ISDA Safe, Efficient Markets

Revisiting EU authorities' concerns with regards to clearing at UK Tier 2 CCPs

Introduction

1. The purpose of this note is to discuss the argument put forward by EU authorities that clearing at UK Tier 2 CCPs carries a financial stability risk, as well as risks to monetary policy implementation. First, we highlight that the Tier 2 designation depends largely on the CCPs' size, which does not translate into increased risk, if the CCPs are subject to appropriate risk management and supervision. Second, we note that EMIR 2.2 precisely ensures that: UK Tier 2 CCPs are held to the exact same standards as EU CCPs, further to EMIR 2.2, and are directly supervised by ESMA in addition to being supervised by the Bank of England. This affords EU authorities robust safeguards in a recovery scenario. As such, clearing at UK CCPs is not riskier than clearing at EU CCPs. Third, we discuss concerns in relation to risks to monetary policy implementation. Finally, we discuss any remaining crisis scenario concerns.

Size is a significant driver in the Tier 2 designation process

2. The introduction of the clearing mandates, after the Global Financial Crisis, have led to considerably larger exposures to CCPs. As noted in a Banque de France Financial Stability Review article (April 2017)[1], "*[t]his in itself is not a concern*", because subject to appropriate risk management, *"they act as risk poolers, not risk takers, and they therefore reduce the overall level of risk in the global financial system (not to mention other benefits such as a more efficient use of scarce collateral)."*

3. Whether a CCP is large does not mean it is riskier: as evidenced by recent episodes of market stress, a default event at a small CCP can have significant effects on other market participants, as for example in the case of the default of a clearing member at Nasdaq AB in Sweden, which led to the consumption of two-third of the CCP's default fund. In fact, CCPs which are smaller in size, even if they may not be seen as systemic, may present with risks of their own, such as risks arising from a more concentrated market.

4. What matters when considering the riskiness of a CCP are the standards to which the CCP is held – and EMIR 2.2. ensures that those third country CCPs that are deemed systemically important and designated as "Tier 2" are subject to the exact same standards as EU CCPs. Consequently, the designation of CCP as "Tier 2" does not mean that it is inherently riskier than a comparable CCP established in the EU.

[1] Central clearing: reaping the benefits, controlling the risks (Banque de France Financial Stability Review, 20 April 2017) (bis.org)

5. Among the criteria taken into consideration for the designation of a CCP as "Tier 2", size is a significant driver:

    - As set out in EMIR Article 25(2a), when designating a third country CCP as a Tier 2 CCP, ESMA should take into account the "*nature, size and complexity of the CCP's business in the Union*", "*the effect that the failure of or a disruption to the CCP would have*" on financial markets and EU financial stability, the CCP's membership structure, the extent to which alternative services exist for instruments denominated in EU currencies, and the degree of interconnectedness of the CCP.

    - These criteria are further set out in the Tiering Delegated Act[2], which includes **quantitative thresholds** in its Article 6, in relation to: *(a) the **maximum open interest** of securities transactions, including securities financing transactions, or exchange traded derivatives denominated in Union currencies cleared by the CCP […]; (b) the **maximum notional outstanding** of OTC derivatives transactions denominated in Union currencies cleared by the CCP […]; (c) the **average aggregated margin requirement and default fund contributions** for accounts held at the CCP by clearing members that are entities established in the Union […]; (d) the **estimated largest payment obligation** committed by entities established in the Union or part of a group subject to consolidated supervision in the Union […] in a cover-2 scenario.*

EMIR 2.2. ensures that Tier 2 CCPs are held to the same standards as EU CCPs, under direct supervision from ESMA

Requirement for compliance with EMIR

6. As set out under Article 25 (2b), ESMA shall only recognise the services at a Tier 2 CCP if the CCP complies, "*on an ongoing basis*", with the requirements set out under:
    - Article 16: Tier 2 CCPs have to comply with capital requirements as set out in EMIR;
    - Title IV: Tier 2 CCPs have to comply with all the requirements in EMIR for CCPs in terms of organisational requirements (governance, record keeping, information to competent authorities, business continuity, conflicts of interest), conduct of business (participation requirements, transparency, segregation), prudential requirements (margin, default funds, liquidity risk controls, collateral requirements, investment policy, default procedures),
    - Title V: Tier 2 CCPs have to comply with all the requirements in EMIR in relation to interoperability arrangements.

