

March 2017

## Recovery and resolution of central counterparties

*Impact assessment (SWD(2016) 368, SWD(2016) 369 (summary)) of a Commission proposal for a regulation of the European Parliament and of the Council 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 (COM(2016) 856)*

### Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the European Commission's [impact assessment](#) (IA) accompanying its [proposal](#) above, submitted on 28 November 2016 and referred to Parliament's Committee on Economic and Monetary Affairs (ECON). The quality standards used for this analysis are the Commission's Better Regulation Guidelines and Toolbox of 19 May 2015, fully in force when the Commission's IA was published.

In EU law, a central counterparty (CCP) is 'a legal person 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' (European Market Infrastructures Regulation (EMIR), Article 2). These entities are also called clearing houses. In recent years, the role and systemic importance of central counterparties (CCPs) has expanded with the gradual implementation of the obligation to centrally clear liquid and standardised over-the-counter (OTC) derivatives. The relevant EU regulatory framework lays down prudential requirements for CCPs, as well as requirements regarding their operations, oversight and risk management. No harmonised EU rules, however, exist for the unlikely situations in which these standards prove insufficient to address major financial or operational difficulties that CCPs may incur or their outright failure. The international standard-setting organisations have developed standards for the recovery and resolution of financial market infrastructures, including CCPs. In a 2013 [own-initiative report](#), the European Parliament called on the Commission to prioritise the recovery and resolution of CCPs and reiterated this request in a [2015 resolution](#) on building a capital markets union.<sup>1</sup> Against this background, the Commission's proposal would require CCPs to prepare recovery measures and provide resolution authorities with early intervention and resolution powers.

For more information on the proposal supported by this IA, please see the complementary '[EU Legislation in progress](#)' briefing by the European Parliamentary Research Service (EPRS). An EPRS [implementation appraisal](#) on the European Market Infrastructures Regulation No 648/2012 (EMIR), which is one of the regulations amended by the proposal, is also available.

### Problem definition

The IA clearly identifies the main problem in need of possible EU action: the possible disorderly failure of a central counterparty. The IA argues convincingly that, although the likelihood of this event is extremely small, it would have very serious impacts. The disorderly failure of a CCP could spread to the financial system, as CCPs are central nodes in it, and there is a risk that taxpayers would have to pay the costs.

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<sup>1</sup> Respectively P7\_TA(2013)0533 and P8\_TA(2015)0268)

To simplify, the detailed problems identified in the IA can be summarised as follows:

- supervisors (that is, national competent authorities) and CCPs are not sufficiently prepared to tackle an extremely severe crisis triggered by a failure;
- supervisors' early intervention arrangements are sub-optimal;
- CCPs' resolution processes are less than ideal;
- public funds could be used in crisis situations, 'national systems cannot ensure an optimal and even level of protection of financial stability across Member States' (IA, p. 24).

The IA outlines the scale of the potential global problem, for instance, referring to the interconnection between the market players (IA, p. 15). In some cases, additional details on the main EU markets are provided (for instance, pp. 11-12 and pp. 90-92). In other cases, a better effort could have been made to single out EU data from global ones. For instance, in the table showing which global, systemically important, banks are members of leading global CCPs, it would have been useful to separate EU from non-EU banks and CCPs (IA, p. 95). Likewise, the significant financial amounts involved are provided for the global level, but not for EU level (IA, p. 8). As a point of reference, the IA estimates the volume of over-the-counter transactions globally cleared by CCPs at US\$346.4 trillion (IA, p. 8), that is approximately five times the world gross domestic product for the same year (2012 data).

Currently, there are between 17 and 19 CCPs established in the EU, depending on the list used.<sup>2</sup> Major players include: 1) the CCPs of the LCH.Clearnet Group, established within the EU in the UK and in France; 2) Eurex Clearing, incorporated in Germany; 3) Cassa di Compensazione e Garanzia, in Italy; and 4) the European Multilateral Clearing Facility, established in the Netherlands (IA, p. 90).

