Methodology for assessing a Third Country CCP under Article 25(2c) of EMIR

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1 Introduction

1. Article 25(2c) of EMIR stipulates that "*ESMA, after consulting with the ESRB and in agreement with the relevant central banks of issue (CBIs), and commensurate with the degree of systemic importance of the CCP in accordance with Article 25(2a) of EMIR, 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. […] In its assessment ESMA shall also*:

   a. *explain how compliance with the conditions for Tier 2 CCPs recognition would not sufficiently address the financial stability risk for the Union or for one or more of its Member States;*

   b. *describe the characteristics of the clearing services provided by the CCP, including the liquidity and physical settlement requirements associated with the provision of such services;*

   c. *provide a quantitative technical assessment of the costs and benefits and consequences of a decision not to recognise the CCP to provide certain clearing services or activities, taking into account:*

      i. *the existence of potential alternative substitutes for the provision of the clearing services concerned in the currencies concerned to clearing members, and to the extent the information is available, their clients and indirect clients established in the Union;*

      ii. *the potential consequences of including the outstanding contracts held at the CCP within the scope of the implementing act. […]"*

2. This document gives an indication of the methodology for ESMA to conduct an assessment of whether or not a CCP, or some of its clearing services, are of such substantial system importance that the CCP should not be recognised to provide certain clearing services or activities.

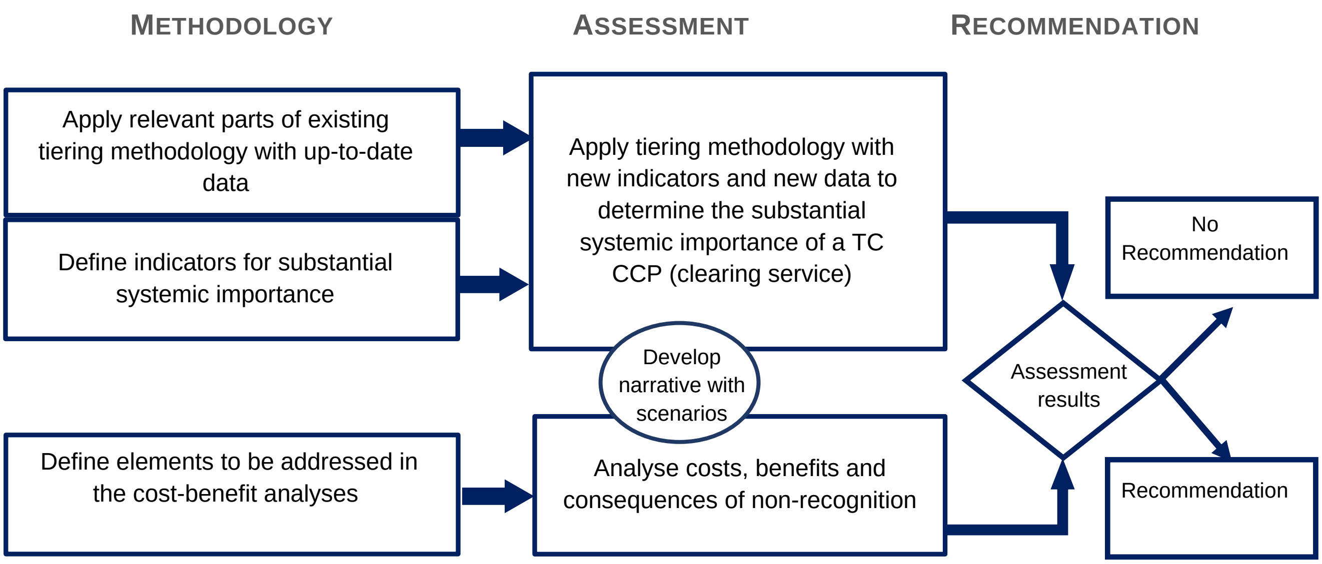
3. The objective of the methodology is to identify relevant components and elements needed to conduct an assessment.

