ENHANCING CENTRAL CLEARING IN THE EU

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The case for central clearing supervision

Cleared markets are not as static as often portrayed. Since the end of the EMIR 2.2 negotiations in March 2019, the clearing landscape in the Union has undergone major changes and has been exposed to important challenges, with EU CCPs expanding their services across markets, currencies and owners.

In less than five years, the number of EU CCPs has risen to 14 with a new CCP established in Croatia, 15 new clearing services have been launched and could be offered EU-wide as a consequence of EMIR, and 3 EU CCPs have gone through acquisitions, including two from non-EU groups. More importantly, 2 cleared markets that are essential for the Union's financial stability, namely euro-denominated repo and CDS markets, have moved or are currently moving at least in part to the continent – and more can be expected to come as a result of the EMIR 3 discussions.

These developments have contributed to a significant increase in notional amounts cleared and in margins collected at EU CCPs, with an increasing concentration of some products at certain CCPs, serving clearing members and clients from all of the EU and beyond. The increasing size of exposures and their concentration have implications for the stability of the EU as a whole and raises necessary questions as to the suitability of our CCP supervisory framework.

A first consideration stems from the design and the role of CCPs. CCPs have multiple connections with key financial market infrastructures and users ranging from large investment banks to corporates and pension funds. All these entities answer to supervisors with different mandates which currently lack a central coordination function to ensure that supervisory responses complement one another and do not diverge. This is true in particular in times of stress, where national supervisors of CCPs will likely focus on maintaining CCP operations at all costs, whereas the competent authorities of clearing members and clients may prioritize the stability of their supervised entities – possibly at the expense of the broader interest of financial stability overall.

A correlate to this resides in the cross-border nature of these cleared exposures, as the said investment bank or pension fund may not be established in the same country as the CCP. This degree of interconnection implies that a disruption at a CCP established in one Member States will necessarily impact multiple key financial and corporate counterparties across the Union. In certain cases, especially among the largest and most systemic ones, EU CCPs may even service more clearing members and clients in other Member States than in the one where they are established, as can be seen with the UK based Tier 2 CCPs. It should also be recalled that 15 EU Member States currently do not have CCPs and are in this sense completely dependent on the supervision of competent authorities in other Members States where CCPs are established.

Based on the above considerations, it is essential that we break away from the misconception that a CCP disruption only has a bearing on the CCP and the Member State where it is established. CCPs cannot be looked at and supervised in isolation. They are deeply interconnected through their clearing members, which can be called on for additional resources and thereby have a bearing on the financial stability of another Member State. The reverse is also true: it is futile to believe that one understands the risk linked to the exposure of a CCP to a bank, if the supervisor of the CCP is not fully aware of the connections that that bank has with other CCPs.

This is why it is essential that we move on from a CCP-centric view of supervision to a more coordinated and integrated view on central clearing and its participants. Strong and effective coordination and integration between all relevant authorities is key to ensure that risks concentrated in EU CCPs are adequately monitored and managed, in order to minimise spill-over effects across Member States.

In addition, a stronger EU view would help reduce occurrences of divergent interpretations of EMIR by NCAs, which may result in different conditions for authorisation of CCPs and supervisory approvals, or worse in regulatory competition to attract clearing activity between Member States. A more unified approach would also increase the predictability and reliability of supervisory decisions for EU CCPs, thereby reducing the administrative burden on CCPs and increasing their attractiveness.

From a CCP-centric view of supervision to a more coordinated and integrated view on central clearing.

The European Commission proposal to review the EMIR framework goes in the right direction, notably with the creation of a Joint Monitoring Mechanism supporting a more horizontal view on central clearing, but does not yet achieve a true EU supervisory perspective on the central clearing ecosystem. While the European Parliament seems to be favourable to a more integrated approach to central clearing supervision, it remains to be seen whether the Council is ready to follow suit – at least for the most systemic and cross-border relevant CCPs.

