

CCPs outstanding issues



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Making clearing safer: two new frameworks for CCPs

In mid-October 2019, the European co-legislators adopted a set of targeted amendments to EMIR – the European framework for CCPs – to strengthen the supervision of CCPs in light of their growing systemic importance (‘EMIR 2.2’). The objective is twofold: first, fostering convergence in the

supervision of CCPs established in the EU, and, second, improving the supervision of third-country CCPs that provide services to EU firms according to the risk they present for the stability of the EU financial system. While not being the only driver, these amendments are of course especially important for the EU in the Brexit context.

The new rules enhance the supervisory role of ESMA and EU Central Banks over third-country CCPs. The amendments introduce a new category of third-country CCPs that are systemic for the financial stability of the EU, and that could therefore become subject to specific requirements and direct supervision from ESMA. As a last resort, the Commission can also require a third-country CCP to provide certain services to EU firms from within the Union. The Commission will soon come up with a set of delegated regulations that will specify how EMIR 2.2 shall be implemented. The Commission is working to make the new approach proportionate, predictable and efficient, while safeguarding financial stability.

The implementation of EMIR 2.2 will require close cooperation with our international counterparts with which we intend to keep an open and balanced dialogue in order to reach a proportionate and common approach to deference in the field of CCP supervision.

Already in 2016, the European Commission adopted a legislative proposal for a framework for the recovery and resolution of CCPs. While a CCP failure is an unlikely event, it is

essential to have in place rules that will enable us to deal with such a situation should it occur. The Commission proposal implements the internationally agreed FSB framework, ensuring that the critical functions of CCPs are preserved while maintaining financial stability and protecting the taxpayers.

The European Parliament adopted its report in March 2018 while the Council adopted its general approach in December 2019. The positions are close, hence a political agreement could be reached soon – potentially during the Croatian presidency.

The current points of divergence are twofold. First, both the Council and the Parliament have proposed to increase the involvement of the CCP’s own resources in the recovery phase. The Council does not require this additional involvement to be prefunded, to the contrary, the Parliament proposes to significantly increase this involvement and make it prefunded. Second, on decision-making in resolution, while insisting on a fair representation of all relevant authorities of potentially affected Member States, the co-legislators recognise the primary role of the CCP’s resolution authority but have different views on the design of the resolution college and on when and how to inform the resolution college about resolution actions.

The CCP Recovery and Resolution Regulation will complete the legal framework applicable to CCPs in order to ensure safe clearing in the EU. ●

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

EMIR 2.2, a new allocation of supervisory responsibilities for CCPs

On 2 January 2020 EMIR 2.2 entered into force, revisiting supervisory arrangements for EU and third-country CCPs in light of the growing size and cross-border dimension of clearing in the Union.

EMIR 2.2 clearly allocates the supervisory responsibilities and enhances ESMA’s role for both authorised EU CCPs and recognised third-country CCPs, especially through the creation of the ‘CCP Supervisory Committee’, an internal committee of ESMA composed of a Chair, two independent members and the competent authorities of Member States with an authorised CCP.

Regarding EU CCPs, diverging supervisory practices across the EU have brought out the need for supervisory convergence: in particular, there have been discrepancies in national practices with respect to the consultation of supervisory colleges ►



► for the purpose of issuing an opinion on CCP extensions of activities and services (Article 15 of EMIR) or risk model changes (Article 49).

Under EMIR 2.2, the home-country supervisor remains ultimately the responsible competent authority of the CCP but ESMA's role has been reinforced in order to promote a convergent approach towards European CCPs and to homogenise the application of EMIR across the EU.

The new CCP Supervisory Committee is responsible for conducting analyses, such as peer reviews of the supervisory activities towards CCPs or Union-wide stress tests of the resilience of CCPs, and promoting convergence between competent authorities and across Colleges through decisions and opinions, especially with regard to supervisory areas which have a cross-border dimension or impact, such as access of trading venues to CCPs (and vice versa), interoperability arrangements,

authorisation and extension of services and activities. [The recruitment process of the Chair and the independent members of the CCP Supervisory Committee is in progress and ESMA's Board of Supervisors should appoint them in the coming months].

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In addition, the composition of EMIR Colleges has been enlarged to central banks of issue and additional competent authorities, where the jurisdiction's financial stability could be impacted by a CCP's financial distress, and their role has been strengthened. EMIR Colleges can provide opinions on additional supervisory areas and a comply or explain process has been introduced for the competent

authorities when they significantly deviate from an opinion issued by the College.

Regarding third-country CCPs, ESMA is responsible, mainly through the CCP Supervisory Committee, for classifying third-country CCPs depending on the level of systemic risk they pose for the Union and effectively and directly supervising recognised CCPs that are determined to be systemically important Tier 2 CCPs. ESMA powers include the ability to conduct investigations and on-site inspections and to impose fines. Besides ESMA, relevant Union central banks of issue are also involved in the recognition, supervision, review of recognition and withdrawal of recognition of third-country CCPs.

