Clearing: EMIR 3 implementation and issues ahead

1. Key measures agreed in the EMIR 3 package

A public representative explained that a political agreement has been reached on the EMIR 3 proposal, although it is yet to be voted on and finally approved. There are three main aspects of the agreement. First, a large number of European counterparties will be required to have an active account at an EU central counterparty (CCP) and to clear a minimum number of trades with that account. Activity will be measured both in qualitative and quantitative terms, with a threshold of up to 900 trades per year depending on the size of the counterparty. In the European Parliament's view this agreement represents a good balance between the need to reduce reliance on third-country CCPs, which was the initial political objective, and maintaining the competitiveness of European counterparties. An obligation for European CCPs and counterparties to share with ESMA information about their clearing activities was also introduced. There is also a review clause for further adjustments if necessary.

Second, the agreed text increases the role of ESMA in the day-to-day supervision of European CCPs, which is a basis for further changes in the longer term. A more decisive shift towards European supervision of CCPs was resisted strongly by the majority of Member States, although ESMA is already directly supervising Tier 2 third-country CCPs. Incremental improvements to the current framework include a greater role for ESMA in the oversight at European level and a greater say in the day-to-day supervision of European CCPs.

Third, supply side measures have been agreed to increase the attractiveness of the clearing framework in Europe, aiming to make clearing in Europe more sustainable and more attractive for outside players. This includes measures to incentivise the use of post-trade risk reduction services and to incentivise central clearing by UCITS and money market funds. There are also measures that give more certainty to market players about the treatment of equity options, measures on the acceptance of collateral for non-financial counterparties (NFCs) and measures that clarify the rules for public entities clearing.

An official concurred that the agreed EMIR 3 text is a major step forward given the importance of clearing activities for the whole ecosystem of European markets. The Chair noted that this agreement will provide the necessary framework to strengthen the ecosystem for clearing in the EU, making it more attractive and resilient. EMIR 3 constitutes a significant shift and will contribute to enhancing the consistency of CCP supervision in the EU. Its implementation will require a major mobilisation on the part of ESMA in particular, with more than 20 Level 2 measures to draft in the coming months. When EMIR3 is implemented, ESMA also will have to run a central database for CCPs, co-manage 14 CCP colleges, and set up and chair a joint monitoring mechanism for financial stability.

2. Measures to reduce dependency on third-country CCPs

2.1 Expected impact of the EMIR 3 active account requirements and related issues

The panellists commented on the active account (AA) measures, which captured a great deal of the attention during the negotiations at Parliament and Council levels. An official welcomed the agreement on AA measures, as it can contribute to kickstarting a positive cycle for European CCPs. The discussions began with the idea that thresholds for forcing the migration of clearing volumes to EU-based CCPs could be imposed by ESMA, but there was no common wisdom on how to determine such thresholds and limited data makes it difficult to assess potential effects of such thresholds in terms of cost and competitiveness. The impact of measures to attract more clearing volume in Europe on the whole clearing chain should also be considered, notably in terms of international competitiveness.

Another official emphasised that the reflexion on active accounts comes from a financial stability perspective. European regulators are concerned that activities based outside the EU may have systemic implications for the Union and be difficult to control. This reasoning is not specific to the EU. Regulators in all jurisdictions want to make sure they are at the forefront of discussions should a loss distribution mechanism be triggered for a CCP defaulting in their jurisdiction. AA measures should allow some progress in terms of financial stability by providing a plan B if something goes wrong for a third-country CCP. The lessons learned from the implementation of AA requirements and measures to enhance data quality will help to identify whether further measures are needed.

An industry representative stated that the intention to reduce the dependency on third country CCPs is relevant. The implications for financial stability of this dependency were demonstrated in 2011. In response to the sovereign debt crisis, LCH applied haircuts to a number of government bonds that were bought for repo. Academic research suggests that these haircuts contributed as much as they reacted to the crisis, which led to the desire of EU policy-makers to reduce the dependency on third-country CCPs. This took place at a time when the UK was still part of the EU, which stresses the importance of supervision not only of third-country CCPs but also within the EU.

The industry representative considered that the measures agreed on AA are well balanced. Given that 75% of transactions on euro swaps do not involve any EU counterparty, a quantitative measure to rapidly relocate clearing in the EU would not only fail to reach its objective, but would also increase the dependency on third country entities for trading, as it would be detrimental for EU market makers, which would ultimately further increase reliance on third country CCPs. Time will tell what the impact of the AA measures will be in terms of the relocation of clearing, but it should initiate momentum around the enhancement of liquidity in EU CCPs.

