HOUSE OF LORDS

Select Committee on the European Union

Financial Affairs Sub-Committee

Oral evidence: Financial regulation and supervision following Brexit

Wednesday 25 October 2017

10.20 am

Watch the meeting

Members present: Baroness Falkner of Margravine (The Chairman); Lord Bruce of Bennachie; Lord Butler of Brockwell; Lord De Mauley; Lord Desai; Lord Fraser of Corriegarth; Lord Haskins; Baroness Liddell of Coatdyke; The Earl of Lindsay; Baroness Neville-Rolfe; Lord Skidelsky; Lord Woolmer of Leeds.

Evidence Session No. 4 Heard in Public Questions 46 – 63

Witnesses

I: Simon Puleston Jones, Head of Europe, FIA, and Daniel Maguire, Chief Executive Officer, the London Clearing House.

Examination of witnesses

Simon Puleston Jones and Daniel Maguire.

Q46 **The Chairman:** Good morning and welcome to our inquiry on financial regulation and supervision following Brexit, Mr Simon Puleston Jones, the head of Europe for the Futures Industry Association, and Mr Daniel Maguire, chief executive officer, the London Clearing House. I have to do some brief housekeeping, which I will do straight away. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the public record in printed form and will be on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise any minor errors. The session is on the record. It is being webcast live and it will be accessible subsequently via the parliamentary website. Welcome again.

Do either of you have any opening remarks that you would like to make, or shall we go straight into questions?

Simon Puleston Jones: I will start. I will explain what FIA is and some of its key concerns on the topic at hand. FIA is a global trade association. We have offices here in London, in Washington DC and in Singapore. We will be opening an office in Brussels next year. We have about 360 members. Our primary members are those investment banks and others which provide access to clearing houses, such as LCH, on behalf of clients. We support the entire ecosystem, so we also have trading venues, clearing houses, energy companies, commodity trading firms and others within the membership.

The three key things that our members have been focused on since the referendum last year are outcomes. The three outcomes that they are particularly keen to try to get to are to minimise disruption, avoid fragmentation and maintain access to markets. In plain English, that means: transitional periods, which we hope to discuss a bit more; and avoiding forced relocation, that means instead going towards enhanced co-operation between the UK and the EU; and, as I say, maintaining market access, however we get to that outcome.

The Chairman: I assume the opening of the office in Brussels next year is driven by the need to be based in the EU, in terms of your members.

Simon Puleston Jones: It is making sure that we are able to service our membership fully as a global trade association, representing those around the globe, including those within the EU 27.

The Chairman: Mr Maguire, did you want to say anything to open with?

Daniel Maguire: I will make a couple of introductory remarks, if I may. Thank you for your interest in what we do and giving us the opportunity here today. My name is Daniel Maguire. I am the chief executive officer of LCH Group. Just by way of context, I have been with the organisation for the best part of 20 years. Clearing derivatives is what I have been doing for most of my career. LCH is part of the LSE Group—the London Stock Exchange Group—which is a global financial markets infrastructure company, spanning the globe in all major jurisdictions.

LCH Group, which I am representing today, has three clearing houses: one in Paris, one in London and one in New York. We are headquartered in London, with operational offices in multiple jurisdictions around the globe. A clearing house acts as a circuit breaker within the overall financial markets system. We are fully aligned with the G20 commitments on reducing systemic risk and promoting financial stability.

By way of context of our position within the marketplace, LCH—and therefore the UK—is a beacon for the management of risk in the space of derivatives. We clear over 90% of the key global interest rate markets across every major currency—all 18 currencies. In 2016, we cleared $666 trillion of notional business. This year, we are on track to head towards $1,000 trillion of new business. Our position in the market is somewhat unprecedented, and we have clients and customers in more than 55 countries around the world.

The Chairman: What are the current preoccupations of your sector in terms of Brexit and the timing, for example, of a transition deal? Given the very specific sectors that you represent, are your needs different from those of financial services overall, and could you elaborate on that?

Daniel Maguire: You are right in pointing out there are maybe some specific requirements around this section of the financial market infrastructure. We are a critical financial market infrastructure provider. In the G20 commitments in Pittsburgh in 2009, it was made clear that clearing—pardon the pun—was a key remedy towards the issues that we had in the financial crisis. Clearing is part of that. Clearing is part of a much broader financial market infrastructure and services in the UK.

What is the industry looking for today around the euro-location policy and Brexit? The one word that I would use consistently is some level of certainty. Right now, we are absent certainty. We welcomed the Prime Minister's Florence speech, where she alluded to the need for more certainty. To be more specific, it is certainty around the transitional period. It is critical to have some signposting or clarity around that before the end of the year. It is critical before the end of 2017.

The background to that is customers are not able to wait much longer. People are worried around a cliff edge. As an organisation, we are worried as well. Much the same as the CEO of LSE Group, Xavier Rolet, said, from our perspective, for our business as a financial market infrastructure provider, we seek something in the region of ideally a three-year standstill. We can then make everything safe and sound as we head towards a transition. To be clear, that is a transition to implementation. That is the timeframe we are looking at, so a finite time period.

As an industry, we are also seeking some indication of a level of agreement on clearing around the enhanced supervision which is the primary statement from the European Commission's proposal in June 2017. It referred to location policy as a last resort, but the primary point is about enhanced supervision. That is absolutely key. A location policy solves nobody's problem. It is in nobody's interest, and it is not in the interest of financial stability.

We are also very grateful for the Governor of the Bank of England's remarks a week or two ago at the Treasury Select Committee about developing this new supervisory arrangement. Our aim is to have some indication of the level of progress that is being made so that people can see tangible and tractable progress and some level of certainty emerging in these uncertain times.

Simon Puleston Jones: I would certainly agree with everything that Daniel has just said. The two key topics you touched on were transitional arrangements and enhanced co-operation, in preference to forcibly relocating. When it comes to transitional arrangements, the response that we filed with the Treasury Select Committee at the end of January this year also called for a three-year transitional arrangement. It acknowledged that it needs to be time-bound and limited.

Why do you need transitional arrangements? On the one hand, it is to avoid the cliff edge that we talk about. It is also to give people enough time to transition to the new world. Much has been made of the need to avoid one regime during a transitional period that is different from today's regime, and then a further change at the end of the process. There needs to be a transition to the end state, which is why "implementation period" is the right phrase. What do people do during that period? It is a lot about moving resources and making sure there is no disruption to clients.

Q47 **The Chairman:** Mr Maguire, you said that you wanted some signposting before the end of 2017. We are hearing conflicting timelines from the industry in this regard. When you use the word "signposting", would you, for example, be content with a declaration in the communiqué of the European Council in December to say that both sides agreed on the need for a transition period lasting X period? TheCityUK told us yesterday in a different context that it wants legal underpinning—it has to be legal, and it completely ruled out anything that was not part of a treaty almost. Where would you be on that?

Daniel Maguire: Ideally both.

The Chairman: Would you expect something legal before December 2017?

Daniel Maguire: It would be good, but it is ambitious. The industry as a whole is seeking that level of certainty. This is very much a technical topic. When you look at the potential outcomes of a proposed euro-location policy, that is the last resort. It is important to stress this is not just a UK point; this is with the EU as well, and there is a US element, which I am sure we will talk to as we go through today. Absent some indication that an enhanced supervisory framework is agreeable, an indication from both sides—be it the Council or otherwise—that there is a level of cohesion, co-operation and heading in the right direction would be very welcome. Whether that is underpinned by legal, time is upon us, but at least from an indicative standpoint we want to see that is headed in the right way.

The Chairman: That would be sufficient. Thank you. I see other members want to come in on that. Mr Puleston Jones, did you want to say anything on that legal certainty point?

Simon Puleston Jones: As you say, it is about certainty. Of course it would be preferable to have something that is legally binding. The reason people are calling for as much certainty as possible by the end of the year is, absent that certainty, what will they do? They will follow the requirements of the Prudential Regulation Authority, which are to contingency plan for the worst-case scenario. In the absence of sufficient comfort, they will have to start the process of executing those contingency plans. That will involve having to make sure that there is no disruption to their ability to service their European clients in particular. There will be a need to look at how they can achieve that. That will involve an increase in the number of roles that they need to perform out of subsidiaries based in continental Europe.

Q48 **Lord Butler of Brockwell:** Because I do not think it comes up again later on, could I just pursue this question of transition for a moment? When you say transition, that is the same as asking for a standstill, is it not, or is it something different?

