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**ESRB response to ESMA's consultation on determining the degree of
systemic importance of LCH Ltd and ICE Clear Europe or some of their
clearing services**

03 December 2021

Pursuant to Article 25(2c) of the European Market Infrastructure Regulation

Dear Mr Löber,

The General Board of the European Systemic Risk Board (ESRB) herewith responds to ESMA's consultation on determining the degree of systemic importance of LCH Ltd and ICE Clear Europe or some of their clearing services. This letter sets out the context to this response before summarising the ESRB's views. It also considers the publication of this letter and of a detailed report that informed the ESRB's views.

Context

In September 2020 ESMA temporarily recognised the UK CCPs LCH Ltd and ICE Clear Europe and classified them as systemically important or likely to become systemically important for the financial stability of the Union or of one or more of its Member States (i.e. Tier 2 CCPs, according to the EMIR 2.2 classification). The temporary recognition entered into force as per 1 January 2021 and is based on the provisions in Article 25(a) of Regulation (EU) No 648/2012 of the European Parliament and of the Council (the European Market Infrastructure Regulation or "EMIR"). The ESRB contributed to this process, by providing its views pursuant to the above-mentioned article. The ESRB took the view that LCH Ltd and ICE Clear Europe are of systemic importance, and therefore agreed with ESMA to classify the two CCPs as Tier 2. Under this category the CCPs can be recognised and the provision of services

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to EU clearing members is allowed under the condition that ESMA has a direct supervisory role at LCH Ltd and ICE Clear Europe.

The recognition of UK CCPs is temporary and valid until 30 June 2022, in line with the EU Commission time-limited decision on the equivalence between the EU and UK regimes for CCPs. Furthermore, as outlined in the EU Commission equivalence decision, ESMA is given the ... *"time to conduct a comprehensive review of the systemic importance of UK CCPs and their clearing services or activities to the Union and take any appropriate measures to address financial stability risks in accordance with Article 25 of Regulation (EU) No 648/2012, including recommending to the Commission that a UK CCP should not be recognised or withdrawing its recognition."* According to this article, the review includes a fully reasoned assessment to examine whether a third country CCP (TC-CCP) or some of its clearing services are of such substantial systemic importance that this TC-CCP should not be recognised to provide certain clearing services or activities. EMIR foresees that as a part of this decision, ESMA consults the ESRB and seeks agreement from the relevant central banks of issue.

The ESRB was consulted by ESMA on 19 November 2021.

The ESRB agrees with ESMA's main findings. In particular, the ESRB agrees with ESMA that the following clearing services are of substantial systemic importance for the financial stability of the EU or one or more of its Member States: LCH Ltd SwapClear for products denominated in EUR and PLN, and short term interest rate (STIR) and credit default swap (CDS) services in EUR operated by ICE Clear Europe Ltd. It also agrees with ESMA that from a financial stability perspective the costs of a decision not to recognise the three clearing services mentioned above would at this point in time outweigh the benefits.

The ESRB takes note that ESMA does under the current circumstances not consider issuing a recommendation to the Commission in the sense of Article 25(2c) of EMIR. Instead, in light of the substantial systemic importance of the three clearing services and the identified risks and vulnerabilities, ESMA proposes that the adoption of follow-up measures be considered to address the risks and vulnerabilities identified in the assessment. In its own assessment, the ESRB arrived at the same conclusion as ESMA with regard to the need for follow-up measures to address vulnerabilities and risk to financial stability. A broad indication of such follow-up measures is provided below.

In addition to the comprehensive assessment report that formed part of ESMA's consultation of the ESRB, the ESRB's response to ESMA is informed by the ESRB's own detailed data analysis and by extensive discussion at expert, technical and policy level. This analysis includes an assessment of the degree of systeminess as well as the costs and benefits and other consequences of a decision not to recognise LCH Ltd and ICE Clear Europe or any of the services provided. The topic has been discussed extensively at the ESRB's Task Force on Central Counterparties, the ESRB's Advisory Technical Committee and the ESRB's Advisory Scientific Committee. Prior to reaching its conclusion at

its meeting on 2 December 2021, the topic was also discussed by the ESRB General Board at its meetings on 24 June 2021 and 23 September 2021.

