Indirect clearing arrangements

BSA response to ESMA CP

17 December 2015

Building Societies Association

Introduction

Building societies are the UK's mutually owned mortgage and savings banks. The BSA, which belongs to the European Association of Co-operative Banks, is the trade association of the UK's 44 independent building societies. While the largest building society has total assets exceeding € 200 billion, many are small. Nearly 30 fall below €1 billion total assets, and more than 20 fall below €500 million total assets.

The BSA supports the more comprehensive response being provided by the EACB. Unlike most European co-operative banks, building societies are not networked or federated. There is no central institution nor an institutional protection scheme. So societies cannot benefit from the intra-group exemption in EMIR Article 3.

Derivatives are not part of building societies' core business at all – they are essentially end-users only. Building societies are permitted by UK law to use derivatives only to manage the intrinsic risks of their business (e.g. interest rate mismatches on fixed rate mortgage or savings products) or to provide interest rate protection direct to their retail clients. They are not permitted to trade derivatives generally.

Consequently, the derivatives transaction volumes for building societies are modest in relation to their balance sheet size, and for small societies are very modest in absolute terms, and with one-way directionality. These features make the business relatively unattractive for clearing providers.

Most building societies would therefore welcome indirect clearing if it added capacity, competition and choice in clearing and thereby reduced the cost, and increased the availability, of clearing services for small-volume end-users. The very largest societies might even contemplate providing indirect clearing, e.g. to other smaller societies, if this were to be permitted by their governing legislation.

General observations

As observed by the Financial Stability Board in early 2014, clearing services globally are concentrated among fewer than ten large banking groups. The direct clearing market in the UK has shrunk further as major firms withdraw. The Commission and others hoped that indirect clearing would help provide alternative access routes to CCPs, but there is no sign of this so far. Authoritative industry bodies such as FIA Europe have analysed why this is so, identifying some regulatory issues – e.g. in particular, the leapfrogging requirement, but also the capital treatment. But we cannot conclude that removing a particular regulatory barrier will necessarily bring in a wave of indirect clearing services relevant to our smaller members – just as with direct clearing, the business of low-volume end-clients may turn out to be inherently unprofitable.

Economics of clearing

Indirect clearing (if it ever works) could provide a useful mode of access to central clearing for small FCs, for whom dealing direct with a clearing member of a CCP is not cost-effective for either side. But indirect clearing still ultimately relies on the clearing capacity of those CCP members – it does not, and cannot, of itself add any overall capacity. The contribution of indirect clearing could be that a small FC's trades cleared indirectly would benefit from the CCP access, and finer transaction processing costs, available to the much larger head client. At the same time, handling the indirect clearing must be sufficiently worthwhile both to the head client and to the clearing member that the head client uses – potentially there are two lots of transaction processing costs for each trade. Nevertheless, if all other circumstances are favourable, we agree that mitigating the specific regulatory obstacles to indirect clearing would be helpful – this is, we think, a necessary, but far from a sufficient, condition for indirect clearing to emerge as a meaningful alternative for small FCs.

Specific obstacles to indirect clearing

FIA Europe addressed this in their June 2015 paper, identifying the requirement for the "leapfrog" payment as the major technical block to indirect clearing because of the possible conflict between this requirement and local insolvency law. FIA also advocated giving indirect clients a choice as to the level of segregation, and credit protection, they wish to benefit from.

However, since indirect clearing remains dependent on underlying direct clearing arrangements between the head client and the clearing member, any obstacles to direct clearing (such as capital and leverage issues identified by FIA) are also bound to have a knock on effect on indirect clearing.

Segregation models

The minimum choice between two proposed models – for an omnibus indirect account; or a gross omnibus indirect account with additional protection features – with other possible models also permitted if they provide adequate protection, seems a sensible, enabling approach.

Default management

We think the proposals, in particular removal of the leapfrog payment obligation for one account structure, represent a move in the right direction, within the confines of the Level 1 text, though we are not clear whether they will entirely take away the blockage identified by the FIA.

Complementary approaches to underlying problem

In the BSA's view, indirect clearing is not an end in itself, but a possible means to an end – widening clearing access for clients in general and - in particular - small FCs, where this is economically feasible. What these proposals will not ensure, however, is the provision of clearing at an acceptable cost to very small FCs whose business -tiny volumes of trades - are likely to remain inherently unprofitable for clearing members and head clients, and for whom the clearing obligation imposes an unnecessary and disproportionate burden. We set out below how this situation could be mitigated in both the short and longer term.

• Short-term in Level 2

In the shorter term, we think a Level 2 route could work as follows, based on a recent helpful precedent on the treatment of derivatives transacted with covered bond vehicles. In August 2015, the Commission published its final delegated Act on the phasing in of the general clearing obligation for interest rate swaps, and provided that under certain conditions, such swaps transacted by covered bond vehicles formed a separate class to which the clearing obligation was not applied at all. This approach could, we consider, be used to ease the burden of clearing for smaller FCs – the class of derivative could be interest-rate swaps entered into for protection purposes (only), by smaller FCs. So it would be clear that there was no general exemption for smaller FCs – if they transact other kinds of derivatives. The Level 2 provision would cover only essential interest- rate protection where needed and used by smaller FCs.

• Long-term in Level 1

Longer term, as the BSA has already robustly advocated in its response[1] to the Commission's consultation on the review of EMIR, the right answer is for the EU to follow other leading jurisdictions such as the USA, Switzerland, Japan and Australia, and relieve small or very small FCs of the burden of clearing, given that their trades cannot on any measure, even in aggregate, be considered remotely systemic. The simplest way to do this is to set an exemption threshold for small FCs with balance sheets no lower than, say, € 5 billion. A higher threshold, say €8 billion, may even be justifiable by impact analysis. We welcome the support of the EACB for this proposal.

[1] https://www.bsa.org.uk/document-library/information/industry-responses/emir-review-bsa-final-response-august-2015.aspx

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The Building Societies Association (BSA) is the voice of the UK's building societies.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the government and parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets