



Central Counterparties Recovery and Resolution Proposal: Frequently Asked Questions

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What are central counterparties (CCPs)?

A central counterparty (CCP) is a financial market infrastructure that links the two parties to a transaction, becoming the buyer to every seller and the seller to every buyer. A CCP's main purpose is to manage the risk of one counterparty defaulting (i.e. not being able to make the required payments when they are due), in doing so, this reduces overall risk in the system. CCPs are, therefore, interconnected with all financial institutions that are active on the markets they clear.

What do CCPs clear and how big are they?

CCPs clear a range of financial instruments including bonds, equities, derivatives and commodities (such as agricultural products, oil and natural gas). They help financial firms and non-financial end users such as corporates to manage their risks better. This makes them an important part of the financial system, as they manage significant amounts of counterparty risk and link multiple banks, other financial counterparties and corporates.

In the EU, there are currently 17 CCPs that clear a significant proportion of the EUR 500 trillion of derivatives outstanding. The scale and importance of CCPs will further increase following the implementation of the G20 commitment to clear standardised over-the-counter (OTC) derivatives through CCPs – this commitment was a key post-crisis measure to make financial markets safer. In 2015, on average more than 50% of the OTC derivatives market was centrally cleared by CCPs across all types of derivative contracts – almost double the percentage from when the G20 commitment was made in 2009. On average, 70% of all new OTC derivatives transactions can now be cleared.

Therefore it is important to ensure there is a framework in place should a CCP get into difficulties.

Why is the Commission proposing a framework for CCP recovery and resolution?

The past financial crisis clearly illustrated that the failure of an important financial institution which is highly interconnected with others in financial markets can cause problems for the rest of the financial system and negatively impact growth across the wider economy.

The [proposal](#) adopted today by the Commission for EU-wide rules for CCP recovery and resolution will help to address this. It ensures that CCPs and authorities in Europe have the means to act decisively in a crisis situation. An effective resolution regime will also reduce moral hazard as it will incentivise less risky behaviour by CCPs and market participants.

The main objectives of the proposal are:

- To ensure that CCPs' critical functions (i.e. those functions and services that are necessary for the financial markets to work) are preserved while maintaining financial stability,
- To help to prevent taxpayers from bearing the costs associated with the restructuring and the resolution of failing CCPs and
- To avoid any unnecessary destruction of value (i.e. higher losses or costs associated to the resolution actions that would otherwise be required to meet the resolution objectives).

This proposal builds on the same principles as the Bank Recovery and Resolution Directive (BRRD). It also strengthens the EU's crisis management framework (comprising both [BRRD](#) and the [Single Resolution Mechanism Regulation](#)) and complements other legislative initiatives designed to make the financial system safer, in particular the risk reduction measures that have been adopted on the 23rd of November.

Why now?

CCPs in the EU are well regulated under the European Market Infrastructure Regulation (EMIR) and they have a number of defences to avoid and absorb losses, which means the risk of failure is relatively low. However, as CCPs are becoming increasingly important in clearing OTC derivatives markets, it is important to ensure there is a framework in place to deal with a CCP should things go

wrong.

At present, there are no harmonised EU rules for the unlikely situations in which CCPs would face severe distress or fail.

How does the proposal relate to work undertaken at international level?

The Commission's initiative is aligned with the existing international guidance on recovery and resolution (see below) and is consistent with international developments in this area.

At the international level, G20 leaders have endorsed an approach developed by the Financial Stability Board (FSB) to address the possible risks posed by the failure of any financial institution (such as banks, financial market infrastructures and insurance undertakings) of global systemic relevance on the financial system. This would be done by using comprehensive and appropriate recovery and resolution tools.

Furthermore, the Committee on Payment and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO) have developed guidance on recovery plans for financial-market infrastructures (see [here](#)) including CCPs, while the FSB has issued further guidance on the application of its Key Attributes of Effective Resolution Regimes to financial market infrastructures such as CCPs (see [here](#))

What are the key elements of the proposal?

The proposal lays out a comprehensive set of measures which aim to ensure that:

- National resolution authorities are designated in each Member State. These could be national central banks, ministries or the existing supervisory authorities.
- National supervisory authorities, as designated under EMIR, are given the tools and powers to intervene in a CCP that is infringing or likely to infringe its prudential requirements and at a sufficiently early stage to address developing problems in a CCP's financial situation;
- CCPs and national supervisory and resolution authorities are adequately prepared for any crisis;
- National resolution authorities have harmonised resolution tools and powers to take rapid and effective action when a CCP failure cannot be avoided;
- National resolution authorities cooperate effectively, including with third country competent authorities.

