CLEARING: REMAINING CHALLENGES AND WAY FORWARD

1. Lessons learned from the COVID-19 crisis in the clearing space

The Chair stated that the clearing sector weathered the impact of COVID-19 very well. A key aspect of clearing is the presence of infrastructures that inherently have a financial stability dimension. In aggregate, European central clearing counterparties (CCPs) seemingly have been faring better on aggregate than their peers outside the Union, which both gives credit to the industry and to the regulatory framework (i.e. EMIR and the anti-procyclicality measures (APC) established by ESMA).

An industry representative observed that the pandemic demonstrated that the measures defined by the G20 concerning CCPs following the 2008 financial crisis are effective. Despite record volatility in March-April 2020, the financial system remained stable and performed as designed and CCPs played a key role in this regard. EMIR has enabled the EU to improve its central clearing ecosystem and is serving as the global benchmark. The margin models have also proven effective and showed fewer procyclical effects than seen elsewhere in the world.

A Central Bank official agreed that CCPs generally performed well during the COVID volatility period of 2020, which was unprecedented in certain aspects with the largest equity move in over 20 years and record volatility in certain markets. The key lesson is that the reforms put in place following the 2008 financial crisis to enhance and encourage the use of central clearing have fundamentally worked. This also changed the way that the financial system works and how it behaves under stress. The experience of March/April 2020 was an ultimate stress test of the clearing system. This time there was no worry about the risk of a large clearing member defaulting or of potential impacts on the whole financial system. Not all CCPs were created equal across the system however. There were very significant increases in initial margin in some parts. Also the realisation of market losses by participants was much faster than in the past due to reforms of variation margin, which is an improvement. The Central Bank official mentioned that international work is ongoing on these issues. A consultation should be released in the following month outlining the conclusions of an analytical phase that drew on a very large collection of data. The impacts on liquidity, and whether there was the right level of preparedness are being assessed in particular.

A second Central Bank official concurred that EMIR 2.2 has successfully passed the test with this unprecedented crisis and proven to be quite efficient. There are no major problems with EMIR, which is the most developed CCP framework at the global level. With the very challenging situation at the beginning of the COVID crisis, initial margins (IM) and margin costs were significant in Europe, but clearing members were generally well-equipped to face these increases in margin calls. They were able to post an additional €30 billion of initial margin to EU and UK CCPs in a matter of one month. On a global scale, the clearing initial margin increased by €300 billion from February to March 2020, especially on exchange rate derivatives, interest rate swaps and FX swaps.

An industry representative agreed with previous speakers that the margin models worked as intended. They were predictable, and there was no change in process, behaviour or parameters across both LCH entities, the result being very gradual, very linear and in single-digit percentages. A degree of caution is however required in this area, because results can differ across CCPs, asset classes and jurisdictions. However, relatively high-calibre, predictable risk management and resilience was generally demonstrated in Europe throughout the COVID crisis.

2. Main challenges related to Brexit in the clearing space

2.1 Fragmentation and financial stability implications

A policy-maker emphasised that Brexit was a fragmenting event. Generally, the EU financial system and the EU financial markets reacted well. However, Brexit has potential financial stability consequences in the clearing space that need to be tackled. The Commission indeed considers that having a high amount of clearing of euro products outside of the European Union following Brexit creates a dis-equilibrium and potential financial stability risks. Work is ongoing in this space to determine what can be done to improve the situation. All of this is also somewhat linked to the whole debate about the EU's open strategic autonomy.

That debate must not be seen as a zero-sum game or an opposition between the EU and the rest of the world, but as an objective for the EU to ensure its own financial stability with the various necessary market infrastructures including CCPs.

