ESRB
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Active account requirement under EMIR 3.0

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Honourable Secretary-General, dear Ms Blanchet,

The General Board of the European Systemic Risk Board (ESRB) is pleased to provide background information on the proposal to introduce an active account requirement (AAR) in the context of the EMIR 3.0 review proposal[1] dated 7 December 2022.

In its response to the European Commission targeted consultation on the review of the central clearing framework in the EU[2], the ESRB considered several measures that would – in combination – help reduce the risks to financial stability arising from reliance on certain clearing services provided by UK central counterparties (CCPs). These measures were (i) introducing higher capital requirements for exposures to Tier 2 CCPs, (ii) introducing active accounts requirements, (iii) setting exposure reduction targets and (iv) broadening the product scope to create more liquid markets. In this context, the ESRB noted that the

1 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.

2 ESRB response to the European Commission targeted consultation on the review of the central clearing framework in the EU, 22 March 2022.

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introduction of an AAR would also be an important prerequisite for building domestic clearing capacity in the EU.

This letter follows up on the ESRB's previous responses and reflects its mandate to contribute to the prevention or mitigation of systemic risks. It draws on analysis discussed at the Advisory Technical Committee and at the General Board, which could serve as input for future discussions on the calibration of a quantitative active account. Naturally, as the scope of an AAR has not been defined by law, the results of the analysis are dependent on the assumptions made.

The analysis shows that two important variables will affect the results given by a quantitative AAR and, as a potential consequence, the effectiveness of the AAR in building clearing capacity in the EU. These variables are (i) the types of trades that fall within the scope of the AAR and (ii) the threshold applied.

Independently of the analysis, the ESRB would also like to make a more fundamental point. If the AAR were to be based on outstanding clearing volumes measured, for example, in terms of the *number of trades* or *notional amounts*, then a quantitative AAR could help reduce such quantities at UK CCPs. However, its introduction would not necessarily result in a reduction of EU clearing members' and clients' *exposures* to the clearing services provided by UK CCPs that the ESRB has deemed to be of substantial systemic importance. Nevertheless, the ESRB still believes that an AAR may help build clearing capacity in the EU and so may reduce risks to financial stability arising from the use of UK CCPs' clearing services.

If the AAR were to be based on *exposures* to third-country CCPs, measured, for example, in terms of initial margins or sensitivity to changes in interest rates, then the AAR would target a broader set of risks to financial stability. However, the ESRB recognises that to monitor compliance with an *exposure-based* AAR, it would be necessary to estimate the marginal contribution of each transaction to the overall exposures to third-country CCPs. Supervisors could do this by regularly stress-testing the positions of clearing members and their clients.

In either case, as the ESRB has previously stated, EU supervision would need to be strengthened commensurately with an increase in clearing activity at EU CCPs.[3]

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[3] ESRB response to ESMA's consultation on determining the degree of systemic importance of LCH Ltd and ICE Clear Europe or some of their clearing services, 3 December 2021.

Background

ESRB opinion provided to ESMA

On 3 December 2021 the ESRB provided the European Securities and Markets Authority (ESMA) with its opinion on the systemic importance of two third-country CCPs, namely LCH Ltd and ICE Clear Europe.[4]

In the opinion that it provided to ESMA, the ESRB took the view that the main risks to financial stability associated with continued recognition of some of these two CCPs' clearing services related to a situation where a UK CCP offering the service(s) would take procyclical measures during a period of market strain, or enter into a recovery phase or, ultimately, into resolution. The ESRB also took the view that there were risks to financial stability associated with the non-recognition of these services. It specified that these risks related to cliff edge effects and to operational and legal risk during and after a transition from the status quo.

Based on an assessment of the balance of these risks, the ESRB deemed certain clearing services to be of substantial systemic importance for the financial stability of the EU or one or more of its Member States. These were specifically the SwapClear services provided by LCH Ltd for products denominated in euro and Polish zloty and the short-term interest rate (STIR) and credit default swap (CDS) services in euro operated by ICE Clear Europe.

The ESRB also agreed with ESMA that – from a financial stability perspective – the costs of a decision not to recognise these three clearing services would, at that point in time, outweigh the benefits.

