Implementation by the Bank of England of ESMA's Guidelines and Recommendations on CCP interoperability arrangements

November 2014

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Consultation Paper

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The Bank of England invites comments on this consultation paper. Comments should reach the Bank by 16 January 2015.

Comments may be sent by email to FMIFeedback@bankofengland.co.uk.

Alternatively, please send comments in writing to:

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Implementation by the Bank of England of ESMA's Guidelines and Recommendations on CCP interoperability arrangements

1. The European Securities and Markets Authority (ESMA) has issued Guidelines and Recommendations[1] ('the Guidelines'), as mandated under Article 54(4) of EMIR,[2] 'with a view to establishing consistent, efficient and effective assessments of interoperability arrangements' in which EU central counterparties (CCPs) participate.

2. The Bank of England ('Bank') has notified ESMA that it will comply with the Guidelines and implement them in respect of CCPs for which it is the National Competent Authority (NCA).

3. Interoperability arrangements offer some financial stability benefits, notably by expanding the scope of netting, but the creation of a link between two or more CCPs also creates risks that need to be prudently managed. As a general matter the Bank expects CCPs to consider the systemic implications of their actions and to mitigate risk both to themselves and to the broader market.[3]

4. This paper consults on the supervisory approach that the Bank is considering taking to implement the ESMA Guidelines in certain specific areas. In many of those areas, UK CCPs are already operating in line with the approaches proposed.

5. This paper discusses five such areas. These are:

(i) the level of margin that should be provided by each CCP to the other ('inter-CCP margin');

(ii) the means by which CCPs source this inter-CCP margin;

(iii) the application of CCP default resources (other than inter-CCP margin) to exposures to interoperating CCPs;

(iv) arrangements to manage the impact on one CCP of the deployment of loss allocation rules by the other; and

(v) the application of the Guidelines to interoperable arrangements for derivative products.

6. This consultation has been sent to UK CCPs and their Risk Committees, non-UK CCPs with which they interoperate, the NCAs of those interoperating CCPs, the Financial Conduct Authority (FCA) and ESMA. It has also been published on the Bank's website.

7. Please send responses to this consultation paper by email to FMIFeedback@bankofengland.co.uk by 16 January 2015.

(i) The level of inter-CCP margin

8. Guideline 3(b)(i) states that the financial risks from interoperability arrangements should be identified, monitored, assessed and mitigated with 'the same rigour as the CCP's exposure arising from its clearing members'. Guideline 3(b)(iii) specifies that CCPs should assess, collect or have access to inter-CCP resources 'necessary to cover credit and liquidity risk arising from the interoperable arrangement, including in extreme but plausible market conditions'.

9. CCP margin models are not normally calibrated to cover the requirement to meet exposures in 'extreme but plausible market conditions'. That requirement is achieved by the addition of other pre-funded resources, notably a mutualised default fund. Unlike an ordinary Clearing Member (CM), an interoperating CCP is not permitted to contribute to another CCP's default fund.[4] This suggests that, unless each interoperating CCP contributes some additional resource to the other to reflect the risk of loss faced by that other CCP in 'extreme but plausible market conditions', the risk management approach would not be of 'the same rigour' as that applied to the ordinary CMs of each CCP.

10. One approach that could ensure compliance with Guideline 3(b)(i) would be for a CCP to collect at least the amount of inter-CCP margin from an interoperating CCP as it would ordinarily collect in margin and default fund contribution combined from a CM with the same positions. This may, however, entail additional costs for CCPs (and their members) participating in interoperability arrangements.

Q1: The Bank would particularly welcome feedback on whether this approach strikes the appropriate balance between safeguarding against the systemic risk of contagion between CCPs and not undermining the benefits of interoperability. The Bank would welcome suggestions for alternative methodologies that would also meet the Guidelines. The approach adopted must unambiguously meet the requirement set out in the Guidelines to cover risks with the same degree of rigour as exposures to clearing members.

(ii) The sourcing of inter-CCP margin

11. Guideline 3(a)(i) states that an interoperability arrangement should not 'impact on the compliance by the CCPs… with the requirements to which they are subject under (EMIR) and relevant technical standards or equivalent regulations in third countries. In this respect these requirements should be met by each CCP on a standalone basis, in particular with reference to pre-funded financial resources including margins'.

