CCPs: COMPLETING THE POST-CRISIS AGENDA

1. EMIR 2.2. implementation next steps

1.1. Progress made with the EMIR 2.2 legislation and next steps

The EMIR 2.2 legislation is now adopted and the main changes introduced concern third-country CCPs that are systemically important for the EU[1]. The focus is shifting to implementation; in particular with three delegated acts that the Commission has to put into place and on which ESMA has been mandated to provide advice. These concern the criteria for tiering, comparable compliance and fees. Three consultation papers were recently issued on these three topics. Following the advice provided by ESMA there will be opportunities for industry and others to give their point of view before the Commission publishes the delegated acts. ESMA will also further engage with stakeholders on what is needed to put the process into place (information needed, how to gather it…). EMIR 2.2 is expected to come into force late-October/early-November 2019.

An industry representative stated that more certainty is needed about the implementation timeframe, given that the transitional measures allowing UK-based CCPs to offer their services in the EU are due to end by March 2020.

An official also stressed that although the focus is now on Level 2 measures, there remain significant elements in the Level 1 text concerning third-country CCPs on which further clarity is needed to make the regime work. One is the requirement for the MoU to specify that third-country authorities will assure the enforcement of ESMA's decisions. It is not certain that third-country authorities will be in a position to sign that requirement from a legal perspective. Understanding is also needed of how the Central Bank of Issue (CBI)'s ability to place requirements directly on a third-country CCP in exceptional circumstances will work in practice and whether that will be acceptable to third-country authorities. Maintaining the high level of supervisory cooperation that currently exists between the Bank of England, ESMA and other European authorities will be essential to make these new arrangements work.

1.2. Main pending issues to be defined at Level 2

Regarding tiering criteria, a regulator noted that ESMA was asked to further specify the quantitative and qualitative criteria for identifying systemic CCPs. These indicators relate to the nature, size and complexity of the third-country CCP business and a number of other aspects including: the effect that a failure or disruption would have on EU markets, the membership structure and the existence of alternative clearing services. One issue is the extent to which this can be qualified through clear thresholds, given the variety of the criteria. In the US, they are proposing very clear thresholds around some of these criteria. ESMA is in the process of defining the criteria and their importance, but establishing thresholds seems more difficult under the legal provisions in the EU.

An official noted that it is important for the third-country CCPs concerned to prepare for the requirements that will be placed on them, and for third-country authorities to know how to prepare to engage with the EU authorities on this.

On comparable compliance, the question is how to avoid any unnecessary overlap of regulation, the regulator explained. ESMA needs to work very closely with the relevant home regulators of third-country CCPs that are systemically relevant to the EU in order to understand how their policies and procedures match up to the EMIR requirements. This will be looked at requirement by requirement but very much from an outcome-based perspective. ESMA also needs to get relevant information on the systemic third-country CCPs concerned.

An official considered that successful supervisory cooperation is based on third-country authorities deferring to the home supervisor, which is in line with G20 international standards. Comparable compliance is one way to achieve this, as the European authorities and Central Banks of Issue (CBIs) will rely on the rules and the supervision of the third-country supervisor, and look to that in the first instance to achieve their goals. With the ESMA consultation it is important that there should be clarity on how that will be applied in practice. The speaker was moreover curious to understand how an outcomes-based assessment can be performed on a requirement-by-requirement basis.

Concerning fees, the regulator noted that the co-legislators have decided that the supervised entities need to pay on a cost-recovery basis, like for other direct supervisory activity conducted at EU level. Third-country CCPs will only pay for the supervision of third-country CCPs, taking into account how much work ESMA will actually conduct in practice on the supervision. There is also a proposal to reduce fees when there is significant reliance on the home supervisor due to comparable compliance.

