Enhancing central clearing in the EU

1. EMIR 3 active account proposal

1.1 Objectives of the EMIR 3 active account proposal

The Chair explained that the EMIR 3 proposal includes a requirement that EU market participants subject to a clearing obligation should be mandated to clear through 'active accounts' at EU CCPs a portion (to be defined) of the products that have been identified by ESMA as of substantial systemic importance. This is a continuation of the work that was initiated with EMIR 2 and the categorisation of central counterparty clearing houses (CCPs) in different tiers, following which ESMA identified clearing activities that can be considered of substantial systemic importance for the EU and invited mitigations for addressing the related risks.

Most of the panellists agreed on the need to strengthen clearing capacities in the EU and the relevance of active account (AA) requirements for achieving this.

An official explained that the proposal to implement AA requirements must be seen in the context of the discussions following Brexit on how to reduce the financial stability risks resulting from the EU's dependency on offshore clearing. The response from the representatives of the EU authorities and a large part of the industry was that a larger proportion of the clearing of euro-denominated clearing activities should take place in the EU. The question however was how this could be achieved. Different options with varying degrees of constraint were assessed for reducing the current over-reliance on offshore clearing. The solution retained to implement AA requirements seems appropriate.

An industry representative agreed that, for activities that are systemically important for the euro, the EU should be the primary regulator and have the necessary supervisory and regulatory powers. Moreover Europe is an attractive place to locate central clearing activity, because the regulatory framework is sound and strong, and thought leadership has been demonstrated in many policy areas such as recovery and resolution, margin appropriateness and margin anti-pro-cyclicality (APC). While colleges work well in normal market conditions, in a crisis situation when every hour counts it is necessary for there to be only one hand at the steering wheel. That means that the current situation, where a significant proportion of euro-denominated instruments is cleared outside the EU, needs to evolve. Market-led solutions such as incentives to attract business to the EU can help to make progress, but are not sufficient to fully alleviate financial stability risks.

A second industry representative agreed that measures are needed to gradually increase clearing flows and volumes in the EU in order to increase clearing capacity and make the EU clearing offer more competitive. This will support Europe's strategic autonomy objectives as well as contribute to financial stability.

A Central Bank official emphasised that the over-reliance on third country CCPs to clear critical derivatives is a source of systemic risk to the EU financial system. The concern is not about the risk management practices of offshore CCPs or decisions taken by the home supervisors of these CCPs in a business as usual scenario. The concern relates to tail risk scenarios, and in particular the possibility that a third-country CCP might take discretionary actions that could have adverse effects on the EU financial system in a crisis situation, because crisis management priorities of the third-country may not be aligned with those of the EU. A situation where the EU authorities are obliged to take ex post corrective actions due to the unintended consequences of discretionary decisions taken by another jurisdiction must be avoided.

The market has made some voluntary efforts to relocate clearing business to EU CCPs, the Central Bank official acknowledged, but not to the extent that is needed for a balanced clearing landscape, especially for interest rate swaps (IRS). Regulatory measures are therefore needed to reduce the stock of clearing exposures to third-countries. The intention is to move gradually and in a measured way, but for progress to be made, some 'nudging' of the market participants is needed.

One of the panellists was against imposing AA measures, because of the risk of impeding access to clearing for EU firms, competitiveness issues and the possible increase of risks in the financial system that these measures may lead to. The AA measure proposed would target mainly IRS. That market is global in nature and multi-currency. EU participants only represent 14% of the IRS market and for euro denominated IRS, EU firms only represent around 25% of the notional cleared volumes. The diversity of transactions and participants at the global CCPs that currently clear euro-denominated IRS such as LCH's Swapclear, enhances the efficiency of risk management and the resilience of the liquidity pool by reducing concentration risk. In addition, EU participants need access to these global liquidity pools to remain competitive. The largest clearing members must continue to have the ability to connect to multiple CCPs to hedge their positions and the smaller players must also have the ability to access the global clearing market. An AA requirement would impede this access if EU participants had to guarantee a minimum market share at certain EU-based clearing providers. This would increase their costs, affect their competitiveness and their ability to manage risks efficiently. AA requirements would also create artificial market fragmentation that might increase risk at market level if netting sets are broken up. That may eventually lead to a dysfunctional clearing market, with an imbalance of supply and demand, and unnecessary directionality with most participants in the EU subject to the same economic cycle.

1.2 Options to operationalise the active account proposal

An official was in favour of a combination of qualitative and quantitative criteria for implementing the AA requirement. A clear quantitative threshold is needed, otherwise the measure will not provide sufficient incentive to bring back euro denominated clearing volumes to continental Europe.