The implementation of this new regime is pending, subject to the finalisation of the Delegated Acts that will define the tiering criteria and the conditions for comparable compliance. This is particularly sensitive taking into account the perspective of the end of the Brexit transition period. ●



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Putting in place ESMA's new supervisory powers

EMIR 2.2 came into force on 1 January 2020. One of the first measures adopted by ESMA has been to establish the CCP Supervisory Committee as an internal committee of ESMA, creating the new governance and

decision-making process. While the recruitment of the Committee's Chair and the two Independent Members is ongoing, the committee has met already a number of times in its interim composition and is organising its new tasks with respect to EU-CCPs.

The provisions in EMIR 2.2 introducing new tasks and processes promoting supervisory convergence in the supervision of EU-CCPs are already applied by ESMA, the relevant competent authorities and CCP colleges. For example, in the case of significant changes to risk models and parameters, CCPs are already applying the revised process.

ESMA has also established a CCP Policy Committee to deal with the new regulatory mandates in EMIR for developing draft regulatory technical standards (RTS) and guidelines. ESMA is now finalising its draft proposals to adjust existing RTS and guidelines on CCP colleges to the new tasks and processes envisaged in EMIR 2.2, and will next work on the remaining mandates for RTS specifying when an extension of authorisation is required and a change to a CCP's risk model or parameters is significant and subject to validation.

However, the provisions in EMIR 2.2 introducing a new regime for the recognition and supervision of Third Country CCPs

(TC-CCPs) are not yet applicable, pending the adoption of the relevant Delegated Acts by the European Commission.

In November 2019, ESMA provided the European Commission with technical advice concerning these Delegated Acts in relation to (i) the tiering criteria to be taken into account by ESMA when determining the systemic importance of TC-CCPs (ii) the minimum elements and the modalities and conditions when assessing comparable compliance for systemically important TC-CCPs, and (iii) the supervisory fees for TC-CCPs.

ESMA's role and ability to perform effective supervision of TC-CCPs will be largely determined by these Delegated Acts. They will determine the TC-CCPs that will be in scope of ESMA's more robust supervision, due to the fact that these CCPs are systematically important for the European Union or one or more of its Member State(s). They will also determine the nature and extent of ESMA's assessment of compliance of those so-called "Tier 2 CCPs" with the EMIR requirements under the new comparable compliance regime and they will determine the fees charged to finance ESMA's supervisory activity. Fees are key to ensure that ESMA's required supervisory costs related to TC-CCPs are covered by the entities and not by EU taxpayers. ●



Toks Oyebode

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Better aligning incentives between CCPs and market participants

It is generally understood that CCPs have grown in systemic importance since the 2008 financial crisis. Together, regulators, CCPs, and market participants have made strides towards improving CCP resilience, recovery and resolution planning. However, a number of critical issues remain outstanding. Moreover, the current period of market volatility associated with

COVID-19 is likely to highlight strengths and vulnerabilities in the system.

J.P. Morgan recently published a paper alongside eighteen other global buy- and sell-side institutions – “A Path Forward for CCP Resilience, Recovery, and Resolution” – which identifies outstanding issues that regulators and CCPs should consider and makes twenty recommendations to address them.

In the spirit of ensuring on-going financial stability in times of market disruption or crisis, the paper seeks to better align incentives between CCPs and market participants and ensure that clearing member and end-user liabilities are appropriately limited and manageable. In doing so, the paper seeks to protect financial stability and ultimately taxpayers, by ensuring that CCPs are resilient and that recovery and resolution processes are reliable and are not procyclical. The paper is intended for a global audience, but many of the recommendations are directly applicable to matters under consideration in the draft EU Regulation on CCP recovery and resolution.

- On resilience, the paper recommends that CCPs should make material contributions of their own capital to the default waterfall in two separate tranches, as a mechanism to align a CCP’s incentives and ensure effective risk management related to the CCP’s clearing activities. In addition, it recommends that CCPs should be responsible for non-default losses, supported by appropriately sized regulatory capital requirements.

- On recovery, the paper emphasizes the importance of compensating market participants for losses incurred through the use of recovery or resolution tools and capping pre-defined assessment rights at an amount equal to each clearing member’s default fund contribution. In addition, the paper emphasizes the need for appropriate governance and regulatory oversight of the use of procyclical recovery tools.
- On resolution, the paper recommends that CCPs set aside ex-ante resources (e.g., issuance of long-term debt that could be bailed-in) for recapitalization, and that regulators conduct regular reviews of CCP rulebooks to ensure a common understanding of CCP risk.

These and other recommendations are covered in more detail in the full paper. The EU should be commended for introducing important measures to improve the safety and soundness of derivatives markets and related financial market infrastructure through the European Market Infrastructure Regulation (EMIR) in 2013. The draft EU Regulation on CCP recovery and resolution presents an opportunity for further progress through the establishment of a comprehensive framework to address the recovery and resolution of CCPs.

