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**ECB-PUBLIC**

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**ESRB response to the European Commission targeted consultation on the review of the central clearing framework in the EU**

22 March 2022

Dear Commissioner McGuinness, Dear Mairead,

I am writing to you with reference to the **targeted consultation on the review of the central clearing framework in the EU** carried out by the Commission services. This was launched on 8 February 2022.

The European Systemic Risk Board (ESRB) welcomes the initiative to consult on measures to improve the competitiveness of European Union (EU) central counterparties (CCPs) and clearing activities and to ensure that their risks are appropriately managed and supervised.

This letter, together with its appendix, constitutes the ESRB's response. It was discussed at the ESRB Advisory Technical Committee meeting of 22 February 2022 and agreed by the ESRB General Board in a written procedure on 21 March.

Reflecting the ESRB's mandate to contribute to the prevention or mitigation of systemic risks to financial stability, this response focuses on those aspects of the consultation that are most relevant from a financial stability perspective. The letter sets out the overarching view of the ESRB, whereas the answers to specific questions raised in the consultation are set out in the appendix to this letter.

## **Context**

This response to the targeted consultation builds on the **ESRB response to the consultation of the European Securities and Markets Authority (ESMA) on determining the degree of systemic importance of LCH Ltd and ICE Clear Europe or some of their clearing services**, dated 3 December 2021.

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In its response, the ESRB identified the short-term interest rate (STIR) and credit default swap (CDS) services in EUR operated by ICE Clear Europe Ltd and the SwapClear services in EUR and PLN operated by LCH Ltd to be of substantial “systemicness” for the EU. Based on an assessment of the balance of risks between continuing to recognise the services and no longer recognising them, the ESRB concluded that at present these services should nevertheless be allowed to be provided in the EU.

The ESRB took the view that the main risks to financial stability associated with continued recognition of these clearing services relate to a situation where a UK CCP offering the service(s) (i) takes procyclical measures during a period of market strain or (ii) enters into a recovery phase or, ultimately, into resolution.

The ESRB therefore proposed in its response to ESMA that any extension of the recognition of the two UK Tier 2 CCPs should be temporary and should go hand in hand with measures designed to reduce risks to financial stability. These measures would, for example, be designed to increase the offer of clearing solutions from EU CCPs, thus enabling EU authorities to achieve a gradual reduction in exposures of EU clearing members to Tier 2 CCPs and strengthening EU supervision commensurately with an increase in clearing activity at EU CCPs.

Reflecting the distinction between EU currencies in the ESRB’s assessment of the substantial systemicness of the clearing services provided by the two UK Tier 2 CCPs considered, the ESRB noted that its views on the need for a reduction in exposures to UK Tier 2 CCPs are focused on services in EUR and PLN provided across the EU and do not apply to CZK, DKK, HUF and SEK. It also noted that other proposals to mitigate systemic risk, such as strengthening ESMA’s powers, should apply across the EU and should not be limited to the above clearing services in EUR and PLN.

### **Overarching view of the ESRB**

The ESRB welcomes the fact that the plans of the European Commission reflect the proposals the ESRB set out in its above-mentioned response to ESMA of 3 December 2021. In particular, the ESRB notes that in the course of 2022, the European Commission plans to put forward proposals for taking the following steps.

- *Build domestic capacity:* the European Commission notes in its consultation document that this would be achieved “*through measures to make the EU more attractive as a competitive and cost-efficient clearing hub, and thus incentivise an expansion of central clearing activities in the EU*”.
- *Strengthen supervision:* the European Commission notes in its consultation document that “*if the EU is to increase its capacity for central clearing, the risks resulting from an increased activity need to be appropriately managed. As such there is a need to strengthen the EU’s supervisory framework for CCPs, including through a stronger role for EU-level supervision*”.

The ESRB’s views, firmly grounded in the ESRB’s mandate with respect to financial stability, are as follows.

First, provided that the forthcoming proposals by the European Commission ultimately succeed in addressing the risks to financial stability identified (and provided that the UK regulatory regime for CCPs continues to be deemed equivalent), the ESRB would – from a financial stability perspective – be in favour of allowing the two UK Tier 2 CCPs to continue offering clearing services in the EU beyond the end of the temporary equivalence period on 30 June 2025. The ESRB would also see a need to increase the level of cooperation with UK authorities in important areas of CCP supervision such as liquidity management, as well as with respect to recovery and resolution.

Second, the proposals by the European Commission should be embedded in a framework applicable to any other CCP that might be classified as Tier 2 in the future. On the one hand, this should not prevent the specific targeting of the risks presented by the two UK Tier 2 CCPs at this stage. On the other hand, any measures that are focused on the two UK Tier 2 CCPs may lead to an undesired scenario where exposure moves to other third-country CCPs.

Third, macroprudential measures, which would be aimed at aligning the incentives of all market participants, using the substantial systemic clearing services with the reduction of systemic risk, should be seen as complementary to voluntary, market-based solutions. The use of Pillar II instruments is outside the scope of macroprudential policy and therefore not taken into account.

Against this backdrop, the ESRB hopes that the following considerations under the headings “Building capacity” and “Strengthening supervision” will help the European Commission to develop its proposals. For these considerations to be turned into proposals, the European Commission would first need to conduct a cost-benefit analysis, including an assessment of unintended consequences, to test their viability. This is particularly true for measures designed to reduce reliance on UK Tier 2 CCPs by lowering exposures, as any exposure targets or limits would need to be calibrated carefully.

