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Euro-Clearing after Brexit

Ten guardrails for resilient and capital-market-efficient EU clearing markets

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A large share of the central clearing of euro-denominated derivatives contracts takes place in the United Kingdom (UK). This has caused alarm bells to ring in the EU and led to increased efforts to bring about a targeted shift of such clearing activities to the EU. In this cepStudy, we elaborate on why such a shift is necessary, which factors should drive political and regulatory decisions on euro-clearing and what the relocation of business towards the EU should and could look like. Ultimately, we present ten dedicated guardrails for an appropriately calibrated regulatory approach.

- Any measures forcing EU market participants to relocate (part of) their euro-clearing business from UK to EU CCPs is a serious encroachment on entrepreneurial freedom and could be perceived as protectionism. Thus, they require proper justification and, if such a rationale exists, an appropriate calibration.
- The rationale exists because Brexit has revealed some risks for the EU that should not be underestimated, including those related to financial stability and monetary policy transmission, and a lack of capabilities on the part of EU supervisors to address such risks. Thus, there is a need for intensified efforts to shift euro-clearing activities towards the EU.
- When calibrating how the urgently needed relocation should take place, the EU should, while following a market driven path, insist on effective steps to be taken by EU market participants to shift their business towards the EU. Only then, is there a real chance for the establishment of resilient and competitive EU clearing markets in the medium term, which can co-exist with global and UK clearing markets.

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1 Introduction

1 February and 31 December 2020 mark significant turning points in the history of the European Union (EU) in various ways. First, the United Kingdom (UK) became a third country and, later, EU law, highly relevant for all EU Member States, ceased to apply to and in the UK. The exit of the UK from the EU was also, and still is, a decisive turning point for the EU's clearing markets. This is because the UK played and still plays a remarkable role as a hub for the central clearing of several types of euro-denominated derivatives contracts. Many EU market participants, e.g. banks, are highly exposed to central counterparties (CCPs) located in the UK. While this was mainly a market driven development after the EU's implementation of central clearing obligations in the aftermath of the financial crisis in 2009, the heavy reliance on UK CCPs became – at least by the time Brexit happened – a particular source of vulnerability for the EU as a whole. Such vulnerability stems from the not to be underestimated risks, inter alia, for the stability and resilience of the EU's financial markets and for the smooth conduct of monetary policy that hinges on the proper functioning of clearing markets. Especially in times of market turmoil, the fact that such business takes place mostly in the UK makes it difficult for EU regulators and supervisors to address such risks adequately and promptly. The high dependency on UK CCPs has thus caused alarm bells to ring in the EU and lead to increased efforts to bring about a targeted shift of such clearing activities to the EU in recent years, but so far with only limited success. Consequently, there are renewed regulatory efforts underway at EU level to strengthen clearing capacity in the EU and reduce the large exposure level of EU market participants to third-country CCPs in the medium-term.

In this cep**Study**, we elaborate on why such a shift is necessary, which factors should drive political and regulatory decisions with respect to euro-clearing and what a relocation of euro-clearing activities to the EU should and could look like. Ultimately, we present ten dedicated guardrails for an appropriately calibrated regulatory strategy. To begin with, Section 2 provides an introduction to the topic and brief explanation of central clearing via central counterparties as well as its benefits and drawbacks. In Section 3, we elaborate on the relevance of the global and euro-denominated (over-the-counter) derivatives markets, the increasing role of the central clearing of derivatives contracts and the particularly high concentration of euro-clearing activities in UK CCPs. Section 4 briefly deals with the consequences of the large market share of UK CCPs with respect to certain euro-denominated derivatives contracts. In Section 5, we determine which factors should drive political and regulatory decisions with respect to euro-clearing activities. In Section 6, we take a closer look at the current EU regulatory framework on derivatives clearing, the recent proposals by the EU Commission to adapt it ("EMIR 3"), and at potential alternative regulatory approaches. Finally, in Section 7 we draw conclusions and establish ten regulatory and supervisory guardrails for more resilient EU clearing markets.

2 Central clearing via central counterparties (CCPs)

2.1 Setting the scene

As a reaction to the global financial market crisis back in 2009 and the broad consensus that emerged in the aftermath that over the counter (OTC) derivatives[1] trading played a significant role in its spread and deepening, the G20 decided in the same year that regulatory efforts are needed to improve the resilience and transparency of derivatives markets and to reduce their systemic risks, in particular, by demanding that standardized OTC derivative contracts be traded on exchanges or electronic trading platforms, cleared through central counterparties (CCPs) and reported to trade repositories.[2] The push for central clearing through CCPs in particular was and still is seen as an essential means of reducing counterparty credit risks in derivatives trading and a decisive factor for a more stable and resilient financial system. Primarily, this arises from the nature of bilateral OTC derivatives transactions where both the seller and the buyer must always consider the fact that the respective counterparty may fail and become unable to meet its respective obligations. In addition, such a failure could not only harm the counterparties involved in a specific trade but also trigger a chain of defaults, leading to broader implications and severe consequences for financial stability. The idea of CCP central clearing is to reallocate such risks from the original counterparties of a trade and centralize them at the level of a CCP, which positions itself between the original seller and the original buyer, acting as purchaser for the original seller and the seller for the original buyer.[3] In that way, a direct transaction between two counterparties is being replaced by two (indirect) transactions between the CCP and the respective counterparties (see Figure 1).[4]

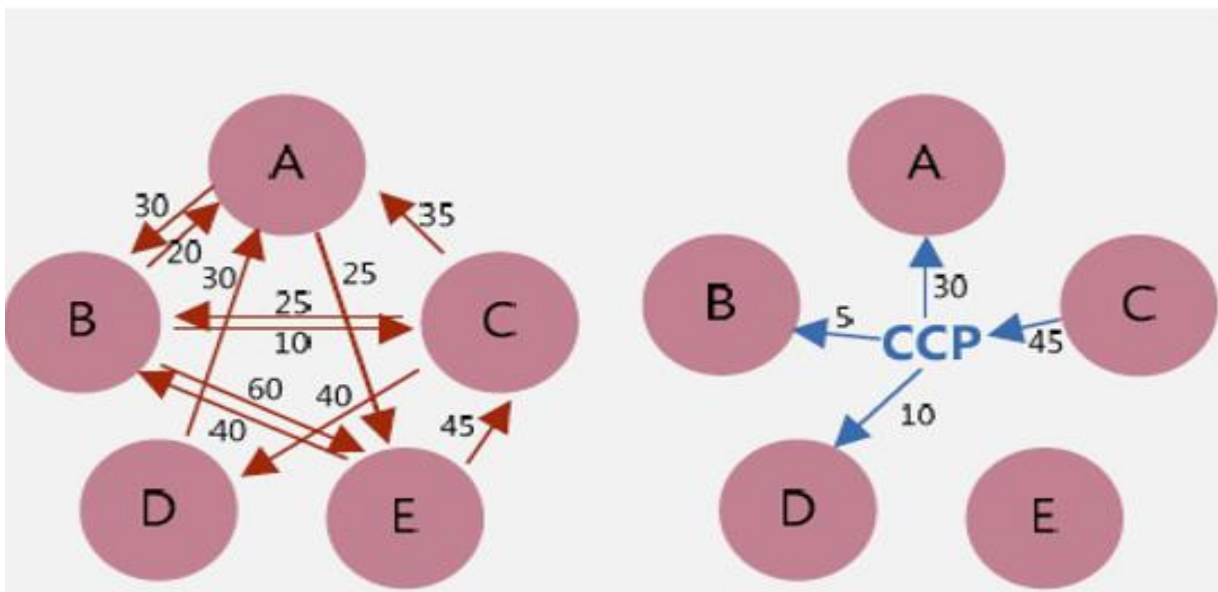

Figure 1: Non-cleared derivative transactions vs. cleared derivatives via CCPs [*Source: Central clearing: trends and current issues", BIS Quarterly Review, December 2015*]

[1] Derivatives are finance products whose value is derived from an underlying instrument. They serve for example to secure interest and exchange rate risks or are used for the purpose of speculation.

[2] Leaders' Statement – The Pittsburgh Summit, G20, 2009.

[3] Eckhardt, P. and Van Roosebeke, B. (2017), Derivative rules (EMIR), cep**PolicyBrief** No. 23/2017, available here.

[4] Brühl, V. (2018), Clearing von außerbörslichen Euro-Derivaten: Wie teuer wäre eine Relokation in die EU nach dem Brexit?, Wirtschaftsdienst, 98(4), 267-275.

With this construct, CCPs basically act as insurers for counterparties. They assume the task of taking over the obligations arising from the derivative transaction in the event of a default of a counterparty, thus shifting the counterparty credit risk from the original seller/buyer and concentrating it with themselves.[5] Furthermore, each counterparty no longer has multiple trade exposures to potentially very many other counterparties, but only a single one to the CCP.[6]

2.2 Benefits and drawbacks of central clearing

2.2.1 Perceived benefits of central clearing

The bundling of counterparty credit risks at the CCP level is generally seen as beneficial for several reasons:

Firstly, the failure of a counterparty to a trade does not directly affect the other counterparty, thereby reducing the risk of subsequent chain reactions that may destabilize the wider financial system.[7]

Secondly, central clearing allows for the implementation of risk reducing netting techniques. With such techniques, the individual settlement of each transaction can be avoided. Instead of that, multiple market participants' transactions can be consolidated. That allows a CCP to net out transactions that offset each other. In this way, a CCP may reduce its overall exposure in case of the default of a market participant and its average counterparty credit risk.[8] Clearing through CCPs can minimize the default risk for the counterparties involved by compensating numerous reciprocal claims.[9] Furthermore, positions netting has dampening effects on price volatility as there is no need to replace total positions.[10]

Thirdly, central clearing allows for the risk-reducing posting of collateral by each party to a trade, in such a way the losses suffered by any party in default may be cushioned.[11] While such posting of collateral can also be negotiated in a bilateral transaction, with the involvement of CCPs it can be standardized, made compulsory and frequently adjusted due to changing market conditions and price developments. Thus, collateral posting is an essential element in securing the exposures arising from derivatives positions and the implicit amount of credit in a transaction can be reduced.[12]

Fourthly, central clearing enables risk reduction for the parties to a derivatives transaction because CCPs must hold equity that can be relied upon in case, inter alia, the posted collateral is insufficient to cover losses, thus, relocating risks from the counterparties involved to the equity holders of a CCP. Such equity holding requirements are also intended to create incentives to avoid excessive risk-taking by CCPs and ensure that they manage the risks they take on appropriately.[13]

And fifthly, central clearing typically includes the establishment of default funds as another line of defense that can be referred to in case a clearing member defaults. Usually, all member firms of a CCP must contribute to such funds. In case the margins (collateral) of a defaulting member firm are insufficient to cover losses, CCPs may use the contributions in such funds. Thus, all CCP member firms accept

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[5] Eckhardt, P. and Van Roosebeke, B (2017).