2 Overview

4. The methodology for ESMA's assessment has been developed based on the requirements of Article 25 (2c) of EMIR and includes i) an extended tiering methodology; ii) reflections to identify how compliance with the conditions for TC CCPs recognition would not sufficiently address EU financial stability risks; and iii) a set of elements to take into consideration in the analysis of costs, benefits, and consequences, including a comprehensive analysis of

risks related to both recognition and non-recognition. The approach is illustrated in Figure 1.

FIGURE 1 STRUCTURE OF THE REVIEW



5. In line with Article 25(2c) of EMIR, ESMA's assessment of whether a CCP is of substantial systemic importance is to be commensurate with the degree of systemic importance of the CCP in accordance with Article 25(2a) of EMIR. Therefore, the 'Methodology for tiering third country CCPs under EMIR 2.2' (the tiering methodology)[1] is proposed as the starting point, to ensure consistency with the assessment of CCPs against the tiering criteria.

6. This approach also facilitates the collection of data for Article 25(2c) on the following aspects:

   - the characteristics of the clearing services provided by the CCP, including the liquidity and physical settlement requirements associated with the provision of such services, as required in Article 25 (2c)(b);

   - the existence of potential alternative substitutes for the provision of the clearing services, as required in Article 25 (2c) (ci).

7. The use of the existing tiering methodology would also support consistent data collection over time and leverages earlier work in relation to data use and methodology.

8. However, EMIR does not specify the indicators for determining whether a CCP (or one of its services) is of such substantial systemic importance that the existing regime would not suffice to manage and mitigate risks for the EU or for individual Member States.

[1] See ESMA70-151-3221

9. Therefore, this methodology supplements the tiering methodology by specifying additional indicators to be further considered in analysing the (substantial) systemic importance per TC CCP clearing service.

10. While compliance of a TC CCP with EMIR, or comparable requirements in the respective third country if comparable compliance applies, is aimed to ensure an adequate operational and financial resilience of the CCP, the objective of the review under EMIR Article 25 (2c) is to understand whether there are cases where the existing framework may not be sufficient to mitigate identified risks.

11. EMIR also does not specify an exhaustive list of elements for conducting an analysis of the cost, benefits and consequences as prescribed under Article 25(2c) of EMIR. The analysis of the cost, benefits and consequences will take into account possible costs, benefits and consequences of recognition as well as non-recognition. The possible impact and probability of the different effects and consequences will be evaluated based on the data collection and analysis. In determining the impact and probability, all relevant elements need to be considered and balanced, weighting the different elements in a comprehensive and fully reasoned manner. The analysis also needs to include possible secondary effects of recognition and non-recognition including effects on how clearing of other currencies and instruments will be affected and related consequences. The analysis also includes potential consequences of including the outstanding contracts held at the CCP, as required by EMIR Article 25 (2c) (cii).

12. Depending on the result of the assessment, where relevant, a recommendation to the Commission may be proposed that the Commission adopt an implementing act confirming that that CCP should not be recognised to provide certain clearing services or activities.

3 Adapting the tiering methodology

3.1 Re-using the tiering methodology to update the tiering results

13. As a starting point, the existing tiering methodology for TC CCPs will be used to make an up-to-date assessment of the relevant characteristics of the TC CCPs. ESMA will request the TC CCP to provide the information required for their tiering assessment (or, where relevant, update the information submitted for their tiering assessment at the time of their application for recognition). Data will be collected at the clearing service level and by asset class where relevant. Box 1 contains an overview of the data collected for the quantitative thresholds under Article 6(1) of the delegated act.[2]

[2] The indicators of the delegated act are not changed for the purpose of this review.

Box 1. Overview of data elements under Article 6(1) of the delegated act

Overview of the quantitative thresholds:

a. Maximum open interest of securities transactions, denominated in Union currencies;
b. Maximum notional outstanding value of OTC derivatives transactions, denominated in Union currencies;
c. Average aggregated margin and default fund contributions by clearing members established in the Union; and
d. Estimated largest payment obligation by entities established in the Union.