A Central Bank official stated that nine months after Brexit the trading and clearing landscape of the EU has already started to shift significantly. On the trading side, the market has been largely relocated to the continent especially to Amsterdam for equity trades. Such changes occurred without major difficulties thanks to the high substitutability of the EU in this area. On the clearing side the situation is more difficult to change, but following the Commission's recommendation to reduce systemic exposure to third-country CCPs, several EU participants have started migrating their positions in interest rate derivatives clearing for example to EU-based CCPs. Although these changes are moving in the right direction they are not yet sufficient to ensure EU financial stability. Some UK-based CCPs are still in a situation of quasi-monopoly for clearing activities in euro. This heavy dependence of the EU financial sector on third-country CCPs remains an important source of concern. The possible solutions that may include the de-recognition of some of the most systemic UK-based CCPs are being assessed by the EU public authorities from a financial stability perspective. The right balance needs to be found also taking into account the market and cost impacts in order to create the right incentives and provide market players with sufficient certainty.

Another Central Bank official stressed that while these post-Brexit financial stability implications need to be taken into account it is also important to consider that the clearing system is fundamentally designed with a cross-border perspective. When the reforms were put in place in 2008 they envisaged CCPs that would have deep pools of liquidity, and that globally significant financial markets would be able to rely on CCPs that were not necessarily tied to a jurisdiction. Currently there is an identical legal framework for clearing in the EU and UK, which provides the tools needed for that. Appropriately managing financial risks on a cross-border level requires deep information sharing and cooperation, which is already happening between the Bank of England and ESMA. The tools and interfaces to address post-Brexit financial stability concerns are therefore in place, as are international standards to ensure that regulation across borders is based on a common view and common set of standards, taking into account the lessons learned since the 2008 financial crisis. That can be a basis for addressing post-Brexit financial stability concerns in a way that does not unpick the global financial reforms put in place in 2008 and that leverages the existence of cross-border CCPs that not only contribute to financial stability but also make central clearing more economical.

An industry representative agreed that stability and resilience should be ensured from a cross-border perspective because markets, participants and currencies are global. By definition financial stability and resilience are a common objective for which global cooperation is needed. UK-based CCPs are global businesses with global participants based in a large number of jurisdictions. The resilience and stability in these CCPs should therefore be leveraged by having robust, resilient cross-border supervision and regulatory oversight, which is quite feasible. ESMA's third-country CCP supervisory oversight is moving in the right direction and is similar to the one conducted by the US CFTC and the Bank of England. In addition there is already proof that this can work since the majority of dollar products are cleared in the UK with oversight from the US. Cross border supervision is key to stability and resilience and we have the right tools to address concerns ex-ante threaded through EMIR.

A policy-maker disagreed about looking at financial stability only from a cross-border perspective. In addition, the argument that because everything worked very well in March/April 2020 proves that there is nothing more to do is somewhat short-sighted. The possibility of a highly unprobable event with very high impact happening cannot be excluded, which is why the EU needs to be vigilant when it comes to its own financial stability. That is why the issue of dependency on CCP structures in the UK is being considered.

2.2 Recognition of UK-based CCPs

An industry representative warned that there is a timing issue with the recognition of UK-based CCPs. EU market participants should be informed about what is going to happen in terms of regulatory developments as soon as possible and, at the latest, prior to the end of March 2022 in order to address the ongoing uncertainty confronting EU clearing members and their clients. If the temporary recognition is to expire at the end of June 2022 then UK CCPs will need to take steps to terminate membership of relevant EU clearing members in good time, meaning three months' notice, so as not to breach Article 25 of EMIR. Work on this important political issue has to speed up. Over-the-counter (OTC) derivatives are concerned as well as other segments such as cash equities. A further challenge concerns EU clearing members. Following the working groups on clearing set up by the Commission, it is understood that it is not currently the intention of the EU authorities to propose measures or incentives to both EU clearing members and third-country clearing members. However, a policy of euro clearing that would only apply to EU-based clearing members would be damaging for those firms from a competitive standpoint, and would not meet the expected political goal of the EU institutions.

The Chair stated that the ongoing review of the temporary Tier 2 CCP recognitions is a key priority. Following the publication of the methodology that would be used, the ESMA CCP Supervisory Committee has been embarking on comprehensive stakeholder engagement, collecting data from a wide variety of players. This will allow a deeper assessment than in the past of potential risk concentrations, cost issues and netting and liquidity issues This will help to inform the evaluation undertaken by the ESMA CCP Supervisory Committee and the Board of Supervisors, as well as the recommendations that may be made to the European Commission before the year's end.

