EPFSF Briefing on
"The European Market Infrastructure Regulation (EMIR): CCP Oversight"
23 Jannuary 2018

Introduction

This EPFSF event examines the proposed revision of the EMIR Regulation in respect of CCP supervision, including the European Commission's suggestions for a further development of the EU supervisory architecture for CCPs. The event will also address supervision of third-country CCPs and the potential consequences of a requirement for a systemically important Tier 2 third-country CCP to establish in an EU Member State if it is to be able to provide clearing services to EU firms (who would not be able – under EMIR - to use a non-recognised third-country CCP). The discussion will address whether such a requirement would increase risk (in the EU27 and globally), costs and operational burdens (associated with migration of portfolios, for example) in derivatives and other financial markets and, on the other hand, whether there is potential for new efficiencies to be gained through cross-margining of euro-denominated Over-The-Counter (OTC) derivative and Exchange-Traded (ETD) products offsetting the initial costs of such a move. Speakers will also assess whether market participants and regulators should have concerns with regards to competition and realisation of the aims of the Capital Markets Union as a result of this proposal. EU regulators and supervisors are currently discussing whether the prudential and monetary policy concerns about the prospect of a CCP outside the EU providing the majority of clearing of financial instruments for EU firms can be satisfactorily addressed through enhanced supervision or whether a more jurisdiction-centric (e.g. imposing a requirement on EU counterparties to use only CCPs established in the EU for certain products) approach is necessary.

The proposal

The European Commission (EC) proposal further develops the EU system of supervision of CCPs, both within and outside of the EU. This revision is deemed necessary by the Commission because of the success of regulators and industry in implementing central clearing for derivatives in accordance with the 2009 Pittsburgh G20 agreement. In Europe, this commitment was delivered via EMIR (2012) and subsequent European Commission Delegated Acts mandating clearing of specific classes of interest rate and credit derivatives (although capital requirements and bilateral risk mitigation rules also incentivise clearing). As the European Commission notes, at end-2015, about 60% of all OTC interest-rate derivatives were cleared (compared with 39% at end-2009). The share of OTC interest rate derivatives cleared grew from 39% to 60% between end-2009 and end-2015.

While the growth of clearing is welcome, the EC believes the EU supervisory system for CCPs needs to be 'upgraded' in consideration of the ever-greater concentration of credit risk in CCPs. There is also the concern that the current EMIR equivalence and recognition regime does not give ESMA appropriate ongoing information about the CCPs it has recognised, both in terms of risk these CCPs manage and in terms of changes to products, rulebooks or risk management. This upgrade addresses supervisory arrangements for both EU CCPs and third-country CCPs to EU firms (on the latter, this concern is particularly acute given that some CCPs clearing a large majority (at present) of the volume in various financial instruments used by EU market participants will be located outside the EU post-Brexit).

The proposed supervisory arrangements for EU CCPs involve the creation of a supervisory mechanism within ESMA: the CCP 'Executive Session'.

The Executive Session shall be composed of permanent members (also a representative of the ECB and of the Commission

who shall be non-voting), of members specific to each CCP, including a representative of the competent authority of the Member State where the CCP is established, and a representative of the relevant central bank(s) of issue (who shall be non-voting). This mechanism will add a new layer in the current system of EMIR Colleges and supervision by National Competent Authorities.

The Executive Session aims to ensure more harmonised implementation of EU legislation, a coherent supervisory approach across the EU and an appropriate level of expertise for decisions on CCPs. Whilst National Competent Authorities would formally remain lead supervisors, they would require consent from ESMA for their actions. Contrary to the current system of EMIR Colleges, the decision will need to have consent from the ESMA CCP Executive Session before being adopted. Some stakeholders believe this would increase the complexity of the supervisory system. This could lead to duplication (national authorities are also part of the Executive Session) and in decrease in efficiency (particularly problematic in a crisis situation where a timely reaction will be of essence, or where CCPs need to adapt their risk models to keep pace with market changes).

