Strengthening EU clearing: key issues and priorities

1. Current status of the EU clearing sector and main challenges to consider

1.1 Resilience of the EU clearing sector

The Chair explained that the situation of the EU clearing sector has been analysed in detail by ESMA in its comprehensive assessment of the risks and vulnerabilities that result from certain services of systemic importance provided by key CCPs (central counterparties) based outside the EU. Higher risk exposures were identified for certain targeted services provided by UK-based CCPs. The suitability of the existing supervisory framework to address and contain such risks was also evaluated. This assessment fed into the European Commission's (EC) comprehensive reflections regarding clearing in the EU and this process is ongoing following a public consultation issued by the EC on enhancing the attractiveness and resilience of EU clearing.

EU CCPs demonstrated their continued resilience during recent stress events in February 2022 that were close to worse case scenarios, the Chair observed. They were able to conduct their activities as expected and clearing members and clients were able to fulfil their obligations. However, these events also demonstrated certain vulnerabilities in terms of concentration and interconnectedness risks, in particular in the commodities and energy markets, that remain insufficiently addressed by the current regulatory and supervisory framework. Certain participants, mainly non-financial institutions, also experienced liquidity stresses during these events potentially putting the entire clearing ecosystem at risk. This may also lead to some further considerations in terms of market structure and access to central clearing.

1.2 Challenges posed by the reliance on UK-based CCPs

A policy-maker noted that clearing has a strong international dimension due to the global and interconnected nature of capital markets. This has led the EU to take a number of equivalence decisions in this area over the years with third-country jurisdictions, to ensure this international connectedness is maintained. There is however a specific situation with the UK following Brexit, with an excessive reliance of the EU on UK-based CCPs. This is related to the broader debate about the 'open strategic autonomy' of the EU and is an additional dimension to take into account with regard to the resilience of financial market infrastructures.

An official stated that the current situation where EU market participants continue to have large exposures to UK CCPs post-Brexit is not sustainable. There are inherent financial stability risks for the EU due to this that must be addressed in the medium-term.

Another official illustrated the financial stability benefits of cross-border clearing. Resilient cross-border CCPs in well-regulated environments help to enhance financial stability by a centralised netting of risk exposures and also by the diversification of risks provided by large pools of liquidity. Large CCPs, such as those in the UK, support the netting of exposures across counterparties, currencies and products and benefit from significant economies of scale and scope. The regulatory choices made as part of the G20 post-crisis reform package were made with a full understanding of these characteristics and of the global nature of the central clearing landscape. Fragmenting the market would split liquidity and drive clearing costs higher, which may reduce incentives to hedge risks, thus increasing the amount of risk to the real economy.

The G20 reforms have put CCPs at the heart of the global financial system, which is why questions about managing risk exposures in overseas jurisdictions are understandable, the official observed. The Bank of England is steadfastly committed to supervisory cooperation and informed reliance on other supervisors, in order to preserve the benefits of cross-border and interconnected markets while managing the related risks. Three main factors are important to consider in this context. The first factor is having equivalent high-level standards between regulatory regimes. The UK has on-shored EU legislation and in the resolution space, the Bank of England is going to be given additional powers to ensure that CCPs can be resolved in the most efficient way, bringing the UK into full alignment with Financial Stability Board (FSB) guidance. The second factor is strong supervisory cooperation and transparency both in business as usual and crisis situations. In this respect the Bank of England has agreed detailed cooperation agreements with European supervisors and other supervisors around the world regarding the supervision of UK CCPs and is committed to making those arrangements work. Additionally, the Bank of England was the first authority to establish global crisis management groups for CCPs, providing a framework for authorities to plan crisis management measures, including a possible orderly resolution, for CCPs that are systemically important in more than one jurisdiction. The third factor is non-discriminatory laws. Given the cross-border nature of clearing it is important to recognise the systemic importance of certain UK CCPs in overseas markets. As part of the Bank of England's new statutory objectives for financial market infrastructure regulation, specific obligations will be in law to consider the impact of the UK's decisions on financial stability in other jurisdictions and non-discrimination on the basis of clearing member jurisdictional location.

A policy-maker agreed that cross-border supervisory cooperation is essential for global CCPs, although it is not necessarily a sufficient tool in all crisis situations. That is why solutions for addressing the potential systemic risks from the excessive dependence of the EU on UK CCPs are being worked on. The fragmentation caused by Brexit and related cliff-edge risks remain a concern for the EU. Those issues have been addressed in the short term by the decision to extend the recognition of UK CCPs until 2025 but solutions are needed to reduce financial stability risk from this dependence in the medium term.

