

Whitepaper

Improving access to central clearing



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As a result of the Covid-19 crisis, financial markets were hit by an external shock of unprecedented size, marked by substantial price corrections, volatility spikes and liquidity contractions. These challenging months have acted as a live test of the resilience of stock exchanges and Financial Market Infrastructures (FMIs), as markets remained opened and fully functional under extreme conditions.

More specifically, Central Counterparties (CCPs) have played a key role in stabilizing financial markets by preserving trust among market participants, ensuring continued access to risk management and avoiding a systematic underestimation and under-collateralization of the level of counterparty credit risk, notably in over-the-counter (OTC) derivative markets.



CCPs: well tested mechanisms to safeguard financial stability

CCPs have always played a key role in managing risks stemming from financial markets. As rigorously regulated and supervised entities, they:

- 1.** Increase transparency – by simplifying the network of counterparties and acting as a neutral third party to evaluate counterparty credit risks, hence avoiding conflicts of interest;
- 2.** Reduce the overall systemic risk and operational costs – by providing an independent valuation of the risk taken on by clearing participants, ensuring the appropriate pre-funding of collateral against potential defaults and reducing overall exposures through multilateral netting;
- 3.** Internalize costs of financial crises – by organizing the mutualization of private losses across the involved participants, protecting the state and citizens from new public bail outs.

The move towards central clearing of OTC derivatives was a key pillar of the G20 Leaders' commitment to reduce the systemic risk associated with OTC derivatives markets. This shift of OTC derivatives on to central clearing was carried out in two ways:

- first, via the clearing mandates making central clearing compulsory for the most standardized trades;
- second, via incentives to centrally clear by imposing additional margin and capital requirements on the remaining uncleared OTC derivatives.

The G20 reforms carried out by the international Standard Setting Bodies (SSBs) are now well-embedded and implemented through the European Markets Infrastructure Regulation (EMIR). While EMIR focused predominantly on OTC derivatives, it regulates EU CCPs clearing various types of financial instruments, including exchange-traded derivatives, commodities, equity and repurchase agreements (repo). Enhancing participation of a broad range of counterparties to central clearing would be in line with the G20 objectives to reduce concentration risks and enhance the portability of client positions, while making a valuable contribution to strengthen the resilience of the overall financial system.

Supporting direct access to central clearing

While the Capital Requirements Regulation (CRR) has enshrined clear rules on the calculation of capital requirements and counterparty limits for the exposures of Clearing Members (most often credit institutions) towards CCPs, the sectoral nature of EU legislation has limited the uptake of similar rules for other types of market participants, thereby unintentionally hindering a broader access to central clearing and undermining incentives to centrally clear different types of financial instruments.

However, ensuring access to central clearing by a broad range of participants across financial instruments is key to ensure a balanced clearing ecosystem, to maximize the netting efficiency of the CCP and its capacity to best manage a potential default of a market participant. CCPs have developed facilitated access models to enable buy-side participants to link directly to the CCP and benefit from increased clearing capacity, a reduction in risk and better economics relative to traditional clearing models. In addition, broadening market access has the added benefit of diminishing concentration at Clearing Member level, thereby mitigating the potential disruption of the default of a large Clearing Member.

Treatment of funds and insurers (Solvency II, MMF, UCTIS)

One example where clarifications to EU legislation are required to ensure a broadening of the access to central clearing concern the treatment of funds and insurers. This would help facilitate the use by buy-side firms (pension funds, insurance undertaking or asset managers) of direct access models which were specifically designed to address their concerns with central clearing.

