Brexit and OTC Derivatives Clearing: The Role of Politics

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I. Introduction

- Clearing and settlement infrastructures are a vital part of financial markets’ activities (plumbing of the financial system)
- The first Giovannini Report (1993) already stated their importance for a capital markets union
- After the 2008 financial crisis radical steps were taken to enhance the role of infrastructures in financial markets, especially in the OTC derivatives sector (G20 post-crisis commitments)
- European Market Infrastructure Regulation (EMIR)
- Markets in Financial Instruments Directive (MIFID II) and Markets in Financial Instruments Regulation (MIFIR)
- FMI have been entrusted with public policy goals (e.g. clearing obligation for OTC derivatives)

- The Commission in a Green Paper (2015) committed to put in place by 2019 the building blocks of a well-regulated Capital Markets Union, encompassing all 28 Member States
  - benefits of capital markets and private risk-taking for the wider economy
  - single rulebook for financial services and high level of investor protection

- After the UK referendum, the Commission stated that Brexit makes the need for a CMU even more salient and invited to actively address the obstacles to the effective free flow of capital across the EU
- However, European leaders expressed doubts about London keeping the lead on clearing
  - UK banks, insurers and asset managers will be affected by Brexit, as they risk losing their passport rights and may be forced to delocalize part of their activities into one or more Member States
  - For FMI, including CCPs, the problem is even more serious, given their relevance and size and the systemic implications of their activities
- We try to identify possible solutions in light of the likely outcomes of Brexit negotiations.

II. Central Clearing of OTC derivatives

- Central clearing services can only be offered by CCPs licensed under EMIR

1. Clearing economics and regulation

- The CCP interposes itself between the original trade counterparties, taking on and concentrating the risks of non-performance and failure of the market
  - CCPs foster efficiency at microeconomic level, reducing transaction costs to market participants
  - Through multilateral netting, CCPs diminish the mass of open exposures of aggregate market participants
  - Due to the concentration of risks, the partial or total failure of a CCP could cause a major financial disruption
  - Increasing amounts of derivatives are now centrally cleared at global level, however in different proportions amongst derivatives classes

(A) Concentration

- Market concentration is coessential to the clearing economy
- The (scale) efficiency margins of multilateral netting increase in the range of cleared products and market increases
- CCPs’ clients also determine the concentration in the market for clearing services (small number of dealers)
- Buy-side concentration has financial stability implications
- Top clearing member-banks hold clearing accounts at multiple CCPs, which raises obvious stability concerns
- The recent ESMA stress tests highlighted that half of the European CCPs' total default resources came from the 10 largest European derivatives dealers groups

(B) Globalisation

- The clearing industry is naturally transnational
- The cross-border nature of clearing services has been addressed by post-crisis regulatory initiatives at international level
- CCPs can presently rely on a globally agreed regulatory framework
- The volume of transactions of a CCP in foreign currencies can be substantial
- CCPs have therefore to manage multiple liquidity risks and benefit from central bank services addressing the systemic implications of liquidity risk governance

- The FSB has recognized that appropriate liquidity arrangements for CCPs in each currency that they clear is one of four basic safeguards for central clearing (EMIR is surprisingly silent on this issue)
- Central banks have addressed the issue of foreign liquidity needs through a cooperative approach
- They are presently linked in a network of bilateral liquidity swaps
- CCPs can thus rely on the competent central bank’s foreign currency deposits in order to manage their liquidity risk.

2. Eurozone vs. City-clearing

- The European clearing industry is concentrated on the providers' side
- 17 authorized CCPs; only 10 also authorized to clear at least one class of derivatives
- 6 CCPs are authorized to offer IRS clearing; 2 clear most European CDS and foreign currency derivatives
- 4 CCPs clear all three classes; all but one are registered in the UK and subject to Bank of England’s supervision
- 2 U.S. CCPs operate from London
- City CCPs account for default resources of more than 90 billion British Pounds, a staggering amount considered the relatively small tax base of the UK
- The City-centricity of clearing infrastructures has historically raised concerns, particularly with regard to the fact that most euro-denominated clearing takes place outside the Eurozone and ECB direct oversight

- These concerns originated the well-known controversy between the ECB and the British government, concerning the so called “location policy”
- In 2011 the ECB issued a binding policy requiring CCPs which settled in euro to be legally incorporated and have full managerial and operational control in the Eurozone
- The UK government questioned its legitimacy bringing a case against the central bank in front of the European Court of Justice
- The ECJ decided the case in 2015 in favour of the UK government and its clearing industry, excluding a regulatory competence of the ECB over CCPs
- However, the question was solved in practice with the adoption of EMIR, which filled the regulatory and supervisory gaps regarding CCPs
- The ECB and the BoE committed to develop the existent liquidity swap lines in order to support the liquidity risk management of CCPs

