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Brexit, financial stability and the supervision of clearing systems
- Andromachi GEORGOSOULI -

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Brexit, financial stability and the supervision of clearing systems

IN-DEPTH ANALYSIS

Abstract
This paper examines the evolution of the supervisory framework of third-country CCPs in the EU making special reference to risks associated with the imminent withdrawal of the United Kingdom from the European Union (Brexit). Its key finding is that the proposed reform is in principle in the right direction but there are still challenges ahead and a more comprehensive package of measures will be required to address them.
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<tr>
<td><strong>CFTC</strong></td>
<td>Commodity Futures Trading Commission</td>
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<td><strong>CCPs</strong></td>
<td>Central Clearing Houses</td>
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<td><strong>CRD IV</strong></td>
<td>Capital Requirements Directive IV</td>
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<td><strong>DCO</strong></td>
<td>Derivatives Clearing Organisation</td>
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<td><strong>EBA</strong></td>
<td>European Banking Authority</td>
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<td><strong>ECB</strong></td>
<td>European Central Bank</td>
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<td><strong>ECJ</strong></td>
<td>European Court of Justice</td>
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<td><strong>EIOPA</strong></td>
<td>European Insurance and Occupational Pensions Authority</td>
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<td><strong>ESAs</strong></td>
<td>European Supervisory Authorities</td>
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<td><strong>ESMA</strong></td>
<td>European Securities and Markets Authority</td>
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<td><strong>EMIR</strong></td>
<td>European Market Infrastructure Regulation</td>
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<td><strong>IOSCO</strong></td>
<td>International Organisation of Securities Commissions</td>
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<td><strong>OTC</strong></td>
<td>Over-the-counter</td>
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<td><strong>SRM</strong></td>
<td>Single Resolution Mechanism</td>
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<td><strong>SSM</strong></td>
<td>Single Supervisory Mechanism</td>
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<tr>
<td><strong>TARGET2</strong></td>
<td>Trans-European Automated Teal-time Gross Settlement Express Transfer System</td>
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<td><strong>TEU</strong></td>
<td>Treaty on European Union</td>
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<td><strong>TFEU</strong></td>
<td>Treaty on the Functioning of the European Union</td>
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<td><strong>TR</strong></td>
<td>Trade Repository</td>
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EXECUTIVE SUMMARY

- The size and cross-border relevance of euro-denominated clearing services in the UK raise salient financial stability and monetary policy concerns for the euro area.
- The imminent withdrawal of the UK from the European Union has been a catalyst for the current reform of the EU legal framework for the supervision of third-country CCPs.
- Brexit imposes particular risks:
  a) It will increase transaction costs.
  b) In the absence of a comprehensive policy to make the euro area an attractive place for the migration of euro-denominated clearing services, it may drive central clearing services overseas.
  c) If transaction costs are high, it will be very difficult to sustain the currently large volume of euro-denominated clearing transactions. If this happens, attempts to turn the euro into a global reserve currency will be undermined.
  d) The cross-border oversight of systemic CCPs will become more difficult.
- Brexit risks are real but nevertheless manageable over time for mainly the following reasons:
  a) Both the EU and the UK will remain committed to international regulatory convergence.
  b) The UK legal framework and overall supervisory approach will continue to be consistent with EU requirements taking into account the ‘Great Repeal Bill’ currently discussed in the UK Parliament.
  c) The relocation requirement can be satisfied by opening up subsidiaries in the euro area.
- The proposed EMIR II legal framework regarding the supervision of third-country CCPs is in principle sound. It is more forward looking, risk-based and proportionate compared to EMIR. Furthermore, the introduction of a relocation requirement as a measure of last resort will enhance existing ECB capabilities to monitor systemic CCPs.
- At the same time there are challenges ahead. Specifically:
  a) An unintended consequence of the relocation requirement might be to drive euro-denominated clearing to an overseas jurisdiction that has been granted equivalence instead of mainland Europe.
  b) The proposed EMIR II framework will continue to evolve around the legal concept of equivalence but equivalence is by its very inception neither resilient over political pressure nor durable enough to provide a reasonably stable mechanism for the long term management of cross-border systemic risks.
  c) The enhanced powers of ESMA are likely to stretch the already overstretched boundaries of the Meroni doctrine and, consequently, expose ESMA to legal risk.
- In response to those challenges the following recommendations were made:
  a) As long as it is desirable to keep the existing high volume of euro-denominated clearing and to attract the relevant business in mainland Europe, a more comprehensive package of measures will be required to turn the euro area into a world-leading hub for capital markets.
b) Treaty amendments are recommended to place the mandate and powers of ESMA on a proper constitutional basis.

c) The Commission should consider changing the existing equivalence framework into a more stable mechanism of cross-border systemic risk management.
1. INTRODUCTION

This paper examines the existing supervisory framework of third-country Central Counterparties (CCPs) in the European Union (EU) and future implications following the imminent withdrawal of the United Kingdom (UK) from the EU. It begins with an overview of the nature of CCPs and their growing importance of the UK-based CCPs in the euro area due to their conspicuous involvement in euro-denominated clearing transactions. It explores the correlation between monetary policy and payment systems and overviews legal aspects of the UK withdrawal from the EU in the event of a hard Brexit scenario. Against this backdrop, it considers the evolution of the supervisory framework of the third-country CCPs in the EU taking into account the equivalence framework of the European Commission, the relevant provisions of the European Market Infrastructure Regulation (EMIR) and the proposed EMIR II framework. It outlines existing and future challenges and concludes with certain recommendations. The key message of this paper is that, even though the proposed reform goes in the right direction, a more comprehensive package of measures will be required to cement the regulatory and supervisory capabilities of EU authorities, preserve the existing high volume of euro-denominated clearing transactions and ensure that the majority of clearing businesses will not be driven away from mainland Europe.
2. LEGAL AND POLICY ISSUES

2.1. The nature of CCPs and their growing importance in the single market

A clearinghouse, which is also known as Central Counterparty (CCP), performs clearing intermediation services in the following way: Once the parties agree on the terms of a transaction (e.g. a derivatives contract), the transaction is registered with a CCP and the CCP acts as middleman between the buyer and the seller. A CCP protects its position by taking collateral from each party to the transaction known as ‘margins’ and by creating a ‘default fund’ through contributions from its members to meet losses that exceed the margins held. This form of intermediation ensures that the contract shall be performed as agreed by the parties and in a timely fashion.

