



# Standards for the use of central counterparties in Eurosystem foreign reserve management operations

## Introduction

In accordance with Article 3 of the Statute of the European System of Central Banks and of the European Central Bank, one of the tasks entrusted to the European System of Central Banks (ESCB) and the European Central Bank (ECB) is the holding and management of the official foreign reserves of the Member States of the European Union. In the Eurosystem, both the ECB and the national central banks (NCBs) of the euro area hold and manage foreign reserves.

The ECB and Eurosystem NCBs<sup>1</sup> invest in a variety of financial instruments in the context of their foreign reserve management, including certain over-the-counter (OTC) derivatives and, in particular, interest rate swaps (IRSs) denominated in foreign currencies. This market is moving over to central counterparty (CCP) clearing as a consequence of legislative initiatives undertaken recently in various jurisdictions around the world in line with the G20 statement calling for all trading in standardised OTC derivatives to be cleared through a CCP by the end of 2012.

The Eurosystem<sup>2</sup> is preparing to potentially use CCPs for IRSs traded in the context of foreign reserve operations. This potential use of CCPs by the Eurosystem stems from possible regulatory requirements relating to counterparties in the jurisdictions in which the Eurosystem trades IRSs. Given their specific legal status and the public function they perform, central banks may be exempted from mandatory clearing. Nevertheless, central banks may also voluntarily decide to make use of CCP services – e.g. in order to benefit from liquidity efficiency where trading is concentrated in market segments served by CCPs, or as further support for the policy objectives pursued as regards systemic risk by moving OTC derivatives over to centralised clearing. In addition, any regulatory requirement could have an extra-jurisdictional effect – i.e. it could also apply to counterparties in another country.

<sup>1</sup> The ECB delegates certain functions relating to the investment of its foreign reserves to Eurosystem NCBs. Thus, in addition to investing their own foreign reserves, NCBs also operate as agents of the ECB on the basis of appropriate mandates. While some portfolio management functions, such as risk management and accounting, are carried out in a centralised manner at the ECB, most of the front and back office functions are delegated to Eurosystem NCBs. When performing these functions, NCBs act on behalf of the ECB on a “disclosed agency” basis. This allows the ECB’s counterparties to distinguish between operations carried out by NCBs on behalf of the ECB and those carried out by NCBs for the management of their own reserves. The ECB receives information online on all trading conducted by NCBs on its behalf. For further details regarding the ECB’s activities in the area of foreign reserves (including the main operational, IT-related and legal issues), see the article entitled “Portfolio management at the ECB”, *Monthly Bulletin*, ECB, April 2006.

<sup>2</sup> In this context, references to the “Eurosystem” relate to the ECB, the NCBs of the Eurosystem that are mandated to operate as agents of the ECB, and NCBs acting on their own behalf.

In view of the potential use of CCPs for clearing IRSs denominated in foreign currencies, the Governing Council of the ECB has established standards governing the use of a CCP – whether directly as a direct clearing member of a CCP or indirectly by using a general clearing member of a CCP. These standards will ensure that the selection of providers of clearing services meets two objectives: (i) ensuring safe and efficient use of infrastructure by the Eurosystem; and (ii) ensuring neutrality vis-à-vis the clearing industry. Assessment against these standards is organised in such a way as to ensure that the information required by the Eurosystem is obtained in an efficient manner.

The Eurosystem will use only duly overseen and supervised CCPs. Thus, the following standards are not intended to cover aspects of the oversight or supervision of CCPs, for which standards already apply. These “user standards” are regarded as an addendum to those existing standards and seek to limit the risks to which the Eurosystem is exposed when IRSs denominated in foreign currencies are cleared via a CCP.

### Standard 1: Adequate status for central banks as CCP participants

CCPs should establish direct access criteria and risk management requirements which are commensurate to the risk profile of central banks. As a result of this special status, central banks should be granted exemptions from: (i) certain access criteria; (ii) initial margin requirements; (iii) default fund contributions; (iv) participation in default management procedures such as mandatory bidding when a defaulter’s portfolio is auctioned; and (v) volume commitments.

### Standard 2: Segregation and portability

CCPs should offer segregation and portability for the Eurosystem’s positions and assets on individual accounts in order to limit risks in the event that a general clearing member is used by the Eurosystem.

### Standard 3: Settlement in central bank money – use of central bank facilities

CCPs should have adequate access and recourse to the central bank facilities available in their jurisdiction. CCPs should use central bank money for cash settlement. CCPs should share information on the availability of central bank services with the Eurosystem.

### Standard 4: Access to relevant information

CCPs should provide the Eurosystem with all information relevant from a user’s perspective.

# 1 Framework for assessing CCPs for Eurosystem foreign reserve management operations

The Eurosystem's assessment of the CCPs used for IRSs denominated in foreign currencies is important for three reasons.

