European Parliament

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Second edition
The 'EU Legislation in Progress' briefings are updated at key stages throughout the legislative procedure.
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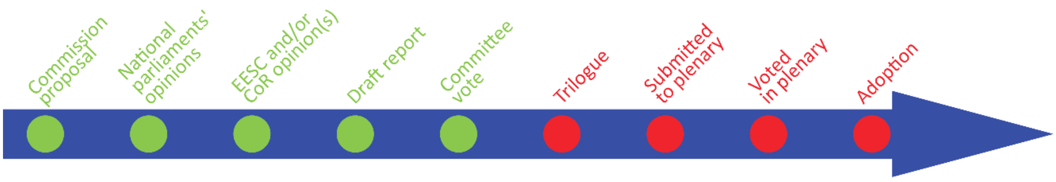
Print

Recovery and resolution of central counterparties (CCPs)

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 operation, 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 resolution, the 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. In November 2016 the European Commission adopted a proposal for a regulation requiring CCPs to prepare recovery measures and providing resolution authorities with early intervention and resolution powers. Parliament's Committee on Economic and Monetary Affairs (ECON) adopted its report on the proposal on 24 January 2018.

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	
COM(2016) 856 final, 28.11.2016, 2016/0365(COD), Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')	
Committee responsible:	Economic and Monetary Affairs (ECON)
Co-rapporteurs:	Kay Swinburne (ECR, United Kingdom) Jakob von Weizsäcker (S&D, Germany)
Shadow rapporteur:	Danuta Maria Hübner (EPP, Poland); Caroline Nagtegaal (ALDE, the Netherlands); Miguel Viegas (GUE/NGL, Portugal); Molly Scott Cato (Greens/EFA, United Kingdom), Bernard Monot (ENF, France)
Next steps expected:	Adoption of the Council's general approach



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Introduction

Financial market infrastructures (FMIs), which include payments systems,[1] central securities depositories (CSDs),[2] securities settlement systems (SSSs),[3] central counterparties (CCPs)[4] and trade repositories (TRs),[5] are vital components of the financial system: they enable market participants to conclude transactions with one another in an effective and orderly manner. The scale of their business and the high degree of interconnection with other players in the financial system make FMIs systemically important by nature.

In recent years in particular, the systemic importance of CCPs has been expanding with the gradual implementation of the G20 commitment to increase the transparency of derivative contracts traded over the counter (OTC) by imposing an obligation to clear liquid (i.e. easily tradable) and standardised contracts centrally in CCPs. The European Union met this obligation by means of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructures Regulation, or 'EMIR').

CCPs have historically proven quite resilient to market distress, including during the financial crises that began in 2008. In recent years CCP risk management has further strengthened owing to several regulatory and industry initiatives. However, it is still possible that in the case of severe market turmoil, a CCP could incur financial or operational difficulties or even outright failure.

Past experience has shown that the distress or disorderly failure of a systemically important financial institution can bring about critical problems for other market participants. Therefore, the need has arisen to lay down harmonised rules to improve CCPs' own ability to restore their long-term viability in the event of difficulties (recovery), and to set out the extraordinary actions that authorities could take to promptly restructure a CCP and preserve the continuity of its critical functions in times of acute stress (resolution), without having recourse to public resources.

1 In general, the term 'payment system' refers to the complete set of instruments, intermediaries, rules, procedures, processes and interbank funds transfer systems that facilitate the circulation of money in a country or currency area.

2 A central securities depository (CSD) is an entity that provides a central point for depositing financial instruments ('securities'), for example bonds and shares. CSDs' clients are typically financial institutions themselves (such as custodian banks and brokers). Although CSDs across the world might have very different activities, the definition introduced by Regulation No 909/2014 describes the core functions performed by a CSD.

3 A securities settlement system (SSS) is a system that allows the transfer of securities, either free of payment (FOP) or against payment (delivery versus payment, DVP).

