Central Counterparties & Post-Brexit Equivalence

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Statement of case

Recently there has been much debate over post-Brexit equivalence, extending to all sectors, products and services. Whilst a member of the EU, the UK was part of the single market. Post-Brexit, we will no longer be a member. Until now, the UK was not subject to equivalence because, like other EU states, it was subject to the European Court of Justice who could sanction the UK if it did not comply with EU-wide laws and regulations. Post Brexit, the UK will no longer be subject to the European Court of Justice – and as a consequence the UK will become a 'third country' in terms of EU regulations, making it subject to equivalence measures when trading with European counterparts. These equivalence measures are designed to protect EU citizens, just as many of the US regulations are designed to protect US citizens.

Equivalence

A number of European regulations include articles that deal with third countries. This recognises the global nature of the financial sector. If a third country passes the equivalence criteria then they can trade with European counterparts. Equivalence does not mean the "same as". Clearly different jurisdictions have different laws and regulations, designed to provide protection in the same way as European laws and regulations. Equivalence determines if the level of protection afforded by a third country's regulations is sufficient to protect EU citizens.

Determining equivalence

There are various dimensions along which you can gauge regulation - in terms of:

- Principles
- Rules
- Outcomes

Determining equivalence across these different dimensions can be tricky. The EU approach is to lay down the criteria irrespective of the dimension adopted. This makes it difficult for some countries to prove equivalence and often the approach adopted is to bring the necessary rules into line if the laws cannot be amended. This is even the case within the single market: the Securities Law Directive which was to harmonise

many of the property laws underpinning securities ownership, never saw the light of day. Harmonising Napoleonic law with case law, common law and ex-Russian statues inherited by the Eastern European countries was just too difficult.

The first real attempt at enforcing equivalence came in the CCP space. A third country CCP had to be a qualifying CCP otherwise the capital requirements imposed on European counterparties clearing through an unqualified CCP would be too onerous to justify its use. As initially implemented, there was no authority for determining which CCP was qualifying – it was up to the participants to make their own judgement. This judgement was to be made on the basis of the hypothetical capital of the CCP - a rather byzantine formula cobbled together from some BIS banking criteria that treated CCPs as banks. Most third country CCPs had no idea how this formula worked. This caused havoc. The solution was to make ESMA responsible for determining equivalence, and this time it would be based on laws and regulations in the third country. This required a detailed mapping of third country laws and regulations against EMIR. If the same levels of protection and reciprocity were in place, then equivalence was granted. ESMA maintains a list of all third country qualifying CCPs.

UK CCPs post-Brexit

Post-Brexit, UK CCPs will be subject to equivalence determinations in order to allow EU counterparts to continue to clear through them. If this were the normal equivalence criteria applied to all qualifying third country (TC) CCPs, then it would not be an issue. The UK CCPs are currently authorised under the single market - the UK laws and regulations are super-equivalent - so there would be no issue in acquiring third country qualifying CCP status. Merely leaving the EU would make no difference. However, equivalence appears to be time dependent – in the UK, but nowhere else. The justification is:

> "[...] the Commission has identified that financial stability risks could arise[1] in the area of central clearing of derivatives through CCPs established in the United Kingdom ('UK CCPs'). In order to give clearing members established in the Union ('Union clearing members') the time to reduce their exposure to United Kingdom market infrastructure as well as CCPs established in the Union ('Union CCPs') the time to develop further their capacity to clear relevant trades[2] , and to address the possible risks to financial stability, it is justified[3] to adopt an equivalence decision for the United Kingdom in that area."

Moving the goal posts

By time-limiting the extension of equivalence for the UK, the EU is choosing to introduce massive potential systemic risk into their own financial markets. All other third country CCPs obtain equivalence indefinitely

[1] No analysis or justification provided.
[2] In other words they are not currently capable – but no operational risk is expected.
[3] Non-sequitur?

- unless something dramatic happens. The extension is to provide financial stability for EU counterparts, as a sudden movement of positions would be chaotic. So, it's not the UK CCPs per se that represent a systemic risk to the EU, it's the forced movement of positions – to be mandated by the EU. They are creating their own financial instability. An implicit assumption is of course that the remaining EU CCPs are up to the job. The concern is that the EU will concentrate risk in CCPs that have an unproven track record in a major swap default and choose, in part, to compete by assuming higher levels of risk.

Equivalence now has a different meaning. It's not the equivalence applied to all other third country CCPs, it's a systemically important criteria that's now being used.

