SECURITIES AND DERIVATIVES CLEARING

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The priorities of ESMA's CCP Supervisory Committee

2020 has seen the establishment of the new supervisory regime for CCPs under EMIR 2.2, a key part of which is the new CCP Supervisory Committee (CCPSC). The appointment of the Chair and the two Independent Members completed the establishment of the CCPSC and, with it, the implementation of the enhanced regimes for the recognition of third country CCPs as well as for supervisory convergence for EU CCPs.

As concerns EU CCPs, further enhancing supervisory convergence is a key priority of the CCPSC. Building on regular exchanges of views and discussions amongst national competent authorities (NCAs) and relevant supervisory decisions and opinions on EU CCPs' initiatives (such as the validation of significant risk model changes), the CCPSC has two primary instruments to further promote common supervisory practices and culture:

- **CCP stress tests:** Annual CCP stress tests measure the level of resilience of CCPs against common stress scenarios and identify issues for follow up via regulation or supervisory actions. The CCPSC is about to embark on the next round of CCPs stress tests, building on experience gained and having regard to new or emerging stress scenarios (such as cyber resilience).
- **Peer Reviews:** Peer reviews of NCAs' supervisory activities towards CCPs have been successful in defining best practices and identifying, where relevant, inconsistencies or divergencies in the application of EU regulatory requirements. The CCPSC has recently completed the 2020 peer review and will soon launch the 2021 exercise.

Looking at third country (TC) CCPs, the review of EMIR introduced a two-tier recognition regime, whereby those third country CCPs qualifying as systemically important for the financial stability of the Union or of one or more of its Member States (so-called Tier 2 CCPs) are subject to EMIR requirements on an ongoing basis. Ahead of the end of the Brexit transition period in September 2020, ESMA adopted temporary recognition decisions (following the Commission's temporary equivalence decision), which expire on 30 June 2022. This enabled a smooth transition for UK CCPs from the EU CCP to the third country CCP regime under EMIR, with two UK CCPs having been recognised as Tier 2 CCPs: ICE Clear Europe and LCH Limited. In respect of TC CCPs, the CCPSC will face three major priorities:

- **Direct supervision of Tier 2 CCPs:** An efficient direct supervision framework will ensure that Tier 2 CCPs comply with EMIR requirements on an ongoing basis, as the case may be under comparable compliance still to be decided.
- **Review of the Tier 2 CCPs' recognition:** The CCPSC is mandated to assess whether the services provided by Tier 2 CCPs, or some of them, are of a systemic nature that is too substantial to be safely provided from outside the Union. The CCPSC will carefully analyse potential risks, dependencies and stability implications that result from the current situation and potential evolutions. It will also look at costs and benefits of a potential relocation of clearing services.
- **Other TC CCPs' recognitions:** The CCPSC also has to review the TC CCPs that were recognised before the entry into force of EMIR 2.2, in order to determine if any of them would qualify as Tier 2 CCP. Finally, in 2021, the CCPSC will process pending applications for recognition of the SEC-regulated US CCPs, following up to the recent Commission equivalence decision adopted under EMIR.

JOCHEN METZGER

Director General, Payments and Settlement Systems, Deutsche Bundesbank

All for one and one for all

With the adoption of the Capital Markets Union Action Plan 2020 a few months ago, the EU Commission started a new and important chapter in the achievement of a single EU capital market. It was Alexandre Dumas who once wrote "all for one and one for all": The same sentiment could be applied to the capital markets union.

In the belief that 27 economies together can achieve more than each one individually, the intention is that the EU will unleash enhanced economic power by providing cross-border financial services both internally and externally, thus increasing its importance and its resilience at the European and international levels.

In particular, with increasing cross-border trading of shares, bonds and derivatives, the economic opportunities of a united capital market will soon present themselves to the member states and lead to sustainable growth. Against this backdrop, the continued removal of cross-border impediments and increased transparency are essential for a level playing field.

CCPs have always played a key role in this respect as they reduce counterparty and settlement risks, thus contributing to secure and continuous economic growth. The new supervisory framework EMIR 2.2 enhances the resilience of these important players.

The recently enacted CCP Recovery and Resolution Regulation augments the regulatory framework with a powerful recovery and resolution regime and completes the picture and the mission initiated at the Pittsburgh summit in 2009. Binding recovery and resolution plans in conjunction with adequate tools to deal with crises will generate more predictability, safety and confidence in the European capital market and ultimately increase trust in the EU's financial system.

In that context, ESMA performs an important function through its supervisory convergence work by promoting the standardisation of supervision practices and compiling a single rulebook for EU financial markets.