The discussion on the possible evolution of the problems does not appear to be fully up to date. For instance, the IA states that the EMIR stress test results were not available at the time of drafting the impact assessment (IA, p. 16), despite the fact that the European Securities and Markets Authority (ESMA) first published these results in April 2016, well before the publication of the IA in November 2016. (See 'Quality of data, research and analysis' below for more details).

## Objectives of the legislative proposal

The hierarchy of objectives of the initiative broadly corresponds to the problems identified. The simplified *general* objectives are to safeguard financial stability; minimise losses for society and strengthen the single market (see IA, p. 21 for the precise wording). The main *specific* objectives are as follows (IA, pp. 22-24):

1. 'increase preparedness of relevant authorities and CCPs for crisis situations';
2. 'improve early intervention arrangements for supervisors';
3. 'ensure resolution of CCPs in a timely and robust manner ...';
4. 'develop appropriate cost/loss allocation arrangements ...'.

The IA defines a fifth specific objective, which is to 'reduce market fragmentation and ensure that all stakeholders (owners, clearing members and clients) are treated fairly regardless of their location' (IA, pp. 23-24). However, this objective is not used explicitly to compare the options. *Operational* objectives are also defined (IA, pp. 22-24).

## Range of options considered

The IA makes an attempt at presenting the main components of the Commission's proposal (IA, pp. 25-59). The discussion of some options, in terms of content and legal instruments, is moved to the last annex (IA, pp. 108-112). This annex contains 'secondary policy options, those considered less crucial and those raised by some stakeholders but which are less expedient in view of the main objectives targeted by this impact assessment' (IA, p. 25, footnote 59). Then, it focuses on how best to achieve the specific objectives highlighted above.

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<sup>2</sup> There are 19 CCPs, according to ESMA's [MiFID database](#); and there are 17 CCPs according to ESMA's [EMIR database](#).

In terms of content, the IA discards the following options at an early stage, giving a shorter assessment (IA, pp. 110-112):

- permanent resolution colleges, whereby home and host authorities would be attributed specific powers in cross-border resolution;
- EU-level supervision and resolution of CCPs;
- a system similar to the Dodd-Frank Act in the USA, whereby – possibly – the European Systemic Risk Board would designate systemic non-bank institutions; and the Single Resolution Board would be mandated to plan resolution and potentially resolve institutions;
- state ownership of CCPs;
- access by CCPs to central bank liquidity.

Similarly, the following legal instruments are discarded (IA, pp. 108-109):

- adoption of soft law instruments or self-regulation by CCPs;
- application of the Bank Recovery and Resolution Directive to CCPs.

The presentation of the main policy options, combined with the analysis of their impacts, stretches over more than 20 pages. This briefing, therefore, simplifies and shortens the main options, for the sake of clarity, in the following way. First, it does not list the 'no policy change' scenario, which is used correctly to compare the alternatives. Second, it does not use the IA's own classification as option 1, 2, etc., which, in this case, might have distracted the reader. Third, it prioritises what appear to be the main specific objective(s) for each set of options. It acknowledges, however, that according to the IA, the sets of options contribute to achieving additional specific objectives. Fourth, it highlights the choices retained and combined in the IA with a tick (✓), and those being discarded with a cross (✗).

As a result, the following options are considered in the IA to achieve the following objectives (from 1 to 4 below).

1. Increase preparedness of relevant authorities and CCPs for crisis situations (IA, section 6.2)

- ✓ CCPs to develop and maintain recovery plans
- ✓ Resolutions authorities to develop and maintain resolution plans, resolution strategies and operational plans

2. Improve early intervention arrangements for supervisors (IA, section 6.3)

- ✓ Enhanced early intervention tools — 'provide supervisors with means for enhanced monitoring and effective early intervention (including giving directions to CCP in the recovery phase) to attempt to prevent an irreversible solvency situation or other cause of failure from arising' (IA, p. 31)
- ✓ Recapitalisation plans — 'provide supervisors with powers to require CCPs to replenish their financial resources if they had used their capital to absorb losses during a recovery' (IA, p. 31)

The following two objectives are largely intertwined:

3. Ensure resolution of CCPs in a timely and robust manner; and

4. Develop appropriate cost/loss allocation arrangements

Options are described in three different sections.