4 A central counterparty (CCP) is an entity that interposes itself, in one or more markets, between the counterparties to the contracts traded, becoming the buyer to every seller and the seller to every buyer and thereby guaranteeing the performance of open contracts.

5 Trade repositories (TRs) centrally collect and maintain the records of derivatives. They play a central role in enhancing the transparency of derivative markets and reducing risks to financial stability.

Context

Once the buyer and the seller of a financial instrument conclude a transaction, the post-trading system ensures that the trade agreements are effectively enforced, by matching all buy and sell orders in the market (*clearing*), transferring securities and cash under the contract (*settlement*) and safekeeping securities (*custody*).

CCPs play a key role in clearing. They stand between the buyer and the seller (typically banks or other financial institutions), acting as the buyer to each seller and the seller to each buyer. On a bilateral basis, CCPs reduce the 'counterparty risk', which is the risk that a financial transaction is not successful because the buyer is unable to pay the price or the seller unable to deliver the securities. On a multilateral basis, CCPs reduce exposure but mutualise risk, by netting[6] down the payments that each member participating in the system ('clearing member') is required to pay to or receive from each other member. The single net payment that each clearing member is expected either to pay or receive as a result of netting is in general significantly lower than the aggregate bilateral exposures that clearing members would have incurred if the transactions had not been centrally cleared. Clearing members have direct access to central clearing by virtue of contractual arrangements with CCPs (referred to as the 'rulebook'), governing all clearing activities. Clearing members also provide their clients (banks and other financial institutions) with indirect access to CCPs.

CCPs deal with clearing members' possible defaults by collecting adequate collateral[7] (in the form of 'margins') to mitigate losses and by retaining additional resources (default funds)[8]. The financial safeguards available to a CCP and the order in which they would be disbursed should a clearing member default are called the 'default waterfall'.

CCPs may also incur losses that depend on other factors ('non-default losses'), such as investment losses, operational risk events, legal risks, or failure of a custodian[9] or settlement platform. Through their activity, CCPs manage essential risks in financial markets, such as liquidity risk[10] and market risk,[11] thereby improving the overall resilience of the financial system.

6 Netting entails offsetting the value of multiple positions or payments due to be exchanged between two or more parties, and can be used to determine which party is owed remuneration in a multiparty agreement.
7 Collateral is a property or other asset that a borrower offers as a way for a creditor to secure the credit claim.
8 The default fund consists of the mutualised resources posted by clearing members that can be only used by the CCP in the event of a member default after all margins and contributions posted by the defaulting member have been depleted and the CCP has used its own dedicated financial resources ('skin in the game').
9 Custodian banks offer custody services – holding (and normally administering) securities on behalf of third parties.
10 Liquidity risk is the risk of not being able to liquidate (sell and receive money in return) an investment.
11 Market risk is the risk of losses in on- and off-balance sheet positions arising from adverse movements in market prices.

Existing situation

Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructure Regulation or EMIR), imposes an obligation to centrally clear liquid and standardised contracts via a CCP. It also lays down overarching prudential requirements for CCPs, as well as requirements regarding their operations and oversight.

Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the Bank Recovery and Resolution Directive or BRRD) provides measures aimed at safeguarding the business continuity of EU banks and EU investment firms, which are typically the clearing members of CCPs. In the event of resolution, these institutions would have to continue to satisfy their obligations towards CCPs even as obligations towards other creditors could be suspended. Furthermore, banks' obligations to CCPs and other FMIs could be exempted from bail-in for broader financial stability reasons.

The result of this regulatory framework is that the probability of CCPs incurring large losses in the event of the financial distress of an EU clearing member bank or EU investment firm is substantially reduced. However, CCPs may also have non-EU institutions or non-financial entities (such as energy companies) as clearing members; these are outside the scope of the BRRD. Ultimately, though unlikely, it is still possible that the risk management system set out according to EMIR is not sufficient to address large losses in cases of severe market turmoil potentially leading to financial or operational distress or outright failure.

At present, while authorised CCPs are able to operate and provide services across the EU, the regulatory framework for addressing potential crises exceeding the requirements of EMIR is fragmented among Member States.