2. Brexit preparedness

2.1. Timing issues and the need for certainty

An official noted that many steps have been taken on the UK and EU sides to deal with a no deal situation. The UK Financial Policy Committee has published a Brexit checklist, and continuity and ability of EU and UK CCPs to provide clearing services in each other's jurisdictions was one of the major risks highlighted in that checklist. The Bank of England took action a couple of years ago announcing a temporary recognition regime, which gives EU CCPs the ability to provide services for three years, during which a full recognition process will be conducted. This process is already well advanced although the temporary recognition regime has not commenced. On the EU side, temporary equivalence was given to the UK CCPs in December 2018. This gave certainty for 12 months, but this is already nearly six months through, and early clarity is needed on what will happen in March 2020. After this date UK CCPs will no longer be able to provide clearing services within the EU.

Another official considered that clarifying what will happen after March 2020 is difficult at a moment when it is still unknown how the UK will follow the EU line of regulation on CCPs, due to the current political uncertainty in the UK. Clarity by December would however help and by then the political uncertainty should have diminished in the UK.

The first official believed that monetary and financial stability need to be ensured regardless of the political environment. That is why the temporary recognition regime

granted in the UK will last for three years starting the day the UK leaves the EU, which leaves sufficient time to provide for a full recognition and give long-term certainty to CCPs and users. It is hoped that the EU will approach this situation in the same way because there are £60 trillion of derivative contracts outstanding between UK CCPs and EU members and clients. That is a huge amount of business that would need to shift if legal uncertainty prevented UK CCPs from clearing them. The pipes may be ready for new business, but shifting that volume of historical business presents a financial stability risk that needs to be dealt with so that it does not crystallise.

An industry representative emphasized that IOSCO quantitative disclosure shows that 64% of the collateral posted by the two main UK-based CCPs is held in the UK and the US combined, with 31% of that 64% based in London and 16% is within the EU27. With that amount of business done in the UK and US, for everything to be completed in time for March 2020 is vastly optimistic. It is therefore urgent to find a solution to extend the temporary recognition regime of the EU.

2.2. Interaction with EMIR 2.2

An industry representative noted that the issue of continuity following the temporary recognition regime interacts with EMIR 2.2 because the initial aspiration was that EMIR 2.2 would be in place such that an extension would not be required. However, realistically that is not possible for March 2020 with all the assessments that are required of how the future UK regime measures up to EMIR 2.2 and how CCPs comply with this regime. It is a major task and the sooner the markets are given some certainty to move forward, the better for all concerned. In addition, a number of elements in EMIR 2.2 will be problematic for non-EU CCPs. Comparable compliance for example is too onerous for them and too big a challenge for ESMA. In a resource-constrained environment it is not clear if this is the right approach.

An official agreed that to have EMIR 2.2 ready for March 2020 is extremely challenging, which is why clarity is needed up front over what will replace the temporary recognition regime, whether EMIR 2.2 or an extension, since financial stability risks have not gone away.

A second industry representative felt that the level of preparedness of the industry is also important to consider in this perspective and it is much higher than 6 months ago. It is therefore really important to identify where the remaining financial stability concerns are, given these changes. Looking at the trading layer of the market where critically important benchmarks are run like fixed income benchmarks, six months ago 60% or so of the trading volume was emanating from members physically located in the UK. That number now is 40%, which is a significant level of adjustment to new objectives and realities. On the clearing side, equally, all the large international clearing members of UK based CCPs have set up EU 27 entities and there are visible changes in where margins are posted. On the end-client side it was a real concern that many of them had only one pipe into Europe. Their company – an EU based CCP - has however enabled the buy-side to build a second access.

A policy maker acknowledged the need for clarity expressed by the private sector, not just in terms of EMIR 2.2, but shorter-term measures. At the same time the Brexit process creates a legal fragmentation of the market that needs handling and a cliff-edge remains possible. Originally, a lengthy transition was foreseen, leaving enough time for negotiations about the longer-term relationship. The objective of the Commission has been to avoid financial stability risk from a cliff-edge in the short term. Understanding is needed that these cliff-edge measures are, for the Commission, steps to the discussions on the longer-term negotiations, but they cannot become the longer-term negotiation outcome themselves. In any case the Commission has shown in the past that it can move quickly when needed and a stability risk will absolutely not be allowed to take place.

