THE NECESSARY RECOGNITION OF UK CCPs: A PRIORITY FOR FINANCIAL STABILITY

Derivatives are critical in enabling EU companies and investors to hedge against risks associated with foreign-exchange, interest-rate or commodities.

For the EU financial markets, as they are currently organized, the 3 UK CCPs – LCH Ltd, ICE Clear Ltd and LME Clear Ltd – play a crucial role. This is particularly well illustrated with SwapClear (LCH Ltd) that has a 95% market share for the clearing of swaps[1] and holds **around 3,000,000 open positions for a notional of 330 trillion USD**[2], of which one third approximately are linked to EU-27 entities.

This paper gives evidence that a **"no-deal" Brexit**, absent appropriate and targeted actions by the European Union, would force EU-27 entities to exit UK CCPs by the end of March 2019.

It concludes that, without prejudice to the way long-term relations between the EU-27 and third countries CCPs should be organized under EMIR2.2 proposals, **a hard Brexit with no transitional recognition of UK CCPs would likely have a dramatic impact in terms of financial stability and on the financing of the EU economy**; we understand that this analysis is shared by EU financial markets regulators and supervisors**.**

With only few weeks of negotiations left, it is crucial to remove uncertainty for EU financial institutions and the financial markets as a whole. More specifically, AMAFI calls for the European Commission **to make it clear, publicly and immediately after the expected November Brexit Summit, that**, were no withdrawal agreement to be reached, or were such agreement to be rejected by the British Parliament, **it would offer an effective solution for the unilateral transitory recognition of UK CCPs**.

Executive summary

Under the existing EU regulatory framework, and in particular Article 25(1) of EMIR, a CCP based in a third country can only provide clearing services to clearing members based in the Union where it is recognized as a qualified CCP (QCCP) by ESMA.

A "no-deal" Brexit would result in UK CCPs losing their status of QCCPs on 29 March 2019 and becoming third country CCPs, at that time, not recognized by ESMA. Therefore, EU-27 members would no longer be able to clear instruments subject to EMIR mandatory clearing in UK CCPs while UK CCPs would stop providing clearing services to EU-27 members in order to be compliant with EU law and their own internal rules.

Consequently, at the end of November or beginning of December, UK CCPs are likely to ask their EU-27 members to get prepared for an off-boarding by 29 March 2019. This means that, prior to that date, EU-27 members would have (i) to engage the closing of their open transactions, (ii) to ensure the transfer of related positions to other CCPs and (iii) to find solutions for new transactions.

[1] LCH, SwapClear Services, https://www.lch.com/services/swapclear.
[2] LCH, Monthly Volumes – SwapClear Global, *Monthly trades outstanding*, https://www.lch.com/services/swapclear/volumes

This process would likely reveal complex, costly and risky for EU-27 entities.

First, because of the lack of clearing alternatives out of the UK for a variety of instruments (notably future contracts, commodities derivatives) new transactions on such instruments would become extremely expensive, making EU-27 entities hardly competitive on this market.

Second, amongst the clearing services provided from the UK, the situation of SwapClear would reveal particularly critical given its high market share (c. 95%) and the magnitude of open positions it holds, with close to 3,000,000 open positions, for a notional of USD 330 trillions.

In the absence of a transitional arrangement, EU-27 entities would be required (i) to find market counterparties to neutralize the risk linked to open positions, (ii) to close positions at SwapClear and (iii) to reopen these positions in a QCCP or via bilateral trades. Not only will this process reveal extremely expensive, but, on 29 March 2019, there is little doubt that it will leave residual open positions which will be subject to auctions[3], making the process even more costly for each concerned EU-27 institution.

Considering that 40 out of the 110 members of SwapClear would be simultaneously impacted, representing 750,000 to 1,000,000 open transactions, this process would likely have **systemic implications**.

