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If you do it, do it right – The need for a Common European Supervisory Architecture for CCPs

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If you do it, do it right – The need for a Common European Supervisory Architecture for CCPs[*]

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In the context of Brexit, changes to the regulatory architecture of CCPs that empower the European securities markets regulator are under way to prevent the threat of a regulatory race to the bottom. However, this empowerment currently leaves the national supervision of common European rules within the EU intact. This policy letter argues that supervisory arbitrage is as much a threat within the EU as outside of it, wherefore a common supervision of CCP rules in the EU is called for. The paper traces the origins of the current set-up and criticizes the current regulatory proposal by the EU Commission as too cumbersome while discussing possible ways forward to achieve European supervision. In contrast to the current proposal of the Commission, we call for a unified supervision within ESMA, combined with a European fiscal backstop.

I. Introduction

The Capital Markets Union (CMU) is the current flagship project of the European Commission. Initiated in 2014, crucial elements of the CMU have passed through the legislative process in record time – supported by the conviction that market-based financing can help lift the growth prospects for the EU. Overall, it is argued that a unified European capital market that facilitates more "market-based financing" will enhance the flow of credit and help overcome the dependency on local bank credit. This follows a particular reading of the crisis that focuses on why the U.S. has recovered so much more

[*] SAFE policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff. An earlier version of this paper appeared in DIW Berlin, Vierteljahreshefte zur Wirtschaftsforschung, Vol. 86, pp. 61-75.

swiftly than the European Union, which now in turn seeks to achieve "resilient market-based financing".[1]

However, in absorbing these lessons, the EU risks neglecting other important insights from the crisis that relate to reasons why the EU sunk so deep into the crisis in the first place – the leniency of national regulators with respect to their national champions. Concerned over the fate of their national banking champions in the context of European financial market integration, national supervision based on European rules was weak and led to lax supervision and the fact that regulatory loopholes in the shadow banking system were not closed.[2] The danger of regulatory competition residing within a system of national supervision of European rules has been taken up rhetorically in the project of Capital Markets Union,[3] but we still need to see meaningful institutional change with respect to securities market supervision of cross-border business in Europe. This holds true in particular with respect to Central Clearing Counterparties (CCPs), which have gained a major importance in financial markets due to post-crisis reforms.[4]

Just like shadow banks pre-crisis, CCPs operate on a high volume and low margin business, which makes regulatory costs a major competitive factor. Hence, the competitive environment in which CCPs operate makes them prone to regulatory competition, where collusion between regulators and the regulated to gain market share might lead to ill-incentivized supervision. These concerns are amplified by a recent report by ESMA, which finds that the established system of supervisory colleges under EMIR, which puts national supervisors in charge and subjects them to peer review to ensure uniform application of common rules, does not work.[5] Furthermore, the chair of ESMA Steven Maijoor just recently warned that an under-margining of CCPs is not a threat, but a reality.[6] For this reason, EU officials are seeking to enhance European supervision of CCPs, especially in view of Brexit.

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[1] Financial Stability Board (2014). Strengthening Oversight and Regulation of Shadow Banking Regulatory framework for haircuts on non-centrally cleared securities financing transactions.

[2] e.g. Thiemann, Matthias (2016). Capital Markets Union and the threat of regulatory competition. Available at: www.feps-europe.eu/assets/658cbc56-4c68-47ac-85c6-85980582c9fc/ed-thiemann-feps-cmupdf.pdf

[3] European Commission (2017). Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment. Available at: http://ec.europa.eu/finance/docs/law/170920-communication-esas_en.pdf

[4] In a nutshell, a CCP is a financial risk management institution that pools, nets and diversifies counter-party risk by setting themselves between the buyer and the seller, guaranteeing the termination of a market transaction. In this way, CCPs can contribute to the stability of the financial system as they lower the interconnectedness of clearing members and limit contagion default risks.

[5] European Markets and Securities Authority (ESMA) (2016). Peer Review under EMIR Art. 21. Supervisory activities on CCPs' Margin and Collateral requirements. Available at: https://www.esma.europa.eu/sites/default/files/library/2016-1683_ccp_peer_review_report.pdf

[6] Panel Discussion at the ILF Conference, Frankfurt at 24 April 2018.

The UK, the center of the systemically important euro-clearing in Europe, leaving the EU and becoming a third country raising concerns over a regulatory race to the bottom.[7] Currently, London is the international financial center for the euro-denominated clearing of trades, accounting for 75 percent of interest-rate derivatives.[8] However, the announcement of Brexit in summer 2016 has raised the question of whether this systemically important market infrastructure has to move to the euro area. A failure of a large CCP in the UK would expose the EU to huge financial risks, while the EU would have no tools to intervene directly. Thus policymakers in the European Commission as well as ESMA and other actors have called for "enhanced supervision at the EU level and/or location requirements"[9], to ensure that CCPs "are subject to the safeguards provided by the EU legal framework"[10], especially in view of the CMU.

