CCPs post-Brexit

Implications for the users of financial markets in the UK and EU27

A paper prepared by the IRSG Post Trade workstream

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation and to TheCityUK.

The Post Trade Workstream includes representatives from post-trade institutions, exchanges, financial intermediaries, institutional investors and custodian banks. A list of the members of the Workstream is at the end of the note.

The objective of the Post Trade Workstream is to provide a cross-sectoral review of post-trade services. These comments reflect a consensus of views within the Workstream. The views of individual members may differ from the consensus in some areas.

This paper discusses the implications for banks and end-users of financial markets (for example, industrial companies and pension funds), if the current legal and regulatory framework for Central Counterparties ("CCPs") continued unchanged after Brexit. It identifies policy measures needed to avoid damaging consequences. It does not discuss possible changes to European Central Bank policy on the location of euro-denominated clearing. The objective of the policy measures identified in this paper is to enable financial markets to continue to function without posing risks to financial stability and for activity to take place where it can do so most efficiently for the benefit of end-users.

Key points

- CCPs play a crucial role managing risk in financial markets, which is critical for financial institutions and non-financial users of the markets.
- The importance of CCPs has been recognised since the financial crisis and the regulatory regime around them has been strengthened, with the objective of requiring markets to clear trades through CCPs that are authorised for that particular type of activity.
- Globally, over $600 trillion of derivative contracts are outstanding, both exchange-traded and OTC (Over-the-counter)[1]. About 40% of trading appears to take place in the UK and less than 10% in the EU27[2].

[1] Source: Bank of England Financial Stability Report, November 2016, page 44

[2] Based on data on trading of interest rate derivatives: http://www.bis.org/statistics/d12_2.pdf

- Currently, clearing is carried out at a pan-European level, with EU27 banks being significant users of UK CCPs and *vice-versa*, but the UK is by far the dominant centre for clearing.
- If no other arrangements were put in place, after Brexit EU27 banks could find themselves in breach of regulations for maintaining positions in UK CCPs that would no longer be authorised under EU regulations and would suffer punitive capital increases. The same could apply to UK banks with positions in EU27 CCPs, depending on the UK regulatory regime.
- Under EU legislation it is not currently possible for the UK to obtain an equivalence determination or for UK CCPs to obtain recognition in advance of Brexit, in order to continue clearing for EU27 banks.
- It is not practical for EU27 banks to move their existing positions from UK CCPs to those within the EU27, not least because there may not be an equivalent product offering within the EU27.
- If no arrangements are made to manage the transition between regimes at Brexit, there is a risk of market disruption and sharply increased costs of clearing, both of which will affect the non-financial end-users of markets in both the UK and the EU27.
- It is likely that if there is prospect of a 'cliff edge', customers will need to start triggering their contingency plans in the near future, which would in turn drive the behaviour of CCPs.
- In order to avoid financial instability and disruption to the operation of markets, it is therefore necessary to agree and put in place transitional arrangements that will enable markets to continue operating.

Introduction

The role of CCPs

Central counterparties ("CCPs"), also known as clearing houses, play a crucial role in managing risks in financial markets. They stand between the buyer and the seller in markets for derivatives and securities. In this way, they protect each party from a possible failure by its counterparty and manage a failure, when one occurs, with as little disruption as possible. CCPs also help manage operational risk by reducing the number of outstanding contracts through a process of netting and portfolio compression and by providing assurance that settlement will occur.

The clearing members of CCPs are generally financial institutions, such as banks and brokers. However, CCPs are also relied on by investing institutions, pension funds and industrial and commercial businesses that use financial markets to manage their interest rate, foreign exchange or commodity price risks. They benefit from the risk management services of CCPs by connecting through clearing members.

The regulatory and legal status of CCPs

While CCP clearing has been an important function of the financial markets for many decades, it has acquired particular significance since the global financial crisis. The G20 resolved in 2009 that, where appropriate, all standardised OTC derivatives contracts should be cleared through CCPs. In the EU, this resolution was implemented by the 2012 EU regulation on OTC derivatives, central counterparties and trade repositories, known as "**EMIR**" (European Market Infrastructure Regulation). Among other things, EMIR requires EU firms to clear certain derivative contracts through a CCP.