Simon Puleston Jones: Essentially it is. We are looking to make sure there is only one change that has to be implemented. If we are talking about maintaining access to UK markets from continental Europe, it is very important that we look at the regulatory authorisations that market infrastructure such as the UK based clearing houses have. In the absence of some sort of grandfathering or standstill, to use your words, there is a risk that the UK market infrastructure finds itself neither approved as a European entity nor having achieved the necessary regulatory status as a third-country entity at the date of exit in order to continue servicing European markets. Yes, we are looking for a standstill in regulation during this transitional period, as firms are given time to implement the new requirements that would apply at the end of that transition period.

Lord Butler of Brockwell: What will your position be if, during what you call the transition period and I call a standstill, there is still no clarity about the eventual destination?

Simon Puleston Jones: The benefits of a transition period are ensuring that if we are in that scenario, where we do not know quite where we are going, what we have not done in the meantime is fragment markets in a way that cuts people off from being able to access markets of their choice on a cross-border basis. It does serve a utility, even if one is not quite sure what that implementation destination is. The sooner we can have certainty on what the new world looks like, the better, because it will give firms longer to prepare for that eventual outcome.

Q49 **Lord Haskins:** Is it not extremely unrealistic to expect some degree of certainty by the end of the year? We have been led to believe there might be a chance at the end of March. The Prime Minister changed her wording rather carefully on Monday from "transition" to "implementation". Implementation suggests that there will be a series of deals that have been done that have to be implemented. That is not going to take place in the next three or six months, so then what happens?

Simon Puleston Jones: The more clarity that can be given now, the more firms are able to adapt to the new world. If they do not get certainty by the end of the year, they will have to start executing their contingency plans, in answer to then what happens. Then what happens is firms start working through,"How do we make sure there is no disruption in our ability to service our clients in continental Europe?". The answer in many cases is by making sure that they have the memberships that they need of European market infrastructure, the right operational resources in subsidiaries in continental Europe, and that they plan for the future.

Yes, the timeframes are challenging, but the more certainty that can be given that there will be some sort of transitional arrangement, the better. There are a number of comments one could point to on both sides of the English Channel that indicate a willingness for transitional arrangements. There is an acknowledgement that, in order to minimise disruption, it is important to keep markets open.

Daniel Maguire: If I may build on that and come back to your question, your Lordship, I am here today as a technician, a market practitioner. I understand the political context and the backdrop, but our goal within this is to ensure that we keep financial stability and keep the financial system safe and sound.

A tremendous amount of work has been done since the G20 commitments. There was the crisis in 2008 and the G20 in 2009. When we refer to a standstill, we are talking very specifically about a standstill in the level of the regulation of supervisory oversight so that, plainly, markets can continue to operate as they do today—safely and soundly—and we can continue to perform our functions.

We are not in any way saying that a transition is kicking it into the long grass. This is about implementation, but, until we get such certainty of what the outcome is and what the actual regulatory framework would be, it is very hard to start planning as an infrastructure company. If you think about an infrastructure company in any walk of life, they are somewhat complex and unwieldy in some regards. When you overlay that with the systemic nature of an organisation such as LCH—and we are not alone in this—we need a period of time to make adjustments and do very meticulous planning looking at the new regulatory tapestry and enhanced supervision that arrives.

For us, it is not absolute certainty by the end of the year on what the outcome is. It is some degree of certainty that there will be a transitional arrangement and that there will be an outcome that arrives at some level of enhanced supervision, rather than the alternative, which is, potentially, a location policy. If we do not have that, people will start to execute their contingency plans. On the prudential regulation point that Simon made, people will start to take their decisions. As those decisions are made, trains start to leave stations, and it is very hard to pull that back.

Lord Haskins: I believe that the train is leaving the station already.

Q50 **Lord Desai:** I am puzzled by this, because uncertainty is your business. That is what people are transacting. We have the certainty that Brexit will take place, bar some earthquake and Governments falling and so on. Have people made contingency plans for the worst outcome—if you do not get any transition certainty? We are already in October. What hope is there we will get anything by December?

Simon Puleston Jones: Essentially the question is: what contingency plans are people making? As one looks at the ecosystem of clearing, that has to be answered from a variety of different perspectives: the firms that are members of trading venues and clearing houses, so executing brokers and clearing brokers; those that are market infrastructures themselves on both sides of the English Channel; and of course clients.

When it comes to access to UK clearing houses from continental Europe, there are a number of services that are provided by continental European clearing houses that are also provided over here in the UK. There are some that are not. It will be easier to contingency plan for something where there is a ready alternative in continental Europe, because you can start to relocate that business to continental Europe at an appropriate time before one gets to March 2019. It does come with a number of downsides.

From a UK perspective, those that are providing services out of London at the moment can increase their presence in their subsidiaries in continental Europe. They can start the process of adding to their memberships of venues in continental Europe to make sure that they can continue to help firms meet their obligations for mandatory trading and mandatory clearing of derivatives in continental Europe. They can think about which trade repository they use in order to meet their requirements.

The planning really splits into those which are in continental Europe already and the rest of the world, and those which are providing services from London into Europe, and then the other way. When one looks at market infrastructure, some have the ability to potentially open up services in continental Europe, or already have affiliates in continental

Europe where they might be able to dual-list contracts, for example. Others do not have quite that availability.

Lord Desai: Is there an estimate of what it is all going to cost?

Simon Puleston Jones: We do not have that. It is too complex a process to put an absolute number on.

The Chairman: Mr Maguire, do you want to come in briefly?

Daniel Maguire: Your Lordship, you are right: we are a clearing house; we are a risk management organisation; we manage uncertainty. What we bring to our members, clients and the marketplace in financial services is certainty. That is why a clearing house is there. It is about giving certainty in both good times and less good times. We are very familiar with dealing with uncertainty.

People look to the financial market infrastructures more now than probably ever around their behaviours and what they are doing in reaction to this current scenario. We come under pressure like everybody else. The fundamental point for us is that, once people start to do contingency plans, us included—we have clearing houses on the continent and in the States—that is work.

That is all doable, but the fundamental is, if we go down the route of invoking contingency plans and we end up in some form of location policy, or some reciprocity in other jurisdictions, this will result in a much more systemic issue; that is, breaking up the pools of liquidity, the transparency, oversight and risk management that have been brought through the centralisation of these markets. It is essentially fragmenting markets when, no less than 10 years ago, the decision was to try to bring those into a more centralised space. It is the impact of the contingency that will create that fragmentation. As a risk management practitioner, that is our major fundamental concern.

Q51 **The Chairman:** We will pick up some of these points on location a little later. We need to move on, but could you briefly comment on the EU (Withdrawal) Bill? Given that you have the PRA Rulebook, the FCA Handbook and now this Bill is going to go through, in terms of your preoccupations, where would you see the right level of legal certainty in transposing EU law? Where would you see that sit: in the withdrawal Bill, in the statutory instruments, or with the regulators? I am slightly leading you in this question, in the sense that I am posing two alternatives. I wonder whether you could tell us what you think about that and add anything else that you would like to say.

Daniel Maguire: I am going to revert to that point of certainty. I am not a legal practitioner, so you will have to forgive me. It is ensuring that, whatever is transposed into UK law, we continue to have that degree of certainty to operate in the markets. I am not able to give direction or advice around that.

The Chairman: Let me ask you the question in another way then. From where you sit, would the timeframe of either option be relevant? If it were done in a more speedy fashion in one way versus another way, would that matter?

Daniel Maguire: If the assumption is speed brings certainty, then absolutely.

Simon Puleston Jones: In terms of the outcome, we have talked a little about maintaining global access to markets. A key part of that is the equivalence arrangements that not only Europe but the US has as well, which are based on the extent to which one country's rules are equivalent to another's. We are very supportive of the approach that the UK is taking, which is to essentially copy and paste European legislation. That means that on day one there will be no material daylight between the rules that would apply in the UK from March 2019 and those that will apply in continental Europe.

In terms of the process of getting there, the devil is in the detail. Yes, one could put in the withdrawal Bill that we essentially copy and paste European legislation. However, then one needs to go through the process of determining which UK regulator will be responsible for which activity. In lieu of the words ESMA or European Commission, who is going to do these things?

The Chairman: The inoperables come into play.

Simon Puleston Jones: Inoperables come into play. It is important to be very clear within the UK regulatory framework who is going to be responsible for supervising and authorising what. Generally speaking, there is a preference for parliaments to set the frameworks and for regulators within their rulebooks to set out details.

Q52 **Lord Skidelsky:** Could I broaden this out a little? The purpose of a clearing house is to contain the threat of contagion igniting a serious crisis, as happened. The first question then is: why was the circuit of contagion not broken pre-2008? You had a system that was fairly London-based. Was it because there was too much fragmentation in the clearing, or was it that there were too many trades outside the clearing—OTC trades? In your view, what produced a failure of the clearing before 2008?

