October 2022

ISDA®

A Roadmap to Make European Clearing More Attractive

EXECUTIVE SUMMARY

ISDA supports the principle of increasing the attractiveness of clearing in Europe. Key to this is ensuring these services are efficient, properly supervised and well regulated.

ISDA notes the concerns expressed by the European Commission (EC) about reliance on non-EU jurisdictions and the desire to further develop the EU's own financial infrastructure, particularly in light of Brexit. The EU should pursue a positive agenda to achieve this – one that creates a framework that fosters a competitive EU financial center, equips the EU with an open market structure commensurate with its status as home of the world's second reserve currency, and enables market participants to choose between different services that meet their needs.

The EU's clearing objectives can be achieved and its concerns addressed by pursuing this positive agenda. All stakeholders should seek to make the EU a place where market participants want to clear and choose to come to, rather than building barriers to accessing non-EU services.

This perspective has been echoed by the EC, including Mairead McGuinness, EC commissioner for financial services, financial stability and capital markets union (CMU), in her stated aim to "make the EU more attractive as a competitive and cost-efficient clearing hub, and so incentivize an expansion of central clearing activities in the EU"[1].

ISDA has proposed 15 specific and implementable actions that, taken together, would represent a positive and comprehensive strategy to boost the attractiveness of the EU clearing market.

Widen the range of market participants clearing in Europe:

1. Enable pension scheme arrangements (PSAs) to centrally clear;
2. Promote voluntary clearing by public entities;
3. Recalibrate the Undertakings for Collective Investment in Transferable Securities (UCITS) counterparty exposure limits to distinguish between cleared and non-cleared trades;
4. Amend the Settlement Finality Directive (SFD) and Financial Collateral Directive (FCD) to expand eligible participants and collateral.

Give European central counterparties (CCPs) a competitive edge:

5. Pursue an approach to regulation of EU CCPs that supports competitiveness and innovation;
6. Provide harmonized central bank access for EU CCPs;
7. Support bankruptcy-remote initial margin (IM) with regulation;
8. Improve EU CCP operational processes;
9. Expand European Central Bank (ECB) operating hours of Target 2 (T2) and Target 2 Securities (T2S);
10. Encourage the EC to promote anti-procyclicality tools for collateral haircuts, which will boost confidence in EU CCPs;

[1] Announcement on proposed way forward for central clearing by Mairead McGuinness, commissioner for financial services, financial stability and capital markets union, European Commission (EC), November 10, 2021, https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_5905

Remove unnecessary barriers to clearing in Europe:

11. Harness the potential of post-trade risk reduction (PTRR) services;
12. Protect intragroup transactions;
13. Prevent duplicative and conflicting requirements for international firms;
14. Promote international openness by amending rules on recognition of third-country CCPs;
15. Fill gaps in crisis management powers over systemic CCPs.

Not all of these measures require legislative change, and some could be implemented relatively quickly – for instance, steps to nudge public entities to clear, an operational decision to widen the T2 window and some practical adjustments to supervisory approaches. EU CCPs are already working to improve operational processes.

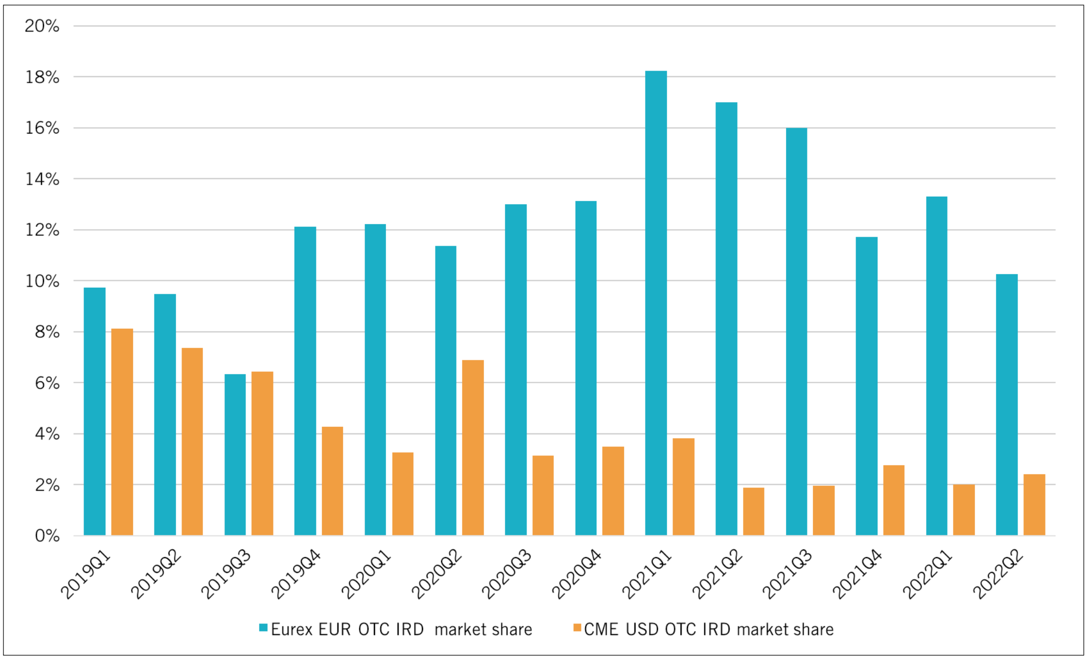
At the same time, this is a comprehensive agenda, and all the components have a role to play. Individual steps will not guarantee an immediate increase in the EU share of euro clearing, but the roadmap as a whole should deliver enduring, positive change.