CCPs are perceived as low-risk counterparties because they are subject to capital buffers, risk-sharing arrangements among their CCPs members and enhanced management practices as well as other regulatory requirements. CCPs improve market transparency and they are conducive to financial stability and market efficiency and liquidity.1 By becoming the prime counterparty for the seller and the prime counterparty for the buyer through the function of multilateral netting and the mutualisation of incurred losses, CCPs mitigate counterparty risks and reduce the volume of open net exposures. In addition, they harness market confidence because neither of the parties to a transaction will have to worry about counterparty default.2 CCPs come with benefits but they also bear risks. For example, as the volume of trading cleared centrally increases, so it does the degree of credit, liquidity and operational risks concentrated in CCPs rendering CCPs themselves potential sources of systemic risk.3 The concentration of risk makes the failure of one or more CCPs a major threat to the stability of the entire financial system.4

CCPs are of increasing significance in the EU.5 Ever since the entry into force of EMIR and the imposition of a legal obligation to clear eligible Over-The-Counter (OTC) derivatives centrally, CCPs cross-border activity increased dramatically.6 Despite the growth of central clearing, the number of CCPs remained stable. Currently, 17 CCPs are headquartered in the EU and authorised by EMIR,7 whereas 28 third-country CCPs have received recognition under EMIR’s equivalence procedures. Moreover, the greatest volume of euro-denominated transactions are cleared through CCPs which are based in the UK.

2.2. The nexus between monetary policy and payment systems

The monetary policy of the euro area lies with the Eurosystem and according to Article 3(1)(c) of the Treaty on the Functioning of the European Union (TFEU) is an exclusive EU

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2 Ibid.
5 Ibid.
6 This legal obligation was introduced in 2012 with the adoption of the European Market Infrastructure Regulation (EMIR) and in particular Article 4. The aim of this measure was to reduce systemic risk linked with derivatives trading in accordance with the 2009 G20 Pittsburgh Agreement. G20 Leaders Statement : The Pittsburgh Summit (September 24-25, 2009) Pittsburgh at http://www.g20.utoronto.ca/2009/2009communique0925.html.
Brexit, financial stability and the supervision of clearing systems

According to Article 127(1) TFEU, the primary objective of the Eurosystem is that of price stability in the Eurozone. Strictly speaking, financial stability is not part of the constitutional mandate of the European Central Bank (ECB) and, therefore, it does not bear the status of core competence as those enlisted in Article 127(2). The financial stability is a task conferred upon the ECB by means of EU Secondary legislation – specifically, the Single Supervisory Mechanism Regulation (SRMR) and in accordance with Article 127(6). As a macroprudential regulator, the ECB is endowed with macro-prudential powers to carry out the supervision of systemic banks in the euro area and it has responsibility in the pre-insolvency stage of their resolution.

The Eurosystem is currently the owner and operator of a second-generation real-time gross settlement system for cross-border payments between commercial banks located in the euro area. This system comprises two platforms: TARGET2 for the settlement of payments and TARGET2 Securities for the settlement of securities. According to Article 22 of the European System of Central Banks (ESCB) and the ECB Statute, the ‘ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Union and with other countries.’ The exact scope of Article 22 of the Statute has been a matter of dispute. In the landmark case United Kingdom of Great Britain and Northern Ireland v European Central Bank, the European Court of Justice (ECJ) excluded CCPs from the regulatory competence of ECB noting that securities do not constitute payment although they may be regarded as being the subject matter of a transaction that gives rise to a fund transfer. The decision of the ECJ was based inter alia on the combined reading or Article 127(1) and (2) of TFEU with Article 22 of the ECB Statute. It was supported by the legal concept of ‘payment’ in the context of Article 63(2) TFEU according to which payment includes the “cash” leg of clearing operations but falls short from also including the ”securities” leg of the clearing operations of a CCP. The ECJ also took into account the definition of the term ‘payment system’ adopted in the Payment Services Directive.

Monetary policy and payment systems are closely intertwined. To appreciate their interaction, it helps to look into the historical evolution of core functions of central banks as the bankers’

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9 The Eurosystem comprises the ECB and the National Central Banks (NCBs) of the 19 Member States that have adopted the euro as their currency. It should not be confused with the European System of Central Banks (ESCB) through the participation of the ECB and the national central banks of all Member States of the EU including the Bank of England pending the withdrawal of the UK from the EU. Article 282(1) TFEU.
13 United Kingdom v European Central Bank (Sweden, Spain, and France intervening) in Case T-496/11 [2015] 3 CMLR 8. This is further discussed in Section 4.2 below.
14 Ibid., para 97. For a case commentary see, Ananiadis-Bassias, E. (2016). The ECB’s “Location Policy” for Central Counterparties: is the General Court Drawing a Line, or Taking One Step Back to Take Two Steps Forward?, European Law Review, (1), 122-130. This is further discussed in Section 4.2 below.
15 Case T-496/11, paras 96-97, (above n 13).
16 Ibid., para 94.
bank, as well as the role of central banks in monetary policy and the preservation of financial stability.\textsuperscript{17}

Central banks are the providers of the ultimate settlement in the payment system. To maintain confidence over the settlement asset as a store of value and as a unit of account, the central bank has every incentive to control closely the terms on which its banknotes are made available to the banking system. This control lies at the heart of the traditional monetary policy objective of central banks. Suppose that a central bank prints more and more of its banknotes. If this is not matched with increasing demand for the banknotes of the central bank, the value of the banknotes will decrease, eventually the banknotes of the central bank will not be treated, as “safe” and confidence over the settlement asset will be undermined.\textsuperscript{18} The nexus between monetary policy and payment systems often creates tension as, for example, when any increase in the total supply of reserve balances for payment purposes interferes with price stability as a key objective of monetary policy.\textsuperscript{19} Nevertheless, central banks have developed tools to safeguard price stability without compromising the smooth functioning of the payment system. For instance, nowadays a distinction is drawn between, on the one hand, the provision of day-to-day liquidity and, on the other hand, the provision of credit for the implementation of monetary policy.

