CLEARING: REMAINING CHALLENGES AND WAY FORWARD

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The ESMA CCP Supervisory Committee's view on key CCP risks in 2021/22

In line with its Strategic Orientation, risk-driven assessments are a crucial part of the work of ESMA. Therefore, in performing its supervisory tasks, the ESMA CCP Supervisory Committee (CCP SC) has focused on identifying emerging risks impacting CCPs and their ecosystem to better tailor and adapt its supervisory and convergence actions.

While ESMA was the first authority to conduct jurisdiction-wide CCP stress-testing exercises and continues to closely monitor the development of risks impacting EU and third-country CCPs, real life often provides the most valuable lessons. The global market turmoil in March 2020 following government containment measures against COVID-19 has acted as a live test on the resilience of the financial sector and has helped identify certain unresolved vulnerabilities.

Overall, it is worth reiterating that CCPs have performed well throughout the crisis, despite the surge in clearing activity coupled with a rise in initial and variation margins. In the EU, no default procedures were triggered at CCPs and no waterfall resources needed to be used, showing the overall resilience of the sector, but also of its supervisory and regulatory framework.

However, questions remain as to whether some initial margin increases (beyond those linked to increased volumes and portfolio changes) acted in a procyclical manner, potentially diffusing or even amplifying liquidity stress to other parts of the financial system, and therefore should be mitigated through regulatory or supervisory measures. While EU CCPs, thanks to the EMIR anti-procyclicality measures, mostly appear to have experienced milder margin increases compared to the ones in other jurisdictions in similar asset classes, this does not mean that there is no room for improvement.

ESMA is currently considering whether targeted changes to Regulatory Technical Standards (RTS) and Guidelines are needed and will be contributing to the respective activities of the FSB and the dedicated BCBS-CPMI-IOSCO working group on anti-procyclicality.

Beyond the size of margin increases, the predictability of margin models as well as Clearing Member and client preparedness seemed to have also played a key role in limiting the potentially destabilizing effect of margin calls. Accordingly, the CCP SC has decided to focus its upcoming Peer Reviews on supervisory practices of National Competent Authorities (NCAs) regarding member due diligence checks including for clients and proper monitoring of concentration risks due to member positions.

The COVID-19 lockdowns have also tested the contingency plans of CCPs and their members where, in a matter of days, entire teams were asked to leave office premises and to work from home. ESMA, in coordination with NCAs, has closely monitored the impact of the COVID-19 crisis on EU CCPs, including by conducting a fire drill focusing on teleworking aspects.

While these impressive efforts have enabled markets to continue functioning remotely for months, it has at the same time increased our dependence on the IT sector and especially on certain third-party providers. This trend is likely to continue even as life begins to return to normal.

In this context, operational risks have become of particular concern given the high degree of interconnectedness of CCPs with the rest of the financial sector and require heightened attention of regulators and supervisors. Therefore, ESMA welcomes the proposition by the European Commission to strengthen the digital operational resilience of the financial sector as a whole and hope the co-legislators will come to a speedy agreement.

ESMA has also decided to include operational risk as part of the framework for the 4th CCP stress test. It will focus on operational risk events affecting third-party entities on which CCPs rely to provide their services, assessing the importance of shared service providers in the clearing industry and interconnections of CCPs. In addition, the 4th stress test will use improved methodologies, based on lessons learned from previous exercises, and will also assess the combination of concentration costs and credit losses when liquidating defaulting portfolios. Finally, the 2021 Peer Review will be focusing on how NCAs assess the resilience of CCPs to cyber-risks and their Business Continuity Plans (BCP) in remote working arrangements.

Overall, while the G20-led reforms of the financial regulatory framework have shown their effectiveness, there is no time for complacency. Indeed, market risks remain elevated and may deteriorate even further once public support measures start drying out, especially for Non-Financial Counterparties (NFCs), which may have knock-on insolvability effects. In this context, delivering on the remaining pieces of the financial reforms will remain a key priority, notably with regards to default management auctions, the implementation of recovery and resolution plans and the full rollout of the OTC derivatives reforms.