Europe's Starting Point

UK-based CCPs currently handle a very high percentage of interest rate swaps (IRS) denominated in global currencies, including the euro, but the share of EU CCPs has increased since Brexit (see annex). Eurex has a larger market share in euro-denominated over-the-counter (OTC) interest rate derivatives (IRD) than CME's market share in US dollar-denominated OTC IRD (see Chart 1).

The challenge is building on those volumes while ensuring continued choice.

Chart 1: Market Share of Eurex and CME in Home Currency OTC IRD by New Volume (US Dollars)



Source: ClarusSoft CCPView

SECTION 1: WIDEN THE RANGE OF MARKET PARTICIPANTS CLEARING IN EUROPE

Increasing the range of market participants using EU infrastructure would boost liquidity on clearing platforms. This is linked to the wider EU goal of promoting central clearing as a vital tool for safe and resilient markets.

Actions to support this aim include:

1. Enable PSAs to centrally clear;
2. Promote voluntary clearing by public entities;
3. Recalibrate UCITS counterparty exposure limits to distinguish between cleared and non-cleared trades;
4. Amend the SFD and FCD to expand eligible participants and collateral.

1. Enable PSAs to centrally clear

The EU could take some practical measures to boost buy-side participation in central clearing. For example, the main obstacle for PSAs to clear is a lack of cash to post as variation margin (VM) in stressed market conditions. This could be overcome by developing a central-bank-backed service providing collateral transformation to PSAs and other buy-side participants. PSAs would then be able to convert high-quality collateral into cash to meet VM calls in stressed markets.

PSAs hold high-quality liquid assets (HQLAs) that, in normal market conditions, can be converted into cash. However, these HQLAs would be subject to higher volatility in stressed market conditions: there would be fewer buyers and strong selling pressure. As a result, PSAs may not be able to generate sufficient cash to meet VM calls. Other buy-side participants could face similar cash constraints.

Given these circumstances, requiring PSAs to clear could lead to financial stability issues in a situation like the COVID crisis in March 2020. Future crises could be even worse. The market stress in March 2020 followed a long period of decreasing interest rates when PSA swap portfolios were deep in-the-money. PSAs responded by returning collateral received from their counterparties, which was largely invested in money market funds (MMFs). As long as these MMFs offered liquidity, there was no issue returning the collateral. With interest rates now trending upward, most received collateral will have been returned. If another crisis hits, PSAs will likely struggle to source cash to meet VM calls.

A central-bank-backed service providing collateral transformation would encourage the buy side to turn to central clearing and would provide comfort for PSAs as they adapt to mandatory clearing, expected by June 2023 following the final extension of the clearing exemption for PSAs by the EC[2].

An EC report[3] states that European insurance companies and pension funds had to pay an additional €50 billion in VM to their counterparties between March 11 and March 23, 2020. During this period, PSAs were not required to clear and so could post bonds as VM for their non-cleared derivatives. Liquidity risk was with their dealer counterparties. If PSAs had been clearing during this period, then they would have had to source significant amounts of cash to fund VM through the repo market.

