EMIR 3.0 – an unfortunate case of the national interest outshining the European interest

Apostolos Thomadakis*

Summary

The EU's ambition is to encourage clearing at EU CCPs and with EU clearing members. This is to reduce reliance on systemic non-EU CCPs, and to build a more attractive and robust EU clearing market. To achieve this, EMIR 3.0 requires EU clearing members and clients subject to the clearing obligation to hold active accounts at EU CCPs. The minimum number of derivative contracts to be cleared is set to at least five trades per annum for the relevant subcategories of trades and derivatives classes.

Although it is very unlikely that this will fulfil the EU's ambition, more importantly it risks diminishing the competitive position of EU firms, leading to EU clients who do not fall under the clearing obligations to use non-EU clearing members, and concentrating non-EU clients' euro-denominated interest rate swaps trading activity with non-EU dealers.

Instead, what is missing from EMIR's final text published on 14 February, is a centralised supervisory framework. Just enhancing the current supervision mechanism is not enough. A European centralised supervisor will not only strengthen risk monitoring and (eventually) minimise systemic risks but will also reduce supervision costs, the number of procedures, divergent interpretations of EMIR rules, and the exchange of data.

* ***Apostolos Thomadakis*** *is Head of Research at ECMI and Research Fellow at CEPS.*

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European Capital Markets Institute, Place du Congrès 1, 1000 Brussels, Belgium
www.ecmi.eu, ecmi@ceps.eu

Lehman Brothers' bankruptcy in 2008 motivated the push towards central clearing, requiring derivatives (i.e. those in scope of mandatory clearing) to be cleared through central counterparties (CCPs). The aim was that risks flowing from a major bank's failure should no longer cascade through the whole financial system because of the interconnectedness created by derivatives. The Blue Book previously offered the European Central Bank (ECB) a comprehensive description of the main payment and securities settlement systems in EU Member States (both euro and non-euro area countries), covering domestic as well as cross-border aspects of these systems. The collected data allowed the ECB to know at any time where risks were located and the extent of the exposures concerned. This was the case up until 2008 when the Bank of England refused to give specific details concerning the operations of UK CCPs to the ECB, due to its competition sensitive information.

Initially, in 2009, a Communication from the European Commission argued that there are strong reasons for CCP clearing to be located in Europe, and thus a location requirement may be necessary. This idea was also supported by Ecofin. Despite this, when the European Market Infrastructure Regulation (EMIR) proposal was published in 2010, it did not contain a location requirement.

In its Eurosystem Oversight Policy Framework of 2011, the ECB concluded that a location policy should apply to CCPs which, on average, have a daily net credit exposure of more than EUR 5 billion in one of the main euro-denominated product categories. This was challenged by the UK in the Court of Justice of the European Union, which in 2015 ruled that the ECB did not have the power in its statutes to prescribe a location policy requirement for CCPs. From its side, the Commission decided to not intervene. In 2019, EMIR 2.2 enhanced the supervision of third-country CCPs, while it made the supervision of EU CCPs more coherent. An ECB proposal to amend Article 22 of its own Statutes was withdrawn by the ECB in the course of the negotiations on the EMIR 2.2 proposal.

Clearing is critically important for capital markets as it reduces the systemic risk posed by OTC derivatives. Well-developed and resilient CCPs do not only support trading and ensure good management of risks stemming from derivatives transactions, but they also allow capital markets to function efficiently and transparently. As in the case of banks, a systemic problem in clearing is a problem for everyone. That is why the Commission is concerned and wants to ensure that EU CCPs are safe and well supervised.

EMIR 3.0 and the two elephants in the room

In December 2022, the Commission proposed a new clearing package, EMIR 3.0. The aim was not to create a European hub for euro-denominated derivatives clearing[1]. Instead, EMIR 3.0 has two clear objectives. First, to develop a competitive and efficient clearing system within the EU. Competitive financial market infrastructures and financial market participants are key

[1] In particular, the proposal required a proportion of activity in euro- and Polish zloty-denominated interest rate swaps, credit default swaps denominated in euro, as well as short-term interest rate derivatives denominated in euro, to be cleared at an EU CCP.

foundations for the Capital Markets Union project. Second, to reduce the dependence – and consequently the risk exposure – on systemic non-EU CCPs. The EU's current level of dependence on third-countries CCPs poses risks to the EU's financial stability and its monetary policy.

To achieve these objectives, the EMIR 3.0 proposal included measures that will improve the attractiveness of EU CCPs (e.g. by shortening and simplifying the approval process for new derivative products and services), encourage central clearing in EU (e.g. by requiring EU clearing members and clients subject to the clearing obligation to hold active accounts with EU CCPs, the so-called active account requirement or AAR), and strengthen the role of EU authorities, particularly the European and Securities Markets Authority (ESMA) in supervising EU CCPs. The latter two, the active accounts and supervision, were the big elephants in the room.

