
Consultation Response

Review of the Central Clearing Framework in the EU

22 March 2022

Introduction:

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's open consultation for the review of the Central Clearing Framework in the EU.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its Members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors, and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME, through its Post Trade division, has been a strong supporter of the creation of a single integrated post-trading process for securities transactions in Europe, to achieve harmonisation, standardisation and consolidation through best practice and regulation.

This submission is broadly focused on the clearing framework for cash markets, unless otherwise specified.

AFME supports the objectives of increasing the attractiveness of the EU as a clearing hub, with an appropriate harmonised supervisory framework that promotes open access, competition and user choice, whilst mitigating potential risks to EU financial stability.

In this context, the EU should prioritise a strategy to increase the capacity of its capital markets that focuses on promoting competitiveness and attractiveness, along with fostering innovation and deeper integration and supporting Capital Markets Union.

The European Commission should also continue its efforts to strengthen the EU wholesale markets ecosystem as part of its Capital Markets Union project, which would require both the enhancement of financial integration and the development and deepening of financial markets, including working towards greater consistency and convergence of relevant legal frameworks across the EU.

It is important that the Commission continues to pursue cooperation at the international level on the regulatory framework for clearing. AFME believes that maintaining open markets and regulatory consistency to the extent possible is beneficial to all stakeholders in markets with a global dimension.

Open access within the EU for Cash Equities:

The EU's strategy should be founded on the principle of open access encouraging user choice and competition in the provision of clearing services.

Fair and open access to clearing infrastructures, as mandated by the existing MiFID 2/ MIFIR rules, (which emphasise the need to closely evaluate the effectiveness of the open access conditions for CCPs) is crucial for maintaining integrated, safe, efficient and continuous markets for cash equities. Facilitating open access also leads to lower costs, enhanced service levels, greater capital efficiency and innovation.

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Open access to third-country clearing infrastructures:

Given the global and interconnected nature of financial markets participants, we consider that any initiatives that could end up creating new barriers would not contribute to the development of EU capital markets, but may instead undermine the competitiveness of EU-based entities.

The EU should continue striving to foster cross-border financial flows and promoting open capital markets at a global level. For EU capital markets to thrive, it is key to maintain and develop open capital markets that are capable of providing access to global capital pools and funding opportunities, whilst ensuring market integrity and fairness of treatment between EU firms and third-country entities.

Where relevant, the EU should consider further measures to promote increased harmonisation and standardisation of operational processes, and to remove existing barriers that reduce the attractiveness of EU clearing infrastructures.

The Capital Markets Union should be seen as a structural reform by which the legislators and policy makers at the EU and national level, as well as the market participants themselves, dismantle existing barriers to the cross-border functioning of the single market in capital.

Scope of clearing participants:

- **Clearing Obligation for Pension Scheme Arrangements (PSAs)**

The consultation itself refers to the temporary clearing exemption to central clearing under EMIR. We note that ESMA's latest report¹ to the European Commission recommends to further extend this exemption until June 2023, which reflects that there are still a number of outstanding challenges that would need to be addressed prior to PSAs becoming subject to mandatory clearing obligation.

The inclusion of PSA clearing would potentially result in a significant increase of liquidity in the ecosystem. Given the nature of pension funds' portfolios –they are less likely to hold multi-currency portfolios than other market participants– they might be less disincentivised from clearing at EU CCPs as other entities would, since they would potentially be less affected by the absence of cross-currency netting.

However, the key remaining issue for PSAs is the need to post variation margin (VM) in cash in case of market stress (when they may be required by CCPs to post significant amounts of variation margin). We believe that the clearing obligation should not apply to pension schemes until a suitable technical solution for the posting of non-cash collateral as VM has been developed by Central Counterparties ("CCPs") to address pension funds' lack of cash for use as collateral.

- **Clearing by private entities that do not access CCPs directly**

With clearing fees increasing over the past decade to cover costs associated with onboarding, KYC and regulatory capital costs, some participants may find little incentives to clearing.

It should also be noted that there are participants within the trade custody value chain that may not have a direct access to a CCP. Clients are not typically direct clearing participants and therefore require access to clearing through members of a CCP, and one of the most common issues is the lower degree of access to central clearing for some categories of clients.

¹ <https://www.esma.europa.eu/press-news/esma-news/esma-recommends-clearing-obligation-pension-funds-start-in-june-2023>

With views on broadening the scope of clearing participants, the EU should explore alternatives such as promoting direct or sponsored clearing access for non-direct CCP market participants. These actions should be on a voluntary basis, and driven by the creation of a commercial incentive for these new clearing participants.

- **Clearing by public entities**

AFME is also broadly supportive of measures to encourage further clearing by public entities, since widespread clearing by public entities could have an important signalling effect, along with incentivising the expansion of clearing activities in the EU.

Product Scope:

- **Products subject to the clearing obligation**

We consider that EMIR is sufficiently comprehensive with regards to the procedures and mechanisms for the EU authorities to determine the scope of products subject to mandatory clearing, and already covers the standards of volume and liquidity on which basis that mandate should apply.

AFME believes that a change on any of the currently existing EMIR provisions would not be necessary or desirable, therefore we are not supportive of implementing actions that would represent changes to the existing requirements on clearing thresholds based on the level of activity.

- **Considerations regarding impact on other products**

When implementing actions designed towards transitioning to EU-based CCPs, we strongly recommend that specific consideration should be given to ensure that any measures that are introduced do not have unintended consequences for other products, which we believe are outside of the Commission's focus (e.g. cash equities).

In particular, we believe it is important that the existing interoperability arrangements for centrally cleared cash equities are not inadvertently affected.