III. Brexit, EMIR and Equivalence

- The EU will follow a phased approach to Brexit negotiations
- A priority will be to reach consensus on the UK withdrawal (including financial contributions)
- The debate will then focus on the new framework of the EU-UK relationship, which includes the status and treatment of cross-border financial institutions and services
- The future outcomes of Brexit negotiations are difficult to predict
- The possibility of a soft Brexit should not be totally excluded
- However, it is highly unlikely that the remaining Member States will let the UK cherry-pick amongst the EU Treaty fundamental freedoms (immigration policy)

- Hard Brexit is more likely at the moment, with two options available to mitigate its consequences:
  - equivalence, which is however foreseen only for some types of services, including clearing activities, or
  - an agreement between the EU and the UK covering financial services, clearing activities in particular
- If consensus is not reached and if the UK CCPs are not recognized as equivalent under EMIR, they will be precluded from offering services in the EU post-Brexit
  - No doubt, they could set-up subsidiaries in the EU and offer their services from there
  - However, this possibility is less interesting for CCPs than for banks

1. Non-consensual Brexit and equivalence

- Under Article 25 EMIR, a third country CCP may provide clearing services to clearing members or trading venues established in the Union only where it is recognised by ESMA
- ESMA may recognise a CCP established in a third country only after that the Commission has adopted an implementing act determining that
  - the legal and supervisory arrangements of that country ensure that CCPs comply with legally binding requirements which are equivalent
  - CCPs are subject to effective supervision and enforcement
  - the legal framework of the third-country provides for an effective equivalent system for the recognition of CCPs authorised under other countries' legal regimes
  - ESMA will recognise a CCP after consulting all competent authorities

- The equivalence decision is exposed to political interference given the high stakes involved and the wide discretion reserved to the Commission
    - the relevant regime is no doubt more cumbersome and unpredictable than the single licence presently in force
    - given that the UK has implemented EMIR, both the Commission equivalence decision and ESMA recognition of UK CCPs should not be problematic
    - the UK also has a strong supervisory cooperation track record with respect to global colleges concerning transatlantic CCPs
    - however, the equivalence regime actually requires the presence of a third country, while the UK will be a member State at least until March 2019

- The equivalence framework is intrinsically unstable
- The Commission could revoke its equivalence decision at any time, for example because of regulatory changes in the third country at issue or in the EU
- ESMA may withdraw its recognition of a third country CCP where it finds that the relevant conditions are no longer met
- The UK would have no access to the European Court of Justice for remedies against the Commission or ESMA

- The equivalence framework raises further concerns from the financial stability perspective
  - EMIR does not consider the need for mutual central banking support of CCPs in a third country
  - The ECB does not participate either in the equivalence decision or in the recognition procedure, except for being consulted by ESMA
  - The equivalence framework does not address the need for liquidity swap agreements between central banks in support of clearing infrastructures
  - It is to be seen whether the ECB will continue to provide assistance in support of UK CCPs post-Brexit

2. Consensual Brexit and agreement on clearing

- A comprehensive agreement would regulate the framework for the UK's future relationship with the EU, including the financial services sector in general and CCPs in particular.
- UK CCPs would benefit from a tailor-made access right to the single market and continue to clear euro-denominated products
- The agreement should also provide the UK with institutional protection, which would not be available under the equivalence regime
- A legal mechanism should be established to manage the evolution of the separated EU and UK rulebooks and ensure the crossborder consistency of regulatory frameworks
- The agreement should provide for appropriate enforcement and dispute resolution measures, including a dispute settlement institution

- The resulting partnership framework would be atypical in the panorama of EU trade and partnership deals with third countries
- The UK would maintain a unique level of integration with the EU financial system
- Unlike the “Swiss solution”, the Brexit deal would be structured as a comprehensive agreement, covering any sector of interest
- It would be similar in scope to the Canadian-European free trade agreement (CETA), but with a wider coverage of financial services

- If a comprehensive deal becomes unfeasible, divorcing parties could reach consensus on specific areas, with a sector-to-sector approach
- It is unclear whether and to what extent the agreement at issue could also cover the relationship between the Bank of England and the ECB as to liquidity assistance to CCPs
  - The UK could not rely on the guarantees foreseen for Eurozone-outs under the February 2016 agreement
  - The ECB could invoke its independence in order not to renew the existing swap lines or to provide a lower safety back-up to market
- However, given the institutional complexities involved, the two years deadline makes any consensual outcome hard, if not impossible, to finalize

3. Proposed EMIR reform

- In view of the growing importance of foreign CCPs for the Union, the Commission suggests
  - to strengthen the EU's ability to identify, monitor and mitigate the financial stability risks posed by non-EU domiciled CCPs
  - to enhance the role of ESMA and of the relevant Union's central banks in relation to financial instruments denominated in Union currencies that are cleared in CCPs located outside the Union