Daniel Maguire: Clearing is not a new concept. It has been around since at least 1888 with LCH. It comes mainly out of the futures markets. The advent of OTC—over the counter—markets coming into the clearing house and the clearing space was around 1999-2000. Pre-crisis, LCH's services for clearing interest rate swaps were live. We had a sufficiency of participants and trades in the clearing house, but the truth is the majority of the marketplace, from the sell side, the bank side and the buy side—the real money, the real economy—were on the outside of clearing. They were all what we refer to as bilateral transactions under ISDAs and legal agreements.

I was very heavily personally involved in the closeout and unwind of the Lehman portfolio in the clearing house on the swap side. At that point more people were rushing to clearing because of counterparty risk exposure. Then, post 2008, the market essentially bifurcated into a cleared market and an uncleared market. We saw different execution pricing and so on.

Following that, the G20 commitment in Pittsburgh in 2009 was a shot in the arm to the clearing industry. Subsequently, the underpinning of the financial markets from an OTC standpoint has seen the advent of Dodd-Frank in 2010 in America and EMIR in Europe. That has mandated all entities, all users, to come into the clearing house. Before that it was voluntarily the case. Post 2010 and into 2013, 2014 and 2015 we have seen mandates coming from around the globe, which all stem from the G20 commitment—that was the point where clearing started to gravitate. Today, two-thirds of the OTC market is in a clearing house, with the full transparency that you get.

Lord Skidelsky: But one-third is still outside.

Daniel Maguire: One-third is outside. It is probably important to say that clearing is not the panacea for every product. Some products probably should not be in clearing because of their liquidity features and risk features. I am confident that we are on a path where most major asset classes—interest rates, credit, foreign exchange—have mostly moved into the clearing house.

Lord Skidelsky: Is your fear of fragmentation that some of these trades will now escape the compulsion to come into clearing? Will they be able to move between different clearing regimes? What is the fear of fragmentation here?

Simon Puleston Jones: May I just add to the earlier question before moving on to that? It is a slightly different topic. In your earlier question, you talked about the failure of clearing in 2008. Just to be very clear, as Daniel explained in his answer, it was not clearing that failed. It was the bilateral world, where one bank would face another using derivatives. Typically, that relationship was not subject to margining requirements, so there was no collateral to protect yourself against the risk of your counterparty defaulting. There was not as much transparency as there is today as to who is doing what with whom.

That is why, in 2009, the G20 commitments were put forward to suggest that there be more trading of derivatives on venues, more clearing of those derivatives through clearing houses, and more reporting of data relating to transactions to trade repositories. That improved transparency on who is doing what with whom. You can see it because it has been reported and/or it has been done on venues. With clearing, that has always been a regime that has required odd risk-mitigation techniques such as margin.

As you say, the G20 commitments on the one hand wanted to incentivise more central clearing, but they did not leave the OTC markets as they were in 2008 either. They acknowledged that clearing came through the crisis extremely well. It managed to either transfer positions or close out positions in a matter of days, not the several years that it has taken in the OTC world for people to get their money back, with no option to transfer their exposures to others as readily as is possible in clearing.

Secondly, in the OTC world the European laws in recent years have now required that those markets also be subject to certain risk-mitigation techniques, including the mandatory provision of collateral to counterparties. Much has been done to try to address some of the risks that would otherwise have remained in OTC markets, as well as trying to incentivise more on venue execution of derivatives.

Lord Skidelsky: This is my last question. What more remains to be done? Our overriding interest is to prevent anything like 2008 happening again, in so far as these sorts of regimes can do it.

Simon Puleston Jones: Dan, do you want to address the previous question about fragmentation first, just so we are clear on that?

The Chairman: Briefly.

Daniel Maguire: When you have a crisis it is important to have the ability to monitor everything coming up to that crisis. That is what we call business as usual in a clearing house. In fact, default management is actually business as usual. It is just a bit more heated and sweaty, as you can imagine. When you look at the markets today, there is full choice across the globe. There are many clearing houses across the globe today. There is competition and choice within clearing houses. What you generally find in most marketplaces, although not all, is the market will choose its desired outcome. Generally, you will find a gravitational to one CCP having not all but a large amount of the business. That is not specific to LCH. That is just a general market dynamic.

Lord Skidelsky: Is it the most efficient?

Daniel Maguire: It is the most efficient, absolutely. That is a much better way of putting it. From a systemic risk standpoint, it means that we have all the risk in one place. In the eventuality of a default of a major institution—a sell side or a pension fund or whatever—the vast majority of the risk is in one place. There is one entity charged with unwinding, with the collective membership, because there is a mutualisation element of this. It is all in one place, with full disclosure on risk management approaches, and able to close that out. From a systemic risk and stability standpoint, one place with the majority of the risk being able to go and actively close that out is probably the most orderly way to do that.

If you go down the route of fragmentation, you could have many pots of the same risk in many different jurisdictions, all trying to come in. You could have longs in one CCP, shorts in another, and so on. It can become very unwieldy. Going back to the G20 commitment thing, it is about safety, soundness and financial stability. The market is choosing that it is better in one place. The risk managers and the systemic risk managers think the same.

It becomes inefficient for markets, and if there is an artificial fragmentation of the markets, which is what a location policy could do, that is a forced fragmentation. Absent intervention, markets do not fragment. If you insert something artificial or some form of fiat that will create that, the expectation is it will cause problems with systemic risk.

Finally, there is a cost implication and it is material. The cost implication of things not in one netting set is quite material. We have done a very deep, detailed analysis, which we would be very happy to provide to the Committee. We estimate in the EU alone, for EU entities, the cost implication is to the tune of $25 billion—a single basis point—if there is a change in price. That is a material change in execution price and cost to the real economy.

Simon Puleston Jones: In terms of fragmentation, the more pots, to use your expression, there are clearing a single product, you lose those netting benefits. That increases the cost for users, because they have to hold more capital.

One thing that does concern some of the EU 27 countries is the way that something called the leverage ratio works. Under the capital rules in Europe it essentially creates a constraint for those clearing members which provide access to clearing from a balance sheet perspective. It gives them a finite ability, using their balance sheet, to clear business for clients. If you fragment your portfolios across multiple clearing houses, then you lose the netting benefits. From a leverage ratio perspective, that means to clear the same portfolio you are using a lot more of your balance sheet. The more you fragment, the more rapidly you run out of capacity to clear, which is important.

Q53 **Lord Bruce of Bennachie:** We have had a number of witnesses talking about equivalence. The first thing they will say is it is patchy across the sector. Secondly, they will say that it can be unilaterally terminated by the EU. How would the equivalence apply to CCPs, and how does that fit with obvious concerns across the rest of the industry? In other words, are the CCPs in a different place?

Simon Puleston Jones: In terms of equivalence today, it is important for UK clearing houses once they are outside the European Union. In order for continental Europeans to be able to continue to meet their mandatory clearing obligations under European laws, they can do it only on third-country clearing houses that have been recognised for that purpose. The regime around equivalence is under review in Europe. In answer to an earlier question of what more needs to be done, or is still to be done, the whole process of looking at cross-border issues is under review.

As you are likely aware, there is now a proposed process of tiering CCPs depending on how systemically important they are to the European Union. That would then drive the options that are available for that particular product or service. Will they enhance the co-operation arrangements that are in place between European regulatory authorities and the UK regulatory authorities? That is certainly the preferred outcome. Alternatively, in extremis, will they deny that regulatory approval to UK market infrastructure? That would mean the industry then has to go and find another way of enabling people to comply with their European regulatory requirements.

Lord Bruce of Bennachie: Is that not the nub of the problem? Mr Maguire, you said location solves nobody's problems, but relocation is already happening. Some of our European partners are very keen to take a piece of the action away. Does equivalence do the deal, or do you need to have a free trade agreement? How realistic is an agreement? What you are looking for is as close as possible to the status quo that is not the status quo. They are basically saying, "We are not going to reward you for leaving. We are not even going to leave you as well off for leaving".

Simon Puleston Jones: Equivalence is the internationally recognised way of enabling cross-border markets to operate. It is what Europe does for all other countries around the world. It is what the US does to enable access to its markets. It is the traditional framework.

One could, in theory, provide more certainty and durability in a free trade agreement, but financial services do not traditionally sit within free trade agreements. It does not mean they cannot. What you would be requesting is a specific framework that is not operated by Europe for the rest of the world.

Daniel Maguire: Just to bring this CCP point into focus, your Lordship, there are two tools. One is equivalence, which is done at the jurisdictional level. That would make a third country equivalent. I believe Europe has designated 32 jurisdictions as equivalent, from Japan to South Africa to Dubai, et cetera. That is the status quo today. They do have that third-country equivalence regime.