3. CCP recovery and resolution (CCP R&R)

3.1. Need for and conditions of an effective EU CCP R&R regime

The Chair noted that the EU CCP recovery and resolution framework that was proposed some time ago has not yet been adopted and is back on the programme of the co-legislators now that EMIR 2.2 has been agreed.

An industry representative stated that two key themes should be focused on. Firstly, the EU CCP R&R framework must ensure that the incentive structure of the CCP is maintained to protect taxpayers' money. EMIR creates the right incentive structure with the way the framework for default management is set out based on the concept that the defaulter pays and then the risk mutualisation layer that exists below. The key point is that as participants to the CCP introduce risk they have to provide the funds to manage that risk through Initial Margin (IM) and default funds. Testing these mechanisms with all the stakeholders concerned is also essential. Secondly, the regime needs to be designed to deal with genuinely unpredictable market events, like a situation with potentially a multi-member default along with extreme market conditions that would make CCP existing recovery tools unable to be used. That type of event will also probably involve cross-border aspects. That is where the regulatory cooperation defined by EMIR 2.2 becomes key. The process also needs to be as predictable as possible, consistent across borders and across CCPs, and as much as possible the procedures and processes need to be known ex-ante.

An official emphasised the need to make sure that the EU regime can interact internationally. Regard is needed to the development of international standards, which are however going slower at the moment than the regulation in the EU. It is important that they should be reconciled eventually, given the international nature of many CCPs. An industry speaker believed that it is the case and that the EU framework as proposed fits well with the international standards that have been defined for CCP R&R.

3.2. A focus on recovery and avoiding resolution as far as possible

An industry speaker considered that a long way can be gone with well-designed recovery planning and regulatory cooperation, so there first needs to be understanding about how those tools are going to be applied before thinking about resolution. It is hard to define what is needed after. At that point it really becomes a cooperation issue between the authorities to decide the appropriate next steps. These will be unpredictable events by nature, so it is hard to legislate for every type of event.

A second industry representative agreed that most of the effort should be spent on recovery, since making this work may mean that resolution is not required. Moreover, it is an extraordinarily complex task to try and anticipate what a CCP going into resolution looks like and what is happening to the other actors in the financial market at that time. Anticipating this is helpful but it is difficult to put in legislation.

A third industry representative added that with EMIR the risk standards of CCPs are geared towards surviving the default of the two largest clients. Given that these large clearing members all have international client bases, this

means that there is normally a long way to go before hitting the area where recovery and resolution rules become relevant.

Another industry representative suggested that the best way to avoid moving to the resolution phase is to go back to the fundamental principles of CCPs and make sure that benefits of clearing are preserved even in a crisis situation. Two main principles should persist. The first is the mutualisation of losses, because the broader the pain is shared, the smaller it is for everybody. This mutualisation principle needs to be maintained, so it means that very quickly all stakeholders should be involved to ensure that a matched book is restored when necessary. The second point is that the right incentives need to be in place. However, the speaker believed that it cannot be fully excluded that one day it may be necessary to move to a resolution phase which is why it is necessary to have these plans in place.

A policy-maker commented that the view of the EU authorities is that resolution planning is needed. An official felt that the focus should be on CCP resilience as well as on recovery. There may be situations where the recovery process promulgates risk in the system in an unacceptable way or it may be clear after a certain stage that the recovery plan is not going to work. The CCP will not be able to see that; only the authorities have the cross-market view across both the CCPs and their participants. There may therefore be a case for resolution authorities to step in before the end of the recovery plan and going into resolution if it is going to end up with a better solution.

A regulator felt that there should be a sufficient recovery period and process for the CCP to be able to try to manage the situation they are facing. This requires having the right incentives in place at the CCP and also the clearing members. There must also be sufficient preparation, because having worked through a few recovery scenarios beforehand is very helpful. However the recovery phase cannot be entirely relied on. If it ultimately fails, there needs to be a process in place that works into resolution.