In addition, the ESRB proposed that any extension of the recognition should be temporary and be supported by measures to (i) increase the offer of clearing solutions from EU CCPs clearing those instruments and (ii) reduce risks to financial stability linked to the substantially systemic services operated by ICE Clear Europe and LCH Ltd.

As part of this, the ESRB saw a need to identify a set of credible measures that would enable EU authorities to achieve a gradual reduction in *exposures* of EU clearing members to Tier 2 CCPs and strengthen the EU CCP supervisory framework commensurately with an increase in clearing activity at EU CCPs.

[4] ibid.

ESRB response to the European Commission targeted consultation

The substantial systemic importance of some of the clearing services provided by these two third-country CCPs triggered concerns at the European Commission and at the ESRB that EU market participants were reliant on these CCPs and that this dependency could give rise to financial stability risks. To address these concerns, on 8 February 2022 the European Commission launched a targeted consultation on the review of the central clearing framework in the EU[5] to which the ESRB responded on 22 March 2022.[6]

The views that the ESRB expressed in its response were firmly grounded in its financial stability mandate. The ESRB welcomed the fact that the European Commission's plans reflected the proposals the ESRB set out in its response to ESMA of 3 December 2021. In particular, the ESRB noted that in the course of 2022, the European Commission planned to put forward proposals for building domestic capacity *"through measures to make the EU more attractive as a competitive and cost-efficient clearing hub*" and thus "*incentivise an expansion of central clearing activities in the EU"*. The ESRB also noted the need to strengthen supervision in the EU as set out by the European Commission in its consultation document, which states: *"[I]f the EU is to increase its capacity for central clearing, the risks resulting from an increased activity need to be appropriately managed. As such there is a need to strengthen the EU's supervisory framework for CCPs, including through a stronger role for EU-level supervision."*

The European Commission's plans to build domestic capacity included the introduction of an AAR. In its response the ESRB said that it considered this to be an important prerequisite for meeting one of the overarching objectives of the Commission's consultation, namely to build domestic capacity and thus provide an incentive for expanding central clearing activities in the EU.

EMIR 3.0 proposal and active account requirement

On 7 December 2022 the European Commission published a proposal for a review of EMIR[7] (the "EMIR 3.0" proposal) setting out measures to mitigate excessive exposures to third-country central counterparties and improve the efficiency of EU clearing markets.

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5 Targeted consultation on the review of the central clearing framework in the EU, 8 February 2022 - 22 March 2022.

6 ESRB response to the European Commission targeted consultation on the review of the central clearing framework in the EU, 22 March 2022.

7 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.

The EMIR 3.0 proposal includes introducing an AAR. This would require EU market participants to hold active accounts at EU CCPs for derivative contracts related to those clearing services that have been identified by ESMA as being of substantial systemic importance for the financial stability of the EU or one or more of its Member States. These clearing services are namely those for interest rate derivatives in euro and Polish zloty, STIR derivatives in euro and CDS in euro. The European Commission's proposal includes the requirement of a minimum proportion of transactions to be cleared through these accounts with EU CCPs. However, in its proposal the European Commission does not define this proportion, instead leaving the definition to be set out in a level 2 act.

The European Commission's proposal for the AAR is being discussed in the European Parliament and in the Council. Part of the proposal is to apply the AAR to new trades only and to exempt market-making and client clearing activities.

Preliminary findings

As part of its financial stability mandate, the ESRB has continuously monitored the clearing ecosystem over the last several years. This monitoring activity is based on granular, transaction-level data on derivatives stemming from the EMIR regulation. The ESRB has analysed recent developments in the clearing ecosystem, with a focus on the financial stability risks associated with third-country clearing. In addition, the ESRB has analysed the potential determinants of a quantitative AAR and its financial stability implications.

The findings of the analysis are as follows.

1) With the clearing of credit default swaps being moved from ICE Clear Europe to US and EU CCPs, the remaining instruments that the ESRB has previously identified as being of substantial systemic importance are interest rate instruments denominated in euro and Polish zloty cleared at LCH Ltd and STIR derivatives in euro cleared at ICE Clear Europe. Eurex clears the majority of euro-denominated interest rate instruments in the EU.[8]
2) The analysis focuses on euro-denominated interest rate instruments, and does not include derivatives denominated in Polish zloty. It assumes that a possible quantitative AAR would be implemented as a ratio between the notional volumes outstanding cleared at Eurex (the numerator)

[8] The EU CCPs authorised to clear the above-mentioned interest rate instruments are BME Clearing, Eurex Clearing, KDPW, and Nasdaq Clearing. KDPW is the only EU CCP that clears interest rate instruments denominated in Polish zloty.

and the combined notional volumes outstanding at Eurex and LCH Ltd (the denominator). In order to understand the dynamics and evolution of a quantitative AAR designed according to these assumptions, one has to analyse the development of the numerator and that of the denominator.