### ***Building capacity***

Building capacity relies on EU CCPs increasing the supply of clearing services they offer. Such an increase in supply is important, as any measures taken to reduce exposures towards, and thus reliance on, clearing services of substantial systemicness at UK Tier 2 CCPs could otherwise impair the ability of EU clearing members and EU clients to hedge risk. While increased demand for central clearing in the EU may create its own supply as EU CCPs see new business opportunities, “organic growth” of this kind might be slow. Therefore, other measures to increase the supply of clearing services within the EU might also be needed. However, such measures would be likely to fall outside the mandate of the ESRB. The remainder of this section therefore focuses on increasing the demand for central clearing and on complementary measures designed to help ensure that risks to financial stability are being addressed. Nevertheless, the ESRB’s proposal strives to emphasise the need for both “pull” measures that encourage clearing at EU CCPs and “push” measures aimed at providing an incentive for EU market participants to move their clearing activities to EU CCPs.

A wider application of the clearing obligation applying to more entities and asset classes would increase the demand for central clearing. It is a long-standing view of the ESRB<sup>1</sup> that central clearing is a cornerstone of the post-crisis reforms set out in the **2009 G20 Pittsburgh agreement to make the financial system safer**. The ESRB has therefore repeatedly advocated a wider application of the clearing obligation to encompass entities and asset classes that are currently not in scope or had been exempted. For example, the ESRB has called for an end to the exemption from the clearing obligation for pension scheme arrangements (PSAs).<sup>2</sup>

An increase in the demand for central clearing brought about by a wider application of the clearing obligation might result in an increase in the use of UK CCPs, owing to economies of scale. Therefore, a wider application of the clearing obligation would need to be flanked by measures designed to (i) increase the resilience of EU clearing members using the systemically important clearing services in the event that the two UK Tier 2 CCPs take procyclical measures during a period of market strain or enter into a recovery phase and (ii) gradually reduce the reliance of EU clearing members and/or EU clients on the services identified at the two UK Tier 2 CCPs through exposure reduction. Although measures to build resilience would result in an increase in the cost of clearing at these CCPs relative to the current situation, they may not necessarily – depending on the calibration – lead to a reduction in the exposures of EU clearing members and EU clients. Equally, reducing reliance on the two UK Tier 2 CCPs may not necessarily result in a level of resilience that is deemed sufficient. This would depend on the degree of exposure reduction and the level of loss absorption capacity at EU clearing members. Measures designed to build resilience and to reduce reliance would therefore need to be considered as complementary rather than substitute measures.

To address risks to financial stability, a combination of microprudential and macroprudential measures might be most effective. The ESRB has identified risks that might arise during market strain resulting from reliance on certain clearing services operated by the two UK Tier 2 CCPs. These risks are not limited to the reliance of individual EU clearing members and EU clients on those services; they also include the reliance of the EU

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<sup>1</sup> See, for example, **Advice of the European Systemic Risk Board of 31 July 2012 submitted to the European Securities and Markets Authority in accordance with Article 46(3) of Regulation (EU) No 468/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories concerning the eligibility of collateral for CCPs (ESRB/2012/3)**; the **ESRB response to ESMA Consultation Paper No. 4 on the clearing obligation for other OTC interest rate derivatives**; the **ESRB response to the ESMA Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity**; and the **Revision of the European Market Infrastructure Regulation**.

<sup>2</sup> See **ESRB opinion on ESMA report on Central Clearing Solutions for Pension Scheme Arrangements**.

financial system on certain services. This means that any measures to build resilience or reduce reliance should take into account both individual and system-wide elements. In addition, “reducing reliance” implies that the objective of any measure would be primarily – but not exclusively – considered in terms of relative exposures, given that operationalising such measures and achieving such an outcome may also require a reduction in absolute exposures.

### *Building resilience*

Higher Pillar 1 microprudential risk weights for exposures to clearing services identified as being of a substantially systemic nature would increase clearing members’ capacity to absorb losses if one of the two UK Tier 2 CCPs were to enter recovery or resolution during a period of market strain. They might also act as a disincentive to relying on UK Tier 2 CCPs, provided an alternative means of clearing exists (if there is no such alternative means, a higher cost of central clearing might create an incentive to clear in a third country rather than in the EU). Exposures to CCPs are subject to prudential rules under the Capital Requirements Regulation (CRR)<sup>3</sup>, which distinguishes between CCPs that are authorised or recognised in the EU (“qualifying CCPs”) and CCPs that are not (“non-qualifying CCPs”). Exposures to the former are subject to lower capital charges<sup>4</sup>, whereas exposures to the latter are subject to higher capital charges<sup>5</sup>. An “intermediate category” for exposures to clearing services of Tier 2 CCPs that are deemed to be of substantial systemic significance but remain recognised, and thus qualifying, would align the way exposures are treated under the CRR with the tiering categories under the European Market Infrastructure Regulation (EMIR)<sup>6</sup>.

A macroprudential buffer could be applied to reflect the collective resilience to clearing services that are deemed to be of a substantially systemic nature. Such a buffer would only apply on an EU-wide basis to clearing members that are exposed to these services. It would be set based on an assessment of the systemic

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<sup>3</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

<sup>4</sup> In the case of exposures to qualifying CCPs, a bank that acts as a clearing member must apply a 2% risk weight (this applies to margins and pre-funded default fund contributions; there is a 0% risk weight for unfunded default fund contributions).

<sup>5</sup> In the case of exposures to non-qualifying CCPs, banks must apply a risk weight using the standardised approach to their trade exposures and a risk weight of 1,250% to their default fund contributions.

<sup>6</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p.1).

risks for the EU financial system as a whole arising from reliance on these services. The Capital Requirements Directive (CRD IV)<sup>7</sup> already includes a conceptually similar tool in the form of the systemic risk buffer (Article 133 of the CRD IV). The systemic risk buffer can be applied to foreign exposures, but it remains to be seen whether it can be applied to a subset of foreign exposures. Article 133(9) of the CRD IV appears to leave room for this, so it might be possible to apply the systemic risk buffer only to exposures to Tier 2 CCPs (Article 133 (5)(e) of the CRD V). This provision would need to be looked at and possibly adapted accordingly, as would the provision regarding responsibility for deciding the level of the systemic risk buffer, given its EU-wide application.