Overview of the indicators relating to the five criteria of EMIR Article 25 (2a):

a. The nature, size, market share and complexity of the CCP's business;
b. The effect of failure of or a disruption to a CCP;
c. The CCP's clearing membership structure;
d. The alternative clearing services provided by other CCPs; and
e. The CCP's relationships, interdependencies or other interactions.[3]

3.2 Substantial systemic importance indicators

14. A TC CCP is to be considered of substantial system importance when, even if it complies with the conditions for recognition as a TC CCP (including compliance with EMIR requirements - or comparable third country requirements where comparable compliance applies), it is of such substantial systemic importance to the EU that it should not be recognised. This is relevant in cases of crisis management, early-intervention measures, recovery and resolution (which are not covered under EMIR), but also in Business as Usual (BAU) conditions, e.g. with reference to interdependences with EU participants and markets.

15. In order to determine when a CCP is of substantial systemic importance, the assessment under Article 25(2c) should thus take into account, at least the following indicators:

    a. Size of credit exposures of EU participants (including EU clearing Members and EU clients), where relevant, (measured by margin and/or default fund contributions) in proportion to their buffer capacity.[4]

    b. Size of aggregate credit exposures of EU participants at Member State and EU level (measured by margin and default fund contributions) in proportion to relevant benchmarks, e.g. resolution funds

    c. Size of liquidity exposures of EU participants in proportion to their buffer capacity.

[3] This would include an analysis of possible contagion paths, taking into account the relative size of EU clearing members.
[4] For instance, EU banks are required to comply with minimum capital requirements and meet Minimum Requirements for own funds and Eligible Liabilities (MREL) targets.

d. Size of liquidity exposures in proportion to relevant benchmarks, e.g. the available liquidity in the market.

e. Size of non-prefunded losses in case recovery or resolution plans are triggered in comparison to the buffer capacity of EU participants.

f. Size of non-prefunded losses in case recovery or resolution plans are triggered in comparison to relevant benchmarks.

g. Impact of non-access to services (i.e. due to cost, loss of access, operational failures).

16. These indicators are further described in the following subsections. The assessment of a TC CCP against these indicators will also take into account potential spill-over effects, through the CCP's interconnections with, and interdependencies on, different types of market participants.

Indicator 1: Size of credit exposures of EU participants in proportion to their buffer capacity

17. This indicator has the following dimensions:

a. Default fund contributions from EU clearing members (CMs) (and, where relevant, interoperable CCPs) in different currencies as a percentage of their regulatory capital.

b. Margin contributions from EU CMs and interoperable EU CCPs as a percentage of regulatory capital.

c. Share of EU CMs' credit exposures stemming from EU client positions.

d. Share of TC CMs' credit exposures stemming from EU client positions.

Indicator 2: Size of aggregate credit exposures of EU participants in proportion to relevant benchmarks

18. This indicator has the following dimensions:

a. Potential total losses to EU CMs (and, where relevant, interoperable CCPs) aggregated at EU level and per Member State in proportion to relevant benchmarks, e.g. resolution funds and the aggregation of banks' capital at a national level.

b. Share of EU CMs' credit exposures stemming from EU client positions aggregated per Member State.

c. Share of TC CMs' credit exposures stemming from EU client positions aggregated per Member State.

Indicator 3: Size of liquidity exposures of EU participants in proportion to their buffer capacity

19. This indicator has the following dimensions:

a. Size of the potential liquidity risk due to payments due by EU CMs, including cash calls, and interoperable EU CCPs in proportion to (regulatory) liquid resources.

b. Size of the potential liquidity risk to EU liquidity providers as a percentage of the liquid resources of the liquidity providers.

c. Size of the potential liquidity risk due to delayed payments/settlements to EU payment systems, CSDs/SSS in relation to relevant benchmarks.