ESMA supervision and consultation of central banks of issue

What does EMIR 2.2 say?

7. As set out under Article 25b(1), ESMA is responsible for supervising the compliance of Tier 2 CCPs with these requirements, on an ongoing basis, in addition to the BoE.

[2] EUR-Lex - 32020R1303 - EN - EUR-Lex (europa.eu)

8. With regards to Article 41 (margin requirements), 44 (liquidity risk controls), 46 (collateral requirements), 50 (settlement) and 54 (approval of interoperability arrangements), ESMA is required to consult the central banks of issue in the EU (i.e. the ECB for euro-denominated products).

9. As a result, ESMA and the ECB have significant powers over the models and parameters used by the Tier 2 CCP, and Tier 2 CCP have to comply with the EMIR requirements in relation to margin requirements and collateral haircuts, including the requirement set out under Article 41 of the EMIR RTS[3], setting out that *"the CCP shall demonstrate to the competent authority that haircuts are calculated in a conservative manner to limit as far as possible procyclical effects."*

10. These powers are relevant to the concern expressed by ESMA in its December 2021 report, around *"[t]he crisis management scenario where LCH Ltd may decide to change margin and collateral requirements [which] could affect the financing conditions for EU banks"*. The powers afforded to ESMA by EMIR 2.2, as highlighted above, ensure that **ESMA is able to supervise Tier 2 CCPs' compliance with EMIR in relation to any decision related to changes in margin and collateral requirements**, such that the concerns set out by ESMA in relation to changes in margin and collateral requirements are not left unaddressed.

How does ESMA supervision work in practice?

11. **In concrete terms, the EMIR 2.2 supervisory framework for Tier 2 CCPs entails the following:**
    - **Regular technical meetings** with ESMA at a working level;
    - **Annual confirmation by the Tier 2 CCP of ongoing compliance with EU EMIR**, which is a very extensive exercise (comprising around 100 supporting documents);
    - ESMA has **clear visibility of all Tier 2 current and future initiatives every 4 months**;
    - ESMA reviews **Tier 2 risk models changes** and can ask for amendments. Initiatives cannot be implemented unless they have been **validated by ESMA** first;
    - Tier 2 CCPs are required to send **qualitative and quantitative reports directly to ESMA** as part of bespoke **ESMA's data reporting requirements**;
    - Tier 2 CCPs work on deep dive reviews **on selected areas that are initiated by ESMA** or jointly with BoE;
    - ESMA can conduct **regular meetings with senior management and Board Directors**.

12. **In summary, by requiring Tier 2 CCPs to comply with Article 16 and Title IV *"on an ongoing basis"* as set out in EMIR, under supervision by ESMA, Tier 2 CCPs are held to exactly the same prudential requirements as EU CCPs, and are therefore not riskier.**

Supervision, cooperation and enforcement

13. To carry out its supervisory tasks vis-à-vis Tier 2 CCPs, EMIR 2.2 sets out that ESMA shall establish a college for third-country CCPs *(Article 25c).* This college shall notably include EU competent authorities for EU CCPs and competent authorities responsible for the supervision of the clearing members established in the EU – which means that **prudential supervisors in**

[3] EUR-Lex - 02013R0153-20160615 - EN - EUR-Lex (europa.eu)

the EU are involved in the supervisory decisions that have a bearing on Tier 2 CCPs where the banks that they supervise are members.

14. **As set out under Article 25(7), cooperation arrangements** are required to provide for mechanisms that provide EU authorities with **ample and prompt information in business-as-usual circumstances and crisis situations.** This includes: mechanisms enabling ESMA to request any additional information (paragraph (a)) and conduct investigation and on-site inspection in the third country CCP (paragraph d)) and mechanisms for third-country authorities to inform ESMA, the third-country CCP college, central banks of issue "*without undue delay of any* ***emergency situations relating to the recognised CCP, including developments in financial markets, which may have an adverse effect on market liquidity and the stability of the financial system in the Union or one of its Member States and the procedures and contingency plans to address such situations"*** (paragraph (g)).