- First, it allows the Eurosystem to acquire sufficient information on the relevant financial market infrastructures, given that the investment of official foreign reserves is a public function and requires, among other things, efficient and safe clearing and settlement of the transactions carried out. This should ensure that the financial instruments in which the Eurosystem's foreign reserves are invested can easily be cleared and settled and transformed into foreign exchange cash positions when needed for the purposes of statutory interventions in foreign currencies.
- Second, it allows the Eurosystem to ensure neutrality vis-à-vis the clearing industry. Given the Eurosystem's broader statutory tasks in the field of clearing and settlement, it is important that the Eurosystem's selection and use of financial market infrastructures as a *user* be based on clearly defined and publicly available requirements.
- Third, in the interests of efficiency, it allows the Eurosystem to avoid unnecessary duplication of effort when obtaining the information required, as well as minimising the burden on the financial market infrastructures themselves, which are already subject to oversight and supervision by competent authorities.

The Eurosystem's assessment of a CCP as a user will be based on a two-stage approach: first, the CCP will need to be properly overseen and/or supervised, with a positive assessment provided by the relevant authority on the basis of applicable oversight standards; and second, a set of more specific user standards will need to be applied. If necessary, the Eurosystem may contact relevant authorities and/or CCPs themselves to request information on whether (and potentially how) CCPs comply with the relevant oversight standards and/or to obtain information needed in order to verify compliance with the user standards.

As the clearing of OTC derivatives by CCPs involves particular features and challenges, the first, general requirement is that a CCP be duly overseen and/or supervised and comply with the relevant oversight standards/recommendations.

These user standards are applicable to CCPs providing clearing services for financial contracts which are of relevance for the Eurosystem's foreign reserve management – e.g. OTC derivatives such as IRSs denominated in foreign currencies. Compliance with these user standards is a precondition for eligibility to provide clearing services to the Eurosystem and indicates that CCPs fulfil the Eurosystem's requirements as a user, which stem from its specific status and functions and its objectives of safe and efficient clearing and settlement of the instruments used in the investment of its foreign reserves. This assessment is also necessary in the event that the Eurosystem elects to participate indirectly in a CCP (i.e. via a general clearing member), because the requirements that a CCP imposes on general clearing members may

have consequences for those clearing members' clients (e.g. rules on segregation at the level of the general clearing member that are necessary to ensure that the Eurosystem's investment/margin positions are properly protected from custody risk).

While all positively assessed CCPs are eligible for use by the Eurosystem, the selection of CCPs and general clearing members will be based on operational criteria (e.g. cost and service levels).

This framework is designed to ensure neutrality vis-à-vis the CCP market. Any CCP that begins to offer clearing services relevant for the Eurosystem's investment of foreign reserves in IRSs denominated in foreign currencies will be eligible for assessment. If a new entrant is found to meet these user standards, it can then be considered for selection by the Eurosystem.

## 2 Compliance with oversight standards

Central counterparties are key components of the financial system, as they perform critical functions in the clearing and settlement of securities. A financial, legal or operational problem in a CCP can be a source of systemic disturbance for the financial system as a whole. Consequently, the Eurosystem's first requirement is that a CCP be duly overseen and/or supervised and demonstrate to the Eurosystem that it has been positively assessed against the oversight standards in force at the time of that assessment. For the purposes of such an assessment, the relevant international standards are as follows:

- in the short-term, the 2004 CPSS/IOSCO "Recommendations for Central Counterparties", complemented by the 2010 CPSS/IOSCO "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives" (and, for CCPs established in the EU, compliance with the ESCB/CESR "Recommendations for Central Counterparties");
- in the medium to longer term (i.e. as of their finalisation, which is expected in 2012), the CPSS/IOSCO "Principles for financial market infrastructures", which are currently being prepared by the two committees (and, for CCPs established in the EU, any future oversight standards that replace the current ESCB/CESR "Recommendations for Central Counterparties").

The Eurosystem may contact supervisory and/or oversight authorities in the jurisdictions in which CCPs are established (and, to the extent necessary, CCPs themselves), asking for information on whether (and potentially how) CCPs comply with the oversight standards.

## 3 User standards for CCPs

### Standard 1: Adequate status for central banks as CCP participants

*CCPs should establish direct access criteria and risk management requirements which are commensurate to the risk profile of central banks. As a result of this special status, central banks should be granted exemptions from: (i) certain access criteria; (ii) initial margin requirements; (iii) default fund contributions; (iv) participation in default management procedures such as mandatory bidding when a defaulter's portfolio is auctioned; and (v) volume commitments.*

CCPs' access criteria and membership obligations (e.g. contributions to default funds and participation in default management procedures) are aimed at protecting the CCP and its users from the impact of any defaults by CCP members. However, the conditions governing direct access to a CCP should take into account the specific nature, legal status, public function and risk profile of the Eurosystem.

