SECURITIES AND DERIVATIVES CLEARING: REMAINING CHALLENGES

1. The role of clearing in preserving financial stability in the EU

1.1 Experience of the March-April 2020 market stress

The Chair emphasized the role of central clearing counterparties (CCPs) as regards mitigating risks to financial stability, particularly market risk, and in addressing the potential default of clearing members. However, CCPs themselves can also be a source of systemic risk, so safeguarding their resilience is of utmost importance. This resilience was tested during the last year with several events occurring, including in particular the immediate impact of the Covid crisis in March 2020, leading to high volatility and in some instances raising issues of procyclicality. The Chair noted that EU CCPs had been comparatively less affected, which may be attributed in part to the existing strong anti-procyclicality requirements under EMIR.

An industry representative stated that the March 2020 market stress resulted in a different landscape from the 2008-09 global financial crisis, thanks to appropriate collateralisation. Trust in the resilience of the system and the collateralisation and transparency organised around the CCPs helped limit the impact of March events to a volatility, liquidity and funding issue, rather than a credit or market risk crisis, which could have happened without collateralisation. CCPs also played a key role in ensuring predictability throughout these times of market turbulence. The speaker's institution – a major CCP – was able to maintain stable and predictable margins, which did not demonstrate any procyclical behaviour, thanks to the embedded anti-procyclicality measures in all its clearing services.

An official agreed that CCPs showed good resilience through the Covid crisis. It was more than a stress test exercise, because such a stress could not have been imagined, and CCPs overcame the challenge. That was also thanks to regulation. One point to underline about initial margins is the magnitude of the impact of volatility on margin calls experienced in March 2020 and the risk of liquidity stress. Quarterly public figures show that the amount of collateral posted to clearing houses to meet initial margin requirements increased by $270 billion globally, or 48% during the first quarter of 2020. Such evolutions require close monitoring.

1.2 Lessons learned from the Covid crisis regarding procyclicality

An official considered that margin increases are necessary to ensure the resilience of CCPs in adverse market conditions. A CCP must collect more margin to protect itself, but increased margin calls may impact the ability of clearing members and their clients to meet them in a timely manner if their liquidity situation is impaired, so the right balance must be found.

Another official stated that the experiences of the 2008 and 2020 crises demonstrate the contribution that CCPs make to keeping the financial system stable, bringing discipline into a formerly bilateral and uncollateralised world, and the importance of higher margins for tackling higher volatility. Existing EU frameworks support the role of clearing however certain aspects may need considering for the future. Tools have been put in place to tackle procyclicality, but less procyclicality in times of crisis comes at the expense of higher average margins throughout the cycle. This is a trade-off that the industry and the regulators need to make, with an ecosystem-wide perspective. The responsibility for avoiding procyclicality should not lie solely with CCPs. Clearing members should also consider making greater use of over-collateralisation, and how to better absorb high margin calls in unavoidable times of high volatility should be thought through to the buy-side. Everyone should indeed be willing to pay a small price for more safety and stability.

The first official agreed that increased margin calls during the Covid crisis raised potential procyclicality issues. There is on-going work at the international level on these questions which is to be supported. The Financial Stability Board (FSB), CPMI-IOSCO and the Basel Committee on Banking Supervision (BCBS) are working jointly on further assessing the procyclical effects of margin calls, why and how they materialise, which entities are most exposed, and in what markets. This will allow for a finetuning of policy in this area and also help to identify ways to mitigate procyclical effects without impairing the ability of CCPs to protect themselves.

1.3 The need for supervisory cooperation and convergence regarding CCPs

An official stated that the regulation put in place with EMIR 2.2 and the CCP recovery and resolution regime is fit for purpose in normal times and during episodes of market stress. EMIR adequately allocates supervisory responsibilities within the EU, while providing rules for ensuring effective cooperation, coordination and information sharing among stakeholders. Improving the current situation would mean enhancing the sharing of information in a more open way among regulators and also with other market stakeholders, but this is probably more a matter of mindset than regulation, the official felt.

Another official agreed that for large CCPs, cooperation at the European level is essential and observed that the revised EMIR 2.2 framework supports this. For systemic CCPs this should be implemented in concrete terms because the tools exist. In the future a strengthening of supervision might be needed at the EU level, but it is important to first evaluate how EMIR 2.2 is working. Data collection is essential in this perspective and it is crucial that all market participants provide as much information as possible.