The supervisory arrangements proposed for third-country CCPs are understood to be deemed necessary largely because a significant share of financial contracts denominated in EU currencies is cleared in CCPs located outside the EU and in the UK (which is planning to withdraw from the EU). After Brexit, clearing of Euro-denominated contracts (for example) in these CCPs may be cleared outside the supervisory purview of the EU. The European Commission points to

- Firstly, the difficulties ESMA has encountered in accessing information on third-country CCPs, in conducting on-site inspections and in sharing information with relevant EU regulators, supervisors and central banks. The EC is concerned that third-country CCP practices and/or adjustments to risk management models will not be picked up by EU authorities, with financial stability implications.
- Secondly, the potential for misalignment between supervisory and central bank objectives within colleges, which acquires an additional dimension for third-country CCPs where non-EU authorities are involved, in the EC's view.
- Thirdly, the concern that changes in a third-country CCP rulebook or in the third-country's regulatory framework could negatively affect regulatory or supervisory outcomes, potentially skewing a previously level playing field. There is no mechanism – in the EC's view – to ensure the EU is informed of such changes and equipped to react accordingly.

The EC sought to design a proportionate framework for supervising third-country CCPs. The proposal distinguishes between tier 1 (non-systemically important for the EU) CCPs that can operate under the current Equivalence system under EMIR and tier 2 (systemically important for the EU) CCPs subject to EMIR requirements and ESMA supervision. CCPs are identified as systemically important based on an ESMA assessment of: their nature, size and complexity; likely impact on the financial system – including the EU financial system of disruption or failure of an EU CCP; the membership structure of the CCP and its interconnectedness with other market infrastructure. These criteria would be elaborated in due course in a Delegated Act.

The consequence of determination by ESMA of a third-country CCP as Tier 2 CCP would be that the CCP would have to meet further conditions in order to be recognised and permitted to provide clearing services in the EU. These relate to:

- Compliance with specific EMIR requirements for CCPs, for instance around margin, collateral, liquidity and capital.
- Confidence on the part of EU central banks of issue that the third-country CCP complies with requirements they impose relating to their monetary policy tasks.
- The ability for ESMA to access the CCP and any information held at it, on request, backed by legal enforceability in that third-country.

If ESMA, in agreement with relevant Central Banks of Issue, believes that the CCP is so systemically important to the EU that these provisions are not sufficient, it can propose to the EC that the CCP is de-recognised and can only continue clearing the affected products for EU firms if established in the EU – a requirement described by Commission Vice-President Dombrovskis as a 'last resort' when announcing the adoption of the proposal on 13 June last year.

Arguments in favour of requiring certain tier 2 third-country CCPs 'of substantial systemic importance' to establish in the EU in order to offer clearing to EU firms

Regulatory authorities, market infrastructures and market participants who support a requirement for tier 2 third-country CCPs 'of substantial systemic importance' (such that the 'financial stability of the Union or one or more of its Member States' cannot be ensured) to establish in the EU in order to service EU firms do so for the following reasons:

- Financial stability

The financial crisis has illustrated the importance of financial stability, in particular avoidance of negative spill-over effects for the broader economy and general society. With such a requirement, CCPs clearing substantial amounts of Euro-denominated transactions would – if they want to continue servicing EU firms - be forced to establish within an EU Member State. Therefore, ECJ jurisprudence will be guaranteed – with the ECB more confident that it will be able to fulfil its monetary policy mandate, its decisions enforceable. Those favouring such a policy point out that without such a requirement, the ECB would have to rely on the central bank in the jurisdiction of the relevant third-country CCP to take decisions safeguarding the interest of the Euro currency area in a crisis situation. However, the third-country central bank's mandate will be limited to its own currency area. From the perspective of proponents of this policy, Brexit calls into question the extent to which the ECB could rely on the Bank of England to act in the interest of the ECB and the Euro currency area during a crisis situation, or whether its priority would rather be its own mandate and currency.

- Increased competition

Those supporting a policy requiring establishment in an EU Member State of a tier 2 third-country CCP of 'substantial systemic importance' (in order for that CCP to be able to offer services in the EU) highlight that about 97% of the global swaps market is cleared in one London-based CCP, and describe that market as highly concentrated. While some market participants argue that the negative side-effects of concentration are off-set by efficiency gains, those who support such a requirement opine that clients and indirect clients of clearing members (i.e. they do not face the CCP as a counterparty , as is the case for the vast majority of entities in exchange-traded and OTC derivative business) do not benefit from sufficient choice between different CCPs. Promotion of an EU-based alternative would bring more competition to the market and result in more choice, better service and reduced costs, in their view.