Payment systems, central counterparties and central securities depositories make up the mosaic of post-trade financial market infrastructure of the single market.\textsuperscript{20} A reliable payment system for the distribution of the ultimate asset is a fundamental prerequisite of financial stability and for the effective implementation of monetary policy.\textsuperscript{21} Payment systems are susceptible to a wide range of risks – most notably - credit risk, liquidity risk, operational risk and legal risk.\textsuperscript{22} The materialisation of any of those risks can trigger the disruption of the payment system causing wider liquidity and credit problems. The execution of a payment obligation requires a fund transfer.\textsuperscript{23} The latter is not possible without clearing and settlement. While clearing warrants that cleared transactions will be honoured, settlement describes the completion of transactions or the completion of a processing with the aim of discharging the obligations of the parties through the transfer of funds or securities.\textsuperscript{24} Conversely, clearinghouses are not able to perform their function unless they have access to a payment system and a securities settlement system.\textsuperscript{25} While the former is necessary for


\textsuperscript{20} The provision of reporting services completes the picture of the system of post-trade financial market infrastructure described above. Ferrarini, G., Saguato, P. (2015), pg 582. (above n 1).


\textsuperscript{23} This description of ‘payment’ draws on the definition of ‘payment’ in a strict sense of the term as provided in the ECB Glossary of terms related to payment, clearing and settlement (December 2009) https://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlemetsystemsen.pdf.


\textsuperscript{25} This access is essential irrespective of whether the payment system is operated by a central bank or by a financial institution.
the transfer of liquid assets, the latter is essential for the transfer of ownership of traded securities and their custody.

Given the inter-connectedness of payment with clearing, the smooth operation of payment systems in part depends on the smooth functioning of the clearing services currently provided by CCPs. Concentration and globalisation are essential to a thriving clearing industry but, at the same time, these features are also complicit in increasing market interconnectedness with systemic implications.\(^{26}\) Given the high volume of clearing in foreign currencies and their conspicuous interdependence with other segments of the financial systems, it is paramount that CCPs have the capacity to manage liquidity risks and have access to central bank services. To pre-empt disruptions to the payment system as a result of disturbances in the transfer of liquid assets or securities associated with the operations of UK-based CCPs involved in high volumes of euro-denominated clearing, the ECB and the Bank of England signed up a mutual Agreement to extend the scope of their standing swap line in order to facilitate the provision of multi-currency liquidity support to CCPs in the UK and the euro area coupled with enhanced exchange of information and cooperation arrangements.\(^{27}\)

2.3. The UK withdrawal from the EU & the hard Brexit scenario

The EU legal framework of financial regulation is based on the Treaty objective for the creation of a single market and the fundamental freedoms of free movement of capital, free movement of services and freedom of establishment.\(^{28}\) The financial crisis of 2008 precipitated a legal reform of such a magnitude that it changed dramatically the institutional design of EU regulation and supervision. Notable developments include the creation of three European Supervisory Authorities - the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)- focusing respectively on the banking, the securities and the insurance sectors - the centralisation of prudential supervision and financial crisis prevention and management for euro area countries participating in the Banking Union and a far more harmonised legal framework of EU financial regulation.\(^{29}\) Member States benefit out of this advanced legal and institutional framework and the concomitant system of passporting rights as long as they continue to remain members of the EU.

Although it is meant to be permanent, membership in the EU is not irreversible. Article 50 of the TFEU provides for a mechanism of withdrawal. According to this mechanism, a Member State must inter alia notify the European Council and negotiate the terms of its withdrawal with the European Union. Agreement must be reached within two years with the possibility of extension subject to the agreement of all parties concerned. The UK invoked Article 50 of TFEU. The withdrawal procedure was triggered on 29 March 2017 and the UK is scheduled to leave on 29 March 2019. Since March 2017, a European Union (Withdrawal) Bill was


\(^{28}\) Article 3(3) of the Treaty on the European Union (TEU) on the creation of an internal market, Article 26 (2) TFEU regarding freedom of services and freedom of capital and Article 49 TFEU on freedom of establishment.

introduced to the British Parliament. The Withdrawal Bill aims inter alia to (a) repeal the European Communities Act 1972, (b) to put an end to the supremacy of EU law over UK law, (c) convert EU law into domestic law and (d) to enable domestic law to reflect the content of a withdrawal agreement under Article 50 of TEU once the UK leaves the EU.30

At this early stage of development, it is difficult to predict with certainty whether there will be an agreement between the UK and the EU as well as the specific terms of this agreement. Although market integration and the rise of the multi-speed Europe would have been unimaginable without an element of cherry-picking on the menu, it is equally true that the mutation of the UK into a ‘third-county’ is historically unprecedented and that so far cherry-picking has never been offered to a high impact third-country and former Member State like the UK.31 This being the case, the remaining of this analysis will proceed on the basis of a hard Brexit scenario. According to this scenario, the UK withdraws without any transitional agreement, becomes a third-country and, as a result, it can no longer benefit from passporting rights, although in the future it might benefit out of obtaining equivalence status, based on a decision and subject to the absolute discretion of the Commission.32

