EU Commission proposal for Third Country CCPs

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. 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.

The key points are:

Financial markets operate internationally. Many CCPs provide services cross-border and it is normal practice for the recipient country (the EU in this case) to set the requirements that CCPs have to meet, with the two objectives of making it possible for market users to have access to CCPs in third countries and to do so in a safe way.

However, we believe the EU's proposal goes further than necessary and risks damaging the interests of market users in the EU:

- The proposal requires third country CCPs that are considered systemically important to be recognised in the EU by fully applying EMIR requirements and being subject to direct supervision by ESMA and EU central banks. We believe the EU should place greater reliance on compliance with the CCP's home-country regime, provided this meets international standards, and not require compliance with EMIR. This would be in line with the practice of other countries.
- The proposal would require the CCP as a whole to comply, even if only certain services were systemically important in the EU. We believe the assessment of systemic importance should be conducted at the level of individual CCP services, provided that there are separate default funds and resources. This would be in line with the practice of other countries.
- The proposal includes the possibility of not recognising a third-country CCP on the basis of its systemic importance, even if it directly applied the EMIR requirements and was supervised by ESMA (the so-called "location policy"). This is more stringent than the practice of other countries.

There is a risk that these policies would deter international CCPs from providing services to users in the EU. In particular, a decision not to recognise a third-country CCP on systemic risk grounds would not necessarily result in that CCP relocating its business to the EU. It might relocate only a subset of its business or none at all. These developments would result in fragmentation of liquidity for market users in the EU with consequently higher costs.

If all or part of a CCP's business was relocated, this would mean closing positions in one CCP and re-opening them in another. Doing this between CCPs in different legal jurisdictions would be legally and operationally complex and expensive for end-users.

The proposal also requires CCPs to comply with requirements imposed by relevant EU central banks of issue "in the exercise of their monetary policy tasks". We believe that CCPs need to be reviewed from prudential and financial stability perspectives; not only a monetary policy perspective, and that prudential

requirements should take precedence. It will be important that the Bank of England and relevant EU central banks work together to agree an approach that will be appropriate not only for business as usual but also in conditions of market stress.

Implementation of the new arrangements is likely to overlap with the transition to post-Brexit arrangements. It is essential to agree arrangements to manage the transition of UK CCPs to the new regime, which may occur at Brexit or later; such transitional arrangements will be critical in any event.

A regulatory regime based on mutual recognition under international standards remains the long-term objective, to complement or supersede this proposal.

BACKGROUND

Summary of the proposal

The Commission is proposing to develop the existing third-country regime for CCPs located outside the EU, based on their systemic impact on the EU.

The Commission proposes (in effect) three tiers:

- Tier 1: non-systemically important – for these CCPs arrangements continue as now
- Tier 2: systemically important – these CCPs must meet further conditions (below)
- "Specifically substantial systemic significance" (SSSS) – these CCPs will not be recognised but must be established in EU

The determination whether a CCP is Tier 2 is based on four criteria: the nature, size and complexity of its business; the effect that its failure would have on financial stability of the EU; its clearing membership structure; and its interdependencies with other financial market infrastructures.

The requirements for Tier 2 CCPs are:

- Ongoing compliance with EU requirements (or home country requirements if deemed comparable);
- Written confirmation from the relevant EU central banks of issue that it complies with their requirements, including the type of collateral held, the level of haircuts, investment policy or collateral segregation and availability of liquidity arrangements between central banks;
- Direct supervision by ESMA, including guarantees of access to its data and to its premises by ESMA.

Comment on the overall implications of the proposal

The proposal does not *automatically* require a CCP clearing euro or any other business to be located inside the EU. Whether it will require this in practice will depend on a number of judgements described below.

This creates the possibility for UK-based Tier 2 CCPs to continue to operate under UK supervision, provided the Bank of England, ESMA and relevant EU central banks, notably the ECB, reach agreement.