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Clearing: the status quo is not an option

In the wake of the global financial crisis that unfolded more than a decade ago, and in line with the international consensus at the time, the EU adopted its landmark legislation the European Market Infrastructure Regulation (EMIR) with the aim of making OTC derivatives (OTCDs) markets and central counterparties safer and more transparent.

More recently, these rules have been adjusted and updated in the following ways: In June 2019, a Regulation introducing more proportionate requirements for smaller firms (the so-called "EMIR Refit") entered into force and in January 2020, EMIR 2.2 was published, providing for a more consistent and robust supervision of central counterparties. This was particularly important in light of the growing systemic importance of CCPs and the expected impact that the withdrawal of the United Kingdom from the EU would have on the supervision of central clearing in the EU. Finally, in February this year, the new Regulation on recovery and resolution of CCPs entered into force. In parallel, work is ongoing at the technical level to develop the so-called "level 2" measures, which are necessary to make the framework fully operational.

These legal texts provide a robust framework for EU and third-country CCPs and their users, recognising the global nature and interconnectedness of derivatives markets while mitigating financial stability risks arising from derivatives cleared inside and outside the Union. In particular, the overarching goal of EMIR 2.2 is to mitigate risks in derivatives clearing as its scale and importance continue to grow, while taking into account the role and impact of third-country CCPs in the clearing of financial instruments that are relevant for the stability of the EU financial system. In this respect, EMIR 2.2 introduces a new framework for third-country CCPs.

Those CCPs are subject to a 'sliding scale' of additional supervisory requirements by ESMA and relevant central banks of issue (CBIs), based on objective criteria. While less systemic 'Tier 1' CCPs remain under the primary responsibility of the home supervisor, 'Tier 2' CCPs, which are of a more systemic nature, are subject to direct supervision by ESMA, in close cooperation with the relevant CBIs, making sure that potential contagion risk stemming from these CCPs is appropriately mitigated from an EU perspective. Moreover, such systemic Tier 2 CCPs would only be allowed to offer services in the EU if they applied for authorisation in a Member State of the Union. According to the EMIR framework, the systemic nature – for the Union and its Member States – of CCPs located outside of the EU and wishing to offer clearing services to EU clearing members and trading venues, is being assessed by ESMA and the relevant CBIs.

EU exposure to UK CCPs must be reduced, without creating new risks.

In September 2020, the Commission adopted a conditional and time-limited equivalence decision for UK CCPs in order to avoid cliff-edge effects on 1 January 2021 and the materialisation of risks for the financial stability of the Union and its Member States. Subsequently, ESMA recognised CCPs established in the United Kingdom under the EMIR framework, allowing EU market participants to continue using their services until the equivalence decision expires on 30 June 2022. Out of the three CCPs operating in the UK, ESMA has concluded that two of them should be tiered as Tier 2 CCPs.

As stated in the equivalence decision and in the Commission Communication on Open and Strategic Autonomy of 19 January 2021, the vast amounts of euro-denominated contracts cleared and settled by UK CCPs raises financial-stability concerns, particularly in the case of a crisis. There is therefore a clear expectation that Union clearing participants reduce their exposures to those CCPs, in particular OTCDs exposures that are denominated in euro and other Union currencies. EU CCPs need to build up their clearing capacity in parallel.

In addition to ESMA's work under EMIR 2.2, the Commission, together with the ECB and the European Supervisory Authorities, are in close contact with market participants to assess possible technical issues relating to the transfer of contracts denominated in euro or other EU currencies to central counterparties located in the EU.

In addition to the reduction of exposures, there is also a need to monitor and if needed mitigate the emergence of any new financial stability risks, both for the EU and globally. The overarching objective has always been to approach the issue of risks related to third country clearing and CCPs from the perspective of risks to EU financial stability.

