CLEARING: EMIR3 AND FURTHER PRIORITIES

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Implementing EMIR 3

In February 2024, the co-legislators finally reached a provisional agreement on the third revision of the European Market Infrastructure Regulation (EMIR 3) proposed by the European Commission. This agreement has triggered an intense phase of implementation work for ESMA, both in terms of developing the necessary implementing measures and establishing new processes and structures to fill the legislative text with life.

ESMA has been mandated to develop no less than 28 Regulatory and Implementing Technical Standards and Guidelines, most of which will have to be finalised within the twelve months following the publication of the review in the EU Official Journal. Given these ambitious timelines and the absence of any additional staff or resources granted for the new tasks, ESMA will have to strictly prioritise and sequence the preparation of the level 2 work.

For the centrally cleared space, this will mean focusing first on measures addressing financial stability risks stemming from the exposures of EU clearing members and clients to third-country CCPs of substantial systemic importance for the EU. ESMA will have only six months to specify the conditions for operational and representative active accounts, which certain counterparties clearing relevant derivatives contracts will be required to maintain at EU CCPs. ESMA aims at swiftly publishing a public consultation on those draft standards to allow sufficient time to consult a broad range of stakeholders and fellow EU authorities, which are associated in the preparation of the RTS.

Second, ESMA will develop measures and processes aimed at streamlining and shortening supervisory procedures, reducing time to market and enhancing the competitiveness of EU CCPs. Under EMIR 3, CCPs will be able to benefit from new accelerated procedures for extensions of services under certain conditions and non-significant changes to their models and parameters. To support these efforts, ESMA is also mandated to build a new central database where EU CCPs will be able to submit in one place their applications for authorisation, extension of services, validation of risk models, as well as their monthly reporting.

Third, ESMA will work on strengthening the resilience of EU CCPs and the wider clearing ecosystem, particularly in light of the lessons learnt from the 2022 energy crisis. In this context, ESMA has been mandated to improve the transparency of margin requirements collected by CCPs and clearing members and to consider the potential procyclical effects of haircuts on collateral on the broader ecosystem. ESMA is also required to clarify the minimum requirements for the onboarding and continued participation of clearing members, including the specific case of Non-Financial Counterparties (NFCs), and to specify under which conditions NFCs can use uncollateralised bank guarantees as clearing members and clients.

EMIR 3 will also strengthen ESMA's role within the supervisory framework for EU CCPs. Under the new provisions, ESMA will co-chair with the relevant National Competent Authorities (NCAs) the supervisory colleges of 14 EU CCPs and adopt newly required opinions on the CCPs' annual reviews, supported by on-site inspections to which ESMA may be invited to participate. The toolkit of ESMA to support supervisory convergence has been expanded, as the CCP Supervisory Committee will be able to adopt supervisory priorities, as well as new opinions assessing EU CCPs' compliance with EMIR 3 provisions subject to a 'comply or explain to the Board of ESMA' mechanism. ESMA will also have the authority to request meetings with NCAs and CCPs on matters of concern, including emergency situations or compliance issues, and request information directly from CCPs under certain conditions, when the NCAs has failed to answer in due time.

While these steps are significant for strengthening a common supervisory approach for EU CCPs, greater progress could have been achieved in advancing the Capital Markets Union, particularly for the most systemic CCPs. The creation of a Joint Monitoring Mechanism, whilst being a positive step towards a more comprehensive view on the central clearing ecosystem, will by itself not be sufficient to address all risks related to the increase in clearing activity in the EU.

A more integrated and coordinated supervisory framework for CCPs at the EU level is necessary.

Clearing members and clients often reside in different Member States from the CCPs' place of establishment. In the event of a CCP disruption, the impact is not confined to a single national fiscal domain and may not even primarily affect the CCP's home jurisdiction. The repercussions can spread across borders, impacting key financial and corporate entities throughout the Union and beyond.

