

How to address CCP outstanding issues?



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The challenging new supervisory framework of CCPs

CCPs supervision is key for the stability of the financial markets, and as such, is considered as a cornerstone within the EU financial regulation. Despite the market volatility and the operational challenges CCPs had to face during the Covid-19 situation, EU CCPs demonstrated their resilience and their shock absorbing function during this crisis; it was all the more welcome than the Nasdaq Clearing episode in 2018 had demonstrated possible weaknesses of CCPs. The recent ESMA

stress test has confirmed the robustness of EU 28 CCPs while pointing attention at concentration risks in case of default(s).

The CCP supervisory framework is evolving in the EU, both with the entry into force of EMIR 2.2 and of the accompanying delegated regulation concerning third-country CCPs and with the finalization of the regulation dealing with the resolution of CCPs. They are both supposed to strengthen the resilience of these core market infrastructures.

Let me just highlight how challenging the implementation of these new regulation will be.

EMIR 2.2 reinforces dramatically the responsibilities of ESMA through the new established ESMA CCP Supervision Committee. The aim is both to foster the convergence of supervisory practices for the EU CCPs, although they remain directly supervised by their national competent authorities, and, on the other hand, to grant ESMA with direct supervisory powers regarding third-country CCPs classified as Tier 2 (CCPs considered as systematically important for the financial stability of the EU), to be exercised in close coordination with their third-country competent authorities. This new set of responsibilities means ESMA will have to find its own way as a credible supervisor of third-country CCPs, although it has neither such role for EU CCPs, nor for EU clearing members or for EU trading platforms.

This to some extent wobbly solution is linked to the almost visceral attachment of member states to a national supervision

of market infrastructures whatever their systemic importance and, regarding CCPs it has been confirmed by the recently agreed regulatory framework for resolution. CCP resolution will remain a national matter even if resolution colleges will facilitate adequate coordination.

The EU approaches therefore the end of the transition period of the Brexit in a relatively weak position and the question of whether to grant equivalence to the UK CCPs arises once again.

While it is clear that the ultimate goal should be to ensure the EU has significant market infrastructures for all the financial products issued by EU entities or which are denominated in an EU currency, in the short term however, in order to avoid any detrimental cliff-edge effect to the EU financial stability, the EU Commission has rightly announced its intention to adopt a time-limited equivalent decision for the UK CCP legal framework. In addition, for the UK CCPs to be able to continue to provide clearing services to EU clearing members or EU trading venues, ESMA shall issue recognition decisions with the related classification as Tier 1 or Tier 2 CCP, in due course.

However, procrastination should stop and the medium term goal should either be clearly and officially endorsed, even if the efficiency of financial markets and the clearing infrastructure may not be fully optimal, or abandoned. In that perspective the stance of the ECB would be key by asserting that it is not prepared to directly or indirectly provide liquidity to third country CCPs. ●

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Euro clearing comes home – Time for a change of perspective?

The EU CCP Recovery and Resolution framework has progressed to the final stages of the legislative process and is highly likely to enter into force towards the end of the year. However, a closer look at another EU issue appears more pressing: the EU and the UK are still in the process of negotiating an agreement that sets out a new partnership after the end of the Brexit transition period in December 2020. In absence of an extension of the

transition period, a no-deal Brexit has once again become a plausible scenario that euro clearing participants have to prepare for.

After the end of the transition period, UK-based CCPs will become third-country CCPs. This means that a large portion of clearing business relevant to the EU, especially euro clearing business, will take place outside the EU. ►



on their systemic relevance for the EU. In such a scenario, ESMA could classify UK CCPs, such as LCH Ltd. and ICE Clear Europe, as Tier 2 CCPs and join the Bank of England in supervising them directly.

“The future of EU financial services lies with and within the EU – not outside the EU.”

Currently, we can assume that the revised third-country CCP framework under EMIR is fit for purpose to accommodate London-based CCPs, given that EU law is still applicable in the UK. However, it appears unlikely that this will hold in the medium and long term. The UK government has made it clear on several occasions that it intends to diverge from the EU’s regulatory and supervisory frameworks in the area of financial services, including those on central clearing. Undercutting EMIR provisions will put the practical co-existence of EU and UK regulation and supervision at risk, perhaps rendering it impossible to follow through. It is thus very wise

that the Commission intends to adopt a time-limited equivalence decision, which underscores the possibility of the process being revised should the UK’s future regulatory regime substantially diverge from EU law.

