

CCPs: completing the post-crisis agenda



Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

EMIR 2.2, the way forward for Level-2 requirements

In April 2019 the EU Institutions politically agreed amendments to the EMIR Regulation regarding supervision of CCPs, also called “EMIR 2.2”.

The outcome of this agreement is to be welcomed, especially in light of the main objectives of the legislative proposal, namely ensuring financial stability through EU-level oversight over international financial infrastructures that are critical for the operation of the European markets.

With EMIR 2.2 coming into force, ESMA will receive an enhanced role in monitoring recognised Third Country Central Counterparties (TC-CCPs) and, for those TC-CCPs that are determined to be systemically important Tier 2 CCPs, ESMA will take over direct supervisory tasks. In this context it should be noted that the relevant Central Banks of Issue (CBI) will also be granted a role in some important decisions on Tier 2 CCPs.

In view of the political agreement and the challenging implementation timeline, ESMA has already been requested by the European Commission to provide its Technical Advice on three central Level 2 measures which will then be proposed by the Commission as Delegated Acts. These central Level 2 measures cover the tiering criteria, comparable compliance and supervisory fees that the CCPs will be charged.

Following consultation, ESMA aims at finalising the Technical Advice in Autumn 2019. Looking at the tiering criteria, the agreed Level 1 text of the EMIR 2.2 establishes already five tiering criteria which ESMA shall take into consideration to determine the systemic importance of a TC-CCP:

1. the nature, size and complexity of the TC-CCP’s business;
2. the effect of the failure of or a disruption to the TC-CCP;
3. the TC-CCP’s clearing membership structure;
4. the existence of alternative clearing services;
5. the TC-CCP’s relationships, interdependencies or other interactions.

ESMA’s role is to propose in its Technical Advice how to further specify these criteria through a set of quantitative and qualitative indicators. The aim, and the challenge, is to strike the right balance between having a comprehensive set of indicators and information to fully grasp the profile of a TC-CCP, while keeping the burden for TC-CCP to a minimum.



>>> Regarding comparable compliance, EMIR 2.2 allows for a Tier 2 CCP to submit a request to ESMA to assess the extent to which compliance with EMIR requirements is satisfied by its compliance with the comparable requirements applicable in the third country. ESMA's approach in the Consultation Paper provides for a requirement-by-requirement assessment, at the CCP-level and on an outcome basis. The proposed approach aims at ensuring that, where comparable compliance applies, a Tier 2 CCP, by complying with comparable requirements in their home country, will always comply with the core provisions of EMIR and satisfy the regulatory objective of the other provisions.

"ESMA will receive an enhanced role in monitoring recognised Third Country Central Counterparties."

- VERENA ROSS

Turning to the third Level 2 measure and ESMA's Technical Advice on supervisory fees, the Consultation Paper addresses the following key items: ESMA's applicable budgeting approach, the main activities that ESMA will need to carry out and the relevant high-level costs for the supervision of TC-CCPs, the one-off fee for initial recognition of TC-CCPs and how comparable compliance will be reflected in the fees that TC-CCPs will be charged.

After the entry into force of EMIR 2.2, ESMA will continue its close cooperation with the regulators and supervisors involved with CCPs around the globe. We are very committed to build further on the existing good cooperation we have put in place with our counterparts in US, Asia and beyond. ●



Erik Tim Müller

Chief Executive Officer,
Eurex Clearing AG

CCP recovery and resolution – preserving the EMIR incentive structure

Following the G20 commitments made in Pittsburgh, CCPs have moved into the spotlight by managing risks from financial markets in a neutral and independent manner. As rigorously regulated and supervised entities, they increase transparency, reduce overall systemic risk and – perhaps most importantly – internalize the costs of financial crises by organizing the private mutualization of losses, protecting the state and citizens from new public bail outs.

The EU has set the global regulatory benchmark with its European Market Infrastructure Regulation (EMIR). Most importantly, the EMIR framework has enshrined a robust

incentive structure where all stakeholders of the CCP ecosystem have an impetus to support the stability and integrity of our financial system.

CCP Recovery and Resolution must continue building on the key achievements of EMIR– and prevent public funds from being used when facing severe market turmoil, in the interest of taxpayers and the broader society. The key to preserving the building blocks established by EMIR is to ensure that all participants – both the clearing members and the CCP – remain incentivized to contain a financial crisis within the EMIR waterfall.