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Financial stability: the compass to guide decisions on clearing

With the 2008 financial crisis and more recently with the Covid crisis, the world (re)discovered that the financial systems' interconnectedness, traditionally considered as a factor of growth, may also lead to a faster and more abrupt transmission of financial shocks.

In both crises CCPs have demonstrated operational and financial robustness, which was extremely valuable in times of market turmoil. Their systemic importance has indeed been rising over the last few years, among others as clearing obligation on certain segments gradually entered into force. Any CCP's even temporary failure would have knock-on effects that could be devastating for financial stability.

To have a deeper dive into CCPs' overall resilience, BCBS, CPMI and IOSCO have launched recent surveys in order to determine whether margin practices and anti-procyclicality tools proved adequate during the Covid crisis, in particular in March and April 2020. Depending on the conclusion of these surveys, and more generally on the lessons learnt during the crisis, recommendations could be issued in order to further improve and harmonize margin calls and anti-procyclicality tools, as well as to reinforce their transparency and foreseeability for clearing members and their clients.

Regulators have constantly adapted to financial systems' increasing interconnectedness. What happens beyond our borders cannot be ignored: stronger cooperation is ever more essential especially for CCPs which concentrate positions of financial actors. Today, enlarged cooperation is necessary, such as global colleges: the Banque de France will hold LCH SA's first global college this year, with attendance by both European and third country authorities.

On top of these cooperative arrangements, in 2020 the EU adopted EMIR2, which introduced a risk-based approach for third country CCPs: when categorized as systemic, on the basis of quantitative indicators, they are subject to closer monitoring, and to certain direct supervisory powers from ESMA. Where such direct powers are not sufficient to guarantee EU's financial stability, offshore CCPs would not be allowed to provide clearing services to EU entities. In this respect, an important decision will be made by the European Union in the coming months.

The aim of all facets of regulatory work is to ensure that economic actors can operate safely.

ESMA, on the basis of a comprehensive methodology it has recently published in this regard, is hence expected to perform an analysis –through both a quantitative and a qualitative prism- of offshore CCPs' substantial importance, and a full cost-benefit analysis. This will support a recommendation to the Commission in the first quarter of 2022, after consultation of the both the ESRB and central banks of issue (including the Eurosystem). By end-June 2022, i.e. before the temporary equivalence decision taken following Brexit expires, the Commission may in turn, against that background, adopt an implementing act to induce relocation of clearing services in the EU.

This process is an important one and all aspects need to be examined very carefully. Concerns voiced by market players on difficulties related to relocation are being heard. Notably, EU regulators are aware of challenges such as the possible directionality of EU members' positions in these CCPs and the need to find new counterparties, which would push liquidity prices up. There is a need to examine how costs can be mitigated, maybe with an appropriate transition period, up to two and a half years. There is also a need for EU CCPs to further strengthen their offers – although much has already been done on certain segments – and for EU market players to orderly migrate their positions.

But on top of these elements, financial stability issues also have to be examined. In particular, one has to think forward, in a potential new crisis situation, while EU entities' risk exposures to third country CCPs remain very significant, which turns out to be a kind of vulnerability especially in a crisis, recovery or resolution situation. In such cases, even for the so-call Tier 2 CCP, EU authorities' powers are de facto very limited: they are fully dependent upon third-country authorities' appetite for information sharing and coordination in an emergency situation. This issue is central, because financial stability is a public good for the economic actors, be they banks, financial institutions, companies, individuals.

All in all financial stability remains the decisive angle when deciding on such a matter. Eventually, an approach proportionate with risks has to be taken, and we should not lose sight that overall, the aim of all facets of regulatory work is to ensure that economic actors can operate safely.