Comparative elements

According to the European Commission's impact assessment, no Member State has yet established a full national regime for CCP recovery and resolution. The United Kingdom, Italy, France and Germany have partial regimes.

Between 2011 and 2013, the **United Kingdom** introduced a series of amendments to existing legislation that set out measures to recover and resolve CCPs established in the country. The resolution goals are, with no order of priority: to preserve the continuity of CCP core services; protect public resources; avoid, to the extent possible, interfering with property rights; protect and enhance the stability of the financial systems of the United Kingdom; and protect and enhance public confidence in the financial systems of the country.

In this framework, CCPs are required to lay down recovery plans and establish loss allocation mechanisms to be activated once the default resources envisaged under EMIR are depleted. The CCP supervisor – the Bank of England – has been provided with intervention powers, for broader financial stability reasons, that might be used, for example, to direct a CCP not to use its loss allocations to write off all contracts in a single service. Furthermore, in the event of resolution of a CCP, the resolution authority – a functionally separate area of the Bank of England – would be provided with the power to sell part or all of the CCP business and to establish a bridge institution. The Treasury (UK finance ministry) may make a compensation order, in exceptional circumstances, in order to safeguard the financial interests of those affected by transfer orders made in relation to CCP resolution. The exercise of any resolution power is deemed to be a measure of last resort, but can be effected prior to insolvency. Before exercising such powers, the resolution authority should check that: (a) a CCP is failing, or likely to fail, and (b) it is not reasonably likely that action – taken by, or in respect of, the CCP – will enable the CCP to maintain the continuity of any critical clearing services it provides. The Treasury would further have to assess that a public interest exists in placing the CCP in resolution rather than insolvency. The United Kingdom recovery and resolution regime for CCPs is in line with the FSB key attributes (see 'Preparation of the proposal'); however, to be fully compliant, loss absorption measures would need to be implemented.

In 2007 **Italy** extended its resolution framework for FMIs to CCPs. It now includes a Special Administration regime (SAR), aimed at preserving the CCP's business continuity, and a Compulsory Administrative Liquidation regime (CALR). A CCP may be subject to the SAR if serious irregularities in the management of the CCP and/or serious capital shortfalls arise. On the other hand, it might be placed under the CALR if authorisation has been withdrawn by the competent supervisory authority – the Bank of Italy – or the courts have declared the CCP to be insolvent. As part of this regime, the operations of the CCP would be frozen, all CCP payments would be suspended, and contracts would be terminated. The Bank of Italy may permit operations to continue on a temporary basis. In both cases, the Bank of Italy – as designated resolution authority – would have broad discretion to use its powers. It could, for example, direct the activities of the special administrator appointed under the SAR and require that any initiative taken by the liquidator in the CALR obtain its prior consent. Initial margin is bankruptcy remote, so it would not be touched in either regime. Other powers include the ability to enforce any previously agreed position allocation mechanisms.

In **France** and **Germany**, CCPs are required to have a banking licence. Consequently, their authorities have the powers envisaged under the BRRD. However, as not all BRRD tools would suit the resolution of CCPs, the regime would not be effective.

Parliament's starting position

In a 2013 own-initiative resolution, the European Parliament called on the Commission to prioritise the recovery and resolution of central counterparties (CCPs) and of central securities depositories (CSDs) exposed to credit risk, and to consider whether it was appropriate to develop similar legislation for other financial institutions in the areas of insurance, asset management and payments. The Parliament reiterated this request in a 2015 resolution on building a capital markets union.

Proposal

Preparation of the proposal

The European Commission, in a 2010 communication, promised to investigate 'what crisis management and resolution arrangements, if any, are necessary and appropriate for (...) financial institutions' other than banks. Following that communication, the Commission launched a consultation on a possible framework for recovery and resolution of non-bank financial institutions in 2012.