An industry representative considered that the AA measures need to take into account the global characteristics of the clearing market and should also preserve the competitiveness of the European financial institutions that are members of EU CCPs, which is a matter of strategic autonomy for the EU. Currently, 95% of euro swaps are cleared through LCH, and 75% of euro swaps do not involve any European counterparties, which means that most of the liquidity of the euro-denominated swap markets is outside Europe. Clients not subject to EMIR cannot be forced to clear inside Europe, since EMIR is not extraterritorial. In addition, the split of clearing between several CCPs that a relocation of the clearing of euro denominated swaps to the EU would entail, would lead to additional costs and liquidity needs for clients that have multi-product or multi-currency positions, with a deterioration of their netting benefits. For a 10-year euro swap, it would be three basis points more costly to clear in the EU for those clients, due to lower liquidity. Finally, forcing a fast relocation of significant clearing flows to EU CCPs that might not match clients' pricing expectations would either expose dealers to unsound market basis risks or lead to the CCPs losing trades.

The best solution would therefore be a two-phase approach, the industry speaker suggested, starting with a qualitative phase to ensure that AAs at EU CCPs are operational in case there is a need to host new clearing flows in the EU. After this first phase, ESMA could conduct an assessment of the efficiency of the qualitative approach and determine whether quantitative thresholds need to be fixed in a second phase. A new legislative process would be needed to achieve a relevant definition of a perimeter of this quantitative AA requirement and the calibration of the thresholds. The Chair noted that an approach involving a new legislative process could take a long time to implement in the absence of an improvement of the current EU legislative processes and supervisory tools.

A second industry representative also favoured a more gradual approach to the implementation of AA requirements with a first qualitative phase. The assumption that EU clearing members can relocate transactions with EU clients to an EU CCP with minimal costs is misguided. When a trade arrives at a clearing member, the choice of the CCP has already been made by the client. Putting a quantitative constraint on EU clearing members and EU market makers would not result in a transfer of liquidity from UK CCPs to EU CCPs, but instead in the transfer of client volumes from EU clearing members to non-EU clearing members. A quantitative approach that is not properly calibrated, and that does not include a market-making exemption, would therefore be counterproductive and increase the euro swap market's dependency on non-EU market makers and clearing members.

What is needed to mitigate the risks from the dependency on off-shore CCPs is to ensure that EU CCPs are scalable enough to clear a significantly larger number of transactions if a fall-back scenario is needed in case of disruption, the industry speaker stated. That requires strengthening the competitiveness and attractiveness of the EU clearing system. A certain number of provisions aiming to achieve this are already in the EMIR 3 text, but a measure would be needed to encourage more voluntary clearing by national and supranational European entities within EU CCPs to increase their liquidity and the diversity of the flows they clear. A second aspect is about margin exemption for equity options. The current exemption expires in early January and is likely to be revived under EMIR 3, as both the EU Parliament and the Council have included it in their proposals. EU market participants will hence need a solution to cover the interim period until EMIR 3 comes into force.

A third industry representative agreed that the AA measures should not disadvantage European clearing members. There have been calls from banks for certain exemptions on the market-making side and on the global client clearing side, which need to be taken into account because European banks should not end up being in a poorer position as a result of AA requirements. A two-step approach starting with a more qualitative step and then having the possibility of an automatic transition into quantitative measures could be a compromise. However, the qualitative requirements should be drafted in such a way that a reduction of risk can be initiated and that these measures cannot be easily circumvented.

A fourth industry representative stated that from a financial stability perspective what should be checked is that the main global clearing members have different options to clear euro denominated swaps and that those options are valid so they can shift their positions if needed in the event of a crisis. However, putting in place quantitative thresholds for clearing at EU CCPs does not address that. Other measures of EMIR 3 aiming to facilitate buy-side access to central clearing seem more relevant. The access of pension funds, insurance companies, and other market players financing the real economy to central clearing would indeed guarantee a more diversified and resilient membership of EU clearing houses. There is also a need to address inconsistencies in the EU regulatory framework that currently impede access to clearing. Sponsored models have been put in place, which allow the buy-side to mitigate some of the cost and the sell-side to reduce the balance sheet costs of access to clearing. The ongoing discussion about recognising these models should be pursued. This would not only broaden access to CCPs but also help to achieve a more stable, shock-resistant EU clearing ecosystem with deeper liquidity pools.

A Central Bank official emphasised that no progress will be made if a minimum level of activity and thresholds are not imposed for AAs. Without this, AAs will serve as a contingency. There might be some token transactions posted on them, but they will basically remain inactive. In effect, a qualitative phase one has been taking place for several years. Some progress has been made, but that has tapered off recently so more action needs to be taken. This is why an AA measure with actual thresholds is needed. The potential impact on market-making must be considered, but simply carving out this business from the threshold is difficult, because it constitutes the bulk of EU clearing members' activity at present. If market-making is excluded, the additional business brought to EU CCPs will be limited, there will be no additional liquidity, so entities will not move to EU CCPs. That is a 'chicken and egg' situation. The thresholds and their phasing-in need to be set carefully however, as any possible exemptions, following a technical assessment conducted by ESMA in cooperation with other authorities and taking into account market needs and risk mitigation objectives.