Despite the efforts made by lawmakers, it has become apparent that the uncertainty surrounding Brexit and its implications for the EU market is here to stay, and that there are no simple, risk-free solutions. This warrants a clear and simple message: The future of EU financial services lies with and within the EU – not outside the EU. If the market is looking for certainty, it should shift its focus away from the UK. A mid-term strategy would be for market participants to reduce their exposure to London and to explore and develop clearing capacities within the jurisdictional borders of the EU. The EU offers viable alternatives to London-based clearing that have shown promising growth in recent years, in particular with regard to euro clearing. It is time for a radical change of perspective to bring about the certainty the market has been seeking. ●

▶ Without recognition, these CCPs will not be able to offer certain services to market participants in the EU. Essentially, two things need to happen for these CCPs to be recognised under the EMIR third-country framework. First, the European Commission has to declare the UK’s regulatory and supervisory framework equivalent to the corresponding frameworks in the EU. Second, ESMA needs to recognise these CCPs, depending

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Implementation of EMIR 2.2 moving to the next round

The regulatory framework for the recognition and supervision of third country CCPs introduced with EMIR 2.2 has been complemented with the European Commission Delegated Acts in July this year, namely the Delegated Act on the tiering criteria and the Delegated Act on comparable compliance. With the entry into force of these Delegated Acts, ESMA enhanced powers vis-à-vis third country CCPs will be enabled, including the one to determine whether a third country CCP is systemically important for the Union or one of its Member States (“Tier 2 CCP”).

This will be a key novelty in the process for the recognition of UK-CCPs, which upon

the end of the Brexit transition period, will need to be recognised by ESMA in order to continue to provide their clearing services in the Union. In this context, the Delegated Act on tiering criteria further specified the criteria for such a determination and provided some further predictability to third country CCPs.

“ESMA is committed to implement the new regime for the recognition and supervision of Tier 2 CCPs, and so to ensure an even level-playing field between EU CCPs and Tier 2 CCPs.”

Over past months, ESMA has been working with all relevant stakeholders in order to ensure a timely decision on the recognition of UK CCPs, upon the adoption of the respective equivalence decision by the Commission, in order to prevent any cliff-edge effect at the end of the Brexit transition period. As



required by EMIR 2.2, over the course of 18 months from the entry into force of the Delegated Acts, ESMA will also review its past decisions on the currently recognised third country CCPs to determine if any of them would meet the criteria for Tier 2 CCPs, and with that be subject to direct supervision of ESMA to ensure their ongoing compliance with EMIR requirements. ▶

► In parallel ESMA continues to build up its team in its newly established CCP Directorate to be ready to undertake the new EMIR 2.2 tasks. The Chair and the two Independent Members of the CCP Supervisory Committee that will soon join ESMA will lead the implementation of its new supervisory powers vis-à-vis Tier 2 CCPs.

ESMA is committed to implement the new regime for the recognition and supervision

of Tier 2 CCPs, and so to ensure an even level-playing field between EU CCPs and Tier 2 CCPs. ESMA will also ensure that Tier 2 CCPs maintain an adequate level of resilience in line with EMIR requirements to prevent any systemic risk for the Union.

Now looking at the recent experience during the COVID-19 crisis, the existing EMIR framework proved to be effective in ensuring the resilience of

EU CCPs throughout the market events and turbulences experienced during unprecedented market conditions related to the crisis. ESMA, together with NCAs and central banks, has closely monitored the performance of EU-CCPs through the CCP colleges. In addition, ESMA published recently its CCP stress test exercise which used stress scenarios which were consistent with the shocks experienced during the COVID-19 outbreak. ●



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CCP RR completes the financial stability agenda - but more remains to be done

After more than three and a half years of negotiations, EU policy-makers have finally reached an agreement on a framework for the recovery and resolution of CCPs (CCP RR), completing the final piece of the puzzle to the G20 reforms. Twelve years after the great financial crisis we now have a much more resilient financial system and CCPs have once again proven their key function as financial stability anchors during the COVID-19 pandemic.