At global level, in 2011 the Financial Stability Board (FSB) developed the Key Attributes of Effective Resolution Regimes, in which the key elements for recovery and resolution of systemic financial institutions are enshrined; the aim being to preserve business continuity while not exposing taxpayers to losses. In 2014, the FSB issued further guidance on the application of the key attributes to FMIs, including CCPs. The Committee on Payment Systems and Market Infrastructure together with the International Organization of Securities Commissions (CPMI-IOSCO) updated the global standards on financial markets infrastructures in 2014, to enhance CCP resilience, recovery planning and resolvability. In April 2015, international committees, including the Basel Committee on Banking Supervision (BCBS), decided to adopt a joint work plan on CCP resilience, recovery and resolvability. In mid-2016, these organisations consulted further on core parts of this guidance. The G20 leaders endorsed the enhanced framework in September 2016.

In its impact assessment, the European Commission builds a convincing case for action at a European Union level in this field, and states that the proposal published in November 2016 is fully in line with the latest policy discussions and orientation by the FSB and the G20. Notwithstanding this, according to the March 2017 initial appraisal by the European Parliamentary Research Service, some potentially important developments are not sufficiently reflected in the impact assessment. These include potential scenarios opened in the clearing world following the UK referendum on EU membership of 23 June 2016.

In July 2017, international committees published three guidance documents (CCP resilience guidance, CCP recovery guidance and CCP resolution guidance) and two reports (Interdependencies study and Implementation report) completing the April 2015 joint workplan.

The changes the proposal would bring

Considering their central and growing role in financial markets, all European CCPs are regarded as being systemically important and therefore are included within the scope of the proposed regulation.

First, the proposed new EU rules are based on **preparation and prevention tools**. In this respect, they require (i) CCPs to prepare recovery plans envisaging measures to be taken in the event of financial difficulties exceeding the risk management defences under EMIR, (ii) national supervisors to review and approve these plans, (iii) national authorities to lay down resolution plans in the event of a CCP's failure.

Both default and non-default losses must be taken into account by CCPs when designing recovery plans, including those relating to fraud or cyber-attacks. CCPs themselves will have to develop appropriate indicators to inform clearing participants and authorities on when the plans should be activated. The CCP recovery framework is aimed at achieving CCP recovery and business continuity by means of a combination of tools to re-allocate positions and allocate losses. These include (i) termination of defaulted participants' contracts ('total or partial tear ups'), (ii) reallocation of defaulting counterparties' positions to solvent clearing members on the basis of voluntary agreements (i.e. by auction), (iii) requests for additional contributions from solvent members ('cash calls') and (iv) allocation of losses to solvent clearing members by cutting the payments they would have received as a result of an economic gain in a derivative contract ('variation margin gain haircuts'). Recovery plans should not assume access to extraordinary public financial support or expose taxpayers to the risk of loss. CCPs are allowed to fix the appropriate options and recovery tools. However, contractual arrangements should be agreed with clearing members, in order to bind or commit them to act in accordance with the agreed measures if they are triggered, irrespective of the jurisdiction members are based in.

Considering the possible impacts of a recovery plan on clearing members and other stakeholders across borders, the supervisory college set up under EMIR should work alongside the competent authority in the review and approval process.

Resolution plans, to be prepared by resolution authorities, must indicate how a CCP would be restructured and the continuity of its critical functions preserved in the event of failure. As in the case of recovery plans, both default and non-default risk scenarios must be taken into account and no extraordinary public financial support should be assumed, besides access to central bank facilities under standard terms. However recourse to government stabilisation tools is allowed under stringent conditions.

Resolution plans should establish the powers and tools that authorities would use should a CCP meet the conditions for resolution. In all cases, the exercise of early intervention and resolution powers by authorities should be proportionate to the business model, market share and systemic relevance of the CCP, both in the jurisdiction in which it is established and in others that are relevant. As part of resolution planning, resolution authorities should also evaluate the overall viability of the CCP and remove any obstacles. Consequently, they should for example have powers to require the CCP to change specific business practices or its operational or legal structures, revise any intra-group arrangements that could hamper resolution, or increase risk management defences on a case-by-case basis.