A more integrated and coordinated supervisory framework for CCPs at the EU level is necessary. It would go a long way in addressing this situation and the interests of the Member States potentially most exposed in the event of a CCP failure – such improvement should be considered under the new Commission.

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Enabling central clearing in the EU to respond to its challenges

The aim of the new EMIR 3 regulation is to enhance the EU's central clearing ecosystem, making it safer, more transparent, and more efficient. To achieve this, several key changes are introduced, including implementing an active account requirement, tweaks to the overall supervisory architecture and relevant supervisory processes for EU central counterparties (CCPs), and targeted amendments to CCP requirements. In this context, some of the biggest priorities to address moving forward relate to the integration of new asset classes and technologies, the adequacy of liquidity risk management in times of stress, as well as the ever-present concern relating to data quality and the ensuing quantitative analyses.

First, crypto-assets and crypto-derivatives are already on the radar of CCPs. At least seven CCPs on both sides of the Atlantic have planned or already started to offer clearing services for crypto investments. This innovation is not without challenges. The level of standardization of contracts for these instruments may be lower, which increases legal and operational risks. The availability of historical data is limited, hampering risk management tools and possibly causing distortions when estimating underlying risks. The volatility of these new asset classes, compared with traditional ones, can be higher – often linked to huge hype cycles – and the participant base may be different, with implications for the overall liquidity of trades. For public authorities, understanding the nuances of crypto activities better is critical to determining whether the current regulatory requirements and supervisory approaches remain suitable safeguards or require adaptation.

The technological stack that characterizes the cryptocurrency domain could also impact the clearing ecosystem through the adoption of new settlement models, where payments are made through digital currencies. In this regard, one key factor is the availability of a safe settlement asset. The Eurosystem is conducting experiments and trials on three alternative interoperability solutions between its payment infrastructures and DLT platforms – including Banca d'Italia's technologically neutral TIPS Hash-Link solution – that would allow wholesale financial transactions to be settled in central bank money. Looking at payments and settlement more broadly, we must consider how EMIR interacts with other regulations, particularly MICAR.

Second, as the clearing ecosystem becomes larger and more interconnected, the importance of CCPs grows, but so do the risks they bear. A cornerstone of financial stability remains CCPs' liquidity safeguards, which include access to central bank facilities. While CCPs are responsible for having sound risk management, access to central bank liquidity may be crucial in times of stress. However, such access is at the discretion of central banks and requirements may change depending on whether the CCP has a banking licence. Allowing CCPs in the European environment to have proper access to central bank facilities – subject to appropriate rule-based safeguards and procedures to monitor their fulfilment, and mindful of potential moral hazard issues – is fundamental. This is recognized by EMIR 3, which mandates the European Commission to report to the European Parliament and the Council on generalized central bank access for EU CCPs, assessing level playing field and financial stability considerations, and in relation to the situation in third countries.

Lastly, the availability of timely, high quality data is a must for supervisory authorities, as well as industry experts and academic researchers. For instance, Banca d'Italia monitors changes in margins and other indicators of supervised CCPs on an intra-day basis. EMIR mandates the reporting of derivatives transactions, a unique source of information for financial stability and market supervision. EMIR data, as they are called, provide a better understanding of financial markets, facilitate the development of real-time risk metrics, and help visualize and capture interconnections between counterparties. Unfortunately, dealing with EMIR data is still no easy task, due to its complexity, stemming from its dimensionality, the nature of derivative instruments, and the heterogeneous quality of the information reported. Although EMIR reporting reliability has improved significantly over time, it is crucial for each stakeholder (e.g. reporting counterparties, trade repositories, and competent authorities) to work on further enhancing the usability of the records. CCPs play an important role in ensuring the quality and completeness of EMIR reporting.

Innovation and the increasing range of services require more knowledge and better risk management.