3. Main remaining challenges and issues in the European clearing space

The Chair considered that there remains a wide range of risks to be tackled in the clearing space concerning CCPs, including market concentration risk, default management, and recovery issues. Some emerging challenges will also need to be taken into account going forward in the clearing space, including climate risk, cyber resilience and potential disruptions coming from digital innovations.

An industry representative added two further challenges that need considering: the reference rate reform and the implications of client clearing. Concerning the reference rate reform, globally the industry is in a major transition from the old LIBOR/IBOR to new reference rates. That is an existential challenge for the industry and a great source of risk. Although there is much talk about the technical details, the top priority for many firms is ensuring that they safely, soundly and seamlessly get all of the reference rate transition done over the course of the year, excluding dollar, for the IBORs and LIBORs. This is a cross-border, cross-regulator and multi-currency task which is particularly challenging. Secondly, access to client clearing and clearing member capacity will continue to be very important. Uncleared Margin Rules (UMR) phases 5 and 6 are coming in, as well as the clearing obligation for pension funds. Regarding repurchase agreements (repos), LCH has launched sponsored access both in the EU and UK in order to provide buy-side clients and dealers with access to reliable funding and liquidity, the importance of which was shown at the outset of the COVID crisis. Clearing plays a part in these improvements, but it is not the only solution. It is also important to be able to support the issuance of more recovery and debt instruments like NGEU (Next Generation EU) and SURE (Support to mitigate Unemployment Risks in an Emergency) debts.

Another industry representative added that for the upcoming MiFID II review open access needs to be further discussed. While it is generally understood that open access rules may need rethinking with the emergence of new infrastructures, ESMA recently issued a statement on open access to CCPs for exchange-traded derivatives (ETD) where it indicated that national competent authorities (NCA) are expected to not prioritise actions on this matter. On cash equities, the experience shows that open access spurred competition among market infrastructures and led to a general decrease of costs, demonstrating that it continues to be a relevant topic.

4. Ongoing regulatory and supervisory initiatives concerning EU and non-EU CCPs

A policy-maker noted that from a policy standpoint clearing supports the broader Capital Markets Union (CMU) and Economic and Monetary Union (EMU) agendas. It is regulated by the EMIR framework which demonstrated its fit-for-purposeness during the COVID crisis and will be completed and by the CCP recovery and resolution regime for which Level 2 technical standards are being defined with the support of ESMA. This regulatory framework is also broadly based on the international guidelines that were defined after the 2008 financial crisis and will be updated in a coherent way with international discussions in this area.

The Chair also emphasised the quantum leap that has been achieved in terms of CCP supervisory convergence in the EU with the implementation of the ESMA CCP Supervisory Committee which is now operational and is also starting to engage with third-country CCPs. There is a perception that EMIR 2.2 has not fundamentally changed the existing supervisory set-up for EU CCPs, but actually a huge amount of progress has been made with the ESMA CCP Supervisory Committee becoming a key cornerstone of the overall framework, monitoring college decisions, the actions of NCAs and possible changes in the margin models of CCPs. Another aspect which needs to be considered is the financial stability dimension and the fact that in clearing, and the CCP area in particular, risks do not necessarily concentrate in the host jurisdiction of a CCP, given the structure and the way the clearing business has been organised with the reliance on clearing members. That is recognised by EMIR 2.2, and the direct supervision by ESMA of those CCPs which are supposed to be of systemic importance for EU financial stability has been built up.

4.1 Margins, liquidity and anti-procyclicality measures

An industry representative was supportive of the reviews that are underway to improve current measures with a timeline set for year-end. The EU authorities are reviewing existing anti-procyclicality (APC) requirements to enhance their functioning. The international standard-setting bodies are also analysing the impact of the pandemic on margins and liquidity compliance. Some elements however need to be considered in the context of this analysis. First, in the bilateral space, where APC measures are not applied and the full rollout of margin requirements has been repeatedly delayed, the effectiveness of risk management standards to create a level playing field between the bilateral world and the CCP world has to be reassessed. Secondly, globally competing CCPs must not be incentivised to undercut margin requirements. A minimum standard that could ensure global consistency in this respect should at least be considered by the international community.