In this policy letter, we argue that this approach should be applied not only to the EU-UK relationship, but also in the pan-European dimension, given that the threats of regulatory competition within the EU are as virulent as those from outside of it. Hence, fixing the threat of regulatory competition through a strong EU supervision of third-country compliance with capital market rules, e. g. in the UK, should only be the first step towards creating a regulatory architecture that focuses on a strong common European supervision of common European rules. Based on this threat and on the insight that common laws without common supervision are not able to prevent a regulatory race to the bottom, the solution for the banking sector was to create the (yet-to-be-completed) Banking Union. This policy letter supports the calls for a strong, centralized euro area market supervision for CCPs and explores the two different pathways currently available to arrive at such a development, one of which should be chosen by the European Council in June 2018.

II. EMIR and the shortcomings of the current supervisory frame

CCPs have been promoted in the aftermath of the financial crisis by global as well as European bodies, as they proved to be a resilient component of the financial system during the turmoil. In particular, they were embraced by the G20 and the EU to deal with the problems of OTC derivatives, by forcing mandatory clearing on all standardized derivatives. Thereby, CCPs have become a central cornerstone

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[7] E.g. expressed in a recent draft report of the European Parliament: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-619.413%2b02%2bDOC%2bPDF%2bV0%2f%2fEN

[8] Bloomberg (2017). EU Seeks Power Over London Derivative Clearing After Brexit. Available at: www.bloomberg.com/news/articles/2017-05-04/eu-seeks-power-over-london-s-lucrative-euro-derivative-clearing

[9] European Commission (2017). Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union, p. 4. Available at: https://ec.europa.eu/info/sites/info/files/170504-emir-communication_en.pdf

[10] Ibid.

of the post-crisis European financial architecture. Since then, the strongly increasing competition among CCPs has led to a consolidation in the sector, but also raised concerns over regulatory arbitrage.[11] These developments have resulted in the fact that CCPs today have become themselves "too-big-too-fail", as an insolvency of a large clearing house may cause a new financial crisis.

Since 2012, the European Market Infrastructure Regulation (EMIR)[12] is the centerpiece of CCP regulation in Europe. It represents the outcome of arduous years of negotiation and aims to ensure the financial stability of CCPs by defining specific key measures and minimum requirements for a sound internal risk management. To cover potential losses if one or a set of its clearing members defaults, CCPs have three "lines of defense" that follow the waterfall principle, namely:

1. The CCP is obliged to take an appropriate margin on cleared assets to cover the counterparty default risk as well as the price fluctuation risk of the assets.
2. All clearing members have to contribute to certain default funds which cover any losses that might occur if the margins turn out to be insufficient.
3. If the default fund is also insufficient, the CCP is liable with 25 percent of the amount of the respective default fund – this is known as the "skin in the game".

While EMIR defines a prudent common regulatory framework for CCPs, the supervision of those rules primarily remains with national competent authorities (NCAs), such as national central banks or financial services authorities, which bears the risk of regulatory and in particular supervisory arbitrage, as the financial crisis has shown. As a consequence of the lessons learned after the financial crisis, the European Commission initially considered a common European supervision of CCPs in its supervisory framework.[13] At the same time, the European Securities and Markets Authority (ESMA) should control a consistent application of EMIR.[14] At first glance, this organization of CCP supervision seems to ensure the compliance of all jurisdictions. However, ESMA lacks capabilities to intervene when a CCP engages in regulatory arbitrage behavior as it is "as a club of national regulators, a congregation of them, a secretariat"[15], but not an independent supervisory agency. Thus, issues of regulatory and supervisory

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[11] Krahnen, J.-P. and L. Pelizzon (2016). "Predatory" margins and the regulation and supervision of central counterparty clearing houses (CCPs). White Paper Series, No. 41. Available at: https://www.econstor.eu/bitstream/10419/146373/1/867777885.pdf

[12] Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 27.7.2012. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=DE

[13] European Commission (2009). European financial supervision. Available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf

[14] cf. Recital 10 EMIR.