The supply of central clearing services in the EU is set to grow, driven by regulatory action and innovation. An environment with increasing interdependencies among sectors, functions and actors requires market participants and public authorities to monitor and manage risks adequately, ensuring systemic implications are duly considered, while seizing opportunities.

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Beyond EMIR 3.0: the future has just started

The definitive text of EMIR review (EMIR 3.0) has finally been published, bringing much-needed visibility after years of uncertainty on the European post-Brexit regulatory landscape. While a broad consensus emerged among EU member states and market participants on the materiality of the risks posed by the overreliance of the EU financial sector on UK CCPs, the critical debate centered on defining an effective strategy to reduce this dependency, while mitigating costs for market participants.

The main measure of EMIR 3.0 to initiate the rebalancing of the exposures toward the UK is the obligation for EU financial and non-financial counterparties to have an active account with an EU CCP. One can only regret that a more ambitious set-up of the measure was not retained, especially in the context of interest rate market normalisation, triggering more need for interest rate risk hedging and where, as a consequence, the volumes of EUR IRDs cleared in the UK have kept increasing significantly in the past year (more than +40% since 2022). ESMA will assess the effectiveness of the measure 18 months after its implementation and regulators will stand ready to take stronger measures if the reduction of this heavy dependence is not achieved.

There won't be any complacency: **the stakes are too high. It is crucial that Europe achieves strategic autonomy**. This, alongside strengthening EU authorities' powers, the creation of attractive and adequate clearing services to fund the real economy, based on resilient EU CCPs, are essential foundations of the Capital Markets Union / European Savings and Investment Union, which remains a key priority for Europe. We are not there yet, EMIR 3.0 is a decisive step in this direction but not the endpoint.

During the past four years many events and developments unfolded. The financial system has come under severe strain, which has raised questions on procyclicality and clients' liquidity preparedness in high volatility contexts, but also proved the overall good resilience of EU CCPs' risk management and the importance to maintain adequate regulatory and supervisory framework. In parallel, the European clearing ecosystem has been changing fast: the clearing sector is expanding into new markets and developing models to better adapt to the profile and demand of clients in terms of access, products and collateral. Evidences of this evolution include the increasing demand for direct access from the buy-side through sponsored and special membership models and the development of crypto derivatives clearing. These initiatives raise challenges linked to risks and model complexification. Challenges are even higher in a context of emerging new technologies and increased cyber-risk.

> **The stakes are too high: it is crucial that Europe achieves strategic autonomy.**

For instance, when it comes to crypto derivatives clearing, CCPs have to adapt their margin models to capture the volatile behaviour of these assets, often coping with limited historical data, and risk management framework to take into account higher operational and cyber risks. On another operational hand, the implications of the T+1 settlement transition in North-America have to be assessed. The modalities for the transition to T+1 in the EU also need to be defined.

European regulators and supervisors play a key role in ensuring the creation of a safe financial environment, which helps strengthen and preserve the competitiveness of European participants. EMIR 3.0 is a first significant leap toward the building of a European framework that should also consider strengthening the supervision at European level, at least for systemic cross-border entities, not only for the most important CCPs, but also for funds and trading venues. This could be a way to ensure an agile, resilient and more integrated European financial sector, accelerating supervisory approvals, and gain in attractiveness.

These are the key priorities for the future of EU clearing. First, reducing dependency on other jurisdictions, while strengthening and developing capacity in the EU, with a rationalised clearing offer. Besides, financial institutions must both step up their adaptation to structural cyber risks and take stock of the opportunities offered by innovation, looking at AI to improve internal risk management tools, but also anticipate potential impacts on business models of the DLT adoption along the CCPs' value chain. Regulators and supervisors will also maintain a strong focus on the EU cyber resilience strategy, of which DORA is a significant milestone. Working together in this direction is an essential prerequisite for developing a stronger European framework and the infrastructures of the European Savings and Investment Union.