The ESRB's analysis and considerations informing the ESRB's views are summarised in the appendix to this letter. A comprehensive technical report, which reflects the work of the ESRB Task Force on Central Counterparties conducted over one year, is attached as a separate document.

Overarching view of the ESRB

The ESRB's analysis showed that certain clearing services provided by the two UK Tier 2 CCPs might be of substantial systemicness of the EU or one or more of its Member States and should be considered in detail, i.e. (i) Swapclear, operated by LCH Ltd; for all contracts denominated in EU currencies, i.e. CZK, DKK, EUR, HUF, PLN, and SEK; (ii) the Short Term Interest Rates (STIR) service, operated by ICE Clear Europe; for contracts denominated in EUR; (iii) the Credit Default Swap (CDS) service, operated by ICE Clear Europe; for contracts denominated in EUR. The ESRB is of the view that the main risks to financial stability associated with continued recognition of these clearing services relate to a situation where a UK CCP offering the service(s) would take procyclical measures during a period of market strain, or enter into a recovery phase or, ultimately, into resolution. The main risks to financial stability associated with the non-recognition of these services relate to cliff edge effects and operational and legal risk during and after a transition from the status quo. The ESRB's view reflects its assessment of the balance of these risks.

The ESRB is of the view that the SwapClear services in CZK, DKK, HUF, and SEK operated by LCH Ltd are not deemed of substantial systemicness for the EU and that they should therefore be allowed to be provided in the EU.

This assessment reflects *inter alia* lower volumes and/or less interconnectedness risks than for services in EUR and PLN such that for the SwapClear services in CZK, DKK, HUF and SEK the costs of non-recognition would clearly outweigh the benefits.

The ESRB is of the view that the STIR and CDS services in EUR operated by ICE Clear Europe Ltd and the SwapClear services in EUR and PLN operated by LCH Ltd, are of substantial systemicness for the EU, but that they should nevertheless be allowed to be provided in the EU.

This assessment is more finely balanced than for the SwapClear services in CZK, DKK, HUF and SEK; albeit that the ESRB still deems that the costs of non-recognition would outweigh the benefits.

The ESRB proposes that any extension of the current recognition of the two UK Tier 2 CCPs should be temporary, and that it should be supported by measures to increase the offer of clearing solutions from EU CCPs, and to reduce risks to financial stability linked to the substantially systemic services operated by ICE Clear Europe Ltd and LCH Ltd.

These measures respect the de jure binary setting of the decision process set out in EMIR. Reflecting this, they do not impose conditions on the legal process set out in EMIR. But the ESRB considers it important that such accompanying measures would be put in place.

The ESRB is of the view that a temporary recognition should go hand-in-hand with:

- **the strengthening of ESMA's powers outside the EU. The ESRB proposes to revise the legal framework of Tier 2 CCPs to make ESMA's role more incisive, with particular regard to crises situations, i.e. a CCP's recovery or resolution, while enhancing the cooperation with UK authorities;**
- **identifying a set of credible measures that would enable EU authorities to achieve a gradual reduction in exposures of EU clearing members to Tier 2 CCPs and strengthen EU supervision commensurate with an increase in clearing activity at EU CCPs. As part of these measures the EU Commission might, for instance, wish to consider:**
 - **providing macro- and micro-prudential authorities with the power to impose higher risk-based capital charges on the exposures of EU intermediaries at Tier 2 CCPs, when deemed of substantial systemicness, and/or take other measures to incentivise a reduction of those exposures (the CRD/CRR review provides an opportunity to include such powers);**
 - **strengthening of ESMA's powers within the EU, such that, as exposures to EU CCPs grow beyond certain thresholds (including as part of any reduction of the UK CCP market shares to the clearing services identified), the legal and supervisory framework in the EU would adequately reflect the greater role of some EU CCPs.**

Reflecting the distinction between EU currencies in the ESRB's assessment of the substantial systemicness of the clearing services of the two UK Tier 2 CCPs considered, the above views concerning the need for a reduction of exposures to UK Tier 2 CCPs via other mitigating measures focus on EUR and PLN and do not apply to CZK, DKK, HUF and SEK. Other proposals to mitigate systemic risk, such as a strengthening of ESMA powers, should, to the contrary, apply across the EU. In this respect, the EU Commission should identify the appropriate timeframe and conditions that would be needed for such a strengthening of ESMA's powers within the EU.