A Central Bank official stated that the question of initial margin (IM) has to be considered further, because the challenges observed were mainly due to the integration of market volatility by CCP models and not as much by position changes from members. The question of procyclicality and the need to have more global convergence on the tools and recommendations with respect to margin procyclicality and transparency remain key. A balance should also be struck between model reactivity to stress and the smoothing of peaks and troughs, because a situation where the same model would apply or be imposed on all CCPs may have the unintended consequence of reducing the anti-procyclicality benefits of a sound diversity of approaches. The official added that the FSB and CPMI-IOSCO are currently working on these important and challenging questions, which are however not the only ones to be tackled. Lessons should be drawn from all vulnerabilities observed during the crisis. In particular, there are improvements needed in member robustness, particularly in funds. There are also vulnerabilities related to the liquidity of some entities and issues related to liquidity pressures that need tackling. The CCP recovery and resolution framework also needs to be generalised.

An industry representative considered that the topic of operational resilience deserves more attention when it comes to infrastructure. Whilst margins are discussed a great deal, there has not been much discussion around the massive spikes in volumes handled by CCPs. There were large volumes across all of the different asset classes as well as large changes in asset prices. There were major flows, and very significant margin calls and margin flows as well. All of that put stress on the infrastructure. Although al went well during the COVID crisis, it is important to continue to find ways to embed a culture of operational risk resilience and risk management, not just in the CCPs but also in the wider settlement, payments and collateral ecosystem which is highly interconnected.

Another Central Bank official emphasized that looking at transparency is going to be fundamentally important. It is not certain that every CCP and every client understands the functioning and implications of margin models and that the level of transparency is sufficient. There is a need to improve this and to make sure that comparable metrics across CCPs and markets are available and also that these allow to define what level of IM requirements may be needed in normal and stress situations. Liquidity preparedness is a second issue to consider, especially concerning non-bank clients. There is a very wide range of practices and a wide range of preparedness. There is also an issue around potential liquidity management strategies all being the same. That is something that the FSB work mentioned by a previous speaker is addressing in particular.

There has to be more of an international conversation on these issues, the Central Bank official believed. The conversation within Europe ended up with EMIR and APC measures and now the level of implementation of these measures needs to be assessed, as well as their effectiveness. There is also a broader global conversation about responsiveness to volatility, which is an inherent feature of CCP models, and which should be maintained. However, there will be a trade-off between the initial margin level going into a stress and how quickly initial margin needs to rise in a stress. There should be a global conversation on the costs and benefits of that, together with some level setting. Not all CCPs were created equal and there has to be consideration of how to have a global conversation that allows regulators, supervisors and international standard setters to think about what is appropriate.

The Central Bank official agreed with a previous speaker that operational resilience is another important topic in this context. The Bank of England published a new policy on this in the last year to complement the EMIR requirements. The financial resilience aspects talked about with margin are important, but it is important to ensure that operational resilience keeps pace.

4.2 CCP recovery and resolution (R&R)

An industry representative noted regarding CCP R&R that the EU has taken a leading role globally in pursuing a regime that balances the needs of the different stakeholders. However, the fact that the second skin in the game that is embedded in the system may be financed by existing CCP capital means that it will not shift the loss-absorbing responsibility away from clearing members. There should not be any compromise on the incentive structures of the CCP. The level playing field dimension is also important here.

The international standard-setting bodies should continue their work in the R&R space, and the EU should actively participate in this discussion in order to put forward a balanced approach.

An industry representative stressed the importance of the publication of the proposed regulatory technical standard (RTS) on CCP R&R. The introduction of a second skin in the game in the form of a second tranche of direct CCP capital is welcome, although this will not be used before assets of non-defaulting clearing members have been used by the CCP. One important point are the calculation amendments of the second tranche of the skin in the game. This is still to be defined and the consultation is still open. While the range for setting this skin in the game is floored at 10% and capped at 25%, it is necessary that the set parameters should be well determined. Their institution, a major clearing member, favours a high percentage.