Indicator 4: Size of liquidity exposures in proportion to relevant benchmarks

20. This indicator has the following dimensions:

a. Size of the potential liquidity risk to EU CMs, EU clients, interoperable CCPs, and EU liquidity providers aggregated per Union currencies in proportion to relevant benchmarks, e.g. available liquidity in the market and the size of monetary and repo markets.

b. Size of the potential liquidity risk to EU liquidity providers as a percentage of the liquidity on related markets.

c. Size of the potential liquidity risk due to delayed payments/settlements to EU payment systems and CSDs/SSS in relation to relevant benchmarks, such as the interconnections of the banks (and, where relevant, UK CCPs) in the FMIs and the size of the net and gross payment flows that are impacted.

d. Size of collateral held at the CCP aggregated per EU currency and Member State of origin of the issuer.

Indicator 5: Size of non-prefunded losses in case recovery or resolution plans are triggered in comparison to capacity of EU participants

21. This indicator has the following dimensions:

a. Potential default losses allocation or cash calls to EU CMs as a percentage of their regulatory capital.

b. Potential default losses allocation or cash calls to EU Clients.

c. Potential default losses allocation of cash calls to interoperable EU-CCPs as a percentage of their regulatory capital.

d. Potential non-default losses allocation or cash call to EU CMs, Clients and interoperable CCPs as a percentage of their regulatory capital, where relevant.

Indicator 6: Size of non-prefunded losses in case recovery or resolution plans are triggered in comparison to relevant benchmarks

22. The indicator has the following dimensions:

a. Potential default losses allocation and cash calls to EU CMs aggregated at EU level and per Member State in comparison to relevant benchmarks, i.e. resolution funds, aggregate of banks' capital at national level.

b. Potential default losses allocation and cash calls to EU clients aggregated at EU level and per Member State in comparison to relevant benchmarks, i.e. resolution funds, and the aggregate of banks' capital at national level.

Indicator 7: Impact of non-access to services (i.e. due to cost, loss of access, operational failures)

23. The indicator has the following dimensions:

a. Disruption to trading / price discovery for cleared EU products (benchmarks) and EU securities due to delayed payments of CCP.

b. Disruption of services to EU trading venues and EU physical markets.

c. Impact on EU CMs, EU clients, and interoperable EU CCPs due to wind down or closure of service(s).

d. Impact on EU products (benchmarks, EU securities, and EU currencies) due to wind down or closure of service(s).

4 Analyses of Costs, Benefits and Consequences

24. As required by EMIR Article 25 (2c)(c), ESMA's review should include a quantitative technical assessment of the costs, benefits and consequences of a decision not to recognise the CCP to provide certain clearing services or activities, taking into account:

- the existence of potential alternative substitutes for the provision of the clearing services concerned for each class of derivatives and currency concerned to clearing members, and to the extent the information is available, their clients and indirect clients established in the Union;

- the potential consequences of including the outstanding contracts held at the CCP within the scope of the implementing act.

25. The aim of the cost benefit analysis is to present the possible impacts, their extent in terms of costs and benefits, that could arise from a decision not to recognise a TC CCP. The scope is intended to be broad, ranging from detailed operational impacts on different stakeholders, such as the transfer costs incurred by firms in changing CCPs, to much wider impacts, such as the effects on risks to EU clients, EU Member States and on the financial stability of the EU as a whole. ESMA will consult the ESRB and other relevant stakeholders in order to identify costs, benefits and consequences that could arise from a decision not to recognise a TC CCP.

26. This section describes the different elements that ESMA will consider in order to obtain a comprehensive understanding of the cost, benefits, and consequences for different stakeholders, including EU clearing members, clients and authorities. Where quantitative information is difficult to obtain, the quantitative analysis will be complemented with a qualitative analysis.

27. The analysis of the elements will be based on information that will be obtained from TC CCPs, EU CCPs, clearing members, clients, NCAs, CBIs, the ESRB and other European institutions. ESMA will prepare information requests for the different target groups as defined for the elements described below.