A second industry representative agreed that a workable compromise has been achieved concerning the AA measures. This will likely kickstart a dynamic, the effects of which will need to be evaluated with the 18-month review clause, but it is hard to predict what the effect of this measure will be. In December 2020, figures published by the Commission showed that only 60% of counterparties that fall under the EMIR clearing obligation had an account at an EU CCP. The onboarding activity into EU CCPs has been quite muted since and market participants have not prepared sufficiently for changes to their current setup, despite ongoing discussions about reducing dependency on third-country CCPs. This status quo is not tolerable in the long run and action needs to be initiated.

The industry speaker emphasized that according to the AA agreement, counterparties need to have a minimum level of activity at EU CCPs. It is hoped that by the time the review is performed in 18 months' time that changes will have been initiated by market participants. The evaluation needs to consider costs and also the advantages of transferring business to the EU, for example in terms of portfolio margining that are not available in the UK.

A third industry representative concurred that the political agreement on AA is an important step forward, although potential shortcomings need consideration. AA requirements will likely increase the cost of clearing for EU firms and reduce efficiency by creating constraints that may hinder the optimisation of clearing flows in the global markets. This may negatively impact the competitiveness of the larger EU players compared to their international counterparts that do not have the same constraints. It may also reduce the access of the smaller counterparts to the larger pools of liquidity if they cannot afford to have more than one operational account. This may also have implications in terms of financial stability, because in periods of intense market stress and particularly in the extreme case of the failure of a CCP, everyone needs to have access to liquidity, and with the AA measures there is the risk that access will be limited to the biggest firms.

The industry speaker added that AA should remain a fallback option and not become a tool of industrial policy aiming to structure the market. Users must remain free to choose their CCP and retain access to third-country CCPs in markets that will remain global. The capital markets union (CMU) will not be achieved by erecting barriers. The solution for mitigating financial stability risks is around an effective supervision of these CCPs.

2.2 Market-led evolutions

Some panellists highlighted market-led shifts of clearing activity to the EU that have taken place over the last few years, demonstrating that part of the changes can be made without regulatory action.

An industry representative observed that since the EU sovereign debt crisis the clearing of euro repos has been relocated fully within the EU, which has solved dependency issues for this part of the market without regulatory intervention. The Chair noted that there has also been market-driven developments in the credit default swaps (CDS) market with a split in the product range between the US and the EU, showing that liquidity pools and supervisory actions are not always the main underlying drivers.

Another industry representative added that changes have also been made through market-led solutions in the interest rate swap (IRS) area, where about 20% of volumes in risk-based metrics – corresponding to €33 trillion in notional outstanding - and 10% of trading volumes have been moved from the UK to the EU. It is important to consider market shares in terms of notional outstanding value rather than trading volumes, as a risk-based approach is more relevant for the issue at stake. For example, a Dutch pension fund might not trade all that much but will have large directional positions. Statistics in notional outstanding value show that quite a significant proportion of business has moved voluntarily to the EU. This is not sufficiently considered in the current evaluations by the EU institutions.

A Central Bank official was in favour of market-led solutions as a complement to regulatory action. In addition EU CCPs need to make their clearing services more attractive both for listed and OTC derivatives, which are quite different. This will take time, as EU CCPs need to improve their business models for OTC derivatives.

3. Supervision of EU CCPs

An official noted that the strengthening of the European level supervision of EU CCPs is an important aspect of the agreement. At present ESMA has direct supervisory powers on Tier 2 third-country CCPs, but no direct supervisory powers for the activities of European-based CCPs. This must be adjusted in the perspective of an expected increase of the activity and systemicity of EU-based CCPs. The proposal made by the ECON Committee to move towards an EU level supervision of CCPs met strong resistance but a compromise was eventually found. There is hope that the co-chairing of CCP colleges by ESMA proposed in EMIR 3 will bring more supervisory convergence. The step will remain limited, given the level of systemicity of CCPs, but the lessons learned from this change could be a basis to decide in the future review of EMIR 3 whether a stronger shift of supervision at the EU level would be beneficial, also depending on the volumes relocated to the EU.

An industry representative suggested that there could have been a bigger role for ESMA in the supervision of EU CCPs, in the same way as for Tier 2 third-country CCPs, which would also have been a way for the market to collectively gain experience in terms of tackling clearing risks. The Chair agreed that a full picture inside and outside of the EU of clearing risks is needed to have an appropriate perspective on the supervisory side. There is significant enhancement of access to data and information contained in the EMIR 3 proposal, but to what extent this will shed light on some of the underlying issues on the risk side is yet to be seen.

A Central Bank official stated that the main question to address when considering a move towards a fully centralised supervisory model for EU CCP is: which tax authorities would foot the bill in the event that the financial resources pooled by a CCP that has failed are not sufficient to solve the crisis, and whether the tax authorities concerned would eventually be able to recover their money. The current discussions on fiscal responsibility in this context must be pursued. An official agreed that fiscal responsibilities for CCPs are an important topic that needs to be further assessed in the years to come.