For example, there is a regulatory mismatch in the Solvency II Directive. The importance of the insurance industry to the Capital Markets Union as one of the largest institutional investors in the EU should be mirrored in the (re-) insurance undertakings' exposure to CCPs. However, unlike for credit and financial institutions as governed in the CRR, Solvency II does not explicitly foresee insurance undertakings to be (direct) clearing members of CCPs but only addresses their exposure to Clearing Members, resulting in a fallout of beneficial treatments when calculating counterparty default risk. When insurances or pension funds access a CCP directly through facilitated clearing models, Solvency II should clarify and apply explicitly the preferential risk weights accorded to credit institutions as Clearing Members also to insurance undertakings and pension funds in alignment with the CRR II look-through criteria.

Similarly, Money Market Funds (MMF), which are established mostly as UCITS under UCITS V and MMFs under the EU MMF Regulation, in contrast to the CRR, do not recognize the specific nature of centrally cleared transactions. Specifically, the current regulations divert from the CRR and, thereby, disincentivize central clearing with respect to an imposition of calculation of counterparty limits, exposure amounts and collateral diversification requirements for centrally cleared transactions, in effect, disincentivizing central

clearing. For example, currently the MMF Regulation states a counterparty limit of maximum 15% for EU MMFs while a 20% limit exists for UCITS in UCITS V, with no specific provision for CCPs. In contrast, the AIFMD does not include any provision limiting counterparty exposure at all. These provisions do not recognize that a CCP as a central counterparty becomes the buyer and seller to all centrally cleared trades (and would thereby hit the limit much faster than others), nor that the exposure via the CCP is substantially less risky than to other financial counterparties.

Consequently, these limits greatly hinder the uptake of risk reducing and efficient direct repo and OTC clearing in the EU by buy-side entities. As there is only a single combined limit for both asset classes, buy-side entities could also quickly face the choice to either adhere to regulatory counterparty limits or to meet the mandatory clearing obligation for OTC IRS although direct access clearing models are regulatory accepted.

Equally, very detailed collateral diversification requirements down to the number of ISINs received as collateral are applicable for UCITS and EU MMFs. However, for example CRR Large Exposure Rules only require credit institutions to monitor collateral issuer concentration for transactions for which the counterparty's risk weight is worse than that of the collateral received.

Properly recognizing the ESMA Qualifying CCP risk weight of only 2% in UCITS V, the EU MMF Regulation and AIFMD would reduce the operational burden for fund managers.

To further increase the attractiveness of central clearing by the buy-side and foster the EU's centrally cleared repo and OTC markets, policy-makers should explore additional regulatory incentives to accompany this measure:

Regulatory requirements should allow that UCITS/AIFs that have received collateral via a title transfer in an SFT should be permitted to pledge back this collateral to the provider of the collateral as long as the collateral is held bankruptcy remote from the initial collateral provider. In addition, UCITS should be allowed to net exposures arising from centrally cleared derivatives and SFTs for the calculation of counterparty risk limit. To this end, UCITS should be permitted to raise cash through repo markets in order to meet cash margin requirements from centrally cleared derivatives.

In following these recommendations, the buy-side would not only benefit from the high risk management standards from CCPs, but in general systemic risk could be further decreased in a continued approach to stabilize and safeguard financial markets.

Area	EU legislation	Recommendation
SFTs	CRR, NSFR (Article 427 Regulation (EU) 573/2013)	<ul style="list-style-type: none"> revise stability assessments in NSFR to recognize stable funding benefits of cleared repo markets
Insurers	Solvency II (Article 105.5 Regulation (EU) 2009/138)	<ul style="list-style-type: none"> explicitly adopt beneficial risk weight for CCP cleared transactions cleared directly with CCP similar to CRR
Funds	UCITS (Article 52 Directive 2009/65/EC) MMF (Article 17 Regulation (EU) 2017/1131)	<ul style="list-style-type: none"> exclude CCP cleared transactions from counterparty, exposure and diversification requirements similar to CRR reflecting the risk reducing nature and systemic importance of CCPs allow that all UCITS/AIFs that have received collateral via title transfer in an SFT are permitted to pledge back this collateral to the provider allow UCITS to net exposures when using repo markets to raise cash to meet cash VM requirements

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