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After 3 comes 4: staying ahead of the curve

Looking at the past decade and the long way we have come since EMIR 1.0, we can safely agree that the EU has set the global benchmark on clearing regulation. A new financial stability reality can be observed around the most significant periods of market stress, where EU CCPs have proven best-in-class across key issues such as anti-procyclicality, transparency and predictability of margin calls.

Rather than falling into the complacency trap, we should continue to challenge ourselves and structurally improve the attractiveness of the EU's clearing ecosystem – in-line with the thinking around EMIR 3.0. The revised framework contains critical elements that will make a real difference and move the needle on a number of well-known issues.

A shorter time-to market reality will significantly improve the ability of EU CCPs to launch products and services in a competitive manner – whilst also meaning that liquidity around new asset-classes and instruments can in future evolve around a stronger Euro-denominated reality, a key aspect in the context of the open strategic autonomy and the future EU Competitiveness Deal.

And: We should not forget the important positive contribution the shorter time-to-market makes for an improved resilience and stability: In future, risk models can be adapted in a much more reasonable timeframe to factor in recent stress events that are key to consider for appropriate risk management and margin calibration.

Beyond this, EMIR 3.0 has also brought a broader pool of eligible collateral, improvements around portability, a reduction of regulatory hurdles for the buy-side to use CCPs, and an enhanced supervisory regime with automatic information sharing and emergency intervention powers for ESMA. Finally, let us not forget about the active account regime, intended to address the financial stability concerns associated with offshore clearing and a reduction of the systemic overreliance on third country infrastructures.

With entry into force expected by the end of this year, ESMA is already advancing its important work to boost preparedness for the new requirements on time. Ensuring readiness and effective implementation will remain a key priority in the months ahead. At Eurex Clearing, we remain committed to supporting customers and advancing on our "Home of the Euro Yield curve" strategy that will drive new realities around cross-cutting efficiencies.

Efficiency is also the buzzword when it comes to the vision for the new EU legislative period and what it means for the clearing regulation beyond the implementation of EMIR 3.0. In light of the challenges around growth and competitiveness but also a different geopolitical reality, the next years should cater for a necessary reflection on a number of topics and trends where the EU needs to stay ahead of the curve to ensure its clearing ecosystem remains globally competitive.

Boost the attractiveness of the EU's clearing ecosystem in-line with the ambition around the SIU.

The most important dimension in this context evolves around the need to foster a true level playing field for EU CCPs and non-EU CCPs but also vis-á-vis bilateral markets. A bouquet of different topics has emerged that require further assessment.

For instance, no other major jurisdiction requires their CCPs to hold a banking license to access central banks and adhere to banking regulation on top of the stringent CCP rules. While we see progress around the upcoming report contained in EMIR 3.0 and the Eurosystem's active work around the IMF's recommendation to harmonize access policies, a timely solution remains critical.

Another key item in this context concerns the EU's more conservative approach to MPOR requirements as well as APC measures. In both dimensions, a trend towards flexibility could prove to support the attractiveness of the EU's clearing ecosystem – noting that other jurisdictions, such as the US, have shown that this does not necessarily come at the expense of financial stability.

Speaking about the US: The introduction of a repo clearing mandate for US Treasuries should be further discussed in the EU. This seems particularly important in light of potential new pockets of risks that require more attention. Past crises have taught us that sound risk-management practices should be ensured before a potential accident happens – and in light of the global financial system remaining susceptible to further shocks, certain aspects, such as minimum haircuts in bilateral repo markets, seem long overdue.

Finally, the EU should continue with its global thought-leadership role in the digitalisation context, advancing on its important CBDC work as a key ingredient for the technological evolution across global capital markets – and pair it with the ability to capitalise on CCP innovation, such as cross-margining.

Taken together, this will pave the way to boost the attractiveness of the EU's clearing ecosystem in-line with the ambition around the SIU (Savings and Investments Union), matching a more demand-oriented approach that reflects the need for growth, competitiveness and a safeguarding of the EU's global role.