PIERO CIPOLLONE

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Liquidity of financial markets and central clearing in times of stress

Financial turmoil episodes occurred in the last years have confirmed that central counterparties (CCP) margin requirements can become a source of liquidity pressure for participants; the potential vicious circle between market liquidity and CCP margining practices is a significant concern of public authorities. A related key feature is the access of CCPs to central bank liquidity in times of stress. In this context, supervision and regulation play a key role.

Margins can be procyclical, and this is an extremely delicate issue. Margins should increase with risk, which is perceived as higher in times of stress. But, as liquidity conditions tighten, participants may find it difficult to provide additional collateral at short notice; their tendency to refrain from engaging in trades due to margin costs could amplify the liquidity crisis. Furthermore CCPs may be tempted to strengthen their competitive position, adopting models with weaker counter-cyclical tools and lower margin levels.

To avoid negative feedback loops on market liquidity, CCP regulators and supervisors have to ensure a level playing field among CCPs in terms of risk management models, avoiding a race to the bottom which could have disruptive effects on financial stability.

While risk models play a key role in calculating the forward-looking component of margins, in times of stress the primary driver of large calls are often their intraday component, the 'variation margins' (VMs), which are inherently deterministic. Even though VMs do not represent a source of liquidity drain, being only the redistribution of resources across members, the failure of timely execution of this process can lead to liquidity strains; time-lag in the collection and redistribution of VMs - whereby CCPs call intraday VM and dispatch them only the next morning - should be limited to the largest extent possible.

Another facet of these issues relates to collateral availability. Clearing participants may face difficulties in accessing highly liquid collateral to promptly meet CCP margin calls, especially during stress periods. These difficulties emerged during the recent turmoil in commodities markets, where a number of clearing participants, in particular non-financials, strived to increase their credit lines with commercial banks and even asked for direct liquidity support from central banks. Looking ahead, the issue could become more acute, should new strains materialize in a context of monetary policy tightening. A solution could be to widen the list of eligible collateral, limiting the enlargement to non-financial counterparties where appropriate, but it must be assessed against the potential risks it would entail for CCPs and the wider financial system.

Finally, attention must be paid to the conditions under which CCPs can access central bank liquidity in times of stress. Back in 2018, when assessing the euro-area financial sector, the IMF emphasized that access to central bank facilities provides a safety net in times of market tensions, which is of paramount importance for financial stability. This issue is also crucial for establishing a robust framework for the recovery and resolution of CCPs and for developing clearing capacity in the EU.

Importantly, all these issues are already being tackled. The FSB and the international standard setting bodies are working on CCP margin practices. At EU level, EMIR is being reviewed. The Eurosystem is also progressing well with its work on CCPs' access to central bank liquidity. It is important not to lose momentum.

In this context, let me underline the importance that the monitoring activity is up to the challenges the supervisory authorities are called to face. As CCPs are required to review margin levels on an ongoing basis and intraday liquidity flows become more and more relevant, authorities must adopt monitoring tools allowing for high-frequency information on the clearing system functioning.

Mitigate procyclicality, ensure access to central bank money, strengthen cross-border supervision.

At the Bank of Italy, we have been following such an approach for many years, including for settlement systems and trading venues supervised by the Bank; in crisis times it proved to be a valuable tool for gathering information on a timely basis, allowing the Bank to make promptly the relevant decisions, when needed.

In a monetary and capital market union, an adequate role of CCPs in times of stress also requires strong cross-border supervision. In this sense, the Bank of Italy welcomes the strengthening of the role of ESMA called for by the revision of EMIR. It has to be pursued through an appropriate combination of the responsibilities between the national authorities, in charge of supervision, and the ESMA, in charge of supervisory convergence at EU level.