Quite apart from the EMIR central clearing obligation over eligible OTC derivatives, the increase in the volume of euro-denominated transactions by CCPs domiciled in the City of London can be attributed to the following two factors. On the one hand, the membership of the UK in the EU and, on the other hand, the arguably unique ecosystem of the City of London which offers access to the certainty of a business-friendly and cosmopolitan common law jurisdiction and the security of oversight and regulation by highly experienced supervisory authorities.33 When the UK exits the EU, the first one of the two components that made the UK such an attractive place of business for the provision euro-denominated clearing services – namely, that of EU membership will be lost.34

As passporting rights will no longer be available, UK-based CCPs will be treated as third-country CCPs and, hence, be subject to the Commission’s equivalence regime. If equivalence is not granted and UK-based CCPs are not recognised as per relevant EMIR requirements (or for the lengthy period of time that it will be required for the Commission to make a determination about equivalence), UK-based CCPs will not be able to provide their services to their EU clearing members and clients, unless they move their business in the EU. As a rule, this involves taking steps to establish a legal entity in one or more Member States and obtain authorisation.35

31 For the exploration of various scenarios see European Research Centre for Economic and Financial Governance. (2017) Implications of Brexit on EU financial Services. European Parliament ECON Committee (IP/A/ECON/2016-22), pp 14-19. The making of the European Economic and Monetary Union (EMU) is a recent example of ‘cherry-picking’. See Protocol (No 15) on Certain Provisions Relating to the UK and Northern Ireland, and Protocol (No 16) on Certain Provisions Relating to Denmark attached to the TEU. Thanks to a special agreement, Norway Iceland and Lichtenstein enjoy membership in the European Economic Area and full access to the EU single market but this ‘cherry-picking’ may not be available to the UK because, unlike those countries, the UK is perceived as ‘high impact’ future third-country once it exits the EU. See also Ringe, W. G. (2018). The Irrelevance of Brexit for the European Financial Market. Oxford University Legal Research Paper Series, paper No 10/2017 pg 6 (expressing the opposite view on the grounds that eventually both the UK and the EU will have to take into account pressing political and economic realities).
32 The equivalence regime of the European Commission is discussed separately below in Section 2.1.
33 On the arguably unique ecosystem of the City of London see European Research Centre for Economic and Financial Governance (2017), pg 51, (above 31).
34 Thanks to the single passport regime, CCPs are currently able to operate in other Member States (‘host’ Member States) as long as they are authorised by the relevant competent authority of the ‘home’ Member State namely the State where they are established and they have gone through a notification procedure.
With the loss of passporting rights, it is highly likely that existing portfolio efficiencies will be eroded causing margin pool benefits currently available by UK CCPs to evaporate. Transactions costs will also increase taking the form, for example, of 'switch trades' for EU based counterparties and for transactions cleared outside the EU, as they will have to reopen and clear them in EU based CCPs in order to comply with relevant EU law central clearing requirements.\(^36\) As the cost of mandatory euro-denominated central clearing will go up, the number of parties choosing euro as the currency for their transactions will drop down. In their attempt to continue offering comparable clearing services at competitive prices, UK-based CCPs will have to migrate elsewhere. The fragmented\(^37\) and comparably small size of the market landscape in mainland Europe seems to suggest that especially those UK-based clearing houses with no subsidiaries in Europe may choose to migrate overseas and, in particular, in countries which have been granted already equivalence status (e.g. US) because these markets are big enough to allow the creation of the requisite level of margin pool benefits through portfolio efficiencies.\(^38\)

The conversion of the UK from a Member State to a third-country is not expected to reduce market interdependence but it will make the cross-border supervision of (systemic) third-country CCPs more challenging, as long as supervisory inconsistencies, problems of coordination and difficulties in accessing relevant information persist. To be sure, the ECB and Bank of England Agreement for the facilitation of multi-currency liquidity support to CCPs and for enhanced cooperation and exchange of information is meant to address those problems. Nevertheless, when this Agreement was entered into force, the Bank of England was the central bank of a Member State and a member of the European System of Central Banks, and not a central bank of a third-country of uncertain (for the time being) equivalence status. In other words, it was a mechanism that was designed to address cross-border issues of financial crisis prevention and management between the ECB and a central bank of another Member State and not between the ECB and the central bank of a third-country. Granted that the UK CCPs will no longer be subject to the supervisory and regulatory framework of EU CCPs under EMIR,\(^39\) the terms of this Agreement will have to be renegotiated so that they are adapted to the new reality.

The risks described above are real but the devastating consequences of their materialisation should not be blown out of proportion to the extent in which they overstate the differences between the EU and the UK legal frameworks and regulatory approaches and as long as they are manageable by the industry.

The existing UK supervisory and regulatory framework is very sophisticated, consistent with international standards and compliant with EU law. This is unlikely to change dramatically post-Brexit for mainly two reasons: First, and as it is evident from the content of the Great Repeal Bill, the UK as a third-country will have an incentive to remain as close as possible to EU law for otherwise any prospect for a favourable and stable equivalence deal will be put

\(^{36}\) **Ibid.**, pg 46.

\(^{37}\) See notably, International Swaps and Derivatives Association (ISDA). (2017) 'Response to the Commission’s proposed regulation as regards the procedure and authorities involved for the authorisation of CCPs and requirements for recognition of third-country CCPs’ at [https://ec.europa.eu/info/law/better-regulation/feedback/7276/attachment/090166e5b593d1db_ga](https://ec.europa.eu/info/law/better-regulation/feedback/7276/attachment/090166e5b593d1db_ga); and further Jenkinson, N. (2007), pg 42 (above 21).