DANIEL MAGUIRE

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Cross-border markets require cross-border supervisory practices

Global financial markets best operate when they can freely balance supply and demand supported by highly capable and resilient infrastructures and participants. This not only makes markets more efficient but also safer. To oversee cross-border markets and the infrastructures they support, cross border cooperation between national supervision plays a key role.

As a financial market infrastructure providing services in 60 jurisdictions and licenced in 11, LCH is a strong advocate of an international approach to the regulation and supervision of internationally active market infrastructures in line with G20 Recommendations.

As a Tier 2 Third Country CCP ("TC CCP"), LCH Ltd is directly subject to the EU EMIR requirements as well as the UK requirements stemming from the on-shored EMIR text. The UK government clearly stated its intention to continue strengthening what is one of the world's most robust regulatory regimes for central counterparties (Chancellor Rishi Sunak MP, Mansion House speech, 1 July 1, 2021). In addition, LCH Ltd is subject to rules of several jurisdictions including the US. We provide our UK, EU, US and Asian members with a highly robust and consistent risk framework applying the highest standards available under the direct supervision of, among others, ESMA, the CFTC, the Reserve Bank of Australia, the Quebec AMF, and the OSC, in addition to our home supervisor, the Bank of England.

During March's 2020 heightened market volatility, LCH's Paris and London entities' risk and margin models performed as designed, with no intervention required and with total margins increasing gradually, and only by single digits. This contributed positively to the markets' resilience and financial stability during extreme market stress. Furthermore, LCH Ltd has been working closely with global regulators over the last few years to ensure the safe and smooth critical transition from IBORs to new reference rates.

In the UK, LCH SA. benefits from the Bank of England's three-year Temporary Permission Regime ("TPR"), and clarity was provided very early on the ability of UK entities to continue accessing EU CCPs.

EMIR 2.2 provides the tools for an effective cross-border supervisory framework.

In the EU, however, LCH Ltd.'s current recognition elapses on 30 June 2022. ESMA is assessing UK CCPs systemic importance in the EU in order to determine if UK CCPs or of some of their services should be denied recognition, taking into account costs, benefits and consequences to EU markets and its participants.

Denial of recognition or regulatory driven reduction of exposures of EU firms to TC CCPs would result in loss of access to a well-established and highly liquid market, increased costs, loss of competitiveness of EU firms and significant financial stability risks for the EU. Mandating EU firms to clear in an EU captive market will reduce choice and competition. In the case of EUR IRS this would leave EU firms captive in a market representing 27% of the EUR IRS notional registered at LCH's SwapClear in 2020, the vast majority of the market (73%) being registered by non-EU firms.

Migration costs would be significant and EU firms' inability to provide products and services at best prices will impair their ability to remain competitive across all currencies, not just Euro. Market fragmentation would lead to fluctuations in CCP basis and heightened bid/offer costs for EU firms in the long run.

From a financial stability perspective, the reduced size and diversity of participants (i.e. EU firms only) in a fragmented market poses substantial financial stability risks particularly with regards to default management. A captive smaller market would have much greater concentration risk and likely to be directional. Ultimately, such market would become riskier and less resilient to market shocks. A diversified clearing services supported by greater liquidity, a wide membership that is subject to different economic dynamics and clearing diversified portfolio, has strong benefits to financial stability. We should ensure EU firms can continue managing their risks by accessing such diversified clearing services.

The newly implemented EMIR 2.2 framework strengthens the supervision of third country CCPs. In addition to the direct supervision by ESMA, it gives EU Central Banks the ability to require CCPs to open deposit accounts in their currency i.e. in the case of the Euro, all Euro payment flows processed through Target 2. LCH Ltd is fully supportive of this requirement.

EMIR 2.2 provides the tools for an effective cross-border supervisory framework based on open and constructive dialog, including on financial stability risks during market stress, while preventing the regionalization of EUR clearing. We must leverage those tools to address any potential remaining financial stability concern as a market, whilst avoiding the increased costs and risk of any form of market fragmentation imposed on EU firms. This would enable EU firms to continue accessing global markets safely.