FIONA VAN ECHELPOEL

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Striking the right balance for the active account requirement

The degree of overreliance on third-country central counterparties (CCPs) has been a long-standing debate. Authorities of the European Union, including the European Central Bank (ECB), have repeatedly called for EU market participants to reduce their exposures especially to UK CCPs. Looking at the clearing landscape as of June 2023: about 80% of the total notional outstanding of euro-denominated interest rate swaps is still cleared outside the EU; about 50% of EU clients active in this market do not clear any trades in the EU, and among those clients, 47% clear euro-only portfolios outside the EU despite viable alternative clearing options existing in the EU. At this point, it is worth revisiting why this situation could be problematic.

The main concern relates to stressed market scenarios and in particular, the possibility that a third-country CCP may take discretionary actions which could have adverse effects on the EU financial system. The type of adverse effects in this respect include, among others, increased margin requirements or collateral haircuts on financial instruments critical for the financial stability of the EU or certain default management decisions. These actions are part of the typical CCP risk and default management toolkit and hence not problematic in themselves - but they can raise sensitive issues in default scenarios if taken on a scale or within a timeframe that may lead to market stress or deepen difficulties at an EU financial institution or even an EU Member State.

In addition, they may have implications for the implementation of monetary policy and the smooth functioning of payment systems within the EU. While CCPs and their authorities across the globe aim to set out rules-based default management and recovery and resolution procedures, there will always be a degree of discretion for decision-taking. In a tail-risk scenario, crisis management objectives and priorities of a third-country jurisdiction may not be aligned with those of the EU. This potential mismatch of interests can only be resolved by addressing overreliance at the core and thus moving a meaningful portion of clearing exposures to EU CCPs, subject to the supervision of an EU competent authority. The existence of a common market and currency, the interdependencies between EU financial institutions and the framework of cooperation established among EU authorities ensure that interests within the EU are better aligned than they would be vis-à-vis a third country.

A thorough analysis is essential before concluding on the key features of the active account

The requirement to hold an "active account" at an EU CCP, as set out in the legislative proposal to review the European Market Infrastructure Regulation ("EMIR 3") proposal, constitutes an important and necessary first step towards a more balanced clearing landscape, effecting both a reduction in excessive exposures and a building up of EU-based clearing activities. While overreliance can be addressed over the medium-term, cost and competitiveness issues arise in the short-term making it difficult for policymakers to strike the right balance.

However, focusing on short-term aspects only runs the risk of losing sight of the overall objectives of the active account. For example, it has been argued that commercially critical activities like market making should be exempt from the scope of the active account. Considering that a substantial portion of EU market participants' clearing activity is in market making, such exemption may render the active account essentially ineffective in reducing overreliance and adversely weigh on the possibility of building up liquidity pools at EU CCPs.

Several approaches can be deployed when implementing the active account depending on the priorities assigned to the various objectives, but a common understanding of the underlying quantities, metrics, assumptions, and definitions is crucial. A thorough analysis is essential before concluding on the key features of the active account to ensure this novel tool is brought forward in an effective, proportionate and prudent manner. In this vein, the calibration of the active account should leverage on the technical expertise of European Securities and Markets Authority (ESMA) in cooperation with other EU authorities.

After years of debate, it is time that the dynamics in European clearing markets change. The market has repeatedly proven that it can adapt to and optimise along new macroeconomic and regulatory circumstances. Market participants should consider EMIR 3 an opportunity to help shape and enhance the EU clearing landscape and actively participate in a constructive dialogue with the relevant authorities during the transition phase.

After all, the building up of an active and resilient EU-based clearing market is an essential element of the development of the Capital Markets Union which will benefit EU financial markets as a whole.

EVA WIMMER
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Active Accounts in the EU must be made effective

The discussion on the clearing of euro-denominated interest rate swaps – the so-called Euroclearing – has come a long way. Since the early days more than a decade ago the EU has pursued the goal to effectively address the financial stability risks that over-the-counter derivatives clearing and in particular Euroclearing entails. Since the United Kingdom's withdrawal from the EU the clearing of substantial parts of euro-denominated interest rate swap business takes place outside the EU. In view of the substantial systemic importance of Euroclearing to the EU this situation entails serious risks for the preservation of EU financial stability.

