Clearing: priorities for enhancing financial stability and the EU clearing ecosystem

1. Approach concerning UK-based CCPs

1.1 Update on risk assessments and temporary recognition decisions

A regulator noted that ESMA has issued the outcome of its comprehensive assessment of the issues around systemically important third country central counterparties CCPs (TC CCPs). Three clearing services were identified as being of substantial systemic importance for the EU: SwapClear in LCH Ltd in relation to euro and Polish zloty, the credit default swap (CDS) and short term interest rate segments in euro within ICE Clear Europe. After a comprehensive cost-benefit analysis, ESMA concluded that the costs of derecognising these services would outweigh the benefits in the current situation, but identified a range of important risks and vulnerabilities associated with these clearing services which need to be addressed.

A policy-maker explained that clearing is an essential part of the Capital Markets Union (CMU). The Commission decided to extend the temporary equivalence decision covering the UK framework for CCPs by 3 years in order to avoid a cliff-edge, which would pave the way for ESMA to extend its recognition of UK CCPs under EMIR for the same period (i.e. until 30 June 2025). This delay will also give the Commission time to put in place a strategy for increasing the EU clearing capacity and ensuring greater financial stability. Initial ideas have been proposed through a public consultation.

1.2 Potential financial stability issues posed by the dependency of the EU on UK CCPs

A policy-maker stated that the Commission is paying considerable attention to clearing, because UK CCPs offer services that are critical to many EU players, but are now outside the EU regulatory and supervisory perimeter. This raises questions about how to manage potential financial stability risks posed by these CCPs. There have been some moves from European market participants over the last few months to open accounts at EU CCPs and engage with these CCPs for clearing but, according to the assessments conducted by ESMA, there continues to be an over-reliance on systemic third-country CCPs which could threaten financial stability, particularly in periods of stress.

A Central Bank official agreed that UK CCPs continue to pose financial stability risks to the EU, given the high volume of clearing occurring at UK CCPs. While clearing volumes for over the counter (OTC) interest rate derivatives have grown at EU CCPs, the current market share amounting to around 21% is insufficient and shifts to the EU have remained marginal. London also controls around 90% of euro swaps cleared and has a 90% global market share in interest rate derivatives. The exposure of EU market participants to UK CCPs therefore continues to be very high, which is not sustainable because of the dependency it creates and the exposure to possible disruptions in the operations of UK CCPs this may lead to, even though this is a tail risk.

An industry speaker disagreed with the remarks of the previous panellists about the financial stability risks posed by UK CCPs to the EU, emphasising that LCH Ltd for example is directly supervised by ESMA and subject to the EU EMIR law, and this will not change. LCH also has a deposit account with the European Central Bank (ECB), which is important for financial stability because collateral in Europe is held in cash at the ECB.

A Central Bank official agreed on the importance of ensuring financial stability in the clearing space, suggesting that the G20 decision that CCPs should be part of the solution to the financial crisis and problems in derivatives markets was made in full awareness that CCPs had to be cross-border and multi-currency. As a result of this deliberate G20 policy, clearing has grown. Regulators have to ensure that CCPs do not pose a risk to their financial markets. But this can be done without sacrificing the benefits of cross-border clearing, by developing tools to make sure that home supervisors, through cooperation, can provide safety and by moving in a direction to be able to give those assurances and avoid fragmentation.

1.3 The importance of EU-UK supervisory cooperation

A Central Bank official considered that major UK CCPs will remain systematically important for the EU in the foreseeable future, which means that close and constructive cooperation between the EU and UK authorities will be needed in the coming years. EMIR 2.2 already grants enhanced powers to ESMA to supervise and oversee Tier 2 systemically important CCPs, and ESMA has made several suggestions about how to improve its supervisory capacity in this regard. Legislative action to support this evolution will also be needed and in this respect the Commission's ongoing consultation is welcome.

