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Recovery and Resolution of CCPs: Obsessing over regulatory symmetry?

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We already know quite a lot about the legislative initiatives and supervisory guidance on the recovery and resolution of central counterparties (CCPs). As Steven Maijoor nicely put it, the task of managing the risk of default by CCP can be condensed into three interlinked aspects: "resilience, recovery and resolution".[1] Having all this in mind, I would like to focus in this commentary on the international and institutional dimensions of the current EU proposals for recovery and resolution and then briefly conclude with a question of European institutional design that, to my mind, remains unanswered in the current EMIR 2.2 framework.

Resilience, recovery and resolution

Resilience is based on requirements that impose: i) pre-funded resources to cover default losses under extreme but plausible market conditions, including at least the default of the two biggest clearing members; ii) capital requirements to protect against the risks of non-default

[1] Steven Maijoor, "Resilience, Recovery and Resolution: Three essential Rs for CCPs", paper presented at ILF Conference on Resolution in Europe: The Unresolved Questions, Goethe University, Frankfurt am Main, 23 April 2018.

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losses (operational, legal and business risks) and to provide "skin-in-the-game" for CCPs' operators; and iii) concentration limits on transactions, to contain investment and custody losses and on clearing members' counterparts, to contain the illiquidity risks.

Yet, and on top of that, as Benoit Coeuré also recently observed,[2] the resilience of CCPs is *per se* particularly strong: CCPs manage the risk of a matched book and, unlike deposit-funded banks, rely on the financial strength of their members to provide margins and, if they prove insufficient, on their collective awareness that they will be called upon to share additional losses (through cash calls, haircuts of variation margins, forced allocation of positions and contracts, full or partial tear up and other tools).[3] Coeuré captures this point very well, noting that "bail-in is integral to CCPs' operational set up" and, in turn, that since banks are the most important clearing members, bank supervision, recovery and resolution help ensure that clearing members meet all clearing obligations and therefore do not pose a threat to CCP continuity.

Recovery comes when CCPs must address uncovered default losses beyond the pre-funded resources or uncovered non-default losses. This should be, in principle, an unlikely event, if plans meant to ensure resilience and ongoing supervision have been duly engineered and implemented. Resolution should occur as a tail event – a 'black swan' – but an extremely catastrophic one. And this justifies the ammunition of resolution instruments that are currently devised to ensure an orderly default procedure for CCPs without disruption of critical services to preserve financial stability.

Again, as noted by Maijoor, "recovery and resolution arrangements should maintain incentives to ensure reliance in the business as usual situation". Moreover, recovery has a micro-perspective (the objective to maintain a CCP's viability as a going concern: note, however, that this cannot be at the price of jeopardising financial stability; if there is a conflict, macro-prudential needs should prevail over the micro-prudential ones and "the competent authority may require the CCP to refrain from taking the recovery measure: see Article 9(4) EC Proposal for a Regulation on CCP recovery and resolution), whereas resolution has a macro-perspective (the objective is to pursue financial stability by preserving the continuity of critical services, possibly also by a successor entity, if the CCP is wound down). This has important implications: what we qualify as an essential critical service is likely to be different in a recovery perspective (which is meant to preserve all services vital to the ongoing viability of the entity) and in a resolution perspective (which is meant to focus only on services vital to financial stability). Thus, strategies, planning and tools may also be different.

International perspective

If we look at recovery and resolution of CCPs from an international standpoint, it is clear that Europe is a latecomer. The US Commodity Futures Trading Commission (CFTC) was the first CCP supervisor to finalise a rule in 2013 – and thus some five years ago, by now – establishing

[2] "A cooperative approach to CCP recovery and resolution", Paper presented at ILF Conference on Resolution in Europe: The Unresolved Questions, Goethe University, Frankfurt am Main, 23 April 2018.
[3] On the specific recovery tools, see CPMI IOSCO, "Recovery of financial markets infrastructures", revision July 2017, p. 4.

recovery and resolution planning requirements. Subsequent CFTC guidance, adopted in 2017, raised further the bar, as has been noted,[4] on the depth and breadth of detail and analysis expected for CCPs. And this occurred when banks and insurance companies in the US received some relief with respect to their resolution plans.

In turn, international standards for recovery of financial market infrastructures were first developed in 2014 by the Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO) and then refined and revised in July 2017. More recently CPMI-IOSCO issued, in April 2018, a framework for supervisory stress testing of CCPs. The Financial Stability Board (FSB), in turn, adopted in 2014 its Key Attributes, issued in July 2017 its guidance on CCPs Resolution and Resolution Planning and on 21 June 2018 its very interesting "Funding Strategy Elements for an Implementable Resolution Plan".