- The proposal introduces a new binary classification for recognized third-country CCPs
- ‘Tier one’ CCPs that do not pose a material threat to the EU financial stability
- ‘Tier two’ CCPs that are, or are likely to become, systemically important to the financial stability of the Union or its Member States
- The latter will have to comply with a sliding scale of additional prudential requirements, proportional to their systemic importance, and will be subject to direct supervision by ESMA and by the relevant Union’s central banks
- If ESMA and the relevant central banks conclude that a ‘Tier2’ CCP is of such systemic importance that even additional requirements will not sufficiently guarantee the financial stability of the EU, a location decision will be adopted (the CCP will relocate inside the European Union and obtain a EU authorisation)

- The proposed reform would enhance the powers of ESMA and the relevant CBIs to regulate and supervise CCPs from a financial stability perspective
- A similar reform would also bring unintended consequences, which could severely impact the market by putting ‘Tier 2’ CCPs at a disadvantage in respect of competitors
- Third country CCPs recognized as systemically important would become subject to the same requirements that apply to EU CCPs, so as to ensure a level playing field between EU and foreign clearing providers.
- However, they would fall under a double compliance regime, which would no doubt raise compliance costs while giving rise to conflicts of rules, putting cross border clearing providers at a disadvantage.
- The mechanism of substitute compliance appears to be crucial for limiting the costs at issue, but much depends on the Commission’s delegated regulation

- However, a location decision case by case appears more proportionate than the previous location policy enacted by the ECB
- it will impose a location requirement only as a last resort measure
- it will substantially set a threshold related to the systemic relevance of the CCP
- a ‘relocation trigger’ would set a limit to the clearing volumes of cross-border CCPs (impact on scale efficiencies)
- All these factors could discourage the provision of cross-border clearing services and fragment the market across currency reference zones

IV. Speculating on the worst-case scenario

- If the two stated scenarios did not materialize or the ECB made them unattractive to market participants, UK CCPs could not access the EU market any more from their seats in London
- As a result, EU financial institutions would find it difficult to comply with EMIR unless new CCPs were swiftly created in one or more Member States or existing CCPs extended their scope
- Fragmentation of the clearing industry would increase transaction costs to customers at European level, with dubious gains in terms of financial stability

- Replacing current London providers would nevertheless prove difficult
- The IRS sector represents 85% of the value of outstanding derivatives in Europe and more than one trillion € in notional value cleared daily, with Swapclear servicing more than 95% of the overall European market
- Other CCPs, like Eurex and the clearinghouses of the Chicago Mercantile Exchange are also licenced to provide clearing services under EMIR
- The possibility of a transitional agreement, at least postponing the worst-case scenario, should therefore be carefully assessed. The transitional status should extend the present regime (including ECJ jurisdiction) to UK CCPs for some time after Brexit

- In the long run, Euro derivatives clearing will concentrate in a single CCP, presumably domiciled in the Eurozone with the ECB's back-up
    - it will be crucial for this CCP to reach a critical clearing volume, in order to exploit the scale benefits and lower the indirect costs of clearing for market participants.
    - Eurex appears to be in pole position, given that it is already authorized, has an offer fungible with that of Swapclear and has its main seat in Frankfurt
    - UK CCPs could either set-up subsidiaries in EU Member States or extend the product coverage of already registered ones, similarly to what banking groups are either planning to do or already doing in view of Brexit

  - However, the scale economies of clearing make subsidiaries more costly, as a result of fragmentation of the clearing pool and the ensuing distance from the clearing's efficiency *optimum*
  - Foreign CCPs, which are already recognized in the Union, could gain market shares in foreign currency clearing, like U.S. CCPs for IRS in dollar
- In a similar scenario, clearing providers could engage in cooperative strategies in order to increase their efficiency and resiliency, as it has long been the case in the equity sector
  - Cooperative agreements (or network strategies) would remedy the fragmentation of the risk pool amongst European financial firms,
  - The group structure of CCPs could create incentives to engage in similar strategies

V. Network strategies as a Private solution

- Network strategies are integration and harmonization initiatives amongst CCPs, which aim to replicate the clearing's efficiency optimum, *i.e.* a single CCP clearing products across all possible asset classes
- In Europe network strategies are widely implemented in the equity sector
- With the raising importance of OTC derivatives, they could be extended to derivatives CCPs, so as to overcome the fragmentation in the industry

1. Cross-margining agreements

- They are the weakest form of cooperation possible between two or more clearinghouses
- Individual clearinghouses usually cross-margin the ETD and OTC portfolios of the CCP's clearing brokers, so as to clear them in a single liquidity pool
- In the case of inter-CCPs cross-margining, clearing brokers offset their exposures across correlated instruments as if they were cleared trough the same clearinghouse
- For a cross-margin link to work, three conditions should be met
  - cross-margined products present a strong and reliable correlation
  - the margin calculation systems of interconnected CCPs present a certain degree of harmonization and a high degree of information exchange between them
  - clearing brokers participate in all the CCPs involved