[6] Domanski, D., Gambacorta, L., & Picillo, C. (2015), Central clearing: trends and current issues. BIS Quarterly Review December 2015.

[7] Brühl, V. (2018).

[8] EU-Commission (2022), Impact assessment, SWD(2022) 697, 8 December 2022.

[9] Eckhardt, P. and Van Roosebeke, B. (2017).

[10] Pirrong, C. (2011), The economics of central clearing: theory and practice.

[11] These usually include initial and variation margins.

[12] EU-Commission (2022); Pirrong, C. (2011).

[13] Pirrong, C. (2011).

some risks which therefore leads to a partial mutualization and redistribution of these risks among CCP members.[14,15]

2.2.2 Perceived drawbacks of central clearing

Even though CCP central clearing offers various benefits, it does not come without costs:

Firstly, the simple regulatory upgrading of the role of CCPs in financial markets after the financial crisis in 2009 has led to an increase in the number and size of CCPs and the volumes traded through them. A sharp rise in linkages in the financial systems that involve CCPs can be seen. Thus, they have become highly important and critical financial infrastructure providers for the clearing of financial contracts, and their soundness is therefore of paramount importance for the resilience of financial markets.[16]

Secondly, central clearing of derivatives is prone to economies of scope and scale. This mostly relates to the virtues of netting opportunities. Due to diversification effects, the advantages of netting usually rise with the scope of cleared financial instruments covered by a CCP. The markets for central clearing are, furthermore, markets that are susceptible to high fixed and low marginal costs and the business considers higher liquidity as absolutely beneficial. In addition to that, specialization in these markets matters a lot due to its high complexity. As a consequence, they tend to be highly concentrated, and usually only a few CCPs can hold their own in such markets and those that can generally tend to be large.[17,18,19]

Thirdly, while CCPs may, like insurance providers, buffer negative shocks such as the default of a market participant, i.e. small shocks, they may not be able to absorb any shock, regardless of its size (for instance, the default of several CCP members at the same time). At certain levels, even the many resources that CCPs can draw on to cover losses may simply be fully depleted, calling their own solvency into question. At the same time, the failure of a CCP or CCPs does not usually remain isolated but creates a source of macro-prudential risk and may trigger domino effects and have systemic and destructive implications.[20] Thus, in critical situations, the affected CCPs may suddenly lose their role as a stabilizer of the markets and may instead cause unwanted instability.[21,22] Or as the Commission pointed out back in 2019: “The concentration of risk makes the failure of a CCP a low-probability but a potentially extremely high-impact event”.[23] Ultimately, this somewhat reignites the major "too big to fail" debate, that emerged after the financial crisis with respect to systemically important banks. Like banks, CCPs may also be prone to “runs” if market participants lose trust in their viability, which may

[14] EU-Commission (2022); Pirrong, C. (2011).

[15] Overall, central clearing via CCPs, thus includes several lines of defense to cope with the default of a clearing participant. These are, in particular, the postings of initial and variation margins by clearing participants, the contributions to default funds, both from defaulting and non-defaulting CCP members and the capital holdings of the CCPs themselves [EU-Commission (2022)].

[16] Eckhardt, P. and Van Roosebeke, B. (2017); Brühl, V. (2018); Pirrong, C. (2011); EU-Commission (2022).

[17] In 2016, for instance, there were 15 CCPs for interest rate and 6 CCPs for credit products [EU-Commission (2016), Impact assessment, SWD(2016) 368, 28 November 2016].

[18] Ultimately, CCPs share several characteristics of natural monopolies.

[19] Eckhardt, P. and Van Roosebeke, B. (2017); Domanski, D., Gambacorta, L., & Picillo, C. (2015); EU-Commission (2016).

[20] Notably, the clearing members may, in such a situation, struggle to manage and close their open transactions and the search for alternatives may prove very challenging, if not impossible.

[21] Domanski, D., Gambacorta, L., & Picillo, C. (2015).

[22] EU-Commission (2016).

[23] EU Commission (2017), COM(2017) 331, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, Recital 3.

inevitably create liquidity stress. Such stress can also come into play and be further triggered where access to credit and funding markets is impeded. Such impediment can make it difficult for CCPs to liquidate posted collateral at prices high enough for them to meet their obligations with respect to members who have defaulted, thus leading to self-reinforcing fire-sales.[24,25]

Fourthly, it must be kept in mind that having recourse to CCPs does not reduce the interconnectedness within financial markets, which is often deemed to be problematic as risks can easily spread among market participants. While CCPs may reduce direct interlinkage between counterparties to a transaction, such interlinkage is simply replaced by new forms of linkages that involve CCPs.[26]

Fifthly, as CCPs act as a kind of insurer for market participants, there is always the risk of peculiarities arising, as in many types of insurances business. On the one hand, moral hazard behavior may become apparent. Often, there is a knowledge imbalance between the insurer (here: a CCP) and the insured (here: the clearing members). If the former is unable to observe the risk-taking behavior of the latter (sufficiently), the latter will be prone to misaligned incentives and their risk-taking may exceed tolerable levels. On the other hand, information asymmetries between CCPs and their clearing members may also lead to adverse selection behavior. Clearing members may be able to take advantage of their greater ability to judge the risks of the products they want to be cleared by CCPs and thus focus on products where CCPs underestimate the risks.[27] Both types of behavior may act as further drivers for less stability of the central clearing approach, and operate as a further catalyst for CCP specialization and concentration.

2.2.3 The bottom lines

The strengthening of CCPs as central intermediaries and managers of counterparty risks on the financial markets was a decisive step towards more efficient settlement of derivative transactions, to reduce and reallocate counterparty risk and bring more transparency into the formerly rather opaque OTC derivatives markets. Nonetheless, such strengthening came with new dangers which, if not properly addressed with strict regulation of CCP activities, proper supervision and rigorous enforcement, will make the "new normal" prone to perpetual failure, i.e. it may be perceived as a "robust-yet-fragile"[28] regime.

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[24] EU-Commission (2016).
[25] Domanski, D., Gambacorta, L., & Picillo, C. (2015).
[26] Pirrong, C. (2011).
[27] Pirrong, C. (2011).
[28] Haldane, A (2009): "Rethinking the financial network", speech at the Financial Student Association, Amsterdam, April.

3 The relevance of central clearing

Such “robust-yet-fragile” structuring of the derivatives markets wouldn't have to be a cause for concern if the markets were small and manageable. However, this is by no means the case:

3.1 The OTC derivates markets and the growth of central clearing

In general, the importance of the global over-the-counter (OTC) derivatives markets cannot be overstated. It is a multi-trillion international and highly interconnected business. According to the Bank for International Settlements (BIS)[29], the worldwide notional outstanding amount of OTC derivatives stood at a whopping $715 trillion at end-June 2023, which marks an astonishing increase of roughly 16% compared to end-December 2022.[30] The majority of the derivatives traded are attributable to interest-rate derivatives (80.3%) and foreign exchange derivatives (16.8%)[31], while credit derivatives (1.4%), equity-linked contracts (1.1%) and commodity contracts (0.3%) only represent a small fraction of the global markets. With respect to strong interest-rate derivatives trading, as much as 33.2% or $190.6 trillion of the worldwide outstanding notional amount of interest-rate derivatives was denominated in euro by end-June 2023.[32,33]

With the beginning of efforts by the international community to require market participants to clear standardized derivatives contracts via CCPs, in the aftermath of the global financial market crisis[34], there has also been a steady rise in the number and volume of such contracts being cleared, especially when considering interest-rate and credit derivatives[35]. In the first half of 2023, more than three quarters of the outstanding notional amount of interest-rate (77.8% or $446.2 trillion) and more than two thirds (68.7% or $6.95 trillion) of credit derivatives was centrally cleared.[36]

3.2 The concentration of central clearing of euro-denominated contracts

However, while clearing activities increased substantially in recent years, and despite numerous CCPs being both located and authorized in the EU, and offering services in the EU[37], a high concentration of those activities are evident in the UK with respect to several asset classes. Particularly striking is the dominance of UK-based CCPs in relation to interest-rate derivatives. At the end of 2020, the clearing service of just one UK CCP – SwapClear by LCH Ltd. – was responsible for more than 90% of all OTC interest-rate derivatives clearing globally. In terms of euro denominated trades, Swap Clear accounted

[29] Bank for International Settlements (BIS), OTC derivatives statistics at end-June 2023, 16 November 2023.

[30] At the end of December 2022, the respective figure stood at $618 trillion.

[31] At the end of June 2023, the notional outstanding amount of interest rate derivatives stood at $573.7 trillion and that of foreign exchange derivatives at $120.25 trillion.

[32] Bank for International Settlements (BIS), OTC derivatives statistics at end-June 2023, 16 November.

[33] Notably, there are indications for some relocation of OTC interest rate derivatives trading business from the UK to the EU as the turnover of euro-denominated contracts within the UK decreased between 2022 and 2019, while turnover within the EU increased, albeit from a low level [Walther, U. (2023), OTC derivatives trading: First signs of a shift from London towards EU financial centres, Deutsche Bank, 3 March 2023.

[34] In the EU, the clearing obligation started, for instance, to apply for interest rate derivatives in June 2016 and for certain credit derivatives in February 2017, when traded between financial counterparties [Delegated Regulation (EU) 2015/2205 and Delegated Regulation (EU) 2016/592].

[35] Due to an absence in comparable clearing obligations, central clearing does not play a similarly large role for other types of derivatives contracts.

[36] Bank for International Settlements (BIS), OTC derivatives statistics at end-December 2022, 17 May 2023.