The ESRB stands ready to contribute to defining such measures. The progress with and the success of these measures would need to be reviewed ahead of the expiry date of the further temporary recognition.

Publication

Both the appendix to this letter and the technical report form an integral part of this response. The ESRB consents to publication should ESMA wish to make the letter and the appendix public. Prior of

doing so, ESMA is requested to liaise with the ESRB to establish if any parts need to be redacted to protect institution-specific information. The ESRB would not consent to ESMA making the technical report public in its current form. The reason is that the technical report contains data that may allow identifying individual institutions. Should ESMA decide to publish this letter and the appendix, the ESRB would also do so subsequent to ESMA's publication. At present, the ESRB does not plan to publish the letter and the appendix and/or a redacted version of the technical report at its own initiative. It may, however, at its own discretion, decide to do so at a later date, in which case it would inform ESMA in a timely manner.

Yours sincerely,



Francesco Mazzaferro

Head of the ESRB Secretariat

Cc.

Ms Verena Ross, Chair, European Securities and Markets Authority

Mr John Berrigan, Director-General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Mr Ugo Bassi, Director for Financial Markets, European Commission

Encl.

Summary of analysis and considerations informing the ESRB's policy stance

Technical report on the analysis of systemic importance of UK CCPs

Appendix

Summary of analysis and considerations informing the ESRB's policy stance

Introduction

The netting of exposures is central to the risk reduction benefits associated with clearing at CCPs. This centrality is reflected in their name – central counterparties (CCPs) – and the greater the centrality of CCPs through the concentration of exposures, the greater the potential benefits from a financial stability perspective. During 'business as usual', this centrality reduces costs, as each clearing member can net across a larger set of positions than would otherwise be the case. This reduces exposures and thus collateral needs. During times of market strains, a benefit from a financial stability perspective is that losses that might arise from the default of one clearing member – and are not fully covered by the collateral posted by the defaulter at the CCP – can be shared amongst the large set of remaining clearing members. This is done according to a pre-agreed formula set out in the CCP's rule book, using the prefunded resources of the clearing members according to the so-called default waterfall.

Centrality can, however, create risks if the CCP becomes impaired and enters into a recovery phase or, ultimately, into resolution (a tail risk). CCP recovery and particularly resolution means that the CCPs own rules about how to share losses amongst clearing members are superseded by the regulatory rules governing recovery and resolution. In resolution, the resolution authority (or the CCP on instruction of the resolution authority) can take discretionary decisions regarding the tools used and their scope. For instance, the resolution authority / CCP might be able to demand that surviving clearing members provide further cash; reduce the amount of gains the CCP pays to those clearing members that are owed money (so-called variation margin gain haircuts); and/or apply partial or full tear-up to a specific scope of products. Risks may also arise in a time of market strain, where the CCP may impose sudden measures that could impact specific members and their economies more significantly, such as high increases in haircuts on sovereign collateral.

From an EU perspective, these risks are especially important if the CCP is located outside the EU and if exposures of EU clearing members to the CCP are large. When deciding on the tools to be used, a foreign resolution authority might be incentivised to use tools that ultimately minimise losses for domestic clearing members at the expense of non-domestic clearing members, including those from the EU. This risk arises from the fact that neither the discretion given to resolution authorities outside the EU is governed and constrained by the provisions in the EU recovery and resolution framework for CCPs, nor can EU authorities intervene during the resolution process. If the exposures of EU clearing members at CCPs outside the EU are large, and/or if there is little alternative to clearing products at the foreign CCP, this can pose risks to financial stability in the EU. This raises the question of whether it might be safer not to allow certain foreign (third-country) CCPs to provide (some of) their services in the EU, when they are substantially systemic for the EU or some of its Member States.