\(^{38}\) See notably Lannoo, K. (2017) Derivatives Clearing and Brexit: A comment on the proposed EMIR revisions. ECMI Policy Brief No. 25, pg 10 (arguing that that “a protectionist reaction will only damage the EU, and favour the US”).

into jeopardy.\footnote{HM Government. (2017) The United Kingdom’s exit from and the new partnership with the European Union, at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/589191/The_United_Kingdom_s_exit_from_and_partnership_with_the_EU_Web.pdf; Department for Exiting the European Union. (2017) Legislating for the United Kingdom’s withdrawal from the European Union at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/604516/Great_repeal_bill_white_paper_accessible.pdf; Armour, J. (2017), Brexit and Financial Services, \textit{Oxford Review of Economic Policy} 33 (2017), S54- S69, S61 et seq (arguing that UK law will be substantially equivalent to EU law at the time of the Brexit).} Second, the UK (like the EU) will continue to be committed to the promotion of international regulatory convergence according to soft-law standards in this field namely the same set of soft-law standards that set the tone for policy and legal developments in the EU. Turning now, on the industry capabilities to manage transition and post-Brexit implications of the UK withdrawal from the EU, it should be noted that any EU relocation requirement may be satisfied by UK based CCPs by keeping the headquarters in the UK and moving Euro-denominated currency trades to existing or newly established subsidiaries located in euro area Member States.\footnote{Schoenmaker, D. (2016). The UK Financial Sector and EU Integration after Brexit: The Issue of Passporting, pg 9 at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2844253; European Research Centre for Economic and Financial Governance. (2017), pg 48, (above n 31).}

That being said, the psychological dimension of Brexit should not be ignored. Even if one were to assume that impact of hard Brexit would be less dramatic than expected, prevailing official risk perceptions speak volumes about the lack of trust that underpins EU-UK relationships since the invocation of the withdrawal procedure of Article 50 of TFEU. Mistrust is a major problem. It dents the spirit of cooperation and undermines mutual reliance as it creates incentives for isolation and introversion namely sub-optimal attitudes to the treatment on transnational systemic threats especially at times of emergency. A practical implication of this might be that the current efforts of the UK government to incorporate EU legislation into domestic law post-Brexit may not be enough to secure the granting of equivalence status in the near future.
3. THE SUPERVISION OF THIRD-COUNTRY CCPS IN THE EU

3.1. The equivalence framework of the European Commission

Equivalence is a piece of legal engineering for the management of cross-border activities.\textsuperscript{42} Equivalence is not granted, unless the European Commission is satisfied that third-country jurisdictions adhere to, implement and enforce the same high standards of financial regulation and supervision as those of the EU. A determination about the equivalence of a foreign regulatory framework with its European counterpart entails a careful balancing exercise. It involves taking into account the promotion of wider Treaty objectives without ignoring the desirability of international regulatory convergence.\textsuperscript{43} In making such determinations, the European Commission receives technical advice from the European Supervisory Authorities and, where appropriate, it may also take into account reports of international organisations and input from other stakeholders.\textsuperscript{44} In relation to the supervision of third-country CCPs, the European Commission has drawn recently a distinction between low impact and high impact jurisdictions as an acknowledgement of the fact that the granting of equivalence in some third countries may involve taking up more supervisory and regulatory risks for EU authorities compared to others.\textsuperscript{45} In the same spirit, the European Commission recommends ‘introducing specific thresholds, which would justify more proportionate treatment of some "lower impact" jurisdictions’.\textsuperscript{46}

Third-countries may express an interest in being considered for equivalence but they are not entitled to receive a positive determination even when all necessary requirements obtain. The outcome of such a determination depends entirely on the discretion of the European Commission. More generally, the relevant implementing act of the European Commission may be granted in full or in part, it may be permanent or temporary or subject to certain conditions. In all those cases, it may be later adjusted or may be even withdrawn or terminated.\textsuperscript{47}

In theory, equivalence comes with three advantages.\textsuperscript{48} It reduces unnecessary overlaps. It allows for the application of a less burdensome prudential regime. It enables EU based market actors to access a wide range of financial services and instruments. In practice, equivalence may not be suitable in all occasions. For example, it is of limited use where third-country regulatory and supervisory frameworks are absent or rudimentary, when they are not comparably effective or they bear out different regulatory outcomes.\textsuperscript{49} Problems may also arise when confidence is low as to the genuineness of the commitment of third-country authorities to cross-border cooperation or when equivalence cannot provide a relatively stable framework for cross-border supervision and regulation due to frequent reviews.

3.2. The supervision of third-country CCPs under EMIR

EMIR entered into force on 16 August 2012.\textsuperscript{50} It applies to CCPs and their clearing members, to financial and non-financial counterparties, Trade Repositories and trading venues where

\textsuperscript{43} On equivalence see ibid., pg 9.
\textsuperscript{44} See Article 33(2) of ESAs Regulations (above n 29); European Commission. (2017), SWD(2017) 102 final, pp 8-11, (above n 42).
\textsuperscript{45} Ibid., pg 11.
\textsuperscript{46} Ibid., pg 10.
\textsuperscript{47} On equivalence see ibid., pp 9, 12.
\textsuperscript{48} Ibid., pg 7.
\textsuperscript{49} Ibid., pg 9.
so provided. EMIR requires Central Counterparties to be authorised to offer central clearing services in the EU.\textsuperscript{51} It also introduces a legal obligation (subject to certain exceptions), according to which certain OTC derivative transactions must be cleared centrally.\textsuperscript{52} This clearing obligation is satisfied in two ways: The first one is by becoming a member of an EMIR authorised CCPs. The second is by becoming a member indirectly through an agent. Other requirements include risk mitigation procedures, and rules on initial and variation margins, record keeping and reporting requirements.

The supervision of CCPs in the EU differs depending on whether a CCP is located in a EU Member State or in a third-country (e.g. US, Japan etc.). National competent authorities are primarily responsible for the supervision of CCPs in the EU. ESMA, relevant ESCB members and other relevant national competent authorities are also involved at supervisory college level.\textsuperscript{53} The supervision of third-country CCPs under EMIR is governed by the so-called equivalence rules of EMIR.\textsuperscript{54} Specifically, third-country CCPs are prohibited from providing clearing services in the EU unless they are recognised. ESMA is directly responsible for their recognition.\textsuperscript{55} ESMA also assesses the compliance of the third-country CCP with macroprudential standards.\textsuperscript{56} A third-country CCP is recognised provided that it is granted equivalence status by the European Commission.\textsuperscript{57} The practical implication of recognition is not to subject the recognised third-country CCP under the supervision of EU authorities but rather to require the recognised CCP to continue to comply with the rules of its home jurisdiction.