In the area of CCPs, ESMA supports the Member States' authorities in the coordinated supervision of EU CCPs by issuing peer reviews and stress tests and by participating in CCP colleges and in the CCP Supervisory Committee, and, in future, in CCP resolution colleges.

ESMA performs an important function through its supervisory convergence work.

Outside of the EU, ESMA's supervision of systemically important third-country CCPs ensures that the high EU standards are not being eroded.

This European approach has fully proven its worth in terms of coordinated and harmonised supervision, precisely because it allows the local specialisations of the CCPs to be optimally taken into account by the respective national authorities. This is crucial since not all CCPs clear the same products, and many have different risk profiles and varying legal systems, but it also enables a consistent methodology to be reinforced, best practices to be defined and thus the goal of achieving a single capital market to be fostered.

However, this will not be the end: with the advance of digitalisation, a changing clearing landscape will emerge. New market players will bring with them new opportunities, but also new risk.

Questions are arising concerning, in particular, how to integrate these new players into the single capital market. The answer for that can only be "same activity, same risks, same rules".

NATHALIE AUFAUVRE

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Adding predictability to resiliency: the post-Covid challenges of margining

The Covid outbreak in spring 2020 triggered extreme market moves in some financial sectors like equity markets. In addition, the global financial system had to adapt quickly to lockdown measures that were imposed in all jurisdictions. In this unprecedented context, EU CCPs and their members proved remarkable financial and operational resilience. Margin collection continued smoothly, without any member default and EU CCPs deployed business continuity plans to carry out their activities on a fully remote basis.

While this crisis has showed that post-2008 reforms were useful, including clearing mandates and CCP regulations, some events at global level have raised questions on the preparedness of actors, especially the liquidity capacity of some non-banks to meet higher margin calls.

EMIR is a robust framework for CCP resilience that involves close cooperation and supervisory convergence and has just been complemented by a regulation on recovery and resolution. Yet, EU authorities pay close attention to the above-mentioned vulnerabilities, and have therefore undertaken policy work at ESMA and ESRB level to enhance the stability of the clearing chain.

Financial actors need more predictable margin practices, without weakening CCPs' first defense lines. In this respect, the clearing membership of EU CCPs should remain subject to high liquidity and operational standards. Similarly, collateral eligibility should remain limited to highly liquid assets, and any broadening should be closely monitored to ensure this does not create additional liquidity risk for CCPs.

Predictability should help limiting margin procyclicality. Margins should be calibrated so that their level would remain adapted through the economic cycle, while smoothening peaks and troughs. More specifically, authorities should deal in priority with fluctuations of initial margin models and monitor discretional changes. While EMIR already requires CCPs to implement anti-procyclicality tools in their IM models (e.g. floors, buffers) they could be subject to further guidance, including possible steering power from authorities and transparency. More generally, CCPs could disclose more granular, frequent data on margin breaches and increases. EU authorities could develop enriched disclosure standards in this regard.

Beyond CCPs, and to better consider liquidity strains at ecosystem level stemming from margin requirements, transparency should be improved on uncleared markets and vis-à-vis client clearing practices. End-users might be subject to liquidity pressures through collateral restrictions or add-ons set by clearing agents or bilateral counterparties. In June 2020, the ESRB issued recommendations on this issue that national authorities are now implementing.

While the EU should not wait to take action, international standard-setting bodies will have a key role to play too. While CCPs are a sizeable part of the question and the CPMI-IOSCO Quantitative Disclosures could be refined, we welcome the holistic approach on assessing margin practices in the financial sector that FSB, CPMI-IOSCO and BCBS have together embraced. We think this ambitious work will result in substantial supervisory outcomes and proposals.

DANIEL MAGUIRE

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Post Trade, LSEG

The need for a diversified clearing ecosystem

CCPs are an integral part of the financial ecosystem. They support financial stability through robust and resilient risk management frameworks and diversified memberships spanning multiple jurisdictions, forming deep pools of liquidity. CCP membership is a key feature that contributes to making a CCP resilient to market shocks and defaults.

This has been illustrated during the Covid-19 associated market stress, where CCPs have successfully preserved financial stability. The anti-procyclicality measures enshrined in LCH's risk management framework ensured that margin increases were highly predictable with limited impact on our members' liquidity requirements. For e.g. the largest daily increase in total margin called during March 2020 was only at 3.5% despite the volatility observed on markets.

LCH's SwapClear serves customers in 62 different jurisdictions, has registered services in 11 jurisdictions and clears products in 27 different currencies. Internationally integrated businesses bring material benefits to users across jurisdictions, especially in the case of OTC derivatives markets which are truly global. They should be supported by consistent global and supervisory oversight based on cooperation and proportionate deference mechanisms.