[15] Interview with a European CCP supervisor, October 2016.

arbitrage are also pressing for CCPs. Hence, in the "Peer-Review" from 2016, ESMA identified diverging supervisory approaches across the EU regarding margin and collateral requirements as a problem to be addressed.[16]

The strong fragmentation of supervision in the EU was caused by a refusal of the member states to share the fiscal burden of resolving a failed CCP – the same refusal which initially also had prevented the formation of a common EU banking supervision in 2009[17] and which continues to plague the yet-to-be-completed Banking Union. The necessity to align the modus of supervision with the fiscal responsibilities connected to it essentially rendered common EU supervision for CCPs impossible.[18] The need for strong common supervision was brought up again in the context of the review of EMIR in 2015, but no consensus could be reached on how to resolve it. Instead, member states such as the UK insisted that there is no European central backstop for CCPs, and thus "[t]he UK could not […] support the transfer of direct supervision of market infrastructures such as Central Counterparties (CCPs) and Central Securities Depositaries (CSDs) to a European level"[19]. The Bank of England argued that the supervisory infrastructure should remain national[20] with the installed European Supervisory Agencies (ESA) as main agents to achieve convergence. In the meantime, ESMA emphasizes that "the systemic importance of CCPs is increasing while commercial incentives for CCPs to compete on the basis of risk remain"[21]. However, back in 2016, this conclusion only led to attempts to improve the data quality regarding supervisory decisions.[22]

With the UK leaving the EU, the context of regulatory concerns has shifted completely, now putting the risk of supervisory laxity center stage. Here, the current debate over a revision of EMIR ("EMIR 2.2") as well as over the recovery and resolution framework for CCPs become crucial as both regulations are linked to the idea of a common European supervision.

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[16] European Markets and Securities Authority (ESMA) (2016b). Peer Review under EMIR Art. 21. Supervisory activities on CCPs' Margin and Collateral requirements, pp. 41-42.

[17] Moloney, N. (2014). EU securities and financial markets regulation. Oxford: Oxford University Press; De Larosière Report (2009). Report of the High-Level Group on Financial Supervision in the EU. Available at: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

[18] cf. Recital 52 EMIR.

[19] Bank of England (2015). Comment Letter by the BoE from 2015, published in the Department for Exiting the European Union 2017. Available at: http://europeanmemorandum.cabinetoffice.gov.uk/files/2015/03/6408-15_UK_Response_to_Q25_-_ESAs.pdf

[20] ibid.

[21] European Markets and Securities Authority (ESMA) (2016). Supervisory Convergence. Work Programme 2016, p. 9. Available at: https://www.esma.europa.eu/sites/default/files/library/2016-203_2016_supervisory_convergence_work_programme.pdf

[22] ibid.

III. The Capital Markets Union: Market integration and supervisory convergence

Right from the beginning of the CMU as a project, it was clear that the removal of barriers may also create new sources of financial instability.[23] The European Commission entertained a new discourse on markets, which besides integration put the integrity and financial stability of the single market center stage.[24] The awareness regarding the danger of regulatory and supervisory arbitrage, in particular with respect to cross-border activities, led to focus on supervisory convergence.[25] Given this sensitivity, the CMU project contained a program to encourage further convergence of supervision in Europe. In line with this short-term activity, the Five Presidents' Report formulated a longer term vision whereby the CMU should not only improve cross-border capital flows within the EU but also "lead ultimately to a single European capital markets Supervisor"[26].

Concretely, the European Commission proposed to strive towards further supervisory convergence,[27]which led to the creation of a supervisory convergence standing committee at ESMA in 2016.[28] The work of this committee revealed substantial shortcomings regarding the harmonization of supervision in the EU.[29] This and the decision by the UK to leave the European Union set off a dynamic towards empowering ESMA's supervisory competencies with respect to CCPs in 2017, a dynamic which started after the Commission published its initial proposals on EMIR 2.0. Due to the temporal proximity of the latter to Brexit, no reaction yet to the new event was included, a fact that was about to change.

IV. Brexit and the current window of opportunity for a common European Supervision

As a reaction to the initial EMIR proposal of the European Commission, the comment letters, in particular by ESMA but also by the French regulator Autorité des marchés financiers (AMF), pointed to the need for a reaction to Brexit, which would empower ESMA to deal with the threat of a regulatory

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[23] European Commission (2015). Green paper. Building a Capital Markets Union. Available at: http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

[24] Arguably, this aspect of CMU gained in strength with the replacement of Commissioner Jonathan Hill by Commissioner Valdis Dombrovski in 2016. But already in 2014, the Commissions' report on the operations of the ESAs mentions the possibility of a "direct supervision of highly integrated market infrastructure, such as CCPs" (European Commission (2014)). Report on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), p. 13. Available at: http://ec.europa.eu/internal_market/finances/docs/committees/140808-esfs-review_en.pdf

[25] European Commission (2017). Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union; European Commission (2015). Action Plan on Building a Capital Markets Union. Available at: https://www.corporategovernancecommittee.be/sites/default/files/generated/files/legal/2015_468_en.pdf

[26] Five Presidents Report (2015). Completing Europe's Economic and Monetary Union, p 12. Available at: https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf

[27] European Commission (2015). Action Plan on Building a Capital Markets Union, p. 27.