Over the short term, the anticipated exclusion of EU-27 entities from UK CCPs would highly likely result in:

- A very important transfer of income from EU-27 entities to their competitors;
- An immediate and deep deterioration of market conditions on FIC derivatives;
- The simultaneous triggering of numerous auctions on 30 March 2019, potentially 10 times the size of the auction that followed the collapse of Lehman Brothers, leading to chaotic market conditions.

But the absence of a transitional arrangement by EU authorities would also have deep medium term consequences. Overall, deprived of their access to UK CCPs with no time to adapt, EU-27 banks would lose their credibility in the client clearing business, lose access to non EU-27 clients willing to continue clearing at UK CCPs, and would see their hedging cost increasing making their business less profitable. Such outcome, affecting all EU-27 entities in parallel, would result in making the financing of the EU economy extremely difficult and is hardly compatible with the objective of building a Capital Markets Union post-Brexit.

In light of the above, AMAFI recommends that EU authorities, when announcing the outcome of the expected November Brexit Summit, and regardless of such outcome, send **a clear and pre-emptive signal of their intention to act unilaterally to ensure the continued access of EU-27 entities to UK CCPs after 29 March 2019**.

As things currently stand and whilst several options could be considered (incl. to suspend both clearing obligations and the punitive treatment of uncleared transactions for a minimal period; or to accelerate the current review of EMIR and CRR), AMAFI tends to consider that **the best available option is for the EU to recognise UK CCPs on a unilateral basis and for a limited period of time**.

[3] A member which loses its membership has to close or transfer its open positions. For those positions which remain when the member is effectively off-boarded, an auction process is triggered, in which the remaining members of the CCP are expected to participate.

1. Absent a specific transitional arrangement on clearing services, the consequences of a "no-deal Brexit" would likely trigger a systemic crisis on EU FIC markets

1.1 *Under current rules and regulations, a "no-deal Brexit" would lead UK CCPs to exclude their EU-27 members by the end of March 2019*

Considering the current EU regulatory framework, Article 25 (1) of EMIR stipulates:

> "*A CCP established in a third country may provide clearing services to clearing members or trading venues established in the Union only where that CCP is recognized by ESMA*".

More specifically, ESMA can only grant recognition to a third-country CCP after consulting competent authorities (*Article 25 (2), EMIR*) and where (i) the European Commission has adopted an implementing act, (ii) the CCP is authorized in the relevant third country and (iii) cooperation arrangements have been agreed. Moreover, ESMA took the position that UK CCPs will not be able to submit an application for recognition before the UK becomes a third-country i.e. not before 29 March 2019.

As things currently stand, if no withdrawal agreement is reached between the UK and the EU, **UK CCPs would de facto lose their qualified CCP status at that date and would become third country CCPs not recognized by ESMA**.

Consequences would be twofold:

- **EU-27 market participants** (both members and end users) **would no longer be able to clear products subject to EMIR mandatory clearing on UK CCPs** based on Article 4.3 of EMIR: "*The OTC derivative contracts that are subject to the clearing obligation […] shall be cleared in a CCP authorised under Article 14 or recognised under Article 25*";
- UK CCPs would stop providing clearing services to EU-27 members in order not to be deliberately in breach of EU regulations.

Besides, CCPs internal rules stipulate that **members should be able to participate to the auctions that would be triggered to liquidate a defaulting member's positions**. For the best bidder, an auction leads to the conclusion of new transactions cleared by the CCP. As a result, EU-27 members, having lost their capacity to compensate new transactions with UK CCPs, would also lose their ability to participate to auctions, and would have their membership challenged as a result.

Therefore, considering EMIR requirements and their own internal rules, it can be expected that UK CCPs will take no risk on the integrity of their businesses so that, in the event of a "no-deal" Brexit, **they will require their EU-27 members to leave the CCP by the end of March 2019**. Operationally speaking, they would do so by **issuing 90-day termination notices**, hence no later than by the end of December 2018, and probably before that, e.g. between mid-November and mid-December.

