Strengthening EU clearing

1. Strengthening EU clearing and reducing over-reliance on offshore clearing

1.1 Proposals made by the European Commission to review the EMIR framework (EMIR 3)

The Chair stated that, about 16 months ago, ESMA published a report on the risks resulting from the overreliance of EU entities on UK-based central counterparties (CCPs) for euro-denominated derivatives. Three clearing services considered to be systemically important for the EU, particularly in times of stress, were identified: interest rate derivatives denominated in euro and Polish zloty and short-term interest rate futures and credit default swaps denominated in euro. The factors considered included the size of exposures of EU market participants, interconnections between these services and the EU and the availability of alternative services in the EU. The Commission then proposed a review of the European Market Infrastructure Regulation (EMIR 3). Since then, a number of events in the banking and CDS markets have demonstrated the need to continue paying close attention to the resilience of CCPs.

A policy-maker stated that the EMIR 3 review, which is part of the latest Capital Markets Union (CMU) action plan is as much about CMU as it is about Brexit. Recent years have shown that overreliance on a single external supply source in critical sectors can be risky. Supply chains can be broken, so one needs a minimum domestic capacity in key areas and then to diversify the rest. This reasoning applies to critical financial activities, including central clearing, although diversifying is difficult in clearing because it is a market where economies of scale and scope encourage concentration. There is also a need to build a domestic capacity in clearing as a basis for a large and integrated EU capital market as part of the CMU initiative. The strategic dimension of clearing appeared more acutely with Brexit, because a large part of the capacity was outside the Union for certain instruments. Following Brexit, the risk emerged of significant divergence in the rules. There has since been no evidence of divergence in how CCPs are regulated, but political rhetoric in the UK about potential deregulation created concern in the EU, which impacted on the framing of the technical discussion. Strengthening EU clearing, which is one of the main objectives of EMIR 3, is an important issue both in terms of strategic autonomy and of market development. There has been some modest movement in onshoring critical clearing activities since Brexit, but it is not sufficient.

The proposal that the Commission adopted on 7 December 2022 has three main objectives, the policy-maker explained. First, to create a clearing ecosystem in the EU that is sufficiently competitive, with measures to streamline administrative procedures and to better reflect the risk-reducing role of CCPs in counterparty credit risk. The second objective is to improve the safety and resilience of the EU clearing ecosystem, with enhanced supervision of EU CCPs and a reinforced EMIR framework. The focus is on improving monitoring of cross-border risks and strengthening EU supervision. The third objective is to enhance the economic security of the EU with measures such as the introduction of mandatory active accounts in EU CCPs. For these different measures, the European Commission will define the principles, while ESMA determines the parameters. The market has been consulted on these proposals, which aim to create positive incentives rather than new restrictions. The costs of fragmenting liquidity with these measures have to be balanced against the strategic objectives. These issues will be fine-tuned, once EMIR 3 is adopted by the co-legislators.

The Chair noted the need for a certain agility given the constantly evolving environment. ESMA will contribute to the fine-tuning of the measures with further assessments if needed.

1.2 Implications of the strategic autonomy objectives of EMIR 3 for the EU clearing market

An industry speaker stated that care should be taken to meet the objectives of EMIR 3 without negatively impacting the competitiveness of EU clearing members and their clients. EMIR 3 will provide useful improvements and simplifications in different areas such as the authorisation of new clearing services, the recognition of smaller third-country CCPs and eligibility of new forms of collateral at CCP level. However, some measures may impact the competitiveness of EU firms if they are not appropriately calibrated. For example, the proposed Pillar 2 prudential rules could be an additional barrier for EU clearing members in providing services to clients, while non-EU banks would not be subject to the same rules.

A second industry speaker explained that the global IRS clearing market grew significantly following the 2008 financial crisis and the measures mandating the central clearing of standardised derivatives. The problem is that the market has tended to concentrate in one location now outside the EU. This raises issues of open strategic autonomy for the EU and also of market structure due to limited choice and competition in the market. This has led Eurex to build an alternative liquidity pool for Euro swaps in the EU over the last five years, which has now reached 20% market share in notional outstanding amounts.

1.3 Issues raised by the active account provisions

An industry speaker welcomed the EMIR 3 proposal requesting market participants subject to the clearing obligation to maintain an active account at an EU CCP for systemically relevant products. This targeted measure should allow the rebalancing into the EU of a proportion of clearing activities currently performed at Tier 2 UK CCPs, whilst simultaneously allowing for flexibility with the possibility to continue clearing in London. If non-EU clients of an EU bank prefer to execute a trade in London, that should be possible if the client does not fall under the EMIR clearing obligation. The clearing market structure in the EU will need to satisfy the EU's objectives while remaining accessible to global clients.