[28] European Markets and Securities Authority (ESMA) (2016). Supervisory Convergence. Work Programme. 2016.

[29] European Markets and Securities Authority (ESMA) (2016). Peer Review under EMIR Art. 21. Supervisory activities on CCPs' Margin and Collateral requirements.

race to the bottom. In May 2017, the European Commission issued a communication for the upcoming legislative proposal, in which it states that "[c]ritical capital market functions whose sound performance and effective supervision is central to the functioning of capital markets call for more centralisation of supervision"[30]. In its impact assessment for the revision of the EMIR supervisory framework in June 2017, the Commission discusses two options. Option 1 considers the possibility of a single European supervisory authority which could be either ESMA, the ECB or a newly established body. This option would ensure a coherent application of the common rule book, however, the European Commission states that it would also have two significant shortcomings: a) the misalignment of supervisory and fiscal responsibilities and b) inadequate reflection of NCAs' and national central banks' policy mandates and major budgetary consequences.[31] In the European Commission's current proposal, national supervisors would hence remain responsible for the supervision of CCPs while an additional mechanism within ESMA – the "executive session" – should ensure supervisory convergence and balance the responsibilities among the involved institutions. This new mechanisms should be equipped with special tasks in the intersection of ESMA, national supervisors and central banks and shall embody a specific number of permanent members, supplemented by further non-permanent members from institutions of interest. The system of supervisory colleges would persist but could be chaired by the head of the executive session. In response to comments by national public authorities, this set-up shall promote further convergence while supervisory and fiscal responsibilities would remain aligned.[32]

However, the establishment of an independent supervisory body within a supervisor would likely create additional confusions or turf wars. Even the chair of ESMA does not embrace such a dual approach.[33] Despite the fact that the recent amendments to this proposal by the European Parliament improved and simplified this new supervisory mechanism within ESMA, the establishment of a real single European supervisor is still not achieved. While it is argued that "several authorities would remain associated with supervision, the EU mechanism would *de facto* ensure single supervision of CCPs established in the EU by promoting a coherent application of EMIR throughout the Internal Market"[34]. But this only holds true for CCPs *outside* the EU. While ESMA should be entrusted with the direct supervision of recognized third-country CCPs, the supervision of CCPs *within* the EU would still

[30] European Commission (2017). Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union, p. 3.
[31] European Commission (2017). Impact Assessment. SWD(2017) 246 final, p. 59. Available at: https://ec.europa.eu/transparency/regdoc/rep/10102/2017/EN/SWD-2017-246-F1-EN-MAIN-PART-1.PDF
[32] European Commission (2017b). Impact Assessment, pp. 58-59.
[33] Maijoor, S. (2018). Resilience, Recovery and Resolution: three essential Rs for CCPs, ILF Conference "Resolution in Europe: The Unresolved Questions" – Monday 23 April 2018 – Goethe University, Frankfurt am Main, p. 8. Available at: https://www.esma.europa.eu/sites/default/files/library/speech_ilf_conference_in_frankfurt_23_april_2018.pdf
[34] European Commission (2017). Impact Assessment. SWD(2017) 246 final, p. 58, italics in the original.

follow the home-country principle to a substantial degree. Although the latest proposal for EMIR 2.2 is a significant improvement over the current supervisory architecture, even a simplified governance mechanism under the umbrella of ESMA would not fully address issues of regulatory arbitrage among CCPs.

These incremental proposals have occurred despite the fact that major obstacles towards common European CCP supervision have been removed in recent years. ESMA has proven itself as a capable regulator in recent years, building up a track record of capabilities for supervision and expertise,[35] an expertise which is only to expand with the recent hiring of personnel. Furthermore, the decision of the European Court of Justice in 2014 to decide the legality of the short-selling ban in Europe has weakened the Meroni doctrine, which limits the ability to delegate powers from EU institutions to separated bodies, facilitating the transfer of supervisory powers to ESMA.[36] In line with these developments, the current proposal in the context of the ESA review envisions an empowerment of ESMA, which both in terms of its financing and its decision-taking is to become more independent from NCAs.[37] Furthermore, in the public consultation in summer 2017, a majority of stakeholders agreed with the need for common supervision.[38] The only problem remaining is the question of the fiscal liabilities which should be aligned with the level of supervision, making the creation of a single European resolution fund a necessity.[39]