15. The cooperation arrangements should also include mechanisms requiring third country authorities *"to* ***assure the effective enforcement of decisions adopted by ESMA*** *in accordance with Articles 25b, 25f to 25m, 25p and 25q"* (paragraph (f)). These decisions relate to any of the following supervision action from ESMA: request for information, general investigations, on-site inspections, supervisory measures in the case of infringements, fines, penalties, withdrawal of recognition. For all these decisions, the third-country authority responsible for the supervision of the Tier 2 CCP is required to "*assure [their] effective enforcement*", which means that **ESMA's supervisory roles also comes with enforcement powers, which cannot be overruled by the third-country supervisory authority**.

EU central banks of issue also have powers to address any concerns pertaining to monetary policy

16. In its assessments of UK Tier 2 CCPs (December 2021), ESMA noted that central banks of issue in the EU *"may consider SwapClear as systemically important service for the implementation of their monetary policy and for the financial stability of their currency area."* Similarly, ESMA also noted that *"[w]ith respect to ICEU's F&O segment, the assessment finds that the euro-denominated STIR derivatives are instruments of importance for the monetary policy of the euro area and as such are at the nexus of the EU financial system."*

17. We agree that the ***trading*** of interest rates, both with interest rate swaps or STIRs will be part of monetary policy transmission, as for instance swap rates affect the prices of mortgages and therefore provide a link between central bank rates and the customer. With derivatives markets being global, it should not matter where these contracts are traded. One could argue that the fragmentation of trading caused by the restrictions of the derivative trading obligation that made UK trading venues not accessible for EU derivatives users and vice versa will have introduced fragmentation and friction, therefore already affecting monetary policy transmission.

18. However, whether the ***clearing*** of derivative instruments denominated in EU currencies is relevant for monetary policy implementation is questionable. Clearing is a process that happens after trading – hence why it is often refer to as a post-trade process. Therefore, it

does not play any role in price discovery or the transmission of monetary policy decision on the yield curve. From a monetary policy transmission perspective, the clearing of interest rates derivatives is therefore not as relevant as the clearing of repo transactions. Indeed, in the case of repo clearing, the physical settlement aspect could be linked to monetary policy transmission – but there does not appear to be a similar nexus between monetary policy and the clearing of interest rate derivatives.

19. ESMA suggests that "*disruptions [at Tier 2 CCPs] may have direct effects through EU clearing members and clients, some of which are monetary policy counterparties and indirect effects through the functioning of financial market*". This would be a concern for every CCP, including European ones. A lot of effort has been spent over the last decade to develop mechanisms, tools and regulation to support recovery and resolution of CCPs, with the aim to avoid disruptions in clearing.

20. In any case, any concerns that EU authorities may have in relation to monetary policy could be addressed via existing EMIR 2.2 powers. In that regard, EMIR 2.2 provides for the **EU central banks of issue's ability to impose requirements to these CCPs in relation to their monetary tasks**, as set out under Article 25(2b)(b). For example, the ECB can and does require that UK CCPs open euro deposit accounts at the ECB, so that the ECB can maintain visibility on EUR flows.

21. Article 25(2b)(b)(iv) further sets out that the central banks of issue may require Tier 2 CCPs *"**to comply with requirements, applied in exceptional situations by the central bank of issue, within its competences to address temporary systemic liquidity risks*** affecting the **transmission of monetary policy** or the smooth operation of payment systems, and **relating to liquidity risk control**, **margin requirements**, **collateral**, settlement arrangements or interoperability arrangements."

22. Outside of the EMIR framework, the BoE and ECB have agreed liquidity lines[4] under which the ECB can provide the BoE with euro in exchange for some form of collateral based on predefined terms and vice versa.