- ✓ Soft triggers – Public authorities would have some discretion about when to trigger resolution.
- ✗ (*Option discarded*) Hard triggers — Public authorities would automatically trigger resolution when quantitative thresholds were met.
- ✓ Minimum set of common resolution tools — Member States could develop further nation-specific tools.
- ✗ (*Option discarded*) Prescriptive resolution tools — These include maximum harmonisation, a hierarchy for tool use, and prohibition for Member States to develop further tools. (IA, section 6.4, pp. 34-39)
- ✓ Write-down of equity (and debt, if any) — Part of the losses would be borne by owners (and by unsubordinated debt holder, if any).

- ✓ Additional loss-absorbency — CCPs would have an additional layer similar to the total loss-absorbing capacity (TLAC) developed by the Financial Stability Board for Global Systemically Important Banks (G-SIB).
- ✓ Transfer of critical functions to a solvent third party or a bridge CCP — The IA presents the first alternative as a private sector purchase, difficult and time-consuming in this industry (IA, p. 43); the bridge CCP, on the other hand, is presented as a different temporary option, where the authority would set up a wholly owned or controlled CCP before the sale to a third party.
- ✓ Temporary administration — A public authority would temporarily take over the management of the entity.
- ✓ Moratorium on payments and temporary stay on early termination rights — 'The application of this power would prevent counterparties from enforcing their claims or exercising their contractual rights to terminate contracts in relation to the CCP under resolution in a way which could frustrate efforts by the authority to accurately ascertain its value and secure its critical functions' (IA, p. 41) (IA, section 6.5, pp. 39-46).
- ✓ Cash calls on clearing members — The resolution authority could enforce a cash request to clearing members, as per their existing and outstanding contractually agreed obligations with the CCP.
- ✓ Dedicated resolution authority cash calls on clearing members — 'The resolution authority would have the exclusive right to call on clearing members for further cash to support CCP resolution when the CCP's existing resources and contractually agreed cash calls under the recovery plan are exhausted' (IA, p. 46).
- ✓ Auction/allocation — This would involve auctioning or allocating the positions of defaulting clearing members to non-defaulting clearing members.
- ✓ Termination (also known as tear-up) of contracts — This means 'terminating contracts of the defaulter that the CCP cannot honour to re-establish the CCP's matched book' (IA, p. 46).
- ✓ Variation margin haircutting — This is defined as the 'pro rata reduction of the amounts owed by the CCP to its clearing members holding positive net positions' (IA, p. 47).
- ✗ *[Option discarded]* Initial margin haircutting — 'This tool would consist in writing down the initial margin provided by non-defaulting clearing members' (IA, p. 47).
- ✗ *[Option discarded]* Resolution fund — This is a last resort fund that would be built up from contributions by CCPs and their clearing members or by the bank resolution funds set up under the Bank Recovery and Resolution Directive and the Single Resolution Mechanism.  
(IA, section 6.6, pp. 46-59)

As it can be seen, the IA discards only four options (those marked with the symbol ✗), beyond the 'no policy change'. The Commission states that the preferred options are in line with international work-streams. Furthermore, it states that the 'Regulation does not mandate which tools and powers to use in different scenarios but leaves the choice to the [resolution] authority, depending on the circumstances but where practicable in line with the resolution plan agreed by the resolution college' (explanatory memorandum to the proposal, p. 15).

## Scope of the impact assessment

The analysis of the impacts is carried out in two steps. The IA first selects the preferred options and then provides an overall assessment of all the options taken together.