3.3. Some notable challenges and proposal for EMIR II

The EMIR recognition and supervisory framework applicable to third-country CCPs is currently under review.\textsuperscript{58} In June 2017, the European Commission put forward a concrete set of proposals for reforms (EMIR II), which is expected to take effect before the end of 2019.\textsuperscript{59}

\textsuperscript{51} An authorisation see EMIR, Article 14. EMIR Article 55 also introduces a registration requirement for Trade Repositories (TR).

\textsuperscript{52} EMIR, Article 4. The central clearing obligation is subject to exceptions. For example, intragroup transactions and pension schemes arrangements are exempt. See Articles 4(2), 11(7), 89(2).

\textsuperscript{53} EMIR, Articles 18, 22.

\textsuperscript{54} EMIR Articles 13, 25.

\textsuperscript{55} EMIR, Articles 25.


\textsuperscript{58} European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a 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 final (Strasbourg, 13/6/2017) 2017/1036 (COD). In addition to the June EMIR II proposal, two further substantive pieces of CCP related EU legislation have been proposed: A proposal for a special recovery and resolution framework for CCPs; and a proposal for reviewing certain substantive requirements of the original EMIR. 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 final (Brussels, 28.11.2016) ; Proposal for a Regulation of the European Parliament and of the Council 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 final (Brussels, 4.5.2017).

\textsuperscript{59} Proposal for a Regulation of the European Parliament and of the Council 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 final (Strasbourg, 13/6/2017) 2017/1036 (COD), pg 6 ; Deloitte (2017), (above n 35).
The planned withdrawal of the UK from the EU has been a key driver of reform as it inflamed concerns about the effectiveness of this framework. The proposal of the European Commission brings attention to a range of pitfalls with the existing EMIR supervisory framework applicable to third-country CCPs. For instance, it has been observed that the EMIR equivalence framework has created a situation, where EU based CCPs are found in competitive disadvantaged compared to recognised non-EU CCPs as the former are required to comply with stricter requirements. In addition, the EU seems to take a far more flexible and lenient approach compared to the approach adopted in other jurisdictions. The EU also seems to rely more extensively on the capabilities of foreign rules and authorities to the future detriment of the interests of CCPs established in the EU. Equivalence can also become burdensome when granted to high-impact third countries to the extent in which it will necessitate repetitive reassessments to ensure the effective monitoring of systemic risks.

In response to those challenges, the EMIR II proposal seeks to introduce a far more integrated framework for the furtherance of the long-term goal of a deeper and more integrated capital market in the EU. A key feature of the proposed changes is the provision of greater powers to ESMA, the European Commission and the ECB.

Specifically, the proposal envisages a two-Tier system of supervision for CCPs that are not domiciled in the EU. Non-systemic CCPs will be classified into Tier 1 CCPs. Potentially systemic and already systemic CCPs will fall under Tier 2 and will be subject to a sliding scale of additional prudential requirements. These requirements will reflect their systemic significance. Furthermore, they will be subject to the direct supervision of ESMA as well as relevant central banks. Tier-2 third-country CCPs will not be required to automatically relocate to an EU Member State. Instead, ESMA will be entrusted with broad powers to determine the systemic significance of the third-country CCP in question. If ESMA, in agreement with the relevant central banks, concludes that additional requirements will not be enough to guarantee financial stability, the third-country CCP will be denied recognition. It will be required to relocate in the EU and to obtain an EU authorisation. To be able to carry out the task as a central bank of issue as per the proposed EMIR II, on 23 June 2017, the ECB made a Recommendation for the amendment of Article 22 of its Statute so that clearing systems for financial instruments are brought within its remit of regulatory powers alongside clearing and payment systems.

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64 PWC (2017) (above n 63).


4. **CRITICAL OVERVIEW**

4.1. **Is the sliding scale in the right direction?**

With the introduction of a sliding scale for the supervision of potentially systemic third-country CCPs, a serious attempt has been made to ensure that EU supervision is proportionate to the risks posed by third-country CCPs. The proposed sliding scale is based on a set of different criteria which will reflect the varying degrees of systemic significance of CCPs. Existing EMIR supervisory arrangements evolving around the legal concepts of equivalence and recognition will continue to apply to Tier 1 CCPs. Tier 2 CCPs will be subject to additional requirements. Relocation will be required only as last resort. A further advantage of the recommended supervisory framework is that it will enhance the supervisory capabilities of EU authorities in addressing risks proactively. Proactive crisis management is essential to ensure the continuity of the critical functions of market infrastructures. Such a proactive approach would ensure greater consistency between the proposed recognition and supervisory framework of CCPs with currently proposed EU legislation on CCP recovery and resolution and it would attune the EU legal framework with relevant international standards developed by the Financial Stability Board (FSB). The proposed treatment of certain third-country CCPs as systemic will also help restore a level playing field in the EU.

The proposed sliding scale tries to balance out two conflicting policy considerations: On the one hand, the need to enhance the capacity of EU regulators to oversee CCPs in order to preserve financial stability and, on the other hand, the desirability of preserving the efficiency and smooth functioning of financial market infrastructures. Nevertheless, one needs to be mindful of certain unintended consequences. For example, the cost of compliance is likely to increase in the case of Tier 2 CCPs as they would be subject to requirements that apply to EU and foreign providers of clearing services. In addition, the relocation requirement is bound to have an impact on scale efficiencies and it may propel market fragmentation, as it would set a limit to cross-border clearing volumes.