[REDACTED]

It shows that the SwapClear service operated by LCH Ltd clears contracts denominated in six EU currencies, whereas ICE Clear Europe clears STIR and CDS contracts denominated in EUR only (chart 1 right).

[REDACTED]

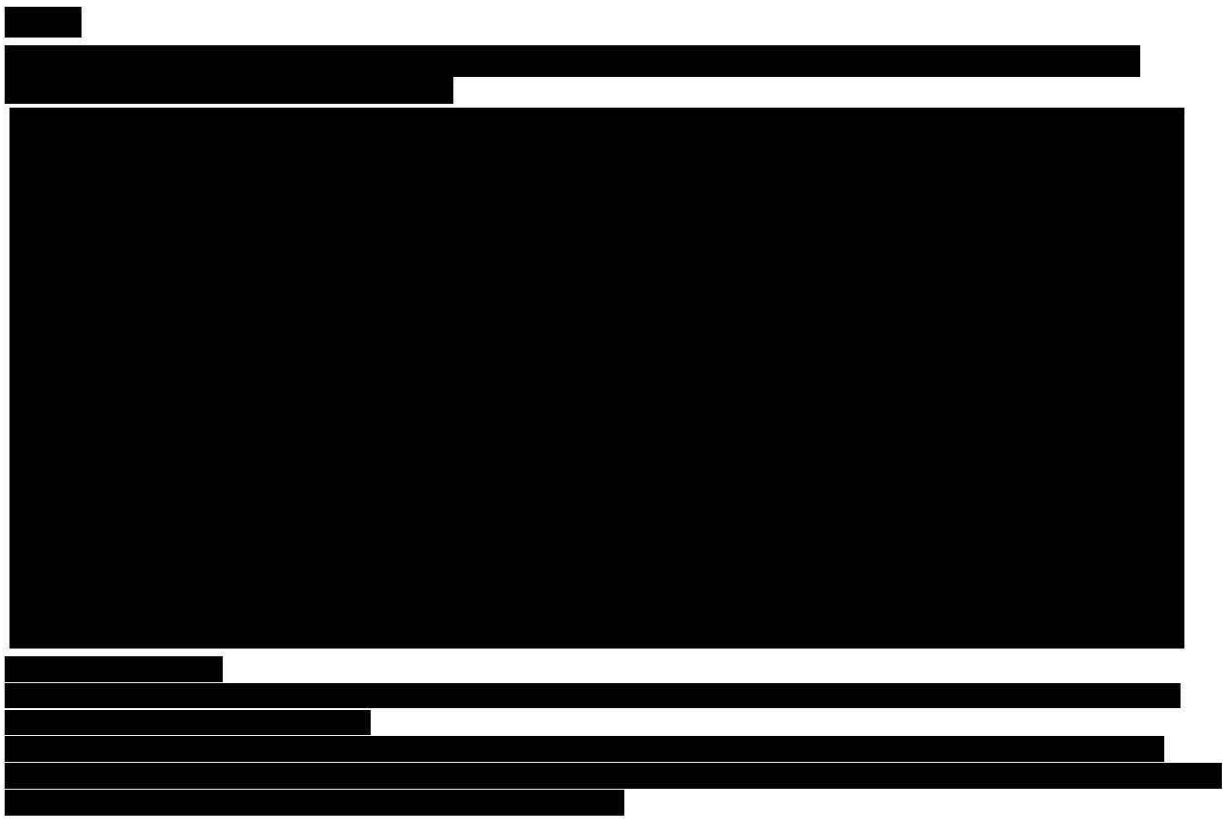
[REDACTED]

[REDACTED]

