD, an ICSD and a custodian bank. What rules should apply to which? The definitions and vocabulary currently in use no longer made sense. Organisations should be looked at from a functional view point and not by what they are called.

One participant asked whether legislation of CSDs was really needed now, given that the ECB’s T2S project was a work in progress and there was legislative indigestion elsewhere.

It was acknowledged that the Parliament had yet to focus on the CSD issue. But if the Commission produced a proposal, legislation was almost sure to follow. The Commission doesn’t withdraw projects and the Parliament rarely stops them. Progress on CSDs might be slower than progress on issues related to the G20 agenda. If any EU institution were to kick regulation on CSDs into the long grass, it would likely be the Council of Ministers.

The Role of European Parliament and its processes

The meeting provided some useful guidance on how the legislative process works in the European Parliament. The ECON Committee, Chaired by Sharon Bowles, faces a packed agenda. The Committee chair takes up issues when they are proposed by the Commission. That provides the opportunity to give a keynote speech and outline thoughts and principles concerning the proposals, which can be referred to when the legislation reaches the committee stage of parliamentary scrutiny some months later. It is in the ECON Committee that amendments are tabled and compromises reached.

Financial services legislation is subject to co-decision, where Parliament and the Council of Ministers have to agree on the final form. Resolution of differences between the two sides takes place in the Trilogue.

It turned out that there is no formal rule book governing Trilogues. But in the case of financial services, they are chaired by the ECON chair, which illustrates how the Parliament’s power has increased over the years. The task is to reconcile the positions of Commission, Council and Parliament.

It was suggested that in the UK, too much attention is given to the Council position, which amounted to less than half the story. In the case of EMIR, positions secured for the UK by Chancellor George Osborne in the Ecofin Council of October 2011 had been in the European Parliament text for over a year.
The lesson for lobbyists was to act at an early stage and talk to the parliament. If any wished to suggest amendments to the Parliament, they should be short, leaving technical details for the Trilogue after the political agreements have been reached. The Trilogue process could be lengthy, involving hundreds of hours of negotiations. Agreement on the EU’s alternative investment fund legislation necessitated 38 Trilogues meetings of about 3 hours each.

Unlike some other legislative bodies, there is no institutional pressure on the European Parliament to prioritise legislation. The Commission’s proposals are handled in parallel work streams. Each piece of legislation will have a rapporteur and shadow rapporteurs. These will have often relatively short exchanges before a report is produced. But there can then be a huge number of amendments (around 4,000 on the proposal for CRD IV). These will be isolated into categories as a prelude to finding compromise among the rapporteurs. First port of call is find a compromise that the vast majority can agree to. Only if that fails, will the lead rapporteur start to exclude people. There is always pressure on dissenters to stay engaged and be inside the tent even if they consider the emerging legislation to be imperfect, because once outside the process, they have no influence in the later stages.

The ECON Committee’s goal is to keep the overarching “level one” legislation as lean as possible. But policy cannot be delegated to ESMA (the European Securities and Markets Authority) and other European Supervisory Authorities. As a result, the EU has to frame legislation in greater detail than the US in the case of Dodd-Frank, for example.

This can mean that texts get longer as they pass through the parliament. Sometimes, this is necessary to correct inadequate Commission texts. At other times, the parliament will include recitals to get points into the public consciousness and show how it wants things to develop. The ECON Committee is reconciled to having to revisit existing legislation. There may be no appetite for wholesale revision. But some legislation – Basel, for example – will be revisited eternally and forever. Already in the proposed CRD IV, the committee can see that zero risk weighting of sovereign debt is a nonsense and that trade finance is in the wrong asset class. The proposed revisions to MiFID are sure be incomplete when they reach the parliament.

One speaker from the floor expressed concern that lobbying might result in EU standards drifting away from global standards. However, he praised the Parliament for adjusting EMIR so that it addressed the issue of pro-cyclicality. The Parliament had also recognised the importance of CCPs knowing about their large clients. A failure to know about clients lay behind the last known CCP failure – that of the CCP for the Hong Kong futures market in 1987.