[37] Currently, there are 14 CCPs located in the EU authorized to offer services and activities in the EU [ESMA (2022), List of Central Counterparties authorised to offer services and activities in the Union, ESMA70-148-523, last update on 10 November 2022]. Furthermore, there are as much as 38 CCPs from third countries recognized to offer services and activities in the EU [ESMA (2023), List of third-country central counterparties recognised to offer services and activities in the Union, ESMA70-152-348, last update on 26 October 2023].

for more than 80% and with respect to other EU currencies for more than 90%.[38] Of all euro-denominated interest-rate swap trades taking place globally in the first half of 2021, 94% were cleared by CCPs located in the UK, while only 6% could be attributed to CCPs based in the EU (see Figure 2).[39]

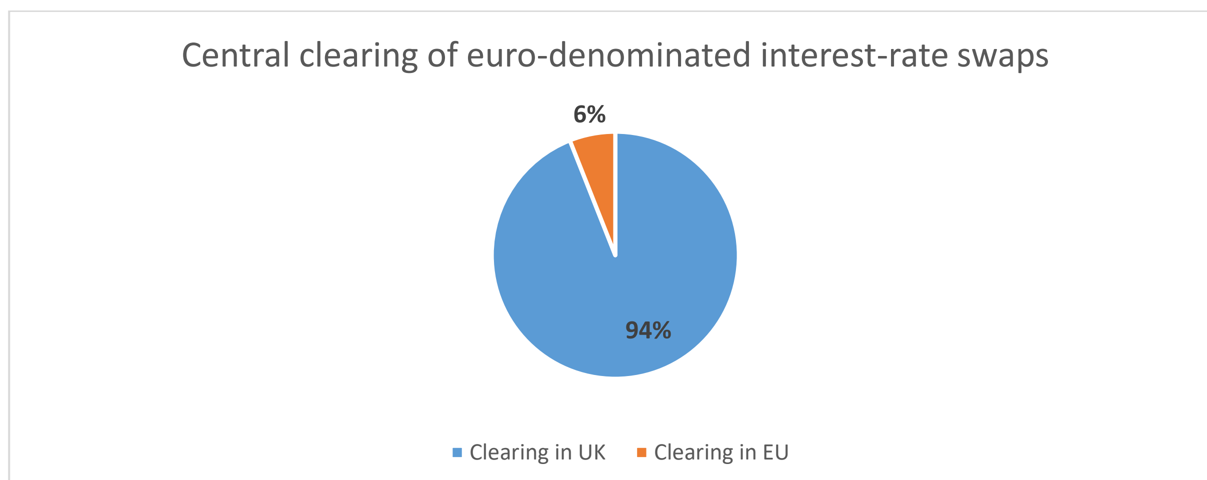

Figure 2: Central clearing of euro-denominated interest-rate swaps [*Source: Thomadakis, A. and K. Lannoo (2021)*]

Furthermore, only half of market participants located in the EU that are active in euro-denominated interest swaps transactions do (also) clear those trades within the EU.[40] And, the EU's reliance on UK CCPs is not limited to the large interest-rate derivatives clearing segment, but also to credit default swaps, where UK CCPs have a strong market share of about 40%.[41] What is more, a large share – over one third – of any collateral that is being posted by clearing members from the EU is posted to third-country CCPs.[42,43]

4 Consequences of the large market share of UK CCPs

As shown above, a predominant share of the central clearing of euro-denominated OTC interest-rate and credit derivatives, takes place in the UK, despite its not to be underestimated risks for the stability and resilience of EU financial markets and for the smooth conduct of monetary policy. Even before the departure of the UK from the EU as a result of Brexit in 2020, the extreme concentration of activities in UK has caused alarm bells to ring at the level of governments and supervisors in the euro area as well as at the ECB. Calls, especially in France, to promote central clearing in the euro area as a strategic necessity, thus relocating business away from non-euro Member States (including the UK)[44], date back to 2009. In 2011, the ECB took up these calls by challenging the idea that central clearing of euro-denominated derivatives should continue to take place in the UK, instead demanding that larger CCPs

[38] EU-Commission (2022), Commission Staff Working Document, Impact Assessment Report, SWD(2022) 697, p. 114.

[39] Thomadakis, A. and K. Lannoo (2021), "Setting EU CCP policy – much more than meets the eye", CEPS-ECMI Study, Centre for European Policy Studies.

[40] ECB (2023a), Central clearing in turbulent times: frontiers in regulation and oversight, Keynote speech by Fabio Panetta, Member of the Executive Board of the ECB, at the Fifth Joint Deutsche Bundesbank, European Central Bank and Federal Reserve Bank of Chicago Conference on CCP Risk Management, Frankfurt am Main, 22 June 2023.

[41] Fabio Panetta: Central clearing and the changing landscape, Welcome address by Mr Fabio Panetta, Member of the Executive Board of the European Central Bank, at the Third Annual Joint Conference of the Deutsche Bundesbank, European Central Bank and Federal Reserve Bank of Chicago on CCP Risk Management, Frankfurt am Main, 3 March 2021.

[42] ECB (2023a).

[43] For additional information, see also ESMA Market Report, EU Derivatives Markets 2023, ESMA50-54821-2930, 6 December 2023, available here.

[44] James, S., & Quaglia, L. (2019), Brexit and the political economy of euro-denominated clearing, Review of International Political Economy, 1, 1-23.

must prove that they are located within the euro area[45]. Although the European Court of Justice (ECJ) rejected those demands in 2015, citing the ECB's lack of competence for regulating central clearing[46,47], the discussions about whether the clearing of euro-denominated contracts should primarily take place within the euro area continued. They gained further momentum with the Brexit vote in 2016, and the emergence of the fact that, with the UK's departure, most of the business would then be taking place in a third country – outside the EU's common internal market – not subject to the EU's direct regulatory and supervisory control, leading to a situation, where it was necessary to "consider the extent to which the EU should depend on non-EU countries for critical market infrastructure"[48].

5 Factors that should drive political and regulatory decisions on euro-clearing

As shown above, the reliance on UK CCPs for clearing of certain euro-denominated derivatives is striking. Such reliance calls for a discussion on whether this situation is sustainable and sound both now and in the foreseeable future, or whether there are paramount factors that may make it necessary to adjust the political and/or regulatory stance:

5.1 Financial stability and systemic risks

A main driver of the EU's build-up of central clearing structures in the aftermath of the financial crisis in 2009 was the intention to reduce systemic risks in derivatives trading. And indeed, concentrating counterparty risk management at CCP level and granting them the role of the main risk managers, is an effective means in this regard. Nonetheless, in concentrating financial risks at the CCP level – in combination with the dynamics of clearing markets – can lead to a situation where such entities themselves become systemically important. Thus, CCPs may be both a solution, by reducing systemic risks, and a problem in that they can be a source of systemic risks. The EU needs to be prepared, especially in the latter case, as the failure of CCPs could threaten financial stability.[49,50,51] Similarly, this also applies to a failure of any big CCP located in the UK which EU market participants rely on for the clearing of euro-denominated derivatives contracts. This has already been confirmed several times by various institutions:

First, the EU-Commission concluded that the concentration of a significant proportion of clearing activities in third countries creates dependencies for EU market participants and raises concerns that the failure of dominant non-EU CCPs "can have substantial destabilizing effects on clearing members, their clients or on other financial market infrastructures". The reasons are (1) the sheer size of exposures,

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45 ECB (2011). Eurosystem oversight policy framework, July 2011.

46 United Kingdom v ECB, Case T-496/11.

47 In response, the ECB recommended an amendment to the Statute of the ESCB to extend its powers to the Regulation of CCPs [Recommendation for a Decision of the European Parliament and of the Council amending Article 22 of the Statute of the European System of Central Banks and of the European Central Bank, ECB/2017/18], however, it was not fully successful in extending its powers.

48 Panetta, F. (2021), Central clearing and the changing landscape. ECB speech, Frankfurt am Main, 3 March 2021.

49 De Houwer, F., & De Smet, J. (2023), The European Commission's equivalence decisions for third-country central counterparties: between financial stability and political considerations.

50 James, S., & Quaglia, L. (2019). Brexit and the political economy of euro-denominated clearing. Review of International Political Economy 1, 1-23.

51 Thomadakis, A. and K. Lannoo (2021).

(2) the interconnections with the wider financial system[52], and (3) the fact that there is a lack of alternative clearing services available.[53]

Second, ESMA concluded that financial stability risks may arise during crisis events. Most notably, there is the risk that EU market participants may simply lose access to non-EU CCPs, which could disrupt derivatives trading or, ultimately, bring it to a halt.[54] Furthermore, while ESMA claims that in the case of an isolated event at LCH Ltd, liquidity risks for EU clearing members can be contained, this may not be true a broader financial crisis. In the event of "a failure of SwapClear [there may be] large losses, impacting a broad range of actors, including EU banks, EU pension funds and insurance companies, and EU companies hedging their interest exposures through Swap Clear".[55] And, additionally, "in any event, a move to alternatives will come with delays and additional costs".[56]

Third, agreement with this assessment also comes from the ECB which argues that "excessive exposures to and continued excessive reliance on third-country CCPs" pose risks for the EU's financial stability that call for the necessity to reduce exposures deemed having a significant systemic relevance.[57] Furthermore, it sees an "adequate domestic clearing capacity" as supporting financial stability and ensuring the "smooth functioning of euro area markets", where the financial risk implications of any disruption to critical clearing services would be "much greater" than a gradual move of euro-clearing business to EU CCPs.[58]

Fourth, the ESRB also identifies financial stability risks. In particular, it sees dangers in UK CCPs offering systemically relevant services to take "procyclical measures during a period of market strain" or in the possibility of them entering "into a recovery phase or, ultimately, into resolution". Thus, it concludes that any further recognition of systemic UK CCPs should only be temporary and efforts to reduce financial stability risks should be intensified.[59]

In conclusion, there is wide consensus that there are substantial financial stability risks related to the significant systemic importance of UK CCPs for the EU. They call for effective mitigation measures to be implemented.

5.2 Risks for monetary policy implementation and the stability of the euro

Beyond pure financial stability risks, any disruption to euro-clearing at a third-country CCP could also lead to risks to a smooth implementation of monetary policy and to the stability of the euro. Such fears have their origin mainly in the financial crisis that also severely affected the markets for sovereign bonds. At the time, CCPs had wide discretion with respect to adjusting margin levels and changing

[52] In general, large global banks that are clearing members at a CCP are often also clearing members at other CCPs. Furthermore, some clearing members sometimes achieve a high degree of dominance at a certain CCP. Both lead to many interdependencies between CCPs and clearing members increasing the risk of "system-wide contagion" [EU-Commission (2022), p. 19].

[53] EU-Commission (2022), p. 11.

[54] ESMA (2021), Assessment Report under Article 25(2c) of EMIR, Assessment of LCH Ltd and ICE Clear Europe Ltd, ESMA91-372-1945, 16 December 2021, p. 7.

[55] Ibid, p. 45.

[56] Ibid, p. 46.

[57] ECB (2023b), Opinion of the European Central Bank of 26 April 2023 on a proposal for a regulation amending Regulations (EU) No 648/2012, (EU) No 575/2013 and (EU) 2017/1131 as regards excessive exposures to third-country central counterparties and improve the efficiency of union clearing markets and a proposal for a Directive amending directives 2009/65/EU, 2013/36/EU and (EU) 2019/2034 as regards the treatment of concentration risk towards central counterparties and the counterparty risk on centrally cleared derivative transactions (CON/2023/11) 2023/C 204/03.

[58] ECB (2023a).

[59] ESRB (2022).

haircuts. However, such CCP risk management measures also had a major impact on the sovereign bond markets also in EU Member States[60]. Thus, UK CCPs also had a say in determining the riskiness of sovereign debt. Ultimately, the government bonds of several EU Member States became more costly and their yields rose. As a consequence, decisions taken by UK CCPs added to enhanced pressure on the ECB to intervene in the markets to ensure their proper functioning.[61] As with Brexit, the ECB and EU supervisory bodies lost powers to influence actions taken by UK CCPs. The fear regained prominence that the resulting (limited) ability to control the behavior of said CCPs could undermine or restrict the central banks' ability to conduct monetary policy, leading to the view that any policies promoting the EU's capacities for euro-clearing may be instruments to improve its room for manoeuvre and, ultimately, its ability to oversee the markets for euro-denominated and centrally cleared derivatives.

