ISDA® Safe, Efficient Markets

ISDA comments on EMIR 3 Active Account proposal

1. ISDA supports the objective to increase the attractiveness of clearing in the EU. Competitive and innovative EU CCPs will increase clearing in the EU and help deepening EU capital markets. We support the proposal to streamline the supervisory procedures for the approval of new products and model changes for EU CCPs. This will allow EU CCPs to be quicker to launch new products, which is critical to the competitiveness of the EU clearing ecosystem.
2. Requiring EU clearing participants (clearing members and their clients, including end users) to use EU CCPs for a proportion of their business in certain products (Active Account Requirement) will not make the EU derivatives market safer or more attractive. On the contrary, it will lead to market fragmentation – and fragmentation creates systemic and operational risks. The additional safeguards introduced in EMIR 2.2 in response to Brexit ensure that clearing on UK CCPs is safe and does not raise any financial stability risk.
3. Requiring EU market participants to clear a proportion of their business on EU CCPs will introduce additional costs, ultimately hurting European pension savers and investors and the EU economy**.** It will also make EU clearing members and clients less competitive than third-country firms.
4. Ultimately, an Active Account Requirement will not advance financial stability in the EU, but will negatively impact EU market participants. Policymakers should be aware of the detrimental impacts to the EU financial industry and end-users like pension funds, and the risks that such a requirement introduces. At present, no sufficiently detailed cost/benefit analysis is available. We believe there needs to be a cost benefit analysis before a decision is made on the appropriateness of this requirement.

How does EMIR 2.2 address any potential financial stability risks arising from clearing on third country CCPs?

5. Following Brexit, the EU strengthened the framework for third country CCPs to ensure that it was safe for EU market participants to continue clearing on UK CCPs. EMIR 2.2 introduced additional safeguards for UK CCPs that are considered systematically important (Tier 2 CCPs)[1]:

    - **Tier 2 CCPs are required to comply with EMIR CCP rules** (article 25(2b)(a)). This mitigates any risk of UK CCPs becoming subject to lower standards than EU CCPs in the future[2];
    - **ESMA has supervisory and enforcement powers over Tier 2 CCPs.** Article 25(7) requires ESMA to have cooperation arrangements in place with the Bank of England[3] that provides, among other things, for the coordination of supervisory activities (including on-site inspections) and

[1] ESMA has identified two UK CCPs as Tier 2 CCPs: LCH. Clearnet and ICE Clear Europe.

[2] There is no evidence that the UK intends to lower CCP standards. To the contrary, the UK recently introduced a Senior Manager Regime for CCPs that promotes the safety and soundness of regulated financial services firms, by creating a system that enables firms and regulators to hold individuals within firms, and particularly senior decision-makers, to account.

[3] Memorandum of Understanding between ESMA and the Bank of England to set out arrangements for cooperation on the monitoring and supervision of CCPs established in the UK.

sharing of information both in Business as Usual (BaU) and in emergency situations. ESMA also has general investigation powers (article 25i) and powers to impose fines (article 25j) over UK CCPs;

- **ECB[4] has oversight powers over Tier 2 CCPs in BaU and crisis scenario** (article 25(2b)(b)). The ECB can and does require that UK CCPs open euro deposit accounts at the ECB. In exceptional circumstances the ECB can also impose additional requirement on Tier 2 CCPs to address any risk to the transmission of monetary policy for up to 12 months. Outside the EMIR framework, the Bank of England and ECB have agreed liquidity lines[5] under which the ECB can provide the Bank of England with euro in exchange for some form of collateral based on predefined terms and vice versa.

6. In addition, the UK has introduced a CCP recovery and resolution framework that is consistent with the EU one and includes a very strict no-creditor-worse-off construct that ensures that in a resolution scenario clearing participants are treated fairly irrespective of where they are established. In other words, in a resolution scenario, EU clearing members cannot be treated worse than UK clearing members.

By requiring UK CCPs to comply with EMIR high standards and giving EU authorities powers over these CCPs, EMIR 2.2 already effectively mitigates any potential financial stability risks arising from EU participants accessing UK CCPs.

How would Active Accounts impact financial stability?

7. While an Active Account Requirement is presented as a way to reduce perceived excessive reliance on UK CCPs by reducing the volume of euro-denominated products cleared on these CCPs, it amounts to forced relocation as it requires a portion of business to be cleared in the EU.

