CLEARING: EMIR3 AND ISSUES AHEAD

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Reconsidering the national bias to fiscal responsibility and supervision

Central counterparties (CCPs) operate in a highly globalized financial landscape where clearing transactions transcend national boundaries, serving multiple currencies and participants across a wide range of jurisdictions. However, the supervision of CCPs mostly remains to this day a national affair, with National Competent Authorities (NCAs) overseeing entities established within their borders.

While the argument for maintaining national supervision often revolves around fiscal responsibility and the assumption that national governments may need to use public funds as a last resort to resolve a crisis, recognizing the limitations of this reasoning in the context of CCP clearing is essential.

Within the European Union, clearing members and clients of CCPs are very often situated in Member States different from the place of establishment of the CCP. CCPs calculate and collect collateral from clearing members against their exposures to financial contracts and are allowed to mutualise those resources in case of a member default, creating a complex web of interconnectedness. In the event of a disruption at a CCP, the impact is not confined to the national fiscal domain. It may not even fall primarily on the CCP home jurisdiction, as the CCP itself did not accrue the risk. The repercussions can permeate across borders, affecting key financial and corporate entities across the Union – and beyond.

Considering the consequences that the failure of a CCP and the subsequent implications may have on the financial system and the economy of a Member State, the EU recovery and resolution framework has been put in place to complement EMIR and set in stone the distribution of competences among relevant supervisory and resolution authorities across the life cycle of a CCP. It has also been designed to enable swift and decisive action to stem contagion.

To avoid the recourse to public money and limit moral hazard, the CCP Recovery and Resolution Regulation requires that CCPs and resolution authorities respectively draft recovery and resolution plans including the possibility to require additional resources beyond the margins and default fund contributions foreseen under EMIR. In effect, these position and loss absorbing tools would largely be borne by the clearing participants to ensure the continuity of the contracts into which they entered. In such cases, and while less significant in total amount, the second layer of 'skin-in-the-game' of the CCP would be used first as an incentive mechanism for the CCP to support the proper risk management and recovery of the CCP.

In doing so, the CCP Recovery and Resolution Regulation effectively clarified where the additional funds necessary to cover losses from a CCP failure would be sourced. As a last resort, the fiscal responsibility of the Member States where clearing participants are established may be engaged, which may be challenging, in particular in the case of non-banks (insurers, funds) which do not have a proper resolution regime.

Therefore, while fiscal responsibility is a valid concern, the misconception that fiscal responsibility rests within the Member State of the CCP should be dispelled, as the onus is rather on the Member States of the clearing members and clients.

In this context, a much more integrated and coordinated supervisory framework at EU level would be warranted, taking into account the situation in all those of Member States which may be most exposed in case of a CCP failure. A national authority on its own can intrinsically not achieve such a holistic assessment of the cross border picture.

The creation of a Joint Monitoring Mechanism proposed by the European Commission under the EMIR 3 proposal is a positive move in the direction of a more horizontal view on central clearing. However, more is needed to recognize and reconcile the multiple fiscal responsibilities which exist in the Union, as a disruption at a CCP can reverberate across the EU, necessitating a collective and comprehensive response.

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Acknowledging the broader implications of CCP disruptions and fostering collaboration among relevant authorities are indispensable steps towards ensuring the stability of the European Union's financial system in an increasingly interconnected world.

Similar considerations apply on the global scale for CCPs which serve as providers of clearing services in multiple jurisdictions. For the most systemic among them, traditional models of collaboration between authorities – including global supervisory colleges, primarily set up to share ex post information – have limits, which may call for a rethink of global supervisory structures in due course.

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EMIR 3.0: making the EU clearing framework more competitive and resilient

The clearing landscape in the Union has changed significantly since the adoption of the European Markets Infrastructure Regulation (EMIR) and its revisions.

The role of CCPs - and the risks that they manage - has grown considerably, and the withdrawal of the United Kingdom from the Union significantly altered the market dynamics and increased the reliance of EU clearing members (CMs) and clients on market infrastructure of third-country jurisdiction.

The global pandemic, the Russian aggression on Ukraine, the energy crisis, and high-inflation, all increased the risks in the system, affected the orderly functioning of markets and offered invaluable lessons for the future of the EU clearing ecosystem.

EMIR 3.0 is an important opportunity to adapt the rulebook for the Union's clearing ecosystem, and ensures that it remains safe, robust and competitive.

