FÉDÉRATION BANCAIRE FRANÇAISE

ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

EMIR 3.0

ENABLING A SMOOTH AND PROPORTIONATE RELOCATION OF EURO-DERIVATIVE TRANSACTIONS TO STRENGHTEN THE EU FINANCIAL STABILITY AND THE ATTRACTVENESS OF THE EU CLEARING OFFER WHILE ENSURING THE COMPETITIVENESS OF EU ACTORS

Since the Global Financial Crisis, the development of central clearing has made it even more important for each jurisdiction to have sufficient oversight and control over the market infrastructures that are systematically important to them.

The European Union has already made a number of significant steps in that direction, most notably with the relocation in the Eurozone of the clearing of all euro-denominated repos – the most direct tools of monetary policy transmission – since Q1 2019.

Still, **the fact that circa 95% of euro-denominated interest rate swaps remain cleared in the UK[1] constitutes a legitimate concern for EU authorities**. Indeed, this situation raises very concrete implications for the EU's financial stability and more broadly for the development by the EU of its Open Strategic Autonomy.

As a first step, the European Commission (EC) decided in February 2022 to extend the equivalence decision to UK central counterparties ("CCPs") until 30 June 2025[2]. Then, with the objective of a more permanent approach, the EC proposed the third review of the European Market Infrastructure Regulation (EMIR 3.0) in December 2022 to incentivize the relocation of EU actors' euro-derivative transactions to an EU CCP.

Several factors need to be taken into account when addressing this issue.

First, **the reduction of exposure for the sole EU market participants to non-EU CCPs is not, and should not be considered as, the most appropriate way to manage the systemic risk posed by central clearing**[3]. The reduction of this risk should not rely exclusively on the decreasing activity of EU actors outside the EU. For instance, two alternative fruitful paths to explore are (i) increased powers of EU authorities in the supervision of third country systemic CCPs and (ii) the obligation (knowing today it is only an option as provided for by the EMIR Refit regulation) for such CCPs to locate margins in EU-currencies within the EU.

Second, and even more importantly, **EU authorities should consider the fact that a too brutal relocation policy would not only fail** but would also backfire by disenfranchising EU entities at the trading level, ultimately reinforcing the prominent position of third-country dealers and CCPs for two reasons:

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[1] 1Q23 CCP Volumes and Share in IRD | (clarusft.com)

[2] https://finance.ec.europa.eu/publications/capital-markets-union-commission-extends-time-limited-equivalence-uk-central-counterparties-and_en

[3] It should be reminded that US authorities do not limit the market share of non-US CCPs in the clearing of US instruments, nor consider that a location policy would be relevant to manage the systemic dimension of clearing.

- **EMIR has no extraterritorial effect**, which implies that a prescriptive approach (through, for instance, quantitative thresholds on a minimum share of volumes to be cleared with EU CCPs), would be applicable only to EU actors subject to EMIR, which would automatically create an unlevelled playing field detrimental to their competitiveness, and even detrimental to other EU actors not subject to EMIR, i.e., their hedging costs would be higher than those of their third-country competitors.

- **About 75 % of the euro-denominated derivative transactions are executed exclusively by non-EU counterparties**, which implies that only a minority of transactions (the 25% which involve at least one EU entity) may be subject to new EU regulatory and operational constraints[4]. This would exacerbate the impact on any unlevelled playing field. Any minimum quantitative threshold is therefore likely to create market fragmentation and price disparities between the UK market and the narrower EU market at the expense of all EU market participants, i.e., clients and market-makers.

With this in mind, and while we promoted the endorsement of an "*operational active account*" solution, **in order to preserve the competitiveness of EU financial actors and, therefore, to maintain their ability to contract with non-EU counterparties while reducing reliance on non-EU CCPs, the French financial industry supports a gradual, operational, and market led approach, rather than a big-bang prescriptive one.**

The purpose of this paper is to describe our approach regarding (1.) the "*operational active account*" proposal as well as (2.) other issues we consider as important in the EMIR 3.0 negotiations.

1. The "*active account*" proposal, its content and its rationale

As afore mentioned, **we are supportive of an "*operational active account*"** ("**OAA**") **solution**. The OAA can be described as a requirement imposed on EU actors subject to the EMIR clearing obligation to open and maintain permanently an "*active account*" with an EU CCP. It ensures a partial relocation of their euro-derivative transactions within the EU while also ensuring a permanent and operational back-up solution permanently available and operationally ready as a fall back to systemically important third country Tier 2 CCPs in case of a major shock on the global financial markets, or where operational issue prevent EU market participants to access such CCPs.

We support in a first phase an OAA without prescriptive volumes of euro-derivative transactions to be cleared with EU CCPs, whereby the two following conditions would apply:

- **Daily margin calls on any opened positions**, and

- **A commitment by each EU market actor having traded euro-derivatives, during a specific time-period** (6 months, for instance) **at various maturity buckets** (for instance, less than 2 years, between 2 and 5 years, between 5 and 10 years, more than 10 years) **to clear at least one of these (new) transactions at each bucket within an EU CCP**.