- The margin contributions may be held in a single account, managed by one CCP also on behalf of the others, or in separate accounts at each of the partnering clearinghouses
- When a participant defaults, the CCPs must share losses and gains related to the defaulter's position
- This creates exposures amongst CCPs, each facing the risk that others' default
- A similar risk should be covered through collateralization
- EMIR explicitly considers cross-margining only within an individual CCP
- Inter CCPs cross-margins are not considered, but not prohibited
- They are not found in Europe, but are frequent in the US, however mainly in the ETD sector

2. Participant link

- It is an asymmetric network strategy between two CCPs
- The *away* CCP takes the status of a clearing member in the *home* CCP
- Clearing members of the away CCP enjoy the possibility to clear the link products at the home CCP
- This requires harmonization of operational standards and risk mitigation procedures between the two CCPs
- However, it is usually not possible for participants to net their obligations in both directions
- Moreover only the participating CCP pays margins to the home CCP; the home CCP does not pay margins to the linked CCP, thus creating unilateral inter-CCPs exposures

- EMIR does not touch upon this type of link, leaving the question of its legitimacy open
  - The PFMI principles make reference to it, restating that every open position of the CCP has to be duly and fully covered
  - Links of this type are not found in the European derivatives industry, but they could be used post-Brexit to establish a network between EU and UK CCPs in the and CCPs

3. Interoperability

- EMIR defines it as “an arrangement between two or more CCPs that involves a cross-system execution of transactions”
- It is a “peer to peer link”
- Clearing members can clear trades between them without being members of the same CCP
- The two (or more) CCPs have in place special arrangements under which they exchange margins and other financial resources on a reciprocal basis
- The linked CCPs face current and future exposures to each other as a result of the process

- Interoperability arrangements are subject to EMIR (Articles 51-54) and to ESMA guidelines and recommendations
  - CCPs that enter into an interoperability arrangement must put in place adequate policies, procedures and systems to effectively identify, monitor and manage the risks arising from the arrangement
  - They should also identify, monitor and address potential interdependences and correlations that arise from an interoperability arrangement
  - The issue of inter-CCP exposures is also addressed, in the sense that CCPs only have to pay each other initial margins (not variation margins and default fund contributions)
  - Interoperability arrangements have to be approved by the competent supervisory authority, also with the engagement of the college of regulators

- Article 1 EMIR states that Title V shall apply to transferable securities and money market instruments, implicitly excluding derivatives
- Nevertheless, ESMA concluded that despite not being covered by EMIR, interoperability remains not prohibited in the derivatives area
- NCAs apply the ESMA guidelines in their monitoring of interoperability links, so that EMIR indirectly applies to derivatives interoperability
- Yet in 2015 ESMA published a report on the possibility to extend title V also to derivatives, supporting its extension to ETD instruments, but not to OTC derivatives, which appear to remain uncovered by the interoperability framework
- Interoperability arrangements are diffuse in the equity sector, where CCPs are connected across Europe.
- For derivatives there is only one link working at present between LCH.Clearnet, the UK CCP, and SIX x-clear Norwegian branch – ex Oslo Boars – , a CCP subject to Swiss law and supervision

4. Assessment

- Links between CCPs differ and are more diffuse in the equity sector than in the derivatives one
- They create additional interconnections between CCPs, which may act as contagion channels of possible systemic events
- Similar concerns motivate the prudent approach of European regulators, who have been so far reluctant to actively promote network strategies in derivatives markets
- Given Brexit, we could imagine an extension of CCPs links to the OTC sector, provided that regulators remove existing barriers and refrain from setting further ones to cooperative solutions

VI. Concluding Remarks

- The EU clearing industry has historically developed and is still predominantly concentrated in the City of London
- The size and cross-border relevance of modern CCPs raise financial stability concerns
- Central bank support is essential to the safe and orderly functioning of clearing infrastructures, especially for those clearing derivatives denominated in different currencies
- Brexit could have an impact on the transaction costs of clearing, while also posing new challenges to systemic risk
- If the EU and the UK did not reach a trade agreement covering clearing services, a worst-case scenario could materialize in the terms described above
- However, a mitigating role could be played by private initiatives, such as network strategies

- In the end, Europe is facing a difficult trade-off between the transaction costs of clearing and the systemic risks generated by the relevant infrastructures
- Brexit could modify the transaction costs of clearing, while posing new issues from a systemic risk perspective
- The Commission proposal to enhance the regulation and supervision of third country CCPs is welcome, provided it is implemented in ways which do not excessively alter the balance between transactional efficiency and systemic implications of clearing infrastructures