

## Derivatives clearing after Brexit

### EU short- and medium-term priorities

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- For reasons of financial stability, the EMIR Regulation requires financial and certain other counterparties to clear OTC-derivatives with central counterparties (CCPs). This is currently mainly done at LCH.Clearnet in London. The United Kingdom will leave the EU on 29 March 2019.
- In the case of a soft Brexit, the EU should continue to allow CCP clearing in London for as short a period as possible through a unilateral declaration. This should be replaced as soon as possible by an equivalence decision for LCH.Clearnet under the proposed EMIR 2.2 Regulation.
- In the case of a hard Brexit, the EU Commission rightly wants to quickly make an equivalence decision in favour of LCH.Clearnet. If this takes longer, however, it should also make a unilateral statement in the case of a hard Brexit, enabling EU companies to clear through CCPs in the UK.
- The EU should establish centralised EU supervision of CCPs in order to manage threats to financial stability. Close cooperation with euro area banking supervisors and settlement authorities must be ensured in the restructuring and settlement of CCPs.
- European supervision does not have full powers to intervene in systemically relevant CCPs that are not domiciled in the EU. Therefore, there are good reasons to require LCH.Clearnet to be located in the EU.

## 1 Clearing: Background

Under the EMIR Regulation (European Market Infrastructure Regulation<sup>1</sup>, see [cepPolicyBrief](#)), in the EU, trading in a number of over-the-counter derivatives ("OTC derivatives") is subject to clearing<sup>2</sup>. The obligation applies to interest rate derivatives (successively since June 2016<sup>3</sup>) and certain credit derivatives [credit default swaps, CDSs, successively since February 2017<sup>4</sup>] traded between financial counterparties (such as banks or insurance companies). From December 2018, it will also apply to trading with or between non-financial counterparties if their derivative volume exceeds a clearing threshold.

Under the EMIR Regulation, derivatives must be cleared with a central counterparty (CCP) domiciled or recognised in the EU. CCPs are companies that interpose between the counterparties to a derivative transaction and reduce the risks for the counterparties. They act for the buyer as seller and for the seller as buyer. Examples of CCPs are Eurex Clearing AG in Frankfurt and LCH.Clearnet in London.

The added value of clearing with central counterparties for financial stability is undisputed; the netting of many positions and the central risk management of CCPs reduce credit risk. However, CCPs have become systemically relevant financial market players not least because of their regulatory upgrading. The concentration of risks with CCPs is aggravated by the fact that clearing represents a market with very few providers due to large economies of scale.

Most recently, the EU Commission proposed three amendments to the EMIR Regulation, which are currently being negotiated in the European Parliament and the Council of Ministers:

- In November 2016, a few months after the Brexit referendum, it presented a proposal for a Regulation amending the EMIR rules on the recovery and resolution of CCPs.<sup>5</sup>
- At the beginning of May 2017, it proposed some easing of the clearing obligations (so-called EMIR 2.1).<sup>6</sup>
- Directly related to the Brexit is its proposal of June 2017 for rules on the future handling of third country CCPs (so-called EMIR 2.2).<sup>7</sup>

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<sup>1</sup> 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.

<sup>2</sup> The obligation stems from the G20 Heads of State and Government's decision in response to the financial crisis (Pittsburgh Summit Declaration, September 2009).

<sup>3</sup> Delegated Commission Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council with regulatory technical standards for the clearing obligation.

<sup>4</sup> Delegated Commission Regulation (EU) 2016/592 of 1 March 2016 supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council with regulatory technical standards for the clearing obligation.

<sup>5</sup> Proposal COM(2016) 856 of 28 November 2016 for a Regulation of the European Parliament and of the Council establishing a framework for the rehabilitation and settlement of Central Counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012 and (EU) No 2015/2365.

<sup>6</sup> Proposal COM(2017) 208 of 4 May 2017 for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, suspension of the clearing obligation, reporting requirements, risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty, registration and supervision of trade repositories and requirements for trade repositories.