Given the key role of post-trade market infrastructures in supporting efficient capital allocation and vibrant capital markets, the review is also coherent with the broader objectives of the Capital Market Union (CMU).

The position of the European Parliament (EP), for which I have the honour of being Rapporteur, seeks to seize the opportunity provided by the review to implement ambitious and forward-looking changes, grouped around three main thematic blocks: supply-side measures, demand-side measures (i.e. Active Account Requirement) and supervision.

On the supply side measure, the EP amendments reflect the view that providing the conditions for CMs and clients to choose to clear with EU CCPs may be the single, most effective and most sustainable way to increase clearing in the EU and reduce the reliance on third country (TC) CCPs. More efficient regulatory approval timelines are essential for the competitiveness of EU CCPs on a global scale. The EP's amendments thus seek to enable EU CCPs expanding their offerings more rapidly, simplifying and reducing the burden that they face.

On the 'Active Account Requirement' (AAR), the EP opted for a gradual phase-in of the measure, in light of the novelty of the requirement and its potential impact on the competitiveness of EU CMs and clients. The proposed approach introduces a 'qualitative' first phase, followed by a 'quantitative' second phase, where a minimum level of activity to be maintained at EU CCPs would be introduced.

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However, the introduction of the threshold would be subject to a series of pre-conditions, such as detailed assessment of its impact on the competitive position of EU counterparties on the global market, thereby addressing the inherent tension between the political goal of reducing reliance on TC-CCPs and protecting the competitiveness of EU firms.

The phased approach will also allow ESMA and the Commission to collect the data to assess the costs and benefits of the AAR and to measure the impact of its implementation. Finally, the EP has called on the Council and the Commission to use this review to 'update' the Union's supervisory framework and make it fit for the future.

The current approach of decentralised supervision is no longer suitable to address the increasing cross-border exposures cleared at EU CCPs and the systemic interconnectedness between CCPs, CMs and clients. A more coordinated and integrated approach to the supervision of EU CCPs is necessary, especially as more systemic activity is expected to shift towards the Union via the AAR.

More centralised supervision would strengthen EU-wide risk monitoring and ensure a level playing field in the Single Market. It would reduce divergent interpretations by NCAs, increase efficiencies, and ensure that risks concentrated in EU CCPs are adequately managed, minimising systemic risk and spill-over effects across Member States.

ESMA should be empowered with a direct supervisory role vis-a-vis EU CCPs. NCAs could continue to have an active role as part of the College and in the context of Joint Supervisory Activities, ensuring that the local specificities of each market are taken into account. This set-up would allow ESMA to take a proactive approach on EU financial stability risks and achieve efficient supervision that takes into account the cross-border issues.
In short, the changes proposed by the Parliament are focused on the long-term challenges that Europe will face. More notably, they are underpinned by the view that any EU policy to further develop EU clearing should be part of a clear long-term strategy for our Capital Market Union (CMU).

In this sense, much of the discussion has been narrowly focusing on the Active Account Requirement, possibly losing sight of the bigger picture.

All three elements of the proposal: supply-side measures, AAR and the changes to the supervisory framework will shape the EU clearing ecosystems for years to come, and increase its attractiveness in a decisive and sustainable way. Concluding this review and striking the right level of ambition is a necessity, and an opportunity that Europe must not miss.

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Central clearing in Europe: policy challenges in an ever more integrated market

EMIR 3 can be considered as adequately designed to reduce the EU's excessive exposure to UK-based central counter-parties (CCPs), enhance the supervisory framework for CCPs, and make the latter more efficient and resilient. However, it is fair to say that the concerns expressed by national authorities and industry stakeholders during the EMIR 3 negotia-tions are leading to less ambitious results than expected.

A case in point is the review of ESMA's role in the supervision of EU CCPs. In the growing and increasingly integrated EU clearing market, ESMA's mission of ensuring supervisory convergence across national authorities is becoming even more important. Nevertheless, the final outcome of EMIR 3 is unlikely to strengthen ESMA's role as significantly as originally envisaged by the European Commission. In this context, the Italian authorities put forward a proposal that aims to: i) keep the supervisory system simple; and ii) make it more integrated, without interfering with the supervisory and fiscal responsibilities of national authorities. In this proposal, ESMA would play a more active role in the supervision of CCPs and, more specifically, would co-chair the EMIR colleges. In the event of disagreement between the co-chairs, the final decision would rest with the national competent authority, which should provide an accurate explanation if it deviates from ESMA's proposal.