Consequently, CCPs should be both allowed and prepared to offer special conditions for the Eurosystem. Such special conditions should, in particular, include exemptions from the following obligations.

- (i) *Direct access criteria* should not apply to the extent that they are not suitable for central banks (e.g. as regards the range of admissible institutions, equity capital requirements, minimum portfolio levels and the requirement to be supervised by relevant authorities). Central banks have specific statutory tasks and a special legal status, so the rationale underlying certain access criteria does not apply to central banks.
- (ii) *Initial margin requirements* are also set in order to limit a CCP's exposure to its participants, so are not relevant for central banks.
- (iii) *Default fund contributions* should not apply, as central banks cannot go bankrupt and such one-sided participation in loss-sharing and other mutualisation agreements would not be appropriate. Otherwise, central banks would, by definition, find themselves in the position of having to absorb losses due to any defaults by other participants, while not posing similar risks to other participants. The expectation that other participants' losses would be absorbed would also generate undesirable moral hazard.
- (iv) *Participation in default management procedures* (e.g. mandatory bidding when a defaulting member's portfolio is auctioned, or an obligation to take on a percentage of a defaulter's portfolio) is also inappropriate for a central bank, for similar reasons (as central banks cannot go bankrupt, a one-sided risk taking is inappropriate in terms of risk).
- (v) In the case of a central bank, a CCP should not apply access criteria that oblige a participant to clear all (or a large part) of its business in that CCP (i.e. *volume commitments*).

## Standard 2: Segregation and portability

*CCPs should offer segregation and portability for the Eurosystem's positions and assets on individual accounts in order to limit risks in the event that a general clearing member is used by the Eurosystem.*

It is important that the Eurosystem's trading position and assets are not at risk in the event that a general clearing member used by the Eurosystem defaults. Thus, it should be possible for trading positions and related assets to be transferred to a new general clearing member without undue delay. A prerequisite for such portability of trading positions and assets is that Eurosystem positions and assets are held under a regime allowing adequate operational and legal segregation, both at the level of the CCP and at the level of the general clearing member, in order, in particular, to prevent such positions and assets from being subject to claims by the general clearing member's creditors.<sup>3</sup>

Were the Eurosystem to use a CCP indirectly via a general clearing member, and were that clearing member to default, it would be essential, in order to allow the Eurosystem to carry out its statutory tasks in the areas of foreign reserve management and foreign exchange intervention at any time, that the segregation and portability of its assets and positions be ensured – i.e. that those positions and assets could be safely, quickly and smoothly transferred to another general clearing member.

Thus, adequate operational and legal measures are required in order to make segregation and portability viable and effective not only at the level of the CCP, but also at the level of the general clearing member. Once a CCP has been positively assessed against these user standards, the Eurosystem will verify the adequacy of the measures put in place by any general clearing member providing clearing services to that CCP. Because these operational measures are part of the clearing service provided by a general clearing member, segregation and portability at the level of the general clearing member will be considered in any subsequent selection procedure.

## Standard 3: Settlement in central bank money – use of central bank facilities

*CCPs should have adequate access and recourse to the central bank facilities available in their jurisdiction. CCPs should use central bank money for cash settlement. CCPs should share information on the availability of central bank services with the Eurosystem.*

The Eurosystem is interested in CCPs' risk management, particularly as regards their recourse to available facilities in order to reduce their liquidity risk and improve their liquidity situation when handling a member's default. The use of central bank money for the cash settlement of IRS operations is seen as important. The cash

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<sup>3</sup> "Segregation" is a method of protecting a customer's collateral and contractual positions whereby a direct participant holds or accounts for them separately from its own collateral and positions. "Portability" refers to operational aspects of the transfer of contractual positions, funds or securities from one party to another by means of the conveyance of money or financial instruments.

positions of the Eurosystem should be settled in an account held by a Eurosystem central bank with the central bank issuing the relevant currency.

Access to other central bank facilities (e.g. credit facilities) has a significant impact on a CCP's risk and liquidity management capabilities, especially in times of stress in financial markets. Consequently, CCPs should share information with the Eurosystem on the central bank facilities to which they have access.

## Standard 4: Access to relevant information

*CCPs should provide the Eurosystem with all information relevant from a user's perspective.*

A CCP should provide the Eurosystem with all information relevant from a user's perspective in order to allow the Eurosystem to identify and evaluate the risks and conditions entailed by participation in that CCP. This information should include the rights and obligations of participants, risks to participants and details of the CCP's risk management framework, relevant information on the CCP (including financial statements), the fee schedule and other information on clearing costs, and statistics on the use of the CCP.

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