

## 7. CCPs in the post-Brexit era

### The future of market infrastructures after the UK departs from the EU

**The importance of Central Counterparties (CCPs) has become greater since the last financial crisis. In the EU, a substantial volume of euro-denominated trades are cleared in the UK. Brexit is likely to have an impact on the current status-quo. In this regard, the European Commission (EC) has presented a proposal to grant ESMA and Central Banks, additional powers in the supervision and authorization of CCPs.**

CCPs play an important role in the economy. They become the counterparty to each sides of an operation, and by netting the positions of multiple trades across agents and collecting collateral they are able to reduce counterparty and systemic risk. Nearly 62% of all OTC contracts are centrally cleared (75% for interest rates derivatives)<sup>1</sup>.

In the EU, the European Market Infrastructure Regulation (EMIR) oversees the registration and supervision process for CCPs. After the implementation of this regulation, the clearing of some asset classes was mandatory. For the case of CCPs located in third countries, there are two requirements: first, that the third country's legal framework is granted equivalence for EMIR, and second, that the corresponding CCP is authorised and registered by ESMA. If otherwise, EU agents cannot use these CCPs services for regulatory purposes.

Currently, a substantial volume of trades in the EU is conducted through CCPs located in the UK (particularly, euro-denominated derivative transactions). Once the UK ceases to be a Member State, it will become a third country. Then, unless the EU and the UK are able to secure a transitional period, in March 2019 CCPs located in the UK will no longer be able to provide services to EU clients. Under the current situation, the UK will need to go through the third country equivalence process, and CCPs will need to be authorized by ESMA.

Considering that until now the UK has been a full member of the EU, and henceforth it has applied all of the EU regulations and directives, the equivalence process for EMIR should not pose a major difficulty from a technical perspective. Nevertheless, if the UK decides to modify its regulatory/supervisory framework, equivalence could be revoked. Considering the sheer volume of EU-based clients using UK-based CCPs, we would expect close scrutiny by EU authorities and this solution might not be a long term alternative.

Furthermore, the EC has recently issued a proposal to modify, among other issues, the authorisation and recognition process for third-country CCPs. The EC recognizes there is the *"risk that changes to the CCP...regulatory framework in a third-country could negatively affect regulatory or supervisory outcomes,...creating scope for regulatory...arbitrage"*. In order to cope with this issue, the ESMA would be empowered to set additional requirements for third country CCPs, depending on their systemic importance (as measured by objective criteria such as size, complexity, membership structure, or the effect that failure would have on the EU).

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1: Bank for International Settlements (2016). [OTC derivatives statistics](#) at end-June 2016.

Non-systemically important CCPs (Tier 1 CCPs) would be subject to the same implementation of EMIR equivalence that is currently used. But systemically important CCPs (Tier 2 CCPs) would be subject to enhanced supervisory requirements (depending on the degree of systemic risk). These additional requirements include, among other aspects, ongoing compliance with prudential requirements for EU-CCPs, the ability of the ESMA to conduct on-site inspections upon request, or any other requirement that relevant central banks deem necessary to guarantee the correct implementation of their monetary policy tasks. Additionally, there might be cases in which ESMA determines that the risks posed by a specific non-EU CCP to the financial stability of the EU (or one of its Member States) are so significant that even full oversight and compliance with the enhanced framework would not be sufficient to reduce such risks. In such cases, the ESMA would recommend that the EC should not to recognise the CCP. If such a CCP decides to service EU clients, it would need to be established and authorised in one Member State<sup>2</sup>.

**Figure 7.1** The European Commission's proposal



Source: BBVA Research

Given the importance of CCPs to the financial network, stronger supervision seems to be a reasonable approach. It is important to recognise as well, that if a location policy is enforced, and UK-based CCPs have to settle in a Member State, there might be a fragmentation of the liquidity pool, thus increasing the cost of using these CCPs. Nevertheless, EU's financial stability must prevail over other objectives. During periods of financial stress, rules in third countries might change in adapting to the new environment, but such rules might not be fully compatible with EU goals. Finally, it is worth mentioning that, whatever the outcome of this proposed reform (and the Brexit negotiations), a sufficiently long transition period is needed to allow firms to adapt their structures to the new environment. Given the complexity and the high interdependencies of CCPs, time is key to adapt positions to suit a different set of conditions; unravelling positions in a short period of time could lead to serious problems for the industry, as well as overall stability.

2: In 2011 the ECB tried to impose a location policy on CCPs with a high exposure to euro-denominated products, which would have forced CCPs located in the UK to relocate to a Euro Member State. The UK opposed this measures, and took it to the General Court of the EU, which ruled in 2015 that the "ECB does not have the competence necessary to impose such a requirement on CCPs".

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