3) The analysis shows that the clearing dynamics are composed of three main factors:
    1. an additive contribution represented by the notional amount of new trades within a given time period;
    2. a first subtractive contribution represented by the notional amount of trades that mature within the same period;
    3. a second subtractive contribution represented by the notional amount of trades that are compressed within the same period.
4) Comparison of these factors for the two CCPs - calibrated using publicly available information - shows the following:
    1. The notional amount of new trades at LCH Ltd is at least one order of magnitude larger than those at Eurex.
    2. The maturity profile does not have a significant impact on the dynamics observed for the two CCPs.
    3. The amount of notional compressed at LCH Ltd is high (at around one quadrillion of notional amounts per year across all of LCH Ltd clearing services on all instruments). This means that despite the large inflows of notional volumes from new trades, notional amounts outstanding at LCH Ltd are not growing strongly.
5) This dynamic shows that the amount of notional outstanding follows a process whereby positions are frequently rebalanced (e.g. for market-making purposes), reflecting the fact that notional amounts are not a good measure of exposures and risks.
6) Computing an active account ratio as at today's date shows that large banks and clients would have a low active account ratio, as they clear a large majority of notional amounts oustanding at LCH Ltd. In addition, notional outstanding is concentrated in just a few clearing members and clients. Therefore, a significant shift at the aggregate level cannot be achieved without large banks and clients clearing a substantial fraction of their notional outstanding at Eurex.
7) The details of its implementation will have a substantial impact on the effectiveness of the AAR. The analysis shows that the types of trades in scope will significantly affect the result. For instance, market-making volumes correspond to about 70-80% of the total notional outstanding at LCH Ltd. Therefore, a carve-out of market-making volumes would substantially reduce the scope of application of a potential quantitative AAR. The frequency of calculation of the ratio is also important. For example, calculating the AAR at a given point in time, such as the end of a quarter, could result in similar window-dressing dynamics to those observed for the leverage ratio.
8) A quantitative active account based on notional amounts rather than risk-based measures (such as exposures or sensitivities) could help build capacity at Eurex. However, on its own, it would not

reflect financial stability risks. In addition, as compression affects the ratio between the notional volumes outstanding cleared at Eurex and the combined notional volumes outstanding at Eurex and LCH Ltd, both CCPs could influence this ratio by changing their compression efficiency.

Conclusion

The ESRB supports the introduction of an AAR as a tool to help build domestic capacity in the EU. The ESRB also believes that if a quantitative active account were established, its effectiveness in helping to build clearing capacity in the EU would depend on the types of trades that fall within the scope of the AAR and the threshold applied.

The analysis performed by the ESRB for euro-denominated interest rate derivatives indicates that if the proposed AAR were limited to new trades and exempted market-making and client clearing, then – even if it were combined with a high threshold – it might have little impact on its own in bringing clearing volumes for these instruments to EU CCPs and building clearing capacity in the EU. In addition, the introduction of the AAR would need to be accompanied by market developments such as an expansion in the range of services offered by EU CCP.

More fundamentally, if the AAR focuses on the *number* or *notional amounts* of trades, rather than the *exposures* associated with the trades, its introduction may not result in a reduction in EU clearing members' and clients' exposures to the clearing services provided by UK CCPs that the ESRB has deemed to be of substantial systemic importance.

Therefore, although the ESRB believes that an AAR can help build clearing capacity, it considers that an AAR on its own would probably be insufficient to address the risks to financial stability that the ESRB has previously identified. In addition, the ESRB has previously stated that EU supervision would need to be strengthened commensurately with an increase in clearing activity at EU.

Finally, please be informed that this letter is being sent in parallel to the European Parliament and the European Commission and will be published on the ESRB's website.

Yours sincerely,