Response to the Bank of England Consultation Paper

The Bank of England's approach to determining commercially reasonable payments for contracts subject to a statutory tear up in CCP resolution

Executive summary

The International Swaps and Derivatives Association (ISDA) and the Futures Industry Association (FIA) (collectively, the Associations) appreciate the opportunity to provide our response to the Bank of England's Consultation Paper setting out its approach to determining commercially reasonable payments for contracts subject to a statutory tear up in CCP resolution.[1]

We would welcome the publication by the BoE of an "approach to CCP resolution" document[2], which we believe would be the right document to provide context by including all information related to the BoE's approach to using its various CCP resolution powers.

In addition, we strongly encourage the BoE, as part of its resolvability assessments, to look into the CCP's own rules and arrangements to generate commercially reasonable prices.

This response covers the positions of our members on the buy-side and sell-side. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views.

Detailed commentary

Comment on the scope of the tear-up power

The Associations welcome the assurance that the BoE's intention, as outlined in the overview, would "typically be to conduct a 'partial tear up', limiting the number of contracts affected". We emphasise that this power should be applied to the smallest portion of illiquid contracts as possible to achieve the BoE's special resolution objectives. However, we note that the approach being consulted on could apply to both full and partial tear up. The BoE states in paragraph 3.5 that the scope of any statutory tear-up would be determined "at the time of resolution" based "on a scenario specific judgement considering a range of factors, including the special resolution objectives".

We welcome that HMT's CCP Special Resolution Regime Code of Practice[3] notes that the BoE would seek to make the scope of the tear-up as narrow as possible. While we appreciate the focus of this consultation is on the BoE's approach to determining a commercially reasonable price for contracts subject to tear up, we seek further assurance that the BoE would apply this to the narrowest scope of contracts necessary to restore a matched book. Additionally, we would welcome more clarity on how the BoE will make its judgement in defining the scope of contracts to be torn up. In this context, we also refer to our paper "Partial Tear-Up and Other Position Allocation Tools"[4].

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[1] The Bank of England's approach to determining commercially reasonable payments for contracts subject to a statutory tear up in CCP resolution | Bank of England

[2] We understand that the BoE intends to publish such document, as noted in the executive summary of its updated 'Purple Book', published in December 2023.

[3] Central Counterparties Special Resolution Regime Code of Practice - GOV.UK (www.gov.uk)

[4] https://www.isda.org/2021/05/28/partial-tear-up-and-other-position-allocation-tools/

Response to the consultation questions

Question 1: Do respondents have any views on the Bank's proposed approach of using the CCP's existing arrangements to determine a commercially reasonable valuation for contracts subject to a statutory tear up (unless the Bank considers it necessary to use an alternative pricing approach)?

In paragraph 4.2, the BoE notes that, when relying on the CCP's own rules and arrangement to generate commercially reasonable prices for contracts being torn up, it considers that "commercially reasonable prices in this case should be representative of the mark-to-market prices that the CCP would use for margining purposes". Further in paragraph 4.5, the BoE suggests that, in most circumstances, it would expect that "the prices generated by the CCP will represent a commercially reasonable valuation of each contract".

We caution against placing too much reliance in this approach. Valuation will be extremely challenging in a scenario where an auction has already failed, and the resolution authority must resort to tear-up. The core issue in such a scenario is likely the absence of a clear market price. A failed auction may indicate that no auction participants are sufficiently confident in their ability to price the auction portfolio, suggesting that the CCP methodology will also not result in fair market prices.

As a first step, we suggest that the BoE should evaluate further the CCP's rules and arrangements to generate commercially reasonable prices, as part of the resolvability assessment. Additionally, it is crucial to examine whether termination prices should be bid, mid or ask. At banks, contracts must be valued at the price they could be liquidated. To achieve this, banks usually mark positions at mid, and carry a bid/ask valuation adjustment, recognizing that the true cost to liquidate is not the mid value. As such, if a contract is long and terminated contracts are valued at the bid price, firms whose contracts are terminated would face an immediate loss equal to the difference between their marked valuation and the mid-price. Yet, a case could also be made that when tearing up trades, a long position should be closed out at ask price, because the market participant whose long position has been closed would need to replace it and therefore look at the price at which someone is willing to sell.

Question 2: Do respondents have any views on the Bank's proposed approach to assessing whether it considers the CCP's proposed prices to be commercially reasonable?

The BoE states that it would "consider a range of inputs when assessing whether prices are commercially reasonable". We suggest that the BoE also considers the specific circumstances that led the auction to fail, as these factors could significantly influence whether the prices generated by the CCP are appropriate. As mentioned in response to Question 1, a failed auction might indicate the absence of a clear market price. Alternatively, the auction could fail because the auction portfolio is too big, requiring the bid prices to be significantly below the mid-price due to market risk or capital cost. This issue might be mitigated by better auction design, such as breaking the portfolio into smaller more manageable portfolios, which could reduce the need for tear-up.

Nevertheless, if termination becomes necessary, it is important to recognise that prices derived from exchanges or other venues may not accurately reflect the fair value of larger contracts within the auction portfolio, as they would be based on trades in small quantities.

We appreciate the BoE's assurance that statutory tear-up is not intended as a means to allocate losses to members. As a result, when assessing whether prices are commercially reasonable, the BoE should ensure that the proposed prices do not economically result in the allocation of losses to some market participants. We fully agree that "commercially reasonable" in this context should mean that the exercise of this power does not lead to any form of loss allocation. We would welcome further details on how the BoE would ensure that the proposed prices achieve that stated objective.

Question 3: Do respondents have any views on the Bank's proposed approach to generating alternative prices in circumstances in which the Bank concludes that one or more prices proposed by the CCP are not commercially reasonable?

We would like to emphasise that determining a fair market price in a scenario where terminations are necessary will be extremely challenging. Ultimately, the fair market value is determined by what someone would be willing to pay for the portfolio or contract. The BoE suggests using the following inputs if an alternative pricing method is required: a. current prices relating to the same or very similar contract(s), b. recent prices relating to the same or very similar contract(s), c. a modelled price calculated by a third party.

Regarding prices relating to similar contracts referenced in a. and b., we caution that these prices might not necessarily be representative of mark-to-market price(s) of the portfolio being terminated if the termination involves a very large portfolio. The fair value, in this case, would have to include the cost of liquidating a concentrated portfolio.

For b., recent prices, we strongly advise against using anything other than the most recent prices. The termination price should reflect the prevailing market conditions as close as possible to the exact day and time of the contracts' termination, incorporating all information available at that moment.

Regarding c., a modelled price, this approach could be helpful if the calculation was straightforward, such as pricing interest rate swaps using interest rate curves based on futures prices. However, the utility of this approach becomes questionable if these models rely on inputs requiring estimation, such as in the case of using volatility estimates for pricing swaptions.

We also note that valuations depend heavily on the specific market conditions at the time of termination. A tool effective in one market situation might not be applicable in another.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. Information about FIA and its activities is available on the Association's website: www.fia.org.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.