

The European Commission proposes new rules for the recovery and resolution of Central Counterparties. February 2017.

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On November 28 the European Commission (EC) published its [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.](#)

Central counterparties (CCPs) make an important contribution to financial market stability, helping financial and non-financial firms manage and mitigate their risks. CCPs process huge volumes of derivative contracts every day. The volumes managed have risen sharply in recent years and will continue to grow, due to the obligation introduced in several jurisdictions to clear standardised over-the-counter (OTC) derivatives through CCPs.

This recent legal push dates back to September 2009 and the G20 Pittsburgh Summit, where a commitment was reached to centrally clear standardised OTC derivatives by the end of 2012 at the latest. The aim is to make derivatives trading more secure and block contagion to the financial system if one or other counterparty defaults on its obligations.

In the European Union (EU), the volume of derivative contracts being cleared through CCPs has risen significantly in recent years and continues to rise.

European CCPs are already regulated by EMIR (Regulation EU 648/2012 of the European Parliament and Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories), which, besides imposing central clearing of certain standardised OTC derivatives in the EU for the first time, introduced a firm framework of risk management strategies (strict membership requirements, appropriate initial margins and a guarantee fund to cover defaults as well as other financial resources) designed for CCPs to cover potential losses.

The new proposal finalises the regulatory framework for recovery and resolution of CCPs in the EU, a crucial measure given their expanding scale and cross-border and global importance with the concomitant risks to the EU's financial stability.

The proposed rules build on the same principles as those in the Banking Recovery and Resolution Directive - BRRD- (Directive 2014/59/EU of the European Parliament and Council, of 15 May 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms) and are based on the international standards published by the Committee for Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO). However, the proposal also contains CCP-specific tools that better suit the CCPs' default management procedures and operating rules.

THE PROPOSAL: KEY POINTS

The main aim is to prevent or manage situations where a CCP runs into severe financial difficulties or failure, thereby minimising contagion risks to the financial system and to the wider EU economy.

The new Regulation proposes a full set of measures designed to:

- a) ensure that all Member States appoint a specific National CCPs Resolution Authority;
- b) that the National Competent Authorities have the tools and powers to intervene when a CCP is infringing, or at risk of infringing, its prudential requirements and can do so early enough to prevent it falling into financial difficulties;
- c) that the CCPs and National Supervisory and Resolution Authorities are adequately prepared for any potential crisis;
- d) that National Resolution Authorities all have a harmonised toolset and powers to act quickly and effectively when needed;
- e) that National Authorities cooperate effectively, including with third countries outside the EU.

The primary thrust of the proposal is that CCPs and National Resolution Authorities should be prepared and ready for problems occurring.

CCPs and National Resolution Authorities must draw up Recovery and Resolution Plans, respectively.

The CCP's Recovery Plan must include measures to tackle any kind of severe financial difficulty that exceeds the pre-funded resources designated to cover defaults and other available resources defined by EMIR. It must include scenarios involving defaults by CCP clearing members and the occurrence of other risks or losses for the CCP itself such as fraud or cyberattacks. Plans must be reviewed by the CCP's supervisor.

For their part, National Resolution Authorities must draw up specific Resolution Plans for each CCP, indicating how a CCP would be restructured and its critical functions maintained in the unlikely event of a failure.

Secondly, the proposal would enhance the powers of supervisory authorities to intervene early.

Adding to powers already available under EMIR, the new Regulation proposes to grant additional powers to intervene early when a CCP infringes or is about to infringe, the prudential requirements of EMIR, before the situation becomes critical or deteriorates irreversibly.

Thirdly, it provides National Resolution Authorities with a set of tools for the resolution of CCPs.

The aim is to make sure that the key clearing and settlement functions and services of the CCP will be able to continue in the event of resolution, with no need for a rescue, and that shareholders bear appropriate losses.

Conditions for resolution of a CCP and the proposed resolution tools.

A CCP can be placed into resolution when:

- a) there is no realistic prospect of its recovery in a reasonable timeframe;
- b) all other intervention measures have been tried and failed or the CCP's situation may pose a threat to the financial stability of one or more member states;
- c) liquidating the CCP under ordinary insolvency procedures could lead to prolonged market uncertainty or

financial instability.

Competent national authorities have wide discretion to intervene before it is too late to make sure the resolution process is effective and fulfils its purpose.

The Regulation proposes various resolution tools, including:

- a) **The sale of business tool**, whereby the authorities would sell all or part of the CCPs business to another entity;
- b) **The bridge CCP tool**, which consists on identifying the CCP's critical functions and separating them into a new CCP (the bridge CCP) that may ultimately be sold on to another entity, leaving the original CCP still running non-critical functions and ready for liquidation under ordinary insolvency proceedings;
- c) **Position allocation tool**, to rematching the CCP's book;
- d) **Loss allocation tool**, to cover the losses, restore the CCP's capacity to meet its payment obligations, recapitalise the CCP and replenish its pre-funded financial resources;
- e) **Write-down and conversion of capital and debt instruments or other unsecured liabilities tool**, to absorb losses, recapitalise the CCP or bridge CCP or support the use of the sale of business tool.

Coordination between EU Authorities when resolving a CCP.

The cross-border and in many cases global scope of CCPs means that, for the system to work, National Competent Authorities involved must cooperate effectively, particularly on resolution measures for a troubled CCP, to protect financial stability in all member states and effectively resolve the CCP concerned.

For this to happen, National Resolution Authorities will establish and chair CCP Resolution Colleges, whose members will be the relevant authorities from across the EU.

The new Regulation further proposes that ESMA should be the authority responsible for coordination, mainly in the prevention and early intervention phases and particularly on Resolution Plans, to facilitate joint decision-making by the authorities of the different EU Member States.

It also proposes ESMA to establish a Resolution Committee made up of the National Resolution Authorities of all Member States, and with the Banking Supervisory and Resolution Authorities invited to sit in as observers to ensure all relevant information is available during the resolution process.

Next steps.

The proposal for a resolution on the framework for recovery and resolution of CCPs has been submitted to the European Parliament and the Council in late November 2016 and is pending validation and approval.

Links:

[Press release - Creating a stronger financial system: new EU rules for recovery and resolution of central counterparties.](#)

[European Commission Proposal - Regulation of the European Parliament and Council on the framework for the recovery and resolution of Central Counterparties.](#)