By the UK exiting, we are no longer fully bound by EMIR. Looking at the status quo in the international community, there is equivalence, but there is also a model referred to as direct registration. Direct registration is more at an operating entity level, rather than a jurisdictional level. These two things interplay. In the US you can have either/or.

I have been personally involved in pretty much every one of these elements. LCH as an organisation has been directly registered in every jurisdiction in which we operate. Today we are directly registered in Canada, Australia, Japan, the States under the CFTC, and many other jurisdictions. What that gives you as an organisation and, more importantly, your clients—the customers around the world—is the certainty that you as an entity can operate in those jurisdictions, regardless of the equivalence point.

Lord Bruce of Bennachie: Is the EU one jurisdiction at the moment?

Daniel Maguire: Technically today we are, as a nation, part of the EU, so we are subject to EMIR. Post the exit, from our perspective it will be seen as one jurisdiction.

Lord Bruce of Bennachie: As a final point, you talk about your EU clients, so how will you service your EU clients once we are outside and do not have the agreements we want? Also, there are those clients from outside the EU who have previously used London-based or UK-based companies to transact their business within the EU. How much of the business is that, and how much of a risk is it if we do not get a comprehensive agreement?

Simon Puleston Jones: I will start with how you service European clients post Brexit from London, and then Dan can talk a little about the extent to which European users are given a share of your markets.

In terms of servicing, if I am a bank in London and I want to service my European clients for clearing post Brexit, how do I do that? The European regulation, MiFID II, sets out a variety of investment services and investment activities that you have to be authorised to conduct. If you are within continental Europe, you can do that if you are an investment firm or a credit institution. If you are outside, you are currently predominantly relying on the third-country mechanisms.

The first question is: who is your client? Is your client a wholesale client, or is it a retail client? If it is a wholesale client, that is governed by Article 46 of MiFIR, which looks at whether the UK is recognised as an equivalent jurisdiction. If it is, then great. Subject to co-operation agreements being in place, you can continue to service your European clients from London.

Even if it is not, or if a decision has not yet been made on equivalence, it then comes to a choice, member state by member state, as to whether they will continue to allow firms based in London to service continental European clients. In the last couple of weeks, we have seen Germany say that it would, in principle, be keen to ensure that that is still a possibility. The reason why that is less attractive than successfully getting equivalence is you potentially end up with a patchwork quilt of some countries saying it is okay and others saying it is not.

For retail clients, the national regulators in each of the individual 27 member states can require the firm in London to set up a branch in that member state. From that branch it can service only the clients that are in that country. It cannot service German clients from the French branch, for example. The other way is something called reverse inquiry, where the continental European clients approach the entities in London. There are some concerns about the extent to which one can fully rely on that day in, day out as a way of doing business.

The way to mitigate the risks of there being no deal on equivalence is to ensure that you have the right regulatory approvals in one or more

European subsidiary at the point of exit. That ensures you are able to rely on continental European authorisations as an investment firm or a credit institution.

Lord Bruce of Bennachie: That sounds costly, bureaucratic and fragmented.

Simon Puleston Jones: It is certainly costly, because you have to increase the capital base of your subsidiary and set one up if you do not have one already. You have to increase your office space. You have your staff costs. You have the costs of repapering all your client relationships, putting in place liquidity and funding arrangements for that new EU subsidiary if it is not there already, and so on. The key objective, however, is to ensure there is no disruption in firms' ability to service their clients. We talked earlier about contingency planning. Part of that contingency planning does mean making sure that you have the right resources in continental Europe. Then even if there is no deal on equivalence, you are still able to service those clients.

I would be very happy to follow up in writing to the Committee. We are currently putting together a document that answers many of the questions that you are posing. The three key things are what is the impact of no deal on cleared derivatives, what is the contingency planning that firms are currently carrying out, and what would firms be doing during a transitional period, so why they actually need one.

Daniel Maguire: On the topic of quantum, very specifically, if you take the volume of business, we are the major provider in interest rate derivatives clearing, so it is a good bellwether. We calculate 14% of the volume we clear on an annualised basis is originated by EU-based entities. That is not just euro; that is in all currencies. That does not sound a tremendous amount, notwithstanding the underlying $666 trillion of notional.

The point is that, if you break that out, first you have that fragmentation. You will have a large pool and a small pool—an international and a sort of onshore pool, potentially. This is not a zero-sum game. Fragmentation will impact everybody, but it creates precedents. Crucially, for the UK and the centricity of London as a global player on the financial markets, if we start to see business peeling away, this sets a precedent. There are other currencies or other entities that could start to consider something similar. That is the bigger point for us around this.

Q54 **Baroness Neville-Rolfe:** You are helping us cast light on what is a very niche, complex and important area. We are very interested in your thoughts on transition as soon as practicable. I am keen on looking at the practicalities of what might be agreed—assuming we are going to get a deal—particularly the continuity of contracts. How is the futures industry impacted by the potential for a contractual cliff edge if grandfathering is not agreed? Grandfathering seems a useful contractual device. Are the issues of contractual continuity distinctive for the futures industry and for clearing houses, or is there a parallel, for example, with insurance?

Simon Puleston Jones: Broadly speaking, the issues for the clearing of swaps and the clearing of futures are going to be the same from a contractual perspective, notwithstanding that there is a variety of industry standard documents that one can use for that purpose. For the clearing of swaps, one can either use ISDA documentation or we also publish our own documentation. We have published documentation jointly with ISDA. On the futures side, ISDA does not provide documentation but FIA does in Europe. The issues are going to be broadly the same because the types of events that give rise to termination are similar.

ISDA has done some excellent work looking at this very issue from the point of view of its documentation. It highlights uncertainty in its analysis. It does a good job of looking at what different events might be triggered, whether it be force majeure or something like illegality, if it becomes illegal for people to continue to perform services.

While I am aware that ISDA and the Bank of England are discussing how to address some of these issues, it is worth bearing in mind that just because an event gives the entitlement to a party to terminate a relationship, that does not mean that it will then proceed to terminate. It would typically not be in someone's interests to terminate unless absolutely necessary—because, for example, it is categorically illegal to continue what they are doing under their contract. By terminating, they risk also terminating the hedges that they have put on to risk-manage their positions. If they are not able to pull those out to a back-up clearing broker, in compliance with the applicable regulation, they would have no opportunity other than to terminate.

To answer your specific question about futures, we are currently looking at that, but we do not have a definitive and finished analysis of that at this stage. When we do, we can follow up with the Committee.

Baroness Neville-Rolfe: What kinds of mechanisms would be involved? We got the impression that there might need to be some EU or UK rules and regulations on this. I think the work with the Bank of England is looking at that. Often existing contracts have these major adverse event clauses and things in them. Can you help us—you have tried already—to clarify the two or three key areas that are important?

Simon Puleston Jones: We are looking at things like whether it is illegal to continue with the contract or, if it is not illegal, it is still impossible to effectively perform the bargain that you originally struck—a force majeure event. The analysis done so far says it is theoretically possible that, in particular, illegality might be triggered. However, it is not sufficiently clear at the moment, because we do not know what the laws will be at the end of the negotiation to determine whether illegality is something that might give rise to termination.

A lot of this ultimately is going to be driven by regulation and the ultimate political outcome, rather than the terms of the contract. As one thinks about the positions that are currently cleared by Europeans on a clearing house in London, if those Europeans were to be prohibited post exit day from continuing to clear those positions in London, what happens to those existing positions? Are they stuck there? There is a mechanical compression that LCH uses to reduce the operational risk at clearing houses. That process involves entry into a new contract to replace the ones that you have compressed. Will that be prohibited as a matter of European law?

Baroness Neville-Rolfe: That is why grandfathering helps.

Simon Puleston Jones: That is why grandfathering helps, so that we can continue making use of the risk management tools that are provided by the industry while we try to reach a conclusion on the final destination of European and UK regulation.

Baroness Neville-Rolfe: Would grandfathering last for a long time, so not just to the end of the transition period but, in principle, until the contract ran out? Is that how you view this working?

Simon Puleston Jones: We tend to talk about grandfathering not in a contractual sense but in a regulatory sense. We tend to talk about it as very finite and time-bound, so as to provide that period where we have a framework that keeps markets open. It avoids fragmentation. It minimises disruption while the industry is given time to move towards implementing the new regime, once it comes into place at the end of that transition period. From a regulatory perspective, the grandfathering would end at the end of the transition period. The extent to which grandfathering is needed beyond that for contractual reasons is something that still requires further analysis at this stage.

Baroness Neville-Rolfe: That is where you might want to talk to the insurance industry, because they have quite a big issue with that.

Simon Puleston Jones: It is an important point you raise. The insurance industry is a different industry. It is subject to entirely different documentation and entirely different issues. The cleared derivatives industry is esoteric and not readily comparable with other industries, and certainly not with a one-size-fits-all solution.