The Chair considered that supervisory convergence is key for ensuring a level playing field across EU

CCPs and beyond, which is also a precondition for ensuring an adequate level of risk management. The EU supervisory framework should embrace a broad EU-wide perspective, considering all risks posed by both EU and non-EU CCPs to EU financial stability, including through interdependencies and interconnections across markets and jurisdictions.

1.4 Progress made with the CCP recovery and resolution framework

An industry representative explained that the CCP recovery and resolution regulation, which is the second main regulatory framework in the clearing area in addition to EMIR 2.2, reinforces the risk management framework for EU CCPs and their clearing members, thanks to the second tranche of capital contribution by CCPs (also known as 'skin in the game') and clarifications of the tools that can be used by the resolution authorities. A great deal of work remains to be accomplished for implementing this regulation, especially concerning Level 2 regulation, but the speaker viewed it as a competitive advantage for the EU financial system and market participants.

The Chair noted that the new EU CCP recovery and resolution regulation provides ESMA with a number of additional tasks, which include the setting up of 19 technical standards, most of which are to be delivered by the end of 2021, as well as the establishment of a resolution committee to support the process.

2. The role of clearing in supporting the post-Covid recovery and the CMU

2.1 Supporting debt issuances related to the EU recovery programme

An industry representative stated that CCPs have a key role to play in EU recovery and green transition initiatives. Clearing can bring safety and soundness to the securities issuances related to these initiatives from inception and also support these instruments by making them widely acceptable as assets for investors and as a reliable funding tool for EU banks[1].

Clearing may also contribute to developing the international role for the euro, the industry representative emphasized. A few years ago the clearing of euro debt was shifted from London to Paris and the high volumes of euro government debt cleared in Paris[2] have attracted key non-European Economic Area (EEA) players. Now there are not only US and UK, but also Australian, Canadian and Japanese members who have joined the euro debt clearing service in Paris. In the view of the industry speaker, that helps the internationalisation of the euro both from a debt and currency standpoint, so is a concrete contribution to the CMU and an area of development for the future.

2.2 Facilitating cross-border investments

An industry representative noted that CCPs also facilitate cross-border investments, which are key to CMU, because they are the basis for ensuring the EU financial ecosystem's competitiveness and efficiency. It is critical to have a strong EU financial ecosystem that can compete beyond its borders. EU and non-EU CCPs provide critical pipework for investments to flow across borders. For that, it is vital that CCPs can facilitate market needs, whether markets are local, regional within Europe, or global. Market specificities and requirements need to be supported by regulation and supervision that avoid unnecessary barriers to efficiency and access to liquidity.

The speaker's institution – a major CCP - has also been a consistent supporter of implementing a direct supervision of EU CCPs at ESMA level, comparable to what EMIR 2.2 introduces for third-country CCPs. While remaining aware of the political sensitivities, this is important for moving towards more efficient supervision and regulation at EU level, which remains another key CMU objective.

3. Regulatory and supervisory approaches concerning non-EU CCPs

3.1 Changes in the derivatives trading and clearing market following Brexit and pending questions

Concerning derivatives trading, an industry representative stated that the evolutions during the Brexit transition period show the need for further coordination at the EU level. In the equity market market participants anticipated the application of the MiFIR share trading obligation, so 1 January saw a large liquidity move of EU shares into EU trading platforms and a subsequent liquidity split between the UK for UK shares, and the EU for EU shares. There was less coordination however in the application of derivative trading obligations for euro-denominated OTC derivatives, particularly interest rate swaps (IRS). This lack of coordination between European jurisdictions generated a significant shift of trading volumes to US venues, especially from firms active on both sides of the channel. This is a lost opportunity for the EU, the industry speaker considered, as it will be hard to relocate these volumes.

Another industry representative confirmed that there have been tangible changes in where OTC derivative trading is taking place. The majority of trading for both credit default swaps (CDS) and interest rate swaps (IRS) has moved to US swap execution facilities (SEF). For example two thirds of euro IRS are traded outside the EU. The interdealer euro CDS market is also now primarily traded out of the US. This means that EU firms, especially the sales side, have lost access to

1. The example of the role played in this perspective by the LCH Group was given. The Paris-based LCH SA in particular supported the EU's first debt issuances by clearing EU debt issued under the SURE (Support to mitigate Unemployment Risks in an Emergency) instrument from the outset. That was publicised in order to ensure that market confidence was secured pre-issuance and to support trading and collateralisation. Of the €75.5 billion dispersed to the 17 member states under the EU SURE programme, LCH cleared about 10 billion, which are now used as collateral for covering margins across business and services in LCH SA. CCPs may support in the same way the issuances related to the EU Next Generation programme, as well as the issuance of green debt. The issuances of the German, French and Italian government green debts for example are cleared, and this has resulted in growing trading of these assets.