> "ESMA may only recognise a CCP established in a third country where the Commission has adopted an implementing act determining that the legal and supervisory arrangements governing CCPs from that country are equivalent to the requirements set out in Regulation (EU) No 648/2012[4] and after it has determined whether the CCP is systemically important for the financial stability of the Union.[5]"

The EU has now introduced a tiering system for third country CCPs. Tier 2 CCPs are systemically important with the detailed criteria laid down in EU 2020-1303

These detailed criteria support EU 2019-2099 which states in para 2(c) page 21:

> "ESMA, after consulting the ESRB and in agreement with the central banks of issue referred to in point (f) of paragraph 3 in accordance with Article 24b(3) and commensurate with the degree of systemic importance of the CCP in accordance with paragraph 2a of this Article, may, on the basis of a fully reasoned assessment, conclude that a CCP or some of its clearing services are of such substantial systemic importance that that CCP should not be recognised to provide certain clearing services or activities."

Here we go – "a fully reasoned assessment". Despite all the empirical criteria laid down, the third country CCP may still pass – but this cannot be allowed, so we deem it to be too important (substantial systemic importance), a new rational criteria at the sole discretion of ESMA. Transparency, fairness, level playing field – ESMA's having none of it. ESMA's plans for 2021 include direct supervision of TC CCPs (page 37 of the attached):

[4] How could they not be equivalent?
[5] There is nothing in Article 25 of EMIR (nor EMIR refit) about systemically important CCPs.

The notion of systemically important entities was introduced by the FSB. Being a SIFI has consequences for recovery & resolution and therefore the capital requirements of the entity, not their qualifying CCP status or their equivalence. The classification of SIFIs is the responsibility of the NCA – in this case not ESMA or any EU NCA. The EU has hijacked this notion for its own purpose. This is called 'home state regulation' and was supposed to be a principle of the EU. Instead we have host state regulation – except the UK CCP does not sell into Europe but Europeans buy the service from the UK. Thus, the recent EU pronouncement that EU participants will no longer be able to do this. In the UK we would call that a restriction on trade. Effectively the EU is admitting that it cannot compete on a level playing field and is using regulation to distort the markets in its own favour. The EU has abandoned its principles in favour of its principal.

At least, the House of Commons is asserting its authority:

House of Commons Letter to HM Treasury on Supervision of UK CCPs

Further to our previous newsflash, the European Scrutiny Committee (ESC) of the House of Commons has sent a letter to HM Treasury on the EU supervision of UK central counterparties (CCP) under EMIR 2.2. The letter was written prior to ESMA's recognition of the three UK CCPs as third-country CCPs and the announcement of the memorandum of understanding between the Bank of England (BoE) and the European Securities and Markets Authority (ESMA).

In the letter, the ESC expressed its concern that access to the EU market is conditional on EMIR 2.2 compliance for regulatory alignment with the EU regulatory framework. In addition, the ESC is concerned about the EU's expressed objective of increasing its domestic clearing capacity for derivatives. The letter includes the following questions addressed to HM Treasury regarding the impact of EMIR 2.2 in the UK:

- Supervisory cooperation between the BoE and ESMA: The ESC requested an explanation on how the UK will maintain the regulatory autonomy of the BoE, considering that market access under EMIR 2.2 depends on a supervisory agreement between ESMA and the BoE containing assurances that the BoE will enforce supervisory decisions taken by ESMA. The ESC asked if any discussions are taking place between the UK and the EU regarding the implementation of the assurance requirement;
- Comparable compliance for tier 2 third-country CCPs under EMIR 2.2: The ESC asks for clarification on whether the UK will commit to provisions of EMIR 2.2 that are relevant to the comparable compliance regime for systemically important CCPs. The ESC noted that the comparable compliance regime requires continuous UK regulatory alignment with EU law. The ESC asked for an explanation on how UK CCPs may be able to comply with EMIR 2.2 if the comparable compliance regime is not recognised;
- Recovery and Resolution Regulation for CCPs: The ESC asked for an explanation on whether the new European CCPs Recovery and Resolution Regulation will be considered for assessing the continued equivalence of third-country regulatory regimes to the EMIR 2.2 regime.

A link to the ESC is available here: ESC Letter on Supervision of UK CCPs

Penalty decision

Central banks are exempt from ESMA regulation, with no equivalence required, so the UK should seriously consider putting LCH Ltd under the Bank of England.

In the event of a major European counterparty default which taxpayers do you want to plug the hole? Currently is would be the UK taxpayer if the CCP were LCH Ltd. In the future the EU will underwrite the enhanced systemic risk introduced by these changes and not the UK taxpayer.

It's not just Brexit that the EU has to contend with. These regulations cover the TC CCPs in the USA which will probably provoke a very strong response if they go down the route of a "fully reasoned assessment".