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SPEAKING FOR AMERICAN BUSINESS IN EUROPE

Our position

Review of the European Market Infrastructure Regulation

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Executive summary

The Capital Markets Union and similar initiatives make the EU more attractive for capital markets business. However, although punitive regulatory localisation requirements might be considered as a short-term panacea, they would weaken the attractiveness of EU financial markets in the long term. As such, the narrative on EU open strategic autonomy, including for financial services and clearing, may harm the significant non-EU investor base, reinforcing the need for EU policymakers to come with positive proposals to develop European markets and capabilities.

Introduction

Completing the Capital Market Union (CMU) is now more important than ever. The consequences of Russian aggression in Ukraine, coupled with the long-term effects of high inflation rates on real economy lending and energy prices are all the more reason for EU institutions to build a unified system of capital markets. As outlined in an earlier position paper, the CMU is a positive development, as is the European Commission's comprehensive strategy outlined in its 2020 Action Plan.[1]

EU institutions have taken significant steps over the last months to create the right incentives for the emergence of a fully functioning CMU. Recent agreements on the review of the European Long-Term Investment Funds Regulation (ELTIF), together with the on-going work on the Alternative Investment Fund Managers Directive(AIFMD), Markets in Financial Instruments Regulation/Directive (MiFIR/D), Central Securities Depositories Regulation (CSDR), Capital Requirements Regulation III (CRR III) and Capital Requirements Directive VI (CRD VI) will play a critical role in supporting economic recovery after the COVID-19 crisis and in channelling private funds into investments in the green and digital transitions to build an inclusive and resilient economy.

However, EU capital markets remain vastly fragmented along national lines, which undermines financial stability and Europe's growth potential. Similarly, as recognised by the European Commission itself, post-trade systems in the EU have developed nationally with different forms and different business practices. This fragmentation makes cross-border clearing and settlement more complex than it is at the national level and creates costs, risks and inefficiencies for investors, institutions and issuers.

Due to the global dimension of derivatives markets, a competitive and open clearing ecosystem in the EU is essential for a well-functioning CMU, in which the third country aspects play a critical role. The European Commission's proposal to review the European Market Infrastructure Regulation (EMIR) is a positive development, as is the Commission's willingness to address the causes of reliance on non-EU jurisdictions by enhancing the attractiveness of the EU's own financial clearing infrastructures.

US market participants are active at UK and other non-EU central counterparties (CCPs), some of which have substantial market shares in the clearing market for certain US dollar-denominated products. In light of this, the paper below suggests improvements to the EMIR 3.0 proposal that include:

- Technical tweaks to fully exploit the benefits of some of the Commission's proposals.
- Awareness of the potential adverse consequences of constraining provisions.
- Ideas and positive proposals to develop European markets and capabilities.

[1] AmCham EU: Position paper on the Capital Markets Union package, July 2022 (available here).

Proposed improvements of certain provisions

If implemented in a balanced and timely manner and developed in full transparency and coordination with the industry, several of the Commission's conceptual proposals have the potential to improve the attractiveness of EU CCPs and promote transparency for CCP initial margin, while enhancing the overall resilience of the EU clearing ecosystem.

- **Intragroup transactions**: We acknowledge the removal of equivalence as a pre-condition for use of the intragroup transaction exemption from clearing obligation and margining requirements. However, the Commission's empowerment foreseen in Article 3, to adopt a delegated act aiming at identifying third countries which may not benefit from the exemption, has the potential to create unnecessary uncertainty and fragmentation for firms. In a similar way, the Commission's proposed deletion of Article 13 does not envisage the need for a new mechanism addressing the issue of duplicative or conflicting rules for firms. This could have important unintended consequences, especially for margin purposes.

- **New clearing services and activities**: The streamlining of supervisory approval for new clearing services and activities would also contribute to the emergence of a more competitive and reactive EU clearing offer. These measures would ultimately foster the competitiveness of the EU clearing ecosystem by enabling EU CCPs to be more reactive, agile and innovative in the products they offer. Ultimately, streamlining new clearing services and activities within EU CCPs also has the potential to decrease regulatory costs incurred by CCPs, which would reduce costs of clearing for clearing members and their clients.

- **Pension scheme arrangements (PSA) exemption**: The introduction of an exemption from the clearing obligation where an EU financial counterparty or a non-financial counterparty – subject to the clearing obligation under EMIR – enters into a transaction with a PSA established in a third country (which is exempted from the clearing obligation under its national law) would strengthen the competitiveness of EU firms.

- **Money Market Fund (MMF) / Undertaking for Collective Investment in Transferable Securities (UCITS) amendments**: Excluding all centrally cleared derivative transactions, including Repurchase Agreement derivatives, from the counterparty risk limits appears to be an important step in establishing a level playing field between exchange traded and over-the-counter (OTC) derivatives and to better reflect CCPs' risk-reducing nature in derivative transactions.

Primary concerns about the Active Account Requirement (AAR)

The most significant concern over the proposal is the Commission's active account requirement and associated Capital Requirements Directive (CRD) amendments. While the Commission's impact assessment concludes that no major operating costs would stem from this new requirement since most clearing members already have active accounts at EU CCPs, this measure could amount to an indirect forced relocation of some clearing activity, thereby undermining the sound principle of competitive and open markets. The costs for market participants would also be greater than foreseen in the Commission's impact assessment, which does not include the direct costs of opening and maintaining new active accounts at an EU CCP, the costs resulting from a loss of netting and the costs associated with maintaining separate pools of collateral.

