EXPLANATORY MEMORANDUM TO

THE CENTRAL COUNTERPARTIES (TRANSITIONAL PROVISION) (EXTENSION AND AMENDMENT) REGULATIONS 2022

2022 No. 1244

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

2.1 This instrument extends the temporary recognition regime ("TRR") for overseas central counterparties ("CCPs") by 12 months, so that the expiry date is pushed back until 31 December 2024. This will allow overseas CCPs currently in the regime to continue to offer clearing services in the UK whilst they wait for their applications for recognition to be determined by the Bank of England ("the Bank").

2.2 It also extends the transitional regime for qualifying CCPs ("QCCPs") contained within the Capital Requirements Regulation ("CRR") for an additional 12 months. The expiry date of this transitional regime differs between individual CCPs as it is dependent on when a firm has applied for recognition in the UK. However, for most firms within the regime, the expiry date currently falls on 31 December 2022.

2.3 The QCCP transitional regime ensures that UK firms with indirect exposures to these QCCPs can continue to benefit from favourable capital treatment. "Indirect exposures" could occur, for example, where a UK firm receives clearing services from the relevant overseas CCP via another firm. The extension will ensure that UK firms with indirect exposures to the QCCPs within the regime will not face a sudden and disruptive increase in their capital requirements on the expiry of the transitional.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is the whole United Kingdom.

4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is the whole United Kingdom.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

Amendment relating to the Temporary Recognition Regime (TRR)

6.1 The UK's regulatory framework for CCPs is set out primarily in the European Market Infrastructure Regulation ("EMIR"), as retained in domestic UK law by virtue of the European Union (Withdrawal) Act 2018 ("EUWA 2018") and amended by regulations made under section 8 of the EUWA 2018. This legislation, as amended and forming part of retained EU law, is referred to in this explanatory memorandum as UK EMIR. UK EMIR lays down rules on over-the-counter ("OTC") derivatives and trade repositories, as well as CCPs.

6.2 The Central Counterparties (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018[1] (the "CCP Regulations") is one of the statutory instruments that amended UK EMIR in order to deal with deficiencies arising from the withdrawal of the UK from the EU. Regulations 11 to 26 provide for the TRR, enabling overseas CCPs to continue to offer their clearing services in the UK for a period of three years after the end of the transition period ("TP") (i.e., until 31 December 2023). There have been several other instruments made under section 8 of EUWA 2018 which have made amendments to UK EMIR to ensure it works in a UK context after EU withdrawal.

6.3 This instrument makes an amendment to regulation 18 of the CCP Regulations, to allow overseas CCPs within the TRR to continue providing clearing services into the UK for an additional 12 months beyond 31 December 2023. Regulation 18(2) of the CCP Regulations gives HM Treasury power to extend this period for up to 12 months at a time, if satisfied that it is necessary and proportionate to do so to avoid disruption to the financial stability of the United Kingdom. This is the first time this power has been exercised.

Amendment relating to the QCCP transitional regime

6.4 The CRR, as retained in domestic law by virtue of the EUWA 2018, is a core part of the UK's prudential regulation regime for banks, building societies and investment firms. The CRR sets out various standards for the management of capital, liquidity, and credit risk. This includes standards on the amounts of capital and liquid assets that firms must hold against different types of exposures, for example exposures to CCPs or central banks.

6.5 The CRR was extensively amended as a result of the UK's exit from the EU, by regulations[2] made in exercise of the powers in section 8 of the EUWA 2018. These ensure it continues to operate effectively following the withdrawal of the UK from the EU.

6.6 Article 497 of the CRR establishes a transitional period during which institutions may treat exposures to certain overseas CCPs as exposures to QCCPs. This two-year period is referred to as the "QCCP transitional regime" in this explanatory memorandum, and was initially put in place by the EU to ensure continuity for EU

[1] SI 2018/1184. SI 2020/56 amended these regulations to provide for the period of the TRR to be calculated by reference to the end of the transition period, instead of exit day. These regulations were also amended by SI 2020/648 and SI 2022/1080.