The Chair added that as part of ESMA's assessment of Tier 2 CCPs, several scenarios were identified in which the two Tier 2 CCPs established in the UK may potentially pose a financial stability risk to the EU or individual Member States. Distress or disruptions in the provision of critical clearing services could significantly destabilize financial stability in the Union, in particular given the size of the exposures of EU clearing members, clients, and currencies and the limited alternative clearing services in certain markets. In the field of crisis management, ESMA has currently only limited powers over Tier 2 CCPs, which constrains the ability of ESMA to act and mitigate the impact of a Tier 2 CCP recovery or resolution on EU clearing participants and financial stability. This is why ESMA is very supportive of the Commission's efforts to reduce the EU's excessive dependence on UK CCPs, but also to enhance the supervisory system to better withstand crises.

An industry representative stressed that interest rate swaps (IRSs) are a crucial component of the market from a risk management perspective and are a key output of the G20 reforms. What was possibly not anticipated is that the market for euro denominated IRS and for some other currencies would end up being concentrated in London. In this debate about the reliance on the UK for certain instruments and activities, it is important to consider that strong market infrastructures, such as stock exchanges and clearing houses which are not regional infrastructures but are among the leaders at the global level, have been successfully developed in the EU. The position is very different in capital markets from the type of dependence there is on third-country cloud service providers for example. Their institution, a leading EU-based CCP, has licences in many jurisdictions in the world, including the US and Asia, and trades the global benchmarks in the equity and fixed income sectors. They are also active in the IRS market.

2. Measures proposed for strengthening EU clearing

The Chair emphasised that strengthening the EU framework for CCPs is important both from a financial stability perspective and for building the capital markets union (CMU), due to the central role of these infrastructures for the functioning of capital markets.

A policy-maker agreed that linking the clearing debate back with the CMU is very relevant, as clearing is indeed a key element for the development of capital markets. In the feedback to the Commission's recent consultations there was a confirmation of the importance of looking at the supply side in terms of how to increase clearing capacities in the EU, but also looking at what needs to be and could be done on the demand side to encourage more use of EU-based CCPs. The EC is assessing the potential impact of incentives and disincentives that may be used for increasing central clearing in the EU and considering how supervisory arrangements may have to evolve in this perspective. The aim is to put forward legislative proposals later this year.

2.1 Policy measures proposed

An official observed that different measures enabling EU CCPs to expand their EU-wide clearing capacities and to attract additional clearing volume need to be implemented in order to reduce the large exposures EU market participants have to UK-based CCPs and the related financial stability risks. Market participants and supervisors also need guidance on how to assess the progress made towards reducing the overreliance of the EU on UK CCPs. Explicit overall exposure reduction targets or guidelines on an overall plan to reduce the exposure to UK CCPs could be established.

An industry representative suggested that the measures for strengthening EU clearing need to find an appropriate balance between regulatory requirements, guidance, and measures to improve the attractiveness of the EU clearing market, the latter option potentially being the most effective. A widening of the scope of the clearing obligation and extending voluntary clearing seem appropriate. EU public institutions should voluntarily clear in order to increase the intrinsic liquidity in the EU market and show confidence in central clearing. That would contribute to attract further investment by non-EU clients in the EU market. The expiry of the clearing exemption for EU pension funds could also bring further intrinsic liquidity, provided appropriate measures are put in place to accompany this change. As the main issue for pension funds is to convert their securities into cash to face margin calls, they are dependent on the proper functioning of the repo market at all times at reasonable pricing conditions. This requires ensuring that banks are able to support these activities, taking into account the prudential treatment of securities financing transactions (SFT) activity (capital requirements and balance sheet leverage ratio) which needs to be amended, and possibly providing a fall-back repo facility at the ECB available to banks in difficult times, especially for European government bonds, to support the increasing needs of pension funds. Sponsored clearing which extends the benefits of direct CCP membership to the buy-side may also be part of the solution, but it is not in the speaker's view the optimal solution, for risk purposes.

The industry speaker moreover emphasized that the fact that EU clearing members do not have a dominant market share also needs considering. Forcing EU banks alone to move their liquidity to EU CCPs may harm them and not have a significant impact on the overall market in the absence of measures also targeting non-

EU actors such as binding extraterritorial measures, which are not on the table at this point in time. Indeed non-EU actors are not particularly inclined to move to an EU CCP because of the current lower liquidity pool. In addition, given that for non-EU players the main currency in which they operate is not the euro in most cases but the USD, moving to an EU-based CCP may reduce their current level of cross-currency netting efficiencies.

A second industry speaker also welcomed the measures proposed by the EU authorities for strengthening EU clearing, although some may be better suited than others to accelerate the build-up of volume. Broadening the list of institutions and instruments subject to mandatory clearing seems a good idea in particular e.g. including other sovereigns/quasi-sovereigns and the pension funds.