On their side, upon receipt of such termination notices, **EU-27 members would have to:**

- Engage the closing of their open transactions at UK CCPs;
- Ensure the transfer of related positions to other CCPs;
- Find solutions for new transactions.

1.2 *For a variety of instruments, the absence of clearing alternative out of the UK would leave EU entities having to rely on bilateral trading*

To date, there is no clearing alternative outside of the United Kingdom for certain instruments, such as:

- **GBP repos** cleared at RepoClear Ltd (LCH Ltd);
- Various **commodities derivatives** cleared by LME Clear Ltd;
- **Non Deliverable Forwards** cleared at ForexClear (LCH Ltd);
- **Future contracts** negotiated on Liffe.

For EU-27 entities, the absence of clearing alternative would mean that any new transaction on these instruments – be it to re-open the positions closed at the UK CCP or for any future commercial activity – would have to be concluded on a bilateral basis. This **would reveal extremely expensive**[4], both from a margin and RWA point of view, **making EU-27 entities hardly competitive on this market.**

1.3 *EU-27 firms' need to exit massive open positions on IRS would likely generate a systemic risk for financial markets*

Amongst the clearing services provided from the UK, **the situation of SwapClear is specific** for at least two reasons:

- Its **very high market share**, 95% of vanilla Interest Rates Swaps being cleared at SwapClear;
- The **magnitude of open positions**, linked to the maturity of cleared interest rate instruments. On average, SwapClear registers circa 20,000 trades a day (of which one third are swaps) but holds close to 3,000,000 open positions, for a notional of USD 330 trillions.

At the level of an **individual entity**, the **reception of a termination notice** implies three necessary simultaneous actions:

1. To find market counterparties in order to neutralise the risk linked to the open positions at SwapClear by the deadline of the notice;
2. To close positions at SwapClear; and
3. To reopen these positions in a qualified CCP (Eurex or CME) or through bilateral trades.

This can reveal excessively expensive, since the firm (i) will have to pay the bid-offer spread on each transaction exited from SwapClear and entered symmetrically at the QCCP and (ii) is likely to be hit by a unfavourable price difference between SwapClear and the QCCP (basis effect), especially if the QCCP has a very limited pool of liquidity.

At the **end of the termination notice period** and if the above process cannot be fully processed, SwapClear would consider that any residual open position would be in default and therefore **subject to an auction.** This would trigger **further losses for the EU-27 entity.**

What is problematic for an individual entity would likely take systemic proportions when affecting simultaneously 40 out of the 110 members of SwapClear[5] representing 750,000 to 1,000,000 open positions.

[4] Most notably, the loss of direct access to CCPs would result in an increase of RWA charge and cost of capital linked to margins posted by a 50 factor. By the same token, the RWA charge and cost of capital linked to the contribution to default funds would be multiplied by a several dozen factor.
[5] LCH, *Member Search*, https://www.lch.com/membership/member-search

Indeed, several effects would concur to making the outcome of such a process probably catastrophic:

- The definition of the clearing obligation in EMIR, which exempts corporates, central banks, pension funds and supra-nationals, means that the **EU-27 entities' open positions are unbalanced**, and probably quite similar from one EU-27 entity to another. As a result, non-EU-27 financial institutions potentially interested in being counterpart for the closing of open positions will require **a premium to cover the risk of further sales of similar directional positions;**
- These financial institutions will also take into consideration the **risk of multiple auctions at the end of March 2019** which would lead to a massive number of open positions being sold at **fire-sale prices**;
- Such considerations are likely to result in an **immediate degradation of market conditions**, feeding both EU27 entities difficulty to close their open positions and non-EU27 financial institutions reluctance to be their counterpart. This, in turn, would **nurture the risk of multiple, massive and simultaneous auctions on 30 March 2019.** It is therefore highly likely that **many EU-27 institutions will not be able to close all their open positions before 29 March 2019.**