EMIR also provides the framework for an authorisation and recognition regime for CCPs based both within and outside the EU. More specifically, it provides:

- that any entity established in the EU may only provide CCP clearing services where it is authorised under EMIR by the relevant EU Member State's regulator (or "**competent authority**"); and
- that a CCP established in a "third country" (i.e. a state outside the EU) may only provide clearing services to clearing members, exchanges and other "trading venues" that are established in the EU where such CCP is recognised by the European Securities and Markets Authority ("**ESMA**"). (A CCP established in a "third country" may provide clearing services to clients established in the EU without recognition from ESMA so long as those clients are clearing through clearing members established outside of the EU.)

The regulatory status of CCPs is important for the banks[3] that use them as well as end-users such as corporates that trade derivatives (eg. for hedging purposes):

- under EMIR, EU counterparties can only satisfy their clearing obligation for mandated derivative products by clearing them at an EU CCP authorised under EMIR, or a third-country CCP that has been granted recognition by ESMA under EMIR;
- under the EU Capital Requirements Regulation (CRR), the capital requirements for derivatives trades cleared through Qualifying CCPs (QCCPs) are significantly less onerous than for trades cleared through non-QCCPs. This principle is codified in the Basel capital standards that apply internationally. Only EU CCPs authorised under EMIR and third country CCPs recognised under EMIR qualify as QCCPs for the purpose of CRR. EU credit institutions and investment firms are required to apply punitive capital treatment to their exposures to a CCP established in a third-country unless that CCP has first been granted recognition by ESMA under EMIR. The higher capital charges for EU credit institutions and investment firms with exposures to a third-country CCP that has *not* been granted recognition by ESMA would effectively prohibit the continuation of business because it is rendered uneconomic by virtue of the non-QCCP status of such CCP: capital requirements would increase 50 times for direct clearing members, and 25 times for non-

[3] And other regulated financial firms, such as broker-dealers, but for simplicity they are all referred to as "banks".

direct clearing members[4]. Europe has been the only jurisdiction to include CCP recognition as an express legal prerequisite for a foreign CCP to obtain QCCP status.

The status of CCPs is also important for securities trading platforms. There are a number of securities trading platforms in the UK and the EU27 which clear their trades through both UK and EU27 CCPs, using interoperability arrangements between the CCPs to provide an integrated service. This is facilitated by the fact that all the CCPs operate under the same regulatory regime.

The non-EU countries with EU regulatory equivalence determinations in respect of their rules on CCP supervision are listed in Annex 1.

In addition to their regulatory status, CCPs rely on a combination of national laws (for example, in relation to netting and default management) and EU law (for example, in relation to settlement finality and financial collateral) to ensure that there is a sound legal basis for their operations. The overarching EU regulatory framework provides the necessary legal certainty that national laws underpinning a CCP will be respected throughout the EU.

What happens at Brexit

Derivatives markets are currently closely integrated across the EU: banks and clients across the EU trade with each other and clear their trades at a variety of CCPs, some in the UK, some in the EU27. Putting in place a regime that supports this degree of integration after Brexit is likely to prove difficult. This paper therefore starts from the assumption that following Brexit the UK becomes a "third country" for regulatory purposes.