It is now time to start thinking about the conditions for an effective implementation of the new measures. These conditions are diverse and require a balanced approach.

First, the active involvement of all industry stakeholders is key to achieving the expected results. Public authorities can do a lot to create a favourable environment, promote good practices and catalyse innovation. However, the power of market incentives in advanced financial systems should not be underestimated. The recent increase in LCH SA's share of the credit default swap market, undoubtedly facilitated by Ice Clear Europe's decision to exit this market segment, signals that the geography of clearing flows is more fluid than one might think and that supply-side effects also play a role in the market for clearing services. Structural characteristics such as currency diversification, margin transparency, accessibility of the testing environment and ease of client portability can all greatly contribute to the attractiveness of the EU clearing industry.

Secondly, in addition to carefully monitoring the effects of the measures taken to ensure that the efforts are justified by the expected results, it is essential to adhere to the principles of gradualness and proportionality during the implementation phase. This implies gradually adapting to the new rules and avoiding excessive burdens or abrupt discontinuities in industry practices. In line with these principles, especially with regard to the active account requirement, we support the adoption of differentiated requirements depending on the size of the portfolio (proportionality) and we believe that appropriate phasing-in stages should be defined (gradualness).

As far as future policy work beyond EMIR 3 is concerned, there is no room for complacency, as the industry is constantly subject to powerful drivers of changes, the first of which is innovation. With regard to the clearing of crypto-assets, we need to assess the extent to which the EMIR regulation is applicable and able to cover risks; we also need to look into its possible interactions with other regulations (e.g. MiCAR). The rapid development of private and public forms of digital money may lead to a search for new types of settlement assets or settlement modes, which would require an assessment by the authorities of their compatibility with a safe and sound CCP ecosystem. As regards the shortening of the settlement cycle, the shift from "t+2" to "t+1" would not call the business model of CCPs into question, whereas a shift to "t+0" could have far-reaching consequences.

The second driver of change is the structural evolution of the clearing industry. A noticeable development is the concentration in the provision of clearing services by clearing members. As for CCPs, competition between them is increasing and this puts pressure on the cost of clearing (direct fees and opportunity costs of posting guarantees). These trends may have a number of undesirable consequences in terms of availability, affordability and resilience of clearing services for the investor community.

Ensuring competitiveness and fair competition, keeping up with innovation.

Another aspect that cuts across innovation and other structural factors is the quality and timeliness of the data contained in trade repositories. Reliable and rapidly accessible data on trading flows are key factors for monitoring and analysing market developments.

The fast-moving market environment affects the nature and intensity of the concentration, operational and liquidity risks faced by CCPs. Public authorities will continue to monitor market developments closely and stand ready to take appropriate action.

ISABELLE GIROLAMI
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Competitiveness as a guiding principle

LSEG is a financial market infrastructure provider headquartered in London, with significant operations in Europe, where we employ over 3000 people across 19 Member States.

LSEG operates two leading multi-asset class clearing houses (CCPs): LCH Limited, headquartered in London and of which I am the CEO, and LCH SA in Paris. 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. This includes the EU, where LCH Limited is directly subject to the EU EMIR framework and directly supervised by ESMA as a Tier 2 CCP.

While it might seem odd to say so, we 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.

As such, we welcome EMIR's ambition to strengthen the supervisory framework for EU CCPs and streamline approval processes. Better supervision is conductive for a safer ecosystem, which combined with a CCP's ability to quickly adapt to market demands will only result in a more attractive and competitive landscape.

However, we are still concerned with the complexity of the EU supervisory structure. EMIR 3 negotiations are unlikely to fully address the fact that EU CCPs face diverse European regulators, both at the national and EU level, sometimes in a duplicative manner. Considering the cross-border, and even pan-European role of some EU CCPs (including LCH SA) we are of the view that direct EU supervision would simplify the structure and support the global competitiveness of EU CCPs.

As per the third country aspects of the regulation, I am pleased to see an enhancement of the cooperation agreement between ESMA and the competent authorities of Tier 2 CCPs. If the objective is to mitigate an eventual crisis and preserve financial stability, this seems to me the best course of action. These will complement the current framework ensuring strong cooperation, direct application of EMIR, and ESMA supervisory and enforcement powers over Tier 2 CCPs such as on-site inspections and the validation of new initiatives.