[2] EC delegated regulation, May 6, 2021, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0962&from=EN

[3] Footnote 21, page 4, Report from the Commission to the European Parliament and the Council, June 9, 2022, ec.europa.eu/finance/docs/level-2-measures/report-emir-delegated-act-2022-3584_en.pdf

ISDA recommends that policymakers conduct an in-depth analysis of how central bank access could be intermediated to allow PSAs to convert HQLAs into cash, potentially limiting this to a last-resort tool that is only used in stressed market conditions.

2. Promote voluntary clearing by public entities

While several public entities already choose to clear, increasing the number of public entities that do so would add to liquidity in the European clearing market and increase domestic capacity. The EU should consider recommending that public entities clear. While European CCPs would likely be the natural home for clearing by EU public entities, ISDA does not believe it should be mandated.

Clearing by European public entities would send a strong message of confidence in European CCPs. It would reduce overall risk for public entities, reflecting the benefits that central clearing brings in terms of market resilience.

To avoid concerns about public entities contributing to the default fund or participating in mutualization, these entities could clear as clients or via new direct or sponsored access models.

3. Recalibrate UCITS counterparty exposure limits to distinguish cleared and non-cleared trades

The EU should amend the UCITS Directive to incentivize clearing of OTC derivatives.

The directive and associated guidance does not currently distinguish between cleared and non-cleared OTC derivatives when setting counterparty exposure limits. In particular, it fails to reflect the account segregation models available for centrally cleared OTC derivatives.

Under the Committee of European Securities Regulators guidelines on Article 52 of the UCITS Directive, VM and IM posted/received in cash relating to exchange-traded derivatives do not need to be considered when calculating counterparty credit risk, as long as they are protected under client money rules. However, most EU jurisdictions do not have client money segregation rules, which means the current framework does not incentivize funds to use EU clearing brokers for exchange-traded derivatives.

As recommended by the European Securities and Markets (ESMA)[4], the EU should amend Article 52(1)(b) of UCITS Directive and update associated guidance to enable exposures to cleared derivatives to be treated consistently.

This distinction will better incentivize UCITS funds to clear OTC derivatives.

4. Amend the SFD and FCD to expand clearing

Amending the SFD to expand the list of eligible participants would help spur wider use of clearing. This would ensure EU CCPs can accept a broader range of participants while still qualifying for SFD protection.

To expand the types of financial instruments eligible to be used as collateral, the EU should also align the definition of 'financial instruments' in the FCD with the definition under the revised Markets in Financial Instruments Directive (MIFID II).

This would capture emissions allowances, as well as other instruments that fall under MIFID but are not currently in scope of the FCD.

[4] European Securities and Markets Authority (ESMA) Opinion on Impact of EMIR on UCITS, May 22, 2016, www.esma.europa.eu/sites/default/files/library/2015/11/2015-880_esma_opinion_on_impact_of_emir_on_ucits.pdf

SECTION 2: HOW TO GIVE EUROPEAN CCPS A COMPETITIVE EDGE

A number of changes can be made that would help better position the EU from a global perspective, without sacrificing any regulatory or supervisory rigor. CCPs could also make further progress towards adopting clearing management best practices[5].

Actions to support this aim include:

5. Pursue an approach to regulation of EU CCPs that supports competitiveness and innovation;
6. Provide harmonized central bank access for EU CCPs;
7. Support bankruptcy-remote IM with regulation;
8. Improve EU CCP operational processes;
9. Expand ECB operating hours of T2 and T2S;
10. Encourage the EC to promote anti-procyclicality tools for collateral haircuts, which will boost confidence in EU CCPs;

5. Pursue an approach to regulation of EU CCPs that supports competitiveness and innovation

To support the competitiveness of EU CCPs, policymakers should consider allowing CCPs to accept a wider range of collateral, including MMFs and exchange-traded funds, so they can meet the needs of the market, particularly buy-side firms.

The EU supervisory framework should be simplified to enable CCPs to adapt and compete in a rapidly evolving financial system. A first step could be to review the processes of supervision between ESMA, national competent authorities (NCAs) and other parties to identify bottlenecks and inefficiencies.

For example, it can sometimes take more than three years to launch a new product. It involves long discussions with supervisors to deem a submission file complete before beginning the relevant processes under the European Market Infrastructure Regulation (EMIR), including extension of activities or services (Article 15) and a review of models, stress testing and back-testing (Article 49).