The European Commission has held a series of roundtable discussions with stakeholders to discuss potential measures to address the financial stability risks. Whereas some of the proposed measures such as requiring immediate relocation would create cliff-edge risks and would therefore have negative implications for financial stability in the EU themselves, other measures such as capital add-ons or liquidity buffers would be harmful to EU market participants only and would thus create an unlevel playing-field vis-à-vis non-EU competitors.

As a result, the European Commission has come forward with a new approach – the so-called Active Account – which would require EU market participants to establish and actively use an account for Euroclearing instruments at a clearing house/CCP located in the EU. ESMA would have the possibility to set a minimum quantitative level of activity if this is required to safeguard financial stability. According to the European Commission this approach would strengthen the clearing at EU CCPs and reduce the overreliance of EU market participants on clearing at CCPs that are of substantial systemic importance to the Union, but are located in third countries.

However, it should be noted that despite various initiatives undertaken by EU CCPs in recent years to build a liquid Euroclearing market in the EU, for the time being, the bulk of Euroclearing has remained outside of the EU and the overreliance of EU market participants on offshore clearing is ongoing. If one wants to take this more into account, then targeted adjustments to the Commission proposalcan be considered.

However, these adjustments should not jeopardize the goal of bringing more Euroclearing activities to the EU. As a first step and to create the necessary momentum for changing the status quo so as to further strengthen clearing activities in the Union, it is necessary that Active Accounts are fully operational from the outset and that they provide for a minimum level of activity of at least 10% in new contracts. As a second step, in order to keep the momentum created with the introduction of the Active Account and in order to progressively reduce financial stability risks to the Union, the European Commission should be mandated to adjust the calibration of the quantitative requirements over time without further recourse to the co-legislators being required.

Active Accounts in the EU must be an exemption for client clearing services provided to third-country clients could be introduced and be further specified by ESMA.

The adjustments should be undertaken by the European Commission on a regular basis and be based upon recurring assessments by ESMA of the clearing activities undertaken by EU market participants in relevant instruments. In its assessments ESMA should take into account the reduction in clearing of relevant derivative contracts at third-country CCPs by EU market participants and should consider the costs, risks and burden of increasing the required proportion of activity for those participants.

In order to ensure a level-playing field and to avoid competitive disadvantages for EU market participants vis-à-vis non-EU operators targeted exemptions, for example an exemption for client clearing services provided to third-country clients could be introduced and be further specified by ESMA.

At the same time, the regulatory framework and the supervisory processes regarding the extension of authorization and validation of risk models should be streamlined so as to make clearing in the EU more attractive and to reduce the time to market of new products and services for EU CCPs. In this process, one should pay close attention not to introduce new procedures and not to increase the number of ex-ante assessments by the various supervisory bodies such as the national competent authorities, the colleges and ESMA. Otherwise the intended effect of streamlining might not materialize or might even turn into the opposite.

In any case, a further strengthening of ESMA role in the supervisory process should not compromise the existing final supervisory responsibility of the national competent authority since this could lead to a decoupling of the supervisory responsibility and the fiscal responsibility of the Member State where the CCP is located.

JULIEN JARDELOT

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Adapted standards and level playing are essential for clearing competitiveness

LSEG operates two leading multi-asset class clearing houses (CCPs): LCH Limited – in London – and LCH SA – in Paris. Both provide risk management capabilities across a range of asset classes, including OTC interest rates, fixed income, FX, CDS, equities, and commodities. LCH Group's CCPs offer clearing services to members and clients across the globe and as such are subject to the supervision and regulation of numerous jurisdictions.