Q55 **Lord Butler of Brockwell:** May I ask you about the regulation of the derivatives industry? How global is the regulation of the derivatives industry now, and what part does the UK play in it? Will the UK be able to continue to play a part following Brexit?

Daniel Maguire: The derivatives industry as a whole has a lot of global co-ordination from a regulatory and supervisory standpoint. Coming back again to the G20, 2009 and beyond that, with the Financial Stability Board, there have been standards for cross-border regulation that have evolved out of there through Dodd-Frank, through EMIR and through other jurisdictions. There is cross-border recognition and a clear acknowledgement that, for internationally integrated markets such as the derivatives market, specifically the interest rates market, there is a need for global co-ordination and global, to an extent, deference between different jurisdictions, depending on the location of the CCP.

As a starting point, I would say that it is a global market that has a high degree of globally co-ordinated regulation and supervision. What is the UK's role within that? The UK—and London specifically—is seen as one of the premier locations for derivatives clearing and derivatives expertise, notwithstanding other jurisdictions, of course. The UK has played a very influential role through the FSB and through IOSCO. I will not give lots of acronyms, but in a lot of the international regulatory co-ordination and regulatory bodies, the UK is absolutely at the table.

Regardless of where we end within this process, it is absolutely essential that the UK stays at that table and is shaping and influencing that regulation for this market. Notwithstanding a degree of fragmentation, the UK and London will still be very relevant to those derivatives markets, and overseeing them, clearing them and underpinning them. That needs to continue. It is imperative that the authorities of the UK sit at those tables and shape and influence the global regulation for these markets.

Simon Puleston Jones: I would just add a few things on that. Absolutely, the market is typically global. We have talked a lot about concentration and the benefits of having everything in one place. When we talk about it being global, to some extent there are individual contracts that you could clear in the US or Europe or the UK post Brexit, potentially. There is competition on a global scale. There are also some contracts where the only place you can go and do something is in one potential venue. There it is global in the sense that that one venue needs access to all the players around the globe who wish to be able to trade and clear on those markets.

When it comes to the international standard-setters, the Governor of the Bank of England is the current chairman of the Financial Stability Board. Because the industry is global, the people at CPMI-IOSCO have agreed global standards that are used as the framework for the regimes in the US, Europe and elsewhere. That has largely, although not line by line, been followed by both the US and continental Europe.

We have other bodies. Europe has something called the financial services dialogue. It meets annually with its peers in the US and Asia to compare notes on how they are dealing with regulatory change and challenges that they see in their markets. One can envisage a forum such as that between the EU 27 and the UK post Brexit to ensure continued dialogue between the UK and European regulatory authorities.

What part can the UK play? The UK will have its own seat at the table, rather than as part of the EU, post Brexit, at those important global standard-setters. It will have a more singular voice, if you like, at that table. When it comes to European regulation, the Financial Conduct Authority has been a strong driver of a lot of initiatives. The UK really prides itself on the strength of its regulation and so will often go beyond what was agreed with the other 27 member states to further enhance the regulatory regime here in the UK.

Lord Butler of Brockwell: Are you reassuring us that there is no real risk of the UK slipping away from the table because the regulation is conducted at G20 and IOSCO level? I saw a report that Mr Giancarlo had said that the US had to make concessions in order to agree with the EU, and he was not much in the mood to make further concessions. Is there a risk that the UK will become in some way separated from this regulatory machinery?

Daniel Maguire: Ensuring that the UK remains the centre for global clearing of derivatives assures our place at the table. That is the link between the two. If we start to see a fragmentation from the UK, that, by definition, will make us a little less relevant. I think it was the US Treasury's capital markets report that gave some clarity from the US standpoint about the CFTC, which is headed by Chairman Giancarlo, whom you referred to, and the SEC—the Securities and Exchange Commission—rules. The guidance is to ensure that the US rules are compatible with non-US jurisdictions as well. That is an acknowledgement of the need for harmony around the cross-border rules and jurisdictions. I do not necessarily see that we would become far away from this, but it really is about being internationally relevant. Clearing makes the UK internationally relevant in that regard.

We would encourage the European Commission to adopt that similar proportionate approach, because that is very much aligned with those international standards of the peers and practices. We are seeing right now the potential for the European Commission to go beyond and away from the internationally agreed standards and practices, so we are very much encouraging it to adopt something similar to that.

If we remain very much the premier clearing destination, that de facto makes us one of the premier regulatory supervisors in shaping the regulation internationally around that. We have excellent co-operation with the US—with the CFTC, the SEC and other supervisory authorities in the US.

Simon Puleston Jones: There are perhaps two aspects to your question. One is a seat at the table of the global standard-setters, which one envisages the UK will continue to have post Brexit. The other is dealing with the cross-border conflicts of law, which goes to CFTC Chairman Giancarlo's point, when you have two sets of rule-setters. Where those conflicts arise, in order to continue to facilitate cross-border business in a way that minimises fragmentation and avoids siloing of business in Europe and the US, you need to have rules that operate together as part of a global community.

Q56 **Lord Desai:** Are you happy on the US side that we will be properly aligned with the US regulations if we go alone? I take it that US regulations are currently aligned with EU regulations.

Simon Puleston Jones: Yes, they are. There have been equivalence deals on clearing, and a number of clearing houses in the US have been recognised, to use the parlance, in EMIR. Just in the last couple of weeks, there was a joint announcement between Chairman Giancarlo and Vice-

President Dombrovskis at the European Commission of an agreement in principle to recognise the trading venues in the US. We have that recognition in principle on trading and already for clearing.

I am conscious that the question that is often asked is around the change of regulation in the US. There is an initiative called Project KISS—"Keep it simple, stupid"—which has been adopted by the CFTC, and it is not looking at a bonfire of regulation at all, if that is a concern here. What it is looking at is applying the regulation it has in the most appropriate way, rather than tearing it up. It is very clear that there is no appetite on either side of the Atlantic to move away from mutually agreed arrangements on equivalence because, as the vice-president of the European Commission highlighted, if you start doing that, you will start moving towards a higher risk of fragmentation, which is not in anyone's interests.

Lord Desai: Thank you.

The Chairman: Mr Maguire, with your US experience, did you want to come in?

Daniel Maguire: The US regulatory regime, relative to LCH specifically but UK clearing houses generally, is a very good starting point. We established what we call a DCO—derivatives clearing organisation—licence in 2001, so this is not new. Having regulatory oversight of our organisation from overseas is by no means new. We have that level of oversight from many G20 jurisdictions today.

Some say that the European Commission proposal to supervise third-country CCP is mirroring the CFTC approach. It is not. It is an important point to raise with the Committee. There are a couple of examples to give some texture to that. The CFTC supervision is applied to the businesses and the services at LCH that are relevant to the US market and the US economy. We are clearly relevant to the US market in the clearing of interest rate swaps and increasingly in the clearing of foreign exchange. However, on other services, where we clear repos, equities and other such products, the CFTC has what is referred to as a no-action relief or, basically, no oversight of that element of the business, whereas the EC proposal is to have oversight of the entire CCP. That is one important point and we think that is a very good starting point because that has been effective not just in peacetime but through Lehman Brothers and other defaults such as MF Global and things like that.

The second point where it is fundamentally different is that there is no concept within the CFTC regime and supervisory oversight of some form of either location policy or what is sometimes known as "denial of recognition". It does not have powers that enforce the repatriation of certain businesses into the States. That is a good starting point of an example of global regulation between G20 nations working very well. It is not unique to the US but it is often held up as a bellwether for this. It is important that the starting point for the European Commission is similar to that, because that has been proven to work and there is precedent.

Q57 **Baroness Liddell of Coatdyke:** I want to talk a little about the future role of the EU regulators post Brexit. You have answered some of the points in relation to Lord Butler's and Lord Desai's questions. Given the EMIR review, what sorts of extra powers do you think will be granted to ESMA and the ECB arising from that? What impact would it have on the UK as a third country? What signals from that do you see for the role of how EU regulation will be conducted in a world without the UK as part of the EU?

Simon Puleston Jones: In terms of the role of ESMA, what we are seeing through the EMIR Review is a greater centralisation of powers in ESMA when it comes to the supervision of European clearing houses. To the question, "From outside Europe, to whom do I pick up the phone if I want to speak to Europe?", the answer is ESMA. At least that is the proposal. ESMA would have a greater ability to access information related to third-country clearing houses, as well as the right to visit locally on the ground to check compliance. It has been suggested that ESMA might have the ability to exercise a degree of control over the ability of non-EU clearing houses with respect to their margining methodology, including how they value certain collateral that is provided to the clearing house, known as "haircuts". It would look to have a greater degree of control over third country CCPs than it does today.