Measured in terms of 'capital at risks' in case of the CCP entering recovery or resolutions, clearing members active in EUR-derivatives clearing have the highest exposure to LCH SwapClear and ICE Clear Europe¹ relative to their capital, while members active in HUF-derivatives, SEK-derivatives and DKK-derivatives clearing have the lowest exposure. The total value of the default resources posted by clearing members is a better measure of the amount of risk managed by a CCP and the exposure to clearing members to the CCP than the notional amount. The reason is that the relationship between the notional amount and the cash flows exchanged for a contract varies across products. For example, for interest rate swaps, only the interest calculated on the notional amount is exchanged, whereas for CDS the notional is exchanged only in case of credit

¹ ICE Clear Europe services considered are CDS Clearing and Futures and Options (F&O) Clearing. ICE Clear Europe F&O Clearing includes STIR derivatives clearing.

events of the referenced entity or underlying security. In contrast, the value of default resources posted at the CCP is a proxy for clearing members' credit exposures in case a CCP enters recovery or resolution. Chart 2 shows the exposures of EU members of ICE Clear Europe and LCH SwapClear. The exposure is displayed as a percentage of clearing members' total regulatory capital. In the chart clearing members are grouped by currency of activity. The exposure of clearing members active in EUR-derivatives is the highest, [REDACTED]. The exposure to SwapClear of clearing members active in SEK-derivatives and HUF-derivatives [REDACTED] is the lowest [REDACTED] and the exposure of members active in DKK-derivatives is the third lowest [REDACTED]. Clearing members active in PLN-derivatives clearing have an exposure to SwapClear similar to that of members active in EUR and CZK-derivatives [REDACTED].



For products subject to the clearing obligations, EU alternatives to SwapClear operated by LCH Ltd. and the Short-Term Interest Rates (STIR) and Credit Default Swap (CDS) services operated by ICE Clear Europe exist. As shown in Table 1, for CDS, OTC Interest Rate derivatives (IRDs) and STIR derivative products denominated in EU currencies that are subject to the clearing obligation, an alternative clearing service in the EU (which is sufficiently liquid) exists. OTC IRDs referencing BUBOR and PRIBOR are not subject to the clearing obligation. In case of non-recognition of LCH Ltd SwapClear, centrally cleared OTC IRDs referencing BUBOR and PRIBOR might move to the bilateral sphere.

Table 1: **Substitutability by Product**

LCH Ltd SwapClear - (OTC) Interest Rate Derivatives					ICE Clear Europe - CDS				
	Underlying	Currency	Clearing Obligation*	Alternative in the EU		Underlying	Currency	Clearing Obligation*	Alternative in the EU
	EURIBOR	EUR	✓	✓		iTraxx	EUR	✓	✓
	EONIA	EUR	✓	✓		Single Name NFC	EUR	✗	✓
	WIBOR	PLN	✓	✓		Single Name FC	EUR	✗	✓
	STIBOR	SEK	✓	✓		Single Name Banks	EUR	✗	✓
	BUBOR	HUF	✗	✗		Single Name Insurance C.	EUR	✗	✓
	PRIBOR	CZK	✗	✗	ICE Clear Europe - (ETD) STIR				
	CIBOR	DKK	✗	✓		EURIBOR	EUR	-	✓

Source: EMIR data, ESMA

Notes: *Clearing obligation is ticked in case the clearing obligation applies to at least one tenor or maturity for the product class. An alternative is a clearing service that is deemed capable of offering a sufficiently liquid alternative or able to develop one in the near future.

The Tier 2 framework provides room for UK CCPs and UK authorities to adopt rules and practices that are less conservative than those in the EU. This is shown in table 2. Moreover, Regulation 2021/23 on the recovery and resolution framework of CCPs, was finalised after Brexit and is therefore not transposed to the UK. The UK has its own CCP recovery and resolution framework that differs slightly from the EU framework.