A third industry representative suggested that in terms of policy measures, the EU should stay away from any restrictive measures, which may destabilise markets, focusing instead on EU competitiveness, international attractiveness and supervisory cooperation with the home supervisors of non-EU CCPs. Measures that would result in locking EU firms into the EU or into EU CCPs would impede competitiveness. The same goes for any artificial impediments that may be put in place, such as higher capital charges on EU firms clearing in non-EU CCPs. What is mainly needed for reinforcing clearing on the continent is a regulatory level playing field ensuring that the EU is not at a disadvantage compared to other jurisdictions, because clearing services are very international. In this perspective, EU clearing obligations need to be reviewed to ensure consistency with the US in particular. The US has a CDS (credit default swap) clearing mandate, which the EU does not. The Derivatives Trading Obligation (DTO) is also somewhat restrictive in terms of being able to clear European CDS in EU CCPs. Addressing these issues will make EU clearing more competitive and will benefit the clearing system.

A fourth industry representative stated that one important factor to consider in the context of this initiative is the reduction of the number of the players actively participating in market infrastructures with the growth of internalisation related to order execution services provided by certain intermediaries. This is detracting flows from infrastructures that operate in a more transparent way and is potentially impacting the quality of price formation and the competitiveness of EU post-trading. While the measures proposed by the EC to enhance the competitiveness of EU markets, such as increasing the scope of players accessing CCPs, broadening the range of collateral included and active account requirements are positive, it is necessary to ensure that all market stakeholders, including financial intermediaries, are moving in the same direction. It is important also to bear in mind that clearing is a global environment and the products are easy to substitute. The flows can go to different jurisdictions depending in part on the regulatory framework. Therefore the proposals made by the EC should aim to enhance the attractiveness of the EU central clearing market. A harmonisation of rules concerning Central Banks is moreover needed to allow an equivalent access to the facilities of the Central Bank, extend timetables and conclude reciprocal agreements between Central Banks with regard to clearing activities.

The Chair noted that there is a need to evaluate precisely the potential impacts of the different proposals that are on the table and make sure that they are calibrated in a way that does not create unwanted side effects. This assessment should not be limited to the bipolar situation between the UK and the EU but should take into account the broader clearing market. Measures should also consider the functioning of the wider ecosystem, including clearing members, intermediaries and clients, also bearing in mind the reduction of the number of financial institutions willing to take on clearing business in the current environment.

2.2 Market-led initiatives

An industry representative emphasised the importance of market-led solutions for developing the EU clearing capacity. Their institution, a major EU-based CCP, is growing an EU-based alternative pool of liquidity for the clearing of euro denominated instruments, providing efficiencies across listed and over-the-counter (OTC) instruments to portfolio margin the euro exposures, with repo as an important component. An alternative liquidity pool was launched for euro denominated IRS with the support of 10 financial institutions who share the governance and the benefits and which now represents a 20% market share in this segment. This shows that it is possible for the EU to be competitive in this business and this EU-based pool of liquidity can also help to limit cliff-effects if the recognition of UK CCPs is discontinued at relatively short notice.

Another industry representative further illustrated the potential of market-led solutions for developing clearing capacity in the EU. Their organisation, a major UK-based CCP which also has a large EU-based business clearing euro fixed income and equities in particular, was able to also acquire a significant position in the European CDS business over the years, reaching a 50% market share thanks to a continuous investment in developing risk management practice and business development with clients. This shows that it is possible to develop capacity on the continent through market-led initiative.

2.3 Mandating live accounts at EU CCPs

A Central Bank official suggested that to foster the usage of EU-based clearing houses, a regulatory requirement for EU clearing members to establish and maintain an active clearing account at an EU CCP should be introduced. Such an account could be accompanied by a predetermined minimum activity level, which could be adjusted quantitatively depending on the remaining level of systemic overreliance on UK CCPs.

An industry representative agreed that mandating a second active account with an EU CCP seems appropriate from a systemic risk perspective in order to allow market participants to test-drive their connection with an EU-based CCP. A second industry speaker was favourable to a qualitative assessment of the benefits and possible impacts of active accounts. Such a measure needs to be handled with care because of potential impacts on market liquidity and trading decisions.