An industry speaker emphasised that the solution for ensuring financial stability is to strengthen supervisory responsibilities and powers and also supervisory cooperation. Derivative markets are global by nature and any action to fragment them may create risks which cannot be foreseen. LCH is comfortable working with different countries; it has 11 different licences. With the adequate supervision, market forces will allow the market to evolve towards a structure that is relevant for the marketplace. For example five years ago the share of euro CDSs, single names and euro indices, cleared at LCH SA the Paris-based sister entity of LCH Ltd was 5%. Now it has grown to nearly 50%. Regulation did not push this to happen; it was achieved through efforts made by the CCP to provide products and services relevant for the marketplace.

A Central Bank official described how the Bank of England, as it implements its own version of EMIR 2.2, will ensure that there are very high standards of cooperation and transparency between regulators, especially where CCPs have a significant market share in a domestic market. Communication between the Bank of England, ESMA and other relevant authorities is frequent and the Bank of England believes it has the necessary tools and information to make sure that financial stability aims can be achieved with regard to CCPs.

In the UK, the Bank of England has consulted on an approach called 'informed reliance', the Central Bank official explained, whereby the UK authorities would not need to regulate a foreign CCP directly if there is a high level of information and cooperation. The level necessary will depend on the risks posed by a CCP to financial stability in the UK. The objective is to ensure financial stability without undermining the global clearing market. This system will only work if there is mutual trust however, which is why cooperation is important. UK regulators are also taking steps to make very clear that, even in times of crisis, they do not discriminate clearing members on the basis of nationality, because there is a need to consider financial stability from a global perspective. The path forward is to build more trust and comfort about cross-border activities and more visibility and reassurances about what may happen in the event of a crisis. This will make it possible to preserve the financial stability benefits of global CCPs. Moving in the other direction would be a mistake.

A regulator observed that cooperation is the underlying principle of both the UK and EU approaches. EMIR reflects this. For Tier 1 non-systemic CCPs, there is a principle of mutual reliance. For systemic CCPs, however, there must be consideration of the specific issues that these CCPs raise in terms of elevated exposures and supervisory approach needed for tackling crisis situations, in order to define appropriate further steps. The regulator added that the goal of supervision is both the safety and efficiency of infrastructure. This can be a difficult balance to strike, but it is an objective that is shared between supervisors across the world.

A policy-maker stressed that supervisory cooperation between the EU and the UK will remain crucial, but not all issues can be tackled that way. Reducing the over-reliance of the EU on foreign CCPs and the related risks also requires assessing options to further strengthen the EU clearing ecosystem.

2. Issues raised by the recognition of non-UK third-country CCPs

An industry representative suggested that there is a growing point of tension for EU clearing members and counterparties concerning the equivalence and recognition process of non-UK third country CCPs. The 'qualified CCP' status that is applicable to many foreign clearing houses that operate under a framework that has not yet been recognised as equivalent by the EU will no longer be available after June 2022. This status currently allows EU stakeholders to treat these CCPs in terms of capital requirements as if they were recognized as equivalent. If nothing is done to address this, the risk weighted assets (RWAs) allocated to transactions involving these third country CCPs will need to be multiplied by roughly 50 times, which will make it difficult for EU clearing members to continue providing services to their clients for these CCPs at a reasonable cost.

While the 3 year equivalence granted to the UK CCPs allow sufficient time to review and implement relevant solutions, the June 2022 deadline applicable to these other Third Country CCPs will come fast and the issues raised will need to be addressed shortly, the industry speaker emphasized. The CCPs affected by this problem fall into three categories. First, there are the US CCPs which are very important for EU stakeholders; the US framework is recognised as equivalent by the European Commission, but the process of formal recognition is still underway at ESMA and it is uncertain whether it will be achieved before the deadline. Secondly, there are local market CCPs based in China, Turkey or Latin America, which currently have neither equivalence nor recognition. Finally, there are authorised CCPs recognized by ESMA e.g. in India that are undergoing reviews in respect of EMIR 2.2, which will require agreement on a new memorandum of understanding (MOU). The range of market activities covered by these different CCPs is very wide, making this a significant issue for EU banks. The problem concerns mainly the second group of CCPs in local markets, because for the US and Indian ones there are recognition processes underway. Specific proposals have been made by the financial institutions concerned for addressing this issue on a case-by-case basis, for example solutions are being implemented in the US and UK to allow the non EU peers of EU banks to continue clearing with these CCPs, at least the Chinese ones.