The reason why an international approach, and not just a national or regional one, is necessary is clear: many CCPs are globally systemic, in that they clear derivatives in global markets and their members and clients' members are from across the world. It is very difficult to identify a financial player (in this case a financial infrastructure) that is less parochial and more interconnected than CCPs, although it is true that among the 26 across 15 jurisdictions in North America, South America, Europe and Asia-Pacific assessed for their interdependence by the FSB and IOSCO in July 2017,[5] some are more peripheral and less systemically relevant (but also the less interconnected present at least one node of interconnection with the globally systemically).

This calls for detailed international standards and their loyal implementation through strong international cooperation among all competent authorities responsible for all major cross-border CCPs. However, whilst we have the standards, we do not have any joint resolution planning among competent authorities and, as again Benoit Coeuré rightly noted, despite the requirement to this effect in the FSB Key Attributes, "no cross border crisis management arrangements are yet in place". This means that, globally, we are quite advanced in the development of our law in the books (our 'coding') for CCPs recovery and resolution (including rules on the establishment of Crisis Management Groups and CCP-specific cooperative agreements: see FSB Key Attributes 7 and 8 and p. 9 of FSB Guidance), but we are still quite unprepared as to the law in action, at least at the level of the external dimension of the cooperation among competent authorities as to cross border, joint recovery and resolution planning. It is sad, but to some extent understandable, if only we consider that the centrality of CCPs is a product of post-crisis regulation and CCP supervision is still at its infancy.

The good news, however, is that the direction we are taking at the global level is clear and progress is measurable. This should be qualified, however, with a comment, which may be obvious: the fewer in number and the bigger in size and expertise the CCPs competent authorities, the easier it is to implement their international strict cooperation.

[4] D. Ryan, "Recovery and Resolution: Uneven Bars for CCPs and Banks", paper presented at Harvard Law School Forum on Corporate Governance and Financial Regulation, Cambridge, MA, 27 August 2016.
[5] FSB, OICV-IOSCO, 'Analysis of Central Clearing Interdependencies', 5 July 2017 (data as of 30.9.2016).

Developments at EU level

Unfortunately, despite its best efforts with recent legislative initiatives, Europe seems still quite unable to deliver an optimal regional dimension of supervision on EU CCPs. In Europe we still supervise EU CCPs at the local level, adopting different supervisory schemes (in the UK and Italy CCPs are not licensed as banks, as they are in France and Germany) and we still credit what is clearly a misconception of the possible effects of their resolution: that this would entail national fiscal responsibility of the member state of establishment. This is however a misguided policy.

On the one hand, it is self-evident that, as again Benoit Coeuré noted, "given that cross-border membership of EU banks in EU CCPs is widespread", interdependence and spill-over effects would be such that a failure of a major EU CCP would generate EU-wide fiscal risks, and namely fiscal risks in each member state where CCP participants are located. On the other hand, even assuming that a CCP's home country may be called into action as a temporary public sector backstop funding mechanism (as envisaged e.g. from the FSB Funding Strategy Elements of an Implementable Resolution Plan and in turn by Articles 45-47 of the Commission proposal for a Regulation on CCPs' recovery and resolution), "to provide temporary public funding during resolution, such support would be then recouped from clearing members, in line with their obligations to contribute to comprehensive loss absorption".

One may argue that under the European Market Infrastructure Regulation (EMIR), EU CCPs are supervised by the home country supervisor with the assistance of colleges. The problem lies however with the functioning of such colleges. A reality check shows that these colleges can include as many as 20 member authorities, that the decision making powers, despite college assistance, are firmly in the hands of the home country competent authority, that there are significant differences in supervisory practises (also on model validation processes) and that the role of central banks is not adequately reflected in the colleges. One must be quite an optimistic person indeed to trust that this clearly sub-optimal, fully decentralised institutional design engineered for EU CCPs supervision[6] and now transplanted by the current proposal on CCPs recovery and resolution in the resolution context[7], is up to the task.

At the same time, it seems to me that this institutional design for EU CCPs' supervision and resolution sits in sharp contrast with the envisaged policy to be adopted vis-à-vis third country CCPs. This latter policy was clearly engineered as a response to Brexit and with an hawkish flavour in it, if one considers the exposed 'nuclear weapon' of CCP re-location for Tier2 CCPs posing a risk to the Union's financial stability.

