EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2023 (RESOLUTION OF CENTRAL COUNTERPARTIES: CALCULATION OF MAXIMUM AMOUNTS FOR CASH CALLS AND USE OF SPECIFIED FUNDS) REGULATIONS 2023

2023 No. 1195

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

2.1 This instrument sets the maximum amounts of cash that may be specified in cash call instruments made by the Bank of England (the Bank). The power to make cash call instruments is part of the Bank's powers to stabilise a central counterparty (CCP) in resolution, as provided for by Schedule 11 to the Financial Services and Markets Act 2023 (c. 29) ('Schedule 11'). Cash call instruments require clearing members of a CCP to pay an amount of cash specified in the instrument to the CCP, and so allow the Bank to generate additional loss absorbing capacity and replenish a CCP's resources. By setting caps on the amount of cash that may be specified, this instrument will give clearing members greater certainty regarding the maximum amount they may be required to contribute under the cash call power should a CCP be placed into resolution.

2.2 The instrument also establishes the circumstances in which the Bank can require the CCP to use specified funds held by the CCP to meet obligations imposed upon a clearing member under a cash call instrument, where that clearing member has failed to meet its obligations under a cash call instrument.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The extent of this instrument is England and Wales, Scotland and Northern Ireland.

4.2 The territorial application of this instrument is UK-wide.

5. European Convention on Human Rights

5.1 As the instrument is subject to the negative procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 The existing resolution regime for central counterparties (CCPs) was introduced in 2014, under Part 1 of the Banking Act 2009 (BA09) as applied and modified by sections 89B to 89G of that Act.

6.2 Schedule 11 introduced an expanded resolution regime for CCPs. This provides the Bank, as the UK's Resolution Authority, with an expanded toolkit to mitigate the risk and impact of a CCP failure and the subsequent risks to financial stability and public funds. This toolkit provides the Bank with a number of statutory tools and powers to generate resources from clearing members and the CCP itself in order to stabilise and recapitalise the CCP, to prevent contagion within the financial sector and reduce any risks of the loss falling to the taxpayer. These tools and powers are additional to any tools or powers that are provided for in a CCP's rulebook.

6.3 Paragraph 32 of Schedule 11 allows the Bank to make cash call instruments as one of its key options for stabilising a CCP. This allows the Bank to require clearing members to pay an amount of cash to the CCP as a means for generating additional loss absorbing capacity and replenishing a CCP's resources.

6.4 Paragraph 32(3) of Schedule 11 provides HM Treasury with the ability to make regulations for calculating the maximum cash amount that a clearing member can be required to pay under cash call instruments. Paragraph 32(3) of Schedule 11 also allows the Treasury to make Regulations regarding the circumstances in which the Bank may require a CCP to use one or more specified funds of the CCP to satisfy all or part of that member's cash call obligations.

7. Policy background

What is being done and why?

7.1 The Financial Services and Markets Act 2023 (Resolution of Central Counterparties: Calculation of Maximum Amounts for Cash Calls and Use of Specified Funds) Regulations 2023 (these Regulations) set caps on the Bank's cash call power by specifying the maximum amounts which clearing members may be required to pay a CCP that is in resolution, and outlining the circumstances in which the Bank can require the CCP to use specified funds held by the CCP to satisfy a clearing member's obligations under a cash call instrument. The Bank may require any clearing member to make a payment under a cash call instrument, whether or not that clearing member caused or contributed to any loss incurred by the CCP. The Bank may use its cash call power to call different amounts from different clearing members.

7.2 These Regulations give the Bank the necessary flexibility to respond to a number of different scenarios in a resolution of a CCP, and ensure that it can appropriately address any failure to pay a cash amount required to be paid under a cash call instrument. These Regulations also provide clarity for industry on the potential costs of a resolution of a CCP.

7.3 Regulations 2 and 3 specify the maximum cash amounts that a clearing member may be required to pay under cash call instruments made by the Bank in the resolution of a CCP. The amounts differ depending on the circumstances of the resolution of a CCP. Regulation 2 sets out the maximum amounts that are available in circumstances where the CCP has incurred a default loss (being a loss arising as a result of a clearing member defaulting on its obligations to a CCP). Regulation 3 sets out the maximum amounts that are available in circumstances where the CCP has incurred any other loss (being non-default loss). If a CCP has incurred both default and non-default loss, then both maximum limits are available separately and independently of each other.

7.4 Regulation 2(1) sets out that in a default loss scenario where there is a default in one clearing service (for which the CCP maintains one prefunded default fund), the maximum amount that a clearing member may be required to pay is two times that clearing member's contribution to the relevant prefunded default fund (as defined in regulation 1(4)).