There are safeguards in EU and UK law in relation to any remaining concerns related to crisis situations

23. A concern of EU rule makers and authorities is that in case of an issue at a Tier 2 CCP, EU clearing members and their clients could be affected by recovery or resolution actions, or that these actions will be designed in a way that would affect EU firms in a disproportionate way. However, it should be noted that EU firms will be affected by recovery and resolution actions at whichever CCP they clear, regardless of whether this CCP is inside or outside the EU.

The UK framework ensures that all creditors will be treated fairly, and that CCPs' senior managers can be held accountable

[4] Central bank liquidity lines (europa.eu)

24. We also do not believe that EU firms will be affected by issues at Tier 2 CCPs in a disproportionate way. The UK has introduced a CCP resolution framework that is consistent with the EU one and includes a very strict no-creditor-worse-off (NCWO) safeguard (stricter than the EU version of this safeguard), which ensures that in a resolution scenario, clearing participants are treated fairly, irrespective of where they are established. In other words, in a resolution scenario, EU clearing members cannot be treated worse than UK clearing members. This is guaranteed by UK law, under the UK Financial Services and Markets Act 2023, Schedule 11[5] and as will be further specified in a forthcoming statutory instrument.

25. In addition, it should be noted that the UK has adopted a Senior Managers and Certification Regime for CCPs, also under the UK Financial Services and Markets Act 2023, Schedule 10, ensuring, amongst others, that senior managers who perform key functions in a CCP are accountable for the decisions that could have a material impact on the CCP, and therefore on financial stability. This suggests that the supervisory and regulatory approach in the UK continues to hold CCPs to very high standards.

Enhancing cooperation with the BoE in relation to recovery and resolution should be explored

26. In the EU, CCP Recovery and Resolution Regulation (EU CCP RRR) Article 76 sets out the EC may make recommendations to the Council with regards to the means of cooperations with third country authorities in relation to recovery and resolution planning of third country CCPs. However, the EC has not made any recommendations in that regard so far. Developing such agreements with the BoE should be considered by EU authorities, as they would fulfil ESMA's recommendation in its December 2021 report to a enhance cooperation with the BoE in relation to recovery and resolution.

EU national authorities already have significant powers with regards to third-country resolution proceedings

27. In its December 2021 report, ESMA also referred to concerns with regards to the impact that the termination of the membership of EU clearing members at Tier 2 CCPs may have. Leaving aside that this is a very unlikely scenario, in the absence of any agreement established further to Article 76 with third-country resolution authorities, Article 77 of the EU CCP RRR sets out that relevant EU national authorities have the power to *"render unenforceable any right to terminate, liquidate or accelerate contracts, or affect the contractual rights"* of third-country CCPs that provide services in the EU *"provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed."*

28. This means that under the EU CCP RRR, EU national authorities could suspend any decision by a third country CCP to terminate membership of EU members, as long as these members continue to meet payments vis-à-vis the CCP. This should address the concern that ESMA has with regards to Tier 2 CCP terminating EU clearing members' access unilaterally.

[5] Financial Services and Markets Act 2023 (legislation.gov.uk)

29. In its 2021 report, ESMA also outlined its concerns with regards to the potential unfair treatment of EU clearing members in resolution proceedings, noting that *"third country authorities might intervene during crisis events by taking early intervention or resolution measures in the primary interest of the third country financial stability which may conflict with the interests of the EU, for example, by disproportionally calling on EU market participants".*

30. However, in relation to this concern – and ignoring the fact that the NCWO safeguard will significantly disincentivize such actions – Article 78 of the EU CCP RRR[6] enables relevant national authorities "*refuse to recognise or to enforce third-country resolution proceedings"* in certain cases. The cases that could warrant the use of this power could be any of the ones listed under Article 78, such as if these resolution proceeding would have "adverse effects on financial stability in their Member State", if EU clearing members and clients were treated unfairly vis-à-vis those of the third-country, if these would have material fiscal implications in EU member states, or if these would be contrary to national law.

31. While these powers are provided to EU national competent authorities rather than ESMA, under the EU CCP RRR, **these are nonetheless powerful protections afforded to EU competent authorities by EU law, in the interest of the safety and soundness of EU clearing members and EU financial stability**.

[6] EUR-Lex - 32021R0023 - EN - EUR-Lex (europa.eu)