[6] For a discussion of existing supervisory arrangements on CCPs and their proposed reform, compare at least D. Busch, "A stronger role for the European supervisory authorities in the EU 27", in Busch, Ferrarini, Avgouleas (eds), *Capital Markets Union in Europe*, Oxford: OUP, 2018, p. 28; M. Lamandini and D. Ramos Munoz, "Supervisory Systems after Brexit: Coordination between EU and UK on a daily basis", EBI Working Paper 2018, forthcoming; R. Bismuth, "The Federalisation of Financial Supervision in the US and the EU: A Historical-Comparative Perspective", in M. Andenas and G. Deipenbrock (eds), *Regulating and Supervising European Financial Markets*, Springer, 2016, p. 231 ff.

[7] Article 4 of the Commission proposal for a Regulation on CCPs' recovery and resolution, noting that, pursuant to Article 4(3) ESMA has no voting rights in the college.

The role of ESMA

However, out of any obsession for regulatory symmetry, the two-tiered approach in third-country (TC) CCP supervision also carries a lesson for EU CCPs supervision. ESMA could be the key supervisor for all systemically relevant Tier 2 CCPs, EU and TC alike. TC CCPs are going to find that their powers are stretched to an unprecedented degree, requiring an extraterritorial dimension for Europe, based on an appropriate MoU with the home country supervisor, mirroring the procedure already followed by US competent authorities. Reliance on national competent authorities and colleges, provided that they are duly geared by ESMA, may be enough for Tier 1 CCPs (and a nice example of applied proportionality, a key principle rightly enshrined also in the EU proposal for a Regulation on CCPs' recovery and resolution under Article 7).

Only in this way will ESMA be able to develop a credible internal supervisory unit for CCPs. (How can we expect ESMA to do so, if it is called only to directly supervise Tier 2 third-countries' CCPs?). And it will credibly be able to act as the single European entry point for international cooperation in cross-border recovery and resolution planning for all globally systemic CCPs. As an aside, I note that Steven Maijoor also rightly argues that "it is important to have the right balance between EU-CCP supervision and TC-CCP supervision because only in that way we can achieve the envisaged benefits in terms of scale and expertise and ensure credibility of EU supervise of TC-CCPs".)

The envisaged reform of its governance with the ESAs reform and the ensuing accommodation of the original proposal for a CCP Executive Session to the new ESAs governance (centred on the CCPs Supervisory Committee and its full-time, professional and independent Chair), seem to point to this end. At the same time, it is worth noting that ESMA, being the sole EU financial supervisory agency with direct supervisory experience beyond the SSM, is going to be granted, through CCPs direct supervision, a pivotal role in the preservation of financial stability. Moreover, this move implies that new micro- and macro-prudential remits will be conferred upon an agency which so far has had little financial stability standing compared to the other financial supervisory agencies.

As I have said, I am not obsessed with regulatory symmetry and I believe that this may turn into an unexpected opportunity to leverage skills and an enhanced role for ESMA. But this also explains why the legislative proposals rightly insist on the complementary role that must be given to the central banks of issue (for which preservation of financial stability is a complementary mandate along with the price stability mandate: see e.g. for the ECB Article 127(1) and 127(5) TFEU).

Concluding remarks

This brings me to the conclusion and to a simple question.

If we can agree that a rational design of institutional engineering would be conducive to a key role for ESMA for all Tier 2 (systemically relevant) CCPs and for a complementary role of the ECB as central bank of issue for all euro-denominated trades (also based on the envisaged reform of Article 22 of its Statute), shouldn't we also ask if the time has come to require a special banking license for all EU CCPs and to take, in this way, also the Single Resolution Board (SRB) into the picture?

So far, out of the 16 EU-based CCPs, 10 are located in the euro area. Three – and among them LCH – are based in the United Kingdom and are therefore bound to become third-country CCPs. Of the remaining three, one is Swedish and is the European leg of Nasdaq OMX clearing (and will thus call for a strong international cooperation between the US and the EU). The latter two are Tier 1 CCPs based in Poland and Hungary. Among the 10 CCPs located within the euro area, some are licensed as banks and already fall, therefore, within the scope of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).

Wouldn't it make sense to bring the 10 CCPs in the euro system under the umbrella of the SRB as a resolution authority and extend to them, as a last resort, the use of the temporary public sector funding mechanism of the Single Resolution Fund (SRF) and its forthcoming final fiscal backstop, the European Monetary Fund?

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