The framework takes into account the global and systemic nature of CCPs. It provides for close coordination between national competent authorities in order to ensure that resolution actions are applied in a coherent manner taking into consideration the impact on affected stakeholders and financial stability.

The **key elements** of the proposal are:

- The framework will be based first on **prevention and preparation**. CCPs (subject to the approval of supervisory authorities) and resolution authorities are required to draw up recovery and resolution plans respectively on how to handle any form of financial distress which would exceed a CCP's existing resources. If resolution authorities identify obstacles to resolvability in the course of the planning process, they can require a CCP to take appropriate measures including changes to its operational or legal structure or to its pre-funded loss-absorbing resources on a case-by-case basis to ensure that it can be resolved with the available tools in a way that does not threaten financial stability and does not involve costs to taxpayers.
- Supervisory authorities have the powers to **intervene at an early stage** (i.e. before the problems become critical and the financial situation deteriorates irreparably) when a CCP is in breach of, or is about to breach, its prudential requirements under EMIR. These powers would complement those in EMIR, constituting specific supervisory options in these circumstances. Amongst others, competent authorities could require the CCP to undertake specific actions in its recovery plan or to make changes to its business strategy or legal or operational structure.
- The framework will provide national authorities with **resolution tools**. While minimising the extent to which the cost of a CCP's failure is borne by Member States and their taxpayers, these tools should ensure that essential clearing functions and services are preserved without the need to bail out the CCP, and that shareholders bear an appropriate part of the losses.

How will national authorities cooperate?

As CCPs are cross border and in many cases global, cooperation between national competent authorities is essential for the system to work. The proposal requires an appropriate coordination of resolution measures in a cross-border context to protect financial stability in all affected Member States and achieve the most effective outcome for the resolution of a CCP.

Considering the role set by EMIR for colleges of supervisory authorities, as well as the possible impacts which resolution actions can have on clearing members and other stakeholders, CCPs' resolution authorities are required to set up and chair resolution colleges for each CCP. The resolution college will include all the relevant authorities from across the EU.

What are the main resolution tools?

In the unlikely event that a CCP does fail, authorities are equipped with tools to resolve the CCP and reducing the impact on financial stability. The main resolution tools include:

- The **sale of business tool** whereby the authorities would sell all or part of the failing CCP to another entity;
- The **bridge CCP tool** which consists of identifying essential functions of the CCP and separating them into a new CCP (bridge CCP) which could be eventually sold to another entity. The old CCP with the non-essential functions would then be liquidated under normal insolvency proceedings;
- The **position allocation tool** (i.e. partial or full termination of contracts) which aims at re-matching the book of the CCP;
- The **loss allocation tools** (i.e. haircutting of variation margin and cash calls enacted by the resolution authority) which aim to cover the losses of the CCP, restore its ability to meet its payment obligation, recapitalise the CCP and replenish its pre-funded financial resources;
- The **write-down and conversion of capital and debt instruments or other unsecured liabilities tool** which aims at absorbing losses, recapitalising the CCP or bridge CCP or support the use of the sale of business tool.

The proposed Regulation does not mandate which tools and powers to use in different scenarios but leaves the choice of the most appropriate tool in each situation to the resolution authority; however, where practicable, the resolution authority should act in line with the agreed resolution plan.

Use of the resolution tools is governed by certain safeguards to ensure all parties affected are fairly treated. One of these safeguards is the principle of "no-creditor-worse-off", according to which no creditor should be worse off in resolution than they would have been in the event the CCP entered into insolvency.

What are the conditions to enter into resolution?

A CCP will become subject to resolution when:

- There are no realistic prospects of recovery over an appropriate timeframe,
- All other intervention measures (such as the default management procedures foreseen in a CCP operating rules or its recovery measures) have been exhausted or could impede the financial stability of one or more Member States,
- Winding up the CCP under normal insolvency proceedings would risk prolonged market uncertainties and financial instability.

Entry into resolution will therefore always occur at a point close to insolvency, though authorities will have a degree of discretion to ensure that they can intervene before it is too late for resolution to meet its objectives.

What will be the role of ESMA?