This puts EU CCPs at a competitive disadvantage where non-EU jurisdictions allow self-certification with non-objection periods of two months or less. The slow and complex process in the EU gives a first-mover advantage to some non-EU CCPs that can be quicker to market with innovative proposals. Decreasing time to market will be critical to the competitiveness of the EU clearing ecosystem.

The current approach for approving new products (Article 15 of EMIR) and/or improvements to risk models (Article 49 of EMIR) should be streamlined to reduce time to market for EU CCPs. The length of time between the initiation of a project and final regulatory approvals can be reduced to be comparable with non-EU jurisdictions.

[5] ISDA whitepaper, CCP Best Practices, January 2019, www.isda.org/a/cigME/CCP-Best-Practice.pdf

EMIR 2.2 has already incorporated clear steps in its framework:

- An initiation phase by NCAs and the college of supervisors;
- File submission;
- Assessment;
- Maximum timelines for review by ESMA and the college of supervisors.

However, it appears that clear timelines only apply for the actual assessment phase and there are significant delays in the initiation and submission phases for EMIR Article 15 and Article 49 changes.

The regulatory framework should also be sufficiently flexible to allow CCPs to adopt new technology such as distributed ledger, which will help to ensure EU CCPs remain competitive in a rapidly evolving environment.

6. Provide harmonized central bank access for EU CCPs

Providing CCPs access to both central bank liquidity and deposit facilities increases the resilience of CCPs, especially in times of stress. As such, policymakers should explore ways to enhance and harmonize such access in order to boost the attractiveness of EU CCPs and prepare the EU for handling greater clearing volumes.

The Principles for Financial Markets Infrastructures (PFMIs) recommend CCPs should use central bank facilities where available as this avoids settlement, credit and liquidity risk arising from the use of commercial bank money. As it stands, there is no harmonized access to central bank services for EU CCPs, unlike in other jurisdictions such as the US. CCPs should not have to obtain bank licenses for central bank access.

7. Support bankruptcy-remote IM with regulation

To provide capital incentives for market participants to clear within the EU, policymakers should address regulatory or other barriers that prevent EU CCPs from accepting IM in a bankruptcy-remote way. This would create financial incentives for market participants, as they would not be required to hold capital against bankruptcy-remote IM posted on cleared transactions.

Many firms also do not count bankruptcy-remote IM against credit limits. Being able to post bankruptcy-remote IM will make it easier for these firms to expand their business without having to increase credit lines.

8. Improve EU CCP operational processes

EU CCPs are already working to improve their operational processes and this should continue, with the aim of becoming best in class. This trajectory will lead to an internationally competitive clearing environment, which will organically attract activity to the EU.

EU CCPs should consult their members and end clients to identify any gaps relative to international best practice. In addition, they should continue to develop their post-trade compression services by working with vendors and market participants. Any existing processes that may be cumbersome should be addressed to increase the competitiveness of EU CCPs and build market confidence in their ability to handle client volumes.

These include processes for onboarding new accounts. Individual segregated accounts and non-cash collateral setups generally take longer to complete, while service levels for completing operational processes can be slower compared to non-EU CCPs. In addition to these delays, the due diligence and know-your-customer requirements set by some local regulators can impede speed to market and impact overall client experience.

Consistent account structures and naming conventions compared to non-EU CCPs could reduce client enquiries, particularly for clients new to accessing EU CCPs. Further streamlining in these areas would facilitate greater use of EU CCPs, significantly enhancing the overall experience of clearing members and clients.

9. Expand ECB operating hours of T2 and T2S

T2 operating hours should be extended to incentivize the use of EU CCPs. This would allow clearing members to pay margin calls in euros after the current T2 closing time of 18:00 CET, and so reduce clearing members' dependence on dollar liquidity. Extending the window for the posting of securities as collateral in T2S would also be helpful to clearing members.

10. Encourage the EC to promote anti-procyclicality tools for collateral haircuts, which will boost confidence in EU CCPs

Setting haircuts in a conservative or counter-cyclical manner could reduce the impact of margin calls during stress events, thereby increasing confidence in EU CCPs and attracting increased volumes of activity.

A significant amount of work has taken place at the European and global levels on anti-procyclicality tools for IM, but there has been less focus on the procyclicality of haircuts. The impact of haircut increases on some member states during the eurozone debt crisis is still often cited as an example of a financial stability risk.