Secondly, the proposal provides competent authorities with **early intervention** powers, so that they can step in when the viability of a CCP is at risk but the point of failure has not yet been reached, or where its actions may be harmful for overall financial stability. The powers would complement those set out in EMIR. Competent authorities could require the CCP to take specific action in its recovery plan, or to abstain from taking such action. As in the case of recovery plans, resolution colleges should be involved in drawing up the resolution plan and agreeing to any measures to address resolvability.

Finally, the regulation sets out **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 when it is in the public interest to place the CCP in resolution rather than insolvency. In line with the Key Attributes for Effective Resolution Regimes, a competent authority could place a CCP in resolution even if not all these conditions were met, notably where the application of further recovery measures could prevent the CCP's failure but could undermine financial stability. Resolution should be carried out by way of several tools, which include: (i) sale of all or part of the failing CCP to another entity; (ii) creation of a publicly controlled bridge CCP, which consists of separating essential functions into a new CCP, while the old CCP would be liquidated under ordinary insolvency proceedings; (iii) various options of loss and position allocations to participants, including write-down of capital and conversion of debt instruments or other unsecured liabilities tools. Depending on the options chosen by the CCP and approved by the supervisory college as part of recovery plans, there can be overlap in the loss and position allocation tools available to the CCP as part of its recovery plan and to the resolution authority.

Resolution authorities should be able to exclude or partially exclude some contracts from loss and position allocation in certain circumstances. However, if such an exclusion results in increased level of loss or exposure applied to other contracts, the 'no creditor worse off principle'[12] should be upheld.

Resolution authorities should put in place cooperation arrangements with authorities in relevant **third countries**. The European Securities and Markets Authority (ESMA) should provide guidance on the relevant content of those arrangements, in order to ascertain common application of the conditions.

12 According to the 'no creditor worse off principle' (NCWO) no creditor or shareholder shall incur greater losses than they would have incurred if the institution placed into resolution had been liquidated under ordinary insolvency proceedings.

Views

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion on this proposal on 29 March 2017.

National parliaments

The legislative proposal has been transmitted to the national parliaments. The deadline for the submission of reasoned opinion on the grounds of subsidiarity was 30 March 2017. No reasoned opinion was submitted, although two chambers opened political dialogue with the Commission.

Stakeholders' views[13]

The various workstreams put forward at institutional level in order to lay down an effective recovery and resolution regime for CCPs triggered a huge debate among the different stakeholders before the presentation of the Commission's proposal.

In a report produced in October 2016, the Centre for European Policy Studies (CEPS) Task Force on Implementing Financial Sector Resolution flagged the importance of removing impediments to FMI resolvability in order to accelerate their resolution. As for CCPs more specifically, CEPS believes that steps should be taken to ensure that the loss allocation process could be completed, if necessary, 'over a resolution weekend'.

The European Association of CCP Clearing Houses (EACH) stressed, in its response to the CPMI-IOSCO consultation of 2016, 'the need for CCPs to be allowed to execute fully their default management process and their recovery plan before the intervention of the resolution authority takes place'. In this vein, a CCP should be placed in resolution only once its own risk management resources are exhausted or have proven ineffective. EACH also pointed out that the exercise of early intervention powers should be a measure of last resort, so that the incentive structure of the CCP and its ability to carry out an orderly loss allocation in full are preserved. In a statement of 30 January 2018, EACH welcomed the European Parliament's work on the proposal for a CCP recovery and resolution regime. EACH particularly appreciated that 'the European Parliament has added safeguards against the moral hazard which could potentially discourage commitment to a private-sector solution in order to benefit from public bail-out'. As reported in one article, however, representatives of CCPs and clearing members disagree on the proposed minimum amount of non-default losses that CCPs must bear before passing on further losses to their members.