"CCP Recovery and Resolution must continue building on the key achievements of EMIR."

- ERIK TIM MÜLLER

Regarding the incentives of the clearing members, compensation claims should be clearly restricted to cases of operational misapplication of recovery measures or be captured under the No Creditor Worse Off (NCWO) >>>

>>> safeguard to act as a check on possible arbitrary decisions of resolution authorities. Allowing for unjustified and automatic compensation claims on tools agreed in the CCP's rulebook would instead void the deterrent effect that the mutualization of losses has on clearing members – thus breaking the carefully crafted incentive structure of the CCP.

Turning to the incentives of the CCP, recovery is effectively a life or death situation. As for any other company, CCP equity should be written down completely as soon as resolution is triggered. This creates the greatest incentive for the CCP to support a successful recovery,

and beforehand, a strong waterfall. Any mandatory use of additional CCP equity before the end of recovery should carefully consider whether this added burden supports the incentive structure of the CCP or instead weakens the CCP at a critical moment.

Last but not least, strong safeguards concerning the use of public money should be ensured at all times to avoid a reintroduction of moral hazard at the heart of financial markets.

Therefore, the recovery and resolution framework should outline clearly stipulated methods for recouping public funds from market participants

and allow its use exclusively on a temporary and refundable basis in highly exceptional circumstances.

With the world economy's performance slowing down, it is fair to assume that times ahead will not be a walk in the park. This underlines the importance of CCP recovery and resolution as the missing puzzle piece in the stability agenda. A strong CCP recovery and resolution framework will avoid public bail outs – and above all, continue to establish financial stability as prerogative and the very basis for sustainable growth. ●



Roger Nolan

Chief of Staff, LCH Limited

Building an efficient and effective CCP recovery and resolution framework

The framework for CCP Recovery and Resolution (R&R) remains a key topic for policy makers. To ensure that CCPs and their clearing community remain reliable circuit-breakers in case of a financial crisis there are two key aspects to consider:

- the importance of standards and incentives put in place by EMIR underpinning the mutualisation of market risk by its members, and

- the importance of regulatory cooperation in considering the potential resolution of an international CCP.

Firstly, CCP R&R is a direct complement to the existing EU and international regulatory frameworks (EMIR/PFMI). As such it should uphold the existing incentives for the CCP membership to support the strong prudential requirements defined by these standards.

As clearing members introduce risk in the system by their trading activities, they provide the vast majority of resources in the CCP's default waterfall, which is calibrated according to their risk exposure. The role of the CCP is to manage these risks. The CCP operates a 'defaulter pays first' principle. In the case that the defaulters' resources are insufficient to cover losses, the CCP's resources would then be used, before any non-defaulting members'. This approach ensures the CCP is appropriately incentivised to have a strong risk management framework. It also ensures a proportionate balance of responsibility between the CCP and its members. Subsidising members' losses with additional CCP resources (such as its operational capital or additional skin in the game) would not only affect these incentives, but it could also weaken the CCP at the worst possible moment: during a financial crisis.

Secondly, CCP R&R aims to address future possible unprecedented and extreme events.

The resolution of a CCP would not happen in isolation. Rather it would follow significant widespread market turmoil, including the resolution and failure of other major banks and market participants. To reach the stage where

a CCP would use recovery tools or be put into resolution would assume that the capital framework and resolution processes of these defaulting banks had already failed, and that the CCP's recovery tools had also been ineffective.

Under this scenario strong cross-border cooperation between authorities representing diverse CCP memberships would be vital to ensure effective resolution of a CCP. However, this must be executed in conjunction with the multiple bank resolutions at stake which would have led to the crisis situation.

"CCP R&R should uphold the existing incentives to support strong prudential requirements."

- ROGER NOLAN

International, mutualised CCPs, supervised by multiple regulatory bodies, subject to wide-ranging coordinated resolution planning facilitate closer supervisory cooperation among regulators, both in normal and crisis times. Such cooperation can be based on the specific third country provisions of CCP R&R as well as the detailed arrangements suggested in EMIR 2.2 which would also avoid ex-ante divergence in the application of CCP resilience, recovery and resolution tools across jurisdictions.