Microprudential Pillar I risk weights could also be combined with a macroprudential buffer if increasing the resilience of individual clearing members is not deemed to sufficiently increase the resilience of the financial sector. As highlighted above, any proposal for new microprudential or macroprudential measures will need to undergo both a cost-benefit analysis and an analysis of financial stability risks to test their viability.

#### *Reducing reliance*

Reducing the reliance of EU clearing members and EU clients on the identified clearing services at the two UK Tier 2 CCPs could take the form of reducing exposures on a voluntary or mandatory basis. A voluntary reduction could take better account of the needs of clearing members and clients, and the ESRB would consider it a preferred outcome. However, the ESRB is mindful that such a voluntary reduction has not occurred so far and that increasing the competitiveness of EU clearing, in isolation, might not be sufficient to trigger a significant migration from UK to EU CCPs. In order to foster migration of exposures to EU CCPs, measures aimed at incentivising the reduction of exposures to UK CCPs would have to be complemented by measures aimed at building commercially attractive EU alternatives, without which a reduction in exposures may not mean increased demand for the services of EU CCPs, but may instead increase exposure to other third-country CCPs. Such increased exposure could result in two or three liquidity pools, one of which might not be subject to direct or indirect EU supervision.

A voluntary reduction might, for example, be achieved by clearing members agreeing third-country CCP exposure reduction targets with their supervisors. Adherence to these targets would then be monitored. Efforts

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<sup>7</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

to build clearing capacity at EU CCPs would be hampered by “first-mover disadvantage”, as those clearing members that were the first to clear at EU CCPs would be faced with lower liquidity than those that continued clearing at the two UK Tier 2 CCPs. Exposure reduction targets to which all EU clearing members would commit would address this first-mover disadvantage by spreading the costs of lower liquidity more evenly across clearing members.

“Mandatory” reductions could be achieved by adapting the large exposure regime in the CRR to clearing members’ exposures to the two UK Tier 2 CCPs. The calculation of large exposures excludes clearing members’ trade exposures and default fund contributions to qualified central counterparties (Article 400(j) of the CRR). However, Article 459 of the CRR might enable the European Commission to impose such requirements on the two UK Tier 2 CCPs based on the assessment of the systemic relevance for the EU of certain clearing services that they provide in EUR and PLN. To be effective, these exposures would need to include client exposures.

### ***Strengthening supervision***

In its response of 3 December 2021 to the above-mentioned consultation by ESMA, the ESRB took a view on this topic, noting the need to strengthen EU supervision commensurately with an increase in clearing activity at EU CCPs. In particular, the ESRB noted that the European Commission might wish to consider strengthening ESMA's powers within the EU. The aim would be that, should EU CCPs grow beyond certain thresholds (including as a result of any reduction of the UK CCP market shares in the clearing services identified), the legal, supervisory and resolution framework in the EU would better reflect the greater role of some EU CCPs.

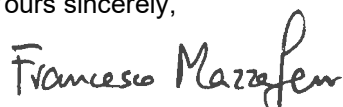
In that response, the ESRB also proposed strengthening ESMA's powers outside the EU. Specifically, the ESRB proposes revising the legal framework of Tier 2 CCPs to make ESMA's role more incisive, particularly with regard to crisis situations, i.e. the recovery or resolution of a CCP, while enhancing the cooperation with UK authorities.

The ESRB considers that more specific proposals to strengthen supervision would be beyond its remit.

### **Publication**

The ESRB will publish this letter, including its appendix, after the consultation deadline has passed.

Yours sincerely,



Francesco Mazzaferro

Head of the ESRB Secretariat

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**ESRB response to the European Commission targeted consultation on the review of the central clearing framework in the EU**



## Appendix

# The ESRB's responses to selected questions in the European Commission's targeted consultation on the review of the central clearing framework in the EU

The ESRB's responses to individual questions are grouped into categories, depending on the scope of the question. In addition, and where applicable, the responses make direct reference to the specific questions in the consultation.

### 1) On enhancing the attractiveness of clearing at EU CCPs

#### **CONSULTATION QUESTIONS (general part)**

*Q1: In the sections below a range of possible options are presented which could support enhancing the attractiveness of clearing at EU CCPs, thus reducing reliance of EU participants on UK CCPs, focussing on both the supply side and the demand side of clearing services.*

The ESRB agrees that a combination of measures and tools could be used to help increase the attractiveness of clearing at EU CCPs and reduce the reliance of EU market participants on identified substantial systemic clearing services at the Tier 2 CCPs. Combining measures that target both the supply and the demand for clearing services would be likely to increase their effectiveness. As stated in the body of this letter, the primary aim of any measure should be to reduce risks to financial stability.

Measures that are within the ESRB's financial stability mandate and that the ESRB considers in its response are (i) introducing higher capital requirements for exposures to Tier 2 CCPs, (ii) introducing active accounts requirements, (iii) setting exposure reduction targets and (iv) broadening the product scope to create more liquid markets. By contrast, the ESRB believes that other stakeholders, including market participants, are better placed to respond to measures aimed for instance at hedge accounting and the application of fair, reasonable, non-discriminatory and transparent (FRANDT) principles.

As set out in the body of the letter, any increase in the demand for clearing that might arise from broadening the clearing obligation may not necessarily mean increased demand for the services of EU CCPs. Therefore, broadening the clearing obligation may not – in isolation – address the risks to financial stability identified by

the ESRB that are associated with the continued recognition of the clearing services of the two UK Tier 2 CCPs.