(1) ESMA, *Guidelines and Recommendations for establishing consistent, efficient and effective assessments of interoperability arrangements: final report* (10 June 2013): www.esma.europa.eu/system/files/2013-323_annex_1_esma_final_report_on_iguidelines_on_interoperability.pdf.
(2) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.
(3) See Bank of England, *The Bank of England's approach to the supervision of financial market infrastructures* (April 2013), pages 7 and 8 www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf.
(4) *Guidelines*, 3(b)(v), page 29.

12. Interoperability exposes an interoperable CCP to counterparty risk from its linked CCP(s) that is new and additional to the counterparty risks arising from exposures to its CMs. These CM exposures must continue to be margined and risk-managed in accordance with EMIR. The Bank's view is therefore that in order to satisfy this requirement, any margin posted by one CCP to another CCP **should be separate from and additional to** the margins already collected by a CCP to cover its exposures to CMs. This is necessary because if margin provided by a CM is posted to an interoperating CCP, it would no longer be readily available to protect against the default of the CM which has provided it. This does not preclude a CCP from calling 'additional' margin from CMs, which could be used as inter-CCP margin. Alternatively, a CCP may employ other kinds of resources, for example that part of its own capital which is not required to meet regulatory requirements (including under Articles 16 and 45 of EMIR).

13. UK CCPs are already operating on this basis, in line with the regulatory position adopted by the Netherlands Authority for the Financial Markets (AFM), De Nederlandsche Bank (DNB), the Swiss Financial Market Supervisory Authority (FINMA), the Swiss National Bank (SNB) and the UK Financial Services Authority (FSA) in 2010.

Q2: Do respondents agree that any margin posted by one CCP to another CCP should be *separate from and additional to* the margins already collected from a CCP's CMs to cover that CCP's exposures to its CMs ?

(iii) CCP default resources other than inter-CCP margin

14. Sections 3(f)(ii) and (iii) of the Guidelines state that a CCP should put in place 'risk management tools, such as margin or default fund policies, to address any weakening of the CCP's overall risk management framework due to the interoperability arrangement' and put in place arrangements 'to meet exposures arising from the interoperability arrangement, including in extreme but plausible market conditions'.

15. In order to meet this requirement, a CCP could include exposures to other CCPs in the calculation of the total pre-funded resources that it needs to hold, and a CCP's default fund could be made available to meet losses caused by the default of an interoperating CCP. In other words, if an exposure to an interoperating CCP is amongst the two largest exposures faced by a CCP, it would set the size of its default fund and other pre-funded financial resources accordingly, and the default fund would be available to meet such a loss.(1) This would ensure that a CCP is able to withstand the simultaneous default of its largest two counterparties, irrespective of whether they are a CM or an interoperable CCP, in extreme but plausible market conditions. This approach would appear to strike an appropriate balance between ensuring that the CCP holds sufficient resources to manage the default of an interoperable CCP, without requiring either CCP to source or provide a potentially very material increase in default resources.

16. If this approach is not taken, then CCPs must employ other means to ensure that they hold sufficient resources to guard against the default of an interoperating CCP in extreme but plausible market conditions, for example by collecting sufficient additional inter-CCP margin to cover the full stressed loss. This is consistent with ESMA guidance.(2)

17. UK CCPs already include the positions of interoperating CCPs in the sizing of the default fund.

Q3: Should CCPs (i) include exposures to inter-operating CCPs when calculating the loss to their largest two members in extreme but plausible market conditions, and (ii) make the default fund available to meet losses incurred following the default of an inter-operating CCP? Are there other ways in which a CCP can meet the ESMA Guidance to put in place arrangements 'to meet exposures arising from the interoperability arrangement, including in extreme but plausible market conditions'?

(iv) Loss allocation rules and post-default arrangements

18. UK CCPs have adopted 'loss allocation rules' that set out how any loss that exceeds the CCP's pre-funded resources will be allocated to participants.(3) Guidelines 3(a)(v)(a-b) state that interoperating CCPs should agree any changes to the rules of one CCP that will directly impact the interoperability agreement. Depending on their design, the loss allocation rules could potentially impact interoperability agreements.