- **Adverse consequences**: The European Commission's AAR provisions would have a negative impact on the derivatives market, EU clearing members and their clients. Such requirements could reduce the attractiveness of the EU's derivatives markets, since clients outside the EU would have no choice but to steer clear of EU financial counterparties or non-financial counterparties subject to the clearing obligation. As a result, both EU clients and clearing members would face a limited offer and provision of EU services. The Commission risks undermining the liquidity of the EU derivatives markets and creating the conditions to undermine financial stability and EU competitiveness.

- **Financial stability concerns:** From a pure financial stability perspective, the implementation of active account requirements risks creating captive EU markets composed of EU firms clearing in EUR subject to the same economic cycle. This has the potential to not only increase wrong-way risk but also impede safe and efficient default management. Furthermore, it is paramount to differentiate the potential impact between clearing members and investors and organisations that are only just subject to the clearing obligation.

- **Market inefficiencies**: Regulatory restrictions imposed on EU firms limiting the level of clearing activity they can conduct at Tier 2 CCPs would restrict their ability to benefit from multicurrency portfolio efficiencies, significantly impacting their ability to manage risks across currencies and perform sound risk management.

- **ESMA's role**: The high degree of delegation to the European Securities and Markets Authority (ESMA) and the competence to conduct a cost-benefit analysis and define an Active Account in practice create much uncertainty. ESMA should carefully consider all costs and risks associated with such requirements at the individual firm level and their ability to access global pools of liquidity once such requirements are applied. Before agreeing on predetermined thresholds, ESMA must conduct an extensive cost-benefit analysis and assessment of the level of activity that will ensure that an AAR does not lead to individual location policies.

- **ESMA's mandate**: If the ARR is retained, policymakers must clarify and specify ESMA's mandates so as to make sure the level 2 processes consider the Regulatory Technical Standards (RTS)' costs and impact on the competitiveness of EU markets infrastructures and participants. In particular:
    - **The size of the required reduction in impacted clearing services could be potentially significant because the Level 1 text sets a high bar by specifying that there must be a reduction to the extent that the services are no longer considered to be of substantial systemic importance. It is unclear what the scale of this would be, given that little can be inferred from the December 2021 ESMA CCP tiering report.**
    - The timeline for reducing exposures could be compressed, as the text says that the reduction must occur by approximately the end of 2026. However, the EMIR 3.0 level 2 rules may not be finished until the end of 2025.
    - Existing safeguards from Recital 11 should be moved directly into the related articles to give them more legal force.

- **CRD requirements:** To bolster the active account requirement, the European Commission also published a separate legislative proposal on amendments to the CRD. These changes could increase Pillar 2 capital requirements, as the proposal requires entities to place greater emphasis on assessing and managing their exposures to CCPs – particularly CCPs of substantial systemic importance – and empowers regulators to apply higher capital charges. The proposed amendments are ambiguous and could capture exposure to other non-EU CCPs in addition to UK CCPs. The CRD amendments would penalise firms for holding exposures at CCPs, which is contrary to the general push by policymakers to encourage more central clearing.

Positive proposals to make the EU clearing ecosystem more attractive

European clearing markets are an important element of the broader European capital market ecosystem. European capital markets are hampered by structural impediments, fragmented markets and market infrastructures. Policy measures to strengthen European capital markets would support the development of European clearing markets, as well as minimise the costs associated with any requirement for active accounts.

- **AAR**: The Commission should include in its proposal further evidence of the expected benefits stemming from the active account requirements as there is, for the moment, no ground on which EU authorities should set prescribed thresholds on the clearing activity at the account level. The AAR provisions do not fulfil the spirit nor the objectives of the CMU as: forced fragmentation increases operational and systemic risk; they would make it harder for EU-based firms to compete for international business; and they would contribute to global inconsistency since no similar requirements could be found in other jurisdictions.

- **Collateral availability and mobility**: Measures to strengthen European capital markets should facilitate access to liquidity pools and improve collateral availability and mobility within the EU. Amendments to Article 46 allowing bank guarantees and public guarantees to be considered eligible as highly liquid collateral fall short of driving progress towards more efficient management of capital and liquidity. A greater harmonisation of the rules relating to collateral management activity, coupled with greater optionality as to how CCP participants can provide collateral to CCPs (EMIR Article 47), would be paramount in overcoming restrictions on collateral usage and barriers to mobility.

- **EU centralised supervision:** Another important step would be the achievement of a centralised EU system for the supervision of CCPs. The Commission's limited proposal in this domain is likely to maintain the current inefficiencies of the framework and the complex arrangements between authorities that lead to long and burdensome procedures. Centralising CCP supervision through a single EU authority (eg ESMA) would allow CCPs and their clients to benefit from a safer environment for their operations to ensure a better monitoring of cross-border risks.

Conclusion

In the context of open and competitive global financial markets, the design and implementation of a fully-fledged EU clearing strategy does not appear problematic as long as it respects the EU Single Market and non-EU markets participants' incentives to take part in the CMU project. The Commission's move away from strict capital requirements that would be equal to a forced re-localisation policy is positive. However, the proposal on active accounts could fall into a similar uncharted territory. Should these requirements be poorly calibrated or scoped, European pension savers could potentially bear the costs of the damage done to the derivatives markets. In addition, the European Commission should provide market participants with legal clarity on the extension of the equivalence decision for UK CCPs beyond June 2025. Such clear and explicit equivalence decisions are necessary to develop a common and unified approach due to the global nature of the industry and the mutual recognition of core regulatory jurisdictions.