This proposal strikes a good balance between EU financial stability interests, the protection of EU taxpayers, and market participants' competitiveness concerns, the industry speaker believed. It is important to have a starting threshold at Level 1 for this measure to prevent uncertainty while technical standards are elaborated, which can take up to 2 years, in a context also where the temporary recognition of UK-based CCPs will expire at the end of June 2025. As regards the calibration, a risk-sensitive methodology paying due regard to EU dealers' activities around market making and non-EU client services would be appropriate. European banks should not be disadvantaged.

A second industry speaker considered the active account measure would be a workable solution if it was designed as a qualitative requirement. If rigid quantitative thresholds are imposed, that will likely result in a spread between euro derivatives cleared at EU and at UK-based CCPs, creating a major barrier for the provision of clearing services by EU financial institutions, unlike non-EU ones, at the expense of EU clients. This measure needs to be carefully calibrated, excluding from its scope non-EU clients and EU clients not subject to EMIR clearing obligations.

An official emphasised that the systemic risks identified in 2021 by ESMA posed by the exposure of the EU to UK-based CCPs have not diminished. The tensions regularly observed in the markets warrant a strong commitment on the part of the public authorities to reduce these exposures. At the same time, the situation in the market is evolving. The building up of clearing capacity in the EU in the CDS and IRS markets may lead to a rebalancing of exposures over time. The implementation of the active account requirements should be looked at very closely in this context. Quantitative requirements are needed to provide incentives, but they should be appropriately calibrated. For the sake of simplicity, it might be best to start from a large basis and then adjust requirements over time according to how the level of systemicity evolves. Intermediate steps can be taken to reach a final target of ensuring that systemicity is no longer substantial.

It is also a matter of monitoring by the authorities, the official suggested. First of all, there could be target-setting in the Level 1 legislation or the regulatory technical standards (RTS). There could then be regular points of review to ensure that the process allows an appropriate reduction of risk, that there are no disruptions to the markets and that participants can absorb the costs. This measure can be implemented intelligently through dialogue with the industry. The measurement of costs and benefits is also very important. A second official agreed that calibration is essential in relation to the active account measures. Caution is needed when calibrating the provision in terms of timing and size.

An industry speaker stated that clients generally do not want to be mandated to keep an active account at EU CCPs. With the June 2025 deadline coming up, their priority is to be able to have continued access to UK and other third-country CCPs, but if the choice is made to implement this measure, then the implications need to be clarified. It targets the clearing services considered by ESMA to be systemically important for the EU, but the broader context needs considering. The EU firms operate in a global market. They represent 17% of the total interest rate derivatives notional traded or cleared, and the euro is about 30% of the total market, but the vast majority of the euro traded and cleared is traded by non-EU firms. As is proven in the data, most clients in the EU will trade as much non-euro as euro instruments. Clients need to continue to be able to access the global liquidity pool to manage their risk and remain competitive.

What is driving market participants in their decision-making is not speculation, but the hedging of underlying real economy risks, which is why there is a difference of opinion in the market about the active account measure, which will remove these efficiencies. There can be a trade-off between efficiency and EU economic security, but it is necessary to be conscious that this will damage EU firms' competitiveness and increase costs if measures are not appropriately designed. An appropriate balance needs to be found between these two objectives. An active account requirement may also damage the safety of the overall ecosystem, because a mandated market fragmentation will lead to a smaller pool of liquidity with more directional risk.

Alternatives exist for solving these challenges, the industry speaker suggested. Some elements of EMIR 2.2 designed to address cross-border risk, such as cross-border supervision and cooperation, can be used. LCH for example is directly supervised by ESMA and also by the US CFTC. This is a proven model that has worked including during periods of stress. If there is a need to go further e.g. in terms of recovery and resolution, that can be defined between ESMA and the Bank of England using the EMIR MoU. The bottom line is that supervisory concerns need supervisory solutions rather than structural fragmentation.

The Chair summarized that the substantial systemic relevance of certain clearing activities cannot be suitably tackled with the existing framework or even by some incremental improvements of the current cross-border supervisory structure. Additional measures are needed that appropriately balance the different necessities and intentions. There should not be too many expectations attached to the active account concept as a single measure however. ESMA has been calling for an array of complementary elements that may help reduce risk and enhance the attractiveness of EU markets.