Such approach would ensure both the functioning / efficiency of the OAA and an operational resilience for all EU market participants in cases of a default of (or loss of access to) a third country Tier 2 CCP (LCH, for instance) on top of ESMA having supervisory and enforcement powers over such Tier 2 CCPs.

[4] Assuming the absence of selection bias, this means that EU entities represent only 13.4% of overall participants in the euro-denominated derivatives markets.

Far from being a *status quo*, this initial, careful approach of the OAA as a first phase would (i) ensure a **gradual and safe relocation within the EU of clearing volumes in euro-derivatives**, (ii) preserve **the competitiveness of EU financial actors**, and (iii) enable **the attractiveness of the EU clearing offer**.

This approach would bring the following benefits:

i) Ensure a gradual and market-led relocation within the EU of euro-derivative transactions without jeopardizing the stability of the EU financial system.

This is illustrated by recent (2022 based) anonymised, consolidated, and averaged data from 3 French banks:

- ✓ Around 58% of EU clients of these 3 French banks trading euro-derivative transactions clear exclusively on LCH.
- ✓ Amongst the clients of these 3 French banks clearing exclusively on LCH, about 68% deal at least 80% of their transactions in euro-derivatives and about 57% deal exclusively in euro-derivatives.

These figures demonstrate that **the potential volume of relocation of euro-derivatives within the EU for EU market participants is significant.** Indeed, a high proportion of EU clients may decide to close their accounts opened in third country Tier 2 CCPs, considering their (quasi) exclusive activity on euro-derivatives and the superfluous costs associated with the opening of two clearing accounts.

ii) Preserve the competitiveness of EU financial actors and, therefore, maintain their ability to contract with non-EU counterparties, which implies to consider the absence of extraterritoriality of EMIR and the fact that about 87% of counterparties to euro-derivative transactions are non-European.

iii) Allow for the improvement of the EU clearing offer with a view to ensuring its attractiveness for an increasing number of counterparties, including non-EU ones.

The primary objective should be to develop EU CCPs rather than to limit the international clearing activities of EU financial actors. The reduction of EU market participant's exposure to third country CCPs should ultimately be the mechanical consequence of EU CCP's development. In that regard, we support EMIR 3.0 measures proposed to increase EU CCPs' attractiveness and welcome the new liquidity that EU pension funds (now subject to the clearing obligation) and public institutions (encouraged to clear voluntarily) will provide to EU CCPs.

This is a crucial issue in a context where extracted market figures show **a cost basis between EUREX and LCH, detrimental to EU financial actors** (for their hedging activities) **and their counterparties** (who may be refrained from clearing on EUREX):

- ✓ **For 10 year-maturity transactions** (calculation basis from 2019 to 2023), the average basis between EUREX and LCH is **0.85** basis point. This basis between these CCPs is material, volatile and unpredictable: it was relatively stable, positive, and small from 2019 until 2022 and it has increased in 2022 (more expensive to clear at EUREX) up to more than **4** basis points over time.

- ✓ **For 30 year-maturity transactions** (calculation basis from 2016 to 2023), the average basis between EUREX and LCH is **1.17** basis point. This basis between these CCPs is also material, volatile and unpredictable but doesn't necessarily follow the same evolution as the 10 year-maturity above. For instance, between 2017 and 2018 this 30-year basis went up to more than **4** basis points and then dropped negatively to almost **-1.5** basis point in 2019. Between 2020 and 2022 the 30-year basis remained in-line with the 10-year basis (stable, positive, and small). Then, in 2022 the 30-year basis, on the contrary of the 10-year basis that spiked as described above, dropped negatively again to around **-1** basis point.

Overall, there are large, volatile, and unpredictable basis per maturity, between cleared swap rates at LCH Ltd and EUREX, which is significantly increasing the cost and risk of hedging for EU market participants. These basis curves are distorted and unpredictable, it is therefore impossible to anticipate hedging costs on top of detrimental PNL impacts of this basis volatility on market participant positions subsequently increasing the cost of capital.

Besides, it is important to remind that the overall total volume of euro-denominated IRS is volatile over time depending on market conditions. These volumes are especially volatile and non-linear at LCH. For instance, when there are significant rate movements in the market, volumes are mechanically increasing at LCH under the activity of Hedge Funds who are predominantly non-EU based. The current EMIR 3 proposal will not have any impact on such activity knowing, non-EU actors will remain able to clear at LCH. It would therefore be more efficient to provide incentive to these actors to clear at EU CCP by improving their competitive offering rather creating regulatory constraints for EU market participants.

In light of these figures and given the systemic nature and impact of any quantitative threshold, a subsequent quantitative approach of the OAA should only be considered (i) at a later stage, (ii) through a new Level 1 legislative proposal, and (iii) only if the above approach fails to reach a meaningful relocation.

To be more specific, ESMA could assess during this first time-period (for instance, 36 months upon the entry into force of the new EMIR 3.0), the effectiveness of this approach and whether financial stability risks are sufficiently mitigated. At the end of this time-period, based on an impact assessment, ESMA would have the discretion to recommend the European Commission to launch **a new legislative proposal** on quantitative thresholds for the active accounts if it considers the initial approach has not been sufficient to meet this objective and the benefits of introducing quantitative thresholds outweigh the costs.