28. For each element ESMA will aim to prepare a substantiated overview of the costs, benefits and consequences and, where relevant, analyse the importance of the findings for different stakeholders and the EU as a whole. This holistic analysis is particularly important for assessing the overall impact on financial stability of whether or not to recognise a CCP to provide certain services.

29. Where the information provided or available to ESMA is limited, the methodology of the analysis may need to be adjusted to reflect this, for example, providing a qualitative analysis where information is insufficient to allow quantification.

4.1 Transfer costs

30. The first element of the cost-benefit analysis is an estimation of the direct costs related to the relocation or transfer of positions from a TC CCP to an EU CCP. Transfer costs comprise all of the costs that EU counterparties would face if they were to move their clearing activities from a TC CCP (service) to an EU CCP (service), including the transaction costs of moving their outstanding cleared transactions (the ‘stock’) to EU CCPs, the legal costs, and the operational costs.

31. In the methodology to analyse this element, ESMA will request estimations of transfer costs from selected EU CCPs, TC CCPs, and a selection of market participants, covering at least the:

   a. Costs of switch trades.

   b. Stock of transactions cleared in the third country and related maturities, and consequently the time needed to reduce the stock.

c. Use of post-trading risk reduction services or switch services of third-party service providers and the potential efficiency gains from these (e.g. less risk, less collateral from compression).

d. Operational costs, including those related to the opening of accounts at an EU CCP, membership costs, IT and operational costs related to establishing necessary networks and operating on new platforms.

e. Costs of repapering (if possible).

f. Other costs, including contributions to the default funds of EU CCPs and the possible additional capital costs related to membership of TC CCPs.

32. ESMA will analyse the responses, in particular the comprehensiveness of the cost elements, and the credibility of assumptions made, such as those applied on time horizon and potential spreads.

33. ESMA will prepare an independent estimation of the transfer costs for one or more clearing services per TC CCP and consult with CBIs, the ESRB and the SSM.

34. It is understood that these transfer costs are non-recurrent in nature and arise if EU counterparties move their clearing business, including existing portfolios of outstanding transactions, to EU CCPs.

35. Finally, it is important to note that this element will explicitly take into account the potential consequences of including the outstanding contracts held at the CCP, as required by Article 25 (2c)(cii).

4.2 Breaking margin netting sets

36. The analysis will also include an estimation of the potential impact of breaking netting sets on EU clearing members and clients.

37. This analysis will cover:

a. Possible cost to EU counterparties from the different types of products whose netting sets are broken.

b. The potential benefits that EU counterparties may gain from cross-product offsets available at EU CCPs, leading to lower collateral costs.

c. Costs related the existence of a 'basis'[5] to which EU counterparties may be exposed.

[5] The 'basis' is the price difference between two CCPs which offer clearing of the same product. Bases can develop between two CCPs if there is a different composition of market participants with more or less directional portfolios across the two CCPs. Bases are not constant, can be volatile and are unpredictable. Directionality of client portfolios may lead to the portfolios of dealers being

d. Factors leading to a higher or lower basis, such as arbitrage and directionality of positions.

e. The potential impact of concentration add-ons.

38. The methodology for this element will be to:

a. Use existing literature to determine relevant elements in calculating netting efficiencies.

b. Determine current bases and estimate how these may evolve based on the driving factors.

c. Request estimations from selected EU CCPs, TC CCPs, and a number of market participants for the losses and gains of netting efficiencies following the move from a TC to an EU CCP.

d. Analyse the CCP responses, using literature and estimations using market data.

e. Prepare an independent estimation of the cost of breaking up netting sets.