Specifically, LCH Limited is directly subject to UK and EU EMIR frameworks, and those in the US, Canada, Australia, and Japan, to name a few. Both LCH Limited and LCH SA are subject to the direct supervision of a wide range of authorities including the Bank of England, ESMA, and the CFTC in the case of LCH Ltd. We operate globally systemic CCPs and as such welcome both the cross-border supervisory scrutiny and stringent rules we are subject to. Our customers thus not only get access to a large and diversified clearing community but also robust risk management standards, subject to the requirements set by the most demanding jurisdictions in the world.

Looking at the ongoing review of EMIR, the European Commission has proposed several measures that have the potential to significantly improve the EU clearing ecosystem.

Chief among them is the streamlining of the supervisory processes. The supervisory structure outlined above has an additional layer for EU CCPs – such as LCH SA – due to the role of national competent authorities, CCP College and ESMA. This affects both EU CCPs' efficiency and their time-to-market for new products and services. Because of the current multi-layered and open-ended supervisory timelines, EU CCPs can take years to launch new products and services responding to market needs. However, in other jurisdictions, competing CCPs count their approval processes in a matter of weeks (in the case of non-objections). Addressing this is key to the competitiveness of EU CCPs, which is why we support the proposals of the European Commission and European Parliament to increase the role of ESMA to simplify the supervision of EU CCPs.

We also suggest that EU CCPs of systemic importance to the Union be directly supervised by EU authorities. This simplification would help to ensure a more harmonised supervision and implementation of EU rules.

> **Rules must improve the attractiveness of EU CCPs rather than define their market share.**

Another crucial component of the European Commission's proposal seeks to facilitate buy-side access to central clearing. These measures aimed at pension funds, insurance companies, and other market players financing the real economy are essential to guarantee a diversified and resilient membership of EU clearing houses. We need to address inconsistencies in the EU regulatory framework that impede access to clearing. This would not only broaden access to CCPs but also achieve a more stable, shock-resistant EU clearing ecosystem with deeper liquidity pools.

Measures that would constrain EU firms' decision of where to clear would do just the opposite. It would affect their competitiveness and ability to manage their risks efficiently. It is not a 'one-off' issue. Artificial market fragmentation, in the form of active account requirements, would have a lasting effect on the costs and risks to EU firms, especially if those are applied widely, with a minimum level of activity required in the EU. In practice, this would not only entail recurring costs for every transaction, but also increased risk, illustrated by greater margins needs. Looking at the numbers, EU firms only represented circa 27% of the notional registered on euro IRS in 2022.

For SwapClear, this represents less than 9% of overall cleared volumes. Such an artificially created captive market would therefore be a fraction of the current, competitive market which also raises questions from a financial stability perspective. A captive market formed by EU firms clearing in euros and subject to the same economic cycle would increase both wrong-way risk and potentially act as an impediment to safe and efficient default management.

Rules must improve the attractiveness of EU CCPs rather than define their market share. This is essential to maintain trust and financial stability. Any measure aimed at defining the market share of a specific CCP will result not only in an unlevel playing field but can also lead to increased financial risk, the opposite of what policymakers are trying to achieve.

CCPs are the anchors of a stable global financial system. This and any future review of their operating framework should always facilitate their risk management role, through simplified and agile regulatory procedures and access to best-in-class technology providers, regardless of their location.

ERIK TIM MÜLLER
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A well-balanced approach to reduce systemic risks and foster EU clearing

EU financial markets and infrastructures play a key role in ensuring resilience and driving economic growth. A strong and attractive clearing landscape is therefore essential for deepening the EU's single market on the 30th anniversary of its creation and strengthening the international role of the Euro, underpinning the political objectives around the Capital Markets Union, financial stability, and an open strategic autonomy. The EU institutions seem united in their approach not to compromise on those objectives amidst the prevailing challenging economic and geopolitical macro-environment.