However, the EU's conditions will apply to the CCP as a whole, not just its clearing activities in the EU. For example, if a US CCP was placed in Tier 2, that CCP as a whole would be required to comply with EU requirements[1]. It would be preferable if the requirement applied only to specified services of the CCP, so that EU regulators are in a position to focus their supervision on the CCP services actually provided in the EU. This is the approach of many regulators around the globe, including the CFTC, which only regulates parts of the CCP business for which the CCP offers services to US clients (via FCM) This means that in practice it does not regulate services provided by the CCP for which there is no US FCM.

[1] CFTC Acting Chairman Giancarlo has stated in response that they do not contemplate any change to the CFTC-EC Equivalence Agreement (statement on 20.06.2017).

The evolving practice of other jurisdictions has been towards adoption of parallel systems of authorisations and exemptions based on mutual recognition. For example, in addition to direct registration, the CFTC provides substituted compliance for a number of regulatory standards, meaning that it will defer to local regulation and not impose its own rules or intervene in the areas in which it has established the substitution. These include rules regarding financial resources (collateral and haircuts) and initial margin requirements[2]. In this sense the proposal of the Commission to allow for comparable compliance is in line with current practices.

Comment on the role of central banks

The proposal states that the requirements imposed by EU central banks of issue would be imposed "in the exercise of their monetary policy tasks". Based apparently on the experience of the euro area crisis of 2011-12, public comments[3] have appeared to suggest there may be a conflict between the prudential requirements of a CCP and monetary policy objectives. In a time of market stress, it may be necessary to find a difficult balance between the prudential requirements of an individual CCP, the stability of the financial system and broader economic objectives. While the Bank of England is in a position to make this balance, as it has prudential, financial stability and monetary policy objectives, the ECB, for example, does not have a financial stability objective in its Statute.

Any co-operative approach agreed between the Bank of England and relevant EU central banks, therefore, must confirm that in the interest of financial stability CCPs are expected to act in accordance with their risk policies and prudential requirements, provided these are consistent with International standards. These international standards include provisions for anti-procyclicality policies to balance the prudential requirements of the CCP and the need not to destabilise markets in times of market stress.

The ECB has proposed[4] an amendment to its statute to give it the power to make regulations for clearing systems. It is not clear whether this is intended simply to give the ECB competence to operate within the proposed EMIR framework or to go beyond it.

Comment on the implications of non-recognition

The decision that a CCP is SSSS and therefore must relocate within the EU is based on a judgement that the risks posed by that entity to the EU's financial stability are of such magnitude that "even a system of full application of EMIR ... is not enough to sufficiently mitigate such risks". In other words, classification of a CCP as SSSS is based on a judgement of its systemic importance, not on the adequacy of co-operation with its home country regulators. This decision is taken by the Commission on the recommendation of ESMA and relevant central banks of issue.

The objective of this proposal should be to develop a co-operative approach that makes it unnecessary to require relocation of a CCP. Consequently, the criteria for requiring relocation should not focus solely on

[2] CFTC Chairman Giancarlo reiterated the importance of mutual regulatory deference in an Op-Ed article in Les Echos (11.09.17): "increased application of deference is the path forward in the cross-border supervision of CCPs. In the post crisis world, there is simply no choice but to follow this path together."
http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlooped091117

[3] For example, "Certain CCP risk management practices, such as collateral haircuts, could have an impact on sovereign bond markets" (The International Role of the euro, ECB, July 2017, p.17).

[4] https://www.ecb.europa.eu/press/pr/date/2017/html/ecb.pr170623.en.html

the size of the CCP but on any systemic risks not addressed by the direct application of EMIR and supervision by ESMA or the home/domestic regulatory regime, as appropriate. The power to require relocation should not be used until it has been demonstrated that the enhanced third-country regime has been fully applied and is insufficient.

If the EU decided not to recognise a third-country CCP on systemic risk grounds, this would not necessarily result in that CCP relocating to the EU. For example, while the business cleared for EU participants by a third-country CCP might be considered of systemic importance to the EU, in many cases business with EU counterparties constitutes only a small proportion of the overall business of the CCP. It is implausible to suggest that a third-country CCP would necessarily relocate its entire business to the EU in order to continue clearing for EU participants; it could choose instead to cease offering clearing services to EU participants.