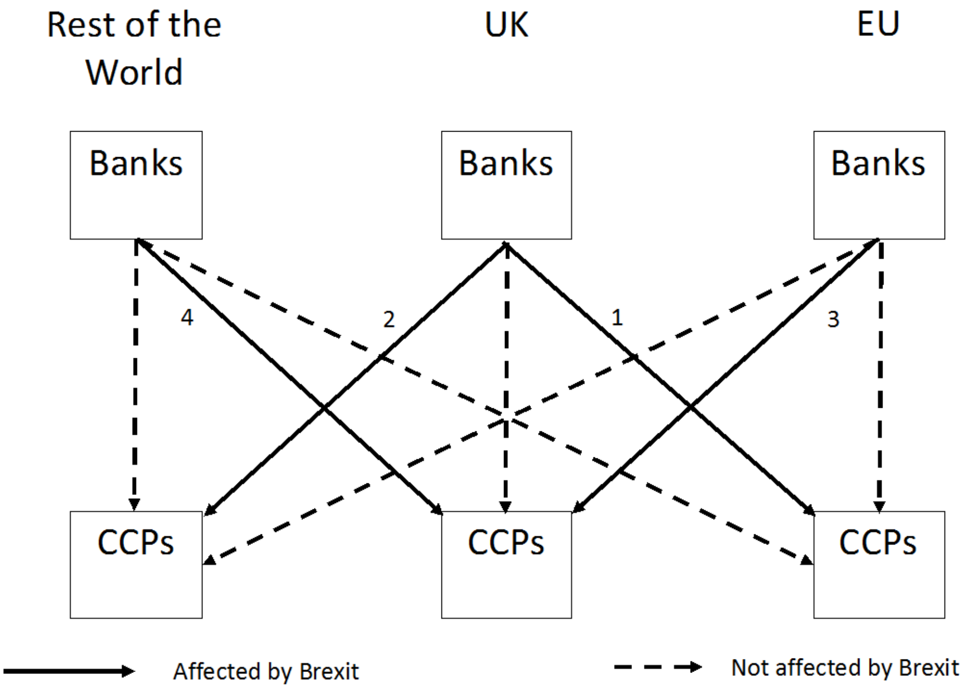
If no transitional arrangements are put in place, the regulatory status of some CCPs for some banks will change overnight from QCCP to non-QCCP, with the result that such banks would have to apply punitive capital treatment to their exposures to such CCPs, thereby rendering clearing through such non-QCCPs uneconomic. Clearing through those CCPs would no longer satisfy clearing mandates for certain banks.

This affects not only the flows of new transactions for clearing, but also the positions already held in CCPs. The existing positions are in many respects more significant both because of their size and because they are hard to move (as discussed below). Even if all new business was re-directed to another CCP, all the positions held in the affected CCPs would attract significantly higher capital requirements and banks would lose the ability to offset new business against existing positions.

This is not just a problem for UK banks and CCPs but affects banks, CCPs and end-users in the EU and the rest of the world, as shown in the diagram below.

[4] Under the standardised approach the direct exposure would move from 2% to 100% (i.e. an unrated corporate) in terms of risk weight. For non-direct i.e. client exposures through a clearing member, the risk weight moves from 4% to 100%.

However, some banks will be on modelled credit risk approaches, so their risk weights on CCPs may be different and these calculations do not factor in the different charges relating to default fund contributions.



Out of the possible combination of location of bank and location of CCP shown in the diagram, four will be affected by the change.

1. UK banks using EU27 CCPs

The status of CCPs in the EU27 for UK bank clearing members/clients after Brexit will depend on the prudential regime adopted in the UK. If this mirrors in the UK the provisions of EMIR and CRR, then EU27 CCPs will no longer be QCCPs for UK banks, as they will no longer have authorised status in the UK. This would be significant for those CCPs, as all but one of the 13 CCPs in the EU27 have UK clearing members, making up between 6% and 50% of their total clearing membership. (Detailed analysis is provided in Annex 2). It would also be significant for those UK banks that have positions in EU27 CCPs as they would suffer a punitive increase in capital requirements on derivative positions held in EU27 CCPs and these non-recognised EU27 CCPs would no longer be available to satisfy UK clearing mandates for the purpose of UK rules replicating EMIR.

Possible responses

If nothing is done to recognise EU27 CCPs in the UK, then banks may seek to move their positions and future transactions with these CCPs out of their UK entities and to other entities to avoid the capital hit.

However, the ability to recognise EU27 CCPs and determine the capital requirements regime for UK banks is within the power of the UK.