Table 2: **EMIR and Tier 2 Comparable compliance requirements**

Requirement	EMIR and regulatory technical standards	Comparable compliance ²
Margin calibration	Confidence interval > 99.5% for OTC derivatives	Confidence interval >99%
Default fund calibration	Historical data should include past 30 years	No such requirement
Liquidity resources	Limitative list of liquid resources	No such requirement
Skin in the game	Mandatory "skin in the game"	No minimum amount
Collateral concentration	No more than 10% of collateral is guaranteed by a single credit institution.	No such requirement.
Anti-procyclicality requirements	Requirement to implement at least one of the APC tools listed	No such requirements.

The degree of systemicness varies across Member States and the currency of denomination of the trades cleared by the two CCPs. For euro-denominated contracts the assessment indicators markedly point towards a substantial systemicness of the three clearing services. Elements of substantial systemicness emerged also for contracts in PLN; for the other EU currencies the assessment is much less conclusive. As none of the indicators points consistently towards the absence of substantial systemicness, the cost-benefit analysis is conducted for all currencies.

² See also the Delegated Regulation on Comparable Compliance - https://eur-lex.europa.eu/legal-content/EN/TXT/?toc=OJ%3AL%3A2020%3A305%3ATOC&uri=uriserv%3AOJ.L_2020.305.01.0013.01.ENG

Part 2 – Costs and benefits relevant from a financial stability perspective that might arise if the above clearing services operated by LCH Ltd and ICE Clear Europe were to be allowed (or not allowed) to be provided in the EU.

The analysis of costs and benefits is multidimensional, considering continued recognition and the non-recognition of the services identified above across two stages and three scenarios. The case of non-recognition is considered for the two stages of (a) transition and (b) post transition. The scenarios considered are (i) business as usual; (ii) market strain, operational disturbance and/or member default; and (iii) CCP resolution. The reason for this multidimensional assessment is that the costs and benefits may differ a lot depending on the situation.

In a 'business as usual' scenario, the largest cost of a relocation consists of increased collateral requirements that would arise from the breaking of netting sets. Industry estimates arrive at a margin increase of approximately 15-20% if euro-denominated interest rate swaps (IRS) had to be cleared at a EU CCPs.³ But these estimates were made prior to Brexit and do not reflect changes in clearing activity that have taken place since. Moreover, costs will differ across the different categories of market participants. For example, clients and end-users would typically hold directional positions with little scope for netting. For these categories of users, a fragmentation of clearing would matter less in terms of splitting of netting sets. The benefits of a relocation are even harder to quantify since they are inherently behaviour-dependant. For example, the willingness of clients to clear in the EU – an important condition for the creation of a large liquidity pool at EU CCPs – cannot be taken for granted, in particular for clients not subject to capital requirements. It would also depend on the willingness and ability in the short to medium term of EU CCPs to provide alternative solutions. EU CCPs would have to identify a business case to justify the investments needed to offer new and/or enhanced clearing services.

In a scenario of market strain, operational disturbance and/or member default or in a scenario of CCP resolution, the costs and benefits analysis of a relocation are hard to quantify. In the "tail risk" linked to a resolution scenarios, there is "room for manoeuvre" for a resolution authority, allowing it to take discretionary decisions to favour domestic participants, albeit that this room is limited by the "no creditor worse off principle". However, such principle applies only ex-post. As such it does not eliminate the possibility that during a crisis financial instability is "exported" to another jurisdiction. In the case of resolution, the estimated benefits of relocation are also difficult to quantify since (like in the business as usual scenario) they are highly dependent on the behaviour of different stakeholders (primarily market participants and their clients). Yet, relocation to EU CCPs would provide power to local resolution authorities to manage the CCP's resolution, instead of relying on a third country authority.

These considerations are reflected in the table below, which shows costs and benefits relative to the alternative, rather than in absolute terms. The table considers the case of recognition and the case of non-recognition across the three scenarios and two stages identified above. As this analysis focusses on costs and benefits that are relevant from a financial stability perspective, benefits are presented in terms of risk reduction, whereas costs are presented in risk terms of risk increases. Reflecting this, benefits are identified in green; costs are in red; and risks mitigants in blue.

