Brexit Seminar:
EQUIVALENCE OF THIRD COUNTRY CCPS

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I. Introduction

1. Background: European Commission reform proposals

- Proposal for a Regulation on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365

- EMIR reform proposals:

  - Proposal for a Regulation amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories, COM(2017)208
    (EMIR I Commission's proposal)
  - Proposal for a Regulation amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, COM(2017)331
    (EMIR II Commission's proposal)
  - Amendment of pending proposal for a Regulation amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (EMIR II Commission's proposal), COM(2017)539

2. Background: Eurozone vs. City-clearing

- The European clearing industry is concentrated on the providers' side
- 17 authorized CCPs; only 10 also authorized to clear at least one class of derivatives
- 6 CCPs are authorized to offer IRS clearing; 2 clear most European CDS and foreign currency derivatives
- 4 CCPs clear all three classes; all but one are registered in the UK and subject to Bank of England's supervision
- 2 U.S. CCPs operate from London
- City CCPs account for default resources of more than 90 billion British Pounds, a staggering amount considered the relatively small tax base of the UK
- The City-centricity of clearing infrastructures has historically raised concerns, particularly with regard to the fact that most euro-denominated clearing takes place outside the Eurozone and ECB direct oversight

- These concerns originated the well-known controversy between the ECB and the British government, concerning the so called “location policy”
- In 2011 the ECB issued a binding policy requiring CCPs which settled in euro to be legally incorporated and have full managerial and operational control in the Eurozone
- The UK government questioned its legitimacy bringing a case against the central bank in front of the European Court of Justice
- The ECJ decided the case in 2015 in favour of the UK government and its clearing industry, excluding a regulatory competence of the ECB over CCPs
- However, the question was solved in practice with the adoption of EMIR, which filled the regulatory and supervisory gaps regarding CCPs
- The ECB and the BoE committed to develop the existent liquidity swap lines in order to support the liquidity risk management of CCPs

II. Equivalence

1. Current situation

- Under Article 25 EMIR, a third country CCP may provide clearing services to clearing members or trading venues established in the Union only where it is recognised by ESMA
- ESMA may recognise a CCP established in a third country only after that the Commission has adopted an implementing act determining that
  - the legal and supervisory arrangements of that country ensure that CCPs comply with legally binding requirements which are equivalent
  - CCPs are subject to effective supervision and enforcement
  - the legal framework of the third-country provides for an effective equivalent system for the recognition of CCPs authorised under other countries' legal regimes
  - ESMA will recognise a CCP after consulting all competent authorities

2. EMIR II Commission's proposal

- In view of the growing importance of foreign CCPs for the Union, the Commission suggests
  - to strengthen the EU's ability to identify, monitor and mitigate the financial stability risks posed by non-EU domiciled CCPs
  - to enhance the role of ESMA and of the relevant Union's central banks in relation to financial instruments denominated in Union currencies that are cleared in CCPs located outside the Union

- The proposal introduces a new binary classification for recognized third-country CCPs:
  - 'Tier one' CCPs that do not pose a material threat to the EU financial stability
  - 'Tier two' CCPs that are, or are likely to become, systemically important to the financial stability of the Union or its Member States

- Tier 2 CCPs will have to comply with
  - the “requirements set out in Article 16 and in Titles IV and V” of EMIR” (subject to “comparable compliance”)
  - the requirements imposed by the central banks of issue
- will have to consent to provide information within 72 h and to admit to unannounced on-site inspections
- and will be subject to direct supervision by ESMA and by the relevant Union’s central banks
- If ESMA and the relevant central banks conclude that a ‘Tier2’ CCP is of such systemic importance that even additional requirements will not sufficiently guarantee the financial stability of the EU (‘Tier2+’), the Commission may (!) adopt an implementing act declaring that the CCP will not be recognised: sometimes referred to as “location decision” (misleading since not requiring relocation)

3. Preliminary evaluation

- The proposed reform would enhance the powers of ESMA and the relevant CBIs to regulate and supervise CCPs from a financial stability perspective
- Third country CCPs recognized as systemically important would become subject to the same requirements that apply to EU CCPs, so as to ensure a level playing field between EU and foreign clearing providers.
- However, they would fall under a double compliance regime, which would raise compliance costs while giving rise to conflicts of rules
- The mechanism of “comparable compliance” appears to be crucial
  - for mitigating the extraterritorial effects of the draft Art. 25(2b)
  - for limiting the costs at issue.

But:

- The non-cooperative nature of Art. 25, i.e. the combination of
  - providing for extensive additional prudential and compliance requirements which are all CCP-based and not service based

  and
  - applying them in a non-cooperative way

  creates the potential for severe international tensions (e.g., strong public statements by the Chairman of the CFTC)

- The location requirement which EU authorities could impose on the largest Tier 2 CCPs could act as a deterrent to the expansion of their clearing volumes beyond a given threshold, indirectly causing fragmentation of the clearing market (impact on scale efficiencies)

- The enhanced equivalence framework raises further concerns from the financial stability perspective
  - FSB has recognized that appropriate liquidity arrangements for CCPs in each currency that they clear is one of four basic safeguards for central clearing
  - Yet:
    - EMIR does not consider the need for mutual central banking support of CCPs in a third country
    - The equivalence framework does not address the need for liquidity swap agreements between central banks in support of clearing infrastructure
  - On the other hand: the omission denies the ECB an independent role in determining whether a CCP can be recognised

4. Additional aspects

- Transitional aspects
  - Treatment of already recognized third-country CCPs

- Treatment of UK CCPs
  - Advanced (conditional) recognition prior to reform entering into force?
  - Possible without a Commission Delegated Regulation specifying the criteria for determining whether a CCP is to be classified as a Tier 2/Tier 2+ CCP?

  - Consequences of a hard Brexit with no prior CCP-recognition
    - Financial institutions: higher capital requirements apply
    - Derivatives contracts which are subject to the EMIR clearing requirement: void?
      - If yes: recognised by English courts
      - If not:
        - Transfer of portfolio is (theoretically) possible
          - But requires consent of all
        - Otherwise counterparty has to terminate contract (costly)

5. The core question: LCH Swapclear as the core

- The Interest Rate Swap (IRS) sector represents 85% of the value of outstanding derivatives in Europe and more than one trillion € in notional value cleared daily, with LCH Swapclear servicing more than 95% of the overall European market

- Any way of of not qualifying LCH Swapclear as a Tier 2+/Tier 3 CCP?

III. Alternative solutions

- Expanding the ECB‘s role by amending Art. 22 ECB Statute?
  - Ordinary legislative procedure (no UK veto position)

- A more cooperative approach with respect to Tier 2 CCPs
  - Scaling back the approach: from CCP-based to services-based approach
  - Providing for the possibility of joint decision-taking if the third country agrees to the model (internationalisation of the college of supervisors-model)

- Others?