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Recent developments on the resilience, recovery and resolution of Central Clearing Counterparties: where do we stand and why do the current discussions matter?

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In our financial systems, so far little-known pieces of infrastructures called Central Clearing Counterparties (CCPs) happen to be crucial to the proper operation of financial markets, by reducing the risks entailed by the riskier types of financial transactions that are concluded. The changes to financial regulation introduced after the 2008-2009 financial crisis have increased the importance of CCPs, and therefore the possible damage that the failure of one of these entities would cause to the entire financial system

In Poland, CCPs matter because of the role they play in integrated financial markets of which we are an integral part: our banks and assert managers are clients and members of CCPs. Poland also has its domestic CCP, KPDW, clearing derivatives as well as debt and equity instruments, that is, shares and bonds, denominated in zloty and in euro.

This is why much reflection has been conducted in international fora and proposals have been recently made at the European Union level in order to, first, establish a regime to deal with the failure of a CCP should it happen, and, second, enhance the supervision of CCPs and make the rules to which they have to obey tougher in order to reduce the likelihood that a CCP would fail in the first place.

Currently, the issue of CCPs has started to acquire political relevance beyond academic and technical circles and discussions and debates have taken a different tone in the context of Brexit. The reason for this is that the largest CCPs of the European Union are located in the UK and clear the vast majority of transactions taking place in euros in the Union.

Therefore, should no proper arrangement for the supervision of third country CCPs be found, the Union would theoretically be left with little to no control over entities that have a crucial importance for its financial system. All parties are aware of the problems and the challenge will now be to find the proper solution to this issue and the proper degree of oversight over third country, including UK, CCPs.

What is central clearing? Why has it been developing over the last decade? What are the new risks associated with the rise of central clearing?

Basics of central clearing

A central clearing counterparty is defined in the texts of international bodies and in EU regulations as an entity *"that interposes itself between the counterparties to the contracts*

traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer".

In concrete terms this means that, when a financial transaction is cleared, the original contract between the two parties is cancelled and replaced by two contracts, in each of which the CCP will replace one of the original parties. There will be a first contract between the CCP and the originally selling party in which the CCP buys the product from the original seller and a second one between the CCP and the original buyer in which the CCP sells the product bought from the original seller to the original buyer.

In economic terms, the end result is the same as with the original transaction. However, the intervention of the CCP makes two crucial differences.

First, in all the new transactions created, one of the counterparties will always be the CCP. This implies that one of the counterparties to the original transaction might fail while the other counterparty will still be able to receive the payments due to it since, after clearing, such payment obligations have become obligations of the CCP. This addresses a risk known as counterparty credit risk, that is, the risk that an entity might default before having honoured its obligations such as making the scheduled payments or delivering the securities agreed on, under the transactions it has entered into.

In this context, the role of the CCP will be to specialise in risk assessment and risk management and to implement practices aiming to collect enough available resources to address the risks of failure from their participants. This way they will remain sure that they themselves can remain sound and able to meet all their commitments. The resources, in the form of cash or very high quality assets, are collected in an amount reflecting the probability, calculated using mathematical models, of the counterparty defaulting over the time of the transaction. To these so-called "initial margins" can be added "variation margins", that is, adjustments made to reflect market fluctuations, as well as, as the case may be, specific additional charges on some entities addressing targeted additional risks.

Secondly, the fact that a CCP will centralise a large number of transactions will allow it to treat the batch of transactions it deals with more efficiently. In particular, treating a large number of operations will enable the CCP to perform, when this is legally allowed, what is known as "multilateral netting", that is, offsetting groups or parts of transactions that, put together, reach the same amount but are of opposite directions. To take a simplifying example, if the CCP owes, in total from different transactions it entered into and at a point in time, 10 million euros to an entity but has already received 8 million euros from the same entity, it will only have to pay this entity 2 million euros. Since with this system the final monetary amounts circulating are lower than they would otherwise be, netting reduces the need for cash in the financial system as well as the risks associated with the processing and performing of the payments.

Economically, clearing is a service that CCPs provide to members, typically large banks, which make contracts and open accounts directly with them. Since membership comes with costs, for instance the requirement to contribute to a specific default fund to be used in case the CCP would incur losses that margins would not be enough to cover, smaller entities such as small banks or asset managers do not become members in order to clear their transactions. They instead access clearing indirectly, through opening accounts with members, of which they are clients, and making contracts with them.