- Costs

While many stakeholders who oppose such a requirement have expressed concern about an increase in costs, other market studies indicate that a requirement that Euro-denominated clearing take place in the EU would result in significant efficiency gains. Based on real portfolio analysis, these studies conclude that, while some losses of efficiencies might be identified at first sight, these could be limited in size and will be compensated over time by new efficiencies across products, including OTC Interest Rate Swaps, ETDs and repos denominated within the same currency. The European Commission's impact assessment assesses that the cost of such a policy could be approximately between €3bn – €7bn, based on the factors they took into account, and data available.

- Reduced risk due to lower concentration

In addition to such cost considerations, supporters of a policy of requiring establishment in the EU for tier 2 third-country CCPs of 'substantial systemic importance' (if they wish to service EU clients) believe that reduced concentration in the market would certainly result in reduced risks. Should a CCP clearing 97% of the global market fail, this would be more problematic than if a CCP facing difficulty had a significantly smaller market share.

- No market disruption and certainty

Supporters of withdrawal of recognition and/or an EU establishment requirement for such CCPs highlight that market led solutions have already been implemented by some EU-based CCPs, which (ahead of any potential location requirement) already offer the concerned clearing services in question. They suggest that market disruption associated with such a requirement would be avoided, and that legal certainty and business continuity, can be ensured, because of these existing offerings.

- Global supervisory precedent in clearing – jurisdictional approach

Finally, proponents of such a requirement highlight that further consideration should be given to the current regulatory policies on the 'local' establishment of certain CCPs in non-EU jurisdictions for clearing of financial instruments. Currently, Japan, China and India have a jurisdictional approach as regards CCP supervision. They take this approach on financial stability grounds, in consideration of the ability of relevant central banks to guarantee the enforcement of their decisions within their own jurisdiction during a crisis. Repo clearing in particular is typically 'local' in nature.

As such, a policy requiring EU establishment of CCPs of 'substantial systemic importance' within the EU, as suggested by the European Commission would not be without precedent in other jurisdictions. While several foreign jurisdictions have highlighted to the EU that the Review of EMIR should not lead to a withdrawal of existing equivalence decisions, these jurisdictions acknowledge the EU's interest to preserve financial stability.

Arguments against requiring certain tier 2 third-country CCPs 'of substantial systemic importance' to establish in the EU in order to offer clearing to EU firms

Regulatory authorities, market infrastructures and market participants who are concerned about the European Commission proposal believe that EU regulatory objectives can be delivered by honouring the cross-border deference principle emphasised in successive Financial Stability Board reports on OTC derivatives regulation, and through regulatory cooperation regarding non-EU CCPs. Those against the adoption of a policy withdrawing recognition and/or requiring EU establishment of third-country CCPs of 'substantial systemic importance' if they are to continue to provide clearing services in the EU note that London's LCH limited is a successful model of supervisory cooperation, clearing more than 80% of USD interest rate swaps, and both authorised in the EU and supervised by and registered (as a Derivatives Clearing Organisation (DCO)) with the CFTC. This aspect of the EC's proposal is of concern for the following interlinked reasons:

- Fragmentation

If one assumes that such a requirement would restrict transactions that include an EU-27 client or EU-27 clearing member, a relatively small part (around 25% in Interest Rate Swaps) of the Euro-denominated cleared derivatives portfolio would be mandatorily cleared on-shore in the EU. This would fragment previously global markets (contradicting G20 commitments), which leads to a number of the issues set out below. It should be recalled that – among all of the classes of cleared financial instruments – OTC derivatives have hitherto been the most global in terms of their trading (think, for example, of the potential nexus that could be asserted by different jurisdictions to a trade involving a Japanese bank and UK hedge fund, denominated in dollars, on a Spanish energy company debt security underlying, and the level of conflict and duplication that market participants could have to grapple with in this eventuality).