The ECB also stressed that disruptions at third-country CCPs could lead to "a partial or total freeze in certain key segments of the financial system (e.g. the euro repo markets) or the contagion of liquidity stress of euro area entities connected to the CCP", which in a severe stress scenario may require the provision of emergency liquidity support.[62] Furthermore, the liquidity position of euro area banks could be negatively impacted, increasing their demand for central bank liquidity, which may have repercussions not only for payments markets, but ultimately also price stability as the primary target of the ECB.[63,64] What is more, where a large, systemically relevant third-country CCP is failing, the ECB's ability to distribute euro to such a CCP may be hampered, as the provision of support may be beyond its remit, which may also call the stability of the euro as the currency of the euro area into question.[65,66]

5.3 Ability to supervise and enforce

As stated in the current equivalence decision of the Commission on the UK's regulatory framework on central clearing, such equivalence is granted largely based on trust that the UK will maintain, apply and enforce its domestic laws applicable to CCPs and that the UK will not alter its regulatory and supervisory framework.[67] While the Commission may change its equivalence decision at any time, it still has to rely, to a certain and not to be underestimated extent, on the goodwill of the UK's government and supervisors not to change its stance on both CCPs located within their territory and on the treatment of clearing members from the EU, including in times of crisis.[68] While it has to be acknowledged that

[60] This is confirmed by ESMA which concludes that sudden adjustments or changes "may induce negative feedback loops, which may also affect sovereign bond markets and interfere with monetary policy transmission channels" [ESMA (2021)].

[61] Chamorro-Courtland, C. (2019), Brexit Scenarios: The Future of Clearing in Europe, Columbia Journal of European Law 169, 2019.

[62] ECB (2017a), The international role of the euro, July 2017.

[63] ECB (2023b).

[64] ECB (2017b), Opinion of the European Central Bank of 4 October 2017 on a proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, CON/2017/39.

[65] ECB (2015), Eurosystem Oversight Policy Framework, September 2015.

[66] ECB (2017b).

[67] EU-Commission (2022c),Commission implementing decision (EU) 2022/174 of 8 February 2022 determining, for a limited period of time, that the regulatory framework applicable to central counterparties in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) No 648/2012 of the European Parliament and of the Council, Recital 14.

[68] Ultimately, ESMA, which is in charge of supervising systemically relevant CCPs (Tier 2), is only able to enforce any supervisory decision vis-à-vis a third-country Tier2 CCP when the third-country supervisors cooperate and allow for such enforcement. ESMA also lacks powers with respect to the crisis management of Tier 2 CCPs. Also, ESMA may have difficulties in

there is a vital interest in coordination and cooperation on the part of UK[69], and the EMIR framework already establishes structures in this regard (see below), it is by no means certain whether such spirit will remain intact in a period of (severe) market turmoil. Ultimately, especially during those periods, the interests of the UK and the EU may not (always) be (fully) aligned. The systemically relevant UK CCPs, the UK government or the Bank of England may opt for measures, which while improving financial stability in UK could undermine it within the EU, since, for instance, the well-being of EU clearing members is not deemed a priority.[70,71] Such fears have also been brought to the table, e.g., by ESMA, which claims that it has "tools to minimise any discriminatory treatment of […] EU clearing members", but lacks "ex-ante intervention powers during a crisis, or in case of recovery or resolution of LCH Ltd".[72] The ECB confirms that there are potential risks that go "beyond the full control of Union authorities". Thus, it calls for both the imposition of measures to decrease the reliance on third-country CCPs[73] and to scale up the efforts for EU supervision over clearing activities deemed systemic to the EU.[74]

5.4 Tendency towards natural monopolies and competition issues

Central clearing markets are characterized by several peculiarities that lead to both high concentration and low competition. This is due to several interrelated factors: First, clearing markets are prone to economies of scale and scope (see above). Second, there are strong network effects. As the number of market participants that clear at a certain CCP rises, the interest for other market participants to clear with that CCP also increases, creating self-reinforcing feedback loops. Such interest rises in particular because the increased number of clearing members usually correlates with enhanced market liquidity and netting efficiency. Third, the creation of clearing hubs at certain locations regularly offers benefits for the market actors involved.[75] Thus, without political intervention, market forces usually drive clearing markets towards the survival of only a small number of CCPs and, ultimately, towards the creation of natural monopolies.[76] This makes the barriers for market entry particularly high and it is frequently challenging, if not impossible, for potential competitors to overcome the strong economies of scale and scope and the network effects.[77] Often, the contestability and assailability of the clearing markets thus has to be questioned. However, such a situation is normally unsound from an economic point of view. A market environment with highly limited competition creates various costs. In particular, with few or only one incumbent CCP in a specific market segment[78], there is a risk of abusive market behavior and monopoly rents creation by said CCPs, as well as limited choice and higher prices for market participants, and less innovative (new) services as incentives for their

accessing decisive information on the conduct of third-country Tier 2 CCPs in times of turmoil [EU-Commission (2022), p. 25].

69 See for instance: UK-EU Memorandum of Understanding on Financial Services Cooperation, updated 27 June 2023.

70 Such discretionary and potentially harmful measure could, e.g., include terminating access of an EU bank to the CCP.

71 Chamorro-Courtland, C. states, for instance, that ESMA had difficulties in accessing information from third-country CCPs, with respect to on-site inspections of said CCPs and in information sharing with EU regulators, supervisors and central banks, resulting in the potential that measures taken by those CCPs remain undetected and/or unaddressed. Furthermore, adjustments to the rules relevant for such CCP or any changes to the regulatory framework in the third country may lead to competitive distortions as well as regulatory or supervisory arbitrage, and limited possibilities for the EU to intervene accordingly and take effective measures [Chamorro-Courtland, C. (2019), p. 192].

72 ESMA (2021), p.45 and 46.

73 ECB (2023b).

74 Panetta, F. (2021).

75 Thomadakis, A. and K. Lannoo (2021).

76 Pirrong, C. (2011).

77 Demange, G., & Piquard, T. (2023). On the Choice of Central Counterparties in the EU. Journal of Financial Markets.

78 Such a judgement applies irrespective of any jurisdictional considerations.

provision is dampened.[79,80] Consequently, regulatory or political measures striving for a more competitive central clearing environment, while coming with certain (transition) risks and costs that need to be addressed properly[81], could promise various benefits in terms of greater user choice, lower prices, additional (innovative) products and services offerings.

5.5 “Open strategic autonomy” and the resilience of euro-clearing markets

The heavy reliance on third-country CCPs, especially from the UK, also has a more strategic dimension for the EU. This plainly resonates with the question of whether the EU – in an increasingly complex and interconnected world – should still allow itself to remain in such dependencies, unable to act in a (more) “autonomous” manner, especially in times of market turmoil which may have devastating repercussions for both EU market participants and the wider economy. Such an ability for the EU to act autonomously can, at least to a certain extent, be called into doubt in relation to the current landscape for many euro-clearing activities. First, EU market participants may simply miss safe and reliable fallback opportunities in the EU in times of crisis, if there are no or only limited clearing capacities available in the EU. Second, the EU may be highly dependent on – potentially impactful – decisions taken by third parties, be it third-country CCPs, supervisors or regulators. Thus, the EU’s opinions may not be heard due to the fact that it is not sitting in the driving seat.[82] And third, without its own central clearing capacities, the EU may simply lack attractiveness as a location to invest and miss out on business opportunities. This leads to the conclusion that the EU would, at this point in time, be virtually at the mercy of any crisis as its abilities to withstand such a crisis are de facto strictly limited. As a consequence, any measures that foster the EU’s euro-clearing markets, including upgrading, supervising and enforcement capabilities, may also be seen as a means to strengthen the sovereignty of the EU and its ability to shape and decide upon its own future. In a way, such a conclusion also resonates with the EU’s desire, which features more and more frequently in its own narrative, firstly to attain “strategic autonomy”, and secondly to maintain an “open economy”, being a conceptual approach that several EU institutions have shaped in recent years.[83] While said approach has many dimensions[84] – here: a policy dimension aimed at strengthening EU businesses and reducing reliance on providers located in third-countries in order to increase the stability and resilience of the euro-clearing market segment – it definitely has its valid justification, because only a vibrant euro-clearing landscape (also)[85] in the EU “allows for” long-term resilience and stability and the elimination of a potential vulnerability.

5.6 The too big to fail problematic and the risk of moral hazard behavior

As elaborated above, the regulatory reform in the aftermath of the financial crisis led to the concentration of risks in CCPs. Due to market dynamics, they have grown considerably in recent years.

[79] Pirrong, C. (2011).

[80] EU-Commission (2022).

[81] Such risks and costs may encompass, for instance, the creation of incentives by CCPs to lower their risk management [Coeuré, B. (2014), “Central Counterparty Recovery and Resolution”, Keynote speech at “Central Clearing – Guarantee of Stability or New Moral Hazard?”, 24 November].

[82] In particular, EU regulators and supervisors may lack capabilities to address financial stability risks for the EU.

[83] See for instance: Council of the European Union (2019). A new strategic agenda for the EU – 2019 – 2024; European Council conclusions, 1-2 October 2020; European Commission (2020), EU Open Strategic Autonomy and the Transatlantic Trade Relationship; COM(2022) 696, Communication from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee, A path towards a stronger EU clearing system.

[84] ECIPE (2023), A Forward-Thinking Approach to Open Strategic Autonomy: Navigating EU Trade Dependencies and Risk Mitigation, Bauer, M., du Roy, O. and Sharma, V., November 2023.

[85] This should not be misunderstood to mean that the EU should, with respect to euro clearing, act in an autarky non-open manner. Financial markets and the clearing business are inherently global and should stay this way.