The proposal subsequently began its passage through the EU's ordinary legislative procedure and, in December 2023, the Council of the EU, the European Parliament (EP) and the Commission started their trialogue negotiations. A provisional agreement was reached in early February 2024 and the final text was published on 13 February. Entering the discussions, all parties agreed on the need to address financial stability risks, but they disagreed on how to achieve it. Regarding the AAR, although there was convergence on the scope and type of contracts, there was divergence on the EP's proposed phase-in approach. There are Member States that want to attract as much activity as possible to their local CCPs, and others that want to protect their clearing members (as relocating would cost money, bring less multi-netting benefits and put EU client clearing members at a competitive disadvantage to their non-EU peers).

Trying to align these interests, in the absence of a quantitative cost-benefit analysis, is a challenging task. Consequently, the final text maintains the Council's less punitive approach of an operational active account with representativeness. It also introduces a requirement for financial counterparties and non-financial counterparties above certain minimal thresholds to hold an active account at an EU CCP and to clear several representative trades from that account.

If not done properly, especially the quantitative threshold, active accounts will add costs to European firms, diminish their competitive position, lead EU clients who are not under the clearing obligations to use non-EU clearing members, and concentrating non-EU clients' euro-denominated interest rate swaps (IRS) trading activity with non-EU dealers (this non-EU activity represents the majority of the EUR IRS market). Additionally, it will result to the loss of netting benefit, the need to maintain margins at two CCPs, and set-up a management framework to deal with requirements for the compliance framework. This puts European firms at risk of simply becoming regional distributors for their global peers. One way or another, active accounts should be implemented in a way that minimises negative outcomes and does not affect the competitive position of EU firms.

Regarding supervision, while the EP favours more centralised supervision for CCPs, the Council has been resisting this and wants to maintain the status quo. But for the Commission this is not an option – maintaining the status quo would be considered a major collective failure. The Council's view is that current supervision works well and that there is no need to give more powers to ESMA. The Council's press release refers to strengthening ESMA's role by providing it with a rather limited coordination role in emergency situations only. Moreover, it highlights twice that ultimate decision-making powers are the responsibility of the national competent authorities (NCAs). This is similar to the CCP Recovery and Resolution Regulation, where the national resolution authorities, rather than ESMA, are in the driving seat. Given that the ultimate underwriting for any resolution costs also rests with the Member States, this is how Member States want to keep it. Having said this, the Council recognises the need for more exchanges of information and cooperation between ESMA and NCAs.

What should be done?

Over the last few years, the clearing industry has witnessed a string of market stress events that have exposed risks and weaknesses. But the storm was weathered, thanks to the industry's flexibility and the swift action of some Member States to provide support to others. Despite this, the current supervisory structure revealed its weaknesses caused by being segregated (i.e. national versus the European interest). Europe, unfortunately, always has the tendency to leave some unfinished business behind, to be inflexible and extremely prescriptive in the way it legislates. Pushing more and more legislation into Level 1 adds to the complexity when circumstances change and require legislative adjustments. While the EU stood for a principles-based approach in the past, with mutual recognition, it is becoming more and more rules based.

If the ambition is to encourage clearing within EU CCPs and with EU clearing members, to reduce reliance on systemic non-EU CCPs, and to build a more attractive and robust EU clearing market, then there is the need for a centralised supervisory framework. Just enhancing the current supervision mechanism would not be enough. Moving away from a national approach to clearing supervision, but at the same time ensuring closer collaboration between NCAs and ESMA, would allow the risks associated with the interconnectedness of the EU financial system, as well as the increased clearing volumes and the growth of cross-border exposure to be sufficiently managed.

Having a European centralised supervisor will not only strengthen risk monitoring and (eventually) minimise systemic risks but would also reduce the costs of supervision, the number of procedures, the divergent interpretations of EMIR rules, and the exchange of data. ESMA should not only supervise Tier 2 third country CCPs, but also all major EU CCPs. The fundamental issue at stake is the fact that in the event of a CCP crisis the financial risks will ultimately lie with a Member State and cannot be shouldered by the industry or by ESMA. Any move towards centralised supervision cannot ignore this key point.

Going forward, Europe needs a framework that does not create obstacles (or at least minimises negative outcomes), as well as a workable setup with realistic processes and timelines (e.g. almost two years to approve new products in Europe compared to a shorter timeframe in other jurisdictions).

Efficiency should not be undermined by complexity and burdensome requirements. Allowing for smooth cross-border transactions is crucial – the going concern for business is cross border, but a crisis is national.

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