ADVICE OF THE EUROPEAN SYSTEMIC RISK BOARD

of 31 July 2012

submitted to the European Securities and Markets Authority in accordance with Article 46(3) of Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories concerning the eligibility of collateral for CCPs

(ESRB/2012/3)

(2012/C 286/10)

1. Legal background

1.1. Article 46(3) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [1] provides that the European Securities and Market Authority (ESMA) has to consult the European Systemic Risk Board (ESRB) and other relevant authorities on the development of draft regulatory technical standards concerning eligible collateral for central counterparties (CCPs). In particular, the consultation relates to the following three issues: (a) the type of eligible collateral that could be considered highly liquid; (b) the haircuts to apply to asset values; and (c) the conditions under which commercial bank guarantees may be accepted by CCPs as collateral.

1.2. On 26 June 2012, the ESRB received from ESMA a request for its advice on the above issues, referring to the ESMA consultation document published on 25 June 2012 [2].

1.3. In accordance with Article 3(2)(b) and (g) and Article 4(2) of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [3], the General Board of the ESRB has adopted this Advice, which is published in accordance with Article 30 of Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board [4].

1.4. The mandate of the ESRB, as defined in Article 3(1) of Regulation (EU) No 1092/2010, embraces the oversight of the financial system as defined in Article 2(b) [5] of Regulation (EU) No 1092/2010; this includes financial system infrastructures such as CCPs and their role within the financial system.

2. Economic background

2.1. CCPs are crucial nodes of the financial system and this role will grow with the implementation of the 2009 Pittsburgh G20 initiative to centrally clear all standardised over-the-counter (OTC) derivatives. Legislation should be drafted with macro-prudential concerns over pro-cyclicality in mind. The ESRB considers that the issue of pro-cyclicality must not be limited to the immediate impact on the resilience of CCPs themselves, and must also relate to the influence of CCP behaviour on the broader financial system.

2.2. The potential use of haircuts and margins applied to collateral as macro-prudential tools is a crucial aspect and the ESRB invites competent macro-prudential authorities to consider it for the first scheduled review of EMIR.

2.3. The ESRB acknowledges that, while every effort should be made to limit pro-cyclicality, this should never compromise CCP resilience.

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[1] OJ L 201, 27.7.2012, p. 39.

[2] ESMA consultation document, 'Draft technical standards for the Regulation on OTC derivatives, CCPs and trade repositories', published on ESMA's website at: http://www.esma.europa.eu

[3] OJ L 331, 15.12.2010, p. 1.

[4] OJ C 58, 24.2.2011, p. 4.

[5] Article 2(b) provides that 'financial system' means all financial institutions, markets, products and market infrastructures.

3. The type of collateral that could be considered highly liquid

3.1. References to the country where the issuer is established should be removed from the low credit risk requirement, as this risk is normally already considered in the issuer's credit risk assessment.

3.2. CCPs should have a high degree of certainty that the transferability and value of collateral are:

— not encumbered by competing rights in favour of third parties,

— ensured via dispossession of the collateral giver,

— not subject to re-characterisation by securities and collateral law pending to a claim made by the collateral giver or a third party, and

— not voidable by national or third country insolvency law during insolvency proceedings against a clearing member or against any other collateral giver.

3.3. CCPs should have appropriate legal and operational safeguards to ensure that cross-border collateral can be used in a timely manner.

3.4. The acceptance of collateral issued by clearing members should be subject to the following prudential measures:

— the use of financial instruments issued by a clearing member and posted as collateral by another clearing member should either be limited or subject to higher haircuts than those applied when they are not issued by a clearing member; the second option should be carefully assessed by competent authorities, given its potential pro-cyclical implications,

— CCPs should only accept securities that are listed and publicly traded,

— legislation should explicitly stipulate how the linkages in the context of cross-collateralisation of clearing members should be measured. Legislation should clarify how a CCP must demonstrate its ability to manage currency risks.

3.5. Concentration limits should be set in alignment with the collateral pool, as the harder it becomes to achieve diversification, the more restricted the range of eligible collateral becomes.

3.6. To ensure legal certainty and market predictability, the ability of a CCP to re-use or accept re-hypothecated collateral should be clarified by the legislation, considering its strong macro-prudential implications.

3.7. Transparency requirements should apply to the eligibility and the use of collateral by CCPs, in order to enable the monitoring by oversight authorities of market behaviour and risk distribution of pledged collateral.

3.8. Legislation on eligibility of collateral should be subject to prudent implementation and frequent review to carefully consider systemic risk.

4. The haircuts to apply to collaterals

4.1. Haircuts should be set in a prudent, and defined in a conservative, manner, so as to protect CCPs and limit pro-cyclical effects.

4.2. From a financial stability point of view, it is desirable to limit pro-cyclical movements in the acceptance criteria and haircuts for CCP collateral. Haircut practices should be designed in a way that minimises sudden and large increases in times of market stress.

4.3. Transparent and predictable procedures for adjusting haircuts in response to changing market conditions should be required.

4.4. In the light of Financial Stability Board (FSB) Principles that were endorsed by the 2012 Mexico City G20 Summit, a mechanistic reliance on credit rating agency (CRA) ratings should be avoided [1].

4.5. CCPs should be required to demonstrate to the competent authority the avoidance of any mechanical trigger, in order to limit pro-cyclical effects. Legislation should be consistent with the FSB Principles for reducing reliance on CRA ratings.

5. **The conditions under which commercial bank guarantees may be accepted as collateral**

5.1. Legislation should define a reliable party for the holding of collateral that backs commercial bank guarantees.

5.2. Commercial bank guarantees should be subject to a limited use and a lower concentration ratio than the one applicable to other eligible collateral.

Done in Frankfurt am Main, 31 July 2012.

The Chair of the ESRB
Mario DRAGHI

(1) FSB, Principles for reducing reliance on CRA ratings, 27 October 2010, in particular Principle III.4, available on the FSB's website at: http://www.financialstabilityboard.org