Because of their sheer size and interconnectedness with market participants and the wider financial markets, CCPs have often become systemically important institutions, which makes them prone to be "too big to fail" in crisis situations. Their failure could lead to massive distortions on the financial markets and also drive other institutions, i.e. clearing members, into insolvency via inevitable chain reactions. However, due to the "too big to fail" status of systemically important CCPs, both they themselves and their clearing members and clients know that their chances of being rescued by governments cannot be underestimated. As a result, they may be incentivized to take excessive risks as they may be able to externalize risks to third parties, i.e. the state and thus, ultimately, the taxpayer. An expectation that market actors, especially those deemed systemically important, are "exempt" from failure leads to moral hazard behavior. This may happen due to increasing chances of rescue measures not funded by market participants themselves. Yet, one of the main lessons learned from the financial crisis was that appropriate regulation should avoid creating such situations in the first place. Furthermore, any special protection for systemically important financial institutions – whether laid down in law or only perceived as an unspoken expectation – distorts competition with non-systemically important market participants. Consequently, EU measures to reduce the reliance on systemically important CCPs, irrespective of their location, may also be seen as policy instruments to counter the too-big-to-fail problematic, to reduce the risk of misaligned incentives, to foster the internalizing of external effects such that market actors include the social costs of their behavior, and to limit the necessity for government and/or taxpayer support.[86,87]

5.7 Avoidance of abrupt equivalence non-recognition

It is still debatable whether ESMA and the Commission would decide against any prolongation of continued recognition of the systemically relevant UK CCPs after mid 2025 if there has not been a sufficient (voluntary and mostly market driven) build-up of clearing capacity in the EU by then. There is nonetheless a risk, especially for EU market participants, that ESMA and the Commission may eventually lose patience and decide not to extend their equivalence decision any further. Both ESMA and the Commission have made clear that the prolongation was only temporary, in particular, to avoid any dangerous cliff-edge effects. At the same time, such an extension was awarded merely to provide market participants with extra time to move to EU CCPs[88] and for measures to be implemented "to achieve a gradual reduction in exposures of EU clearing members to Tier 2 CCPs"[89]. So no carte blanche was granted and ESMA and the Commission will likely consider closely, whether "appropriate measures and safeguards to mitigate risks" have been adopted and "have achieved the desired mitigating effect".[90] Also, the German Bundesrat called for measures to establish a sufficiently liquid clearing market in the relevant product categories within the EU in order to avoid a dilemma scenario once again, that could lead to a "business as usual" outcome.[91] In a way, regulatory measures, like active account provisions, that guide market participants towards a new steady state in which clearing capacity in the EU is built up to such an extent that clearing capacity in the UK is diminished to a non-systemically

[86] Wendt, F. (2015), Central counterparties: addressing their too important to fail nature, International Monetary Fund.

[87] Van Roosebeke, B. (2009) Eine ordnungspolitische EU-Finanzmarktregulierung: „Für einen neuen Umgang mit Risiken", March 2009.

[88] EU Commission (2022).

[89] ESRB (2022).

[90] ESMA (2021).

[91] Bundesrat (2023), Beschluss des Bundesrates zum Vorschlag für eine Verordnung des Europäischen Parlaments und des Rates zur Änderung der Verordnungen (EU) Nr. 648/2012, (EU) Nr. 575/2013 und (EU) 2017/1131 im Hinblick auf Maßnahmen zur Minderung übermäßiger Risikopositionen gegenüber zentralen Gegenparteien aus Drittstaaten und zur Steigerung der Effizienz der Clearingmärkte der Union, Drucksache 32/23.

relevant level, can be seen as a way of removing the risks to market participants which could spread in the event of an abrupt derecognition decision by ESMA, respectively the Commission.

5.8 Market fragmentation, competitiveness and (transition) costs

While there are many well-founded reasons to justify implementing regulatory or supervisory measures that force EU market participants to relocate (part) of their clearing business from the UK to the EU (see previous subsections), such relocation may also face challenges, at least temporarily, as many of the benefits of central clearing at one CCP may often not be fully realized when splitting clearing activities among two or more CCPs, making the markets less efficient. Possible problems often mentioned, include, inter alia, (1) the loss of netting efficiencies, (2) a less deep and more fragmented liquidity pool, (3) higher costs, i.e. due to multiple clearing or membership fees, higher margin/collateral postings, higher default fund contributions etc., (4) increasing complexities in managing clearing member defaults, (5) a rise in operational inefficiencies and (additional) transaction costs, (6) reduction in the competitiveness of EU market participants vis-à-vis market actors not forced to split their clearing activities[92], (7) potential incentives to reduce central clearing of derivatives or derivatives trading generally, or (8) the risk of a non-smooth regulatorily driven shift from the current market reality to an envisaged new market reality, where aspects of the transition or upheaval were not or could not be adequately taken into account.[93,94,95,96] While all these challenges will likely lead to a less efficient clearing environment for EU market participants, and this can and should not be neglected altogether, such efficiency loss may need to be tolerated to some extent, as there are several potential gains – i.e. increased financial stability, improvements in the conduct of monetary policy, more resilient EU clearing markets, increased strategic autonomy of the EU in this field and a closer alignment of economic incentives of market actors – that should outweigh the potential efficiency losses.

[92] Third-country market participants would not be obliged to relocate business to the EU. Thus, they would, in contrast to EU market participants, still be able to clear euro-denominated derivative contracts at (Tier 2) UK CCP without any boundaries.

[93] Thomadakis, A. and K. Lannoo (2021).

[94] EU-Commission (2022).

[95] Chamorro-Courtland, C. (2019).

[96] Gretton, P., & Vines, D. (2018), Towards a framework for trade and investment policy in post-Brexit United Kingdom. In meeting on Brexit and Trade Choices in Europe and Beyond, CEPR and NIESR, London, February, Viewed.

6 The EU's regulatory framework: Today and tomorrow

6.1 Regulatory steps already taken to address risks related to high concentration at UK CCPs

The European Market Infrastructure Regulation (EMIR) lays down clearing requirements for OTC derivative contracts and requirements for the performance of activities of CCPs. According to the Regulation, certain over-the-counter (OTC) derivative contracts must be cleared via CCPs.[97] However, EMIR, as established in 2012, did not address risks related to the high concentration of euro-clearing activities at UK CCPs at that time. Only after Brexit, the Commission realized that there may be a need to amend EMIR to tackle such risks to a greater extent. Thus, in 2017, it came forward with a proposal to revise the Regulation, which was adopted in 2019 (EMIR 2.2).[98] EMIR 2.2 did not establish rules directly obliging market participants to reduce their exposures vis-à-vis third-country CCPs, but mainly tried to address the risks associated with the heavy reliance on certain CCPs by changing the supervisory approach with respect to those CCPs. For this, it introduced a two-tier system, differentiating between non-systemically important (Tier 1) and systemically important (Tier 2) third-country CCPs. ESMA evaluates for each third-country CCP, based on predefined criteria, whether or not such a CCP should be regarded as systemically important.[99] Any third-country CCP, classified as Tier 2 by ESMA, must comply with additional requirements; e.g. organizationally and with respect to conduct of business and prudential rules. Furthermore, such Tier 2 CCPs are subject to direct supervision by ESMA[100] and the ECB, if clearing takes place in euro.[101,102] EMIR 2.2 further contains new provisions stating that ESMA has the right to recommend[103] and the Commission to decide that a third-country CCP or some of the clearing services it provides are of such significant systemic importance that the CCP should not be granted recognition to offer certain clearing services in the EU.[104] As a consequence, such services may only be provided by the concerned CCP if it establishes itself in the EU. For third-country Tier 1 CCPs, the established equivalence regime continues to apply. Thus, they may, if recognized, provide clearing services in the EU by adhering to their home country's regulatory framework. In fact, recognized third-country Tier 2 CCPs that provide clearing services in the EU must adhere to the supervisory requirements established under the EMIR regulatory framework.

6.2 Proposed new regulatory steps to address risks related to high concentration at UK CCPs (EMIR 3 proposal)

With the implementation of EMIR in 2012 and the various revisions of it thereafter, the EU legislators established a solid framework for the central clearing of derivatives contracts. However, as postulated

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97 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.

98 Regulation (EU) 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third country CCPs, 12 December 2019.

99 As of today, ESMA has determined that two CCPs from UK –LCH Ltd and ICEU – qualify as Tier 2 CCPs.

100 ESMA may, for instance impose supervisory measures, like imposing fines or periodic penalty payments.

101 Thus, ESMA is currently responsible for overseeing the two Tier 2 UK CCPs.

102 Even though ESMA was granted direct supervisory powers over those Tier 2 CCPs, third-country supervisory authorities remain primarily responsible for supervision.

103 Such decisions require a comprehensive and justified evaluation proportionate to the CCP's systemic significance.

104 With respect to UK CCPs, the Commission repeatedly came to the conclusion, despite doubts, that the legal and supervisory arrangements of the UK applicable to central counterparties can be considered to be equivalent to the EMIR requirements.

by the Commission in its proposal to amend the EMIR framework of December 2022 (EMIR 3)[105], it still suffers from several weaknesses. First, the concentration of derivative contract clearing is still excessively centered on certain CCPs in third countries, notably the UK, posing persistent financial stability risks to the EU. Second, the authorization procedures for new clearing services and adjustments to risk models for EU CCPs are excessively prolonged and cumbersome. This results in heightened costs and diminished appeal of EU CCPs. And third, any transfer of clearing activities to the EU could lead to additional risks in the EU, and the existing EU supervisory framework may not be fully able to cope with this.[106] As a result, the Commission laid down several measures with the aim of enhancing the attractiveness of EU CCPs, encouraging the transfer of clearing activities to the EU and strengthening the supervisory framework. The main proposals tackling the heavy reliance on third-country CCPs and safeguarding financial stability in the EU and its Member States are presented below:

6.2.1 Active account requirement (AAR)

The central element of the proposal is a so-called “active account requirement (AAR)”. Financial counterparties and non-financial counterparties subject to a clearing obligation must clear a minimum proportion of interest rate derivatives denominated in euro and Polish zloty, credit default swaps denominated in euro, or euro-denominated short-term interest rate derivatives on accounts with EU CCPs.[107] This provision aims to mitigate potential risks arising from excessive exposures of EU market participants and their clients to Tier 2 third-country CCPs.[108] The minimum proportion for each of the three categories of derivative contracts as well as the method for calculating the activities at EU CCPs shall be laid down by ESMA via regulatory technical standards (RTS).[109] ESMA must set the minimum proportion in such a way that fewer derivative contracts are cleared at systemically important CCPs from third countries (Tier 2 CCPs), and the clearing of derivative contracts is no longer of significant systemic importance.[110] Counterparties must calculate their activities with regard to the aforementioned categories of derivative contracts at EU CCPs, report the results to the competent authorities of the respective EU CCP once a year and thereby confirm that they fulfil the obligation.[111] In the event that ESMA determines that certain services or activities provided by third-country CCPs are no longer of significant systemic importance, the Commission is empowered to modify the list of derivative contract categories subject to the minimum proportion requirement via delegated acts.[112] Furthermore, clearing members and clients offering clearing services at both EU and non-EU CCPs must notify their clients about the option to clear relevant contracts at an EU CCP.[113] Additionally, EU clearing members and clients must report the extent of clearing activities conducted at non-EU CCPs to the competent authority.[114]

[105] Proposal for a Regulation of the European Parliament and of the Council of 7 December 2022 amending Regulations (EU) No 648/2012, (EU) No 575/2013 and (EU) 2017/1131 as regards measures to mitigate excessive exposures to third-country central counterparties and improve the efficiency of Union clearing markets, EMIR 3 proposal, COM(2022) 697.
[106] EMIR 3 proposal, p. 1–3.
[107] New Art. 7a (1) and (2), EMIR 3 proposal.
[108] Recital 10 EMIR 3 proposal.
[109] New Art. 7a (5) EMIR 3 proposal.
[110] New Art. 7a (5) EMIR 3 proposal.
[111] New Art. 7a (3) and (4) EMIR 3 proposal.
[112] New Art. 7a (6) EMIR 3 proposal.
[113] New Art. 7b (1) EMIR 3 proposal.
[114] New Art. 7b (2) EMIR 3 proposal.