At the end of the day, AMAFI considers that, absent a transitional arrangement, the predictable string of events that would follow the announcement of a "no-deal" Brexit would result in:

- A very important transfer of income from EU-27 entities to their competitors;
- Because of the anticipations of market players, and of likely rumors on the difficulties faced by EU-27 entities to manage their open positions, an immediate and deep deterioration of market conditions (strong increase of volatility and bid-offer spreads) on FIC derivatives markets, reminiscent of a systemic crisis over the period; and
- The simultaneous triggering of numerous auctions on 30 March 2019, many times (which could be above a 10 factor) the size of the auction that followed the collapse of Lehman Brothers[6], that dealt with "only" 66,000 transactions, likely to result in chaotic market conditions.

Beyond the effects for EU-27 banks, all this will result in a **deep and probably long-lasting degradation of market conditions**, that would be extremely unfavorable for **EU-27 corporate companies** (be it for their risk hedging or issuance needs) **and investors.**

1.4 *In the medium term the brutal loss of access to UK CCPs by EU-27 entities would endanger the financing of the EU-27 economy*

Post 29 March, in a "no-deal" scenario (or if a deal were to be concluded but that would finally be rejected by either parliament) and absent a positive action by EU authorities, the situation of EU-27 banks with regard to clearing would be as follows:

- For **products subject to mandatory clearing under EMIR**, their **access would be limited to the remaining qualified CCPs**, e.g. CME and Eurex for swaps. Because only a minor part of swap trading involves at least one EU-27 based entity, the liquidity pool at these CCPs would remain far smaller than the one at SwapClear. This, plus the directional nature of EU-27 banks cleared positions (see above) would likely result in a **"basis effect"**, e.g. price differences, for the same product, between the small liquidity pool cleared by the QCCPs and the deeper one cleared by SwapClear;

  It should also be underligned that the CCPs that would remain qualified post 29 March 2019 currently hold minor market shares (below 5%), and that their ability to onboard significant

[6] LCH, *Managing Lehman Brothers' default*, http://www.wip.swapclear.com/swaps/swapclear_for_clearing_members/managing_the_lehman_brothers_default.asp

volumes (that would consist of both legacy transactions closed at SwapClear and new transactions from EU-27 entities), especially with no ramp up period, remains untested;

- For **products that are not subject to the clearing obligation**, EU-27 banks would have to rely on bilateral trading, or to clear through one of their non EU-27 competitors (notwithstanding the fact that, if the provision of such access to clearing were deemed to be an investment service under MiFID 2, it would make this set-up impossible). Either way, their **cost would be significantly increased**, by the RWA charge for uncleared transactions or through the commercial margin they would have to pay.

As a consequence of the above:

- **EU-27 banks would hardly remain credible in the client clearing business**, since this business is based on the ability to offer a global service, while they would no longer be in a position to provide access to UK CPPs, or at uncompetitive prices;
- When it comes to the **client execution business**, for instruments subject to EMIR mandatory clearing, EU-27 banks would **lose access to non EU-27 clients** who want to keep clearing on UK CCPs. For other products / clients, they would be **unable to offer competitive pricing**, because of the extra-costs that they would bear (RWA charge for bilateral trades / basis effect for trades cleared at a QCCP / commercial cost for indirect access);
- The same effect would **increase the hedging cost** of EU-27 banks, making their whole FIC business (fixed income, swaps, forex, etc.) less profitable.

At the end of the day, EU-27 banks' competitiveness in fixed income and derivatives markets would be so severely damaged that the viability of their FIC business would be questioned. When such viability issue affects an individual bank, it is unfortunate for that bank. When it affects **all** EU-27 banks, it becomes a **massive issue for the financing of the EU-27 economy**, and is **hardly compatible with the aim to build a Capital Markets Union to foster investment, economic growth and employment**.