13 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

Also responding to the CPMI-IOSCO consultation, the International Swaps and Derivatives Association (ISDA) stated that each CCP subject to international standards on FMIs should have a recovery plan in place and the ability to operate it. ISDA stressed, however, that 'the plan should be transparent to clearing participants, as well as domestic and certain foreign regulators, including resolution authorities'. In September 2017, ISDA published recommendations for the CCP recovery and resolution framework and called on regulators to finalise and implement CCP recovery and resolution strategies.

In its comments on the then forthcoming Commission proposal of December 2015, the European Banking Federation (EBF) flagged that a CCP recovery and resolution regime should be flexible enough to cover different CCP business models, as well as a variety of risk-profiles, with different instruments. The EBF also underlined the need not only 'to strike a balance between clearing members and shareholders of the CCPs, but also to take into account the rights and obligations of the "clients of clearing members" and potentially of their own clients if any'. In its April 2017comments on the Commission's proposal, EBF singled out the key priority issues which, in its opinion, the co-legislators should address when discussing the proposal. Those include that the burden stemming from recovery or resolution should be shared between all participants in the chain and must not be unlimited.

Legislative process

In January 2018, the European Parliament's Committee on Economic and Monetary Affairs (ECON) adopted its report (co-rapporteurs: Kay Swinburne, ECR, United Kingdom, and Jakob von Weizsäcker, S&D, Germany) on the Commission's proposal. It also voted to open trilogue negotiations on that basis (once the Council reaches its own position), a decision confirmed during the February I plenary session.

The amendments proposed by the committee aim to ensure fair and collective commitment of the private sector to rescue a distressed CCP at the recovery stage, to increased loss absorption capacity and minimise risks to taxpayers.

As a general principle, recovery plans should ensure that losses are allocated to stakeholders involved (CCP, clearing members and clients) on the basis of their level of responsibility or ability to control risks. That would put CCPs on the first layer, clearing members on the second, and clients on the third. More specifically:

> Recovery plans should clearly distinguish between default and non-default losses;

> the CCP capital would bear a set amount of losses in default cases, and even more so in non-default cases, before any other recovery tools can be activated;

> Substantial loss absorption by clearing members ought to be foreseen in the recovery plans before any tools are used that allocate losses to clients. The ability of CCPs to include variation-margin gain haircuts in their operating rules is maintained, as this considerably increases the overall loss-absorption capacity; however this tool can only be used if deemed likely to be effective by the supervisor;

> To encourage participation in recovery, greater consideration is given to clients, including granting that non-defaulting clearing members' clients are compensated if recovery was successful thanks to the application of variation margin gain haircuts to their assets.

The credibility of that incentive structure would be enhanced by making recovery plans more binding: if a CCP wished to deviate from the recovery plan, it would need prior approval from the competent authority.

As regards resolution, the full range of tools at the disposal of resolution authorities would be maintained. To increase enforceability, especially vis-à-vis third-country participants, however, the report proposes that certain tools, such as minimum sized resolution cash calls and variation-margin gain haircuts, are included in the CCP's operating rules. The no-creditor-worse-off (NCWO) principle is amended in order to appropriately reflect the theoretical costs of non-intervention, which include any quantifiable adverse effects of systemic instability and market turmoil. In addition, the legal protection for the resolution authority is improved when it takes a decision to accelerate the move from recovery to resolution.

Considering that global CCPs are strongly interconnected through their common clearing institutions, comprehensive stress tests of recovery and resolution arrangements should be carried out, taking into account aggregate effects.

Finally, a review clause would be included to adapt the EU CCP recovery and resolution framework to the institutional architecture resulting from the ongoing review of EMIR and of the European supervisory authorities (ESAs).

In the Council, the file is still being discussed at working party level. Both the Maltese and Estonian Presidencies put forward compromise texts, but there is not yet agreement on the proposal in the working party.

References

EP supporting analysis

Collovà, C., Initial appraisal of a European Commission impact assessment, Recovery and resolution of central counterparties, EPRS, March 2017.

Other sources

Framework for the recovery and resolution of central counterparties, European Parliament, Legislative Observatory (OEIL).