6.2.2 Tackling concentration risks

In a proposal amending the Capital Requirements and the Investment Firms Directive (CRD and IFD) that complements the EMIR 3 proposal[115], the Commission suggests that banks and investment firms must have effective procedures in place to identify, manage, monitor and report concentration risks that could arise from their exposures to CCPs, in particular Tier 2 CCPs. Additionally, management bodies must, in order to monitor and manage concentration risks, develop plans and set targets taking into account the minimum proportions set with respect to the above-mentioned AAR.[116]

The proposal further envisages that the responsible supervisors for banks and investment firms must monitor and assess the management of concentration risks by banks and investment firms. In doing so, they shall also be required to examine the extent to which progress has been made in increasing the proportion of derivatives clearing at EU CCPs.[117] They may also require banks or investment firms to reduce their exposures to a CCP, provided that they identify an excessive concentration risk.[118]

6.2.3 Recognition of third-country CCPs

As elaborated above, a CCP from a third country may only provide clearing services in the EU if it has been recognized by ESMA. In recognizing such CCPs, EMIR differentiates between Tier 1 and Tier 2 third country CCPs.[119] The EMIR 3.0 proposal further clarifies the third-country CCP recognition procedures. In particular, the proposal envisages certain changes with respect to the cooperation agreements between ESMA and the competent authorities of a third country whose legal and supervisory framework has been recognized as equivalent. In future, the agreements should be tailored to the CCPs established in the third countries and be more detailed for Tier 2 CCPs. This involves a more comprehensive exchange of information, particularly extending to a broader spectrum of data for Tier 2 CCPs when compared to their Tier 1 counterparts. The agreements must grant ESMA the right to receive notifications from third-country competent authorities if a Tier 2 CCP has to draw up recovery plans due to financial distress, or if the authority develops resolution plans for the CCP, or if a crisis emerges.[120]

6.2.4 Strengthening the supervisory framework

To enhance supervision, the EMIR 3.0 proposal makes changes with respect to the responsibilities of ESMA, the competent authorities and the college of supervisors:

ESMA's role shall be expanded by giving it the right to make comments on competent authorities' annual reviews and assessments of CCPs, as well as on the margin requirements and the decisions to withdraw a CCP authorization, with a specific emphasis on cross-border risks or risks to EU financial stability.[121]

Competent authorities responsible for CCP supervision will now be mandated to promptly inform, inter alia, ESMA and the College of Supervisors of any crisis situation affecting a CCP. Such crisis situations

[115] Proposal for a Directive of the European Parliament and of the Council amending Directives 2009/65/EU, 2013/36/EU and (EU) 2019/2034 as regards the treatment of concentration risk towards central counterparties and the counterparty risk on centrally cleared derivative transactions, COM (2022) 698.

[116] Amended Art. 74 (1) and Art. 76 (2) Directive 2013/36/EU and amended Art. 26 (1) and Art. 29 (1) Directive (EU)2019/2034, COM (2022) 698.

[117] Amended Art. 81 Directive 2013/36/EU and amended Art. 36 (1) Directive (EU)2019/2034, COM (2022) 698.

[118] Amended Art. 104 (1) Directive 2013/36/EU and amended Art. 39 (2) Directive (EU)2019/2034, COM (2022) 698.

[119] Art. 25 EMIR.

[120] New Art. 25 (7a) and (7b), amended Art. 25 (7) EMIR 3 proposal.

[121] Amended Art. 17 and 23 EMIR 3 proposal.

shall no longer be restricted to those attributable to developments on the financial markets,[122] but will also include, most notably, those that may have an impact on the soundness or resilience of an EU CCP, its clearing members, or clients.[123]

Furthermore, the reform includes the establishment of joint supervisory teams for each EU CCP, comprising representatives from competent authorities, ESMA, and the college of supervisors. These teams are designed to actively participate in on-site inspections and support competent authorities in inspections and assessments of CCPs. Furthermore, the draft law foresees the launch of a joint cross-sectoral supervisory mechanism led by ESMA, and including representatives from, e.g., the Commission and the ECB. This mechanism shall monitor the implementation of measures to reduce exposures to third-country Tier 2 CCPs, relationships between clearing members and clients, identification of concentration risks, and the assessment of efforts to strengthen the attractiveness of EU CCPs.[124]

In addition to that, ESMA may initiate proceedings for breach of EU law if it concludes that a competent authority does not ensure compliance with the envisaged AAR. However, before taking this step, it should first issue guidelines or recommendations.[125] Also ESMA shall be able to convene meetings of the CCP Supervisory Committee in emergency situations, either on its own initiative or upon request, in order to coordinate any reactions of the competent authorities to these situations.[126] It may, furthermore, at the proposal of the CCP Supervisory Committee[127], issue recommendations, in crisis situations, to the competent authorities to take certain temporary or permanent supervisory decisions in order to prevent or mitigate "significant adverse effects" on EU financial stability.[128,129]

6.3 Alternative approaches to address high concentration risks

6.3.1 No changes to the regulatory framework and loss of equivalence status

While the Commission's proposal of December 2022 envisages several measures to address risks related to high concentration at UK CCPs, such as the active account requirement (see Section 6.2), an alternative (regulatory) approach could have been to simply refrain from any further action to address such risks[130]. In such a scenario, the current EMIR framework would remain applicable, while equivalence for the UK would expire on 30 June 2025. Such an approach could have the following repercussions. In a first best scenario, where the threat of the expiry of the equivalence decision is deemed sufficiently credible by market participants, they are likely to develop an interest in relocating business to EU CCPs to avoid any cliff-edge risks associated with the envisaged derecognition in mid-2025. However, although the Commission is trying to exert pressure on EU market participants to relocate business to EU CCPs with the threat of expiration of the equivalence decision, it seems doubtful that such pressure will be deemed credible.[131] If it is not, and the Commission extends the equivalence decision

[122] That encompasses financial market developments which may have an adverse effect on market liquidity, the transmission of monetary policy, the smooth operation of payment systems or the stability of the financial system in any of the Member States where the CCP or one of its clearing members are established.
[123] Amended Art. 24(3) EMIR 3 proposal.
[124] Art. 23b EMIR 3 proposal.
[125] New Art. 23c (4) EMIR 3 proposal.
[126] New Art. 24 (1) and (3) EMIR 3 proposal.
[127] This is a permanent internal committee of ESMA.
[128] New Art. 24 (6) EMIR 3 proposal.
[129] For a more comprehensive overview of the EMIR 3 proposal, see cepDossier Regeländerungen beim Clearing von Derivaten, Nr. 9/2022 (in German only).
[130] This also includes refraining from any AAR.
[131] While the ESRB also favors a voluntary vs. a mandatory reduction, as it would "take better account of the needs of clearing members and clients", it questions whether it would "trigger a significant migration" from UK to EU CCPs [ESRB (2022)].

even further[132], market participants may continue to clear using incumbent Tier 2 UK CCPs, thus retaining the status quo, or even worsening it by increasing reliance on those non-EU CCPs. In such a scenario, the current over-reliance on third-country CCPs may be perpetuated and not addressed appropriately. As a consequence, dangers for the EU's financial stability and for the proper functioning of monetary transmission channels would persist, as would the current impediments to effective supervision and enforcement of third-country CCP activities, and the incentives for the build-up of viable alternatives in the EU would be dampened despite being of key importance for a resilient and stable EU financial market. Thus, maintaining the status quo does not seem to be a valid political strategy to strive for, as it is also in the political interest to avoid any disruptive cliff-edge effects.

6.3.2 Alternative active account options

Option 1 – Voluntary/Mandatory AAR with qualitative criteria only/at first: This option envisages, at least for a specific period of time, that market participants may or must open and maintain an active account at an EU CCP. However, there would not be any quantitative thresholds or targets with respect to the active account. Thus, the speed of relocating business to the EU would be mostly left to the market actors. Such a qualitative approach may be complemented by quantitative targets only where the voluntary approach proves unsuccessful.[133]

Option 2 – Requirement to keep an "operational active account" (OAR) at EU CCPs: One option suggested during the negotiations on EMIR 3[134], was to oblige any EU market participant under the clearing obligation to have an "operational active account" (OAR) at an EU CCP, defined as an account that is permanently functional ("operationally live"), but without any quantitative threshold. Such an account could be seen as a fallback option, in case of a major shock or of regulatory or supervisory divergence. With such an option, market actors would still be able to choose where to clear and to what extent, but the OAR would be used as a ready-to-use plan B. Such a measure would include safeguards to ensure that the accounts really are ready to use, and that supervisors have powers to address any type of non-fulfilment.

Option 3 – AAR with quantitative thresholds set on Level 1: While the Commission calls for an AAR at EU CCPs in combination with the specification of quantitative thresholds to be developed by ESMA and adopted by the Commission on Level 2, there are also calls for such thresholds to be determined at Level 1, i.e. by the legislature itself. For instance, some members of the European Parliament demanding that "at least 40%" of derivative contracts, which have been identified as systemically important, must be cleared at active accounts from EU-CCPs, giving the Commission the power to increase the threshold on Level 2, if necessary, to safeguard financial stability.[135]

Option 4 – AAR phase-in with target level: This option would set a specific "phase-in" timeframe – i.e. five years – by which time a certain proportion – i.e. more than 50% – of risk exposure in the

[132] As of today, there have already been several temporary equivalence decisions adopted by the Commission. These are Commission Implementing Decision (EU) 2018/2031 of 19 December 2018, Commission Implementing Decision (EU) 2019/544 of 3 April 2019, Commission Implementing Decision (EU) 2019/2211 of 19 December 2019, Commission Implementing Decision (EU) 2020/1308 of 21 September 2020 and Commission Implementing Decision (EU) 2022/174 of 8 February 2022.

[133] Such a model is favored, inter alia, by the European Banking Federation [EBF feedback to the EC consultation on the review of the central clearing framework in the EU, March 2022] and the German Banking Industry Committee [Comments, February 2023]. It is also supported by a larger group of Member States [Council of the European Union (2023), EMIR Review, Progress report, 9 June 2023.

[134] Council of the European Union (2023), Non-paper – Requirement of an operational active account (OAA) in EMIR 3, from French delegation, 16 May 2023.