The following responses elaborate on such measures. For these considerations to be turned into proposals, the European Commission would first need to conduct a cost-benefit analysis to test their viability.

## 2) On encouraging clearing by public entities

### I. Scope of clearing participants and products cleared – c) Encourage clearing by public entities

*Q1. To what extent do you think that the participation of public entities would add to the attractiveness of central clearing in the EU?*

*Q2. What are the benefits of public entities to centrally clear? What are the costs and other drawbacks?*

*Q3. What would make it more attractive for public entities (as referred to in Article 1(4) and Article 1(5) EMIR) to centrally clear? Please explain your answer providing, where possible, quantitative evidence and examples, including on the potential costs and benefits.*

The ESRB is of the opinion that the clearing obligation should apply as broadly as possible.<sup>8</sup> A broad clearing obligation makes for more netting of exposures, more risk reduction and fewer financial stability risks.

EMIR exempts public entities from the EMIR requirements in its Level 1 text (Article 1(4) EMIR). This means that neither the clearing obligations nor the reporting obligations apply to public entities.

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<sup>8</sup> See [ESRB opinion on ESMA report on Central Clearing Solutions for Pension Scheme Arrangements](#).

With specific regard to EU central banks, the ESRB sees a number of reasons why this category of entities should continue to be exempt from the clearing obligation. These reasons are directly or indirectly linked to EU banks' independence under Article 130 of the Treaty on the Functioning of the European Union.

Central banks aside, mandating clearing for public entities would increase the demand for clearing services. Public entities are active in products such as credit and interest rate derivatives, where there is reliance on the two Tier 2 UK CCPs.

Mandating clearing for public entities also has a number of drawbacks. These are mainly related to public entities being direct members of CCPs. They concern (i) wrong-way risk and diversification and (ii) mutualisation.

Wrong-way risk materialises when, for instance, the value of the collateral posted by a clearing member is directly linked to the solvability of the clearing member. It could be problematic for public entities to post collateral that would be immune from wrong-way risk, unless extraordinary measures were contemplated, such as mandating EU public bodies to post only collateral issued by a third country. This in turn would create reliance on third countries from another systemic standpoint.

From a mutualisation perspective, the need to deposit margins and contribute to the default funds of CCPs means that public entities would incur costs, including in the form of losses that might arise from their participation in loss-sharing agreements. As these costs would ultimately be borne by taxpayers, the benefits of public entity participation in central clearing from a financial stability perspective should therefore be weighed against the costs public entities would incur. This is particularly relevant when it comes to the potential use of recovery and resolution tools which may involve sharing losses among non-defaulting clearing members and clients. As stipulated in the Central Counterparties Recovery and Resolution Regulation<sup>9</sup>, “[r]ecovery plans should not assume access to extraordinary public financial support or expose taxpayers to the risk of loss” and “[a]n effective resolution regime should minimise the costs of the resolution of a failing CCP borne by the taxpayers”. The potential mutualisation of losses by public entities would be at odds with these provisions.

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<sup>9</sup> Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, (EU) No 600/2014, (EU) No 806/2014 and (EU) 2015/2365 and Directives 2002/47/EC, 2004/25/EC, 2007/36/EC, 2014/59/EC and (EU) 2017/1132 (OJ L 22, 22.01.21, p. 1).

Overall, the ESRB sees the merit of a large pool of liquidity that the (direct or indirect) membership of public entities (apart from central banks) could provide for EU CCPs. In addition, the start of the clearing obligation for PSAs would help add further liquidity to EU CCPs, as EU pension funds generally have a higher share of their activities in European Economic Area (EEA) currencies. ESMA recently recommended that the Commission start applying the clearing obligation to PSAs from 19 June 2023.

### 3) On broadening the product scope of the clearing obligation

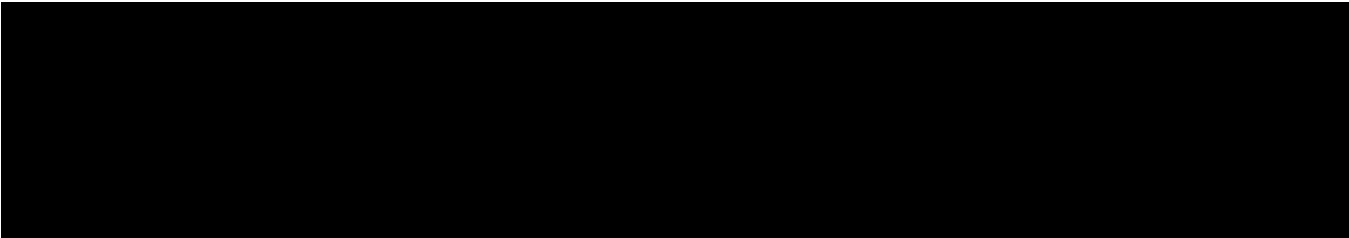
#### **I. Scope of clearing participants and products cleared – d) Broaden the product scope of the clearing obligation**

*Q1: is the range of products currently subject to the clearing obligation wide enough keeping in mind the financial stability angle?*

