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CCPs: evolving risks and supervisory responses
Keynote speech

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Ladies and Gentlemen,

It is a great pleasure for me to deliver this keynote speech before such a distinguished audience. I would have preferred to be able to attend in person this leading industry event which has become a fixture for market participants active in derivatives trading and clearing and securities financing.

I would like to thank the host for inviting me to speak about the evolving risks in the domain of central clearing services. This also provides me an opportunity to share with you how ESMA and the relevant supervisory national authorities in the European Union are coordinating their efforts to respond to the evolving clearing landscape.

1. **ESMA's CCP Supervisory Committee**

As a starting point, allow me to spend a few words on the establishment of the CCP Supervisory Committee at ESMA which started operating in 2020.

The establishment of the CCP Supervisory Committee represents the most tangible EU regulatory response to the need to enhance the supervisory framework for CCPs serving the European financial markets.

As you will know, the Supervisory Committee is composed of representatives from national competent authorities responsible for the supervision of EU CCPs, as well as from those central banks issuing Union currencies referenced by financial instruments cleared by authorised or recognised CCPs. It also encompasses two independent members appointed by ESMA: Ms Nicoletta Giusto, Ms Froukelien Wendt; as well myself, acting as Chair of the committee.

The Supervisory Committee has the mandate to ensure that risks stemming from authorised or recognised CCPs are adequately assessed, monitored and addressed. It is tasked with promoting supervisory convergence in the supervision of EU CCPs, and with monitoring and supervising recognised third-country CCPs, in particular those that are systemically important for the Union. Supporting the Supervisory Committee, ESMA created a CCP Directorate, which is also in charge of other CCP related tasks entrusted to ESMA, such as completing the CCP rule book under EMIR and advancing the new framework for CCP recovery and resolution. These tasks are advanced through a dedicated CCP Policy Committee (to which we are currently calling for expressions of interest in a consultative working group) and soon a new CCP Resolution Committee as prescribed under the new regulation on CCP recovery and resolution.

Under this new set up, ESMA is given a pivotal role in the overall EU regulatory and supervisory framework for CCPs. In order to perform its increased role, a key strategic objective is to further enhance ESMA's analytical capacity and market intelligence, inter alia by leveraging on closer cooperation with competent authorities and central banks, regular industry outreaches on topical issues - like the very successful recent workshop on "CCP Margins and Procyclicality", as well as increased active engagement in international regulatory work of relevance to CCPs.

My ambition is to further strengthen the CCP Directorate not only to continue to conduct all required assessment and monitoring activities on the risks posed to and by CCPs but also to engage in deepened analytical and research activities to anticipate potential risks stemming from emerging market developments and technological innovation.

Indeed, CCPs operate in a highly dynamic ecosystem exposed to continuous changes including technological changes, such as the application of distributed ledger technologies, digitalisation and automatisation. Moreover, financial innovation brings new products suitable for clearing, such as derivatives on tokenised assets, emissions allowance, and products denominated in digital currencies. As a result, the risks posed to and by CCPs continuously evolve. ESMA will have to address these developments proactively to ensure CCPs' resilience in view of evolving risks and to make sure that new services and activities are provided only if and where risks have been properly identified and managed.

From a supervisory perspective, in order to be able to respond to evolving CCP risks, ESMA will rely to a considerable extent on the powers given to the CCP Supervisory Committee with respect to both enhanced convergence in the supervision of EU CCPs and the recognition and supervision of third-country CCPs.

Supervisory convergence

Supervisory convergence aims to ensure that the requirements in EMIR are applied comprehensively and consistently to EU CCPs and that the supervisory activities of national competent authorities are fully aligned when mitigating risks for financial stability.

The recent review of EMIR has significantly enhanced the toolkit for supervisory convergence. Besides discussing and opining on relevant supervisory decisions and establishing common practices across the EU in the CCP Supervisory Committee, there are two key tools for enhanced supervisory convergence: peer reviews and CCP stress tests.

Peer reviews of national competent authorities' supervisory activities on CCPs are conducted annually and have already proven to be successful in defining best practices and identifying inconsistencies or divergencies in the application of regulatory requirements. The Supervisory Committee will select in an agile manner the most topical themes for the next cycles of peer reviews taking into account market developments and emerging risks.