19. In the Bank's view, interoperating CCPs should consider any interaction between their loss allocation rules and the interoperability arrangement and make changes as necessary to the interoperability agreement between them.

20. The Bank does not consider it desirable or feasible to require that a CCP should include an interoperating CCP within the scope of its loss allocation arrangements and UK CCPs currently exclude interoperating CCPs from their loss allocation arrangements. Unless the interoperating CCP agrees to be subject to each other's loss allocation rules, a CCP

(1) Under EMIR Article 43, a CCP must maintain pre-funded default protections which, at all times, enable the CCP to withstand the default of the two clearing members to which it has the largest credit exposures under extreme but plausible market conditions. The approach stated here would enable the CCP to withstand the default of the two counterparties that present the largest exposure to it, whether these counterparties are interoperable CCPs or clearing members. This does not imply that a CCP should contribute to an interoperable CCP's default fund.

(2) *Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR): Questions and Answers*, CCP question 21. Available from www.esma.europa.eu/page/Post-trading-documents.

(3) UK CCPs are required to have such arrangements under the UK Recognition Requirements Regulation (www.legislation.gov.uk/uksi/2013/1908/regulation/3/made?view=plain).

('CCP1') seeking to allocate losses to an interoperating CCP ('CCP2') could result in CCP2 placing CCP1 into default and seizing its margin to offset the allocated loss.

21. Accordingly, trying to allocate losses to an interoperating CCP is unlikely to be effective or conducive to maintaining financial stability. If interoperating CCPs are not, however, included within the scope of one another's loss allocation arrangements, each CCP's loss allocation rules need to be able to apply losses in full to its owners and surviving participants, including losses arising from the default of an interoperating CCP.

22. CCPs should also consider what additional steps they should put in place to mitigate the impact of the default of an interoperating CCP. For example, CCPs should consider whether establishing arrangements to port relevant positions of surviving CMs of the failed CCP to the surviving CCP would assist the surviving CCP to manage the default of the interoperating CCP. This should be done by identifying arrangements that best mitigate the impact on those CMs and on financial stability more broadly.

23. A CCP should consider whether it should have arrangements to terminate open positions with a failed interoperating CCP (and the associated 'other side' of positions held by the CCP's own CMs) in the event that the positions that the failed interoperating CCP holds with the CCP are so large or of a nature that it may not be possible for the surviving CCP to close out, auction or replace them at reasonable cost. Given the effect this would have on its own participants, termination would need to be carefully considered by the CCP's Risk Committee.

Q4: Do respondents agree that it is not desirable or feasible for CCPs to include interoperating CCPs within the scope of their loss-allocation rules? Do respondents have comments on the other measures that interoperating CCPs could put in place to mitigate the impact of the default of an interoperating CCP?

(v) Interoperability for derivatives products

24. The scope of Title V of EMIR (which deals with interoperability arrangements) is limited to transferable securities and money market instruments.(1) The Guidelines, accordingly, only explicitly cover such instruments. ESMA has however also stated that it expects NCAs to apply these Guidelines to interoperability arrangements for derivative products, and that CCPs should have due regard to the provisions in Title V of EMIR when structuring such interoperability arrangements.(2)

25. Conceptually, interoperability for derivatives products raises similar risks as interoperability for securities products, but on a potentially greater scale, given the larger potential credit exposure on derivative products and the greater risk associated with longer-term exposures in more complex instruments.

26. Therefore risk standards applied to interoperable arrangements for derivatives should be at least as stringent as the standards applied to interoperable arrangements for securities.

27. Accordingly, the Bank proposes to apply the standards contained in the Guidelines, as interpreted in this paper, as the minimum necessary in any interoperability arrangement for derivative products in which UK CCPs participate or propose to participate. This would be without prejudice to the CCPs involved needing to assess whether these safeguards are adequate to address the risks of each specific arrangement.

Q5: Do respondents agree that the risk standards applied to interoperable arrangements for derivatives should be at least as stringent as the standards applied to interoperable arrangements for securities?

Bank of England
20 November 2014

(1) EMIR Article 1(3).
(2) *Guidelines*, Paragraph 14, page 7.