..."the Euro market is predominantly traded outside EU borders (75%)"... "EU firms' clear more non-Euro currencies than Euros"

Jurisdictions approach to supervision varies from direct registration requirements to full deference. Some impose the use of local settlement systems and require CCPs to deposit collateral in their local currency on local central banks deposit accounts, giving them visibility on all flows in the currency they manage. EMIR 2.2 introduces the direct supervision of systemically important CCPs and direct application of EMIR requirements.

As such, a Tier 2 CCPs (such as LCH Limited) is subject to requirements at least as demanding as EMIR. This further enhances cross-border supervision of third country CCPs (TC CCPs) and ensures EU firms remain competitive by accessing to global markets and CCPs supporting these.

Accessing global markets is key for EU firms, as the Euro market is predominantly traded outside EU borders (75%) but also because EU firms' clear more non-Euro currencies than Euros. EMIR ensures that EU Firms' hedging activities are supported by a strong supervisory framework. It enables them to access global pools of liquidity and compete with their international peers on a level playing field.

Unfettered access to global markets by EU participants and financial stability are the principles for a successful economic recovery and EMIR provides the foundations upon which market participants and CCPs can operate on a cross-border basis in an open manner leading to economic growth and prosperity.

Market fragmentation would only increase financial stability risk and costs. The EU could draw inspiration from its peers and some of the requirements of EMIR. For example, it could require TC CCPs of systemic importance to the EU to use local settlement systems and deposit local currency cash at the local Central Banks.

This would further improve financial stability through increased oversight capabilities over international Euro flows, ensuring continuous monitoring of market activity but also an additional liquidity tool to be used in case of market stress.

HAROUN BOUCHETA

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EU and third-country CCPs: the risk of fragmentation?

The end of the Brexit transition period marks the start of a new regulatory paradigm between the European Union and United Kingdom especially with regard to UK central counterparties (CCPs).

In the EU, two important regulatory trends have emerged during the past few months.

First, the European Commission has reinforced the framework for managing CCPs' risks through the adoption of EMIR 2.2 but also with the recent adoption of the CCP Recovery and Resolution regulation (which includes a second tranche of skin in the game). In particular for third-country CCPs, EMIR 2.2 has allowed the enhancement of third-country CCPs supervision by ESMA through the revised recognition mechanism.

EMIR 2.2 has also introduced a reinforcement of the application of EMIR key provisions for third-country tier 2 CCPs, considered as creating a systemic risk to the EU. However, with regard to euro-denominated OTC derivatives, EU authorities still consider Europe is too dependent to UK CCPs and does not benefit from sufficient supervisory powers.

Second, the European Commission has granted the UK a temporary equivalence decision for CCP clearing services in order to preserve financial stability, with the grace period running until the 30th of June 2022. In the meantime, the European Commission is encouraging EU-27 market participants to migrate their risk exposures from UK CCPs. Through a recent communication, the Commission reiterated the expectation that EU clearing members and market participants reduce excessive exposures to systemically important UK CCPs, in particular their euro-denominated OTC derivatives exposures.

There are clearly more questions than safe bets here and It is also important to understand the point of view of non-EU clearing members clearing euro transactions and the strategies they will follow. Could the European Commission take a strong stance and impose through regulation to non-EU clearers to clear euro-denominated instruments in the EU? If not, the risk could be to further fragment the derivatives markets and not control the potential risks or outcomes.

A relocation policy of euro clearing that would only involve EU-based clearers will damage those firms and would not meet the expected political goal of EU institutions.

The end of the transition period has evidenced the necessity to adequately anticipate and coordinate the impacts on financial markets of structural regulatory changes. While the trading of shares has not undergone any major issues, due mostly to an effective anticipation by the industry, the trading of OTC derivatives – IRS and CDS - has suffered negative effects for both EU and UK financial markets. The lack of coordination in the application of the derivatives trading obligation (DTO) has generated a significant shift of the dealing volumes on US venues and penalized both EU and UK market volumes.

To avoid the risk of fragmentation, authorities should take into account political, risk and competition considerations. Maximising liquidity is key to CCP efficiency, providing clearing members with cross-margining benefits and clients with larger liquidity pools.

A relocation policy of euro clearing that would only involve EU-based clearers and market players will damage those firms and would not meet the expected political goal of EU institutions. Indeed, to achieve this goal while maintaining CCP efficiency and financial stability, EU authorities will have to work closely with the industry to define the relevant measures to be implemented within a reasonable timeframe.