The choice between the options above is made by comparing the degree to which they achieve the specific objectives set (effectiveness) and their efficiency (cost-effectiveness). It is a qualitative analysis largely based on the expert judgement of the Commission's departments, backed up by relevant sources (See 'Quality of data, research and analysis' below). This framework appears to provide an appropriate technical analysis of the economic impacts. However, in terms of presentation, scoring all of the options against all relevant specific objectives gives rise in this particular case to largely repetitive results. For instance, it seems fair to say that the

comparison tables (see for instance IA, Table 5, p. 58) could have been streamlined or replaced with a narrative text without losing much valuable information. Finally, although coherence with other Commission policies and proportionality are not used explicitly as criteria to compare the options, some considerations relating to these elements are present in the analysis.

The second step — the overall impact of the package — is a qualitative analysis that covers administrative costs and the impact on small and medium-sized enterprises, on the EU budget and on third countries (see relevant sections below), as well as fundamental rights and the social dimension. Finally, the IA states that this proposal has no impacts on the environment. (IA, pp. 59-64).

The IA provides some data about CCPs at Member State level, focusing in particular on the UK, Italy, France and Germany (see, for instance, IA, pp. 11-12 and pp. 90-92). However, the possible scenarios opened up by the UK referendum of 23 June 2016 are not mentioned at all. These scenarios might have deserved an analysis, taking into account the importance of the UK clearing market.

### **Subsidiarity / proportionality**

The proposal is based on Article 114 TFEU, which stipulates competence for the Union to adopt measures for the approximation of Member States' provisions that have as their object the establishment and functioning of the internal market (IA, p. 21). The IA argues that EU action is needed and adds value, not least because CCPs have a cross-border dimension. It quotes as additional arguments experience with banking failures and the divergent and limited approaches taken by Member States to regulate the recovery and resolution of CCPs (IA, pp. 19-21). The subsidiarity deadline is 30 March 2017. At the time of publishing this briefing, no national parliaments had submitted reasoned opinions raising subsidiarity concerns.

The IA explicitly analyses proportionality in a few cases. In particular, it scrutinises whether the provisions are compatible with the Charter of Fundamental Rights, and more specifically the right to property, providing relevant proportionality arguments backed by the case law of the European Court of Justice and the European Court of Human Rights (IA, pp. 60-62).

### **Budgetary or public finance implications**

According to the IA, there are no implications for the EU budget and tasks conferred to the European Supervisory Authorities should be manageable with current resources (IA, p. 60). The explanatory memorandum to the legislative proposal confirms this line (p. 11).

As far as Member States are concerned, the IA states that some elements of the proposal could entail an administrative burden for supervisory and resolution authorities. This is not quantified, but the IA argues that this burden for national authorities is considered proportionate, taking into account risks to financial stability and international commitments (IA, p. 60).

### **SME test / Competitiveness**

The IA argues that the proposal would have both indirect benefits and indirect costs for SMEs and concludes that 'any associated cost in net terms is unlikely to be significant' (IA, p. 60). In the IA's reasoning, this is the result of the benefit deriving from financial stability to businesses — including SMEs — and the costs that CCPs may pass on to their ultimate clients, including SMEs (IA, pp. 59-60).

The IA states that financial stability benefits for CCPs would outweigh any compliance costs and administrative burden on them. The Commission estimates that such costs for CCPs should be lower than the corresponding costs for banks (amounting to €5 million for larger banks and thousands of euros for smaller entities, according to the quoted estimates of the European Banking Authority) (IA, pp. 28-29).

## Simplification and other regulatory implications

First, coherence with EMIR, as well as with the Bank Recovery and Resolution Directive (No 2014/59/EU), is one of the main guiding principles of the analysis.