2. In the RepoClear pool

both providing and taking liquidity, but also to offering their services to clients in the UK, which puts them at a competitive disadvantage and is a concern in terms of financial stability.

Concerning the clearing market, an official stated that, despite preparation on the EU market side, there were no significant changes post-Brexit with the exception of the shifting of repo markets to LCH SA in Paris. There is not much more evolution to expect unless the present framework is changed, and it should not only be looked at against relations with the UK, but US markets also.

When considering whether the current regulatory setup and the relationship with UK CCPs and equivalents should change it is necessary to assess what is needed at the clearing level for safeguarding the financial stability of European markets and what this actually means in the CMU perspective. This assessment should be performed by ESMA, the official observed. It requires analysing the structure and setup of the market and defining for example what a European transaction is, i.e. if it is a transaction denoted in euro, one cleared via a financial market infrastructure in the EU, or a transaction that is handled by a clearing member based in the EU. In the same way on the buy-side, it should be determined whether it is relevant to financial stability in Europe if the buy-side client is European e.g. a European pension fund or insurer.

In the 2008 financial crisis, AIG which was not a bank or a clearing member but an insurance company was bailed out by the US authorities, because it was an extremely important counterparty to all the financial market players, which illustrates what to consider when assessing European financial stability risks. Buy-side liquidity is also key, the official believed, as European players typically deal in various currencies.

The Chair noted that in view of the potential implications of Brexit, the ESMA CCP Supervisory Committee has been tasked with assessing whether certain CCPs or CCP services may be of such substantial systemic relevance that the existing framework may not suffice to address and mitigate the related risks for the stability of the EU financial system. In response, a comprehensive evaluation framework is being established based on a range of qualitative and quantitative indicators, on the basis of which an assessment of potential risks will be conducted, combined with a cost-benefit analysis, that will be concluded by the end of 2021. ESMA will reach out to relevant stakeholders in order to gather comprehensive data to support the assessment of the implications for the EU financial markets. This is a challenging task, but one which needs to be undertaken for the sake of stability.

An industry representative stressed that when considering possible next steps for a euro clearing policy, it is worth remembering that the EU clearing members' footprint is limited compared to others. In the IRS segment EU clearing members have a footprint of around 25-30%, which means that a de-recognition decision under EMIR 2.2 affecting this segment, if applicable to EU stakeholders only, would catch around 30% of volumes. It would damage the EU firms, and would not meet the expected political goal, as the EU authorities would lose their supervisory power on a majority of the volume.

Another industry representative agreed that there has not been a great change in market behaviour since Brexit, which is a function of how markets work and are structured. Derivatives are global and EU firms need access to liquidity and the cross-currency risk management supported by these markets. Concerning the IRS market, 14% have an EU firm represented on what is cleared on a day-to-day basis, and around 25% of the euro IRS flows have an EU firm on them. 75% of the euro cleared IRS market therefore originates outside of the EU. That 25% is vital, but EU participants need access to the rest of the world, including EU currencies, euro and others, for the EU markets to remain competitive.

The debate often polarises on the euro IRS market, but there is a broader question of the access of EU firms to all markets, the industry speaker believed. From the data, EU firms clear more in non-euro than in euro, in terms of daily notional cleared and traded amounts, and most EU firms, both sell-side and buy-side, are clearing more than three currencies with UK-based CCPs. EU firms therefore need access to all currencies and the liquidity in those. That is the underlying market reality. Access to diversified CCPs makes EU firms safer and less prone to financial stability risks, shocks and liquidity squeezes. EU firms must maintain their access to these different markets and, reciprocally, non-EU firms to the EU market too. That will contribute to the CMU.

3.2 Next steps regarding the regulatory and supervisory approach to UK-based CCPs

The Chair noted that Brexit effectively transformed UK-based CCPs from EU infrastructures into third-country ones. Under EMIR 2.2, ESMA through the CCP Supervisory Committee has assumed direct supervisory competences over CCPs determined to be of systemic relevance to the EU financial system. To mitigate potential cliff-edge risks, temporary equivalence decisions have been issued by the European Commission, complemented by corresponding temporary recognition decisions by ESMA for UK-based CCPs. This has helped to smooth the direct impacts of Brexit, whilst providing for the opportunity to undertake a comprehensive assessment of the consequences of such transformation.