While the existing draft Regulation is an important step forward, we strongly believe more can and should be done. Incorporating the recommendations of this industry white paper into the Regulation would further the goal of enhancing financial stability through even more resilient and robust CCPs within the EU. ●

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CCP R&R – Why access to highly liquid markets and resilience matters

The EU CCP Recovery and Resolution (R&R) framework seeks to ensure that, if the conditions for a CCP R&R are met, swift action can be taken to: (i) safeguard financial stability; (ii) secure the continuity of the CCP critical functions; and (iii)

protect taxpayers. We are fully supportive of these objectives and believe that resolution (and to a further extent, recovery) should be managed by the clearing community (including CCPs, clearing members, clients, competent authorities) without recourse to taxpayers.

CCPs manage the risks of the wider market and act as circuit breakers in case of crisis. The use of R&R tools would therefore be the result of a much wider stressed market scenario whereby, for example, several major banks would have defaulted on their obligations towards the CCP, and their corresponding capital requirements and resolution regimes have proven to be insufficient. Even under these conditions, margin requirements and mutualised ►



► resources should still allow CCPs to manage extreme but plausible scenarios. It is therefore imperative to focus on the prevention of a crisis, by ensuring that CCPs operate to the highest standards. It is also vital that everyone is incentivised to support these strong resilience standards.

However, CCP R&R discussions have not typically focussed on prevention, and instead focused on increasing CCP resources to cover for losses from a default. It is important to recognise that increasing CCP resources to cover default losses in recovery or resolution does not strengthen financial stability or CCP resilience. In fact, this would have the opposite effect and increase CCP 'dead capital', which would limit the resources available to strengthen their resilience and increase clearing costs. This could also run counter to and hence

change clearing members' incentives to support the liquidation of a defaulter's portfolio, potentially weakening the resilience of the whole system.

We believe that, in order to ensure a safer and more robust clearing community, in line with CCP R&R objectives, the discussion should be focussed instead on the following two aspects:

- **How to ensure a resilient and diversified CCP membership**, in particular by ensuring that only strong profiles have access to the CCP. CCP membership should also be sufficiently diversified (to limit wrong-way-risk) and actively engage in CCPs' fire-drills, to ensure it is well prepared to respond to a market event.
- **How to ensure the corresponding diversified supervisory input:** CCP R&R

is unlikely to happen in isolation: there is a need to ensure a wide and diversified regulatory overview and input into CCP supervision, and also to 'stress-test' supervisory cooperation to ensure that the entire clearing community (including authorities) is well prepared.

CCP R&R frameworks should be implemented in such a way that there is sufficient preparedness primarily within the clearing community to manage shocks in the most effective way. Supervisors must also be able to use the relevant tools to ensure close ex-ante coordination. In addition to the increased scrutiny on CCP resilience, bringing the clearing community closer is the 'extra-layer' that will be most beneficial to financial stability, and ultimately, taxpayers. ●



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It's all about incentives!

The EU CCP R&R proposal is the latest addition to regulation following the financial crisis. It provides a framework for dealing with events even beyond extreme but plausible scenarios. Since the introduction of the clearing obligation for OTC derivatives, CCPs have become even more crucial providers of post-trade services. Hence, rules on how to deal with

default and non-default related losses are imperative. One particular challenge is how to deal with losses which exceed the resources provided for by the rulebook. In the CCP R&R this challenge is addressed by a multitude of instruments, one of which is a cash call reserved for the use of the resolution authority to cover losses from default as well as non-default related events.

In general, resolution is a very severe and disruptive situation that should be avoided. The best resolution is the one that does not take place. We need to test and increase the resilience of CCPs, applying scenarios in which established correlations cease to exist.

The default management process of a CCP determines the size of the losses. This means that management, shareholders and participants need compelling incentives for contributing to its success. Auctions play a pivotal role here. The more successful the auctions, the more likely it is that the CCP will recover without recourse to recovery measures or resolution.

A strong incentive for the CCP to ensure effective risk management and soundly designed auction processes is its own contribution to the default waterfall, which in the EU currently stands at an additional 25% of a CCP's capital. The draft R&R regulation seeks to add another 25% when in recovery. For clearing members, unsuccessful auctions can mean that losses are mutualised as agreed in the rulebook, pre-funded resources may be used up

and need to be replenished through the assessment regime. Or worse, if losses persist, positions may be returned to the clearing member via partial tear-up. Such consequences represent a clear and strong incentive for clearing members to make meaningful contributions in auctions and should not be weakened by additional contributions of the CCP.

Non-default losses can originate from investment risks, custodian and settlement risks, operational risk, and legal risk and are supposed to be covered by the capital of a CCP. One exception are investment losses where loss-sharing arrangements with clearing members often exist. The draft EU regulation also provides for a cash call in case of resolution caused by a non-default related event. The welcome advantage of this is that it gives the resolution authority additional resources to cover losses. However, it may have repercussions on the incentive structure as clearing members will have to cover losses for which the CCP's shareholders and management bear the ultimate responsibility.

EMIR requires that capital be calibrated by the CCP with the approval of its regulator such as to also cover risks from non-default losses, and the FSB is working on guidance to help resolution authorities calculate potential gaps in resources for loss coverage with the aim of closing them. In the case of non-default related losses, more CCP-side contributions could help avoid increasing the burden on clearing members. ●