EU regulators are strongly committed to fostering financial stability and clearing activities in the Union, therefore calling on market participants to help reshape the European capital markets. EMIR 3.0 is an important milestone in this endeavor, making EU central counterparties (CCPs) and the broader EU clearing ecosystem more globally competitive as well as resilient, especially by reducing systemic risks arising from excessive exposures towards third-country infrastructures.

The ECB recently pointed out our joint responsibility for a robust clearing framework. Notably, there is the need to address the monetary policy and financial stability concerns associated with off-shore clearing of systemically relevant Euro products. EMIR 2.2 ensured that EU authorities have some insights into systemically relevant third country CCPs. However, in a crisis event, their ability to intervene and safeguard the stability of the Euro, the Eurozone and ultimately taxpayer money remains limited. While it is good to see that EMIR 3.0 aims to increase the EU authorities' insights into Tier 2 CCPs' resolution planning, the Commission, ECB, ESRB and ESMA made it very clear that this alone will not suffice.

Rather, they advocate for an appropriate level of relevant Euro clearing activities taking place in the Union. This is where the active account requirement comes in: Taking a targeted and proportionate approach, it only applies to EU market participants that are subject to the clearing obligation and to those products that have been identified as systemically relevant, i.e., Euro OTC IRD, CDS and STIR. It aims at gradually rebalancing only a part of those activities to the EU to reduce systemic risks and build a sustainable domestic clearing ecosystem, while still allowing the flexibility to clear at Tier 2 CCPs. Compared to other policy options, such as derecognition or capital add-ons, the active account shows a spirit of compromise, carefully balancing regulatory objectives and market participants' competitiveness concerns.

Transition into a market structure with more competition and substantially reduced systemic risks.

Of course, EMIR 3.0 may require market participants to adapt if they haven't done so already. However, there is ample evidence that markets can adjust to new realities, for example as evidenced by the G20 reforms after the financial crisis or the IBOR transition. Both huge undertakings that the global community was initially skeptical on but in hindsight mastered flawlessly.

Eurex Clearing's aim is to help the industry transition into a market structure with more competition and substantially reduced systemic risks, while keeping any transition impact to a minimum. This is why we introduced our OTC IRD Partnership Program and recently expanded it to STIR. Our OTC IRD market share has grown to 20 per cent and we have onboarded more than 600 market participants. They can clear at virtually the same terms, with no account fees, and optimize their netting efficiencies as well as funding costs. We continue to provide additional incentives schemes to facilitate the industry's transition, mitigating transitional costs and stimulating deeper liquidity in the EU.

However, if we miss the opportunity to make the best of the active account proposal, we risk compromising the access to Tier 2 CCPs under the current terms. Despite the EU-UK political relations fortunately improving recently, there seems to be little appetite to prolong the temporary equivalence for Tier 2 CCPs in the absence of a joint rebalancing effort. Therefore, the Commission continues to encourage market participants to use the time until mid-2025 for reducing their overreliance on Tier 2 CCPs.

Any other measure but the active account requirement risks having more severe implications for the industry and the financial system. So, we should consider the active account proposal as a well-balanced solution to the current chicken-and-egg situation: If appropriately calibrated, the ideal outcome will be a market structure where activities are rebalanced to the extent that Tier 2 CCPs are not considered a risk to the EU's financial stability anymore. This would allow for maintaining access to Tier 2 CCPs and resolve the cliff-edge risks around the quickly approaching expiry of the temporary equivalence.

STÉPHANE GIORDANO

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An open strategic autonomy for clearing

As a leading financial institution with a global presence and a deeply rooted investment banking & financial markets DNA, Société Générale has welcomed the strategic shift of the Commission to promote, together with financial stability, the concept of "open strategic autonomy" as an objective of its CCP reform.