An industry representative noted that EMIR 2.2 significantly reinforces the supervision of third-country CCPs through tiering and a revised recognition process. This evolution concerning third-country Tier 2 CCPs is welcome, bearing in mind however the issues previously mentioned regarding the access of EU clearing members to CCPs clearing euro-denominated contracts. The EU authorities should carry on working with the industry to define the relevant measures that need putting in place in the perspective of the CMU. This can only be achieved through strong EU players, in cooperation with other non-EU firms, so that all players, clearing members and their clients can benefit from CCP efficiencies and cost margins.

An official stated that EU and UK authorities have recently started working together under the new EMIR 2.2 framework, so it is too early to draw conclusions and assess its functioning. Mechanisms such as comparable compliance have not yet been fully implemented.

Ensuring that UK CCPs fully apply the standards of EMIR 2.2 in years to come remains a key priority, as it is one of the most demanding frameworks for CCPs. This is the beginning, but there is confidence.

A key issue to be tackled over the coming months is the location of systemic clearing activities for the EU – so called Tier 2 activities, the official stressed. A temporary equivalence decision has been granted to UK-based CCPs and during this transition period two main points are being worked on.

The first point is that European institutions need to take a stance on the use of the EMIR location policy. ESMA, the ESRB and the ECB. have begun to assess if some UK CCP clearing segments are of such substantial systemic importance that they should not be recognised as equivalent. The final ESMA report on this question should be published at the beginning of 2022, so that the European Commission can make the final decision ahead of the deadline of June 2022. From a central bank perspective, the question of UK CCPs' systemicity is important, the official believed, because in a crisis, central banks are the lenders of last resort. This question is particularly relevant for products such as euro IRSs or EU CDSs and short-term interest rates referencing EU rates, where positions are concentrated. The current framework of direct supervision by ESMA for tier 2 third-country CCPs is an improvement, but it might not be flawless given the comparable compliance mechanism and the fact that ESMA will not have binding powers over UK CCP risk management practices in times of crisis. UK CCPs, when protecting themselves as requested by national regulation, will not consider the effect of their decisions on EU financial stability. For this reason the benefits of the relocation of certain activities to the EU in terms of financial stability may outweigh the short-term costs incurred.

The second point is that EU clearing members should work on reducing their exposure to UK CCPs, the official emphasized. The Commission has set up a working group of industry representatives and institutions to discuss the benefits and challenges of the location policy's operationalisation and conclusions are expected soon. Initiatives to reduce this exposure have been limited so far, so it is important that these are encouraged both on the clearing member side, for how to operationalise this relocation policy if decided, and on the CCP side, for how to broaden and improve the scope of products accepted for clearing. Cooperation with the UK authorities remains fundamental whatever the decision taken on location and will take place in the context of global colleges set up for systemic CCPs, which allow the association of third-country authorities with the supervision of domestic CCPs. This will facilitate the sharing of data both in normal times and in times of crisis and of regular reports on supervisory activities, and also allow for flexibility in bilateral discussions whenever needed.

The Chair agreed with the importance of global colleges for CCPs as a best practice promoted by CPMI-IOSCO for globally systemic infrastructures. In an EMIR context, given that ESMA has direct supervisory competences over certain UK CCPs that are of systemic relevance for the EU financial stability, this needs to be complemented by a close and robust cooperation between ESMA and the Bank of England. In this regard, there are some remaining issues concerning the application of comparable compliance, such as what happens if, over time, the comparability is no longer ensured, and what the consequences thereof may be.

An industry representative emphasized that while there are discussions about possible EU-UK regulatory divergence related to Brexit in certain areas of finance, these are not relevant for CCPs that endeavour to operate at the highest standards at the global level. The industry representative noted that having regulatory licences from different jurisdictions indeed allows for taking the highest standard of regulatory supervision and applying it globally. When it comes to clearing, convergence at the highest standards is what is requested both from a regulatory standpoint and from the perspective of the organisation, its members and customers.

EMIR 2.2 provides central banks with additional tools, including the possibility for the ECB to impose the use of a central bank account for euro flows associated with a third-country CCP, the industry speaker observed. That is vital, especially for OTC derivatives. What is important concerning clearing, even more so during crises, is the availability of collateral and cash to protect and cover the risks. Having cash in the relevant central bank for the relevant currency further addresses financial stability concerns, to the point that in many jurisdictions cash is deposited and concentrated in the various currencies in the local central bank as well. That is a key financial stability and systemic risk reduction tool. It brings transparency and stability, notably regarding the liquidity draw of the euro markets globally, and helps promote the euro as the growing international currency. Dialogue on supervisory solutions, comparable compliance, and resolving any remaining concerns around that must also continue.