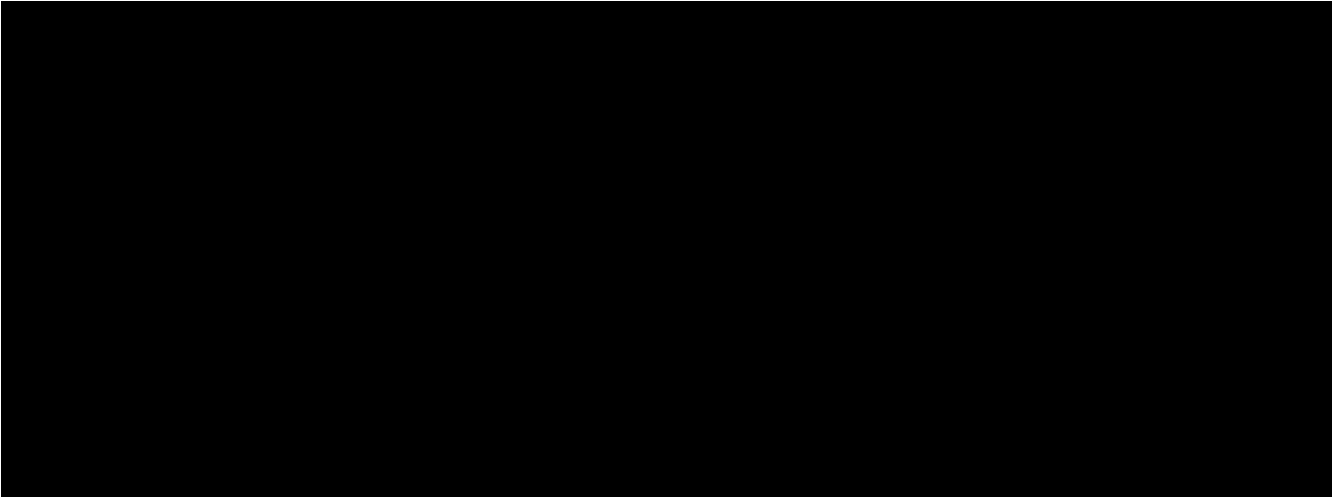
*Q2: Could additional products be subject to the clearing obligation?*

Possible ways to expand the scope of the clearing obligation could be to add maturities to the current product scope of the clearing obligation, with a view to increasing the scale of centrally cleared transactions with these maturities. The aim of this would be to create a more liquid market. Candidates for such an expansion might be certain short-term interest rate derivatives and certain credit derivatives identified below. This would need to take place in accordance with the framework set out in Article 5 of EMIR, and a full assessment would be required.

Currently the clearing obligation covers overnight index swaps (OISs) referencing the euro overnight index average (EONIA) with a maturity of up to three years. As shown in Table 1, the centrally cleared market for maturities between four and ten years is active enough to absorb the non-cleared share. In terms of currencies, this is true for EONIA/euro short-term rate (€STR), sterling overnight index average (SONIA) and USD-denominated OISs. However, EU CCPs offer a sufficiently liquid clearing market for EONIA/€STR only.



As shown in Table 2, most of the sovereign single-name CDSs are bilaterally cleared, and EU CCPs do not offer clearing for this type of product in any currency. Nevertheless, extending the clearing obligation to USD-denominated sovereign single-name CDSs with a maturity of up to five years could have substantial financial stability benefits given the size of this market and could spur the EU CCPs to extend their product offering for CDSs.



#### 4) On capital requirements in CRR/CRD IV and supervisory tools

### **II. Measures towards market participants – a) Broaden the product scope of the clearing obligation**

*Q1: EMIR 2.2 introduced a difference between third-country CCPs which are Tier 1 and those that are Tier 2. How could the greater systemic importance (and associated risks) of Tier 2 third-country CCPs be reflected in the context of banking rules and supervision?*

*Q3. How could a higher risk weight for excessive exposures to a Tier 2 QCCP be designed given their systemic imprint: [...]*

*Question 4. In light of the Commission strategy to reduce excessive reliance on Tier 2 third-country CCPs, what level could be appropriate in your view for the risk weight, to incentivise*

*clearing members to consider other options than a Tier 2 CCP for clearing their derivatives?*

*[text box]*

*Question 5. How do you assess the risk that participants would relocate clearing to other third-country jurisdictions in case a higher capital requirement on excessive exposures to T2 CCPs is imposed?*

*Question 6. Do you include in your operational risk framework scenarios including limitation of access/non-recognition of a third-country CCP, or activation of the EMIR 2.2 process under Article 25.2c (i.e. possibility of de-recognition of a third-country CCP or certain clearing services)?*

## **II. Measures towards market participants – b) Macroprudential tools**

*Question 1. The over-reliance on Tier 2 CCPs presents risks for the financial stability of the Union. Do you think macroprudential tools should be considered to achieve the desired policy objectives, alongside or as a substitute for the use of micro-prudential tools? Please explain your reply in as much detail as possible.*

*Question 2. Do you think a macroprudential buffer should be considered in light of this reliance/exposure?*

For this item, see the considerations in the body of this letter.

### **5) On setting exposure reduction targets**

## **II. Measures towards market participants – c) Set exposure reduction targets**

*Q1. If targets were to be set in some form or another, what do you think could be a reasonable target to achieve in terms of reduction of **overall** euro-denominated exposures of EU participants to Tier 2 UK CCPs? Should exposures to systemic non-EU CCPs somehow be capped?*

*Q1.1 Please explain your answer to Q1 providing, where possible, quantitative evidence and examples. Please also indicate over what timeframe such reduction can be achieved.*

*Q3. Please indicate whether the targets should be set:*

- at a global level (all EU clearing members)- at clearing members' level
- at clearing member and client levels
- other

*Q4. What could be the targets for the services identified by ESMA as being of a substantial systemic importance:*

- Swapclear by LCH Ltd, for both euro and Polish Zloty-denominated products.
- The STIR futures by ICE Clear EU for euro-denominated products.
- The CDS Service by ICE Clear EU for euro-denominated products.

*Please explain your answer providing, where possible, quantitative evidence and examples, including on potential costs and benefits.*

*Q5. What factors should be taken into account in your view when sizing the target and setting the timeline for meeting it?*

The ESRB is of the view that overreliance must be analysed both in relative and in absolute terms.