<sup>7</sup> Proposal COM(2017) 331 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 Regulation (EU) No 648/2012 as regards the procedures and competent authorities applicable to the authorisation of central counterparties and the requirements for the recognition of third country central counterparties.

At the same time, amendments to the EU Financial Supervisory Regulations are being negotiated ("ESA review")<sup>8</sup>. In the CCP context, the question of which bodies in ESMA will make supervisory decisions in the future is particularly relevant.

## 2 Clearing post-Brexit

A significant proportion of financial counterparties in the EU currently fulfil their EMIR clearing obligations through clearing in London. 97% of euro-denominated interest rate derivatives are cleared in London by LCH Ltd.<sup>9</sup> In July 2011, the European Central Bank (ECB) demanded that larger CCPs prove a location within the euro zone.<sup>10</sup> The action brought by the United Kingdom against that decision was upheld by the European Court of Justice.<sup>11</sup> The Court ruled that the ECB does not have the power to regulate the activities of central counterparties. In response, the ECB recommended an amendment to the Statute of the ESCB to extend its powers to the regulation of CCPs.<sup>12</sup> This proposal is currently under discussion in the European Parliament and the Council<sup>13</sup>. It is part of the overall package to clarify supervisory powers over CCPs.

If the Brexit is implemented on 29 March 2019, the United Kingdom will become a 'third country'. Financial and non-financial companies domiciled in the EU will therefore not be able to fulfil their clearing obligations in London without further ado from the end of March 2019. The EMIR Regulation basically requires clearing with a central counterparty authorised in the EU.

This cepAdhoc analyses how the EU should deal with this issue after the Brexit. We distinguish between two scenarios:

- **Soft Brexit:** A withdrawal agreement will come into force by the end of March 2019.<sup>14</sup> This Agreement shall contain: An agreement on exit costs, on the rights of citizens in the UK and EU respectively, and a backstop solution if a later solution for friction-free trade between the Republic of Ireland and Northern Ireland cannot be found. After the Brexit on 29 March 2019, there will be a transitional phase in this case, probably until the end of 2020. During the transitional phase, the United Kingdom will remain in the internal market and will continue to respect EU law. This transitional phase is also conceivable if political agreement is reached on a withdrawal agreement that has not already entered into force.
- **Hard Brexit:** No withdrawal agreement between the EU and the United Kingdom will enter into force by 29 March 2019 and there is no political agreement on this either. In this scenario, the hard Brexit takes place on 29 March 2019.

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<sup>8</sup> See cepPolicyBriefs on [EBA](#), [EIOPA](#) and [ESMA](#) and the [cepStudy on the ESA Review](#).

<sup>9</sup> Commission Impact Assessment, SWD (2017) 246 of 13 June 2017, p. 48.

<sup>10</sup> ECB Eurosystem Oversight Policy Framework, pp. 9-10, 5 July 2011

<sup>11</sup> ECJ [T-496/11 (UK v. ECB)], judgment of 4 March 2015.

<sup>12</sup> ECB Recommendation for a Decision of the European Parliament and of the Council amending Article 22 of the Statute of the European System of Central Banks and of the European Central Bank, ECB/2017/18 of 23 June 2017.

<sup>13</sup> The Statute of the ECB has primary legal status. Some articles of the Statute, including Article 22, may be amended in accordance with Article 129(3) TFEU in the ordinary legislative procedure on a recommendation from the ECB or the Commission.

<sup>14</sup> In order to enter into force, the withdrawal agreement must be ratified in good time. On the EU side, the European Parliament and the European Council (with 20 Member States representing 65% of the EU27 population) must agree. On the British side, the House of Commons must agree.

Depending on whether the Brexit will be a hard or soft one, the third question arises sooner (in the case of a hard Brexit) or later (from 2021 in the case of a soft Brexit).

- shaping **future relations between the** EU-27 and the United Kingdom as a third country.