1.4 Improving CCP supervisory processes in the EU

The Chair noted that the EMIR review will also affect the supervision of EU CCPs. There are still supervisory issues to deal with in this respect. A clear example was what happened recently in the energy and gas markets, with issues of concentration and interdependency that require an adequate supervisory framework and an EU-wide perspective. The Commission has made some suggestions to streamline the supervisory approach to CCPs and enhance its consistency. ESMA also has a critical role in ensuring that sufficiently robust and accessible data and reporting requirements are available.

An official was favourable to a strengthening of the role of ESMA in the supervision of CCPs, but observed that in order to do that effectively, two conditions have to be met. The first is to maintain a clear division of responsibilities between the national competent authorities (NCAs) that are responsible for supervision and the European supervisory authorities (ESAs) responsible for the convergence of supervisory practices. These are two strongly interrelated but different objectives. The second condition is that the new measures proposed should not add complexity to an already complex supervisory framework. Greater involvement of ESMA in key supervisory activities and in emergency measures concerning more than one CCP is important. Granting ESMA a voting right in the EMIR colleges also seems an adequate solution, but the current situation where both ESMA and the NCAs play a leading role in steering the supervisory colleges should be maintained, rather than evolving towards a sole chairmanship by ESMA, because the ultimate responsibility for the safety of CCPs and the fiscal responsibility rest at the national level. In addition it is important that the responsibilities of the national and European authorities are not confused. In this regard, it is not advisable to give ESMA and the supervisory college the power to issue opinions on the results of the annual reviews and assessment processes of CCPs conducted by the national authorities.

The official added that, five years ago, the IMF, in its Financial Sector Assessment Program for the euro area, had suggested that the Eurosystem should further harmonise CCP access to central bank accounts and liquidity provision for financial stability and also competition reasons. Progress still needs to be made in this area, which is under the responsibility of central banks.

An industry speaker welcomed the Commission's proposals to improve the EU supervisory framework. Enhancing the competitiveness and robustness of EU CCPs is vital for EU long-term prosperity and the stability of the financial services industry. In particular the proposal around streamlining the approval processes for new products and services is positive although it was long overdue. Time to market, both on new products and services, is important in a globally competitive market. Similarly, the ability of CCPs to adjust and improve their risk management quickly but sensibly is critical in times of market stress.

2. Measures taken in the energy markets

2.1 EMIR 3 proposals regarding energy markets

A policy-maker stated that much of the political attention paid to the clearing of energy derivatives in the EU was triggered by the stress that some participants experienced in 2022 in meeting their margin calls. Prices went high and became volatile, as well as margin calls. That was expected, but for some companies in the market, that stress resulted in a need for public intervention, mainly in the form of liquidity guarantees.

The European Commission decided to take the opportunity of EMIR 3 to address some of the issues and sources of stress underlying those events, the policy-maker explained, by proposing a wide range of measures for improving the current rulebook. The measures include providing an improved transparency of CCP margin models, improving CCP participation requirements to be met by corporates, broadening CCP eligible collateral in line with the temporary measures put in place during the energy crisis, enhancing reporting requirements on the intra-group derivative exposures of corporates to improve the calculation and review of clearing thresholds, and fostering a greater consideration of the impacts of intraday margins. The proposed amendments came rather late in the legislative process and were not included in the impact assessment, so they will be finalised through targeted consultations with the market, involving people who can have an expert view on these matters.

2.2 Issues to be taken into account in EMIR 3 measures concerning energy markets and margin requirements

An official supported the structural measures proposed in EMIR 3 regarding energy markets and added that the decision was also taken to introduce a cap on the price of pipeline gas as a temporary one-year measure. It is a variable cap because it is linked to the price of liquified natural gas, which is widely traded. It is not the objective of public authorities to intervene on market prices, but last summer was an extraordinary period. At the end of August 2022, the price of pipeline gas in Europe was 10 times higher than its 10-year pre-Ukraine war average. ESMA was tasked with monitoring this price cap mechanism in order to identify any unintended effects. The mechanism only entered into force two months ago, so it is still too early to fully evaluate its effects. In addition, the market situation has improved since. It is however essential to appropriately assess any unintended effect in a timely manner.