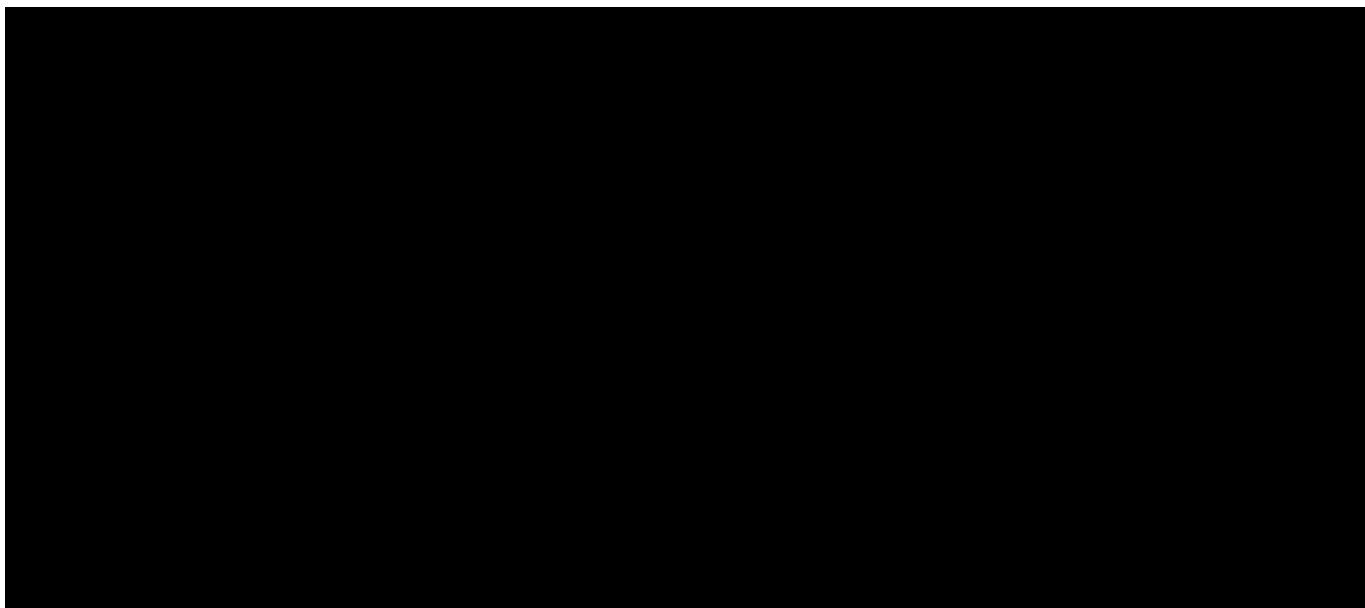
On the one hand, EU overreliance is a relative phenomenon. For instance, the ESRB's assessment concluded that the EU relies substantially on certain clearing services at the two UK Tier 2 CCPs. Relative overreliance could therefore be addressed by increasing the use of EU CCPs, thus reducing the market share of the two UK Tier 2 CCPs. This could for instance be achieved by expanding the scope of the clearing obligation, thus increasing the total volume of transactions cleared, and thereby shifting the balance to make the clearing landscape less concentrated (this only works if new transactions are cleared at EU CCPs and not third-country CCPs).

On the other hand, overreliance is also an absolute phenomenon. Indeed, the ESRB's assessment concluded that EU exposures to UK CCPs were of substantial systemic relevance. Therefore, mitigating the associated risks to financial stability would also require reducing absolute exposures to the substantially systemic clearing services at the two UK Tier 2 CCPs.

Calibrating exposure reduction targets in relative and/or absolute terms is challenging, complicated by the fact that derivative markets evolve dynamically and have been growing over time. One reason is a lack of data to define metrics that would be used to measure reliance and exposures. As shown in Table 3, the reliance on third-country CCPs varies greatly across asset classes and currencies, but the notional amount of contract cleared is not the best measure of the reliance of market participants on a particular CCP. The initial margin posted instead weighs the riskiness of overall positions cleared by CCPs and considers the netting effects and offsetting positions. Chart 1 is a better measure of the reliance of EU members on third-country CCPs. Nevertheless, as the initial margin is computed at the portfolio level, it is not granular enough to allow the risk exposures at the product or currency level to be measured. Additional information currently not available from

trade repository data, such as positions' sensitivities and risk measures, would help assess exposures to third-country CCPs for different products.

In order to face these challenges, it might be necessary to define a set of different indicators to quantify substantially systemic exposures.



## 6) On facilitating the transfer of contracts from outside the EU

### **II. Measures towards market participants – e) Facilitate transfer of contracts from outside the EU**

*Q1. Should a permanent exemption be granted allowing for a novation of legacy trades without triggering any EMIR requirements?*

The ESRB is of the view that the transfer of legacy trades from the two UK Tier 2 CCPs to EU CCPs should not be exempted from EMIR requirements. For example, such an exemption could result in an unlevel playing field. Depending on how this would be set out in the Level 1 text, it could also mean that transactions that were previously cleared at third-country CCPs will not only no longer be subject to the clearing obligation but will also not be subject to any other EMIR requirement, such as the risk management techniques mentioned in Article 11(3) of EMIR. In practice, they would then also be exempt from bilateral margining, and this would certainly result in an increase in financial stability risks.

The only benefit of this proposal is that it would ensure a reduction in exposures to third-country CCPs, thereby reducing the absolute overreliance. The ESRB has its doubts about the effectiveness of this tool: the legacy



trades are currently already exempt from the clearing obligation, and the tool does not provide any incentive for these transactions to be moved. In addition, the tool is detrimental from a financial stability perspective.