[2] These include: Capital Requirements Regulation (Amendment) (EU Exit) Regulations 2018, Capital Requirements Regulation (Amendment) EU Exit) Regulations 2019 and Capital Requirements Regulation (Amendment) EU Exit) Regulations 2021.

firms with exposures to third country CCPs, while both jurisdictional equivalence and CCP recognition were being determined. By retaining the regime following the UK's exit from the EU, UK authorities aimed to guarantee continuity for UK firms with exposures to these CCPs, whilst also ensuring a smooth transition to the post-EU exit regulatory framework. This was intended to provide certainty and stability to participants in international financial markets.

6.7 Article 497 was amended by the Capital Requirements Regulation (Amendment) (EU Exit) Regulations 2019[3] and the Capital Requirements Regulation (Amendment) (EU Exit) Regulations 2021[4], to ensure it continues to operate effectively following the withdrawal of the United Kingdom from the EU. These amendments include providing that (i) a power for the EU Commission to extend this QCCP transitional period by 12 months, in exceptional circumstances, where it is necessary and proportionate in order to avoid disruption to the international financial markets, is transferred to, and is exercisable by, HM Treasury, and (ii) that it can be exercised on more than one occasion. This instrument is the first time that HM Treasury has exercised this power.

7. Policy background

7.1 CCPs are used by firms to reduce certain risks that arise when trading on financial markets, such as derivatives and equities markets. They sit between the buyers and sellers of financial instruments, providing assurance that contractual obligations will be fulfilled. The process of transacting through a CCP is known as "clearing". CCPs have played a vital role in making markets safer following the 2008 financial crisis, and they help substantially in managing potential systemic risk arising from global financial transactions.

7.2 Article 25 of UK EMIR establishes that an overseas CCP may provide clearing services to clearing members or trading venues established in the UK where that overseas CCP has been recognised by the Bank.

7.3 The government did not incorporate into domestic UK law the equivalence decisions for CCPs that the EU had made under Article 25 of EMIR prior to the UK's withdrawal from the EU. Following EU exit, HM Treasury was given the responsibility to undertake new assessments for all overseas jurisdictions, in order to determine whether, in specific areas of financial services regulation, another jurisdiction's regulatory and supervisory frameworks can be deemed equivalent to the UK.

7.4 The Bank of England is, instead, responsible for making the decision to recognise individual CCPs within a jurisdiction deemed to be equivalent. Once the Bank has completed a recognition assessment, it can grant recognition to a CCP. This, in turn, enables UK clearing members and trading venues to use the clearing services of that CCP. This serves to facilitate cross-border financial services activity in relation to that equivalent jurisdiction by permitting market access and reducing regulatory frictions or costs to firms.

[3] SI 2019/1232
[4] SI 2021/558

Amendment relating to the Temporary Recognition Regime (TRR)

7.5 Since the end of the TP, the TRR has ensured that overseas CCPs are able to continue their services in the UK, provided that they were recognised to offer those services in the EU under EMIR before the end of the TP, and had notified the Bank that they intended to continue to do so in the UK post-TP. The Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2022[5] expanded the scope of the TRR, by allowing overseas CCPs that were already in the TRR to offer clearing products in classes of financial instrument that the overseas CCPs are permitted to offer in the country in which they are established, provided that they have notified the Bank of England of their intention to offer these products in the UK. This is in addition to any products that an overseas CCP was already permitted to offer whilst in the TRR. The TRR is currently due to expire on 31 December 2023.