One participant asked whether the Parliament was trying to avoid mismatches between the many directives, regulations being put before it, and how it could achieve continuity.

There was an acknowledgement that difficulties could arise. It was difficult to guarantee continuity of rapporteurs, for example, although there tended to be some continuity between rapporteurs of the Parliament’s own initiative reports and reports on the same issues that followed a Commission proposal. Difficulties could arise because of a silo mentality in the Commission, where officials tended to think only about their own legislative initiatives. A specific problem existed in DG Markt, the Commission internal market directorate because of a recent injection of personnel from DG Competition. DG Comp people were said to come from culture where communication and openness were not the norm and took some time to learn the habits of consultation.
One way of dealing with mismatches was to have an omnibus legislation to iron out the differences. This, however, could be difficult.

**City and standing in Europe**

The meeting also discussed the position of the City when lobbying the European Parliament in the wake of the financial crisis and in the light of the Conservative Party’s decision to quit the EPP, the parliament’s biggest political group. The picture was not a happy one. The City was widely blamed for the economic crisis, with one Belgian Green MEP heard to suggest that London should be bombed. The UK’s position was made worse by past boasting, followed by the post-crisis “mea culpas” of the FSA. The position was especially unpleasant for the UK’s financial attachés working in the Council of Ministers. The City was heard but often ignored. It was sometimes better for the City not to be heard because it then gave others targets to attack.

Lobbyists had to pitch their arguments carefully and get their language right. It didn’t help to complain to MEPs about profits being at risk. But people could be won over by talk about pension funds or man-in-the-street issues. That said, financial expertise was an advantage. Despite the unpleasant atmosphere, UK MEPS were able to help shape the EMIR regulation.

The Tories’ departure from the EPP had proved to be a real disaster and this was now recognised by the UK Government. The UK had no insight into the inner workings of the EPP. Its coordinators acted to keep market dossiers from Tory MEPS. The decision to quit had happened at the worst possible time. If ever the Tories decided to rejoin the EPP, it would be after the Parliament had dealt with the current surge of financial legislation.

**Pointers for the Fellowship**

Each of the panellists was asked to name the two most important actions that would help improve Europe’s Post Trade architecture.

One, referring to an ideal world, called for more time. One could understand 95% of post trade issues in about 10 minutes. It took about 30 years to understand the last piece and that was the tricky bit. Once politicians had the necessary understanding, they should go into a darkened room and come out with the ideal scenario. No-one could rely on experts to come up with what the market requires because of the profusion of vested interests and inefficiencies that underpinned existing business models.

In consequence of MiFID, some stock exchanges had experienced painful, hard and nasty changes that resulted in different, much smaller organisations, doing three times more work for one third of the return. Competition meant change. Most infrastructures had grown up inside national boundaries and never had to compete. Competition had to happen. It hadn’t happened yet in the Post trade space.

Another mentioned the ever widening scope of counterparties for which CCPs are expected to clear as one of biggest issues facing infrastructures. There was a need to assess and reconsider the assumption that infrastructures should set participation requirements purely to control risk. Over last 10 years there had been a significant focus on infrastructures that were set up and operated by large financial institutions. The role of infrastructures was being changed by the G20 and regulators.
They were having to operate with much larger memberships, including small counterparties. This speaker wanted to see infrastructures think more about where the balance lay between open access and controlling risk. There was also a need to catch up with banking regulators and work on recovery and resolution plans for infrastructures that hit trouble.

Another saw the challenge more in terms of finding the right balance. There would be political demands for far more transparency which could lead to the development of structures to remove barriers between infrastructures. Debate might focus on the issue of whether to go for a utility infrastructure. If barriers could not be removed, it was likely that solutions would be mandated which the market would not like. That was the story of T2S. There could be similar moves in the future. As far as the Parliament was concerned, there was no longer any impetus behind the programme to remove the Giovannini barriers.