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Yet, active accounts might thwart these efforts and increase systemic risk within the EU itself. EU firms are concerned that such requirements would dictate where and how they must conduct their clearing operations. Such decisions should be left to risk managers and not impose the use of a particular central counterparty. Active accounts will negatively impact EU capital markets by introducing fragmentation and loss of netting benefits and make the Union overall less resilient to market stresses, with no clear benefit to its financial stability. While operational accounts are unfortunately now a reality, we urge ESMA and EU regulators to apply as much proportionality as possible when introducing them to limit their potential damage to the financial ecosystem.

I want to conclude with two forward-looking thoughts.

Up until now the regulatory spotlight has mostly been shining on banks and financial market infrastructures. Yet, they only represent a section of the broader financial ecosystem, with the remainder including what is traditionally known as the 'buy-side' such as pension funds, hedge funds, asset managers, to name a few.

Central clearing solutions can provide those actors with increased transparency and overall enhance the resiliency of an ever-growing integrated network.

The U.S. recently acted on this front, with the SEC releasing final rules requiring central clearing of certain U.S. Treasury securities secondary cash market transactions and the broader clearing of repurchase and reverse repurchase transactions. Whilst we are not advocating for a similar mandatory approach this side of the Atlantic, we still believe both industry and policymakers should ensure the full leverage of clearing to improve the way risks are managed.

Finally, operational resilience must remain a focal point for regulators and industry alike. I recommend regulators not to be too caught up with the nitty gritty and focus instead on outcome. Industry needs to spend its energy in preventing operational risks rather than imposing stringent requirements that can turn into tick-box exercises. DORA sometimes misses the need to focus on outcomes. I would also point out the importance to ensure policymakers facilitate access to best-in-class providers such as Cloud Service Providers (CSP) to support CCPs operational resilience. Rather than impede their usage regulators should equip themselves with the proper tools to mitigate any concerns they may have.

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Getting ready for EMIR 3.0: preparation as the key to success

The EU has been at the forefront of thought leadership when it comes to clearing regulation. And while it is not only a great achievement that financial stability has been safeguarded in recent periods of market stress, EU CCPs have also set the global benchmark when it comes to anti-procyclicality, transparency and a superior predictability of margin calls. However, in light of challenging economic and geopolitical realities, we should not get complacent and continue to foster the resilience and attractiveness of the EU clearing ecosystem – which is where EMIR 3.0 comes in.

Addressing the stability concerns associated with offshore clearing of systemically relevant business and promoting EU clearing activities remain crucial elements in the broader context of the Capital Markets Union and the EU's open and strategic autonomy agenda. It is reassuring that EU regulators are strongly committed to finalize EMIR 3.0 ahead of the EU elections, setting the scene for the strategic agenda of the upcoming legislative period with a view to structurally strengthening EU markets and CCPs long-term.

In particular, co-legislators converge on the need for the active account requirement to reduce overreliance on third country infrastructures. In line with Eurex Clearing's commitment to support the market's adaption to the new regime and keep the transition impact to a minimum with our OTC IRD and STIR clearing programs, we have achieved a stable 20 percent market share. Other EU CCPs have launched initiatives, too – providing the market with more choice, increased competition and reduced systemic risk concentration.

However, those rebalancing efforts have not yet led to an equilibrium that satisfies EU regulators. It appears that without clear regulatory guidance and enforcement, the status quo will not change, leaving substantial systemic risk concerns in third countries unaddressed and exposing the EU both politically and financially. The co-legislators therefore propose a quantitative element for the active account to ensure effectiveness – the Council by requiring a minimum replication of a firm's UK portfolio in the EU via the representativeness criterion, and the Parliament by installing quantitative targets in a staged approach.

The proposed proportionality by differentiating firms' sizes and activities, strikes the right balance between the regulators' stability concerns and implications for market participants. If those proposals are combined constructively, a meaningful regime can be ensured that truly helps the market to transition towards a healthier market structure while safeguarding firms' global competitiveness.

In the spirit of the Presidency's motto "protect, strengthen, prepare", let us jointly continue to get ready.

In addition, we should not forget that EMIR 3.0 contains a number of critical elements that boost the EU clearing system structurally – meaning that we should remain optimistic about its future strength and competitiveness rather than focusing on why the status quo could never change. These elements include, for example, a shorter time-to market reality, an improved supervisory regime for EU CCPs, and a review of EU CCP's access to central banks. In combination, the EMIR 3.0 implementation will therefore transform the EU's clearing ecosystem by introducing the next era in regulatory evolution and advancing on the EU's path of resilience while boosting global competitiveness.