4.2. **Is the introduction of a relocation requirement sound?**

In response to emerging systemic risks, the ECB should be able to monitor effectively the increasingly complex landscape of financial market infrastructures. To that end, it is essential to have in place a system of supervisory powers and a consistent set of criteria for the evaluation of the systemic significance of emerging risks in the euro area. Moreover, this set of criteria should apply irrespective of the status of the financial institution providing the function in question as an acknowledgement of the fact that nowadays infrastructural services like, for instance, central clearing are provided by banks and non-banks. More generally, the ECB should be able to exert enough influence to preserve price stability while maintaining a level playing. The proposed introduction of a relocation requirement as a measure of last resort for systemic third-country CCPs seems to address those concerns especially if followed

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70 Ibid.
72 European Commission, Proposal COM(2017) 331 final, pg 24 (above n 4) enlisting four objective criteria on the basis of which ESMA will be evaluate the systemic significance of third-country CCPs to qualify as ‘Tier-2’ CCPs.
with the amendment of Article 22 of the ESCB and the ECB Statute as proposed in the relevant ECB Recommendation.

In the past, the ECB had tried to move important clearinghouses in the EU unilaterally on the basis of the Eurosystem Oversight Policy Framework of the 5th of July 2011. Specifically, it required CCPs involved in euro-denominated clearing to be legally incorporated and have full managerial and operational control in the euro area. This attempt failed. In *United Kingdom of Great Britain and Northern Ireland v European Central Bank*, the ECJ annulled the Eurosystem Oversight Policy Framework in favour of the UK on the grounds that the ECB does not possess the power to regulate clearing systems for financial instruments.75 Nevertheless, in the same decision the ECJ crucially clarified that the simplified procedure of Article 129(3) of the TFEU empowers the European Parliament and the Council to amend Article 22 of the Statute of the ESCB upon the recommendation of the ECB or the proposal from the European Commission.76 The introduction of relocation requirements as a measure of last resort for third-country systemic CCPs involved in the clearing of high volumes of euro-denominated transactions will enable the ECB to take better control of systemic risks and to be more effective in its role as the issuing central bank of the single currency, especially if coupled with the amendment of Article 22 of the Statute as per the relevant ECB Recommendation.

Nevertheless, the introduction of a relocation requirements comes with certain pitfalls. Although costs are difficult to quantify with certainty at this early stage, if they prove to be too high, the introduction of relocation elements is likely to have three unintended consequences. The first one is that UK-based CCPs may be driven away from mainland Europe.77 In the face of relocation requirements and other obstacles, they may choose instead to continue providing euro-denominated clearing services by moving their business to an overseas jurisdiction. Jurisdictions, which already benefit out of the equivalence framework like, for example, New York appear to offer an attractive proposition.78 The second one is that euro may no longer be perceived as an attractive currency for the clearing of transactions in financial instruments to the detriment of plans to turn euro into a global reserve currency. Third, EU banks may find it difficult in the future to access liquid trading and to avail themselves for margin pool benefits.79

### 4.3. Future challenges and recommendations

Even though the proposed reform is in principle sound, there are challenges ahead. These challenges primarily derive from the formidable and potentially precarious dynamic between two conflicting policy considerations. The first policy consideration is the promotion of financial stability and market integrity in the euro area which calls for relocation of systemic CCPs in the euro area as a measure of last resort. The second policy consideration is the desirability to ensure a smooth transition towards a post-Brexit market environment that will continue to allow agglomeration in central clearing so that everyone benefits out of the creation of economies of scale.

If UK-based CCPs are eventually required to relocate in the EU in view of their systemic significance, the first challenge that the EU is likely to encounter is that of foreign traders

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75 Case T-496/11 (above n 13).
76 Case T-496/11, paras 108-109 (above n 13).
77 European Research Centre for Economic and Financial Governance. (2017) pg 45, (above n 31).
78 Lannoo (2017), pg 10, (above n 38).
79 See notably Alex Barker and Jim Brunsden, 'EU plan to curb City’s euro clearing set to be flashpoint in Brexit talks' Financial Times (16 December 2016) 1.
finding trading in euro less attractive.\textsuperscript{80} Granted the long-term euro area ambition to turn the euro into a globally competitive currency and a global reserve currency and to transform mainland Europe into a world-leading financial hub, this parameter should be taken very seriously into consideration in designing the supervisory framework of third-country CCPs post-Brexit. To that end, steps should be taken to harness a competitive environment. Progress with the creation of a Capital Markets Union is expected to boost competitiveness but this will not be enough. Competitiveness also requires improvements in the effectiveness of supervisory mechanisms, capital and liquidity requirements to be kept at safe levels, a harmonised system of taxation and policies that are innovation and technology friendly.\textsuperscript{81}

According to the ecosystem argument, the City of London global financial environment is unparalleled due to cultural differences, the English legal system, the English language currently used in the trade, the presence of a well experienced regulators, economies of scale, scope and information sharing.\textsuperscript{82} If the ecosystem argument is valid, then CCPs business will be difficult to relocate without a substantial or even a prohibitive increase of the cost of the financial services currently provided in the UK.\textsuperscript{83} France and Germany which are frequently cited as the most important OTC trading places in the EU are simply too small to match the margin pool benefits currently available in the UK. As long as they remain small, there is nothing to warranty that euro-denominated trades will be relocated in the EU instead of moving elsewhere as, for example, in New York, which has been granted equivalence in 2016 and it is already a big enough market.\textsuperscript{84}

The City of London environment may be unique but from that it does not follow that it cannot be replicated. Quite apart from the fact that investors are free to choose English as their language and English law and English courts for their private law and commercial law disputes irrespective of their domicile, the history of the making of the City of London is pretty instructive of how this might be repeated in the future. As with all other manmade creatures of legal engineering and institutional design, all it requires is political commitment and an endearing upheaval of top down EU legal reforms akin to the wave of British reforms of the conservative government in the late 70’s and early 80’s that led to the Big Bang in the City of London and its transformation into the world leading global hub of financial services (including clearing) that is today.\textsuperscript{85} To be sure, in the case of the EU the time horizon for a reform of such magnitude is very narrow but, on the other hand, the timing seems to be right. The capabilities of ESAs are fast growing and they becoming better overtime.\textsuperscript{86} Legal


\textsuperscript{81} European Research Centre for Economic and Financial Governance. (2017) pg 68, (above n 31) for a comprehensive summary of policy recommendations.