There is also an acknowledgement in Europe that, when they do the equivalence assessments, they typically do it once and then that is it. However, as you are all very aware, it is a moving feast throughout the globe, and so they are proposing to have an annual assessment of equivalence to see what, if anything, has changed and whether that needs in turn to be reflected in the way that Europe is treating those third-country market infrastructures.

Europe has valid and legitimate concerns around the euro and what happens to euro clearing in a crisis if it is all done offshore from its perspective. We can see a world where the most proportionate outcome in order to manage those concerns is to have an enhanced co-operation arrangement between the European and UK regulatory authorities. There is already a model for that between the CFTC in the US and the Bank of England here. Some of the Europeans that I speak to say that it is not sufficiently robust for their purposes, but it certainly shows how it can and does work in the case of critical markets such as dollar clearing. Even though trades may be executed in the US, the vast majority of them are currently cleared here in London through LCH. There are frameworks at work.

The direction of travel that we are strongly encouraging is enhanced co-operation because the alternative—the most simplistic approach—is to say, "Relocate it to Europe so that we have more control over it". However, we feel that that relocation would have a disproportionately negative impact on the industry and on the users of the markets—including your and my pension funds—day in, day out, for a scenario that they are ultimately trying to mitigate, which is when things go wrong.

You can deal with a lot of that by entering into ex ante arrangements so that you agree at the outset, if a UK clearing house or a US clearing house were to default, what those clearing houses would do. What would the supervisory authorities do? Who would be in control of making what decisions? Who has the final say? To what extent might Europe and European authorities, including the central banks, be involved in the decision-making process, whether that be in the default of the CCP or, absent the default of a CCP, another euro crisis, as we had at the beginning of this decade?

Baroness Liddell of Coatdyke: Is the direction of travel taking you to enhanced co-operation?

Simon Puleston Jones: The vast majority of people to whom we speak in continental Europe would like to see an arrangement that keeps markets open without artificially creating fragmentation. There is a strong appetite to avoid disproportionate outcomes on the industry in order to mitigate the concerns.

Q58 **The Earl of Lindsay:** I have a question on the EMIR proposal on CCP location and supervision. If it goes ahead, what will be the impact on both UK and EU CCPs? If you look at that impact in a more granular way, are there some aspects that are broadly welcomed, are there some that you might be neutral about or that the sector might be neutral about, and are there some that you feel ought to be challenged?

Daniel Maguire: I am responsible for clearing houses in the UK and in the EU, so I will talk about the EU first in regard to your question. First, we as an organisation fully agree that it is essential to maintain the right level of oversight in what we refer to as NCAs—national competent authorities—within the European Union. There are local CCPs, of which we have one in LCH and two within the broader group. There are different models and diversity of oversight. It is important to recognise that but, on the flipside, we fully recognise as well the European Commission’s desire to bring more centralisation—going back to Simon’s earlier point—and convergence and consistency in approach. Clearly, as per the proposal, ESMA is well placed to do that.

In terms of areas to think about and focus on, however, as a highly regulated critical market infrastructure, we want regulators to have highly skilled and highly technical people overseeing us. It may sound unusual but we want to ensure that all the jurisdictions we are regulated by and all the authorities or supervisory bodies overseeing this have the right skill set, competencies and so on. We would encourage ESMA, if it is chosen, to continue on the path to grow and develop the organisation.

The Earl of Lindsay: Are you optimistic that it is on that path?

Daniel Maguire: Yes. What could this therefore mean for a third country—the UK? It is worth putting this in some context. Today, we are 100% compliant as an organisation with the EU regulation—EMIR, as it is often referred to—and, in order to continue to be relevant as an organisation from a business standpoint with all the EU entities, our expectation would be to continue to be compliant with that, because that is what clients and customers expect. Yes, it is about legislation and, yes, it is about regulation, but it is also about standards and risk management. I would not go as far as Simon in talking about bonfires, but there is no expectation of a reduction in standards. We need to keep the watermark very high on clearing house standards. It is non-negotiable.

What would it entail? The CFTC—and one would expect ESMA in this instance—would have the same potential rights that it does today, and it is very active in its oversight of the clearing house. There are different elements, to give some colour. If we want to change a risk management model, which is core to what we do, we have to go through a process of internal committees, external committees and then through our regulators, including the US, the European and the UK regulators, among others. If we want to add a new product that is bringing new risk into the clearing house, it is the same. One would expect that to continue, because that is the rigour that is exercised over the clearing house.

Where things may change is that the CFTC today comes in actively and run what we call exams—what you might call audits—where it comes in regularly and examines what we do and how we do it. One would expect that from ESMA. If we take a step back as a global clearing house, that is really systemic to the markets, and as a taxpayer, one would expect to allow the authorities to come in and do that third-party or second check on everything you are doing, and we would welcome that. We do not see that as an inconvenience; we see that as absolutely necessary regardless, because that is about good hygiene for clearing houses.

The Earl of Lindsay: What about the locational point?

Daniel Maguire: There is one element that we dislike, which is around the location point. We have touched on it but I will elaborate. It is important to recognise and welcome that the European Commission proposal is preferring or prioritising enhanced supervision. Vice-President Dombrovskis referred to a location policy being the last resort, but it is still a potential outcome. What does the eventuality of a location policy mean in a hard, no-transition element? It means that LCH in its current form cannot provide the services to its clients on its existing historic portfolio on a go-forward basis, which has material impact, and it means that we have to consider whether we relocate some, if not all, of our business.

When you start to consider that location, the answer is not necessarily relocation to Europe; the answer may be relocation going the other way—to the States. This is an internationally integrated market and, if things did need to move, it is not a fait accompli that business would move to Europe. The whole concept of a clearing house in multi-currency derivatives comes back to the points we were discussing earlier around having everything as much as possible in one place. The idea of splitting pieces up is not in the interest of many.

You then have to contemplate the movement of the entire business. New York, or the US more broadly, is clearly a potential destination for that as well, given that 14% of the business is generated by EU entities and a much greater proportion is generated by US entities. We have to start from a commercial standpoint, risk-wise, thinking about where you put that business. We do not think location is a desirable element of the Commission's proposal.

Simon Puleston Jones: As you know, the EMIR review is split into two separate sections. The first part looks at where EMIR has not fully achieved the objectives that it was hoping for; for example, around reporting. It proposed single-sided reporting and that the market infrastructure does the reporting, rather than today's world where all parts of the ecosystem, whether they be client, the clearing member or the clearing house, have to engage in reporting. It proposed a simplification of the regime there.

It is also concerned with asset protection. It is looking at requirements for bankruptcy remoteness of collateral to make sure that, in the event of a clearing house or clearing broker becoming insolvent, the client's collateral is ring-fenced so that it does not form part of the insolvency estates of those entities. We have highlighted to the European Commission our concerns around whether its proposals as currently cast are completely legally enforceable or whether more work needs to be done.

The final issue it identified in part 1 was around access to clearing. The solution it proposed for that was to require clearing brokers to provide their services on the basis of so-called FRAND principles, which means fair, reasonable and non-discriminatory terms. There, we have been very clear that this cannot mean that it is an equal service to absolutely every client—that there are already requirements to provide clearing services on fair and commercially reasonable terms.

Then, on part 2, there are a few things where we have responded to the European Commission to say that we think a few more changes are required, and they are being discussed. On forced relocation, we have agreed with LCH and the wider industry that the preference is for enhanced co-operation arrangements instead between the UK and European authorities. When it comes to ESMA and ESMA's supervision and oversight role, again, we potentially welcome that but we would like a bit more clarity. We would like more transparency on the process. Also, importantly, when it does its analysis of how systemically important a given clearing house is, we believe that should be considered at a product level, not in terms of the entire legal entity. We are starting to see some movement in the discussions at the European Parliament on that point.

The Earl of Lindsay: Who is driving the locational element? You said earlier that forcible relocation increases fragmentation, which increases systemic risk, and that absolutely flouts the commitment that the G20 has been driving. Can you just explain where the energy and drive are coming from for the locational objectives which could trigger this fragmentation?

Simon Puleston Jones: All member states in the European Union are trying to work through how we preserve financial stability and how we manage our concerns about a majority of the business denominated in euros continuing to be conducted offshore, outside our immediate regulatory remit. There are different schools of thought within the EU 27 as to the extent to which the ECB should have a role and the extent to which forced relocation, rather than enhanced co-operation, is desirable. One has to look only at the feedback to the European Council to determine which country is in which camp. The French are perfectly open. The President of France, the day after the referendum, was very clear, publicly, that he would like to see more business conducted in continental Europe, as was, at the time, the President of the European Commission.

The primary drivers have come from France, and that is not a secret. It is a matter of public record. There is some support from some of the other continental European member states for this.