Moreover, ***CCP stress tests*** are also conducted annually to measure the level of resilience of CCPs against common stress scenarios and to identify issues to follow up, as appropriate by general regulatory or supervisory convergence initiatives, or individual supervisory actions. Building on the experience gained over the previous rounds, the Supervisory Committee is currently enhancing the framework for CCP Stress tests; it recently set up a standing sub-group of experts to deal with the methodological aspects of stress tests with the aim to develop a multi-year plan for CCP stress tests covering a wide spectrum of sources of systemic risks. The Committee is about to launch the next round of CCP stress tests and is currently refining the stress scenarios to be applied, for instance, by linking credit and concentration risk, and developing new modules addressing operational risk (including cyber risk) and environmental risk.

Recognition and supervision of third-country CCPs

Turning to the recognition and supervision of third-country CCPs, the new regime introduced by EMIR 2.2, which is given ESMA more wide-ranging powers, is a response to the need to address the risks posed by those third-country CCPs that are systemically important for the financial stability of the Union or one or more of its Member States (so-called Tier 2 CCPs).

Under this new regime, in September 2020 ESMA decided to temporarily recognise the three UK CCPs as third-country CCPs as from 1 January this year until 30 June next year. This was done in order to avoid cliff edge effects in the clearing domain and to minimise risks to financial stability at the end of the Brexit transition period, in line with the underlying temporary equivalence decision adopted by the European Commission. As you well know, two UK CCPs have been recognised as Tier 2 CCPs: ICE Clear Europe and LCH Limited.

Under EMIR 2.2, ESMA has direct supervisory responsibilities for these Tier 2 CCPs and is currently finalising its supervisory programme and processes to ensure an effective ongoing supervision, as well as to deal with potential emergency situations. We are seeking an efficient cooperation with the Bank of England in order to optimise the respective supervisory activities (including information requests, investigations and on-site inspections) and to mitigate possible frictions. ESMA, through the CCP Supervisory Committee, will ensure that Tier 2 CCPs continue to comply with relevant requirements on an ongoing basis and offer their clearing services to the EU financial markets under a level playing-field with EU CCPs.

Finally, regarding the 34 third-country CCPs that were already recognised under the old EMIR regime, ESMA will review their recognition in the course of this year to assess whether they can continue to provide services in the Union as non-systemically important (Tier 1) or systemically important (Tier 2) CCPs. Following the recent equivalence decision by the European Commission with respect to the CCPs registered with the US Securities and Exchange Commission, ESMA will soon resume the process for the recognition of these CCPs.

Moving forward, the CCP Supervisory Committee will continuously monitor developments in the recognised CCPs and their jurisdictions and review their recognition on a regular basis.

2. Evolving risks in the domain of CCPs

Allow me to focus the second part of my speech on some major risks emerging in the domain of CCPs in connection with recent market and environmental developments. In particular, I would like to touch on unaccomplished structural changes implied by Brexit, as well as certain risks emphasised by the Covid-19 pandemic and conclude with some reflections on environmental risk and interdependencies.

Post-Brexit changes

Starting with the post-Brexit changes, while the temporary recognition of the UK CCPs has allowed for a smooth transition from the previous EU CCP regime to the new third-country regime, at the same time Brexit resulted in two major CCPs of systemic importance for the Union to operate from outside its jurisdiction. From an EU perspective, as I already noted on another occasion, in the clearing space, we may have not yet seen the full implications of Brexit. Whereas in the trading sector, we witnessed the relocation of quite some trading activities from the UK into the EU or elsewhere; in the clearing domain, there have been less pronounced developments, certainly aided by the temporary recognition of UK CCPs.

The Supervisory Committee is tasked to carefully analyse potential risks, dependencies and stability implications that result from the current situation and its potential evolution. It will also consider the effect of initiatives to continue building the Capital Market Union which may further incentivise clearing with EU CCPs. Moreover, in accordance with its mandate, by mid-2022, the Supervisory Committee will assess whether the services provided by the two Tier 2 CCPs, or some of them, are of a systemic nature that is too substantial to be safely provided from abroad. To this end, ESMA is currently defining a methodological framework for the assessment of the relevant systemic risks and supervisory implications, also taking into account the costs and benefits that may result from a potential relocation of clearing services. In conducting this assessment, the committee will collect and consider a wide range of quantitative and qualitative information, engage with all relevant stakeholders, and consult relevant authorities. I am looking forward to such engagements with many of you in the course of this year. The final goal is to propose a sound and objective decision on this matter in the interest of the financial stability of the EU, its member states and market participants, followed by consequent implementation measures.

Procyclicality

Moving to the risks that were highlighted by the Covid-19 pandemic, in early 2020 the pandemic exacerbated market volatility, comparable to or even exceeding past crisis events. During this period, EU CCPs' risk models generally performed well, which is also due to the anti-procyclicality requirements that were implemented by CCPs in compliance with EMIR. These clearly helped minimising margin calls and liquidity pressures on clearing members, also in comparison to what could be witnessed in some other jurisdictions.