### 3 Short-term priority: Ensuring clearing capability

In order to preserve financial market stability, the EU has a vested interest in maintaining the clearing ability of European counterparties even after Brexit. In the short term, this will not be possible without using London as a clearing location. The following section describes how this clearing capability can be ensured with existing and future third country regulations (3.1) and with short-term changes in secondary legislation ("quick fix", 3.2). We recommend how these instruments should be used in soft and hard Brexit (3.3). The alternative of suspending the clearing obligation for certain OTC derivatives after Brexit jeopardises financial market stability and should therefore be rejected.

Both Brexit scenarios require political decisions by the EU to maintain clearing capability. This is not only true for the hard Brexit. Even with a soft Brexit, after which the United Kingdom will remain part of the EU internal market until the end of 2020, it is not easy for EU companies to continue using British clearing houses.

#### 3.1 Ensuring clearing eligibility through interpretation of the third country regime

It remains to be seen whether the existing EMIR Regulation<sup>15</sup> or the revised EMIR 2.2 Regulation will be in force at the time of Brexit. This depends not least on how quickly EU legislators can agree on the EMIR 2.2 text. Both legal acts contain a third country regime which allows clearing with a third country CCP.

##### The existing EMIR Regulation

The EMIR Regulation allows clearing of CCPs which are not authorised in the EU as long as they are recognised by the European Securities and Markets Authority (ESMA).<sup>16</sup> Such recognition is conditional, in particular, on the EU Commission having considered the legal, supervisory and enforcement mechanisms of the third country for CCPs to be equivalent to those of the EU as well as on ESMA having concluded "cooperation agreements" with the competent authority of the third country. However, the scope of these cooperations is limited. It provides for the exchange of information between ESMA and the third country authority and for "procedures for the coordination of supervisory activities"<sup>17</sup>. The Commission may withdraw its equivalence decision at any time if the requirements are not met<sup>18</sup>. ESMA may withdraw the recognition of a third country CCP if the above conditions are no longer fulfilled.<sup>19</sup>

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<sup>15</sup> 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.

<sup>16</sup> Art. 25 Regulation (EU) No. 648/2012.

<sup>17</sup> Art. 25 para. 7 Regulation (EU) No. 648/2012.

<sup>18</sup> Art. 13 para. 4 Regulation (EU) No. 648/2012.

<sup>19</sup> Art. 25 para. 5 Regulation (EU) No. 648/2012.

## The new EMIR 2.2 Regulation

The future third country regime is part of the ongoing negotiations between the Council and the European Parliament on the new EMIR 2.2 Regulation. It is expected to be comparable to the existing EMIR Regulation when considering smaller third country CCPs.

However, ESMA may classify a CCP from a third country as systemically relevant (Tier 2 CCP). In such a case – likely to apply for LCH.Clearnet – the recognition requirements are much stricter<sup>20</sup>. ESMA may recognise such a CCP only if, in addition to the equivalence decision of the Commission and the cooperation agreements, the following conditions in particular are met: The third country CCP

- permanently meets the European organisational, prudential and interoperational requirements<sup>21</sup>,
- has undertaken to open a central bank account with the European Central Bank<sup>22</sup> and agrees to comply with the ECB's liquidity support orders in times of crisis<sup>23</sup>, such as regarding margin requirements or the settlement of payments in central bank money,<sup>24</sup>
- shall allow ESMA access to its premises at all times<sup>25</sup>.

As a last resort, the Commission, acting on a recommendation from ESMA and in accordance with the ECB, may decide that a third country CCP has such a high systemic relevance that even compliance with the above requirements is not sufficient for recognition in the EU. In this case, the CCP can only offer its services with a seat in the EU. The Commission Decision may provide for a transitional period of a maximum of two years during which CCP services may continue to be offered from the third country.<sup>26</sup>

## 3.2 Ensuring clearing capability through legal change ("quick fix")

Practical problems could make the application of the third country rules – of the old or new EMIR Regulation – very challenging. Formally, an equivalence decision by the Commission is only possible after the Brexit on 29 March 2019 because only then will the United Kingdom become a third country. LCH.Clearnet can also only be recognised by ESMA in the EU as a provider of a third country.