Importance of CCPs for the financial system

All transactions can be cleared, but the benefits are more obvious for some types of transactions.

While counterparty credit risk is not a prominent risk for transactions that are one-off events, such as the sale or purchase of shares, it is very present in a wide range of more sophisticated transactions that are very common and play a crucial role on financial markets. This is so because all these transactions involve actions to be performed either in the future or sequentially over a certain period of time, therefore making it essential that the actors involved do not default during the period considered.

One example is the whole class of transactions known as “derivatives”. These include products such as: swaps, that is the exchange between two market actors of cash flows stemming from different origins over a certain period; options, that is the right to buy or sell at a future date a certain product at a certain price pre-agreed at the time of the transaction, or futures, that is, a firm commitment to buy or sell at a future date a certain product at a certain price pre-agreed at the time of the transaction. Widely used, derivatives are part of strategies that allow to reduce risk on financial markets: for instance, options and futures can act as an insurance by putting a ceiling or a floor on the price of the product concerned for the counterparty concerned. Strategies relying on derivatives can thus have very concrete implications on the real economy, allowing importers and exporters to reduce the risks stemming from exchange rate fluctuations or banks to offer credit to borrowers at fixed rates instead of floating ones.

Another example of such important transactions involving a sequence of actions is this of repurchase operations or “repos” which consist in obtaining cash in exchange for a security for a certain period and, at the expiration of the period, giving back the cash and getting back the security. These transactions play a vital role in facilitating the smooth functioning of financial markets since they allow actors to obtain cash when they need it. They are also, crucially, the operations used by central banks to implement their monetary policy.

This overview shows the importance of making these transactions safe and reducing counterparty credit risk, something that CCPs, which have existed for decades but were not attracting very much attention from regulators and legislators until the 2008-2009 financial crisis, are the best placed to do. This is why the leaders of the G20 at the 2009 Pittsburgh summit took the commitment to have all derivative transactions that were not traded on regulated financial markets and that had standard characteristics cleared through CCPs.

Implementation of the Pittsburgh agenda in the EU and EMIR regulation

In the EU, the Pittsburgh agenda started to be implemented by the 2012 European Market Infrastructure Regulation (EMIR).

This regulation established, among others, the whole framework for the authorisation and supervision of CCPs in the EU, basic rules on margining, stress testing of models, and other risk mitigation practices as well as elements on the procedure to follow when the CCP is exposed to a loss and the order in which resources (margins, CCP’s resources, contributions

to the default fund) have to be used in such cases. Most of these rules are further refined in related technical texts.

Most importantly, and directly transposing the Pittsburgh commitment, EMIR introduced a so-called “clearing obligation” for derivative transactions. It applies to those types of derivatives that are identified as suitable for the clearing obligation by the European Securities Market Authority (ESMA), after an investigation that takes as a starting point the list of products currently cleared by CCPs authorised in the Union. Once the derivative has been identified, the entry into force of the obligation is phased-in by type of counterparty. Entities already clearing transactions voluntarily are subject to the requirement first, then larger entities active on derivative markets, and then small entities and entities that are not financial market actors.

The clearing obligation took time to be designed and implemented, starting to apply only in June 2016 for the most common types of derivatives, Interest Rate Swaps. Today, the largest counterparties must clear their interest rate swaps in a variety of currencies as well as some types of Credit Default Swaps (type of financial contract that is analogous to an insurance contract giving right to a payment in case of a default of a specific entity). However, the entry into force of the clearing obligation on these derivatives has been delayed by two years for small financial counterparties due to evidence of the difficulty for those actors to access clearing.

New challenges and international workstreams

As briefly mentioned above, the condition for mandatory clearing to act as an effective risk-reducing measure is that CCPs have in place proper measures in order to be resilient counterparties. CCPs do not actively take risk, but they remove from the transactions and concentrate within themselves the risk created by all the derivative transactions to which they are counterparties.

This is why specific attention should be paid to making CCPs resilient and make sure they have no interest in implementing lax risk management standards. Clearly enough, the resilience of CCPs becomes even more important as more and more transactions must be and are cleared, and in a context in which there are very few existing CCPs clearing huge amounts of transactions. For instance, there are only 17 CCPs recognised in the EU, and, if the focus is only on the types of derivatives cleared, the offer is even narrower as many European CCPs treat only a few types of derivatives.