\textsuperscript{82} European Research Centre for Economic and Financial Governance. (2017) pp 50-51, (above n 31) (the ‘ecosystem argument’ is discussed in the context of hard Brexit scenario to support the claim that hard Brexit would be detrimental to both the UK and the EU).

\textsuperscript{83} UK based CCPs with subsidiaries in mainland Europe are expected to be less affected compared to those currently pursuing their business activities via branches. European Research Centre for Economic and Financial Governance. (2017) pg 51 (above n 31).

\textsuperscript{84} Pending the creation of an ecosystem comparable to the UK regime, New York will remain an attractive destination because its legal culture shares many points in common with English law which happens to be the most favourable choice of law for the issuance of OTC derivatives. European Research Centre for Economic and Financial Governance. (2017) pg 46 (above 31).


uniformity and with that legal certainty and predictability are fast improving too.\textsuperscript{87} Fragmentation remains a barrier to the creation of a concentrated European financial centre but progress with the creation of a Capital Markets Union will mitigate this problem.\textsuperscript{88} Furthermore, the equivalence framework of the European Commission could be deployed as a temporary measure to buy out time that will be required to put such an ambitious plan of action into motion.

In any rate, assuming that the UK will be granted equivalence status by the European Commission, the colossal size of euro-denominated clearing in the UK and its systemic salience for the euro area calls for a legal framework of cross-border supervision and regulation that is comprehensive, certain, predictable, durable and, perhaps, most importantly, resilient over political pressure. EU equivalence does not fit that picture. Accordingly, a third challenge for the European Commission would be to address those pitfalls. This would require moving beyond current attempts to harmonise and improve the consistency of the European Commission’s determinations about equivalence and to even consider its replacement.

Equivalence is but one amongst a range of different instruments that are currently in operation around the world for the effective management of cross-border cooperation and coordination. The relevant 2015 Report of the International Organisation of Securities Commissions (IOSCO) enlists five different approaches:\textsuperscript{89} (a) The national treatment approach currently practised in the US and requiring foreign firms to be subject to the same treatment as domestic financial firms (b) a regulatory approach based on exceptions, where the focus is on selected aspects of cross-border activity of foreign firms to which certain exceptions apply (e.g. Japan); (c) passporting which presupposes an international treaty and an agreement on a common set of rules for the operationalization of a single authorisation regime (e.g. Asia Region Funds Passport initiative) and; (d) international agreements aiming to reduce overlaps and enhance regulatory supervision (e.g. EU-Switzerland Non-Life Insurance Agreement). To be sure, all these approaches work within their own limitations. That being said, the national treatment approach as, for example, it is currently practiced in the US seems to be more transparent, simpler and more durable over time.\textsuperscript{90} It also seems liable to keep market disturbance to a minimum because, under this scheme, EU authorities can undertake the oversight of UK based CCPs, while the latter can continue providing euro-denominated clearing from the City.\textsuperscript{91}

The third challenge relates to the enhanced role of ESMA. According to the proposals currently on the table, ESMA is going to have broad powers regarding the recognition and supervision of third-country CCPs. This is bound to create uncertainty especially for the treatment of Tier 2 CCPs at least initially for the time it will take ESMA to provide guidance on how it intends to exercise its authority.\textsuperscript{92} Moreover, one should not lose sight of the fact that even though


\textsuperscript{91} European Research Centre for Economic and Financial Governance. (2017), pg 65, (above n 31).

\textsuperscript{92} Deloitte (2017), pg 5, (above n 35).
these powers are still officially dressed up as ‘technical’ in nature and ‘advisory’ to the European Commission, the exercise of those powers involves considerable discretion, the accommodation of which may once again test the limits of the Meroni doctrine with unpredictable legal consequences and possibly reputational costs for ESMA.93 This being the case, placing ESMA (EU agencies more generally) in a proper constitutional footing is recommended.

5. CONCLUSION

This paper examined the evolution of the supervisory framework of third-country CCPs in the EU making special reference to the treatment of risks associated with the imminent withdrawal of the UK from the EU (Brexit). The proposed amendments are in the right direction. The EMIR II legal framework will be more proportionate and risk based. The granting of more powers to ESMA is also expected to be instrumental to the implementation of a more proactive approach to cross-border financial crisis management. The introduction of a relocation requirement as a last resort for systemically significant third-country CCPs will also be a welcome development because it will bring those CCPs under the direct supervision of the ECB.

Nevertheless, there are still challenges ahead. An unintended consequence of the relocation requirement might be to drive a substantial part of euro-denominated clearing to an overseas jurisdiction that has been granted equivalence instead of mainland Europe. The EMIR II framework will continue to evolve around the legal concept of equivalence but the equivalence framework of the Commission is by its very inception neither resilient over political pressure nor necessarily durable over time to be able to provide a reasonably stable mechanism for the long term management of cross-border systemic risks. Last but not least, the accommodation of the enhanced powers of ESMA are likely to call for more creative interpretations of the Meroni doctrine in the future with unpredictable legal consequences.

In response to those challenges the following recommendations were made. As long as it is desirable to keep the existing high volume of euro-denominated clearing and to attract the relevant business in mainland Europe, a more comprehensive package of measures will be required to turn the single market into a world-leading hub for capital markets. There is no magic way to do this but thankfully the EU will not have to reinvent the wheel. It can learn from the experience of those who did it first, in this particular case the UK, by finding out how almost forty years ago Great Britain turned the City of London into the unique ecosystem of financial services that it is today. The equivalence framework should also be reconsidered so that it becomes more resilient and stable over time. Treaty amendments also recommended to place the mandate and powers of ESMA on a proper constitutional basis as this would befit its enhanced supervisory role for the smooth and safe functioning the Capital Markets Union.
REFERENCES


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