An industry representative emphasised the EMIR 3 also introduces provisions that aim to shorten the cycle for the introduction of new products, which is an important element of EU CCP competitiveness at the international level.

4. Margin procyclicality issues

The Chair sought the panellists' views on margin procyclicality issues, the lessons learned from recent crisis events and how to improve the transparency and predictability of margins.

An official stated that margin issues go beyond the CCP level and relate more to the way that broader financial markets are functioning. The assessments conducted following margin movements usually show that too much credit was being provided to pay variation margins by a given player. This leads to an excessive concentration of risk in an illiquid market which then triggers margin problems. Efforts undertaken at present at the international level to improve transparency should help to ensure that issues can be identified early enough.

An industry speaker highlighted that Europe has taken the lead on many issues in CCP regulation that include pro-cyclicality measures and also CCP recovery and resolution. Some players that consider that the EU measures on pro-cyclicality are too prescriptive or strict, but that is not the case. Global coordination is needed on such issues to ensure that there is no impact on competitiveness from a misalignment with other jurisdictions. The Chair stated that careful steps have been taken to ensure that the technical standards in the EU do not preclude any international developments, taking heed of what is necessary to enhance convergence across EU CCPs.

The Chair asked whether sufficient consideration has been given to the predictability and transparency needed for clearing members.

An industry representative stated that pro-cyclicality is a difficult concept that is not precisely defined in EMIR 3. Under Article 85(8) proposing a precise definition will be one of the first tasks for ESMA. Margin transparency is key for liquidity preparedness of market participants, which is essential to address the pro-cyclical effects of margins. There is a need for strong international cooperation on this topic. One important aspect to consider is that a CCP addressing pro-cyclicality of margins is likely to end up with higher margin requirements in benign times compared to a CCP that has lower margins but is likely to have more potential for pro-cyclicality in times of crisis. Secondly, Article 38 requires CCPs to offer simulation tools under certain scenarios. There will need to be international cooperation and coordination to define the scenarios to ensure that this does not lead to the addition of extra margins for each CCP, since scenarios are due to be specific for each CCP.

A Central Bank official favoured international work on margin practices. A move in the right direction is the January 2024 report on transparency and responsiveness of initial margins in centrally cleared markets by the BCBS, CPMI and IOSCO. The report sets out 10 policy proposals which aim to increase the resilience of the centrally cleared market ecosystem in times of market stress. The proposals are designed to improve market participants' understanding of centrally cleared initial margin calculations and potential future margin requirements. They cover aspects of CCP transparency, governance and review of initial margin models, as well as clearing member transparency for clients and CCPs.

It is often feared that margin transparency may fuel pro-cyclicality, potentially making investment choices more unstable in stressful conditions, the official stressed. The right approach is being taken by the international standard-setting authorities in not requiring CCPs to be fully transparent about margins, because this allows CCPs to retain some discretion in changing margins. However, CCPs are asked to be fully transparent about how this discretion is used, so that the investor community can prepare to manage stressful conditions and forecast liquidity needs. It is important to have international coordination in this area because there are major differences in the approach to margin transparency and margin pro-cyclicality across jurisdictions. This may take a toll on the level playing field and ability of EU CCPs to be competitive.

The Chair commented that an adequate balance has been achieved in the EMIR 3 proposals and there should not be compromise on elements that are necessary from a stability perspective.

An industry representative suggested that allowing access to clearing for nonbank financial institutions (NBFIs) can also contribute to address pro-cyclicality issues. Although this is a controversial question, allowing NBFIs into repo clearing can help to improve the functioning of the ecosystem.

5. Expected impacts of technology in the clearing space

An industry representative stated that it is important for CCPs to be able to access best-in-class technology and providers such as cloud service providers (CSPs). The move to the public cloud is driven not by cost but by operational resilience. Rather than impede its usage regulators should equip themselves with the proper tools to mitigate any concerns they may have with the use of cloud. Regulators should focus on outcome, which is sometimes missed in DORA, rather than getting caught up with the nitty-gritty of the functioning of CSPs. The industry needs to spend its energy on preventing operational risks rather than following excessively detailed requirements that can turn into tick-box exercises.

An official observed that there are many interesting discussions around how the blockchain can help to improve the full securities processing chain from issuance to settlement, including clearing. This is more a question for the private sector, but there are also potential regulatory implications. Before FTX collapsed there were pretty advanced discussions with the US CFTC about proposals made by FTX to implement a new clearing model with direct access for retail and institutional participants that would allow derivative risks to be assessed and mitigated in real time with an almost continuous setting of margin levels. This included a 24/7 operating auto-liquidation mechanism enabling client positions to be automatically closed out if margins fell below predetermined threshold levels. One further question to be assessed is the implications in the clearing space of a possible move towards T+1 settlement following the changes underway in the US.