By preparing for the worst, the CCP RR framework will further increase the resilience of the private sector and the CCP ecosystem, complementing the existing lines of defense under EMIR. The final deal will request CCPs and Resolution Authorities to draft the recovery and

resolution plans establishing swift processes to cover extreme yet plausible scenarios that could lead to the failure of a CCP and to ensure the continuity of clearing of key critical contracts. It gives strong powers to the Resolution Authority to re-establish a matched-book and increases the contributions of the private sector to internalize potential losses. To further limit moral hazard, the Resolution Authority will have the power to recoup public funds in the extreme event they are used to stabilize the financial situation.

Most importantly to our hearts, the final agreement preserves the incentive structure of the CCP, whereby CCPs have been asked to commit a second tranche of Skin in the Game which can be financed by existing CCP capital, and will therefore not shift the loss absorbing responsibility away from clearing members. Finally, the EU framework has developed a comprehensive view of the value of central clearing, by explaining what the costs of letting a CCP fail would be and thereby limiting compensation to cases where our members would be economically worse off according to the No Creditor Worse Off (NCWO) principle. In a nutshell, the long-awaited agreement ensures that all involved stakeholders have a natural interest to do everything they can to mitigate the impact of a crisis on the broader society.

In terms of next steps, CCPs in the EU need to prepare the implementation of the new framework. We are eager to see the details such as for the NCWO counterfactual and the second Skin in the Game which have to be specified by ESMA via Level 2.

The EU is now one of the first jurisdictions with a CCP RR framework to complete the G20 reforms. However, there is still work to be done to strengthen risk management capacities and proper oversight of

CCPs. The recently published EMIR 2.2 Delegated Acts on the tiering and comparable compliance of third country CCPs strike the right balance between the imperatives of financial stability and market access in this respect. Now, timely implementation is required to prepare for the end of the transition period for UK CCPs post-Brexit and cater for the risks of having substantial, systemic euro-denominated markets managed in an off-shore centre.

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Moreover, given the sense of urgency around the recent crisis, we have observed a delay of some outstanding G20 reforms such as the Uncleared Margin Rules (UMR), which have still not been fully implemented in the EU. In light of the on-going discussions to grant or extend further exemptions from the clearing obligation, we should be mindful of their cumulative impact and avoid creating loopholes to European clearing requirements and weakening incentives to clear to the detriment of risk management.

The COVID-19 pandemic has illustrated that the financial sector is much stronger than in 2008 and the years of the great financial crisis. The reforms passed have borne their fruits. However, there is no room for complacency in light of a new political and economic reality at global level. It is vital that Europe continues to create an efficient clearing ecosystem that is able to withstand extreme market stress and fosters sustainable economic growth, notably protecting the Euro as key currency and fostering an autonomous and sovereign EU. ●



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LCH's management of Covid-19 volatility and support to EU recovery

The recent Covid-19 pandemic and the associated market stress had the potential to put immense strain on the financial services sector. The situation was a test of the industry's contingency measures which were quickly deployed across the board. It has been consistently recognised

that CCPs have adapted well to the market conditions and were successful in supporting financial stability when it was needed most. In addition, the recent ESMA EU-wide stress-test have demonstrated that CCPs are constantly improving their standards of risk management and resilience.

LCH's risk modelling frameworks incorporated the market moves across cleared asset classes during the recent volatility. Prior to and following these market stresses, CCPs have continued to take proactive measures to prevent an excessive decrease in initial margins falling in calm market conditions. Conversely, CCPs have also acted to prevent procyclical increases in market turmoil. This so called anti-procyclicality is enshrined in the design of LCH's risk models and ensures that margin changes are highly predictable. LCH's prudent approach to margin requirements and anti-procyclicality measures, go above and beyond the EMIR requirements. These practices ensured that the margin call mechanism was highly predictable to our users during volatile markets. For example, risk was predominantly absorbed by existing margin and led to single digit incremental margin increases during the most recent turbulent market conditions.

The recent events have also demonstrated the need to ensure all market participants have unfettered access to the deepest and most diversified pools of liquidity, especially during times of market stress. Access to this liquidity is vital in ensuring

well-functioning markets and preserving financial stability.