The Chairman: Where does Germany sit on this?

Simon Puleston Jones: Germany has a mixed view but the majority view seems to be that it would prefer to reach an outcome that does not fragment markets. The reality is that there is a balance to be struck. There are obviously the regulatory objectives of making sure the EU has enough oversight over markets, but then it also has to build a new world that works for the EU 27 post Brexit, and that is best described by its capital markets union project—building a capital markets union in Europe that works for the EU 27.

The Chairman: Do you have a little more time? We still have more to cover.

Daniel Maguire: Absolutely.

Q59 **Lord Woolmer of Leeds:** Taking an overview, without too much detail, when representatives of Clifford Chance came before us, they followed this up with some written comments. They told us that the EU proposals, if implemented, would not significantly affect the euro clearing that takes place in London but would exclude global clearing houses from the EU. The primary negative impact of the measure, therefore, would be on EU banks. That is a benign appraisal. What is your assessment of that assessment? Do you agree with it?

Daniel Maguire: At a headline level, if you accept the case around market fragmentation and the development of a smaller market within the EU, and an international market, the most materially impacted will be those in the smaller market of the EU. We agree that, from a direct impact point of view, it will be felt more within the EU fraternity, rather than the broader international fraternity.

That is at first pass but then, once you get into the detail of globally integrated markets, this is not a zero-sum game. This is a situation where, if you split liquidity out, both sides will lose, and it is more of an argument about who will lose the most. Referring to a point that I mentioned earlier, the concern beyond this is that, if this precipitates some form of broader reciprocation—perhaps retaliation—where this is about not just euros or the EU but other jurisdictions starting to think similarly, the impact is much broader and more meaningful. It is critical that, while we may just focus on this element of the EU part of the market—which is a very important part of the market, I should add, with pension funds, real money and everybody in that—what we should really be considering is, if this happens, what it then leads to next. As I mentioned at the outset, I do not wish to overstate the importance of clearing but it is a fundamental building block of the City of London and of the UK financial services market. If we start to see pieces pulled away—I do not wish to scaremonger—it is hard to determine where that ends. It is about keeping that unity together and providing that enhanced supervision.

Fundamentally, the remarks at a headline level are that, in the first instance, the impact could be short term there. However, thinking about the longer-term impact, it could be broader than perhaps Clifford Chance outlined.

Simon Puleston Jones: You need to look at it at various levels. When we say, "If the EU proposals are implemented, then the consequences are x", one has to look at which bits of the proposals are being implemented. If the EU follows the enhanced oversight model, that would appear to have limited impact on the status quo. If it follows a forced relocation model, who does that impact? It impacts continental Europeans and it limits their choice as to where they can geographically choose to clear their business in order to comply with their requirements.

That is the regulatory answer. There are also market-led initiatives in continental Europe. I should mention that a German clearing house has recently announced a plan to promote an increased amount of euro clearing happening at its clearing house using market forces, giving the industry time to achieve those types of outcomes using tools and processes that it can design to achieve a smooth movement of derivatives, if there are to be any movements, or indeed just providing more choice and more competition in that field. There are market-led solutions, potentially, without one needing to resort to regulatory or politically driven solutions.

Lord Woolmer of Leeds: Is it possible, if the Europeans take a hard line on euro clearing, that the Americans might start to take that view in the longer term in relation to dollar clearing? In the much longer term, how do the Chinese view euro and dollar clearing in London?

Daniel Maguire: There is a distinction between currency and country here. While a lot of this is about euro-location policy, underneath it the question is: is it euro or is it EU entities? It is hard to have jurisdictional oversight of a notional product that does not have any physical, tangible settlement, such as a swap. Chairman Giancarlo and others within the US

Administration have made it very clear in their messaging—it is not for me to talk for him—that they absolutely favour co-operation and they favour proportionality.

There is an outside risk that broader fragmentation could be precipitated by this, but certainly the signs are that, from a G20 standpoint, from an international community standpoint and from a buy-side/sell-side standpoint, there is a strong desire to keep things together. Ultimately, we cannot rule that out. I would hope that is not the case. Many of the rules such as Dodd-Frank are very specifically about US persons rather than US dollars. But the vast majority of US dollar interest rate derivatives are cleared within the UK, and there is sufficient proportionality and co-operation between UK and US regulators. I would not see that as a likely outcome, but we are risk managers—there is always a risk.

Simon Puleston Jones: The US has been very clear in the messaging from Chairman Giancarlo at the CFTC. It took four years to agree their equivalence deal with the EU and it does not consider that any change in relationship between the UK and Europe should impact that deal that took four years to get to. It is a very strong advocate, as is the Bank of England, of an outcomes-based approach when it comes to regulation, rather than a line-by-line review of whether European rules are identical to US ones. As I mentioned earlier, the CFTC already has an arrangement with the Bank of England that gives it comfort that over 90% of dollars globally being cleared here in London is okay for it because of the nature of the enhanced co-operation arrangements that it has in place.

The message there is, first, that there is something that works for the US and, secondly, "Let us lend you, the European Union, the benefit of our experience in reaching these deals with the UK so that we can get to an outcome that is proportionate and best meets a global marketplace".

Q60 **Lord Fraser of Corriegarth:** Are you not being a bit Panglossian about this—it is all going to be the best for the best in all possible worlds? You probably saw Mr Blankfein of Goldman Sachs saying how he was very happy to be in Frankfurt, and it will definitely move some of its people. I was talking to Goldman Sachs yesterday and the figure that was mentioned to me was that 600 of its 6,000 employees in London would go to Frankfurt. Surely there is a lot of political will for the Europeans to benefit from our Brexit. For all the stuff about not wanting fragmentation and so on, there is a big political will from the French and the Germans to have a bit of the cake for themselves at whatever cost.

The Chairman: Does that affect your sector as much as investment banking?

Simon Puleston Jones: Absolutely. I talked earlier about the contingency plans that banks are having to make to ensure that there is no disruption to their ability to service their clients, and how an important part of that is to establish subsidiaries in continental Europe or to beef up their existing presence in order to ensure they have all the regulatory approvals that they need. Those 600 people certainly will not all relate to clearing—far from it—but they will relate to making sure that Goldman Sachs, in your illustration, is able to service its European client base without disruption in reliance on European rules such as MiFID II. That should be seen as part of its contingency planning—based, as requested by the Prudential Regulation Authority, on worst-case scenario planning.

Daniel Maguire: As risk managers, we seldom have a rose-tinted lens on the world. We are realists about this, and this perhaps just builds on a point that was raised by the Earl of Lindsay around the origins of this and who is pushing this, and coming to the point about Germany and France. Yes, there is an acknowledgement as an organisation that things have changed or are changing, so there is no denial about that. There is an acceptance, clearly, that Brexit has happened and we are in implementation, not that it may not happen.

However, the devil in our world is always in the detail, as in everybody's world. What are the things driving this? There are some products in clearing that are commercial tools. You mentioned dollars. Around the world, they are used for hedging purposes and for commercial purposes. There are some products that are cleared—such as repos—that are basically financial instruments based on sovereign debt markets. Sovereign debt markets are often used as a vehicle or a tool for monetary policy transmission. When you start to go through the product set and the asset classes cleared at a clearing house, not every product should be conceived or seen as the same from a systemic risk standpoint.

When you look at the legislation, in terms of the portfolio within our organisation and other clearing houses, there are lots of phrases such as the "central bank of issue of sovereign debt" within the European Commission proposals. We are very cognisant that things have changed, and we see that it is not in the interests of many for internationally integrated swaps to be fragmented.

One can consider debt markets and repo markets of the eurozone being cleared in London perhaps having a different systemic risk profile, especially at a time of crisis in the eurozone. As we start to go through the portfolio, you can see different solutions or different options around that. We are by no means in denial but, on some things, we come from a financial stability and soundness standpoint that things are better kept together; on others, there are perhaps some things to consider around London not being the optimum place.

Q61 **Lord De Mauley:** For the avoidance of doubt, I should declare an interest as a holder of listed securities. Evidence we have taken has suggested that much British commentary views the CCP location issue as little more than a power play to grab tax revenues and jobs, and that the argument should really be about risks, albeit remote, that might crystallise in the heat of a huge crisis. Can you contemplate what such a crisis would involve? Is the EMIR location proposal a proportionate response to these risks? What else should be done in advance to insure against such a crisis, and to what extent is it already being done by regulators?

Simon Puleston Jones: What would a crisis involve? There are typically a couple of scenarios. One is the default of two, three or four clearing members, more or less at the same time, which overstrains the available resources that the clearing house already has, which then moves the clearing house into its recovery and resolution procedures.