Although the EU wishes to preserve financial stability, it has long been unclear whether such an equivalence decision – and the subsequent recognition of UK CCPs – can be taken within a logical second of the Brexit. After all, decisions on the equivalence of third-country rules and on the recognition of third-country CCPs require an elaborate examination, which – strictly speaking – must be preceded by withdrawal from the EU.

On 13 November 2018, however, the EU Commission signalled great flexibility: In the case of a hard Brexit, it wants to make a very quick – albeit temporary – equivalence decision for clearing in the UK. In addition, the Commission invited UK CCPs, in particular LCH.Clearnet, to already submit applications for recognition to ESMA before Brexit.<sup>27</sup>

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<sup>20</sup> The starting point is the provisional compromise text of the Council Presidency of 25 October 2018 (Council document 13539/18).

<sup>21</sup> The CCP may require ESMA to verify whether the compliance of the CCP with third country rules is equivalent to compliance with European requirements [Art. 25a Council compromise text].

<sup>22</sup> Or at the central bank of the EU member state in whose currency financial instruments are cleared at the CCP.

<sup>23</sup> ECB requirements must serve the transmission of monetary policy or the smooth functioning of payment systems [Art. 25 para. 2b lit. b (iv) Council compromise text].

<sup>24</sup> Article 25(2b)(b) Council compromise text.

<sup>25</sup> Article 25(2b)(e) Council compromise text.

<sup>26</sup> Art. 25 para. 2c Council compromise text.

<sup>27</sup> Communication of the Commission, COM(2018) 880, Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: A Contingency Action Plan, p. 8

If this equivalence decision is not reached, clearing capability can alternatively be ensured by short-term legal changes ("quick fix"). In this case, the time between the Brexit on 29 March 2019 and a subsequent equivalence decision by the Commission could be bridged by the EU continuing to allow UK clearing through a secondary exception. It is likely that in this case the EMIR 2.1 or EMIR 2.2 Regulations would be amended ("quick fix") at short notice as they are still under negotiation anyway.

However, in order to avoid undermining the EMIR third-country rule, the EU has an interest in strictly limiting the duration of this exception, i.e. prescribing a fixed expiry date for the exception.

### 3.3 Recommendations

#### Soft Brexit

In case of a soft Brexit, the UK remains part of the internal market until the end of 2020 and is unlikely to deviate from EU law. This applies to prudential CCP requirements under both the existing and new EMIR 2.2 Regulations. The pending adoption of the EMIR 2.2 Regulation is expected to lead to a new European CCP third country regime during the transition period.

We therefore propose that, directly following a soft Brexit at the end of March 2019, there should be a unilateral declaration by the EU under the existing EMIR Regulation which will continue to allow CCP clearing in the UK. With the entry into force of the EMIR 2.2 Regulation – probably during the transitional period until the end of 2020 – this declaration would lose its validity. In the meantime, the Commission, the United Kingdom and LCH Clearnet should make preparations to reach an equivalence decision under the new Tier 2 regime, if appropriate. It remains to be seen whether such a decision will actually be taken or whether LCH Clearnet will be required to relocate to the EU. In any case, the EMIR 2.2 Regulation also provides for transitional solutions in the latter case. This could contribute to maintaining financial market stability by allowing derivatives to continue to be cleared in London, at least temporarily.

#### Hard Brexit

In case of a hard Brexit, the EU is dependent in the short term on the services of London clearing providers. Without a transitional agreement, however, the United Kingdom is explicitly not obliged to apply EU law – a.o. the existing and/or the new EMIR Regulation. However, many of the prudential requirements of the EMIR regulations are based on international standards, so that a fundamental departure of the United Kingdom is not to be expected. This seems to be the Commission's assumption: It advocates an equivalence decision and CCP recognition directly following a hard Brexit<sup>28</sup>. If this scenario turns out to be increasingly uncertain – for example due to a lack of cooperation from the United Kingdom – it may be necessary for the EU to make a unilateral declaration on the continued use of UK CCPs at the end of March 2019 in order to avoid market disruptions. However, this should be very limited in time and lead as quickly as possible to an equivalence decision by the Commission under the EMIR Regulation – i.e. the one then applicable -, which provides for comprehensive cooperation. The unilaterally declared exception could be explained by the need to stabilise financial markets and by the fact that the UK regulatory framework for CCPs is comparable to that of the EU, at least for the time being, given the UK's long-standing EU membership.