7.5 Regulations 2(2) and (3) set out that in a default loss scenario where there is a default in one or more clearing services (for which the CCP maintains more than one prefunded default fund), the maximum amount is two times the clearing member's contribution to each relevant prefunded default fund and this is calculated for each relevant prefunded default fund separately.

7.6 Regulation 2(4) sets out that the maximum cash call amount that relates to a given prefunded default fund is not affected either by the maximum having been reached in relation to another prefunded default fund, or the maximum having been reached in a non-default loss scenario.

7.7 For example, suppose clearing member A, who is a member of clearing services 1 and 2 within the same CCP, is required to contribute £10 million and £15 million to the respective prefunded default funds for these clearing services. If there was a default in clearing service 1 that drove the CCP to resolution, the Bank would be able to call up to £20 million from A. If, subsequently during the same resolution, there was a default in clearing service 2, the Bank would be able to, in theory, call up to a further £30 million from A.

7.8 Regulation 3(1) sets out that in a non-default loss scenario, the maximum amount that a clearing member may be required to pay is three times that clearing member's contributions to all prefunded default funds. Regulation 3(3) states that this maximum cash call amount is not affected by any maximum being reached in the case of cash call instruments relating to default loss.

7.9 The differing caps for a default and non-default loss scenario respectively reflect that the power to reduce variation margin payments ('variation margin gains haircutting' (VMGH)) (paragraph 33 of Schedule 11) is not available in a non-default loss scenario. VMGH is the power for the Bank to reduce or cancel variation margin payments that a CCP would otherwise have been required to make to clearing members whose house and client positions have gained value. As such, a higher cash call cap is necessary in a non-default loss scenario to provide the Bank with the necessary flexibility to effectively carry out a resolution.

7.10 Regulation 4 states that if there is more than one resolution in relation to the same CCP, the maximum limits set out in these Regulations apply separately for each resolution. This ensures that the Bank has the necessary flexibility to carry out any resolution of a CCP.

7.11 Regulation 5 provides that, if a clearing member fails to satisfy its obligations under a cash call instrument, the Bank may require the CCP to use one or more specified funds of the clearing member to satisfy all or part of that clearing member's obligations. Specified funds are held by the CCP in the name of the relevant clearing member. They are defined in regulation 1(4), and include initial margin payments, default fund contributions, and any excess collateral.

7.12 CCPs have their own rulebooks which set out the actions they may take in a recovery scenario (meaning a scenario in which the CCP's ability to maintain the continuity of services it provides and activities it carries out is threatened), and these rulebooks currently include powers to make cash calls. For clarity, the Bank's cash call power as provided by paragraph 32 of Schedule 11 works irrespective of, and independently of, the use of a CCP's existing cash call powers as set out in their own rulebooks.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act

9. Consolidation

9.1 This instrument is not amenable to consolidation.

10. Consultation outcome

10.1 A full consultation in relation to the expanded resolution regime for CCPs was conducted. It ran from 24 February 2021 to 28 May 2021, and the government received 14 written responses, as well as running a number of engagement sessions.

10.2 This consultation covered the intention to set the caps at the quantum outlined above. Some respondents questioned why the statutory cash call power was higher for a non-default loss scenario than a default loss scenario, though other respondents raised support for this proposal. The government response outlined that, as above, the differing caps ensure sufficient loss allocation is available in a non-default loss scenario, given the lack of availability of variation margin gains haircutting. The government outlined its response to these questions in the full consultation response published on 28 March 2022.[1]

10.3 The Treasury also convened the CCP Resolution Liaison Panel to consult on the policy intent behind a number of SIs it intended to lay, including these Regulations. Some Panel members questioned the cash call caps, including the decision to have higher caps for non-default loss scenarios. The full minutes were published on 16 October 2023.[2]

11. Guidance

11.1 There is no specific guidance for this SI. However, HM Treasury intends to publish a Code of Practice which provides wider guidance around the resolution regime, including the use of the cash call power.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A de-minimis impact assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

---

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1063571/Final_Government_Response_To_Consultation_-_CCP_Resolution_digi__002_.pdf
[2] https://www.gov.uk/government/publications/ccp-resolution-liaison-panel-minutes-2023

14. Monitoring & review

14.1 The government intends to monitor the legislation on an ongoing basis in light of emerging risks.

15. Contact

15.1 Edward Henley at HM Treasury (email: edward.henley@hmtreasury.gov.uk) can be contacted with any queries regarding the instrument.

15.2 George Barnes, Deputy Director for Banking Assets and Resolution Strategy at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Economic Secretary, Andrew Griffith, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.