2. UK banks using CCPs in the rest of the world

CCPs in the rest of the world that currently have QCCP status by virtue of having been granted recognition by ESMA will no longer have this status in the UK, if the replacement UK regime does not provide for it. This would be significant for those UK banks that have positions in such CCPs. They would suffer a punitive increase in capital requirements on derivative positions held in such CCPs, a cost that would be passed on to clients, and those CCPs would no longer be available to satisfy UK clearing mandates.

Possible responses

Most of these CCPs have in the past held ROCH[6] status in the UK and the UK should ensure that they are able to transition smoothly back to that status, or otherwise implement transitional provisions recognising those CCPs for the purpose of new UK banking regulations and replicate ESMA's co-operation arrangements with the non-EU CCPs' regulators. Alternatively, the UK should follow the approach of the rest of the world and decouple QCCP status from CCP recognition. Europe has been the only jurisdiction to include CCP recognition as an express legal prerequisite for a foreign CCP to obtain QCCP status. UK banks should be able to treat a foreign CCP as a QCCP so long as the foreign CCP is authorised in its home jurisdiction and that jurisdiction's regulatory regime is consistent with the CPMI-IOSCO PFMIs[7].

3. EU27 banks using UK CCPs

If no actions are taken by EU regulators, after Brexit UK CCPs will no longer be QCCPs for EU27 banks, as they will no longer have authorised or recognised status in the EU. This has the potential for significant market disruption, as it is believed that some 75% of the global interest rate swaps market is cleared through UK CCPs. This is significant for EU27 banks, as the UK CCPs are the largest in the EU: 14 EU27 member states have banks with clearing memberships in UK CCPs, including 20 clearing memberships from German banks and 15 from French banks. (Detailed analysis is in Annex 3.) EU27

[6] Recognised Overseas Clearing Houses

[7] Committee on Payment and Settlement Systems and International Organization of Securities Commissions - Principles for Financial Market Infrastructures. Basel rules implemented in non-EU countries broadly define a QCCP as a CCP that is PFMI-compliant.

banks would suffer a punitive increase in capital requirements on derivative positions held in UK CCPs and UK CCPs would no longer be available to satisfy their EU clearing mandates.

Possible responses

The only ways for EU27 banks to avoid a massive capital hit and also to remain compliant with the EMIR clearing mandate are (i) they move their positions and future transactions with UK CCPs out of their EU entities to avoid the capital hit and remain compliant with the EMIR clearing mandate, or (ii) the European Commission determines the UK's CCP supervision regime to be equivalent under EMIR and then ESMA recognises the UK CCPs under EMIR.

EU27 banks can re-direct new business to CCPs in the EU27 or to other CCPs recognised by ESMA outside the EU, assuming they offer similar facilities to those in the UK. However, it will be difficult to move existing positions, as discussed below, and users would lose the ability to offset their existing portfolios with new trades cleared through non-UK CCPs.

For UK CCPs to be recognised under the EU regime requires two steps. First, the UK regulatory regime must be determined by the European Commission to be equivalent with the EU regime. For other countries this determination has taken years, though it may not be as long, given the starting point of the UK. Second, individual CCPs subsequently need to be recognised by ESMA.

Currently under EMIR, only third country CCPs may apply for ESMA recognition. Immediately before Brexit, the UK CCPs will be EU CCPs and will not therefore be able, technically, to apply for ESMA recognition. Thus, even if equivalence is eventually agreed and UK CCPs recognised, there would be a regulatory gap when UK CCPs had no status in the EU.

4. Banks in the rest of the world using UK CCPs

For banks in the rest of the world, the change in status of CCPs in the UK may not be a significant issue from a regulatory capital perspective, as QCCP status is typically determined under local regulations that reference CPMI-IOSCO PFMIs and could be granted by the national competent authority in a third country. In any case, many of the UK CCPs are recognised in other non-EU countries in their own right (e.g. by holding DCO[8] status under US CFTC rules) and therefore may not be significantly affected by Brexit in respect of bank clearing members and clients in those countries.

