Central counterparty recovery and resolution

The important role played by central counterparties in financial markets, and their systemic relevance, has grown following the financial crisis. This, however, has drawn regulators’ attention to the absence of harmonised rules for situations where such counterparties themselves might be sources of systemic risk, due to operational difficulties or outright failure. To address this, the Commission proposed a regulation on which Parliament is due to vote during the March II plenary session, in order to conclude its first reading before the end of the term.

Background

Central counterparties (CCP) are entities that interpose themselves between counterparties to a financial transaction to guarantee their performance. Following the financial crisis, their role and systemic importance increased significantly. Regulation (EU) No 648/2012 (EMIR) lays down prudential requirements for CCPs, as well as requirements regarding their operation, oversight and risk management. However, no harmonised EU rules cover the situation where a CCP suffers financial or operational difficulties, or fails.

European Commission proposal

To address this, and following work by international standard-setting organisations, the Commission proposed a regulation, focusing on three main axes. First, preparation and prevention tools, requiring (i) CCPs to prepare recovery plans with measures to be taken if financial difficulties exceed their risk management defences under EMIR; (ii) national supervisors to review and approve these plans; and (iii) national authorities to lay down resolution plans in the event of a CCP’s failure. Second, early intervention powers for competent authorities, allowing them to step in when a CCP’s viability is at risk, but before the point of failure has been reached, or where its actions may be harmful for overall financial stability. Lastly, resolution tools, to be activated by resolution authorities when a CCP is failing or likely to fail, when no alternative market solution is workable, and it is in the public interest to place the CCP in resolution rather than insolvency.

European Parliament position

In its amendments to the proposal, Parliament’s Committee on Economic and Monetary Affairs follows the principle that recovery plans must be comprehensive and effective and should ensure that losses are allocated to stakeholders involved, on the basis of their level of responsibility or ability to control risks. Specifically, they should: distinguish between default and non-default losses (but address losses in both cases); provide that CCP capital should bear first losses before other recovery tools are activated; ensure substantial loss absorption by clearing members before any other tools allocate losses to clients; and ensure that non-defaulting clearing members’ clients are compensated if successful recovery was thanks to a reduction in the payments they would have received due to an economic gain in a derivative contract. With regard to early intervention measures, it adds that they must include the power to restrict or prohibit any remuneration of equity, and may restrict, prohibit or freeze any payments of variable remuneration. Lastly, taking into consideration the interconnection of global CCPs, it proposes that comprehensive stress tests and crisis simulation exercises should be carried out regularly. Although the plenary confirmed the ECON committee’s mandate for trilogue negotiations in February, with no prospect of agreement before the elections, the first reading is due to be concluded during the March II plenary session.