[135] European Parliament (2023), Amendments, Draft report, Danuta Maria Hübner, July 2023, see amendments 211 and 258.

systemically relevant derivative contracts must be cleared by EU CCPs. It would only refer to new contracts entered into after the date of application of the new Regulation.[136]

Option 5 – AAR with quantitative thresholds set on Level 2, but with more guidance on Level 1: This approach would basically replicate the regulatory approach as foreseen by the Commission but giving ESMA more guidance on Level 1 with respect to the quantitative threshold to be set. One proposal made by a Member of the European Parliament is to define a minimum level of clearing activity maintained in accounts at EU-CCPs. In defining the quantitative threshold, ESMA would not be allowed to set an "initial" threshold below such minimum level; for instance, 15% of the total clearing activity of a counterparty. Such threshold may then be increased step by step until the systemic relevance problematic is solved.[137]

Option 6 – Phased-in approach: An option envisaged by the responsible rapporteur of the ECON committee is to adopt a phased-in approach for the AAR. In phase 1, EU market participants would be required to have a "materially" active account at an EU CCP, and they would have to exchange initial and variation margins in that account. In this phase, there would be no quantitative threshold, but the counterparties must enter into new positions using the account. After implementation[138], there would be an assessment of whether such a step was or is likely to be sufficiently effective in addressing the financial stability risks, and whether competitiveness is undermined. In phase 2, which would only follow, if phase 1 was deemed ineffective, ESMA would set a quantitative threshold for clearing that must occur using active accounts at EU CCPs.[139]

Option 7 – The ESRB's approach: The ESRB, in general, supports the introduction of a quantitative AAR.[140] It claims, however, that it will only be effective in its aim to reduce reliance on third-country Tier 1 CCPs, if it is based on exposures to third-country CCPs; i.e. in terms of initial margin. By calibrating the AAR in such a way, it would be a risk-based measure. Such effectiveness would be dampened (not fully undermined), if, instead, the AAR were based on the outstanding clearing volumes; i.e. on the number of trades or notional amounts. In this case, there would be a reduction of such quantities at UK CCPs, but not necessarily a reduction of EU clearing members' and clients' exposures, as the basis is "not a good measure of exposures and risks". Furthermore, in the ESRB's opinion, the effectiveness would be lower if market-making and client clearing were excluded and the AAR requirement only applied to new trades.[141]

Option 8 – The ECON committee's approach: In its report on the EMIR 3 proposal of the Commission, the ECON Committee proposes the following solution: Market participants subject to the clearing obligation must hold at least one active account at an EU CCP and must regularly clear derivatives contracts that are deemed systemically relevant using that account. The account is deemed "active" if initial and daily variation margins are posted, when IT connectivity, internal processes and legal documentation are in place and its functioning is guaranteed. Furthermore, the Members of the Committee

[136] Ibid, see amendments 213 and 275.
[137] Ibid, see amendments 212 and 281.
[138] The rapporteur envisages a period of 18 months for this process.
[139] European Parliament (2023), Draft report on the proposal for a regulation of the European Parliament and of the Council amending Regulations (EU) No 648/2012, (EU) No 575/2013 and (EU) 2017/1131 as regards measures to mitigate excessive exposures to third-country central counterparties and improve the efficiency of Union clearing markets, Committee on Economic and Monetary Affairs, Rapporteur: Danuta Hübner, 13.6.2023.
[140] The ESRB states that an AAR is only one element or prerequisite for building clearing capacity in the EU. It demands that it should be combined, in particular, with higher capital requirements for exposures to Tier 2 CCPs, the setting of exposure reduction targets and strengthening of EU supervision over clearing activities within the EU [ESRB (2023)].
[141] ESRB (2023).

agreed on a phase-in approach. The requirement to clear a certain proportion of trades via such an active account should only take effect if the Commission has performed a cost-benefit analysis which indicates that implementing such proportions is reasonable after weighing financial stability against international competitiveness considerations.[142,143]

Option 9 – The Council's approach: On December 6, the Council put forward its active account approach in its mandate for negotiations. It opted for the following solution: Any (non-)financial counterparties that are subject to the clearing obligation shall hold, for the systemically relevant derivative contracts at least one active account at an EU-CCPs that provides clearing services with respect to the derivatives concerned. They shall be required to clear at least a "representative" number of trades in this account[144]. The establishment of such account shall take place within six months after the counterparty became subject to active account holding requirement. The Council envisages that the active account must be permanently functional, its operationality must be ensured (even at short notice, for large volumes and at all times) and the counterparty must be able to clear all new trades with the account. The "representativeness" obligation shall be further specified by ESMA, taking into account (1) different derivative contracts classes, (2) the maturity of the trades and (3) the sizes of a trade.[145,146]

6.3.3 Various other/complementary/substitutional options

Large exposure limits: Another option, also envisaged by the EU Commission, is to have large exposure limits. Such limits would restrict the exposures of EU banks vis-à-vis a specific EU or third country CCPs and could be set as a Pillar 1 requirement under the Capital Regulation (CRR)[147], leading to higher capital requirements for banks in breach of any set limits.[148]

Macroprudential measures: Furthermore, the Commission also reflected on establishing certain "macroprudential measures" to address the high dependencies vis-à-vis- third-country CCPs. These included, inter alia, (1) the possibility of systemic risk buffer implementations, (2) targeted (temporary) actions to tighten large exposure limits, or (3) a limit on the aggregated level of exposures to CCPs.[149]

Exposure reduction targets: This option would include targets for limiting the exposure vis-à-vis a Tier 2 CCP. Such targets may be established in various ways. They may, for instance, be introduced based on clear timelines or phase-in approaches, be set at clearing member or client level, or be set only with respect to system clearing services or more broadly.[150] Furthermore, targets may be set directly by law or be the result of agreements between EU market actors and their respective supervisor(s). Also, such

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[142] European Parliament (2023), MEPs aim to make the EU an attractive clearing hub while addressing risks, Press release, 28. November 2023.

[143] Committee on Economic and Monetary Affairs (2023), Report on the proposal for a regulation of the European Parliament and of the Council amending Regulations (EU) No 648/2012, (EU) No 575/2013 and (EU) 2017/1131 as regards measures to mitigate excessive exposures to third-country central counterparties and improve the efficiency of Union clearing markets, A9-0398/2023, 5 December 2023.

[144] This obligation shall not apply to (1) the provision of client clearing services and (2) to counterparties with a notional clearing volume outstanding of less than six billion euros in the respective derivative contracts.

[145] When specifying the representativeness, ESMA shall limit the different classes of derivative contracts to three, the different maturity ranges to four and the different trade size ranges to three.

[146] Council of the European Union (2023) Mandate for negotiations with the European Parliament on the Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 648/2012, (EU) No 575/2013 and (EU) 2017/1131 as regards measures to mitigate excessive exposures to third-country central counterparties and improve the efficiency of Union clearing markets, 16194/23, 1 December 2023.

[147] Such a model would necessitate bringing banks' exposures vis-à-vis CCPs under the CRR large exposures regime and may require an amendment of Art 459 of the CRR.

[148] EU-Commission (2022), p. 39ff.

[149] EU-Commission (2022), p. 39ff.

[150] EU-Commission (2022), p. 39ff.

targets may be obligatory for any clearing members or specific clearing members clearing at a Tier 2 CCP.[151]

Higher or lower capital requirements: This option would foresee higher capital requirements for exposures vis-à-vis third-country Tier 2 CCPs in order to increase the capacity of clearing to cover losses in times of market turmoil when such CCPs may be doomed to fail.[152] Alternatively or additionally, capital requirements could be set at a lower level for exposures vis-à-vis EU CCPs than exposures vis-à-vis third-country Tier 2 CCPs.

Strict location policies: A rather strict option could be that certain euro-denominated derivatives must be cleared within the EU and by CCPs that are physically located in the EU. Thus, central clearing at (systemically relevant) third-country CCPs would no longer be allowed. While such "location policies" seem quite extreme, they are not without precedent (see Box 1).

Box 1: Location policy in Japan

In 2010, Japan had already decided to mandate Japanese market participants to clear their over the counter IRDs via CCP, i.e. before the EU and the US did so.[153] However, Japan introduced a certain form of location policy and is the only jurisdiction as of today that does so.[154] In general, IRDs must be cleared at a licensed CCP. This can be a Japanese CCP, a licensed CCP from a third-country or a non-licensed third-country CCP that has links to a licensed Japanese CCP. Thus, third-country CCPs are, in principle, not excluded. However, in the past, while some third-country CCPs received a license to clear non-JPY IRDs, none of them are allowed to do so with respect to JPY IRDs. As a result, most JPY IRDs are cleared by the Japan Securities Clearing Corporation (JSCC).[155] Thus, market participants are basically restricted to the local CCP liquidity pool.[156] Despite this, there seems to be a tendency that JSCC is still able to attract more and more foreign market participants. An ever-greater number of international investors clear their JPY swap books at JSCC, especially since 2018, and are using it as an additional clearing house. For instance, in 2017, JSCC had as many as seven non-Japanese clients. In only three years, the number rose to thirty. In comparison, the number of Japanese clearing clients only increased from 57 to 70.[157]

6.3.4 Combination of measures

As shown above, there are multiple sensible and less sensible ways to address the heavy reliance on third-country Tier 2 CCPs. Having said that, it is by no means advisable or necessary to only implement one of the many measures presented to tackle undesirable dependencies. Just as an example, the ESRB

[151] ESRB (2022), ESRB response to the European Commission targeted consultation on the review of the central clearing framework in the EU, ESRB/2022/0047, 22 March 2022.

[152] EU-Commission (2022), p. 39ff. and ESRB (2022).

[153] From a global perspective, the Japanese JPY-denominated IRD markets are rather small. The notional amounts outstanding amount to $26.3 trillion or 4.6%, while the gross market value amounts to $17.36 trillion or 2.4%. Since 2016 a downward trend is observable [Bank for International Settlements (BIS), OTC derivatives statistics at end-June 2023, 16 November].

[154] Both, Australia and Canada also considered adopting location policies. However, they decided either against doing so or its outcome was not comparably strict as compared to the Japanese solution.

[155] Only recently, JSCC announced a new record clearing volume for interest rate swap transactions (1.181 trillion yen as of August 2023 vs. 1.1111 trillion yearly total for 2022 (see here).

[156] IOSCO (2019), Market Fragmentation & Cross-border Regulation, Report, FR07/2019, June 2019; Thomadakis, A. and K. Lannoo (2021); EU-Commission (2022).

[157] Risk.net (2021), Japan's CCP goes global, 29 June 2021, available here.

called for combining an AAR with higher capital requirements for exposures to Tier 2 CCPs, exposure reduction targets, and/or other measures to incentivize exposure reductions.[158]

7 Conclusion and the potential ways forward

Any regulatory or supervisory measures that force EU market participants to relocate (part) of their euro-clearing business from the UK to EU CCPs is, in the first instance, a serious encroachment on entrepreneurial freedom and an interference in well-established business relationships. More generally, obliging market actors where they have to do their (euro-clearing) business – here: increasingly in the EU – and to what extent, can be viewed as departure from the paradigm of open global financial markets, an interference in capital allocation processes and decisions, and ultimately as an instrument of protectionism. Consequently, those measures necessarily require a **proper justification** and, if such rationale is provided and there is one, an **appropriate calibration**.