4.3 General consequences of non-recognition for EU market participants

39. The general consequences of relocation for EU market participants will be assessed in addition to the direct costs outlined above. This will include but are not limited to assessing the:

a. Impact on the competitive position of EU banks, other clearing members, clients, trading venues, FMIs, and products, and the possible migration of trading and clearing outside the EU to another third country.

b. Possible impact on products subject to trading and clearing obligation.

c. Costs in terms of increased financial stability risk, caused by higher counterparty credit risk, higher liquidity risk and higher margin procyclicality as a result of breaking netting sets.

d. Increase in risk to EU clearing members due to there being a smaller member base in EU CCPs to manage defaults, bid in auctions, and the impacts of more directional portfolios on overall credit risk.

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equally directional, leading to larger margin requirements, particularly when dealers breach concentration risk thresholds at a CCP or can only find the offsetting hedging transaction if it is cleared at a different CCP. Dealers will price this higher margin for this directional portfolio into the client transactions, making these transactions more expensive than the same transaction at a different CCP with a different balance of liquidity and directionality.

e. Potential incentives for clearing members to create new companies (outside the EU) within their organization solely to maintain access to TC CCPs.

f. The possibilities for EU companies to hedge their exposures through derivatives.

g. Impacts on access to clearing for EU clearing members and clients.

h. The readiness of EU CCPs to provide alternative substitutes for clearing relevant products to EU clearing members and clients.

40. The general consequences of relocation for EU market participants will also be assessed with respect to how the identified risks for the financial stability of the EU or one of its Member States could be better mitigated and managed if the substantial systemic important TC-CCP's service(s) was(were) provided by an authorised CCP within the Union. A comparison of risks related to a recognition versus a non-recognition decision will be made.

41. The methodology for assessing this will be to:

a. Use (targeted) industry meetings to assess the likelihood of these consequences.

b. Request qualitative and quantitative inputs from sources at these industry meetings.

c. Analyse the credibility and comprehensiveness of these inputs.

d. Consider potential mitigants of the costs.

4.4 Implications for the supervisory framework for CCPs

42. The non-recognition of a TC CCP (service) would impact the supervisory framework for CCPs. For instance, where the TC-CCP was already recognised as a Tier 2 CCP, its tiering status could change from Tier 2 to Tier 1.

43. Analysis of this element will include:

a. An assessment of the percentage of clearing that could move to the EU versus that which remains in the third country, or moves to another third country, and the impact on the tiering of the TC CCP.

b. The potential implications to the supervisory structure following non-recognition and the allocation of responsibilities on the migrated clearing services between ESMA NCAs and TC authorities.

c. A comparison of the availability of information and powers to the ESMA and CBIs under the current regime versus the availability of information and powers in the case a TC CCP that is recognised as Tier 2 CCP would be reclassified as Tier 1 CCP.

d. An assessment of potential actions that could be taken under EMIR 2.2 (in case of recognition) that may lead to regulatory divergences.

e. A comparison of the tools available to ESMA, NCAs, EMIR supervisory colleges and the CBIs to induce change and enforce corrective action.

f. An assessment of the impact of potential relocation of business to a TC CCP established in another third country on its tiering decision.

g. An assessment of the cooperation arrangements between ESMA, NCAs and TC CCP authorities.

h. The extent to which the current framework allows EU authorities to preserve financial stability in crisis, recover or resolution events.

4.5 Supervisory capacity in EU in crisis/recovery/resolution events

44. A key element in the analysis is the capacity of supervisors/CBIs to intervene during a crisis and mitigate shocks that could (potentially) affect financial stability.

45. The qualitative analysis here will cover:

a. The extent of discretionary powers held by TC CCPs and the TC (resolution) authorities and the possible scenarios in which EU market participants could be impacted.

b. ESMA's and CBIs' abilities to access information during a crisis (including in cases of recovery and resolution) and to intervene where EU financial stability is at stake.

c. Effectiveness of coordination between the home authorities and ESMA/CBIs.

d. The availability of central bank swap lines and access to central bank deposit accounts for TC CCPs.

4.6 EU market development considerations

46. The analysis could also consider how an EU infrastructure could contribute to a financially stable market development.