V. Conclusion – Common rules need common supervision

So why not upgrading ESMA to a single European supervisor with direct supervisory power as it is the case for European banks? If regulatory and supervisory arbitrage is a problem with third countries, it can evidently also occur within the EU. This option would "address effectively the need for supervisory convergence"[40] and "substantially simplify the supervisory framework in comparison to the current

[35] Spendzharova, A. (2017). Becoming a Powerful Regulator: The European Securities and Markets Authorities (ESMA) in European Financial Sector Governance. TARN Working Paper Series 8/2017. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2965429

[36] Goldmann, M. (2017). Integrated European Financial Supervision. SAFE Policy Blog. Available at: http://safe-frankfurt.de/policy-blog/details/integrated-european-financial-supervision.html

[37] European Commission (2017). Proposal for a 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, p. 19. Available at: https://eur-lex.europa.eu/resource.html?uri=cellar:80b1cafa-50fe-11e7-a5ca-01aa75ed71a1.0001.02/DOC_1&format=PDF

[38] European Commission (2017). Impact Assessment. SWD(2017) 308 final, 20 September 2017, p. 117. Available at: https://ec.europa.eu/info/law/better-regulation/initiative/113085/attachment/090166e5b5346b59

[39] c.f. Maijoor, S. (2018). Resilience, Recovery and Resolution: three essential Rs for CCPs, ILF Conference "Resolution in Europe: The Unresolved Questions" – Monday 23 April 2018 – Goethe University, Frankfurt am Main.

[40] European Commission (2017). Impact Assessment. SWD(2017) 246 final, pp. 58-59.

supervisory arrangements"[41] as the European Commission in its impact assessment on EMIR 2.2 rightly states. The main reason against a European solution is the misalignment of supervision and fiscal responsibilities. Furthermore, it is argued that clearing houses do not work like banks as the latter are risk takers while CCPs only deal with risks, so why shall they be treated in the same manner?[42] But do those arguments really hold for large, pan-European CCPs in a competitive environment?

While CCPs primarily serve as dealers of risk, the strong competition among them has undoubtedly already led to an erosion of margin and collateral requirements, increasingly transforming them into takers of risk.[43] Furthermore, the waterfall principle − which shall prevent a CCP from bankruptcy − requires that its clearing members, mainly banks, have to bear the initial losses and would be also liable with the default fund while the CCP's shareholders would lose their skin-in-the-game. Those members, as well as the shareholders of a CCP are located across Europe and the world and, thus, globally distribute the initial losses before any tax money would be required. Hence, public authorities would only bear the residual losses while the safety net of CCPs automatically implies burden-sharing beyond national borders.[44] Therefore, a European resolution fund would only mirror an already existing reality. More importantly, such a European backstop would increase the confidence of market participants that the final backstop will indeed become effective which is particularly important for the case of a new turmoil in financial markets as it reduces the incentive for members to stop trading and clearing through this CCP. In addition, this solution would also remove the main obstacles against a direct supervision of ESMA as it would institutionalize a European mechanism for the distribution of losses, aligning fiscal and supervisory responsibilities. In this way, regulatory arbitrage would be prevented and CCPs indeed become a pillar of stability and serve as a resilient market infrastructure when they are most needed.

The current industry infrastructure could help bringing about such a solution. By including only large CCPs, such a European modus of supervision would only include CCPs in two countries, namely France (LCH Clearnet SA) and Germany (Eurex Clearing). In the context of the current French-German initiative for greater European integration, taking this step might be a meaningful impulse for further financial market integration, which protects the integrity and stability of financial markets through the common supervision of common rules. If not, regulatory competition through lax supervision might endanger financial stability. If supervisory arbitrage is a concern, as the EU asserts in the context of Brexit, it is also a concern within Europe. Hence, further market integration should go hand in hand with common

[41] ibid., p. 59.
[42] e.g. recently stressed by B. Cœuré, executive board member of the ECB, at the panel discussion at the ILF Conference, Frankfurt at 24 April 2018.
[43] In a similar fashion stated by S. Maijoor at the panel discussion at the ILF Conference, Frankfurt at 24 April 2018.
[44] Maijoor, S. (2018). Resilience, Recovery and Resolution: three essential Rs for CCPs, ILF Conference "Resolution in Europe: The Unresolved Questions" – Monday 23 April 2018 – Goethe University, Frankfurt am Main, pp. 7-8.

rules *and* common supervision. This policy letter thus encourages the decision takers in the EU to be coherent and consequent in their decision making, transforming CMU rhetoric into policy action.