While these issues have already been addressed in EMIR, the EU should pick up on the suggestion made by the European Systemic Risk Board (ESRB)[6] for further work to be conducted on the procyclicality of haircuts applied to collateral posted as IM to CCPs. In this way, the EU can determine whether more guidance is needed.

As suggested by the ESRB, areas for further study should include the use of qualitative terms such as 'prudent' and 'as far as possible' in EMIR, as these do not sufficiently limit procyclicality. More guidance could also be given on how to consider look-back periods or how to estimate pre-defined minimum haircuts.

[6] Revision of the European Market Infrastructure Regulation, European Systemic Risk Board, April 2017, www.esrb.europa.eu/pub/pdf/reports/20170421_esrb_emir.en.pdf

SECTION 3: HOW TO REMOVE UNNECESSARY BARRIERS TO CLEARING IN EUROPE

The upcoming review of EMIR is an opportunity to take a holistic view of how clearing works in the EU and address any obstacles and deterrents. The EU does not operate in a vacuum and, by its very nature, an attractiveness agenda needs to consider what steps other jurisdictions have taken. The EU could make changes that would help it position itself better in this global context.

Actions to support this aim include:

11. Harness the potential of PTRR services;
12. Protect intragroup transactions;
13. Prevent duplicative and conflicting requirements for EU firms competing internationally;
14. Promote international openness by amending rules on recognition of third-country CCPs;
15. Fill gaps in crisis management powers over systemic CCPs.

11. Harness the potential of PTRR services

PTRR services are increasingly used to free balance sheet resources and reduce risk exposure, not least because more demands are being placed on bank capital and collateral. As such, a conditional, limited exemption from the clearing obligation for PTRR non-price-forming technical output transactions would improve the attractiveness, stability and efficiency of EU clearing and EU capital markets.

The EC should address this issue in its forthcoming proposals. Such a move would align with recommendations made by ESMA in November 2020 for the use of PTRR services to be promoted by permitting a limited and conditional exemption from the EMIR clearing obligation.

This would apply:

- Where technical output transactions resulting from PTRR fall within classes of derivatives subject to the clearing obligation; and
- Where reduction of risk in the bilateral derivatives portfolio would be more efficient if these non-price-forming technical risk-reducing output transactions – which would not exist were it not for PTRR processes – were retained in the bilateral portfolio rather than put into clearing houses.

ESMA also set out recommended conditions for this exemption. To address concerns about circumventing the clearing obligation, there could be a requirement for each bilateral technical risk-reducing transaction resulting from PTRR exercises exempt from the clearing obligation to have an equal and opposite technical risk-reducing transaction booked facing a CCP, on a net basis. This exemption would not cause trades to be removed from clearing.

The UK has proposed implementing a PTRR clearing exemption as part of the Wholesale Markets Review[7]. This raises the prospect that EU firms might be disadvantaged if they cannot participate in such risk-reducing exercises, or can only participate with more complicated product types such as swaptions.

[7] Wholesale Markets Review: Consultation Response, HM Treasury, March 1, 2022, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1057897/Wholesale_Markets_Review_Consultation_Response.pdf

Prohibiting the least complex products from being used (vanilla IRS versus swaptions) when managing outstanding risk exposures goes against the spirt of the regulation and creates barriers to entry for less sophisticated firms. Allowing the least complex products to be used would make PTRR services accessible to a larger set of counterparties and increase the efficiency of risk reduction.

Embracing PTRR services would bring benefits that go beyond boosting the attractiveness of EU CCPs. These services are particularly useful in reducing outstanding notional exposures and counterparty credit risk in the non-cleared derivatives market, thereby reducing systemic risk. PTRR techniques such as portfolio rebalancing, for example, would have significantly reduced outstanding counterparty risk and therefore the size of margin calls during the period of market stress in March 2020. While net VM calls increased by two to three times during this time, gross VM paid and received by counterparties rose from around three or four times the net VM to approximately 12 times the net VM. This created increased liquidity stresses at precisely the time when funding markets were less liquid.

12. Protect intragroup transactions

Intragroup transactions are essential to the centralized management of risk by EU firms and the ability to make investment capital available within the EU. The treatment of these transactions is critical in determining whether there is a level playing field between EU institutions that have business entirely within the bloc and EU firms that operate internationally. This has an impact on how the EU is perceived in terms of market openness and attractiveness.