Over the past 15 years, the EU has undergone many severe and formative crises - from the 2008 Great Financial Crisis and the 2012 Eurozone debt crisis to the most recent Covid crisis in 2020 and the invasion of Ukraine in 2022. All these crises, notably the most recent ones, have demonstrated that, to reinforce its resilience, the EU must reinforce its autonomy and onshore value chains in all strategic domains, from semiconductors to pharmaceuticals. I fully subscribe to that idea. I would add that the financial industry is one such strategic domain, and that the debate on CCP regulation cannot escape these considerations.

This brings me to two critical points. First, the review of EMIR aims to address systemic risk, but it must also contribute to a credible EU industrial policy for clearing. Second, EU authorities must consider the impacts of their proposal all along the value chain, i.e., on the local clearing ecosystem but also on the upstream global trading ecosystem. Without sufficient concern for these two dimensions, the reform underway will fall short of its objectives, and risks increasing, instead of reducing, the dependency of the EU vis-a-vis third country players.

Achieving financial stability does not require quantitative constraints on EU clearing

If EU policy makers are genuinely interested in addressing systemic risk, the worst-case scenario is that market participants are shut out from third country CCPs, because they would lose access to clearing (mostly managed by UK CCPs). Aware of such risk, the Commission has identified the need for a progressive and proportionate approach, hence its proposal to require an "active account" for EU market participants in an EU CCP. To avoid disruption, the qualification of whether "active" or not need not be quantitative at all: the only requirement should be that EU CCPs are scalable enough to clear a significantly larger number of transactions if such a fall-back scenario arises.

Preventing systemic risk does not specifically require that EU CCPs have a large market share. Other instruments, such as shared supervisory measures, stronger powers to the ESMA, or leverage on collateral are far-more-reaching measures. An illustration of this is that the US authorities are not worried that dollar swaps are mostly cleared by LCH.

We need to improve the attractiveness of EU CCPs and of the whole EU financial system.

History shows that success will be achieved if CCPs and their participants transfer their activities to the EU voluntarily. Since 2019, the repo-clearing of euro sovereign debt - the most immediate financial instrument to channel the EU's monetary policy- takes place in the EU, following the decision of LCH to move this activity to Paris, and CDS-clearing takes place in either the US or the EU due to ICE's unilateral decision to leave the UK.

The question should be: how can we make the transfer of activities from third countries to EU CCPs economically sound, from a business and competition point of view?

A quantitative approach to clearing is a self-inflicted damage to our competitiveness

On top of not addressing systemic risk per se, a quantitative account would severely harm our competitiveness.

The CCP reform proposed by the EU, just as any industrial policy, should not ignore its side effects. If we try to go too fast or if we are too restrictive, we will not only fail, but we will also create dependencies vis-à-vis players from third countries. We will regrettably isolate ourselves and deteriorate our capacity to finance ourselves. For example, as 75% of IRS in euro do not involve any EU counterparty, there will continue to be a significant offshore clearing market, with a potential risk of a strong asymmetry of flows in EU CCPs, causing a costly difference in equilibrium price for EU market participants. This would dramatically affect cross-border banks with offshore clients who will lack a compelling motivation to clear in the onshore CCP.

On the contrary, a qualitative approach has its virtues and brings us half-way. Currently, a significant proportion of EU customers clear their euro transactions only with LCH. Ensuring that they open a qualitative active EU account would be a significant step!

To achieve our goals, there is simply more work to do to improve the attractiveness of EU CCPs, and of the whole ecosystem of EU financial markets

The comparative advantage of third-country players lays in favorable conditions for financial activities, excellent infrastructure, suitable human resources, strong culture, and pragmatic regulation. Because there are strong economic arguments for the concentration of activity in a small number of CCPs, hindering market access for reasons of economic orthodoxy will only further jeopardize our competitiveness.

PATRICIA BOGARD

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An operational Active Account to support the relocation of clearing in Europe

The European Commission has released in December 2022 a proposal to review the EMIR regulation, in the wake of the Brexit, and in the context of the upcoming end of equivalence that was granted to UK CCPs by June of 2025.