A regulator agreed that this issue, which shows that clearing markets are global should not be obscured by the focus on Tier 2 CCPs. ESMA is currently reviewing another 33 existing recognitions under the new EMIR regime and renegotiating MOUs with around 17 jurisdictions. This will help to foster a common understanding among authorities about cross-border cooperation needs in a non-systemic context. All efforts are being made by the EU authorities to resolve the outstanding issues within the timeline.

3. Strengthening the EU clearing ecosystem

3.1 On-going consultation on the competitiveness of EU CCPs

A policy-maker emphasised that the Commission's consultation on how to improve the competitiveness of EU CCPs and clearing activities as well as ensure that their risks are appropriately managed and supervised is very open. It aims to create the conditions to make the EU a more attractive place to clear. Market participants are invited to put forward their ideas for improving the current situation. The consultation considers both the supply and demand sides. On the supply side, an important question is how to make it easier and quicker for EU CCPs to offer new products. At present, EU CCPs do not offer the full range of products needed by clients. On the demand side, various issues are being considered. One is the role that capital requirements could play, another one is the idea that market participants could open active accounts at EU CCPs. Another question is whether to broaden the clearing obligation itself. A third question is about the supervision of EU CCPs and whether it should remain local or be more centralised at EU level.

3.2 Current dynamics of the euro clearing market

An industry speaker considered that Europe is already an attractive place to clear and is already globally competitive in the clearing and market infrastructure space. There are more than 70 CCPs in the world at present, but only four are globally relevant: CME and ICE in the US, LCH in the UK and Eurex in Frankfurt. Eurex clears a wide range of products including benchmarks for European equity markets and exchange-traded derivatives. In risk management terms, a strong portfolio based margining approach is in place. The EU has also shown thought leadership on many CCP risk management issues, such as anti procyclicality, margin models, and how to manage recovery and resolution.

The industry speaker stated that the EU could have a greater level of sovereignty in euro clearing. The market was previously concentrated in London for many instruments, but now about 20% of the clearing volume has shifted to the EU through a market-led approach, although it is only 10% on the trading side (which is consistent with the figure previously mentioned of 90% of cleared euro swaps handled in London). This is not a question of technology or risk management standards, but of incentives. EU CCPs have the infrastructure and technology needed to handle significant volumes of transactions. On risk management, EU CCPs have all the necessary tools in place and this is not an area where CCPs compete. What needs to be recognized is that while London has developed as a hub where supply and demand for euro instruments meet, this situation may not last forever because this is not where the supply and demand originate. Inherently, the principal issuers of euro instruments are EU countries, followed by banks and corporates. London is not where euro exposures are ultimately housed either. These exposures are located in pension funds, the European insurance sector, banks and such. The EU has the ingredients to create a healthy and balanced alternative market for the euro, in competition with the UK CCPs. A market led proposal has been put in place by Eurex for example for initiating progress towards this objective with the incentivisation of 10 EU and non-EU banks and institutions to set up a liquidity alternative within Eurex, which also involves adjustments in the governance of the CCP.

Another industry speaker stressed that the euro is not only a European instrument but an international currency. It is a testament to the success of Europe as an economic zone and of European regulations, which have allowed the euro to become so internationally important. 73% of new trade registrations in LCH Ltd originate from non EU entities. This shows that there is a desire, with the discussion about the clearing of euro instruments, to create something local from a currency which is intrinsically global.