Clarifications are required so the availability of the exemption for cross-border intragroup transactions from clearing, margin for non-cleared derivatives and the credit value adjustment (CVA) capital charge – the latter under the Capital Requirements Regulation (CRR) – would not be contingent on EMIR Article 13 equivalence decisions relating to the jurisdictions in which relevant non-EU group entities are located.

At the time of adoption of EMIR and the CRR, the co-legislators wanted these exemptions to be available in practice.

13. Prevent duplicative and conflicting requirements for EU firms competing internationally

Given EU clearing firms and clearing members operate in a global environment, it is important to minimize regulatory incompatibilities in clearing, margin requirements and reporting that can lead to duplicative and conflicting requirements under EU and third-country rules.

It should be feasible for EMIR Article 13 equivalence decisions to enable EU firms competing internationally to avoid such incompatibilities. To achieve this, the conditionality associated with EMIR Article 13 equivalence should be revisited – in particular, the requirement that one of the relevant group entities must be established in the third-country jurisdiction concerned.

14. Promote international openness by amending rules on recognition of third-country CCPs

Although it does not directly affect the environment for EU CCPs, improvements in the overall EU clearing landscape will have an indirect impact on their attractiveness. The EU should therefore pursue changes in prudential and other regulation that have the potential to undermine the EU's credentials as an open, international capital markets hub.

One issue that should be addressed is how the qualifying status in the CRR depends on recognition under EMIR (Article 25). Requiring a CCP to have EMIR recognition status in order to be considered a qualifying CCP under the CRR means smaller CCPs with no EU-domiciled clearing members must gain recognition at considerable expense solely for the CCP to be deemed qualifying.

Changes to make it easier for EU firms to deal with small, third-country CCPs would remove unnecessary friction for clearing participants and regulators. One approach would be for clearing members to assess PFMI compliance for smaller CCPs (ie, often those for which no recognition determination has been made) and determine whether the CCP should qualify for capital purposes in line with current practices in other jurisdictions such as the US.

15. Fill gaps in crisis management powers over systemic CCPs

EMIR delegates supervisory powers over tier-two CCPs to ESMA. ESMA and the Bank of England have entered into a memorandum of understanding that sets out the arrangements for cooperation on the monitoring and supervision of CCPs. These are positive steps.

ESMA's 2021 assessment report[8] under Article 25(2c) of EMIR identified possible gaps in its powers in crisis situations, and in supervisory cooperation in a crisis. To address these issues, ESMA should be consulted when recovery and resolution plans for tier-two CCPs are drafted or amended and participate in the crisis management groups of tier-two CCPs.

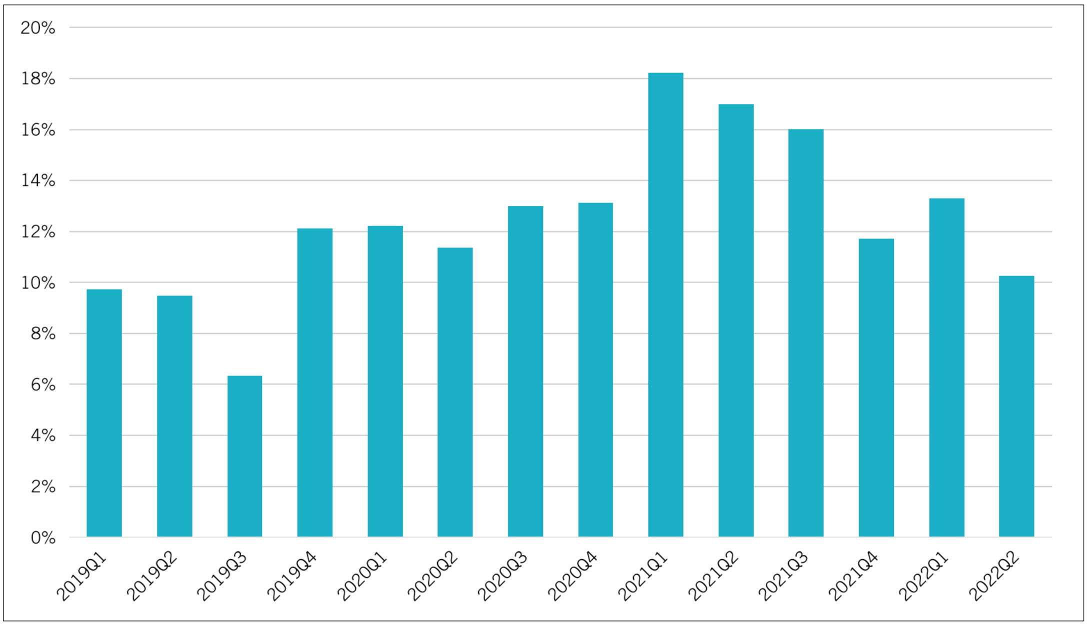
[8] ESMA Publishes Results of its Assessment of Systemically Important UK CCPs, December 17, 2021, www.esma.europa.eu/press-news/esma-news/esma-publishes-results-its-assessment-systemically-important-uk-central