The Chair noted that there are some specific technical aspects on market functioning and price formation to keep a close eye on. ESMA is currently reflecting on the potential consequences of this measure and whether it should be perpetuated. In addition, there is also an on-going discussion about the procyclicality effects of margin models. The technical standards in this regard are being reviewed and it is being considered whether the recent stress events necessitate a rethink of the approach. The revised RTS will soon be published, but this goes hand in hand with the need to have transparent and predictable margin movements.

An industry speaker welcomed the transparency improvements in EMIR 3 about margins. The new obligation for clearing members to inform their clients in a clear and transparent manner about margin calls and CCP margin models, including in stress scenarios, providing them with margin requirement simulations under different scenarios is quite relevant. The recent events on the energy markets have shown that huge changes in margin calls coming from CCPs could happen, including on an intraday basis. For clearing members and their clients, meeting these huge margin calls in cases of stress requires significant efforts in terms of liquidity management and also the use of appropriate tools to interact with clients, in particular in stress periods. Unexpected movements in margin calls could indeed cause additional stress for clearing members and their clients and could ultimately hurt financial stability.

The industry speaker regretted however that there is no equivalent requirement for CCPs vis-à-vis their clearing members. This makes it challenging for clearing members to fulfil their requirements. The CCP transparency obligation that currently exists is limited to initial margins (IM), whereas the clearing members' obligations extend to all margin requirements including variation margin (VM). Moreover, the information currently given by CCPs is sometimes insufficient in periods of stress and may be subject to various disclaimers regarding completeness or accuracy. The obligation would be more manageable if clearing members were systematically and adequately notified before any significant change, e.g. in the context of the CCP risk committee.

2.3 The approach to margin procyclicality issues at the global and US levels

An official stated that margin calls are procyclical by nature. It is when stress comes up that additional margin is needed in the system, resulting in margin calls. The real question is about how to mitigate procyclical effects effectively, enhancing the liquidity preparedness of market participants potentially entering into stress situations with regard to their derivatives portfolios. This has been a topic of discussion at the international level for a few years now, particularly since the pandemic hit in March 2020 and the markets experienced unprecedented volatility. Central banks had to engage in decisive interventions to support and preserve stability. This led to a data-driven exercise under the combined efforts of the Basel Committee, CPMI and IOSCO. The CFTC has been co-chairing this project with the Bank of England.

Based on an empirical assessment of margin dynamics, a report was published at the end of 2022 setting out areas for further work that could lead to policy proposals or considerations. Six areas were identified aiming to make the system safer. One is increasing transparency of CCPs vis-à-vis clearing members, and of clearing members vis-à-vis their clients, so that market participants are better prepared for tackling margin call increases. Other areas of possible policy development include liquidity preparedness measures that market participants may undertake to brace themselves for the impact of potential margin calls and to have resources available when stress times hit, tackling data gaps and improving transparency to regulators and market participants where appropriate.

The official added that VM, which can only be met by cash, typically eclipses the size of IM in terms of calls by an order of five to six times, leading to substantial liquidity demands. The enhancement of VM processing within the clearing ecosystem is a topic under discussion. On the responsiveness of IM to stress, which is the topic of procyclicality, two main issues are being considered. Firstly, how to improve the understanding of market participants of the responsiveness of IM. Secondly, how IM procyclicality can be dampened. These issues concerning VM and IM are also being assessed with regard to the non-cleared OTC space. This work is in its second phase, the policy phase, and is likely to produce a consultative document in mid-2023 that will be shared with market stakeholders.

3. Further issues in the clearing space (uncleared derivatives, digitalisation, crypto…)

An industry speaker stressed that the uncleared derivatives market remains a major pain point. Some of the recent crises have showed this. Many of the lessons learned from clearing can be applied to the uncleared derivatives market and the assessments and policy work underway in that space are welcome and should be pursued.

An official stated that the impact of digitalisation on clearing is a further area to be considered by regulators. So far, DLT has mainly been used in the settlement space, but it is likely that the technology will also be tested by CCPs. New activities such as the clearing of derivatives on crypto assets also need considering from a policy perspective. These activities raise some new challenges for both CCPs and regulators because cryptoassets have specific risk profiles in terms of liquidity risk and high volatility. CCPs would have to adapt their risk management framework and ensure that they capture the right data. The market is quite limited in depth, which is a challenge for regulators and it is fairly recent so there is not that much data. The regulatory framework will have to be adapted to this new type of activity and a careful monitoring of the development of these activities and the related risks will be needed.

The Chair concluded the discussion by noting that the impacts of digitisation in the post-trade clearing and settlement space need considering, because they bring both new opportunities and potential risks.