These two aspects are vital to maintain the benefit of clearing for the wider system which is to incentivise the mutualisation of risk and prevent contagion. ●



Jochen Metzger

Director General, Payments and Settlement Systems, Deutsche Bundesbank

EU regulation on recovery and resolution of CCPs – Just another brick in the wall?

The proposed EU regulation on a framework for the recovery and resolution of central counterparties (CCP-R&R) is a welcome addition to the post-crisis regulatory initiatives. The membership of central banks in the resolution college underpins their role in the resolution planning process. This way, the central

banks can ensure that resolution planning addresses the existence of adequate financial resources and does not rely on the provision of central bank liquidity.

EMIR 2.2 will set the stage for CCP-R&R to be incorporated through its envisaged third-country (TC) regime. The proposed criteria for determining whether a TC CCP is (or is likely to become) systemically important – to be adopted in a forthcoming delegated act – entail several indicators, one of which is consideration of the extent to which the CCP is subject to recovery and resolution framework or regulation. We need to ensure that EU CCP-R&R requires a TC R&R framework on a level playing field. Other important aspects concerning TCs in the context of recovery and resolution are information exchange and enforcement of resolution proceedings. In this respect, CCP-R&R provides for cooperation agreements between authorities which support carrying out resolution tasks and also exercising powers either in Member States in which a TC CCP operates or in TCs in which an EU CCP operates. However, these powers may be rejected in certain cases, which may impact their credibility. Whether enforcement as envisaged in the CCP-R&R is viable remains to be seen.

For systemically important CCPs, the FSB requirement to establish crisis management groups (CMGs) already represents a framework for cooperation between Member States and TCs. In these groups, information on resolution planning, including tools, resources and possible gaps, is shared.

As important as cooperation agreements are, it is still preferable to avoid reaching a stage in which the application of resolution tools is required. It is worth mentioning that there are several lines of defence. Firstly, in their risk management, banks have to take into account exposures to CCPs from the trading book and from contributions to the default management process (DMP). Secondly, compliance with capital and liquidity requirements already captures potential liabilities towards CCPs and is monitored by banking supervisors.

“Sound risk and default management, rehearsed in fire drills, are key for returning to a matched book.”

- JOCHEN METZGER

Thirdly, banks’ resolution planning must factor in obligations towards CCPs. Fourthly, the CCP needs a robust risk management regime which has to be continuously enforced. Lastly, an effective DMP and recovery plan – bearing in mind that the border between the two is fluid – will be key to escaping resolution. In short, sound processes, well tested and rehearsed in fire drills, are paramount for returning to a matched or balanced book. Procedures for successful auctions with incentives for CMs to participate will help to minimise losses, mitigate the depletion of the waterfall, and ultimately avoid resolution. ●

Laurence Caron-Habib

Head of Strategy, Market Intelligence and Public Affairs, BNP Paribas Securities

CCP recovery and resolution plans must preserve clearing fundamentals

The European Commission issued its legislative proposal on recovery and resolution plans (RRPs) for CCPs in November 2016, following the publication of guidelines by the FSB and CPMI-IOSCO at the international level. As

of today, the European Parliament had already adopted its position since January 2018. In the Council, the negotiations were suspended throughout the last several months, as it seemed more urgent to finalise the new framework for CCP supervision, proposed in EMIR 2.2, first. Now that the EMIR 2.2 adoption is behind us, the discussions on CCP recovery and resolutions can resume.

The complexity of this new framework is not to be underestimated, as its main purpose is to ensure the continuity of the critical functions performed by the CCPs in situations so critical that they could actually entail the failure of the CCP. In such context, the most rational approach is to come back to the basics of the functioning of a CCP and its “raison d’être”, and to make sure that these are not compromised in a critical situation.



CCPs have been established with the objective of providing more security to the financial system, and they constructed around two >>>

>>> fundamental principles. The first one is the mutualisation of risks among all its members, including in the precise case of stressed market conditions. The second one is the right alignment of incentives so as to ensure that the members to the CCP will not rush to the exit at the earliest sight of trouble.