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<sup>28</sup>See footnote 27

## 4 Medium-term priority: Supervision of CCPs to ensure financial market stability

Once the EU has ensured its short-term priority after Brexit – safeguarding the clearing ability of European counterparties – important questions remain unanswered concerning the safeguarding of financial stability through effective supervision of CCPs. In principle, this concerns the supervision of CCPs established in the EU (4.1). However, there is a further challenge if CCPs, which are indispensable for continental companies, remain located in the UK (4.2).

### 4.1 Systemically relevant CCPs in the EU

The question for the EU is how it intends to avoid that EU-based CCPs with systemic relevance pose significant threats to financial stability. This question arises both if LCH.Clearnet should establish itself in the EU and if European CCPs establish themselves as an alternative to LCH.Clearnet. Following Brexit, the EU must therefore establish a consistent supervision of CCPs, taking into account that distortions in a CCP can have serious consequences for larger banks across the EU.

There is a strong case for centralised European supervision, for example at the European Securities and Markets Authority (ESMA). Whether this view will prevail in the current negotiations on the Commission proposal in this respect seems more than doubtful at this stage.

Any restructuring or resolution of a European CCP will have far-reaching implications for European banks. Therefore, it is necessary to address these cross-border effects with appropriate institutional arrangements. What makes matters complicated in the EU, is that EU banking supervision is divided into two parts: the majority of banks are part of the banking union (the eurozone), while the rest are not. At least for the euro area, it would be worth considering closely coordinating CCP restructuring or resolution measures with the supervisory and resolution authorities of the banking union, i.e. the ECB and the Single Resolution Mechanism (SRM). A systemically relevant EU CCP would therefore have to be subject to general EU law and at the same time work very closely with institutions attributed to the euro zone, without discriminating against financial participants from non-euro countries. A strategy on how to safeguard this is still to be implemented.

### 4.2 Systemically relevant CCPs in London

Despite an equivalence decision, an LCH.Clearnet located in a third country post Brexit presents a special challenge for the European supervision of CCPs. This can be problematic as it is hard to imagine European supervisors ever having full powers of intervention of a CCP in a third country. In such scenarios, the EU is therefore to a certain extent dependent on the behaviour of the third country supervisory authority.

However, the UK does not necessarily have an interest in strict supervision: lax supervision can lead to comparative cost advantages for UK CCPs if it allows them to offer their services at lower prices than EU CCPs. In the event of a crisis, however, the associated risks to financial stability would mainly manifest themselves in the EU, as most clearing participants – usually larger banks – are established in the EU. Even in the case of concrete crisis measures (restructuring or resolution), there may well be conflicts of interest between the United Kingdom (focussing on the lowest possible cost for the domestic taxpayer) and the EU (attaching importance to financial market stability).

In the event of a crisis, it cannot be ruled out that CCPs will depend on liquidity assistance from the central bank in order to avoid consequential problems for CCP members (such as bank losses). The approval of such assistance shall be at the discretion of the relevant central bank. The ECB has clarified that, in principle, there

is no automatic mechanism for such liquidity support.<sup>29</sup> Nevertheless, liquidity support by central bank money from the ECB in crisis situations would also be quite probable for third country CCPs in order to prevent major distortions. However, unlike EU CCPs, the ECB has very little influence on third country CCPs in the run-up to a crisis, for example on the conditions for access to central bank money. Negative effects on their monetary policy mandate, such as the disruption of the transmission channel due to distortions in the repo market, are also conceivable.

There are therefore good reasons, from systemically relevant CCPs in third countries – here: LCH.Clearnet – to be required to be located in the EU.

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<sup>29</sup> <https://www.ecb.europa.eu/pub/pdf/other/genc-2015-escb-reporten.pdf>