In order to further support international efforts to evaluate the efficiency of anti-procyclicality tools and their implications on margins and liquidity in times of crisis, ESMA has launched a review of the anti-procyclicality measures adopted by EU CCPs. To this end, ESMA is engaging with market participants to exchange views and experience and will follow up on the findings at the EU or global level, as appropriate.

Operational risk and cyber risk

A further risk emphasised by the Covid-19 pandemic is operational risk. During lockdowns and other forms of restrictions to local mobility, CCPs had to adapt to new working conditions and adjusted business continuity procedures. Again, it was comforting to see that EU CCPs continued to operate without noticeable disruptions, sometimes with up to 100% of their staff working from home through remote working arrangements.

Operational resilience of information and communication technology (ICT) systems has been key to supporting this new modus operandi at CCPs, as was the case at other financial firms and also public authorities. This intensified the momentum for various initiatives at the EU level aimed to foster the operational and cyber resilience of financial entities. This will also have a bearing on CCPs, and I would like to recall three significant such developments.

From a regulatory perspective, in October 2020 the European Commission launched, in the context of its Digital Finance Strategy, a new legislative initiative for a Digital Operational Resilience Act (DORA), designed to consolidate and upgrade ICT requirements across all financial entities operating in the EU (which includes CCPs), to ensure all firms are “subject to a common set of standards to mitigate ICT risks”.

From an oversight perspective, already in 2018 the European System of Central Banks (ESCB) developed an European framework to test and improve the resilience of financial infrastructures and institutions against sophisticated cyber-attacks - better known under the acronym TIBER-EU, standing for Threat Intelligence-based Ethical Red Teaming. The TIBER-EU framework is currently being implemented in several Member States and by the ECB in its oversight capacity.

Finally, from a supervisory convergence perspective, the CCP Supervisory Committee is going to review supervisory activities in respect of CCPs’ operational and cyber resilience in order to identify and promote best practices in this field.

Environmental risk

Moving now on to environmental risk, this is becoming an increasingly pressing concern and not only for supervisors. Global warming has increased the likelihood of extreme weather events, natural disasters, and potentially other environment-driven disruptions. These events may affect a CCP in various ways, e.g. through a direct impact on market prices of assets it clears, in particular for commodities (or on existing stable price correlations) or through a direct or indirect impact on its business continuity following operational disruptions.

However, extreme weather events and natural disasters are not the only source of environmental risks. For instance, there is “transition risk”, consisting of the risk of a sharp change in asset prices following a technological and/or regulatory change. Business risk and legal risk are also to be considered in this context, although these risks normally produce effects over a longer time horizon than that usually considered in CCP stress tests scenarios.

The recent review of the ESMA Regulation combined with EMIR 2.2 have mandated ESMA to include also scenarios reflecting the risks stemming from adverse environmental developments in its CCPs stress tests. As a first response and in order to develop EU-wide scenarios affecting multiple CCPs, the CCP Supervisory Committee initiated initial reflections to identify environmental risk scenarios relevant to CCPs.

Interdependencies

Finally, I would like to briefly highlight the importance of identifying and monitoring risks stemming from interdependencies between CCPs, and between CCPs and their clearing members and service providers. In particular, the interconnection between banks and CCPs can be a critical channel of propagation of systemic risk.

Again, ESMA has included interdependencies mapping exercises and a knock-on impact analysis in its CCP stress tests and will continue focussing on this as a matter of priority, including looking more closely at the possibility of system-wide stress tests. Moving forward, the Supervisory Committee will also consider fire drills and crisis simulation exercises as valuable tools to further analysis the interdependencies and the systemic impact of a CCP failure on the ecosystem in which it operates.

Conclusion

In conclusion, let me reiterate that whilst the political, economic, technical and environmental landscape in which CCPs operate is quickly evolving, the recent changes in the powers of ESMA and the establishment of the CCP Supervisory Committee in particular have provided the Union with a robust supervisory structure to respond to challenges and emerging risks. In particular, ESMA and the CCP Supervisory Committee will continue to assess and monitor CCP old and new risks on an ongoing basis in order to identify and minimise any systemic impact for the financial stability of the Union, its member states and market participants. Yet, there is no reason for complacency. As markets and business provision evolve outside and inside the EU, it is paramount that existing structures, including the supervisory framework, are being constantly re-evaluated in order to make sure that risks of systemic relevance for the Union as a whole are met with corresponding mechanisms enabling a coherent EU wide perspective and response.

Many thanks for your attention.