As a result, beyond the minimum pre-requisites of transparency and clear definition of triggers for each phase, following rules should prevail when establishing the recovery and resolution framework for CCPs:

- all participants of a CCP (both direct and indirect) should contribute to the allocation of losses, in proportion to their exposures. As an illustration, end-users should also be part of the variation margin gain haircutting process if this tool is to be used. Consequently, those end-users who would incur losses for the sake of CCP recovery should be eligible for compensation on a pari-passu basis with the clearing members;
- on the CCP side, it should be clearly established that in case of non-default losses, losses are to be accrued to the CCP and not to its members. Therefore, appropriate recalibration of the CCP skin-in-the-game should be part of the negotiation discussions;
- the Initial margin haircut should be excluded from the recovery and resolution toolkit. IM haircut would run counter the principle of IM bankruptcy remoteness, which has just been enshrined in the revised EMIR. Moreover, there is a strong risk that this option would encourage a massive rush to the exit at the time when the CCP would most need to maintain its most important line of defense.

"The most rational approach is to come to the basics of the CCP functioning and its «raison d'être»."

- LAURENCE CARON-HABIB

In addition to these principles, it is essential that the future regulation establishes a legal framework that is practical and unambiguous, allowing for a transparent and efficient implementation. For example, the no-creditor-worse-off safeguard should be defined in an easily understandable way in order to be a real safeguard and be readily actionable when necessary. These are highly important considerations that should inform the lawmakers in their discussions. ●



Finbarr Hutcheson

President, ICE Clear Europe

Promoting supervisory deference through internationally agreed standards

Over many years, CCP risk management practices have been tested during periods of extreme market volatility and sometimes involving clearing member defaults. Clearing has proven to be a fundamentally safe process for managing risk, so much so that following the 2008 financial crisis G20 regulators were tasked with implementing reforms to bring the benefits of clearing, such as increased financial stability, resilience and transparency, to the OTC markets. As a part of the wider clearing community, ICE has worked with global regulators as they implemented agreed standards, such as CPMI-IOSCO's PFMI, which are designed to foster the stability and transparency of markets and protect their geographically diverse users. Adherence to these standards has contributed to the success in these reforms and the proliferation of products and markets that allow for diversity within safe financial market infrastructure.

CCPs do not themselves contribute risk to the global financial system, nor do CCPs increase systemic risk by "concentrating" risk. Instead, CCPs reduce systemic risk by collateralising and managing risk. Cleared positions are centralised in a CCP and risk managed in a highly transparent, disciplined and sophisticated

manner, conforming to global standards. With this in mind, regulators implementing the G20 reforms should not ask "what risks does a third-country CCP present to our own financial market?" Rather, they should ask "how does a third-country CCP's domestic regulator ensure that the CCP employs effective risk management practices consistent with globally agreed standards that promote resilience in all financial markets it serves?"

"CCPs manage risk in a transparent and disciplined manner, conforming to global standards."

- FINBARR HUTCHESON

Supervisory deference and regulatory equivalence have worked well in practice for decades. The CCPs' adoption of the PFMI, and cooperation and information sharing among supervisory authorities, enables this deference and equivalence. With respect to EMIR 2.2, ESMA consulted with the public on the criteria for ESMA's determination of whether a non-EU CCP is systemically important for the financial stability of the EU. If a CCP is deemed systemically important, ESMA describes a comparable compliance regime for such CCP. It remains unclear how ESMA's draft technical advice aligns with the well-established concept of deference and equivalence and whether the use of EMIR requirements as a "floor" for non-EU CCPs will lead to contradictory requirements, duplicative supervision and conflict between multiple CCP regulators during a time of crisis.

Counterparties, market operators and regulators have spent decades creating a global marketplace, and each must do what they can to prevent the real economic harm that fragmentation will cause. Such fragmentation will lead to higher costs for commercial firms, financial institutions and their customers. These higher costs may also limit the jurisdictions that CCPs operate in and thus reduce market access from which clearing members and clients currently benefit. This reduced access will decrease the liquidity needed for well-functioning and safe markets. The EU's goal of assuring appropriate supervision of non-EU CCPs that are systemically important to the EU can be achieved through supervisory cooperation and appropriate deference. This will facilitate continued access to liquid and safe global markets which will be critical to global market participants when the next financial crisis arises. ●