## 7) On the obligation to clear in the EU

### II. Measures towards market participants – f) Obligation to clear in the EU

*Q1. In your view should Article 5 be amended:*

*Yes, so that for new contracts the clearing obligation can only be fulfilled through authorised EU CCPs? / Yes, so that for new contracts the clearing obligation can only be fulfilled through authorised EU CCPs and recognised “Tier 1 CCPs” / No / Don’t know.*

The initiative to strengthen the market for EU-based clearing does not imply that exposures to third-country CCPs should be avoided altogether. From a financial stability point of view, moving all EU market participants’ exposures to a single EU-based CCP would result in a similar concentration at that EU-based CCP, although under closer supervision by EU authorities.

Transferring exposures to a recognised Tier 1 CCP would also increase the systemic importance of that CCP so that it would potentially qualify as a Tier 2 CCP. For example, Chicago Mercantile Exchange Inc. (CME Inc.) is a Tier 1 CCP that offers clearing of over-the-counter (OTC) interest rate swaps (IRSs) denominated in EUR and PLN. If EU members were to shift even partially their [REDACTED] outstanding EUR IRSs from LCH Ltd to CME Inc., this would easily be enough to cause CME Inc. to breach one of the minimum exposure thresholds under Delegated Regulation (EU) 2020/1303 (the Tiering DA)<sup>10</sup>. Indeed, third-country CCPs clearing more than €1 trillion notional of OTC derivatives denominated in EU currencies over a year could

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<sup>10</sup> Commission Delegated Regulation (EU) 2020/1304 of 14 July 2020 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to the minimum elements to be assessed by ESMA when assessing third-country CCPs’ requests for comparable compliance and the modalities and conditions of that assessment (OJ L 305, 21.9.2020, p. 13).

potentially be designated Tier 2 by ESMA.<sup>11</sup> Similarly, a shift of the CDS clearing activity of EU members from ICE Clear Europe Ltd to ICE Clear Credit LLC could result in the same scenario.

## 8) On the active account solution

### II. Measures towards market participants – g) Active account

*Q1: How would you define an active account? Please explain your answer providing, where possible, quantitative evidence or examples, including on potential costs and benefits.*

*Q2: Should the level of activity be quantified?*

*Q3: Should the set level of activity evolve over time, and based on what criteria?*

*Q4: How would an active account work for omnibus client accounts?*

*Q5: How can client clearing service providers ensure that clients maintain an activity in EU CCPs?*

*Q6: What would be the pros and cons, the costs and benefits of mandating the opening of an active account and setting a regulatory level of activity in it?*

*Q7: Would it be useful to impose requirements (e.g. having an active account at an EU CCP) on international banks having a subsidiary in the EU for retail activities?*

The ESRB would consider the idea of requiring EU clearing members to maintain an active account in an EU CCP as an important prerequisite for meeting one of the overarching objectives of this consultation, namely building domestic capacity and thus providing an incentive for the expansion of central clearing activities in the EU. Therefore, the ECB would suggest that the Commission explore the idea further. Requiring EU clearing members to hold an account in the EU, to which they could swiftly reroute their activities cleared in the United Kingdom, would increase their resilience if access to UK CCPs were suddenly restricted. In addition, this could

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<sup>11</sup> Under Article 6(2) of the Tiering DA, ESMA may only determine that a CCP is considered a Tier 2 CCP where at least one of the minimum exposure thresholds is met. Therefore, where such a minimum exposure threshold is met, further assessment of the third-country CCP is required for ESMA to determine whether such a third-country CCP is a Tier 2 CCP.

foster a rebalancing between the United Kingdom and the EU, as the active account requirement would enable EU clearing members to transfer part of their exposures from UK CCPs to an EU CCP.

A key parameter to be defined would be the minimal level of activity for an account to be deemed “active”. This level depends on the objective pursued by the measure. For their resilience to be increased, the EU participants would only need to maintain a residual level of activity in their EU account. Meanwhile, in order to foster a rebalancing, a more stringent definition of an “active” account would be needed.

This minimal level could be set either qualitatively or quantitatively. Qualitative guidance could allow a requirement for accounts to host constant and sufficient activity, thus ensuring that EU participants have the operational requirements in place to reroute their positions at any moment. Meanwhile, quantitative guidance would have the advantage of providing certainty on the level of rebalancing that would be achieved by the solution but would need to be carefully tailored in order to ensure both its efficiency and its proportionality. To reduce negative effects on EU clearing and market participants, the quantitative thresholds could evolve gradually, whether along a predefined timeline or after regular recalibrations by a relevant authority.

## 9) On the transactions resulting from post-trade risk reduction

### **II. Measures towards market participants – i) Transactions resulting from Post Trade Risk Reduction**

*Q1. In your opinion, to what extent could the current outstanding notional amount be reduced? Please explain your answer providing, where possible, quantitative evidence or examples, including on potential costs and benefits.*

*Q2. How should the resulting risk replacement trades be treated with regard to the clearing obligation? Please explain your answer providing, where possible, quantitative evidence or examples, including on potential costs and benefits.*

*Q3. What would be the pros and cons, the costs and benefits of subjecting the risk replacement trades to the clearing obligation? In EU CCPs?*

In an opinion published in June 2020<sup>12</sup>, the ESRB expressed the view that risk replacement trades should not be exempt from the clearing obligation. The ESRB stressed that central clearing provides more transparency in the network of exposures and a more resilient centralised default management process while also reducing bilateral exposures through multilateral netting. Therefore, any exemption from the clearing obligation related to post-trade risk reduction transactions could create a loophole for circumventing the clearing obligation and reversing centrally cleared trades.