- Market Disruption

Those who are concerned by such a requirement opine that were it to apply retroactively (i.e. to legacy transactions), the migration of hundreds of thousands of these transactions will be an enormous legal and operational undertaking. For each transaction to be migrated, a counterparty at the legacy CCP would have to be found to close it, while another counterparty would be required to re-open the transaction at the on-shore CCP.

Market participants concerned by such a policy fear that - whether applying retroactively or prospectively - clearing members and end users would face major legal, operational and governance challenges, including seeking membership of the EU CCP, conducting due diligence on the CCP's governing law and rulebook as well as its risk management methodology, and coordinating a move across to the CCP.

- Competition and Choice

Those who are concerned about such a requirement point out that EU-27 market participants could have less choice, both in terms of CCPs (due to de-recognition of CCPs they were previously using but which they are no longer allowed to use) and in terms of market counterparties (there would be fewer market makers (solely or at least mostly European) than in the case of a non-recognised non-EU CCP providing clearing to a global liquidity pool). A requirement imposed on EU counterparties to use an EU-established CCP in the case where LCH Limited is no longer recognised for Euro IRS clearing would capture only a quarter of that portfolio.

- Risk

Those concerned regarding withdrawal of recognition or a requirement to establish in the EU for such a CCP (if it is to be able to continue to provide services in the EU) assert that the one or more CCPs benefiting from such a requirement may be much smaller than the larger non-EU CCP previously servicing EU counterparties. Risk at this CCP (or these CCPs) would be managed by a smaller number of largely European clearing members exposed to the same (European) economic cycle and therefore exposed to wrong-way risk (trading in Euros and with collateral posted in Euros or EU government bonds), and therefore heavily risk-correlated with each other. In case of a default at such a CCP or CCPs, fewer clearing members would be able to step in to accept the defaulting clearing members' clients, bid in auctions and underwrite the risk in the CCP. This higher risk would – in their view - be reflected in higher initial margin requirements (see 'costs to market participants', below) as well as more resources requested from a smaller pool of clearing members in times of stress.

Opponents of such a requirement assert that to the extent that global banks would intermediate between the on-shore and off-shore liquidity pools, large market movements would create a significant liquidity strain due to large intraday Variation Margin (VM) calls.

- Cost to market participants

Opponents of a requirement to establish in the EU for a third-country CCP of 'substantial systemic importance' are of the view that whether applying with retroactive or prospective effect, a basis (price difference) would be very likely to emerge for identical products cleared (respectively) on the 'onshore' and 'offshore' CCPs. Such price differences are already in evidence for specific products between (LCH Limited's) SwapClear and CME, SwapClear and JSCC (the Japanese CCP) and between SwapClear and Eurex. EU27 firms finding themselves on the wrong side of the basis will pay more for their hedges than they would have done using the global liquidity pool. Whilst these bases are "only" a few basis points, this is already considerably more than usual bid/ask spread of interest rate swaps.

A smaller market would also attract fewer market makers, which could result in stifled competition and wider bid/ask spreads, in the view of market participants that are concerned by a potential location policy.

They are also concerned that fragmenting the market will undermine the economies of scale created by multilateral netting, in turn increasing initial margin levels for clearing members at the EU and non-EU CCPs concerned. These costs would be passed on to end users.

The same can be said for likely capital impacts. A combination of increases in risk-weighted assets (RWAs) resulting from cleared swap exposures and Leverage Ratio impact (caused by diminished ability to compress trades due to fragmented netting sets) would – in the view of opponents of such a policy - see a very significant increase in capital requirements for clearing members, which end users would ultimately pay for.

- Uncertainty

Certainty is valued by investors. While Vice-President Dombrovskis emphasised the 'last resort' nature of a requirement for third-country CCPs of 'substantial systemic importance' to establish in the EU if they are to be able to continue to provide services in the EU, Article 25.2c of the proposed revision of EMIR is very unclear about the basis on which it might decide that the conditions imposed on tier 2 third-country CCPs would not ensure the stability of the Union and its Member States, and what 'substantial systemic importance' means. Those concerned regarding potential for arbitrary interpretation of such a

provision are of the view that even its existence in this context creates uncertainty for market participants who may otherwise wish to commit capital to Europe and may act as another obstacle to Capital Markets Union.

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