Second, the explanatory memorandum to the proposal clarifies that, beyond developing technical standards and guidelines, ESMA would be entrusted with new tasks to be carried out with existing resources. These tasks would involve taking part in resolution colleges (together with the European Banking Authority), making decisions in cases of disagreement, exercising binding mediation, and establishing a new resolution committee, where the European Banking Authority's competent authorities would be invited as observers (memorandum, p. 11). In the proposal, the involvement of the European Supervisory Authorities is developed by the fairly extensive Title II. The IA does not expand on these issues and explicitly states that permanent resolution colleges are not considered in depth in the IA, as the institutional set-up for cross-border resolution is 'secondary to the primary policy imperative of how to ensure that efficient resolution is possible in the first place (...)' (IA, p. 110).

## Relations with third countries

The explanatory memorandum states that the 'legislative proposal is fully in line with the latest [Financial Stability Board] and G20 policy discussions and orientation' (p. 9) and quotes the recent Financial Stability Board's August 2016 discussion note (memorandum, p. 9 and footnote 14). Indeed, coherence with international commitments is one of the guiding principles of this impact assessment and third country impacts are analysed (IA, pp. 63-64). Annex III has more details on the international work undertaken by the Committee on Payments and Markets Infrastructures (CPMI) and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) (IA, pp. 77-85).

It is however remarkable that the IA, published on 28 November 2016, does not mention the 21 [third-country central counterparties recognised to offer services and activities in the Union](#) at that time<sup>3</sup>. For information, these are established in Australia, Canada, Hong Kong, Japan, Mexico, Singapore, South Africa, South Korea, Switzerland, and the United States of America. At first sight, this would appear to be relevant evidence to further substantiate an analysis of relations with non-EU countries.

## Quality of data, research and analysis

Overall, the IA appears to be based on the Commission departments' expert judgement. This is backed up by relevant references, public consultation and coordination with international work-streams. The IA refers notably to:

- international organisations, such as the European Central Bank, the International Monetary Fund, the Financial Stability Board, relevant sectoral committees, the Committee on Payments and Markets Infrastructures (CPMI) and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), the European Supervisory Authorities;
- previous work by the European Commission;
- national organisations, such as the Bank of England;
- academics and experts, in some cases expressing their personal opinion, but published by national organisations (such as the Federal Reserve Bank of Chicago and the Bank of Canada) or by trade associations, such as the International Swaps and Derivatives Association (ISDA);
- individual stakeholders, such as JP Morgan, the LCH.Clearnet group, the Chicago Mercantile Exchange Group, providing contributions to consultations.

The impression given, however, is that the IA has not been fully updated since the summer of 2015. First, the IA does not perform certain parts of the analysis it announces, even though the data needed were available. The IA states that 'further quantitative analysis of potential losses and their effects could be possible in the future once

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<sup>3</sup> ESMA recognised a 22nd CCP, ICE Clear US, Inc., on 14 December 2016.

the ESMA stress tests conclude' (IA, pp. 16-17). This analysis is not performed, even though ESMA published the [results of the first stress tests](#) in April 2016. Second, the annex on international work seems to be updated only up to October 2014 (IA, pp. 77-85). Third, as far as the Financial Stability Board is concerned, the IA quotes the ninth report on over-the-counter derivatives reform issued on 27 July 2015 (IA, p. 8, footnote 17), but not the 10th and 11th reports of the same series, issued respectively on 4 November 2015 and 26 August 2016. Fourth and finally, the IA, published on 28 November 2016, does not mention the 21 third-country central counterparties recognised to offer services and activities in the Union as of that date.

There appear to be limited exceptions where there are more recent updates in the IA itself. For instance, the Annex on the relevant US regime contains at least one element relating to June 2016 (IA, pp. 86-87). Moreover, the IA mentions a meeting of the Member States' expert group, which discussed the international work-streams on 27 June 2016.

## Stakeholder consultation

The IA identifies the stakeholders affected by the problems, throughout the analysis, as:

- *the CCPs themselves;*
- *their clearing members (generally large banks);*
- *the clients of their clearing members (for instance asset managers and pension funds);*
- supervisory and resolution authorities;
- taxpayers;
- the shareholders of CCPs, normally large exchanges; and
- SMEs.