Another scenario with a similar set-up is in the event of a so-called non-default loss, such as in the case of a cyberattack on the clearing house, where there would need to be an entirely separate process of managing that crisis and a separate process for allocating who covers the cost of dealing with that.

The third scenario I alluded to earlier is a eurozone crisis, as we had earlier in the decade: no one has gone into default—there is no problem with the clearing house per se—but there is a problem with one or more currencies that need management.

Those are the sorts of scenarios. What steps are being taken to address those? In the context that we are talking about today, I have already mentioned that we are in favour of having ex ante agreements to deal with things like a euro crisis and how UK regulatory authorities might co-operate and co-ordinate with their European counterparts. Then, when it comes to either a default of clearing members at a clearing house or non-default, that is an active file that is being addressed by the European Commission and going through the European Parliament at the moment as part of its draft regulation to deal with clearing house recovery and resolution. It is on the right track. There are aspects of it that we do not necessarily fully agree with and there are differences of opinion between various parts of the market as to who should be bearing the losses. There are differences of opinion between end users, those who provide access to clearing houses and the clearing houses themselves. It is a very active discussion and it is an important part of finalising those G20 commitments, going back to your earlier question, about what more remains to be done. This is perhaps the last piece of the jigsaw before we start reviewing things.

Daniel Maguire: As a practitioner in the clearing space, there is a dearth of context around this particular point about this scenario that you referred to, your Lordship. It is worth giving a very brief amount of context. Post 2008, there has been a raft of new regulation, new oversight and new capital rules. We are in a much safer place than we perhaps were in 2008. What we are contemplating here is that, if you are not systemic, you are not a successful clearing house. It is an irony that you have to have the business to be systemic. By being systemic, you are systemic in normal times and you are systemic in default, but we are really talking about that default scenario.

What gets you to the point where the clearing house is the systemic node in the marketplace? All the post-crisis regulations, capital rules and supervisory oversight perhaps have not done their job at this point. All the financial backing has not done its job, and we now have a default of one, two, three or perhaps four counterparties in jurisdictions, and these institutions have gone through some form of resolution. That is the world that we are now operating in. Then we say "default". Then we start to do our job of cleaning the defaulters' portfolios and trading and so on. You have to consider that context of where we are, and there have been many things along the way where there have been opportunities to prevent this situation through resolution or things have failed.

Once we get to that point, there are two distinct elements: one is the participants who have had the default; and the other is the product. If you look at the risk management package that we have as a highly regulated organisation, we can withstand, and prove on a real-time basis that we can withstand, the double default of the two biggest counterparties on the planet at any given time. We have contingencies in financial packages. The proof is in the pudding. LCH, as an entity, has handled 10 defaults, including Drexel Burnham Lambert, Barings, Refco, Lehman Brothers and MF Global more recently, and at no point as a clearing house have we ever had to go beyond the resources of the defaulting counterparty.

It is not to say that we should not have the level of scrutiny, but it is very important to put the context around this borderline fait accompli that CCPs will fail. There is a lot—going back to Simon's point—about ex ante rules and legislation and co-operation that should be in place so that we do not get that. It is always a risk—I do not wish to say that it will never happen—but we need to look at the set of events that have got us to that point as well.

Lord De Mauley: In terms of the active file you refer to, how likely is it that the timing of that coming to a resolution will be in tandem with the March 2019 schedule?

The Chairman: This is the EP scrutiny.

Simon Puleston Jones: That is right. It is going through scrutiny at the moment. The short answer is that it is not entirely clear. There are a number of things that are relevant to the Brexit discussion that are happening in continental Europe, not because of Brexit but because Europe is working through how to arrange its regulatory arrangements for the future. In addition to MiFID II that is going live on 3 January next year, we have a review of EMIR, which we have touched on extensively here. One thing we have not mentioned is something called the ESA review, looking at the roles of ESMA and the European Banking Authority as two of the three ESAs, and that is really looking at their role with regard to third countries and their role in supervising European clearing houses. In short, it is proposed that ESMA will get a lot more powers to centrally supervise European clearing houses so that there is a more harmonised approach to regulation across the European Union. Then we have this clearing house recovery and resolution file as well. There are a few moving parts as well as the wider capital markets union project that I mentioned earlier.

Q62 **Baroness Neville-Rolfe:** You have talked a lot about traditional regulation and supervision and, rightly, about dealing with risk and contingency plans. What about innovation? I think of your area as champions of innovation, first on derivatives and now on things such as green finance.

Daniel Maguire: Innovation is in our bloodstream. We have a responsibility to be safe and sound, but we are seeing more requirements and more desire to put more into clearing. People have got the joke that clearing is the way forward. That brings a different set of pressures. On the innovation front, which is clearly a more exciting part of the business, lots of innovation has been brought into the clearing house. An example that you have probably heard Xavier Rolet, chief executive of LSE Group, talk about a lot is compression. Compression is not necessarily a new concept but, on an industrial-scale level, in a clearing house 10 years ago, people would trade and would perhaps match a few days later, clear a few days later and compress a month later. Now people trade and they clear within three to 10 seconds and they compress the same day.

We have therefore seen the life cycle and the window really shorten, and that has made for a much more efficient process. From a systemic risk standpoint, this means that we have talked about very big numbers and "notional", which is the haystack, if you will, with the needle being the risk number. The more that we can compress things and remove the notional out of the system and just look at where the real risk is, the bigger the benefit from a financial stability standpoint because we can risk-manage more clearly. There are lots of new innovations coming into the marketplace, but we have to do innovation in a very safe and controlled way given the systemic importance. There are a lot of regulatory approvals to go through, but the one thing that we, as a clearing house, pride ourselves on is that we have been able to respond and innovate and deliver to our clients and customers lots of new tools and optimisation tools. Compression is probably the poster child of that, but there are many more slightly more technical, geeky things.

Q63 **Lord Haskins:** It says here that there have only been three CCP failures in history—however far back history goes—in France, Kuala Lumpur and Hong Kong. Nevertheless, the Commission has produced its submission for the recovery and resolution of central counterparties. Obviously, Britain has been involved in that. Do you think that the proposal is a good one? Is it a basis for further alignment of future regulation, moving in the opposite direction to the one that we have been talking about recently?

Simon Puleston Jones: It is absolutely a move in the right direction. As I mentioned a moment ago, dealing with the failure of a clearing house—which, as Dan says, is a remote possibility by design—is none the less something that one needs to contemplate and plan for in advance. There are a number of tools that are designed to be available to a clearing house in the event of a failure of one or more of its members. There is a very live debate about which tools to use in which circumstance and who is using those tools. One of them is looking at how one uses margin and collateral. Do you use initial margin that has been provided? We are not in favour of that. Are we in favour of those who are not in default being forcibly given trades that they have not entered into? They may have deliberately chosen not to be in that particular product or that particular market or have that particular direction on their portfolio—so, no, we are not in favour of them being forced to take trades.

We are in favour, at the very end of the default management process, of something called variation margin being used and being available in both recovery and resolution. We are, at FIA, speaking on behalf of the clearing members, rather than the clearing houses, in favour of an increased amount of what is called skin in the game; that is, resources provided by the clearing house itself to cover these losses. We do not believe that, in scenarios where the reason for a default is entirely beyond the control of a clearing member—cyber-risk being an obvious example—that the clearing members should be the ones that have to bear the cost of that, given they were not in control of the risk management of that process.

I know there are some aspects of that where FIA's core membership, being the clearing members, will have a difference of opinion from the CCPs, but that is FIA's position, speaking predominantly on behalf of the clearing members.

Daniel Maguire: If I may just briefly build on that and, respectfully, go up a level here around your key point, recovery and resolution comes back into the context of your Lordship's question about the remote event of a clearing house default. They have happened. Recovery and resolution has come into really sharp focus with the market practitioners, be it within the financial market infrastructure, the clearing members, the dealers, the buy-side and the regulatory fraternity globally. It does give some hope, because what it really has shown is that the fraternity acknowledged, despite the debates that we have been having today and have been had in the continent, that these markets are tremendously interconnected. As CCPs, there are probably a handful of these important nodes around the globe and, when we get to this scenario, having lots of different ways of approaching the same thing, with everybody running in a different direction, would be a bad outcome. Absent any political overlay within it—and, really, it is where technicians and practitioners are getting together—there is a certain comfort that I have that people are naturally co-operating and thinking about global co-ordination as opposed to implementing it in a different direction. There is certainly a degree of hope that I would put into that.

The Chairman: Thank you. Were you done, Chris?

Lord Haskins: Yes.

The Chairman: Thank you. That has been a very fruitful session. We have learned a lot from you and we will reflect carefully on what you have said. Thank you very much for coming. This concludes today's public evidence. The Committee will now meet in private. Thank you.