## 10) Interoperability

### III. Measures towards CCPs – e) Interoperability

*Q1. Do you think EMIR should explicitly cover interoperability arrangements for derivatives? Only for Exchange Traded Derivatives or also OTCs? Please explain your answer to Q1 providing, where possible, quantitative evidence and examples.*

*Q2. In light of efforts to enhance the clearing capacity in the EU and the overall attractiveness of EU CCPs, do you think there would be benefits of developing interoperability links between EU CCPs? If yes, which ones? What do you think would be the benefits and the costs?*

*Q3. Do you think interoperability arrangements for derivatives between EU CCPs could contribute to enhancing the overall liquidity at EU CCPs? Why?*

*Q4. How would you assess a situation in which Interest Rate Swap clearing happens at more than one EU CCP (e.g. at 2 CCPs) and there is an interoperability link between the two concerning such products? Would this be more convenient for market participants?*

*Q5. In the situation described under Q4, how should the risks related to the arrangement be properly dealt with? What kind of safeguards should be there in terms of proper risk management?*

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<sup>12</sup> See [ESRB opinion on ESMA's report on post trade risk reduction services with regards to the clearing obligation \(Article 85\(3a\) EMIR\)](#).

*Q6. In the context of CCP links, what are in your view the costs and benefits of cross-margining arrangements?*

*Q7. Would allowing for cross-margining arrangements in the EU be useful/desirable?*

Interoperability arrangements currently exist only for securities clearing. This is mainly due to the complex risk management structure that accompanies interoperability arrangements. EMIR does not explicitly prohibit interoperability for derivatives but is silent on it. The absence of EMIR provisions relating to the permissiveness of interoperability arrangements for derivatives gives rise to legal uncertainty. This uncertainty should be addressed, ideally by specifying for which types of products and under what conditions interoperability arrangements for derivatives could be approved and established (even if such links were to require additional safeguards).

The ESRB expressed its view in 2016 and in 2019 on the complexities of interoperability in its [report on CCP interoperability arrangements](#). On the one hand, the ESRB noted that interoperability arrangements provide clearing members with greater opportunities for netting and lead to a reduction in outstanding gross exposures in the system. On the other hand, the ESRB noted that interoperability arrangements might introduce complexity into the risk management of linked CCPs and add a direct channel of contagion between CCPs. This is because linked CCPs become directly involved in the loss-sharing mechanism of other linked CCPs. These risks are higher for derivatives clearing activities than for securities clearing, as securities positions are usually settled after two days.

Interoperability could bring significant benefits in a situation where the liquidity in certain derivative products is divided between two or more CCPs by increasing overall liquidity and reducing the costs of fragmentation. However, these benefits need to be balanced against the potential risks that interoperability might bring, especially when it comes to derivatives clearing. These considerations seem particularly important in view of the potential fragmentation that could be induced by regulatory incentives to reduce the reliance on the two UK Tier 2 CCPs.

In conclusion, there appears to be no need at present to enable interoperability for derivatives. However, the approach of recognising the two Tier 2 UK CCPs on a time-limited basis might change the balance of benefits and costs. Also, if EMIR provision were to prohibit interoperability arrangements for derivatives or to remain silent on this topic, some EU CCPs might choose to access other CCPs as regular direct clearing members, which would also create channels of contagion.

It should be noted that the legal framework prevents EU CCPs from establishing cross-margining arrangements, i.e. arrangements whereby positions held at one CCP on certain financial instruments can offset positions on highly correlated financial instruments held at other CCPs (in this respect please see question/answer no. 9 of the ESMA Q&A on EU CCPs). Subject to the above caveats, properly designed and supervised cross-margining arrangements could benefit and facilitate the integration of the EU clearing services market, provided that the relevant risks are effectively analysed and managed. Against this backdrop,

the European Commission might wish to consider whether the current prohibition deserves to be maintained or lifted.

## 11) Monitoring the clearing landscape

### **IV. Monitoring progress towards reduced reliance of EU participants on Tier 2 CCPs**

Monitoring progress towards reduced reliance of EU participants on (the identified substantial systemic clearing services at the) Tier 2 CCPs will require access to high-quality granular data. Information reported under EMIR will constitute an important basis. However, it should be accompanied by other public information (including public disclosures for CCPs) and additional confidential information. It is worth stressing that the reliability of this monitoring process will depend crucially on the completeness and quality of the data reported by EU CCPs, EU clearing members and EU clients. Currently, this work is being hampered by substantial data quality issues. These are due to misreporting by CCPs, clearing members and clients. All EU market participants should improve the quality of the data reported: the data in question should not be incomplete, inaccurate or out of date. In particular, CCPs and clearing members should step up efforts to:

- report accurate and up-to-date information according to the EMIR regulatory technical standards/implementing technical standards and ESMA's reporting guidelines;
- improve the reporting of notional amounts, collateral (variation and initial margins and excess collateral) and other relevant fields, especially indicating client trades;
- promptly and accurately reconcile the information reported with that reported by both EU and non-EU entities (CCPs versus clearing members, clearing members versus clients).

Concentration is also high for clients. This concentration calls for targeted efforts, keeping in mind two additional aspects:

- these banks also clear in the United States, so they could easily move there, rather than move to EU CCPs;
- these banks have subsidiaries in the United Kingdom and could move their trades there, rather than to EU CCPs.

## 12) How should EU-level supervision be given a stronger role?

### **V. Supervision of CCPs – a) Identifying costs related to current supervisory framework and benefits with a stronger role for EU-level supervision**

*Q.2 In your view, what would be the benefits of a stronger role for EU-level supervision?*

*Q2.2. Please indicate whether a stronger role for EU-level supervision could also produce negative side-effects.*

**V. Supervision of CCPs – b) How should EU-level supervision be given a stronger role?**

*Q1. Do you agree that giving a stronger role to EU-level supervision could simplify and accelerate procedures, remove legal uncertainties and possible dual or conflicting instructions, ensure coherent application of EU Regulations, facilitate the coordination with third country supervisory authorities and create a level playing field between EU CCPs.*

*Q2. Please indicate how to give a stronger role to EU-level supervision*

For this item, see the considerations in the body of this letter.