In addition, large CCPs are heavily interconnected. They can be interconnected through membership of financial institutions in several CCPs, meaning that if such an institution is in trouble, it is likely that it will default in two or more CCPs and not only in one. They might also be interconnected, to a various extent depending on the service considered, through services such as the processing of payment, or the safekeeping of assets received as collateral, when such services are provided by one single entity to several CCPs. This results in almost all CCPs being, as one would say of very large banks, systemically significant institutions, the failure of which can have tremendous negative effects on the financial system or the real economy.

In this situation, international work in order to guide legislation has been conducted on the issue of the resilience of CCPs and recommendations have been made in order to allow for

a common approach by all jurisdictions on an issue which, given the global scale of derivative markets, is global in nature.

In April 2012, the International Organisation of Securities Exchanges Commission (IOSCO) released the Principles for Financial Market Infrastructures (PFMI), part of which concerned CCPs and guided the work on EMIR and related technical texts. The current feedback is that these rules have been transposed and working well in the EU, but the reflection on CCP resilience keeps being refined and addressing new areas such as stress testing.

In parallel, in a context where CCPs have become systemic, attention also started to be paid to designing a specific system for the management of the failure of a CCP.

The current standards set by current rules and regulations for CCPs are high and the rules applying to banks offer another line of defence, as banks are subject to capital requirements and recovery and resolution regimes, which reduces the risk that a bank which is a member of a CCP might fail and in turn cause the CCP to incur losses that would cause it to fail. Therefore, the failure of a CCP should be an extremely limited risk, a “tail of the tail event”.

However, setting rules to apply in such cases and ensuring that CCPs are prepared to face such a situation would bring benefits by increasing certainty and improving discipline.

This is why international fora started to reflect on the recovery of CCPs, that is, the actions to be taken to restore the financial position on a CCP in case it is in distress but has not reached the point where its liquidity or solvency is threatened. They also started to reflect on the resolution of CCPs, that is, an alternative regime to insolvency, to be implemented after recovery has failed and if insolvency is not assessed as preferable, aimed to allocate losses and deal with the failure in an orderly way.

Unlike resilience, there is currently no EU legislation governing the recovery and resolution of CCPs, although such a regime has been designed for banks at the global level and implemented in the EU through the Bank Recovery and Resolution Directive.

In 2015 the IOSCO, the Committee on Payments and Market Infrastructures (CPMI) and the Financial Stability Board (FSB) jointly agreed on a workplan including work on the “three Rs”: CCPs’ resilience, recovery and resolution. The CPMI and ISOCO were to work jointly on principles regarding resilience and recovery and the FSB, on its side, was to work on principles regarding resolution.

This workplan was completed last 5 July 2017 with three final guidance documents: one on resilience from the CPMI and the ISOCO, further refining some elements of the PFMI; one on recovery from the CPMI and the IOSCO, and one on resolution from the FSB. It remains now for jurisdictions, of which the EU, to implement the guidance.

Next international priorities in the area of CCPs include the continued monitoring of the implementation of all the agreed principles, the finalisation of the framework on supervisory stress testing for CCPs, and further analysis on three issues: the financial resources that CCPs should hold to support resolution, the interdependencies between CCPs and the impact of post-crisis reforms on the incentives to clear.

What are the current developments at the EU level in relation to CCPs? How do the international and Brexit agenda interact?

The CCP recovery and resolution proposal and its current challenges

In November 2016, the European Commission issued a proposal for a regulation establishing a recovery and resolution regime for CCPs. The proposal adheres closely to the principles agreed internationally. Those were not fully finalised by the time of the release of the proposal, but the Commission took the utmost account of the discussions and draft guidance existing back then. The proposal was actually scheduled for autumn 2015 but was delayed by one year in order to await further and more substantial international work.

The proposal also closely mirrors the existing BRRD applicable to banks, with the basic structure, the procedural elements and some tools available to the authorities conducting resolution being identical in both texts.