Declining to recognise a third-country CCP would have a number of consequences, depending on the type of institution and type of contract. EU banks and other institutions subject to capital requirements would face prohibitive capital requirements if they used an unrecognised CCP, effectively denying them access to the full range of derivatives offered for clearing in the market and to international liquidity, creating a captive EU market. It would also affect non-financial counterparties (NFCs). For derivatives subject to a clearing mandate, NFCs whose business is above the clearing threshold would be unable to clear them through an unrecognised CCP and would similarly lose access to international liquidity. However, NFCs below the clearing threshold could continue to access these derivatives by clearing through non-EU banks, as could NFCs above the clearing threshold for contracts not subject to a clearing mandate.

The consequence of a decision not to recognise a third-country CCP may be the relocation of some of the business of the CCP to another CCP inside the EU or another third-country CCP benefiting from ESMA recognition, rather than a relocation of the CCP itself. However, transfers of positions between CCPs in different jurisdictions raise serious practical difficulties and impose heavy costs, especially when they concern OTC positions.

- If a new CCP had to be established inside the EU to receive the business, the time and cost of obtaining authorisation under EMIR is considerable. Even if the positions were closed in the third-country CCP and re-opened in a CCP that was already authorised, it might need to obtain authorisation for the additional contracts it would be clearing.
- The move would need to be agreed and co-ordinated across all affected market participants. For OTC business, there would be no central entity to manage the process. Some clearing members or end-users located outside the EU might not agree to the move, resulting in fragmentation of liquidity.
- Some banks might need to become new members of the EU CCP, without necessarily being able to terminate their memberships of the non-EU CCP. Indeed, they would probably not want to terminate their existing membership of the non-EU CCP, even if they could, as they would wish to continue to provide access for non-EU clients. This would involve a very significant cost to such firms, as they would contribute additional billions of euros to the default funds of the EU CCP and hold capital against their exposure to it in addition to their contributions to the non-EU CCP.
- End-user clients would bear the cost of opening new accounts at the EU CCP, entering into new contracts and obtaining new legal opinions. To have their OTC positions cleared in the EU, they would need to trade out of positions in the non-EU CCP and trade into positions in the EU CCP, incurring

ticket costs, execution costs and funding additional margins for two CCPs during the process, as well as probably facing higher margin costs if the new market was smaller and less diversified.

- The high volume of additional activity required for the move would incur additional operational risks.
- It takes time to prepare, plan, obtain consent and execute these moves, so any decision not to recognise a third-country CCP must allow sufficient time before it takes effect.

The various possible consequences of non-recognition of a CCP are all likely to result in some form of market fragmentation, as market users would lose the ability to transact business in the largest possible pool of liquidity. Fragmentation adds to the costs paid by end-users, a point illustrated by the Governor of the Bank of England[5].

Timing and transition

Many of the questions about the operation of the proposed policies cannot be answered until the detailed criteria are specified and probably until they are seen in operation. This process is likely to stretch beyond the end of the Article 50 period, risking continued uncertainty about the post-Brexit regime for CCPs and adding complexity to a transition process that is already uncertain.

The proposals do not address the issue of how the transition of UK CCPs from authorised CCPs (inside the EU) to recognised Third-Country CCPs after Brexit will be managed. It remains essential that this is agreed. A potential overlap of the timing for Brexit and the introduction of changes to EMIR make clarification even more important. The preferred approach would be pre-recognition of the UK and UK CCPs to take effect immediately on Brexit. EMIR-recognised CCPs should benefit from a grandfathering clause on the model of the current Article 89 of EMIR.

This review has concentrated on the proposed changes to the regime for Third Country CCPs, on the assumption that the UK will be outside the EU by the time they take effect. It should be noted, however, that if UK CCPs remained subject to EMIR in some form as part of a future transitional arrangement, then the proposed changes to the regime for EU CCPs would become relevant.

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[5] In his Mansion House Speech, 20.06.17http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech983.pdf