CONCLUSION

As with the CMU project as a whole, there is no single measure or seismic step that will transform the EU's share of the euro clearing market. Success will instead be achieved by taking a set of practical and meaningful steps, looking holistically at whether the regulatory environment in the EU reflects its ambitions, and seizing the opportunities posed by the international nature of derivatives trading. This is aligned with the importance of having well-supervised and well-regulated financial market infrastructure. Sound market infrastructure is attractive market infrastructure.

ANNEX: STATE OF EURO CLEARING WITHIN THE EU

Chart 2: Eurex Market Share in Euro-denominated OTC Derivatives by New Volume (US Dollars)

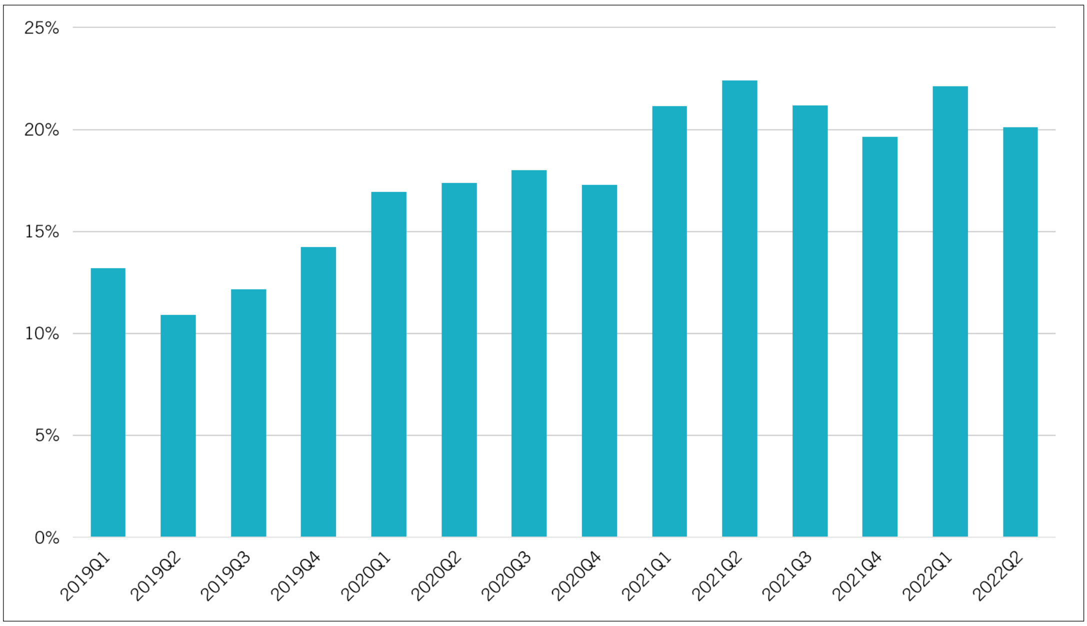


Source: ClarusSoft CCPView

LCH has estimated that the ratio of euro-denominated IRS with an EU nexus by new trade count (new registrations) is around 25%. While Chart 2 illustrates the ratio by new volume (including trade size), it shows the EU already has a non-negligible part of the possible addressable market. This could be increased further by following the roadmap set out in this whitepaper.

Chart 3 shows that while market share in new transactions did not grow consistently over the period, this resulted in an increased market share in terms of open interest (ie, the total portfolio).

Chart 3: Eurex Market Share in Euro-denominated OTC Derivatives by Open Interest (US Dollars)



Source: ClarusSoft CCPView

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 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.