3.3 Possible measures to strengthen the EU clearing ecosystem

A Central Bank official considered it necessary to shift more clearing activities towards the EU over time in order to strengthen the EU financial market, but this will only happen if there are effective incentives. This can be achieved via three measures: improving clearing services in the EU, bringing additional market volume to central clearing in the EU and ensuring that EU market participants concerned build up their clearing capacities in the EU. Achieving these objectives will require the industry to develop a robust long-term strategy and make concrete improvement proposals.

An industry speaker was convinced that attracting additional clearing volumes to the EU could be done, agreeing with previous comments that the EU has some way to go to achieve higher market shares. The question here is around the supporting measures, which can be determined hopefully with the output of the Commission's consultation. A first measure could be to broaden the scope of application of clearing requirements. Many EU institutions, sovereigns and quasi sovereigns exempted from the central clearing obligations are or have become large issuers of euro instruments. Some exemptions, such as the one for pension funds should be reviewed, as proposed by ESMA, in order to get more institutions that hold euro exposures into the clearing ecosystem. Additionally, there are some obstacles that need to be lifted. For instance there are still outstanding issues in the area of hedge accounting. Banks must be able to switch their portfolios in a tax neutral way, if they move from a UK to an EU CCP. Finally, the idea of increasing the number of active accounts is a good one, because it will be possible to avoid cliff edge risks in 2025 if most clients have properly prepared for the transition by opening an account with an EU CCP and test-driven this alternative. At present, out of 600 potential counterparties, only 300 have active accounts at Eurex for example.

A Central Bank official suggested that there is an opportunity to improve the clearing landscape in Europe following the consultation process, with some time in hand to make changes. There is the scope for a fair rebalancing of risks between the EU and UK, because there is no point in having a global monopoly in derivatives. This will require a collective effort from the industry and from the regulators, but it should mainly be an industrial project. Regulators can help in their role as catalysts, but it is essential that they target the most efficient measures. Enhancing the offer for clearing will be essential. A number of proposals made by the Commission in its consultation paper are worth exploring, such as extending the clearing obligation for certain products or extending the scope of participants, if the risks can be properly managed. Another avenue could be to ensure that CCPs systematically offer the use of EU-based CCPs to clients.

The Central Bank official was also favourable to the objective of increasing the number of active accounts. However this action will only be efficient if it is accompanied by regulatory measures to ensure there is a sufficient flow of transactions going through these accounts, and it will not be a success if the measures can only be used if there is a problem. Quantitative aspects are also important, because volume will be required to build up the EU clearing offer. This effort should be supported by incentives and also targets to provide market participants with sufficient visibility. Thresholds for systemic CCPs or systemic clearing segments are already enshrined in EMIR. It would make sense for regulators to show the path for EU clearing by defining quantitative objectives that can be reached with a reasonable and gradual approach. In terms of supervision, the actions proposed should be pragmatic. There is no need for a major overhaul of the EU supervisory structure for clearing which seems quite efficient. It is essential to continue the current collegial approach, especially for CCPs, which have important liquidity needs and for which it is important that the central bank of issue is very much present in the discussion.

An industry speaker highlighted the need to be aware of the directionality of risk in clearing, when speaking about having more clearing activity in Europe. If a European CCP has a concentrated direction of risk, this may actually weaken EU financial stability rather than enhance it. In addition, it would not be surprising if LCH SA were to become systemically relevant for the UK, given the number of participants in the service which are based in the UK. Despite the fact that LCH SA is a euro CCP in terms of the underlying currency, it is very international because many of its participants emanate from the UK and not the EU. This shows again that it is challenging to tamper with markets that are intrinsically global. Every time there is fragmentation in the approach, it creates new and unforeseen risks for regulators.

As a concluding remark, a regulator agreed that tampering with the market could cause issues, but the European public authorities have a responsibility for financial stability and also preserving monetary policy when there are issues that concern the usage of the euro. It will be important to consider carefully the adequacy of the EU's existing supervisory structures in the context of increasing EU clearing volumes. There is also a global dimension to this and it will also be necessary to take a global perspective on how to address globally relevant financial market infrastructures.