As it is the case for banks, the text would require member States to establish ad hoc authorities in charge of resolution. CCPs will have to establish recovery plans setting out the strategies they would follow in a case of financial distress and for the implementation of which they would be responsible, which will have to be validated by resolution authorities. CCP supervisors would be able, before entering resolution, to take early intervention measures. Finally, resolution authorities will draw up resolution plans that they would activate and for the implementation of which they would be responsible in case some liquidity and solvency criteria are met that signal that the financial situation of the CCP has been deteriorating too much. Tools and powers are listed that would allow resolution authorities to allocate losses and/or allow CCP to return to a risk-neutral position, to sell a CCP to a willing purchaser or to leave the CCP to operate temporarily as a bridge institution with relaxed regulation.

The file is now being discussed by the co-legislators, the European Parliament and the Council of the Union.

One of the main challenges will be to make sure that the different tools are suited to the case of CCPs, which have a business model which is different from this of banks. For instance, their balance sheet composition is different, which means that the resources that will be available to cover losses will not the the same as banks (margins and default fund contributions rather than capital). Also, CCPs are not part of large groups carrying similar activities in different countries and do not create branches and subsidiaries but are part of groups, typically owned by companies operating trading platforms, that own different types of financial market infrastructures intervening at different stages of the process following the conclusion of transactions. This has implications for the provisions concerning the resources that parent companies can give to CCPs. Some of the tools introduced in the current proposal, such as the right for resolution authorities to ask for additional cash contributions, to cancel some contracts as a last resort, or to reduce some of the gains that CCPs should pay to their members, are specifically suited to the case of CCPs. Some other tools such as the temporarily operating a CCPs that will keep conducting part of its activities and be progressively wound down are borrowed from the regime applying to banks and it is less sure how they will operate in practice.

Anther challenges will relate to the degree of prescriptiveness of the legislation, concerning in particular recovery plans. The text should be clear enough to provide legal certainty and prevent diverging approaches across CCPs and resolution authorities but it should also

leave enough flexibility to deal with a situation that we know to be, by definition, extreme and with low probability of happening.

There is also a need to keep consistency with the incentives established in EMIR and with the rules already set in EMIR concerning the management of a default. This interaction will have in particular consequences on the reflection on the rules concerning the compensation of creditors, who, according to international rules, have to be compensated if resolution has been implemented and they find themselves worse off than if insolvency had been chosen. In the case of banks, performing the comparison between the outcomes of, respectively, resolution and insolvency is straightforward enough. However, in the case of CCPs, account needs to be taken of a specific already-existing system set out in law but different from insolvency: the EMIR default management procedure.

There will also be a need to distinguish better between situations where it is the failure of a member, typically a bank, that cause the CCP to incur losses and be failing and situations where the losses arise from other reasons, most of which are, unlike the actions of their members, within the control of the CCP such as losses from cyber-attacks, losses on investments made by the CCPs, human and technical errors within the CCP. Both situations will show differently on the accounts of the CCP, entail different responsibilities, and call for different strategies to address them. Therefore, clear distinctions or even distinct sections in recovery and resolution plans might be warranted.

Finally, a last point has changed meaning with the start of the Brexit. It so happens that, for CCPs having activities in several EU member States, which is most of them, decisions on the approval of recovery plans and on resolution plans will be taken by a college comprising representatives from the ESMA, from the European Banking Authority and from a series of supervisors and central banks from relevant countries, for instance the supervisor of the largest clearing members or the central banks of issues of the most relevant Union currencies of the financial instruments cleared. This is the same structure as what exists in EMIR for the supervision of cross-border CCPs but might be too cumbersome for the purposes of resolution actions where swift decision is needed. Reflections have started on the ways of streamlining the system.

However, this specific issue is now being looked at from a very different angle with the departure of the UK from the European Union. Four CCPs out of seventeen, and among them the largest and more diversified ones, are located in the UK. With the UK out of the EU, a new system will have to be found for their supervision. This, from a continental European perspective, also reinforces the case for a single European supervisor for CCPs, as, in the EU-27, few countries will have CCPs on their territory and few regulators will have experience with these entities.

This is a distinct issue from this of recovery and resolution, but will need to be kept in mind when debating on the institutional arrangements for recovery and resolution as a single European supervisor would need to be matched, in order to avoid conflicts of objectives and diverging incentives, by a single European resolution authority.

Brexit and new developments on CCP supervision

A review of EMIR was scheduled for end-2015 and ESMA published a series of four reports analysing the implementation of the regulation in order to guide the review. However, the legislative proposal was delayed and finally scheduled for spring 2017.