2. In front of that risk, EU authorities only have a narrow window of opportunity to act

In light of the highly undesirable outcomes that a brutal loss of access of EU-27 entities to UK CCPs would entail, it appears that a transitional arrangement is required, that would have to be operated under short time constraint.

As detailed above, UK CCPs will likely off-board their EU-27 members by sending 90-day termination notices – hence no later than by end of November – if they consider that they face a serious risk of losing their EMIR qualified status on 29 March, 2019. This would obviously result from the **unability to reach withdrawal agreement** between the UK and the EU-27 at the expected November Brexit Summit, but it could also be the case if an agreement is reached, but they consider that there is a **risk of rejection by either parliament**. The latter scenario being based on the anticipation by UK CCPs of the UK Parliament's reactions, there is a major risk that, if the agreement is deemed fragile, markets lose confidence and become chaotic on the **next day after the expected November Brexit Summit**.

On the other hand, it can be understood that EU institutions could prefer not to make any announcement on the status of UK CCPs post 29 March before the expected November Brexit Summit, as it could **interfere with the ongoing negotiations**.

With these constraints in mind, we recommend that EU authorities, when announcing the outcome of the expected November Brexit Summit, and regardless of such outcome, send a clear and pre-emptive signal of their intention to act unilaterally to ensure the continued access of EU-27 entities to

UK CCPs post 29 March, 2019. In order to preserve financial stability, this communication should specify the means envisaged for this purpose.

3. Amongst three potential options, AMAFI considers that a temporary recognition of UK CCPs might be the most pragmatic and secured solution

As things currently stand, AMAFI considers that three main options could be envisaged.

The first option would be to **suspend both the Clearing Obligation (in EMIR) and the punitive prudential treatment of uncleared transactions (in CRR) for a minimal period.** While attractive in theory, **this solution would not really answer EU-27 entities' concerns and the systemic risk detailed above**, as it addresses the symptoms rather than the roots of the issue. More specifically:

- This solution would only apply to new transactions;
- Since UK CCPs would not be "qualified" anymore according to Article 25(1) of EMIR, this solution would not stop them from sending 90-day termination notices to their EU-27 clients, hence leaving the issue of the liquidation of open positions, and the predictable impact on market conditions, unanswered;
- Besides, having the EU to unilaterally suspend its Clearing Obligation may be hardly acceptable to other G20 jurisdictions, and could have impacts on international relations, for instance on the existing equivalence / substituted compliance agreements.

The second option would be to **accelerate the current review of EMIR and CRR, or to implement a dedicated review of those texts, aside of the ongoing work, to unilaterally extend transitional provisions to temporarily grandfather UK CCPs**. However, since this involves a modification of Level 1 texts, unless a specific process has been organized for Brexit issues, there is a risk that amending these articles would trigger debates on broader issues, resulting in the **impossibility to finish legislative negotiations on time**, e.g. by 29 March 2019.

The third option, **that has AMAFI's preference, would be for the EU to decide unilaterally to recognize UK CCPs as qualified CCPs for a limited period of time**, that could be for instance the shortest between (i) the length of the transition period that would have been granted with a withdrawal agreement (eg at least till December 2020) and (ii) the date of entry in force of EMIR2.2, provided that the final revised regulation is close to the initial EC proposal.

This solution would require to work in parallel on (i) an equivalence decision by the Commission, (ii) the recognition by ESMA of UK CCPs and (iii) the establishment of a Memorandum Of Understanding between ESMA and the FCA[7]. In order to have a recognition status under Article 25 of EMIR by 29 March 2019, this should be done as soon as possible and ideally before any potential political evolution, would the UK current Government not last.

Given the limited time to provide for an effective solution, this option appears to be the safest one.

[7] S. Maijoor, Chair European Securities and Markets Authority, *speech at the World Forum of Exchanges*, Athens, https://www.esma.europa.eu/sites/default/files/library/esma70-156-787_wfe_speech_steven_maijoor.pdf