Moving positions between CCPs

As discussed above, one response to the changes following Brexit would be for EU27 banks to move their positions from CCPs in the UK to CCPs in the EU27 or to other CCPs recognised by ESMA. There are two ways this could be done: by trading out of positions in the UK CCP and opening new trades in the other CCP; or by moving all the positions.

[8] Derivatives Clearing Organization regulated by the US Commodity Futures Trading Commission

Trading out of one CCP into another is possible but would require a vast amount of trading totalling many billions of dollars. This assumes that willing counterparties can be found and equivalent contracts are available in the other CCPs. This raises the question whether there is enough time for those CCPs to receive authorisation from their national competent authority under EMIR to clear these additional contract types and for new clearing members to join them.

Moving positions between CCPs is not unprecedented. In the US, positions were moved between the New York Mercantile Exchange, the Commodity Exchange, the Kansas City Board of Trade and the Chicago Mercantile Exchange clearing houses. In the UK, ICE Futures Europe positions were moved from LCH.Clearnet Limited to ICE Clear Europe and London Metal Exchange positions from LCH.Clearnet Limited to LME Clear. However, it should be noted:

- In all these cases the positions being moved related to trades executed on exchanges, so the exchange was able to mandate the move. Many of the positions in UK CCPs relate to OTC business, where there is no central market manager and there is no obvious historic precedent.
- In all these cases the positions were moved between CCPs in the same country and therefore within the same legal jurisdiction. Transferring positions between countries would mean replacing a set of rights and obligations under one jurisdiction with a set of rights and obligations under a different jurisdiction. It would be difficult to obtain universal agreement to this change.
- In all these cases, the volume of transactions and the quantity of collateral were far less than would be required in the event of a wholesale move of all EU positions from UK CCPs.

In general, a decision by the industry to move positions from UK CCPs to EU27 CCPs (or other recognised CCPs) would face significant challenges:

- To avoid imbalances, the move would need to be agreed and co-ordinated across all affected market participants. This would require UK counterparties to be able and willing to move positions to EU27 CCPs. They in turn would need to obtain consent from their clients to the change of jurisdiction. One has to consider not only the laws applicable to the transferring CCP and the receiving CCP, but also the governing laws applicable to the clearing members and their clients in both sets of CCPs, resulting in an extremely complicated jigsaw of potentially conflicting legal jurisdictions that govern any such transfer. In the case of OTC contracts, there would be no central institution, like an exchange, to manage the co-ordination.
- The two CCPs may not have the same or similar clearing members and some banks may have to first become members of the successor CCP. This would involve a very significant cost to such firms, as they would have to contribute billions of euros to the default funds of such successor CCP and would also have to hold capital against its exposure to such CCP.
- The two CCPs may not have authorization for the same contracts and the receiving CCP may need to obtain authorization under EMIR so as to enable it to clear such contracts.

- A sudden influx of positions into other CCPs could create capacity issues for those successor CCPs. This could have impacts both operationally and in terms of the level of capital that will need to be held by the CCPs and their clearing members. This would lead to further concentration of risk in an even smaller number of clearing houses, with an increased perception that they were “too big to fail”.
- It takes time to prepare, plan, obtain consent and execute these moves. Given the additional complexity in this case, it seems unlikely that a move of positions could be completed within 2-3 years.

In order to avoid EU banks being in breach of the EMIR clearing mandate with existing positions remaining at a non-recognised CCP, the entire move would need to be completed ahead of Brexit. The practical challenges to doing this seem insurmountable.

What do transition arrangements look like?

As it is evidently impractical, if not impossible, for all the reasons stated above to rearrange all positions in affected CCPs ahead of Brexit, it becomes necessary to consider transitional arrangements.