By this time, Brexit negotiations were set to begin and regulators became aware that, once the UK had left the Union, the current regime for the supervision of third country CCPs would be wholly unsuited to a situation in which for instance LCH clearnet, the largest EU CCP located in the UK, which processes up to three-quarters of global euro-denominated derivatives and clears a notional (that is, the gross amount covered by a given contract) 850 billion euros a day would be outside the regulatory perimeter of the Union.

Already in 2011, the European Central Bank had brought a case, which it had lost, to the European Court of Justice in defence of a rule that would have forced the clearing of financial products denominated in euros to take place in the euro area should its volume exceed a certain threshold.

Therefore, voices have started to be heard in favour of requiring the clearing of euro denominated products to take place in the EU.

This measure, according to its proponents, would allow to control the practices of CCPs better. It would also avoid a situation where the CCPs taking the risk belong to one jurisdiction and the entities facing the cost of these risks, that is national authorities and the European Central Bank, which will be responsible for providing liquidity in euros in case a CCP experiences trouble in its euro-denominated business, will be somewhere else.

However, this solution would have the drawback of fragmenting markets and reducing the possibility for CCPs to take advantage of the large number of transactions they process in order to net them and make the market more liquid, thereby likely resulting in increased costs for all actors. It would also mean making the choice of imposing the location of activities instead of leaving market forces decide, without guarantees that the outcome would be economically viable. It would also require existing CCPs in continental Europe to be able to take on additional volumes of transactions and regulators of continental European countries to which the transactions would move to be able to supervise this type of activities.

In any case, relocation would require time for it to happen and for actors to adapt.

A less disruptive, more proportionate option to address valid concerns from each side would be to improve the supervision of third country CCPs, the current regime for which, relying heavily on the supervision of the home country, was perceived as too weak anyway.

In order to accommodate diverging views and interests, the Commission decided to proceed with the review of EMIR in May 2017, but to limit itself to purely technical issues identified by ESMA in its report and not to touch on the issue of CCP supervision.

Then, in June, it issued a proposal dealing exclusively with the supervision of CCP that would introduce a more European approach to CCP supervision and a stricter regime for third country CCPs.

A so-called “CCP executive session”, possible embryo of a European supervisor, would be created within ESMA’s board. It would be dedicated to CCP issues and representatives of the central banks of issue of the main currencies cleared will sit there but with no voting rights. The central bank of issue of the main currencies cleared would also need to give consent to a series of key supervisory decisions such as those relating to the access of CCPs to other CCPs and to other financial market infrastructures, the authorisation and recognition of CCPs, outsourcing and stress testing.

Concerning third country CCPs, the proposal classifies them into two groups.

Tier 1 CCPs, not deemed systemically significant for the Union, would continue to be governed by the current recognition regime, where ESMA is supervisor but relies largely on third country national competent authorities.

Tier 2, “systemically significant”, CCPs would not only have to be subject to requirements comparable to those set out in EMIR but also accept, in order to get equivalence, enhanced requirements relating to the provision of information to ESMA and the right of ESMA to conduct on site-inspections.

The classification of a CCP as Tier 1 or 2 will be made by ESMA on the basis of criteria more or less similar to these used to identify globally systemically significant banks such as the nature, size and complexity of the CCP's business, and the effect that the failure of or a disruption to the CCP would have on financial markets in the Union. These criteria would be further specified by the Commission in a delegated act.

An article of the proposal would finally empower ESMA, in agreement with the relevant central banks of issue and “commensurate with the degree of systemic importance of the CCP”, to declare that a CCP is of such substantial systemic importance that even compliance with the conditions imposed on Tier 2 CCPs does not sufficiently ensure the financial stability of the Union. In such a case, ESMA will recommend that the Commission adopt an implementing act confirming that that CCP should not be granted equivalence. The Commission then may follow the recommendation and oblige the CCP to be recognised in the EU.

In parallel, the ECB issued last June a proposal for a decision amending article 22 of its statute in order to clarify its mandate over CCP oversight. In light of the decision of the European Court of Justice in the judgement relating to the location policy, in which the court ruled that the ECB had no clear mandate concerning CCP oversight, the change is seen as necessary for the ECB to be able to take on the new tasks given by the June Commission proposal.

These two proposals leave the door open to many different approaches and the final architecture for CCP supervision in the EU will now depend on the negotiations within and between the different institutions as well as, probably, on the fate of the Brexit negotiations.