Amendment relating to the QCCP transitional regime

7.6 Overseas CCPs can also benefit from another form of preferential status, known as "qualifying CCP", or QCCP, status. QCCP status alone does not allow overseas CCPs to provide services directly to UK firms or trading venues. Instead, it ensures that UK firms are not subject to higher capital requirements for any indirect exposures they have to the relevant CCP in certain circumstances. As set out in paragraph 2.3, UK firms will have an indirect exposure to the CCP, for example, where a UK firm receives clearing services "indirectly" from the relevant overseas CCP (this means when the UK firm receives clearing services from the CCP via another firm as a 'client', as opposed to being a direct 'clearing member' of the CCP itself).

7.7 Regardless of whether a CCP is classified as a QCCP or not, a firm retains the responsibility to ensure that it maintains adequate capital for its exposures to it. However, under the CRR, the capital requirements for exposures to QCCPs are much less onerous than for exposures to non-QCCPs. The higher capital charges for UK firms with exposures to an overseas CCP that does not benefit from QCCP status would likely prohibit continuation of business with that CCP, as the higher capital requirements would render it uneconomic.

7.8 There are multiple ways in which an overseas CCP can be granted QCCP status. Firstly, overseas CCPs that are recognised under Article 25 EMIR are automatically granted QCCP status. Secondly, as overseas CCPs within the TRR are treated as if recognised under Article 25 EMIR, they also benefit from QCCP status whilst they are in that regime. There is also a time limited "run-off" regime in place for CCPs that enter the TRR but subsequently exit the regime without permanent recognition. CCPs will continue to benefit from QCCP status whilst they are in the run-off regime (for a maximum period of one year).

7.9 Finally, there is the QCCP transitional regime which this statutory instrument is extending. The transitional regime, which, as outlined in paragraph 6.6, sits within Article 497 of the CRR, allows a CCP that has submitted an application for recognition under Article 25 EMIR, and is waiting for that application to be determined, to be treated as if it were a QCCP for two years. The expiry date of the regime, after which a CCP no longer benefits from QCCP status, depends on several factors, including when firms submitted their recognition applications, and whether equivalence has been granted by HM Treasury. As of the laying date of this SI, the

[5] SI 2022/1080

UK has not granted Article 25 EMIR equivalence to the home jurisdictions of the firms within the transitional regime.

7.10 CCPs that submitted their application before the end of the TP are treated as though their application was submitted at the end of the TP on 31 December 2020, which grants them QCCP status for two years[6] until 31 December 2022. This accounts for the majority of firms in the QCCP regime. For firms which submitted their application after the end of the TP, the transitional expires at a later date – which is to say two years after the application was submitted.

What is being done and why?

<u>Amendment relating to the Temporary Recognition Regime (TRR)</u>

7.11 In January 2020, new provisions in EMIR came into force that created a much more complex process for recognising overseas CCPs than was previously the case. When EMIR became part of retained EU law, the Bank was given responsibility for finalising policy on important areas of this more complex procedure, and has subsequently needed to consult on, and implement, the new recognition process in the UK.

7.12 The key change introduced by the new recognition process is the "tiering" of overseas CCPs according to the financial stability risk that they pose, with more onerous recognition requirements imposed on those CCPs that are, or are likely to become, systemically important. The development and implementation of the new recognition process required significant amounts of time and resource to complete, as well as being subject to resourcing pressures caused by the COVID-19 pandemic, which delayed progress.

7.13 As a result of the number of equivalence decisions yet to be made, as well as the incorporation of this new "tiering" process into UK law, some overseas CCPs will not receive permanent recognition within the timescales originally anticipated. Without an extension to the TRR, they will not be able to continue their activities in the UK after the current expiry date of the TRR (31 December 2023).

7.14 This instrument therefore extends the TRR by a period of 12 months (until 31 December 2024), to ensure that the overseas CCPs within it are able to continue their activities in the UK, whilst they await a decision on their application for recognition. This will avoid these firms facing a sudden loss of market access into the UK at the end of 2023. It will also avoid UK clearing members being suddenly unable to continue to clear specific products at these CCPs, requiring them to 'off-board' their positions, which could be costly and risky, especially if done at pace. The TRR was put in place to prevent this outcome and the accompanying disruption to firms and markets, as well as to the UK's financial stability. The TRR continues to fulfil this role and it is therefore necessary to extend the temporary recognition period.