CCP performance during this recent market stress has shown their resilience. It also provides additional confidence in central counterparties as important financial market infrastructures, supporting the orderly functioning of markets.

The Covid-19 volatility also highlighted some operational issues in the settlement process, predominantly driven by materially higher volumes. Settlement efficiencies were affected due to some general frictions between CSDs/ICSDs and T2S. The increased importance of CSDs demonstrates the importance strengthening of settlement connections that facilitate cross-border settlement between ICSDs and EU CSDs.

While the industry is making steps towards some form of 'normality', we must now place all our efforts in supporting economic recovery in the EU and must utilise all tools available such as EU's CMU initiative and EU recovery package to successfully fulfil our two main objectives – ensuring the orderly functioning of markets and supporting financial stability.

LCH Group and especially LCH S.A. is well placed to support EU recovery efforts, by supporting the EU's expanded role as a bond issuer via the Next Generation EU Fund. This is in addition to LCH's current role clearing EU Government debt and repo for European and international sell-side, and, increasingly, buy-side firms. ●

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EU CCP recovery & resolution regulation - A significant milestone

The recent agreement on the EU CCP Recovery and Resolution Regulation marks a significant milestone towards mitigating the systemic risk posed by CCPs and addressing an important

unfinished aspect of the post-crisis financial market reforms.

Implementing a robust CCP recovery and resolution regime is critical to enhance financial stability and address moral hazard concerns by better aligning incentives between CCPs on the one hand and clearing members and market participants on the other. The final regulation makes strides on both these fronts, in particular by:

- introducing a second layer of CCP own-funds capital to the default waterfall, known as a "second skin-in-the-game" (SSITG). The SSITG will sit after member assessments, which will further incentivize CCPs to maintain a conservative default fund.



- eliminating procyclical recovery tools such as initial margin haircutting ▶

- ▶ (IMH). If used, such tools could prove to be detrimental to financial stability by encouraging firms to exit a failing CCP as quickly as possible in order to reduce their exposure.
- capping resolution cash calls at twice the amount of a clearing members' contribution to the default fund. This serves to ensure that such cash calls are measurable, manageable and therefore more reliable. In addition, the regulation requires the resolution authority to consider the impact on financial stability and non-defaulting clearing members before they call for an amount in excess of one time the contribution to the default fund.

Recovery and resolution planning for CCPs is highly complex and in many areas best practice continues to evolve. As such, we welcome the introduction of a review clause to ensure that the EU regulation incorporates the latest thinking. In particular, we believe that the following areas should be revisited:

- While the regulation identifies and aims to address the potential procyclical impacts of resolution cash calls, it does not do the same for recovery cash calls, nor for other potentially procyclical

tools such as variation margin gains haircutting (VMGH) and Partial Tear Ups (PTUs). Implementing additional limitations and oversight on use of such tools would make the regime more reliable.

- Provision of compensation should be broader for those who bear losses during recovery and resolution. This is critical to ensure that incentives continue to be aligned throughout the default process.

The EU CCP Recovery and Resolution Regulation marks a significant milestone towards mitigating the systemic risk posed by CCPs.

- Non-default losses (NDLs) should be wholly for the account of the CCP, with right-sized capital to absorb these, as it is the CCP which manages these risks.
- While we welcome the addition of the SSITG, we believe the total amount CCP SITG should be higher and the required amount should be risk-based.

As referenced in the final regulation, the global work plan on CCP resolution is still

in progress. It is important these global standards are reflected in the regulation once complete. Specifically, the regulation should incorporate the Financial Stability Board's future guidance on resources for CCP resolution and the treatment of CCP equity in resolution, to ensure that CCP equity is fully loss bearing in the event that a CCP enters resolution.

Derivatives clearing remained robust in spite of record volumes during a period of significant market volatility associated with COVID-19. Nevertheless, observations from this period should inform future policymaking. While it is too early to draw definitive conclusions, among others, the size and frequency of initial margin calls and the setting and application of margin add-ons at CCPs are worthy of additional analysis.

Enhancing the resilience, recoverability and resolvability of CCPs has been a longstanding regulatory policy priority for many in the industry and policy community. Continued attention to these important issues will ensure that the EU remains a thought leader on this topic in future. ●