7.1 Proper justification

The rationale for building-up clearing capacities in the EU is clear-cut. Brexit, and with it the fact that most euro-denominated clearing activities moved to a third country not directly under the EU's regulatory and supervisory radar, exposed the EU to not to be underestimated risks. These risks are manifold and include, as elaborated in previous sections, risks related to financial stability and monetary policy transmission, a lack in the supervisors' abilities and capabilities to address such risks in times of market turmoil, market power and abuse problematics, and potential for misaligned and wrong directional incentives by market participants. Furthermore, from a more strategic, resilience orientated point of view, the stepwise relocation of euro-clearing may also contribute to a more sovereign and autonomous EU that is capable of setting its own (clearing) future and of being a decisive element of the capital markets union, which currently lacks much needed momentum in many respects. That said, it is, nonetheless, clear that challenges still need to be addressed when it comes to the process of shifting from the current market environment (excessively heavy reliance and concentration on Tier 2 UK CCPs) to new market surroundings (vibrant euro-clearing in the EU with clearing activity in the UK reduced to a non-systemically relevant level). Such challenges – i.e. potential market fragmentation, loss of netting benefits, issues with less liquidity, competitive distortions vis-à-vis non-EU market participants – must be tackled in a sensible way, and any transition risks mitigated as far as possible. Neglecting them is by no means a healthy solution. However, it should be clear, that there must be "intensified" efforts to shift euro-clearing activities to the EU. The question should be how ("calibration") and not whether.

7.2 Appropriate calibration

So, how could the transition be approached from a political and regulatory perspective. In general, the efforts should primarily follow a market driven path. The less intrusive, the higher the chances of acceptance by all market participants affected. Nonetheless, the European legislature and supervisors must support and underpin the necessary transformation by a credible, viable and long-term regulatory strategy in order to achieve sustainable, resilient and competitive EU clearing markets that can co-exist with global and especially UK clearing markets. Any such rebalancing strategy should rest on ten guardrails:

[158] ESRB (2023).

1) Inaction not a wise solution: While dependencies on Tier 2 UK CCPs have to some extent diminished in recent years, they are still at an unacceptably high level and the recurring calls and pressure from the Commission and EU supervisors for a voluntary shift towards EU CCPs has not yet borne fruit to a sufficient degree. Even the threat of an expiry of the equivalence decision does not seem to have been credible enough to incentivize market participants. It is thus doubtful that such a shift will occur at an increased pace in the foreseeable future without any further regulatory pressure. At the same time, inaction is not a wise solution because, unfortunately the risk to Europe's financial stability will not simply vanish into thin air.

2) Forced (full) relocation is not a valid option: The strictest option would be to "simply" oblige EU market participants to (fully) relocate their euro-clearing activities to the EU, by a specific point in time. However, such a solution, while established, for instance by Japan, is not a straightforward solution. First, such a measure would inevitably and rightly be perceived as pure protectionism and invite harmful retaliatory behavior. Second, it would be disproportionate. The objective should not be to disallow euro-clearing at third-country (Tier 2) CCPs in its entirety, but primarily to reduce the heavy reliance to a more sustainable level, ensuring the EU's resilience to any shock scenario that could affect such third-country CCPs and thereby also, directly or indirectly, the EU economy. And third, such a solution may needlessly distort and weaken competition and restrict the freedom of choice for EU market participants. Thus, this is also not a sound option.

3) Requirement for operational active accounts is sensible but may be not sufficient: The proposal to oblige EU market participants to establish "operational active accounts" at EU CCPs is a sensible step in the right direction as compared to the status quo, where some market actors do not have an account at all, and thus no fallback option for crisis situations. It is therefore a sensible first step to establish more resilient EU clearing markets. Nonetheless, it is not clear whether this will be a sufficient measure. If such operational accounts are not used in normal times as well, they may simply cause (maintenance) costs without providing enough benefits. Furthermore, the "operationality" of such accounts would need to be regularly checked to ensure that they are a realistic and functioning plan B in times of market turmoil. There can be no guarantee of this. The solution is, thus, to build up trust in its viability. It is, however, questionable, whether the EU should rely solely on trust in building its regulatory framework around euro-clearing activities. Certainly, it may be wise to complement such a measure with additional steps to ensure that clearing capacities are effectively built up at EU CCPs.

4) Quantitative thresholds are better than just qualitative ones: As stated before, setting up (operational) active accounts without any quantitative thresholds may be insufficient for increasing euro-clearing capacities in the EU in the long-run, as ultimate incentives for such strengthening may be lacking. An initial "qualitative" solution could only be deemed credible where, after a specific short period of time, there would be quasi-automatic triggers that would force EU market participants to increase their clearing activities in the EU, given that the qualitative approach has not led to a sophisticated outcome. But, as time goes by, political decision-makers may call into question the putting into place of such triggers which, in practice, undermine the workability of such a model. On the other hand, set quantitative thresholds can clearly – if appropriately calibrated – ensure effective capacity build-up, provide legal clarity and establish reliable planning for market actors.

5) A credible stepwise approach ("phase-in") is superior to a hasty one: With the equivalence decision on Tier 2 UK CCPs, the Commission and ESMA offered EU market participants a (last) chance to relocate part of their euro-clearing business to the EU. Until the equivalence deadline elapses in mid-2025, the legislature should avoid forcing EU market participants to achieve any definitive quantitative relocation

targets as this would go against the spirit of the decision. Nonetheless, it should make it clear that subsequently a stepwise reduction in their reliance on Tier 2 UK CCPs – i.e. via yearly increases of quantitative thresholds and based on constant monitoring of (un-)desirable market developments by EU supervisors – is a must and a regulatory obligation. Such an approach would provide both leeway and incentives to adjust in advance, while avoiding an abrupt and particularly costly sudden shift in clearing activities. When pursuing such a phase-in approach after mid-2025, the legislature could differentiate between new and legacy contracts, forcing faster relocation for the former, while leaving market participants more time for the latter.[159]

6) Decisions on Level 1 are preferable: In its proposal on revising EMIR, the Commission envisaged that EU market participants must, in future, clear a minimum proportion of derivatives contracts, which have been identified as systemically important, on active accounts with EU CCPs, leaving the specification of the minimum proportions to ESMA by referring to regulatory technical standards (RTSs) and leaving the adoption of those RTSs to the Commission. However, as the broad discussion on the AAR in recent months has shown, the decision on such quantitative thresholds does not seem to be a technical, but rather a political decision with far-reaching repercussions. Thus, if the legislature opts for establishing quantitative thresholds during the legislative negotiations, it should decide on such thresholds itself; i.e. on Level 1. As such thresholds should not be set in stone forever, and there may be a need for specific, well-justified exemptions, safeguards or adjustments, the legislature may consider granting ESMA and the Commission the power to (1) adjust the thresholds over time within a clearly defined corridor and (2) allow them to provide for explicit exemptions or safeguards, but based on clear criteria already defined on Level 1.

7) Accompanying measures necessary to support the transition: While the AAR should be perceived as the primary measure to address high concentration risks vis-à-vis third-country Tier 2 CCPs, it is by no means the only one, and there may be room and also the necessity for accompanying measures to support the transition. As envisaged by the Commission, the attractiveness of central clearing at EU CCPs should not solely rest on market intrusive measures to increase demand at such CCPs (like the AAR) but must be accompanied by supply-side measures, such as more streamlined authorization processes, or easier adjustment of risk models, if deemed "immaterial". Such measures may allow EU CCPs to offer (new) clearing services in a faster and easier manner, lower their costs, reduce their regulatory burden and increase their competitiveness. Ultimately, such measures may increase the willingness of EU market participants to clear their derivatives at EU CCPs of their own accord and enhance the likelihood that a sufficiently liquid and functioning EU clearing market can evolve, reducing the pressure for forced relocation which would undermine EU market participants' freedoms to conduct a business.

8) Consequences for non-compliance advisable: Any future quantitative AAR may be a decisive precondition for a more resilient European euro-clearing environment. To give it enough traction, the legislature may, nonetheless, think of complementary measures to ensure EU market participants' compliance. While such measures should, in any case, be taken with caution, based on evidence and on a thorough assessment of the reasons for potential non-compliance, they may take, for instance, the form of capital surcharges set by supervisory bodies as Pillar 2 measures to address excessive reliance on the services of a third-country Tier 2 CCP. Such capital surcharges would ensure that non-compliance has real consequences and would be a good means to reduce potential misaligned incentives. However, capital addons should only be stipulated, if there is a lack of any less intrusive

[159] In specific cases, the legislator may also refrain completely from forced relocation for certain legacy contracts.

alternative measure because they can, inter alia, lead to increased costs for EU market participants which do not have to be borne by non-EU market actors, thereby undermining the former's competitiveness.

9) Not going beyond containment of systemic importance of UK Tier 2 CCPs: In general, the open strategic autonomy paradigm that the EU is following requires the EU, on the one hand, to be more autonomous, while, on the other, remaining open. Reducing reliance on Tier 2 UK CCPs should not be perceived as advocating solely in favor of "autonomy", while ignoring "openness". To neglect the latter would be to undermine Europe's reputation as an actor that advocates for free, unrestricted and global (financial) markets. Openness should not fall below the radar. Thus, relocation efforts should not under any circumstances go beyond a level deemed necessary to address the various risks referred to in this publication, i.e. concerning financial stability. EU market participants should still be able to use third-country CCPs, be it from the UK or elsewhere, to a non-systemically relevant extent.

10) Call for EU supervision over CCPs: The build-up of clearing capacities in the EU must go hand in hand with a build-up in supervisory capacities and capabilities in the EU. While such enhanced supervisory capacities and capabilities should be built up both at the national and the European level, as the risks associated with CCPs' clearing activities do not normally materialize solely in one specific Member State, but often spill-over into several Member States or even the entire EU. As ESMA's role in CCP supervision is already at a high level with respect to third-country Tier 2 CCPs, it is also the natural candidate for taking over such a role for EU-CCPs. Granting ESMA such a central supervisory and also enforcement powers would ensure more consistent supervision, better monitoring of cross-border risks, a uniform application of EMIR provisions, and a reduction in regulatory arbitrage risks. At the same time, the centralization of supervisory powers at ESMA must be complemented by strong cooperation and coordination with other European and national supervisory bodies, like the ECB and the banking supervisory and resolution authorities.[160]

[160] See also: Van Roosebeke, B. (2018), Derivate-Clearing nach dem Brexit, Kurz- und mittelfristige Prioritäten der EU, cep**Adhoc**, 20. November 2018, available here.

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