³ <https://www.isda.org/a/U8iDE/brexit-paper-1-final1.pdf>



	Recognition	Non-recognition – During transition	Non-recognition – After transition
Business as Usual	<p>Continued access to global netting pool</p> <p>Maintain constructive relation with UK authorities;</p> <p>Excessive credit and liquidity exposures;</p> <p>Risk of some regulatory and supervisory divergence under the Tier 2 framework;</p> <p>Reducing footprint, voluntary or mandatory.</p>	<p>Reduce reliance of EU on UK CCPs;</p> <p>Supervisory risk: activity could move to TC CCPs not under ESMA supervision;</p> <p>Fragmentation of liquidity pools;</p> <p>Operational risk: closing and opening positions, changing IT systems;</p> <p>Reduction of interest rate risk hedging;</p> <p>Adaptation period; limiting to new contracts.</p>	<p>Reduce reliance of EU on UK CCPs;</p> <p>Supervisory risk: activity could move to TC CCPs not under ESMA supervision;</p> <p>Fragmentation of liquidity pools;</p> <p>Reduction of interest rate risk hedging;</p> <p>Ending exemption of pension scheme arrangements from clearing, to increase liquidity pool within the EU;</p> <p>Stricter rules and supervision.</p>
Market strain	<p>Larger user base in the event of default management (loss distribution, defaulted portfolios auctions, etc.);</p> <p>TC CCPs can take discretionary risk management measures, without considering EU financial stability (e.g. off-boarding EU clearing member in case of a default or other risk-based grounds without the involvement of ESMA or NCA of the CM or applying sudden and high increases in collateral haircuts);</p> <p>Review of comparable compliance requirements, for instance removal of the waiver to comply with the EMIR RTS quantitative requirements;</p> <p>Amend the regulatory framework to require ESMA sign-off for changes in the rulebooks of TC-CCPs (similar to SEC);</p> <p>Alignment of functioning and prerogatives of global colleges with EMIR colleges by UK</p>	<p>EU authorities have ex-ante supervisory power;</p> <p>Prioritising financial stability in the EU;</p> <p>CCPs decisions on access, margins and default management supervised by EU NCAs and EU supervisory college;</p> <p>Bifurcation of portfolios might result in liquidity challenges for clearing members.</p>	<p>EU authorities have ex-ante supervisory power;</p> <p>Prioritising financial stability in the EU;</p> <p>CCPs decisions on access, margins and default management supervised by EU NCAs and EU supervisory college;</p> <p>Bifurcation of portfolios might result in liquidity challenges for clearing members.</p>



	<p>NCAs, thereby providing ex-ante binding power to EU authorities, CBIs and NCAs; Swap lines between ECB and Bank of England facilitate the provision of multi-currency liquidity to UK and euro area CCPs; MoU between ESMA and Bank of England provides for significant information sharing and cooperation, notably in crisis situations.</p>		
Resolution	<p>The TC NRA could choose tools to minimise losses for domestic clearing members, and disadvantage EU clearing members; EU financial stability concerns might not be considered (sufficiently); UK keeps CCP Recovery and Resolution (R&R) framework aligned with EU and allows for joint decision making between UK resolution authorities and ESMA; EU CCP R&R framework is enhanced with more supervisory powers of ESMA; EU R&R provisions could be made part of EMIR to ensure Tier 2 CCPs adhere to the EU R&R framework.</p>	<p>Convergence of supervisory practices and regulatory alignment if activity moves to EU; Prevents the build-up of unmonitored risks that could materialise in a crisis; (equivalence and comparable compliance cannot achieve the same level of convergence or monitoring); Discretion of NRA in resolution is constrained in a comparable / predictable way across EU; Even within the EU the interests of NRA (a national competence) and pan-European authorities may not always be fully aligned.</p>	<p>Convergence of supervisory practices and regulatory alignment if activity moves to EU; Prevents the build-up of unmonitored risks that could materialise in a crisis; (equivalence and comparable compliance cannot achieve the same level of convergence); Discretion of NRA in resolution is constrained in a comparable / predictable way across EU; Even within the EU the interests of NRA (a national competence) and pan-European authorities may not always be fully aligned.</p>