2. Improving CCP supervisory processes

The Chair suggested that one area of progress for the competitiveness and safety of the European clearing market would be to improve the flexibility of the regulatory process and reduce delays for amending the rules in cases where there is a need to adapt them to market evolutions, to close gaps between regulations or to react quickly to a market crisis. This should be part of the objectives of the incoming Commission. This might require improving the current legislative and supervisory processes based on the Lamfalussy approach or providing ESMA and the national competent authorities (NCAs) with additional tools, such as the ability to use no-action letters to react to crises.

An industry representative agreed that current supervisory processes are an issue for competitiveness as it may take several months or even years in the EU to launch new products and services, whereas it takes weeks in many other jurisdictions. The measures proposed in EMIR 3 to streamline supervisory processes with shorter procedures and standardised applications are welcome. Another option is to give more power to ESMA at the supervisory level, which means that the rules can be less specific and can be more easily amended or completed centrally. A further improvement would be for ESMA to have more power in the supervision of EU CCPs.

The Chair agreed that the EMIR 3 proposals to shorten procedures for the authorisation and extension of clearing activities are positive, but the processes for amending legislations will generally remain quite complex and lengthy. A Central Bank official noted that ESMA's competencies when it comes to Tier 2 CCPs can be improved, but ESMA is not their home supervisor.

3. Margin procyclicality issues and access to central bank liquidity

3.1 Margin procyclicality issues and measures proposed for energy markets

An official stated that the energy market crisis of the previous year put significant strain on the clearing of energy derivatives. It is important to strengthen the resilience of the EU clearing system for energy derivatives, strengthen the liquidity preparedness of energy firms and improve the transparency of margin models used by CCPs and the margin requirements imposed by clearing members. In the previous year, ESMA and the CCPs were flexible, but there should be reflection on how to better address such problems. Transparency is needed, including for the collateral systems. The proposal to extend the eligible collateral to un-collateralised bank guarantees for non-financial companies when clearing energy derivatives, and to public guarantees for all types of counterparties is a good idea, but for other possible collateral there should be caution about not posing new risks.

A Central Bank official highlighted that the episodes of financial turmoil in the past year have confirmed that 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. Despite the complexity of the situation, the crisis was handled well thanks to the intervention of ESMA and other public authorities. However, the market still has to be placed on a more solid basis. The EMIR 3 proposals head in the right direction by asking participants to provide more clarity about their liquidity needs and extending eligible collateral, but more reflection is needed on the risks that could be built into the system.

Margin pro-cyclicality is another important matter, the Central Bank official stressed. EMIR 3 measures will help to make participants more aware of the liquidity needs, but further actions are needed. Work is being conducted on these issues at EU level by ESMA, which is revising the regulatory standards, and also at the global level by the BCBS, CPMI and IOSCO. Cooperation with the market is also needed to understand the models for setting the margins.

The Chair noted that proposals have been made to improve the governance of the process in the redraft of the APC measures in order to improve awareness of the importance of transparency, but these measures will not concern all parties, such as non-financials, for which the EMIR3 measures will be needed.

An industry representative observed that the generalisation of central clearing and margin calls following the 2008 financial crisis was based on the idea that the use of liquidity through margin calls would help to avoid the propagation of default events. However, the need for liquidity during the energy markets crisis in 2022 was so massive that it went close to inducing default events. Two solutions could be envisaged for tackling those issues. First, circuit breakers could help to reduce the volatility in markets which leads to higher margin calls. Markets should not end up being blocked, however, because if CCPs have no reference price then they have to increase their margin calls. The second solution would be to increase the transparency on margin models with the provision of simulators for clearing members and their clients.

3.2 Access to central bank liquidity

A Central Bank official noted that attention must be paid to the conditions under which CCPs can access central bank liquidity in times of stress. There is an on-going discussion at the Eurosystem level on this possibility. 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 by making EU CCPs more attractive.

An industry representative emphasised that CCPs making margin calls on one bank and just putting that money in another bank does not ensure financial stability. There were reservations in Europe about opening up monetary policy mechanisms to CCPs. Some, such as Eurex, acquired a full bank licence to have access to the ECB refinancing facility if necessary. Half of the total margin pledged by clients is high quality securities that are mostly eligible with the ECB. Without access to central bank liquidity, CCPs will continue to have bank licences, but that produces conflicts with EMIR. CCPs have two recovery and resolution plans; one for the banking regulator and one for the CCP regulator. Resolving that would be appreciated.