3.3. The need for appropriate incentives and tools in the recovery phase

An industry representative emphasized three main incentives that are needed during the recovery phase and that need to be discussed during the upcoming negotiations on the EU framework. The first is a fair allocation of losses with a distinction between default and non-default losses that needs to be specified in the final text. The second is the size of the skin in the game, which must be commensurate with the amount of resources available in the rest of the waterfall. The third is the avoidance of IM haircutting on which there is a strong consensus. IM haircutting could indeed accelerate the exit of the CCP members and potentially have a pro cyclical and destabilising impact on the CCP ecosystem. There are also other more technical incentives, such as compensation claims by clearing members.

Another industry speaker believed that compensation is also an area where care is needed not to distort incentives. If there is a 'carrot of compensation' at the very end of the chain, then the fear would be that people will not be as incentivised to participate in the very first phases of solving a problem, i.e. during recovery.

A third industry representative considered that putting excessive liability on CCPs would be extremely pro-cyclical. The purpose of clearing is to ensure that the market can survive a default thanks to mutualisation and that firms can continue their business once that default has been tackled. It is in the market's interest to ensure the CCP continues. The people who bring the risk to the CCPs therefore need to have a very significant incentive to help unwind that risk in a situation where a participant has defaulted, together with the CCP that is on the other side of that risk. Who brings the risk back to the CCP and who benefits most from the ongoing continuity should be driving much of the thinking, rather than attempting to make a specific player pay. It is that balance that needs getting right. The industry speaker also emphasized that sufficient flexibility and a menu of tools must be available to the industry and authorities to deal with a recovery situation that cannot be fully war-gamed ex ante. It is difficult to anticipate what the exact scenario will be and how players in the ecosystem will be affected.

A policy-maker remarked that the people who bring risk on CCPs have been mandated to do so, hence the question about who should bear the losses. An official noted that when it comes to non-default related losses, a cash call is not the right approach. This is the sole responsibility of the CCP as an enterprise and as an operator. More equity may be needed to handle these risks. Moreover equity can only play a role in resolution if recovery tools have been exhausted and have not worked. The write down effect cannot be considered earlier.

3.4. The importance of cooperation and of a clear definition of responsibilities

An industry representative noted that recovery and resolution will lay bare who was actually responsible for a default and who from the public sector actually takes responsibility. In the context of multiple supervision, this may be tricky. In the end one person needs to be responsible, which is why this leads back to EMIR 2.2 and how systemically important CCPs are treated.

Given the international dimension of CCPs there needs to be close cooperation and clarity about who is in charge of the recovery and resolution phases, a regulator added, because of the need to take quick decisions that are clear and effective. In a resolution situation, it is also likely that there is a far bigger crisis going beyond the CCP and a few clearing members requiring broad cooperation within the market.

An official emphasized that organisational arrangements for resolution need to work effectively with the arrangements for supervision. It is necessary to know who is in charge in a resolution; this needs to be the resolution authority and the home resolution authority.

Another official noted a link between supervision, resolution and recovery, which EMIR 2.2 acknowledges. One of the criteria to assess if a third-country CCP is systemically relevant is the impact that problems in a recovery or resolution scenario would have on EU financial market stability. In terms of governance there may be difficulties with joint decision making or binding mediation if the fiscal responsibility still rests with the jurisdiction of the home of the CCP, the official believed.

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[1] There have been 47 third-country CCP applicants from 2013, and 32 which have been recognised following the relevant equivalence decisions by the Commission. For the majority of those third-country CCPs EMIR 2.2 does not change much. For systemically important third-country CCPs there will be a greater supervisory role for the CCP committee within ESMA and the need to comply with EMIR (or comparable) rules. Central Banks of Issue (CBIs) will also be involved in the supervision of these CCPs.