A third industry representative explained that implementing an active account requirement at EU CCPs aims to encourage EU clients to seek a credible clearing solution in the EU for derivatives of substantial systemic importance and also to make sure there is a reliable fallback option if the access to the UK CCPs is for any reason suddenly stopped. This is an account where open positions are held with daily margin calls in order to ensure that payment channels are operating smoothly at all times. Starting with a market-led approach for the implementation of this tool, supported by qualitative guidance defined by the public authorities, seems preferable to legislative measures that will be longer to put in place. Regulatory measures could however be developed in parallel, so that they can be implemented if there is insufficient impact from the market led approach at the end of the temporary equivalence extension period for UK-based CCPs (2025). In addition, imposing a minimum quantitative threshold in absolute or relative terms is not the right approach. However, if this option was retained, the client-clearing and market-making activities conducted by EU banks for non-EU clients (and EU clients which are not subject to the clearing obligation) should be carved out from this threshold. Care must also be taken that EU clients do not suffer from such measures. In this perspective, further data need to be gathered during the transition period, about the extent to which EU clients rely on non-EU clients clearing at UK CCPs to match their hedging needs. If the level of dependence is still high that will mean that cutting the access of EU clients to UK CCPs would be detrimental to them in terms of cost and margin predictability.

3. Improving the supervisory approach to clearing activities in the EU

The Chair noted that the EU needs an agile and effective supervision of EU clearing activities and also of the interactions with third-countries. ESMA has made proposals for streamlining these activities that could be implemented very quickly, What is sought is a more effective supervisory system with a holistic view on the users of CCPs, the interconnectedness with the rest of the financial system and the allocation of risks in the market.

An official observed that the current supervisory system based on colleges has a good track record and it is important to make sure that all relevant stakeholders are involved in the supervisory process. Significantly changing the current system with a greater role for a new EU supervisory authority does not seem necessary at this stage. An enhancement of the current supervisory processes and procedures aiming to preserve financial stability would be preferable.

An industry representative felt that the supervisory structure of EU CCPs is currently too complex with a multi-layer supervision, including the ESMA CCP Supervisory Committee, the college of supervisors of each CCP, and the National Competent Authorities (NCAs) concerned, resulting in excessively slow processes to launch new products and services or implement changes to risk models or parameters. In addition, timelines are not defined precisely enough. This is a significant impediment to EU CCPs' time-to-market and their competitiveness relative to non-EU CCPs. There are some recent examples of product approvals taking two or three years to complete as in the case of the sponsored clearing of repo business for pension funds, which is a critical product to launch given the planned removal of the clearing exemption for pension funds that will need an access to liquidity in the future. Authorisation processes take much less time in other jurisdictions, which is a competitive disadvantage for EU CCPs in a global market where first-mover advantage can be decisive.

Moving towards a higher degree of EU-level supervision could help simplify and improve these authorisation processes, the industry speaker suggested. Solutions can also be proposed to shorten approval timelines and enhance the transparency of authorisation processes, such as introducing non-objection mechanisms or self-certification rather than full authorisations and parallelising certain steps of authorisation processes, rather than having to go sequentially through the different regulatory bodies involved. The criteria in Articles 15 and 49 of the EMIR regulation, which determine the need to go through an approval process for new products or services or for changes to CCP risk management models and the procedures for consulting the supervisory college on these changes, should moreover be more proportionate to potential material impact on risk, allowing CCPs to move faster when impacts are limited. This requires a more precise categorisation or tiering of what is really a material shift in terms of risk and operations, similar to those that exist in some other jurisdictions.

A second industry representative agreed with the comments made about time-to-market. Whilst the principles behind the current regime under Articles 15 and 49 are relevant, practical thresholds and timelines need to be set. Approvals for simple changes such as adding a clearing currency in a product like IRS can take over a year to obtain. Comparatively, in the US there is a non-objection system with a 10-day filing period and more self-certification. If the US CFTC raises questions or objects to a new product during that period more information needs to be provided; otherwise, the product can go live. Improving such authorisation processes is essential, but this does not require changes to the supervisory setup. The first step is to define appropriate thresholds of what needs to go through a detailed approval process.

A third industry representative was also in favour of measures to accelerate time-to-market, because remaining competitive in the clearing space requires launching many new products. There are different perspectives across EU jurisdictions on how supervision and approvals should be conducted. Some timelines are defined in the EU, but not for the entire process and all authorities involved. Which authorities to involve should also be defined more precisely, depending on the importance of the adaptations desired and potential risk implications.

A fourth industry representative was very supportive of a stronger and simplified role for ESMA regarding EU CCPs, for easing, shortening the time-to-market and also enhancing supervisory cooperation between the EU and the UK for third-country CCPs.

The Chair acknowledged that time-to-market is an issue. ESMA has defined stringent and short deadlines for the actions it undertakes, requiring a reaction within 20 business days, but there are often no fixed deadlines at the domestic level. Some specific suggestions on what could be done to streamline and improve these processes have been made that need to be further considered.