8. It will introduce new risks:
    - **Increased fragmentation of clearing across CCPs will increase total initial margin posted across the system** because of loss of netting opportunities. More margin posted at the system-level means, by construction, that risk has increased. It also increases potential liquidity pressures arising from margin demands. In a crisis, such higher margin requirements and increased complexity for EU firms to estimate likely margin calls are likely to exacerbate a "dash for cash", leading to a downward spiral of firesale liquidations of assets;
    - **Increased operational risks** from EU market participants having to comply with complex thresholds regarding volume of clearing that is required to be on EU CCPs;
    - **Large global banks will intermediate between the global and the EU liquidity pool**. The way the clearing obligation is designed (covering mostly banks and asset managers but not hedge funds as they are mostly based outside the EU), client flow at EU CCPs will be directional. Banks intermediating between the EU CCPs and the global liquidity pool will therefore have equal

[4] EMIR provides a number of oversight powers to the 'central bank of issue', i.e. the ECB in relation to euro-denominated swaps cleared at UK CCPs.
[5] Central bank liquidity lines (europa.eu)

directional portfolios. This will lead to higher liquidity risk for these banks, as in times of stress, they will be required to post margin intraday with one CCP, while they will only receive margin from the other CCP the next day;

- **Supervisory fragmentation could mean that neither EU nor UK authorities would have a full view of the market anymore**. Given the very high levels of interconnectedness, shared regulatory history, and the importance of the EU to the UK financial industry, the EU can expect to continue to enjoy a high level of oversight of UK CCPs and supervisory cooperation, better than the EU might expect from other jurisdictions to which clearing could relocate.

> *Requiring EU market participants to clear a proportion of derivatives on EU CCPs will not enhance financial stability but will introduce new risks.*

What are the detrimental impacts associated with Active Accounts?

9. Requiring market participants to hold an account at an EU CCP will create costs (e.g. legal documentation, IT change, process changes, account maintenance costs) even if there is no requirements to clear a portion of business at these CCPs ('qualitative requirement')[6].
10. Restricting how much can be cleared at UK CCPs ('quantitative requirement') will introduce additional detrimental impacts and make EU firms less competitive than third country firms:
    - **EU clearing participants will incur potential execution costs, clearing costs and operational costs**;
    - **EU market makers and clearing members will lose client clearing business to non-EU market makers/clearing members**. Clients not in scope of the active account requirement (i.e. non-EU clients or EU clients below the clearing threshold) will likely look for market makers/clearing members that give them unrestricted access to UK CCPs. These clients will likely choose to use non-EU market makers/clearing members that are not required to clear on EU CCPs;
    - **EU market makers will have less access to the global liquidity** pool to balance their trade flow and will have to buy more expensive hedges from their global competitors, thereby becoming regional distributors to global banks;
    - **EU clients will lose best execution.** Wherever the EU cleared price is worse than is available at the UK CCP, EU clients will be forced to accept this worse price, while their third country competitors will have freedom to trade at the best available price. While larger EU clients will only suffer this to the proportion required by regulation, EU clients that cannot support the complexity of two clearing systems will have to accept the EU-cleared price for all trades. Tier 2 CCPs by definition have the greatest volumes, so are likely to have the most liquidity and thus best pricing;

[6] If EU participants are required to clear a few trades on a regular basis (for operational resilience/testing reasons) there would also be some potential execution and clearing costs with a qualitative active account requirement.

- **EU clients which currently clear all the currencies in their portfolios at UK CCPs will lose netting efficiencies** if they are required to clear a proportion of euro-denominated derivatives on an EU CCP.

Active accounts will introduce costs for EU clearing participants. A quantitative requirement will introduce additional detrimental impacts and make EU firms less competitive than third country firms.

How successful would Active Accounts be in making the EU a global centre for derivatives clearing?

11. The introduction of a requirement for market participants to clear a proportion of their business on EU CCPs will not increase the attractiveness of clearing in the EU, but will have the opposite effect of sending a negative signal to global markets. To increase clearing on EU CCPs, the EU should pursue a positive agenda, one that creates a framework that fosters a competitive EU financial center.
12. In addition, the amount of clearing that an Active Account Requirement can shift from the UK to the EU is de facto limited. EU Firms are part of a much wider pool of liquidity on UK CCPs. According to LSEG data[7], EU Firms represented c.30% of the euro denominated Interest Rate Derivatives (IRD) notional registered in 2022 at SwapClear (part of LCH Group). This means that 70% of the euro denominated IRD notional registered at SwapClear originated outside the EU. Even if the EU required 100% of new euro denominated transactions in IRD by EU firms to be cleared at EU CCPs, a large majority of euro denominated transactions in IRD would remain at SwapClear. It is therefore highly unlikely that an Active Account Requirement, with all downsides including financial stability implications and diminished competitiveness of the EU financial sector, would generate a viable and attractive euro clearing market.

It is unlikely that Active Accounts would generate a viable and attractive euro clearing market.

What additional measures can be introduced in EMIR 3.0 to alleviate potential financial stability concerns?

13. The proposed Article 25(7b) (e) would grant ESMA additional powers over Tier 2 CCPs' recovery and resolution plans, including in a crisis scenario. We believe that this could be further strengthened by also giving ESMA a consultative role in the preparation of recovery and resolution plan on Tier 2 CCPs, which is what ESMA requested in the December 2021 report [8]on article 25(2c).

[7] 230310 LSEG response to EMIR 3.0 Final.pdf
[8] ESMA publishes results of its assessment of systemically important UK Central Counterparties (europa.eu)

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.