The proposal is set to address two main long term objectives; managing systemic risk arising from excessive exposure to third-country systemic CCPs for the financial stability of the Union and ensuring strategic autonomy of the clearing ecosystem of the Union.

The key measure introduced by the Commission's proposal in this respect is the active account requirement. The active account is intended to host the part of the clearing flows that will be relocated to Europe.

All counterparties subject to the clearing obligation will have to open and maintain an account at a European CCP, and to feed this account with a regular flow of transactions, so as to ensure that this account and the associated processes are operational. Thus, in the event of a crisis on a non-European CCP, this would allow new clearing flows to be redirected to a European CCP immediately, to ensure operational resilience, which meets the stake of financial stability.

Moreover, the development of clearing flows in Europe and the gradual increase in volumes should make the offer more attractive and competitive; the emergence of a true clearing capacity in Europe is a key challenge in terms of strategic autonomy. To achieve this objective of strategic autonomy, it is also crucial to preserve the competitiveness of financial institutions that are members of European CCPs, while the market remains currently mainly outside Europe and the relocation of the clearing will entail additional costs:

- Currently, LCH Ltd's market share in euro swaps is 95% (Q1 2023); and 75% of euro swaps do not involve EU counterparties; as a consequence, the market liquidity is mainly outside Europe.
- the split of clearing over several CCPs (EU / non-EU) will alter netting benefits for clients that are multi-products and particularly multi-currency.
- the resulting increase in margin calls will trigger additional liquidity needs and costs.
- Due to lower liquidity, clearing at Eurex rather than LCH induces a market basis, resulting in higher costs for EU clearing members and their clients (average 0,85 bp for 10Y € swaps since 2019 with an increase around 3 bp in the last months and a maximum of 4 bp).

> **A too fast relocation of clearing would harm EU competitiveness without meeting the objective sought.**

For all the reasons above, a relocation of clearing activity in Europe that would go too fast would harm EU clearing members' competitiveness without meeting the objectives sought, as entities not subject to the clearing obligation as well as non-EU entities might choose to maintain their clearing activities at LCH with clearing members not subject to mandatory thresholds (i.e. non-EU banks).

For client-driven activity, dealers do not have any control over the choice of CCP; trying to clear a trade at a CCP that does not match clients' pricing expectations would either lead to losing trades and clients franchise or exposing dealers to an unsound basis risk, harming the ability to conduct market-making activities in these products, and ultimately providing competitive pricing to the clients.

While EU authorities wish to push for further commitment from clearing members to achieve a faster pace of relocation, we would recommend the introduction of a two-phased active account requirement for entities subject to the clearing obligation, in order to enable a progressive relocation, and secure the development of a strong and resilient clearing ecosystem in the EU.

In the first phase, the active account opened by entities subject to EMIR would be managed through setting qualitative criteria. One could imagine to request at minimum one transaction to be cleared for each maturity bucket at every semester, the purpose being to ensure the operational efficiency of this active account.

This first phase would not result in a status quo, and could drive a significant move to EU CCPs, as there is a significant share of EU-clients subject to EMIR, dealing mainly or exclusively EUR IRS, and clearing exclusively at LCH.

In order to assess the efforts made during this first phase, ESMA could conduct a general assessment 36 months later, to determine whether it is necessary, and relevant in regard of cost/benefit ratio, to propose minimum quantitative thresholds to be met to increase the pace of relocation as a second phase of this reform.

Finally, public entities could help increase the attractiveness of EU CCPs by clearing part of their transactions at EU CCPs by clearing part of their transactions in the EU; this move would drive significant volumes, providing more liquidity in the European clearing landscape; or at least they could ask for Eurex swap level reference in case of bilateral transactions, which would allow their dealers to hedge with EUREX cleared swaps.

The development of a wider product offer by Eurex could as well be a game changer in the medium term.