Still, given the structure of the market – notably the 87% of non-EU counterparties – even at low levels, we believe that a quantitative approach will have a profound impact on the market for euro-denominated derivatives and on the ability of EU financial actors to compete with their non-EU peers, putting at risk at the end the European objective of reinforcing its strategic autonomy.

2. <u>The other proposals initiated by the French industry</u>

2.1. Preservation of the equivalence provisions

EMIR provisions on equivalence offer European financial actors the benefit of the "*substituted compliance*", i.e., the possibility to defer to the other jurisdictions' legal framework, recognised as equivalent by the European Commission, when they face for instance duplicative or conflicting requirements relating to EMIR margin requirements. This is a necessary tool for European financial actors to avoid having to comply with two sets of duplicative and potentially (slightly) conflicting equivalent rules.

Therefore, **we call for the EMIR's equivalence provisions to be maintained (and therefore reintroduced in the proposal)** with relevant enhancements to allow **European financial actors to remain competitive at international level** without having to comply with duplicative or conflicting margin requirements under EU and equivalent third country rules.

2.2. Granting of a permanent margin exemption in favour of equity options

In various major non-EU jurisdictions (including in the United States), "*equity options*" either are exempted permanently from the exchange of initial and variation margins or are exempted from such requirement on a temporary basis which may be extended[5] or even transformed into a permanent exemption.

Conscious that the end of the current exemption extension under EMIR is approaching, the European Supervisory Authorities (ESAs) sent a letter to the co-legislators stressing that the ongoing EMIR review must clarify this issue. In this context, **the temporary exemption from margin requirements for "*equity options*", granted under EMIR until January 2024, should be rendered permanent** through the current EMIR review.

We believe such permanent margin exemption is key in order to (i) **avoid any market fragmentation** and align the EU treatment for such transactions with other comparable major jurisdictions, and (ii) **preserve the competitiveness of EU financial actors**, without any detrimental impacts on financial stability given the marginal volumes of such instruments compared to the overall volumes of OTC derivatives. Indeed, according to recent *Bank for International Settlements* data (https://stats.bis.org/statx/srs/table/d5.1), equity options represented around **0.55 %** of the notional value outstanding of all OTC derivative contracts in H1 2022).

2.3. Exemption of clearing obligation for third party pension scheme arrangements

The exemption from the clearing obligation that was granted to pension scheme arrangements under Article 89 of EMIR[6] initially until 16 June 2019, then extended by a European Commission Delegated Act[7] has come to an end on 18 June 2023.

While EU pension scheme arrangements (PSA) are now subject to the clearing obligation requirements, in its EMIR 3.0 proposal[8], **the EC proposes to extend this exemption specifically to third country PSAs as long as they are exempted under their own regulatory framework (i.e., applicable for UK PSA)** At this stage, and even though negotiations are still ongoing both the Parliament and the Council support this proposal.

As such, and to ensure a level playing field between UK and EU actors, we consider **it is essential from a competitiveness perspective that EU actors can benefit from a forbearance up until EMIR 3.0 enters into force**.

[5] In a consultation published on July 18th the PRA and the FCA are proposing to extend the UK temporary margin exemption for Equity Option until January 2026 to give more time to monitor international alignment, https://www.bankofengland.co.uk/prudential-regulation/publication/2023/july/margin-requirements-for-non-centrally-cleared-derivatives
[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32012R0648
[7] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022R1671
[8]https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022PC0697&from=EN

2.4. Alleviation of the information constraints imposed on EU clearing members

Considering the huge number of derivative transactions handled by an EU clearing member offering client clearing services, the obligation for such actors to inform their clients about the possibility to clear a derivative transaction with an EU CCP for each derivative transaction would be senseless from a legal viewpoint and would be unrealistic and even unmanageable from an operational viewpoint.

Besides, given the cost basis explained above, the CCP at which a euro-denominated interest rate derivative is to be cleared is agreed ex-ante at the time of trade. As such, no opportunity for the selection of a CCP exists post-trade.

Consequently, **such requirement should be imposed on EU clearing members when entering into relationship with their clients and afterwards only on an annual basis, unless specific circumstances arise**, either on the clearing member's side (i.e., if the latter modifies its clearing offer) or on the client's side (i.e., if the latter decides to enter into new classes of derivatives with the clearing member).

2.5. Clarification of margin transparency requirements on members

We strongly support transparency of CCP margin models for members and their clients, to enable firms to better understand how future margin requirements might evolve (including under stress) and to plan for those eventualities.

CCPs are the only market actors with full sight of the portfolio, and it is the CCP that is in control of the margin model. As such, CCPs are the only market actors in a position to provide this information, and to produce viable stress results.

The original drafting of the proposed Art 38 does not sufficiently clarify the respective roles of the CCP and the Clearing Member in relation to providing margin model (including stress simulation) transparency to the end clients. With this in mind, we support the amendment (Amendment 469) proposed by Dorien Rookmaker to Article 38 which provides much greater clarity and certainty in this regard. Without such specificity, it is possible that members will not be in possession of sufficient information to fully inform their clients.