The objective of the transition arrangements is to ensure that although the regulatory position of a CCP changes at Brexit, there is no interruption in its regulatory status. In principle, this can be achieved in one of two ways:

- Pre-approval: carrying out the necessary regulatory reviews in advance of Brexit, so that UK CCPs operate under one regulatory regime up to Brexit (i.e. as authorised EU CCPs) and are able to carry on under a new regime immediately upon Brexit Day 1 (i.e. as non-EU ESMA/EMIR-recognised CCPs). This is the outcome which provides the most certainty from a legal and market stability perspective, but may be impossible to achieve within the time frame available, not least due to resource constraints at ESMA and the European Commission.
- Grandfathering: allowing CCPs to continue to operate under the old regulatory regime for a period of time while regulatory reviews are carried out to enable them to move to a new regime. For example, Article 89 of EMIR provides for CCPs to continue operating and offering services to EU clearing members and trading venues until regulatory equivalence agreements are reached with non-EU countries. Currently, however, there is no provision in EMIR contemplating a switch of CCP status straight from EMIR authorisation to EMIR recognition, so a legislative change would be required to make this possible.

Conclusions

The overarching objectives for policy towards CCPs after Brexit must be to avoid financial instability and minimise disruption to financial markets and the possible impact on the end-users of those markets (including end-users in the EU27). Ensuring a smooth transition in the status of CCPs in both the UK and the EU27 at Brexit is essential to achieving these objectives. This should be signalled as soon as possible, to prevent customers from making disruptive relocation decisions now, due to the prospect of a cliff edge in 2019.

This will require the following actions:

- The UK needs to put in place a domestic regulatory regime for CCPs incorporating the requirements of the key pieces of EU legislation that support CCPs (EMIR, the Settlement Finality and Financial Collateral Directives).
- In developing a capital regime for banks, the UK should use the opportunity to move away from requiring formal recognition of foreign CCPs.
- Both the UK and the EU27 should put in place arrangements to ensure a smooth transition upon Brexit Day 1 and allow time for new regulatory permissions to be put in place without disrupting markets.
- The UK and the EU27 should agree arrangements for mutual recognition of the key legal features underpinning CCPs (netting, margining and default management).
- The UK should ensure that banks in the UK continue to be able to use CCPs in countries outside the EU27 following Brexit by recognising those CCPs and replicating ESMA's co-operation arrangements with the non-EU CCPs' regulators.

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Workstream membership

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TheCityUK
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This paper presents the views of the Workstream as a whole. Individual members may dissent from some aspects of it.

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Annex 1

Countries that have achieved regulatory equivalence with the EU for CCPs[9]

Decision on 30.10.2014

Australia

Hong Kong

Japan

Singapore

Decision on 13.11.2015

Canada

Korea

Mexico

South Africa

Switzerland

Decision on 15.03.2016

USA (CFTC)

Decision on 16.12.2016

India

Brazil

New Zealand

Japan Commodities

United Arab Emirates

Dubai International Financial Centre

[9] Available at http://ec.europa.eu/finance/financial-markets/derivatives/index_en.htm.

The later dates of subsequent recognition by ESMA of CCPs in those jurisdictions are available at this link: https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf

Annex 2

UK bank participation in EU27 CCPs

Location of CCP	Name of CCP	Number of UK clearing members	% of total clearing membership
France:	LCH.Clearnet SA	33	32%
Italy:	CC&G	30	19%
Spain:	BME Clearing	25	17%
Sweden:	Nasdaq Clearing	23	17%
Germany:	Eurex Clearing	21	39%
Netherlands:	European CCP	15	34%
Hungary:	Keler CCP	13	10%
Austria:	CCP Austria	12	24%
Germany:	European Commodity Clearing	11	48%
Greece:	Athex Clear	5	7%
Netherlands:	ICE Clear Netherlands	2	50%
Portugal:	OMI Clear	2	6%

Annex 3

EU27 bank participation in UK CCPs

Country of origin	Number of discrete clearing memberships in UK CCPs
Germany	20
France	15
Netherlands	11
Spain	6
Sweden	5
Norway	3
Italy	3
Portugal	2
Denmark	2
Belgium	1
Luxembourg	1
Poland	1
Austria	1
Finland	1

Note: other banks from these countries will participate in UK CCPs as clients of clearing members.