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Setting incentives for a robust, efficient and competitive clearing landscape

With the Covid-19 pandemic and the implications of Brexit we experienced a real-life stress test and major market adaptions. Fortunately, the G20 reforms on central clearing of OTC derivatives and collateralization of non-centrally cleared derivatives have significantly strengthened the resilience of our markets which were far better prepared this time. EU CCPs have managed the market moves well. With EMIR, the EU has laid the foundation for a healthy central clearing ecosystem and set a global benchmark, safeguarding the role of CCPs as independent and neutral risk managers of financial markets. It is also one of the first jurisdictions in the world to have a fully-fledged CCP Recovery and Resolution regime, complementing the existing lines of defense for extreme yet plausible scenarios. Nevertheless, efforts in maintaining financial stability and setting the right incentives for the industry must continue.

Major steps have been taken in relation to strong risk management capacities and oversight of CCPs via the EMIR 2.2. framework, striking the right balance between financial stability imperatives and market access. We now have a toolkit to deal with scenarios in which the EU faces monetary policy and financial stability risks where systemically relevant clearing volume is left in a third country off-shore center. This becomes particularly relevant in light of Brexit. With the end of the transition period, the European financial sector needs to adapt. Major global banks have set-up EU entities to continue servicing EU based clients.

We have seen large parts of equity and derivatives trading activities shifting to the EU (and to the US) in accordance with the respective trading obligations in the EU and the UK. And we could also observe that banks and investors have been moving Euro denominated clearing business to the continent. By granting temporary equivalence for UK CCPs until end June 2022, the European Commission however managed to avoid any market disruption, allowing enough time to thoroughly assess the systemic importance of UK CCPs for the Union under the new EMIR 2.2 regime.

The industry is now closely following the ESMA Supervisory Committee's assessment to provide market participants as well as market infrastructures with certainty as regards the long-term set-up when the temporary equivalence elapses. EU regulators have expressed a clear desire that clearing of systemically important financial instruments denominated in Euro takes place within the Union, calling on the industry to reduce exposures to UK CCPs and increase clearing capacities on the continent. The aim is clear, to reduce the dependency for the risk management around our currency on third countries and foster the Union's global sovereignty.

Supporting an innovative and globally competitive clearing landscape in the EU.

We welcome that the Commission has set up a working group together with the industry to discuss any technical, operational and legal issues in this respect. Whilst fully supporting the EU regulators' objectives, I believe that the development of competitive, efficient and resilient markets is best supported by market-driven solutions rather than public intervention – this is why Eurex Clearing continues its commitment to providing choice to the market and becoming the global home of the euro yield curve.

Besides adjusting to the new realities of the post-Brexit world, the Covid-19 pandemic's social and economic impact is still materializing in the EU with slower economic growth, higher public debt levels, and pressure on bank's balance sheets. In this context, let us not forget that efficient and robust risk management as well as a healthy clearing ecosystem are not only key parts for preserving financial stability during times of market turmoil but also for a sustainable recovery.

Against this background, I welcome the global discussions on risks of procyclicality, where Eurex with its globally leading Prisma methodology is setting the benchmark on anti-procyclicality and industry leading risk standards. We need to continue on our endeavor to strengthen both the efficiency and the stability of our markets via innovative and at the same time prudent risk management. And we shall not lose out of sight that some of margining standards for bilateral markets have still not been phased-in more than a decade after the global financial crisis.

For capital markets to play a central role when it comes to a swift recovery from the recent crisis, policy makers and the industry should continue supporting an innovative and globally competitive clearing landscape in the EU.

At Eurex Clearing, we will remain committed to pushing market-led initiatives that help transition the market into a healthier environment market by fostering true competition, choice, and innovation while simultaneously improving risk management, reducing concentration and increasing overall financial stability with a particular focus on Euro and the European Union.