CCPs, clearing members and their clients (author's emphasis above) are given a more prominent place, for instance in a useful table summarising their views and preferences (IA, pp. 105-107). This table also includes a simplified analysis of the views of the European Parliament, on the one hand, and of the Financial Stability Board and IOSCO, on the other. Another useful table also includes the other stakeholders listed above (IA, pp. 65-69).

Stakeholders had the opportunity to contribute to a range of consultation activities, including one online public consultation, in conformity with the Better Regulation guidelines, lasting more than 12 weeks. Some options, which enjoyed some support amongst stakeholders but which the Commission considered less effective, are presented in the Annexes (IA, pp. 108-112; see the section 'Range of options considered' above for an overview).

## Monitoring and evaluation

The IA contains appropriate and succinct monitoring arrangements and indicators, in line with the monitoring being undertaken for the Bank Recovery and Resolution Directive (IA, p. 70).

The IA states simply that there could be an evaluation after three to five years (IA, p. 70). The explanatory memorandum indicates that the evaluation could take place after three years (memorandum, p. 11). The review clause in the Commission proposal (Article 82) leaves the timeframe of the implementation review to be decided.

## Commission Regulatory Scrutiny Board

This impact assessment was approved by the Impact Assessment Board, the predecessor to the Commission Regulatory Scrutiny Board, on 6 May 2015 (explanatory memorandum to the proposal, p. 9). Generally speaking, the IA appears to have taken into account the main comments of the Commission's Board, which related to the need to act at EU level, the range of options presented, administrative costs and support from stakeholders.<sup>4</sup> It

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<sup>4</sup> This opinion has not yet been published on the Regulatory Scrutiny Board's website.

should be noted that one and a half years passed between the Board's meeting and the publication of the proposal and the accompanying impact assessment.

The IA appears to comply broadly with the 2009 Impact Assessment Guidelines, the guidance applicable when DG FISMA met the Board. However, it does not comply with all the requirements of the Better Regulation Guidelines, which have replaced the previous guidance since 19 May 2015 and, after an interim period which expired at the end of 2015, are now fully in force. Although a wealth of information was provided, the new mandatory annex, 'Who is affected by the initiative and how', was not included despite the fact that it would have been useful. This new tool should set out the practical implications of the initiative for a representative business and/or public administration and indicate which key obligations will have to be fulfilled and over what timescale.

## Coherence between the Commission's legislative proposal and IA

The Commission's legislative proposal follows the recommendations expressed in the IA, but deviates from the IA's stance in two instances. First, the IA notes how state ownership of CCPs runs into several difficulties (IA, p. 111). The proposal introduces, as a last resort, *temporary* public ownership in accordance with applicable rules on State aid. Second, the IA notes how CCP access to central bank liquidity would present a moral hazard concern. However, it notes, that a 'combination of rigorous prudential requirements and oversight, and the implementation of appropriate recovery and resolution tools could possibly help mitigate such moral hazard concerns' (IA, p. 112). The proposal introduces *temporary* liquidity support from — and at the discretion of — the central banks, to facilitate the resolution process. These elements are presented in the explanatory memorandum, without making reference to the IA.

## Conclusions

This impact assessment builds a convincing case for action. It is mainly based on expert judgement by the Commission's departments and is backed up by relevant references, public consultation and coordination with international work-streams. The Commission states that the proposal, published in November 2016, is fully in line with the latest policy discussions and orientation by the Financial Stability Board and the G20, quoting a document from August 2016. Notwithstanding this, the Impact assessment itself does not appear to have been fully updated since the summer of 2015. Therefore, some potentially important developments do not seem to be properly reflected in the IA. These include the recognition of non-EU central counterparties, the publication of new material, and the scenarios opened in the clearing world by the UK referendum of 23 June 2016.

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*This note, prepared by the Ex-Ante Impact Assessment Unit for the European Parliament's Committee on Economic and Monetary Affairs (ECON), analyses whether the principal criteria laid down in the Commission's own Impact Assessment Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.*

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