With the new EMIR 3.0 requirements soon entering into force, market participants are well advised to kick-off preparatory work and to ensure readiness for a successful implementation to stay ahead of the curve. Especially the active account is expected to kick-in already six months after finalization and publication of the new legislation, requiring the set-up of EU accounts by early 2025. In this context, we should not forget that EU regulators estimate that 40 percent of all affected entities are not yet connected to any EU CCP.

To support operational readiness, including robust testing through structural simulation environments, Eurex Clearing complimented its partnership and incentive programs with a dedicated onboarding information platform. This will help to avoid another cliff-edge scenario and effectively bolster market participants' implementation efforts.

In the spirit of the Presidency's motto "protect, strengthen, prepare", let us jointly continue to get ready for a successful EMIR 3.0 as the key building block of an EU clearing framework that underpins not only the stability but also the global competitiveness of the future EU financial market.

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EMIR 3.0. or Beta-test for a revived CMU?

Almost 5 years after Brexit, the UK remains the largest European clearing hub for OTC derivatives, across all currencies (including euro and other EU Member State currencies). In response to this issue which was already causing concern in certain quarters pre-Brexit (notably the ECB's 2011 location policy challenged by the UK at the ECJ) the European Commission, with several provisions in its "EMIR 3.0" 2022 proposal, aimed to rebalance the clearing of EU market participants towards EU CCPs alongside measures intending to strengthen their supervisory framework.

Fast forward to 2024, the discussions held at the Council and at the Parliament have resulted in different positions, both with proposals of high quality for the future of EU financial markets. Colegislators have in common that they have wisely avoided the temptation of forcing a rapid and brutal relocation of clearing activities of EU market participants, which would be extremely damaging for financial markets, notably for EU market intermediaries.

It is likely that a strict quantitative rule for relocating activities would ultimately miss its objective – it would only generate an increasingly isolated and illiquid EU pool, as EU global players would face sharp restrictions on their business with international clients. This scenario would undermine the EU competitiveness agenda, in total contradiction with the common institutional goal to increase EU open strategic autonomy.

With now both positions stabilized, two topics seem of paramount importance in the context of the trialogue negotiations - the competitiveness of EU market participants and the effectiveness of EU authorities' oversight. Far from being only technical, the EMIR 3.0. debate is an important building block for the creation of a CMU useful for the EU economy.

First and foremost, we need to define an active account which works sensibly in practice.

Firstly, there should be no misunderstanding about the aim of such an active account. A CCP framework which works well is one that is functional in times of crisis, and a quantitative criterion is objectively not required to determine whether an account is active or not, provided one can ensure that this account provides an operating fall-back solution if access to non-EU CCPs comes to be jeopardized for EU participants. To put it plainly, the only requirement is that EU CCPs are scalable enough to clear a significantly larger number of transactions if such a scenario arises.

EMIR 3.0. is an important building block for the creation of a CMU useful for the EU economy.

Secondly, a differentiated and progressive approach makes sense for the implementation of such a measure. If we want to minimize disruptions to the market and allow the EU ecosystem to adapt smoothly, the most efficient direction of travel is to follow a gradual path, with review clauses, mindful of the competitiveness of market participants.

The other critical question is the supervisory framework and ESMA's mandate in this context. Considering financial stability as a common objective, this seems an ideal case for ESMA to be more directly involved with the supervision of the most critical EU CCPs. There is a deep paradox in the current situation, where ESMA is mandated to secure supervisory over CCPs outside the EU, when it does not have such rights in the EU.

Notwithstanding the need for the authority to develop its expertise, it would be reasonable to grant the ESMA extended supervisory powers over the most systemic European CCPs, i.e., those which have non-negligeable market shares of the clearing of derivatives that are otherwise cleared outside the EU by "super systemic" CCPs and are accordingly likely to be the main beneficiaries of the implementation of active accounts.

In brief, getting EMIR 3.0. right will be an important step towards the establishment of a strong and efficient Capital Markets Union (CMU). Behind the technical debate is the drive to create a robust and autonomous CMU, to drive the financing of the EU economy. 2024 will a key year for determining the future course of the CMU, with the Enrico Letta report "on the future of the single market" and that of Mario Draghi on "European competitiveness", but we should also look at EMIR 3.0 as a beta-test to put into practice the high-level principles of this "CMU of tomorrow".