ESMA will play a coordination role both during the prevention and early intervention stages (in particular in resolution planning), with a view to facilitating the adoption of joint decisions (acting as a binding mediator if necessary). To prepare its decisions under this Regulation, ESMA is required to set up a Resolution Committee composed of CCPs' resolution authorities designated under the proposed Regulation.

Furthermore, in order to ensure full input of the supervisory and resolution authorities of banks (i.e. the CCPs' clearing members) in this process, these authorities shall be invited to participate as observers to the ESMA Resolution Committee.

How will the proposed Regulation affect interactions with third countries?

In order to improve the enforceability of an EU authority's action on clearing members located in third countries, CCPs would be required to ensure that the relevant measures set out in their recovery plans are legally binding across jurisdictions. This means ensuring that recovery options constitute contractual obligations under the law of the country in which the CCP is established, or otherwise demonstrating to the satisfaction of competent and resolution authorities that the plans' provisions are enforceable, for instance under the law of a third country. This would help resolution authorities enforce any outstanding obligations in these plans in resolution.

Similarly, the proposal enables resolution authorities to require CCPs to amend their contracts and other arrangements, in particular under their operating rules, so to facilitate the effective achievement of resolution actions that would affect assets, contracts, rights, liabilities and instruments of ownership of persons located in or governed by the law of third countries.

Beyond this, authorities should engage in cooperation with third country authorities in order to recognise and enforce their decision in relation to any relevant assets or contracts governed by the law of that country.

In order to facilitate the enforcement of actions by a third-country resolution authority on relevant clearing members, contracts or other assets or liabilities located in the EU, relevant Member State authorities will be in charge of recognising and giving effect to them, or refusing to do so in specific circumstances. Recognition will occur provided the third country resolution measures do not have an adverse effect on the financial stability of the Member State, creditors of the CCP receive the same treatment as other creditors regardless of location, and there would be no material fiscal implications for the Member State.

Furthermore, national competent authorities may conclude framework cooperation arrangements with relevant third country authorities for sharing the necessary information and cooperating in carrying out tasks and exercising powers related to the resolution of CCPs.

When will today's Regulation take effect?

Once adopted, the proposed Regulation on CCP Recovery and Resolution shall take effect once the Commission proposal amending the BRRD – which has been put forward by the Commission on 23 November (see [here](#)) – takes effect. This is the case, as that proposal also extends the scope of application of its Title VIII on penalties to CCPs. This extension ensures that sanctioning powers regarding recovery and resolution of financial institutions are consistent.

What work has been previously done on this by the Commission?

In the EU, a [public consultation on a possible recovery and resolution framework for non-bank institutions](#) was carried out by the European Commission between 5 October and 28 December 2012. It inquired about the need for recovery and resolution arrangements mainly in relation to CCPs, central securities depositories and insurance undertakings.

On the whole, the consultation indicated that the priority should be to develop EU-wide recovery and resolution rules for CCPs. The implementation of the G20 requirement for standardised OTC derivatives to be centrally cleared was recognised as a compelling argument in favour of taking action.

What are the next steps?

The proposed Regulation will now be submitted to the European Parliament and the Council of the EU for their approval and adoption.

Key Data

- Outstanding OTC derivatives (31/12/2015): USD 493 trillion.
- Outstanding interest rate OTC derivatives (31/12/2015): USD 384 trillion (78% of the above total outstanding OTC derivatives). This includes swaps, FRAs, options.
- Outstanding credit OTC derivatives (31/12/2015): USD 12 trillion (2,4% of the above total outstanding OTC derivatives).

Source: BIS derivatives statistics and BIS quarterly review December, 2015.

Centrally cleared transactions have almost doubled:

- % interest rate OTC derivatives centrally cleared before clearing obligation = about 36% (end 2009).
- % interest rate OTC derivatives centrally cleared after clearing obligation = about 60% (end 2015).
- % credit OTC derivatives centrally cleared before clearing obligation = about 12% (end 2009).
- % credit OTC derivatives centrally cleared after clearing obligation = about 45 % (end 2015).

Central clearing will increase in the future:

As of June 2015, about USD 90 trillion of interest rate swap (IRS) contracts is centrally cleared, about the half of the IRS market, suggesting scope for a further increase in central clearing.

List of EU CCPs (cf. ESMA Register):

https://www.esma.europa.eu/sites/default/files/library/ccps_authorized_under_emir.pdf

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Attachments

[Factsheet CCPs recoveryresolution.pdf](#)