7.15 This extension is also proportionate, as it will ensure that the TRR will continue to operate as intended, and in a way in which overseas CCPs expect, beyond the end of 2023. It will provide certainty to business and avoid undesirable outcomes which could disrupt international financial markets and cause risks to UK and international financial stability. It also does not result in any significant additional burden on UK or overseas firms.

[6] This is provided for in regulation 12(5) of the CCP Regulations.

Amendment relating to the QCCP transitional regime

7.16 The QCCP transitional regime is due to expire at the end of 2022 for most CCPs within the regime. If it does, UK firms with exposures to the CCPs within this regime will face a sudden increase in their capital requirements.

7.17 This instrument therefore extends the time period for which overseas CCPs possess QCCP status after submitting an application for recognition, from two years post submission to three years. This will avoid disruption at the point that the transitional period expires (the end of 2022 for most firms) and allow UK authorities additional time to progress the outstanding pipeline of equivalence and recognition decisions for overseas jurisdictions and CCPs.

7.18 HM Treasury's power to extend the time limits set out in 497(1) is exercisable in exceptional circumstances, where it is necessary and proportionate in order to avoid disruption to international financial markets. The extension power was originally designed by the EU to be used in a scenario where they were processing a limited number of applications for recognition from overseas CCPs (many of whom would be coming from an equivalent jurisdiction). However, following EU exit, UK authorities need to carry out equivalence assessments and make recognition decisions not only for any new firms that apply, but also for any jurisdiction that benefitted from equivalence and any firm that benefitted from recognition in the EU prior to EU exit.

7.19 Without an extension there is a risk of disruption to international financial markets. By extending the regime, UK firms with exposures to a QCCP will avoid a sudden increase in their capital requirements, which would be needed to align with the requirements for exposures to a non-QCCP. This sudden increase could lead to firms trying to unwind their positions, which would lead to uncertainty and disruption in international financial markets. Extending the transitional regime by an additional twelve months is a proportionate way of addressing these risks. It does not impose any significant burden on UK or overseas firms, and will simply maintain the status quo for an additional, time-limited period.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 There are currently no plans to consolidate the relevant legislation.

10. Consultation outcome

10.1 A public consultation was not undertaken for these amendments as these are small technical amendments, which make use of the powers in the legislation to extend the length of two transitional regimes by 12 months.

10.2 HM Treasury has engaged extensively with the Bank of England and the Financial Conduct Authority on these issues.

11. Guidance

11.1 HM Treasury does not propose to provide any guidance in relation to this instrument.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A full impact assessment has not been prepared for this instrument because the impact of this SI is small (the cost to businesses is < £5m per year). A de minimis impact assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

13.1 The legislation does not apply directly to activities that are undertaken by small businesses.

13.2 The amendments made by this instrument are not expected to have an impact on small businesses, and therefore no action is needed to mitigate the impact on them.

14. Monitoring & review

14.1 The regulation does not include a statutory review clause, and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015, the Economic Secretary to HM Treasury (Andrew Griffith) has made the following statement:

"It is not proportionate to include a review clause in this instrument because the estimated annual net direct cost to business is less than £5 million and the number of small businesses in scope is very low."

15. Contact

15.1 Giorgia Bracelli at HM Treasury (email: Giorgia.bracelli@hmtreasury.gov.uk) can be contacted with any queries regarding the instrument.

15.2 Tom Duggan, Deputy Director for Securities and Markets at HM Treasury, can confirm that this Explanatory Memorandum meets the required standard.

15.3 Andrew Griffith, Economic Secretary to HM Treasury, can confirm that this Explanatory Memorandum meets the required standard.