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Building towards a competitive EU clearing framework

During the past five years, markets have witnessed a legislative flurry similar to the aftermath of the Great Financial Crisis. Foundational EU laws underwent extensive reviews, and markets are now looking for certainty to deliver growth and competitiveness.

For EU CCPs, two major pieces of legislation have been at the forefront: EMIR and DORA.

The third iteration of EMIR has brought positive changes to the clearing landscape. Chief among them is the improvement of 'time-to-market' for products and services. By significantly reducing the authorisation time for new products, services, and changes to risk models, from up to two years to approximately 90 days, CCPs will be better placed to react and adapt to market demands. A shorter approval time with clear timelines will also not only improve the competitiveness of EU CCPs, but also drive down compliance costs. EMIR even introduced a short non-objection period designed to expedite non-substantial changes.

Another important improvement relates to the supervisory level-playing field among EU supervisors. National Competent Authorities occasionally take diverging interpretations of EMIR, resulting in an unlevel playing field. By bringing ESMA closer on supervision, it should drive a much-needed regulatory alignment, ensuring all EU CCPs adhere to the same rules.

Yet, despite this progress, we remain far from a true level playing field in the EU clearing landscape. Due to the political gridlock, EU policymakers have resorted to ever more granular legislative texts to compensate for the lack of a common, centralised supervisor. Regulation should be focused on controlling and managing risk rather than digging deep into every single process, which inevitably hinders the ability of market players to adapt to an ever-changing environment. Instead, we urge lawmakers to put aside national interests and support a single supervisory body for EU CCPs. The EU clearing framework must be organised to nurture fair competition, scale, and speed. That can only be achieved if we are all answering to the same sheriff.

Similarly, DORA will also have a transformational impact of the clearing landscape. By raising the bar across Member States, it will strengthen EU CCPs' operational resilience and harmonise approaches to incident risk management. Yet, much as with EMIR 3, policymakers opted for a detailed, all-encompassing approach that leaves little room for manoeuvring. For example, the new incident reporting rules will result in a considerable number of insignificant incidents having to be reported, creating noise around the incidents which are in fact material.

The EU clearing framework must be organised to nurture fair competition, scale, and speed.

DORA also clashes with certain national laws which restrict the range of providers from which financial institutions can choose. Operational resilience can be undermined by sovereignty requirements, and imposing the use of specific providers to the detriment of best-in-class technology providers can weaken competition. Managing risks is crucial, but taking the wrong approach can lead to controlling a safe graveyard.

To conclude, we offer three recommendations for the upcoming new EU political cycle.

First, we commend the calls to focus on implementation versus the initiation of new legislation. We urge policymakers to use this implementation phase to undertake a thorough holistic review of the EU financial services legislative framework through the prism of competitiveness. Such an exercise, together with the help of industry, will identify existing barriers and impediments to a real level playing field with both EU and non-EU competitors.

From a CCP point of view, we encourage finding pragmatic solutions to simplify the complex supervisory framework. Among the many CMU reports published before the summer recess, there are calls to centralise supervision for critical EU CCPs. As the CEO of one of them, I welcome this intermediate step. Most importantly, it would level the playing field between top market participants, raising competition and innovation as a result.

Lastly, we believe CCPs can play an instrumental role in managing the vulnerabilities resulting from liquidity mismatches which have been identified in many of the international and EU non-bank financial intermediation (NBFI) reports published in recent months. CCPs have developed models that facilitate the buy-side's access to deep pools of liquidity through clearing in both normal and stressed times. Not only would increased access be beneficial for the buy side's liquidity needs, but expanding the membership of CCPs to non-banks will also provide additional stability to the entire ecosystem. Yet, many of the EU regulations underpinning buy-side operations raise barriers to their direct interaction with CCPs. In line with measures taken in other jurisdictions such as the US and the UK, we suggest that policymakers can review such rules for the benefit of financial stability.