Current interoperability arrangements for cash equities depend on the recognition of a third-country CCP. Interoperability has been successful in reducing costs of clearing for EU-based clearing members (and investors), with limited financial stability risk.

We welcome that ESMA's assessment² of the systemic importance of Tier 2 CCPs analysed each sector of the CCPs' offerings separately. We note and agree with ESMA's conclusion that, in respect of LCH, "*EquityClear is an important clearing service for the EU, but it is not of substantial systemic importance.*" Whereas we understand the EC to be focused predominantly on the clearing of certain EEA currency denominated derivatives, ESMA finds that "*EquityClear's market share is limited and there are plenty of alternative services existing in EU.*"

Given the benefits choice and competition that clearing brings to EU market participants, AFME would not support measures which result in an end-state, where EU clearing members cannot access UK CCPs, or securities issued by EU companies are not eligible for clearing at UK CCPs. We urge the EC to ensure that any measures it adopts are calibrated such as to ensure there is no loss of access to the services of UK CCPs where there is no concern financial stability concern.

² https://www.esma.europa.eu/sites/default/files/library/esma91-372-1945_redacted_assessment_report_under_article_252c_of_emir_ukccps_final_1of2.pdf

Impact to EU firms:

Any measures which the EU undertakes should carefully consider the potential broader negative impacts on EU clearing participants and investors.

Due diligence and special care should be considered if aiming for the implementation of initiatives that would allow non-EU market participants to still continue to have access to third-country CCPs for all their transactions, whereas EU-based market participants would be restricted to only using EU CCPs. This might lead to the creation of different pools of liquidity which would ultimately limit liquidity access for the EU market participants. Similarly, other jurisdictions might opt in for applying a similar restriction that would worsen the competitiveness of EU-based entities.

Potential retaliatory measures from other jurisdictions in restricting EU-based firms from access to large pools of liquidity would also be disproportionately impactful for smaller firms, which are typically in a disadvantageous position when seeking access to financial markets. Smaller firms could also struggle with the increased operational and compliance requirements of such measures.

Impact on capital charges as a result of QCCP/non-QCCP status:

There is a potential level playing-field issue if EU institutions that are operating in the international markets were subject to substantial additional capital charges as a result of certain non-EU CCPs not receiving equivalence and recognition status and therefore not being considered a Qualifying CCP (QCCP). This would increase the cost of doing business and thus will likely place EU-based entities at a disadvantaged position compared to non-EU entities in the international markets.

Similarly, we consider that this would not result in increased liquidity but rather the creation of two different pools of liquidity, with an international and more liquid pool outside of the EU and an internal EU pool with less liquidity and higher costs associated.

Obligation to clear in the EU:

AFME is not supportive of the proposal to require EU participants to fulfil the clearing obligation only at EU CCPs or Tier 1 third-country CCPs, since we believe that this would limit market choice. We consider that the costs of preventing the use Tier-2 CCPs would outweigh any potential benefits.

Moreover, the imposition of such requirement would not address the underlying issue of systemic risk, since it could result in a shift with regards to market participants opting to perform their clearing activities at Tier 1 third-country CCPs, which might end up leading to an increase of their systemic risk importance thus ultimately becoming Tier 2 CCPs.

Similarly, any decision to place restrictions or additional requirements in certain areas or certain products could have wider repercussions, such as disincentivising the establishment of EU subsidiaries.

Active accounts:

Many large entities already keep active accounts at EU CCPs as part of their services in order to provide clients with access to EU CCPs, and also as a risk management mechanism, since having access to more than one CCP for a certain product increases financial stability. However, maintaining this structure is only feasible for large entities given the high costs associated with additional clearing relationships. Further, for some products, consolidation of clearing at a single CCP can offer substantial cost savings, even for larger firms, where CCPs offer fee structures based on certain volume

thresholds being cleared, with per-transaction costs reducing where more is cleared. Such arrangements ultimately benefit EU markets and end investors as they can reduce the overall cost of clearing. In addition, freedom of commercial choice in the selection of CCPs is critical in ensuring users can benefit from competition on price and service. Any requirement that would oblige firms to split clearing between CCPs risks increasing the cost users ultimately bear by reducing the opportunity to benefit from consolidation of flow to qualify for higher-volume pricing thresholds.

Although clearing entities offer their clients the option to clear on different CCPs –including EU CCPs– the decision on where to execute and clear is ultimately made by the client, not the clearing member. This decision will be determined at an overall portfolio level in order to maximise netting benefits and will often be based on multiple factors such as liquidity, risk, price, margin and operational efficiencies and regulation.

There are also multiple challenges associated with the maintenance of open accounts, such as increased operational costs for clearing brokers or potential duplicities in terms of AML and KYC procedures, along with delimiting the activity level that defines an open account and its product scope.

AFME does not support the proposal for imposing an obligation to open active accounts at EU CCPs, given the operational complexities that this would represent. We believe that this would not necessarily result in increased liquidity, but rather increasing maintenance costs which would be especially burdensome for smaller firms.

Technological Innovation:

We support continued efforts by EU authorities to consider the potential role of new technologies on Europe's capital markets ecosystems. Where relevant, we believe that the EU should foster experimentation with distributed ledger technology, which may help generate efficiencies and reduce costs of central clearing in the EU, or potentially provide alternative solutions to managing counterparty risk.

Focus of Transitional Measures:

We recommend that the focus of EU measures should be on encouraging new business to be cleared within EU CCPs, rather than enforcing migration of historic positions. There should be a clear distinction between newly executed transactions and those belonging to existing portfolios. Unwinding and moving those historic positions is likely to represent a significant cost for EU firms.